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Press Release

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Budget highlights risks of gilts as liability hedging tools

As F&C's latest Liability Driven Investments (LDI) Survey shows more UK pension schemes turning to government bonds – or gilts - to hedge their liabilities, the firm warns trustees to be cautious about using gilts, especially when taking into account the huge scale of government borrowing announced in the Budget.

The current trend among pension funds to use gilts to hedge liabilities has been partially driven by the argument that gilt yields are higher than swap rates and therefore represent a 'free lunch' opportunity for investors.

Although F&C firmly believes that government bonds have an important role to play in pension schemes' portfolios, this varies from scheme to scheme. For example, a scheme with a surplus can move all assets into gilts to match liability movements with low credit risk. On the other hand, a large scheme with a deficit can allocate a proportion of its assets to gilts, hedge the rest of its liability risk with swaps and allocate other assets to return generating strategies like equities.

"The crucial facts are that most schemes have deficits and do not have enough assets to reduce liability-generated risks via gilts without selling out of all other asset classes," explained Alex Soulsby, derivatives

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fund manager at F&C. "Using swaps means that only a fraction of assets are dedicated to hedging and therefore the portfolio can continue to invest in return generating assets and in so doing seek to reduce the deficit over time. The big question is whether pension schemes should be investing in government bonds that have yields fractions of a percent above swap rates, rather than equities or corporate bonds that are at their lowest prices for a generation. The main argument to support why they should is that swaps are expensive but we disagree."

Since last autumn and the extreme market moves that followed the collapse of Lehman Brothers, longer term swap rates fell below government bond yields. Over the last few months the main focus of the industry has moved towards the cost of global bailouts and expected increase of government debt. On the whole, swap rates continue to trade below European government bond yields. In the UK, issuance of gilts during 2008/2009 and 2009/2010 will exceed all debt ever issued before that time. With this much additional supply it is unsurprising that yields must rise in order to attract buyers.

The LDI Survey is carried out on a quarterly basis by F&C's Asset Liability Management (ALM) team and is based on responses from those derivatives trading desks most closely involved in pensions liability hedging at major investment banks.

The latest survey shows the volume of liabilities hedged during the first quarter of 2009 represented around £8 billion or 1% of the UK defined benefit liabilities, on an FRS17 basis. The results show that the total risk traded using derivatives in the UK during the first quarter of the year was £20 million of interest rate risk and £15 million of inflation risk.

These figures represent a slight increase in both the volume of interest rate LDI and inflation LDI implemented, relative to the previous quarter (see tables). Inflation swap rates rose sharply in January, reversing the sharp falls in the last months of 2008, as buyers took advantage of the attractive levels at the start of the year. Subsequent movements have been more subdued, with investors adopting a more flexible approach to hedging to take advantage of opportunities as they arise. Also, radical central bank policies have continued to cause volatility in the markets, meaning pension funds have been much more tactical when approaching the market.

"With so little capital available and so much government issuance to come, we think it is more likely that the relationship between gilts and swaps continues to look like it does today than how it looked over the last 10 years. Gilts are useful but swaps provide the means for most schemes to hedge liability risks while accessing the return assets they need," Soulsby concluded.

Risk - Volume of UK Pension Fund Liability Hedging (£)

	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09
Interest Rates	24,545,000	22,925,000	22,725,000	19,200,000	20,100,000
Inflation	13,735,000	12,590,000	13,325,000	14,650,000	15,000,000

Liabilities Hedged (£) - F&C Estimate

	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09
Interest Rates	9,327,000,000	8,712,000,000	8,635,500,000	7,296,000,000	7,638,000,000
Inflation	6,868,000,000	6,295,000,000	6,662,500,000	7,325,000,000	7,500,000,000

To obtain a copy of the survey or further information on F&C's LDI solutions please contact F&C's communications team on +44 (0)20 7011 4600

- Ends -

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Notes to Editors

Liability Driven Investment at F&C

- F&C is among the leaders in offering flexible and robust LDI solutions designed to mimic a pension funds' sensitivity to interest rates and inflation.
- F&C's LDI pooled solution invest in interest rate and inflation derivatives to hedge the pension scheme's liability sensitivities and also in assets that are expected to give a return of 3 month GBP LIBOR over a 3 year investment horizon.

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- These pools have on average a leverage of 3 times, meaning a typical fully-funded pension fund can hedge 100% of its liability by only investing 33% of its assets into F&C's LDI pools, thereby allowing the scheme to allocate the majority of its assets into return generating investments.

F&C Investments

- F&C Asset Management (F&C) is a London Stock Exchange listed asset management group which traces its origins back to 1868 with the launch of Foreign & Colonial Investment Trust, the first ever publicly listed investment fund. Foreign & Colonial Investment Trust remains a client of F&C.
- F&C is an active fund manager with a multi-specialist investment model where individual teams have strong accountability for their products and processes. The group is also an active shareholder with a leading franchise in governance and sustainable investment.
- F&C now manages £92.7 billion (€101.1 billion) of assets* for a diverse range of institutional, insurance and retail clients across all major asset classes – equities, bonds, cash and property – as well as alternative and specialist product classes such as Socially Responsible Investment funds, hedge funds, private equity funds and Liability Driven Investments. F&C invests globally and has been a longstanding investor in emerging markets.
- F&C REIT Asset Management is the group's global property asset management business. It was formed in 2008 from the merger of F&C's property division and REIT Asset Management. F&C REIT operates from offices in London, Dublin, Istanbul, Munich, Mumbai and Stockholm.
- F&C manages assets principally from three investment centres: London, Amsterdam and Edinburgh. The group has a global office network spanning twelve countries: China (Hong Kong), France (Paris), Germany (Frankfurt & Munich), India (Mumbai), Ireland (Dublin), The Netherlands (Amsterdam), Portugal (Lisbon), Sweden (Stockholm), Switzerland (Geneva), Turkey (Istanbul), UK (London, Edinburgh, Dorking) and the United States (Boston).
- In March 2009 F&C signed a Memorandum of Agreement with Hua Xia Bank, one of China's twelve nationwide joint stock commercial banks, to establish a joint venture fund management company in China in which F&C will have a 19.5% interest.

* As at 31 March 2009.