

Communiqué

Broaden your horizons

September 2009

After reaching extraordinary depths, credit markets have recorded stellar gains during the past six months. As credit spreads have narrowed, though, investors may be wondering whether they have now missed the boat. In the following article LGIM's Head of Institutional Fixed Income Sales, Malcolm White, explains why we believe this asset class still offers very interesting investment opportunities, which can be enhanced through a global approach.

We began 2009 with dire credit market conditions reflecting an extremely negative environment and poor investor sentiment. It was our belief then that credit spreads on investment grade corporate bonds offered long term investors an exceptional investment opportunity. This assessment of the market proved to be correct as witnessed by subsequent market flows.

Institutional and retail investors have poured money back into credit markets, attracted by historically high yields in an environment of ultra-low deposit rates. Risk appetite increased as they moved away from the low yielding sovereign and gilt markets. As a result, credit spreads have narrowed significantly and some investors are unsure whether the potential remains for further gains. We certainly believe this to be the case.

The opportunity remains

Firstly, while they have come down substantially from the peak of the banking crisis, investment grade credit spreads (the difference in yield between investment grade corporate bonds and similar maturity government bonds) are wide in absolute terms. An historical perspective suggests that spreads currently

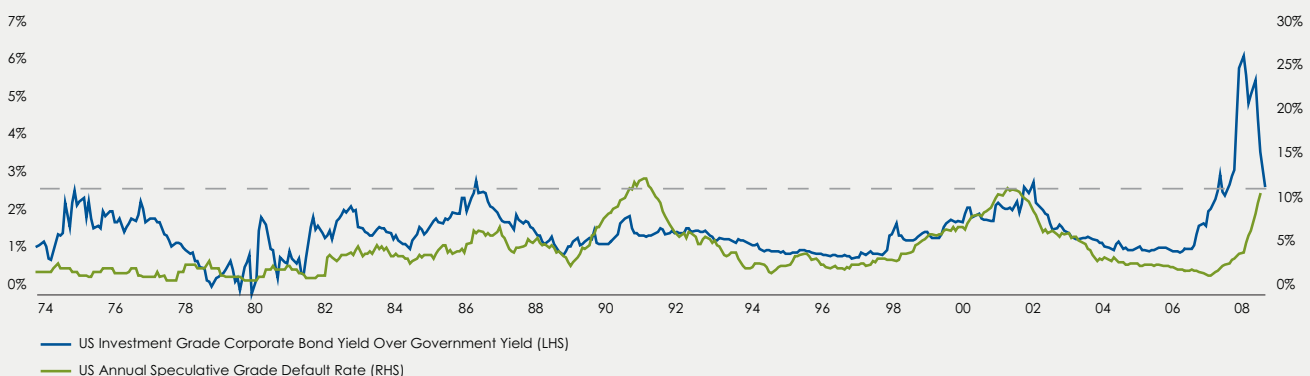
remain at the attractive levels seen back in the depths of 2002. While the risk of further defaults remain, we believe current yields on investment grade bonds as a whole more than compensate investors for the potential of further defaults.

In essence, while credit spreads were pricing in a 1929-type of Great Depression at the start of this year, they are still pricing in a recessionary environment today. With recent signs of improving economic data now emerging, suggesting the worst of the cyclical downturn is now behind us, we believe that the investment grade corporate bond market still offers some exciting opportunities for long-term investors.

Making the most of the opportunity

In order to maximise these potential investment gains, however, investors require access to all the available opportunities. The sterling corporate bond market is roughly one-quarter the size of the euro market and one-fifth the size of the US dollar corporate bond market. With a smaller corporate universe, the sterling market has fewer market participants which can make trading in this market less liquid than the dollar and euro

