

Take Note

STERLING BOND FUND (RIC) – MANAGER AND BENCHMARK CHANGE

At the end of June 2006, we improved the manager line-up in the RIC Sterling Bond Fund by moving from a two-manager to a three-manager structure. We replaced Merrill Lynch Investment Managers with Fidelity Investments and Aberdeen Asset Management (both at a weight of 30%). In addition, Western Asset Management's weight was reduced from 50% to 40%. At this time, we also changed the benchmark of the Fund, moving to the Merrill Lynch Sterling Broad Market Index from the FTSE UK Gilts All Stocks Index.

Reasons for the changes

The new, broader index provides a better representation of the investable universe and affords us the opportunity to access a broader range of investment opportunities, particularly in the corporate bond market. The latter improves the alpha (active outperformance) proposition of the Fund.

Also, within this broader investment universe it is possible to find more diverse investment processes that offer us a wider choice of managers to choose from. This gives us scope to boost manager and process diversification within the Fund. As a result we have expanded the manager line-up in the Fund and brought in two new managers who have particularly strong credit capabilities.

The addition of the new managers improves the process diversification within the Fund. Western has a long-term value driven approach with strong skills in both UK and overseas markets. The firm concentrates on interest rate management and sector rotation. Fidelity has a greater focus on corporate issue selection, leveraging the firm's impressive credit research skills. Fidelity also emphasises yield curve management, which is based on the output of its quantitative models. Aberdeen has a broad range of skills and uses its relative value approach to identify opportunities in government and credit markets. The firm has particular skill in issue selection in the UK credit market and in managing interest rate risk in the UK.

More detail on the benchmark change can be found in the March 2006 Take Note, "Sterling Bond Fund (RIC) – Benchmark Change".

Introducing Aberdeen Asset Management

Aberdeen's strength lies in the depth and calibre of its UK fixed income investment team and its ability to cover a broad spectrum of fixed income markets and strategies. The key investors were previously at Deutsche Asset Management (DeAM) but in late 2005, Aberdeen purchased DeAM's London-based business and its Philadelphia-based US investment grade fixed income business.

The strong leadership of Nik Hart and the firm's strong credit skills are key to our overall positive view. Nik is an insightful investor who brings a great deal of skill to the management of UK portfolios.

Aberdeen has a strong relative value focus, which is supported by detailed credit research. Interest rate management is also a key source of added value and is supported by a strong investment process which incorporates a broad range of economic, political and technical inputs.

Introducing Fidelity Investments

Fidelity is very strong in non-government debt strategies and brings additional issue selection and significant sector rotation skills to the Fund. The firm also seeks excess returns from asset allocation (e.g. into index-linked gilts and foreign bonds on a currency-hedged basis) and yield curve management.

Our positive view is driven by strong leadership and Fidelity's non-government team. Alex Veys, who has final discretion over all UK portfolios, is the lead UK portfolio manager and heads the UK institutional fixed income team. Alex is a knowledgeable, pragmatic and skilful investor. Fidelity's non-government team distinguishes the firm from its peers through the deep resource of 13 credit analysts and their significant experience in this field.

Aside from credit, Fidelity also seeks to add value through yield curve strategies but historically downplays the importance of duration as a source of excess returns. Fidelity also has skills in high yield and emerging debt and should be well placed to make tactical allocations.

What is the expected impact on Fund characteristics?

The Fund's outperformance and risk targets will not change.

The greater process diversification of a three manager structure and the greater diversification through additional investment opportunities offered through changing the benchmark will reduce the tracking error (active manager dispersion) slightly.

The new fund structure will see a greater focus on sector rotation and issue selection and there is likely to be greater non-government exposure. There will be reduced emphasis on top-down macro strategies such as duration management.

Changes to manager weights

Manager	Previous Fund Weight (%)	New Fund Weight (%)
MLIM	50%	
Western	50%	40%
Fidelity		30%
Aberdeen		30%