Avon Pension Fund

Bond portfolio

Contents

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1 Gilts to corporate bonds switch

1.1 Introduction

As part of the recent investment strategy review, it was agreed to increase the benchmark allocation to corporate bonds and reduce the allocation to fixed government bonds. The agreed change was as follows, with the current allocation also shown:

	Original benchmark allocation	New benchmark allocation	Change in strategic allocation	Current allocation (31 March 2013)	Change required in actual allocation
UK Gilts	6%	3%	-3%	3.5%	-0.5%
Index Linked UK Gilts	6%	6%	-	6.7%	-0.7%
UK Corporate Bonds	5%	8%	+3%	6.2%	+1.8%

Data Source: Avon Pension Fund.

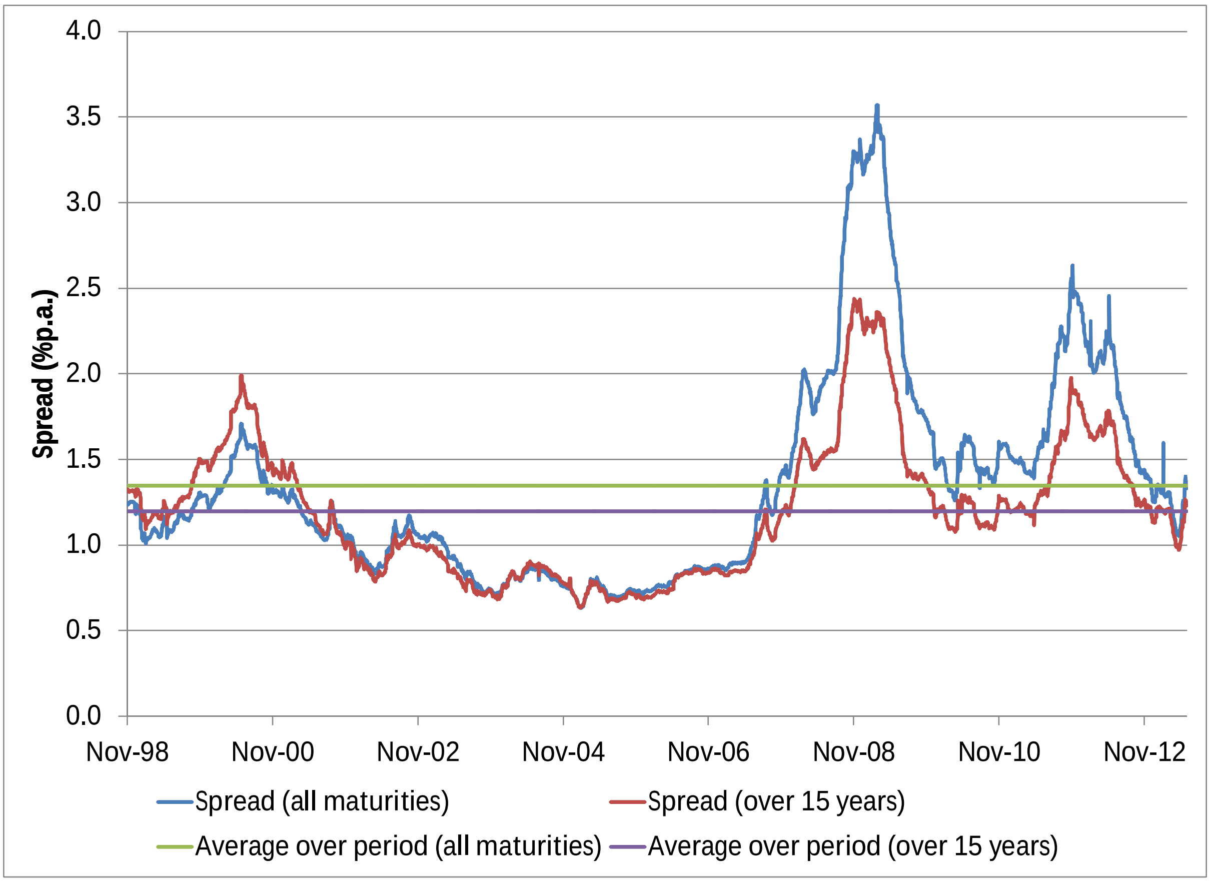
The Fund is currently already underweight to government bonds and overweight to corporate bonds compared to the original benchmark allocation and therefore the movement required to achieve the new benchmark allocation is relatively small. However, it can be seen that addressing the overweight position to index-linked gilts will also be required to bring the allocation to corporate bonds closer to its target. The remainder of this short paper discusses the timing of these moves.

