INVESTMENT NEWS

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

GAD

3 October 2011

MARKET & ECONOMIC REVIEW

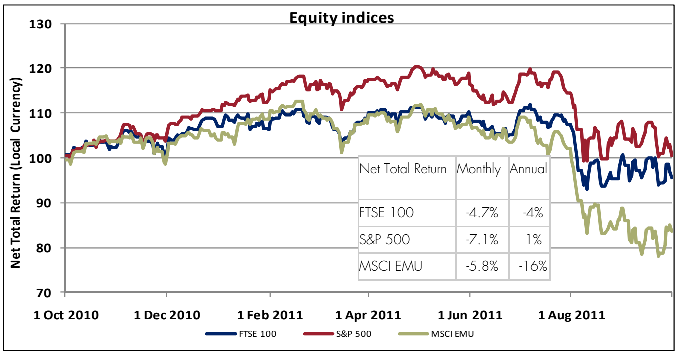
Overview

Following the large losses in August, equity markets remained volatile and largely unresponsive to the stimulus and support packages announced throughout the month. In the US, the Federal Reserve announced 'Operation Twist' which will see the Fed swap bonds maturing in the next few years for longer dated Treasuries in an attempt to put downward pressure on long term rates and make broader financial conditions more accommodative. Such a policy move was last seen in the early 1960s. In the UK, the Bank of England MPC minutes signalled the increased chance of a second round of quantitative easing.

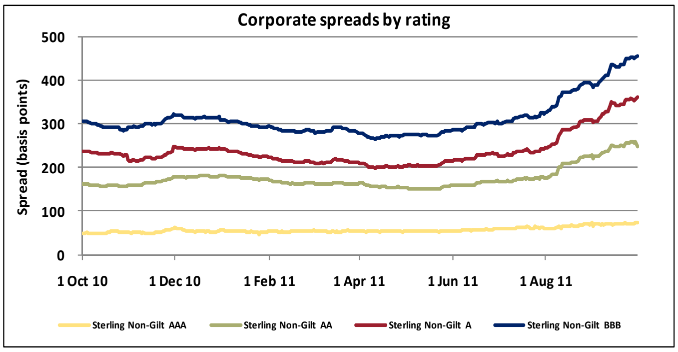
In Europe, German MPs voted to approve a more powerful fund to bail-out troubled Eurozone economies. The vote had looked like a potential stumbling block for Chancellor, Angela Merkel, but in the end was passed quite comfortably.

The European Commission proposed the introduction of a 'Tobin' tax of 0.1% on all financial transactions in EU member countries. The tax would be expected to raise around €57bn a year, coming into effect in 2014. Since London would be the hardest hit by the tax, the UK was expected to oppose such a move.

Equity markets were volatile this month



Credit spreads increased this month

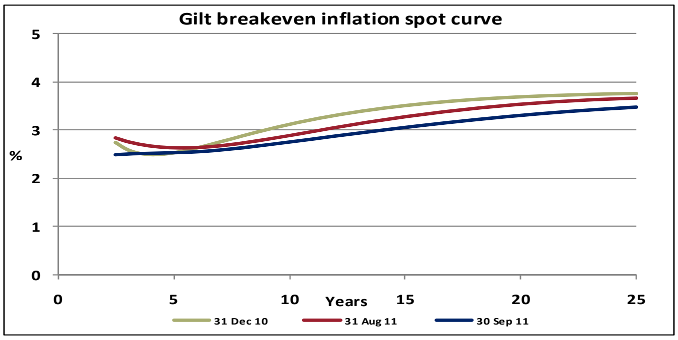


LATEST ECONOMIC NUMBERS

Current Base Rate	0.5%
CPI increase August (%y/y)	4.5%
Halifax house prices August (%m/m)	-2.6%
IPD TR property index August (%m/m)	0.6%
UK total trade balance July	-£4.5bn
VIX (volatility) index	43.0
$/£ exchange rate	1.56

Numbers as at the end of month unless stated

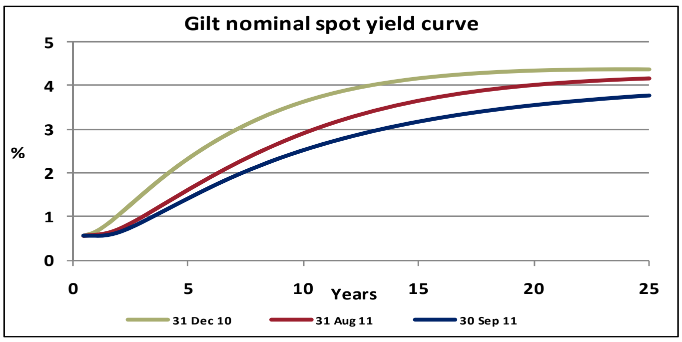
Breakeven inflation fell across the curve



