Communiqué

Credit market opportunities

June 2009

Legal & General Investment Management

LGIM's active fixed interest funds delivered an award winning performance in 2008/09. Below we explain the current investment opportunity available in credit markets, and how this opportunity extends beyond the sterling market into the much larger US dollar and euro markets.

Professional Pensions
UK Pensions AWARDS2009
WINNER
Fixed Interest Manager

Judges comments:

"LGIM continues to lead the way in fixed income"

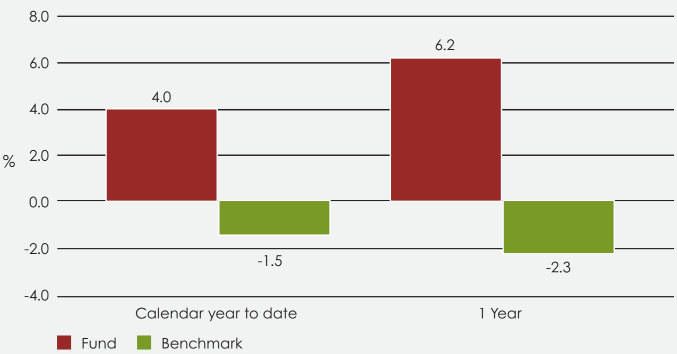
"Despite market conditions, LGIM's funds have continued to turn in a great performance"

The tide has turned

2008 was the year for government bonds as investors sought out capital preservation while the credit crisis played out and the global economy went into decline. After being shunned last year, there has been a renewed interest in corporate bonds in 2009 as investors have been attracted by their historically high yields in an environment of ultra-low gilt yields. The recent performance from credit markets may indicate that the worst is now truly behind us. Lehman Brothers and the reckless lending of Icelandic banks is yesterday's news, and as signs of economic recovery seem to emerge, it is possible that the greatest fixed income returns this year will be found in corporate bond markets.

This new optimistic view of the world is not completely unfounded. While the prospect of further defaults overhang the market and cyclical sectors remain particularly vulnerable to ratings downgrades amidst the current economic decline, most US banks have recently demonstrated that they no longer require government capital injections. Closer to home, UK banks seem to be in a much stronger position than at the beginning of the year. On the corporate side, recent profit results showed most companies exceeding analysts' (admittedly downbeat) expectations. Finally, while the economic environment remains weak, very recent economic data regarding manufacturing confidence, retail sales, industrial production and even home sales are all pointing towards a rosier outcome.

Core Plus Performance to 31 May 2009



Source: All figures are supplied on a mid to mid basis by LGIM and are before the deduction of fees

Core Plus

LGIM's Core Plus Fund invests in sterling, euro and US dollar denominated fixed and floating rate securities and related derivatives.

Growing risk appetite

As optimism has emerged, so too has an increase in investor risk appetite, and this has been the major driving force behind the recent strong performance from credit markets. The average spread – the yield premium required over government bonds - has decreased (principally due to the rise in gilt yields) from 5.6% at the beginning of this year to 4.6% at the end of May.

Last year, Trustees may well have been advised to scale back their exposure to credit markets as the financial crisis spread and the global economy fell into decline. However, as tentative signs emerge that the policy measures undertaken to stem the crisis and support economic growth may be taking hold, there is a risk that the 'flight to safety' has now become overdone. We believe credit markets are still pricing in an unreasonably gloomy picture of the world. At the beginning of the year, corporate bond markets were priced at levels which implied a major world depression, with the yield on investment grade bonds more than compensating an investor for a level of defaults previously unseen.

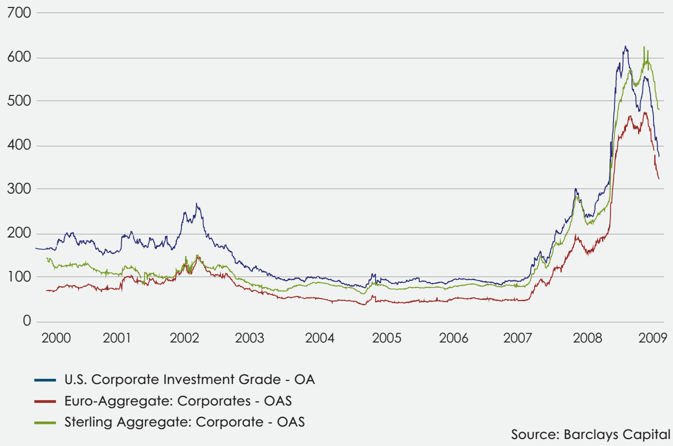
Also, while investors sought the safety of government bonds last year, this asset class has more recently become vulnerable. While government bond yields have risen steeply recently, they remain at low levels, and as the state of public finances deteriorates the level of issuance is likely to increase, putting pressure on government bond prices.