1.2 Current credit spreads

The following table shows the current difference in yield (spread) between investment grade corporate bonds and UK government bonds (non-inflation linked) and the average of this spread since the end of November 1998. It is shown using indices representing bonds of all maturities and also for bonds of maturity 15 years and above. The Fund's corporate bonds and government bonds are managed against all maturities indices. The chart on the next page shows how these spreads have moved over the entire period.

	All maturities	Over 15 years
Current spread (2 July 2013) (p.a.)	1.33%	1.23%
Average spread since 1998 (p.a.)	1.35%	1.20%
Average spread since 2008 (p.a.)	1.91%	1.49%
Lowest spread (p.a.)	0.63% (01/03/2005)	0.63% (24/02/2005)
Highest spread (p.a.)	3.57% (30/03/2009)	2.44% (03/12/2008)

Data Source: Thomson Reuters.



Data Source: Thomson Reuters.

The chart shows that the current spread of corporate bonds over gilts, both all maturities and also when just considering bonds of maturity greater than 15 years, are broadly in line with their averages over the period since 1998. However, those averages include the impact of the extraordinary increase in spreads that were witnessed during the financial crisis of 2008 and 2009, and then again to a lesser extent during 2011 and 2012 during the Euro sovereign debt crisis. The chart shows that there has been an increase in spreads in 2013 to date, albeit a fairly limited increase compared to the previous two periods discussed.

1.3 Current and long term view

It is the view of the JLT Market Forecast Group ("MFG") that, over the longer term, corporate bond yields will be approximately 1% p.a. greater than government bond yields. As such, we believe the scope for further spread tightening is limited compared to the fall in spreads seen over the past 18 months or so.

However, whilst we believe that the spread may continue to be volatile within a range, as seen this year, we do not expect the spreads to increase to the levels seen in 2008/09 and 2011/12. This is because investment grade companies have, in general, improved balance sheets and their resilience to further credit and liquidity crunches as seen in 2008/09. By contrast, whilst UK government bonds have been seen as a safe haven, there are longer term structural issues (a large debt to GDP ratio and sluggish growth) that may put the UK government's ability to borrow under more scrutiny.

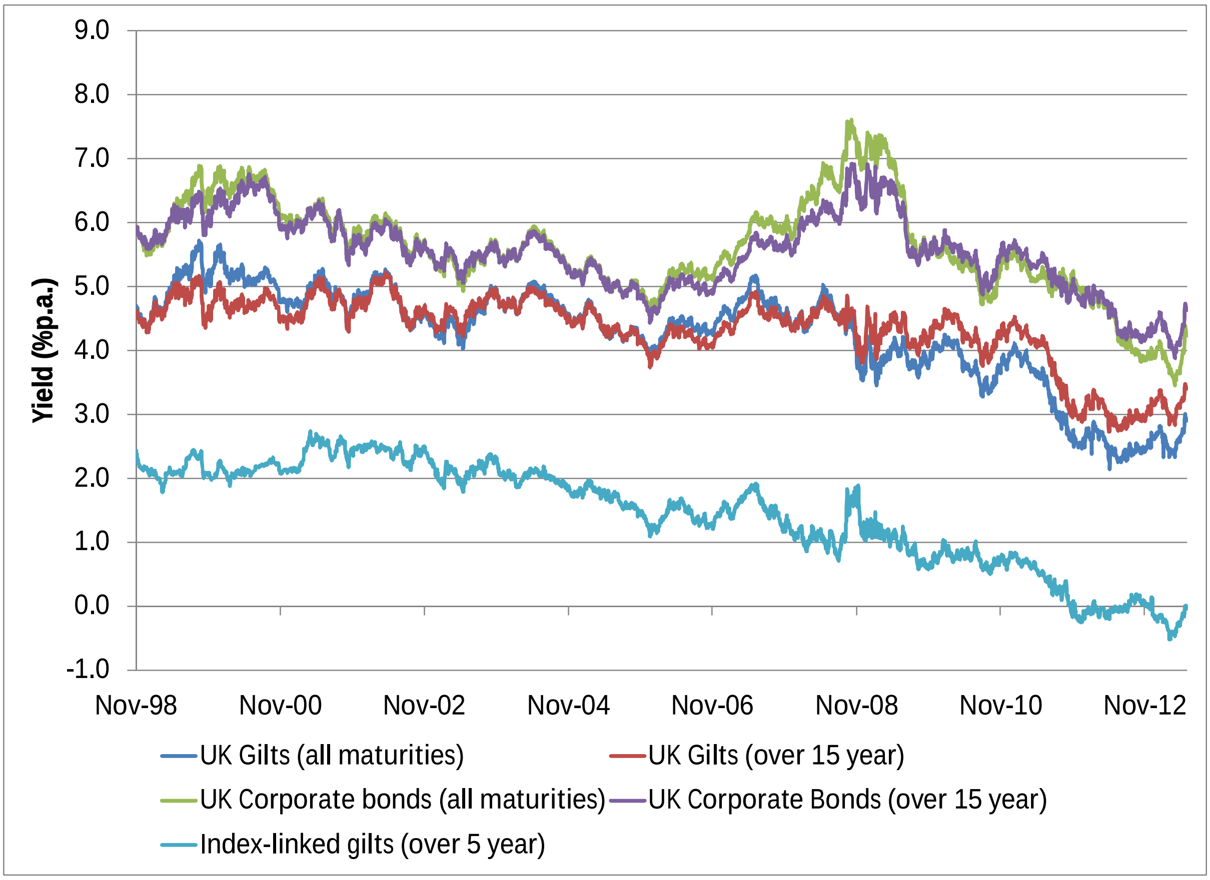
As such, we believe the switch from UK government bonds to corporate bonds should occur immediately rather than be based on a trigger mechanism, although the switch should occur over two to three tranches to diversify the risk of trading on a particularly inopportune day, particularly given the current volatility in markets.

