

Take Note

STERLING BOND FUND (FRIC) – BENCHMARK CHANGE



We are improving the benchmark of the FRIC Sterling Bond Fund by changing it to the Merrill Lynch Sterling Broad Market Index from the FTSE UK Gilts All Stocks Index on 30 June 2006.

Reasons for the change

The main benefits of the benchmark change are the **improved representation** of the investable opportunity set of the UK bond market, the **improved alpha** (active outperformance) proposition of the fund through wider investment opportunities and the **wider choice of managers** available.

The new index covers a much broader spectrum of issues and issuers, i.e. is a better representation of the investable opportunity set. The new index covers 967 bond issues with market value of £657 bn, of which just over 50% represents corporate, quasi governments and securitised bonds. This compares to the FTSE index which just includes 29 issues, all government bonds, representing a market value of half the Merrill index.

Managers in the Fund currently have the freedom to invest in non-government bonds, but in practice the choice of a gilt only benchmark influences the types of credit strategies our managers can implement. For example, although managers can hold exposures to corporate bonds, the managers cannot underweight these holdings relative to the benchmark. Similarly, the different relative risks of UK government and corporate bonds means that our managers invest mainly in liquid high grade issuers so we don't capture the full strength and diversity of their credit processes. The benchmark change enables our managers to utilise a more comprehensive and diverse set of active manager strategies, increasing the Fund's potential to outperform.

A number of highly ranked managers operate primarily in the broad bond market and so would become available to hire for our fund. Longer term, the fund is likely to benefit from the inclusion of new managers, who are experts at running aggregate, both government and non-government issue, assignments. These managers will have the added ability to take over and underweight positions in sectors, individual issuers and corporate bonds as an asset class.

Differences between the new and old benchmarks

The table below shows the characteristics of the new and old benchmarks. In addition to the wider representation of the new index, the Merrill index has a higher "yield to maturity", or expected return, due to the higher expected return from non-government bonds. This means that the expected return from the asset class (separate to active manager performance) should increase slightly.

Summary Table (as at 31 Jan 2006):

Fund Benchmark	NEW <i>Merrill Lynch Sterling Broad Market Index</i>	OLD <i>FTSE Actuaries UK Gilts All Stocks Index</i>
Bloomberg Ticker	UK00 Index	FTRFBGA Index
No of bond issues	967	29
Market value	£657 bn	£336 bn
Yield to maturity	4.4%	4.0%
Duration	8.3 yrs	8.5 yrs
Sovereign issues	47%	100%
Corporate issues	32%	n/a
Other*	21%	n/a
AAA rated	68%	100%
AA/A/BBB rated	32%	n/a

* Quasi and foreign government and securitised debt.

Source: Merrill Lynch and FTSE International.

Will the Fund's investment objectives change?

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

The change will support the Fund's ability to add value above the benchmark. Although the volatility of the benchmark is slightly higher, the tracking error (active manager dispersion around the benchmark) of the Fund will be slightly lower, given the benefits of the additional diversification, but will not change materially.

Will there be a cost due to the change?

In the short term, we expect some turnover in manager portfolios soon after the change. Our portfolio trading group will help ensure that costs are minimised and we firmly believe that the long term benefits of a more diversified fund structure will far outweigh the relatively small initial cost.

In the long term, there may be manager changes to enhance our ability to take advantage of the different skill sets of managers in the non-government bond space.