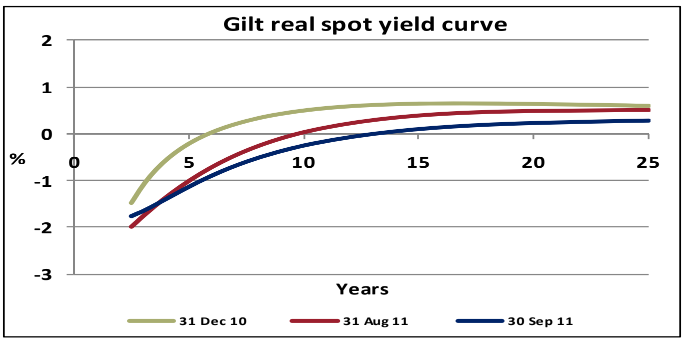
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	6th Oct
Producer Price Index	7th Oct
UK Trade	11th Oct
RPI / CPI	18th Oct
Minutes of MPC meeting	19th Oct
GDP preliminary estimate (Q3)	25th Oct

Nominal yields decreased this month



Real yields fell during the month



All chart data sourced to Bank of England, Merrill Lynch, Financial Times, MSCI & Standard and Poor.

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Infrastructure

With persistent volatility in equity markets and low yields on bonds, pension schemes are increasingly looking towards the universe of 'alternative' asset classes in search of increased diversification and higher returns. At a recent seminar organised by the National Association of Pension Funds (NAPF), Mark Hoban, Financial Secretary to the Treasury, encouraged pension schemes to consider investment in infrastructure more closely.

What infrastructure is and how to get exposure

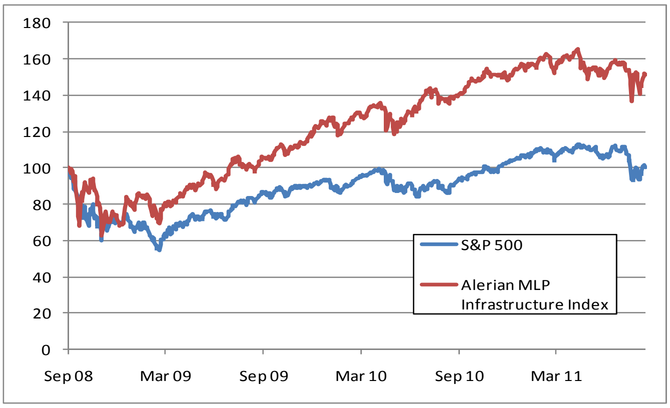
The definition of infrastructure investment is broad and tends to cover a wide range of capital projects . Generally speaking, infrastructure falls into two broad categories: economic infrastructure and social infrastructure. Economic infrastructure covers energy, utilities, transport and communications – so typically includes investments in toll roads, airports, energy distribution and cable networks. As its name suggests, social infrastructure covers investment in community facilities, services and networks such as schools, hospitals, prisons and even parks. One common feature of the different types of infrastructure is limited competition —most operate as natural monopolies or in highly regulated markets with tight controls over prices.

In post-war Europe, infrastructure tended to be controlled and owned by the state, however the trend of privatisation that started in the 1980s and continued with Private Finance Initiatives (PFI) in the late 1990s has seen a gradual increase in the level of private funding in infrastructure. Whilst early investments in infrastructure tended to be in the form of equity or bond investments in privatised utility companies, present day investments tend to be through infrastructure vehicles that have similar characteristics to Private Equity funds. Direct investment tends to be less common, with only a handful of large Canadian and Dutch pension schemes investing and managing the projects directly.

The benefits of investing

There are a number of features of infrastructure that make it attractive to pension schemes. The main benefit is that the returns tend to show low correlation to the returns on other asset classes and so offer potential diversification. Second, as a result of the tight price controls, cashflows are relatively stable and inflation-linked. This, coupled with the fact that contracts tend to be agreed for long periods, means that the investments can offer a good match to the long term real liabilities faced by pension schemes.

Infrastructure index performance



Infrastructure indices such as the Macquarie index or Alerian index (shown) can help funds benchmark infrastructure investments, but the unique characteristics of the underlying investments may present challenges in monitoring performance.

Source: S&P/Alerian

Risks and uncertainties

Against these benefits, there are however a number of risks in making infrastructure investments and it's important for trustees and investment officers to be fully aware of these uncertainties before committing funds. Firstly, as indicated above, infrastructure covers a wide umbrella of investments and it is important that investors fully understand the operational and political risks associated with the underlying investments—an investment in a hospital is more likely to be exposed to political pressure than an investment in a toll road.

Related to this, it is important to recognise that there are different risks associated with the different stages of investment. Although cashflows can be stable once the infrastructure is built, there are usually larger risks involved in the construction stage when costs can spiral.

Secondly, there is no deep and liquid secondary market for selling investments in infrastructure funds, and as a result it can be difficult to transition out of infrastructure once commitments have been made. Thirdly, the asset class is still in its infancy, and as a result there is no clear definition of what the risk/return profile of the asset class looks like in comparison to other assets. As a result of this, schemes may also face challenges in setting appropriate benchmarks and assessing performance.

Lastly, infrastructure investments tend to be highly leveraged with large amounts of debt taken on. This not only increases the level of interest rate risk associated with the investment, but also reduces the certainty of cashflows on the equity piece which infrastructure funds tend to be invested in.

Even with these risks, there is little doubt that the level of interest in infrastructure has grown over recent years and the asset class may continue to gather speed as the western world continues to tighten public finances and the developing world continues to binge on capital investments.

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