So do I take the plunge?

We firmly believe that credit markets as a whole still offer a tremendous medium to long-term opportunity as credit spreads remain at levels which more than compensate investors for the level of defaults which they imply. However, in the past two months the credit spread premium for investment grade bonds over government bonds has reduced by around 1%. Such a rapid improvement (shown in the chart below) raises concern that the market has reacted too quickly, being driven by speculation rather than fundamentals. Also, with the prospect of credit defaults and the potential for downgrades overhanging the market, a cautious approach is certainly required.

With a market which remains volatile and fragile, we believe the opportunities in credit markets can be best extracted through detailed fundamental research at the stock and sector level.

Credit Spreads (as at 31 May 2009)



Source: Barclays Capital

Greater opportunities

The volatile market environment creates significant opportunities for a large and experienced active manager. Through the use of detailed economic and financial market analysis it should be possible to predict how different sectors of the corporate bond market will perform. Based on this analysis, the fund manager can decide upon the sectors that would be best adapted for a given economic environment. This analysis would then lead to formulating their largest allocations to certain sectors and specific bonds. They can also create underweight positions (less than the index) to the sectors of the market which they believe are vulnerable given the current economic climate (for example avoiding cyclical holdings during periods of economic weakness and focusing on the more stable utility sector).

Focus on the overseas credit markets could help produce superior long term returns. For investors willing to allocate a portion of their assets globally (while hedging the currency back to sterling), the US dollar and euro credit markets hold a far wider selection of securities and sectors than the sterling credit market. This allows the fund manager greater flexibility to implement an investment strategy, with a far wider choice of securities, and greater geographical and sectoral diversification.

Under a truly active approach, the best returns and diversification benefits should come from a manager having the ability to allocate based on their assessment of the relative value of each of the available markets. In order to receive the best returns available from credit markets. Trustees need a provider that has demonstrable expertise in and outside the sterling market. A good indication of a strong credit capability can lie in scale, size of resources and quality of analyst coverage and typically a demonstrable track record in delivering results (particularly when times are tough).

The right time?

The tide has changed and the financial market outlook is certainly more positive. Although the market environment remains fragile, and we could witness some setbacks, the current window of opportunity will not remain open indefinitely. As risk appetite increases, current yield spreads should compress significantly, reducing the significant investment opportunity currently available in credit markets.

Accessing the opportunities

LGIM's Core Plus Fund is designed to take full advantage of the larger and more liquid US dollar and euro markets. Fund performance since inception has been significantly better than the iBoxx Sterling Non-Gilt All Stocks Index as a result of defensive sector positioning complemented by successful tactical credit trading and interest rate management.

LGIM was recently awarded Fixed Interest Manager of the Year by Professional Pensions magazine. This award is testament to the stellar results delivered across the range of LGIM active fixed income funds. This regular outperformance has been delivered as a result of the robust structure that has been put in place and the significant enhancements that have been made in recent years.

LGIM Corporate Bond Performance (%) as at 31 May 2009

	Calendar year to date	1 Year		
Core Plus (inception 01.05.08)	4.0	6.2		
Benchmark (iBoxx iBoxx £ Non-Gilt All Stocks Index)	-1.5	-2.3		
relative	*5.5*	*8.5*		
	Calendar year to date	**1 Year**	**3 Years (p.a.)**	**5 Years (p.a.)**
Active Corporate Bond - All Stocks - Fund	0.7	2.9	1.5	4.1
Benchmark (iBoxx iBoxx £ Non-Gilt All Stocks Index)	-1.5	-2.3	-0.7	2.7
relative	*2.2*	*5.2*	*2.2*	*1.4*
	Calendar year to date	**1 Year**	**3 Years (p.a.)**	**5 Years (p.a.)**
Active Corporate Bond - Over 10 year - Fund	-1.2	-0.8	-1.2	2.9
Benchmark (iBoxx £ Non-Gilt 10 Year + Index)	-2.6	-4.4	-2.8	1.9
relative	*1.4*	*3.6*	*1.6*	*1.0*

For more information on LGIM's active fixed interest funds, please contact Malcolm White on 0203 124 3213 or your Client Account Manager.