1.4 Absolute yield levels

The following table shows the absolute level (i.e. not relative to each other) of the corporate bond and government bond indices used in the previous section, and additionally the real yield for index-linked government bonds. The chart shows how these yields have moved over time.

	UK Gilts (All mats)	UK Gilts (Over 15 yr)	UK Corporates (All mats)	UK Corporates (Over 15 yr)	UK Index Linked Gilts (Over 5 yr)
Current yield (2 Jul 2013) (% p.a.)	2.90%	3.40%	4.23%	4.63%	-0.03%
Average yield since 1998 (% p.a.)	4.27%	4.33%	5.61%	5.53%	1.45%
Average yield since 2008 (p.a.)	3.52%	3.90%	5.43%	5.39%	0.58%
Lowest yield (p.a.)	2.14% (06/06/2012)	2.73% (01/06/2012)	3.45% (02/05/2013)	3.88% (02/05/2013)	-0.53% (09/04/2013)
Highest yield (p.a.)	5.72% (14/10/1999)	5.23% (17/05/2002)	7.61% (04/11/2008)	6.92% (04/11/2008)	2.74% (30/04/2001)

Data Source: Thomson Reuters.



Data Source: Thomson Reuters.

Current absolute yields for government, index-linked government and corporate bonds are significantly below their averages over the period. It is expected that yields will rise over the longer term and this is priced into the current shape of the yield curve. This limits to some extent the return on government bonds and corporate bonds.

1.5 Conclusion

The spread of corporate bonds yields relative to government bond yields is slightly above the JLT MFG's long term view. Given the relative outlook for corporate bonds relative to gilts, the implementation of switching gilts to corporate bonds should occur immediately and not be based on any trigger mechanism, although the switch should potentially occur over two or three dealing dates to help diversify the impact of trading on a particularly inopportune day, although it may be advantageous to trade on a single day if there is an opportunity to mitigate dealing costs.

The outlook for bonds in general though is for yields to rise – this along with the low level of both corporate bond and government bond yields limits the return on these investments going forward.

Our outlook for index-linked government bonds is more favourable than conventional government bonds due to the effect of excess demand over supply. However, the JLT MFG has a more positive outlook for corporate bonds than index-linked government bonds as it expects real yields to move back into positive territory, which would limit the return on index-linked gilts. It would therefore be sensible to once again enact this change as soon as possible, although again splitting the transaction across two or three dealing dates for the same reason mentioned above.

It is of course possible that yields will fall further and in this respect the investments provide, albeit limited, protection from the impact of yields on the valuation of the Fund's liabilities.

Given our outlook and taking into account the hedging characteristics of the Fund's bond portfolio, it is our view that this switch should not be used to implement any tactical positions relative to the benchmark.

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