Compensation for potential default



Source: BarCap, Moody's, LGIM

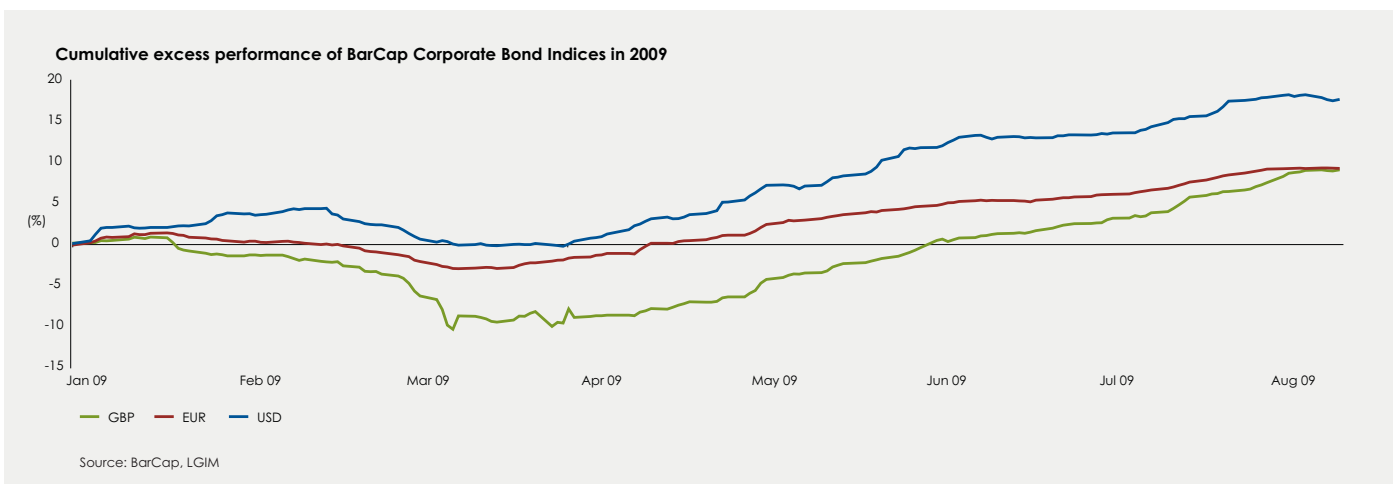
market. Therefore by embracing the wider selection of opportunities, bond managers are afforded greater ability to diversify their portfolio, trade more efficiently and potentially achieve better risk adjusted returns. The significance of each of these benefits becomes clearer once we delve deeper into the breakdown of each of these markets.

In terms of industry sectors, the sterling market is less diverse. It is dominated by debt issued by financial and utility companies. Relative to euro and dollar markets, the sterling credit market is also biased towards longer dated issues (10+ years). While this appears attractive on the surface to some pension plans with long-dated liabilities, it also means that there are fewer choices of short-dated issues, potentially making liquidity constraints an issue and reducing the amount of investment opportunities. By also being able to invest in euro credit for example, investors receive a much greater choice of short-end issues and significantly greater liquidity which can be particularly useful for a fund manager to position

others), the euro and dollar markets offer the ability for increased diversification across issuers. As mentioned above, the sterling market is heavily biased towards financials. Industrials, consumers and telecommunications issues form a small proportion of the sterling market (particularly relative to the dollar market). This concentration risk was particularly detrimental during the recent banking crisis where the large exposure to UK financials together with the lack of name diversification led sterling to underperform euro and dollar corporate bonds during the first half of the year. For example, in December 2008, 14% of the sterling index was taken up by just five names - Barclays, Lloyds, RBS, HSBC and HBOS.

A better deal

There can also be significant valuation differences across markets, which present opportunities from time to time. It is frequently possible for a fund manager to buy the same issuer, with similar duration, in either the dollar or euro markets much cheaper than in the sterling market. It is this ability to source preferred names in the cheapest market,



their portfolio defensively when market conditions become difficult. In the dollar marketplace there are many more investment opportunities in the 'belly' of the maturity curve (bonds with maturities of around 3-10 years), further filling up gaps in the sterling market.

By ratings breakdown there are also clear benefits in having all three markets to choose from. While all three are dominated by A rated securities, the proportion of BBB credit is higher in dollar credit (32%) than sterling (23%). Also, should higher quality corporate debt be needed, the euro market has a higher proportion of AAA and AA rated securities to choose from.

The sterling market contains roughly 700 issues, the euro market roughly 1200 and the dollar approximately 2000. With a larger proportion of unique names (names that have only issued in that particular currency, and not the

and to switch between markets to exploit anomalies, which enable the astute manager to pick up extra return. Such opportunities have been particularly pronounced, in recent months, in the new issue market.

In summary

Euro and dollar markets complement the sterling credit market. They offer greater diversification across maturity profiles, ratings breakdown and sector selection. There are a significant number of unique issuers in these markets which reduces concentration risk and provides increased investment opportunities for a skilled investment manager. Furthermore, with attractive relative value dynamics, more new issuance, greater liquidity and a wider opportunity set, there is significant scope for higher risk adjusted returns.