Demystifying Investm

It is generally agreed that 2008 and early 2009 was a particularly difficult period in the financial markets.

Although stresses in the sub-prime mortgage market began to emerge in 2007 with the collapse of the US mortgage lender New Century, followed by the nationalisation of Northern Rock in early 2008, it was not until 15 September 2008 and the collapse of Lehman Brothers that major financial institutions worldwide experienced severe difficulties.

The root of the recent problems initially stemmed from sub-prime mortgage borrowers defaulting on their loans in increased numbers. As defaults rose, investments products based on mortgage loans that had been 'packaged up' and sold on began to fall in value heavily. As many financial institutions held these investments this in turn led to a credit crisis in the banking sector as banks stopped lending money to each other. This was due to lack of trust in who could repay these loans, but also an attempt to keep cash on their balance sheets to maintain their own solvency.

Due to this lack of trust amongst banks, lending to both businesses and consumers fell dramatically. Where credit was available it became much more expensive, and in many cases existing credit lines were frozen.

The result of this lack of lending in all areas of both the financial markets and the wider economy meant that many businesses became forced sellers of the assets that they held as they looked to raise capital to continue operating. This indiscriminate selling based on necessity rather than the fundamental value of the assets caused the value of all asset classes to fall together, despite their apparent lack of correlation in the past.

Throughout this period the Trust has focused heavily on the security of the assets under its management. This meant taking steps such as:

- Assessing the financial strength of our global custodian (whose duty it is to safeguard the Trust's assets) and all of our investment managers.
- Ensuring that portfolios were appropriately diversified and that there was no meaningful exposure to financial institutions that might have collapsed or financial instruments that might have resulted in serious loss. It is worth noting that the Trust had no exposure to either Icelandic banks or the Bernard Madoff fraud.
- Ensuring that individual managers were acting within the guidelines and restrictions set out in their mandate and that these guidelines and restrictions remained appropriate.

Despite these problems there are some early signs of recovery in the financial markets, although how much this has spread to the wider economy is still being debated. Over the three months to the end of June equity markets have rallied e.g. the FTSE All Share Index has returned 10.9%, and corporate bond markets have begun to look healthier as liquidity returns to the market and fears over the levels of default begin to abate. Indeed, over the same period corporate bonds have returned 6.4% as measured by the iBoxx Sterling Non-Government (All Stocks) Index.

In response to these events the Trust has also developed its risk management capabilities, as well as working on it's governance model to enable it to react more quickly to changing market conditions. We also believe that as markets continue to recover new opportunities will continue to present themselves which we aim to exploit, subject to prudent risk management and due diligence.

To help make sense of some of the investment jargon that has been used by the financial press to describe the recent crisis we have also put together a glossary of the more commonly used terms, along with their meanings.

ABSOLUTE RETURN

This is a type of strategy that aims to provide positive returns in all market conditions, even when stock markets fall. This differs from relative return i.e. returns that are tied to those from stock markets.

ALTERNATIVE INVESTMENTS

This is the general term used to describe any asset that is not a traditional asset such as equities ents

and bonds. Alternative investments are characterised by relative lack of liquidity (i.e. they are not easily bought or sold) and their more complex nature. They include hedge funds and private equity but the alternative investment most commonly used by pension schemes is property. They are used to diversify portfolios due to their low correlation with traditional assets.

BOND
This is a type of debt instrument involving a loan made by an investor to a bond issuer, such as a government or company. In exchange for the loan the issuer agrees to pay a pre-determined rate of interest (the coupon) and to repay the original loan (the principal) on specified dates.

CORRELATION
This is the measure of how the movement in one variable affects the movement of another variable i.e. their interdependence. This can be for two or more variables. In the case of an investment portfolio this could mean how the return from equities affects the return on property.

CREDIT CRUNCH
The term used to describe a shortage of loans (or credit) in the market and the tightening of the conditions for granting loans. In the case of the recent 'credit crunch' there have been two defining criteria:

1. The lack of willingness of banks to lend to each other.
2. The lack of willingness of banks to lend to their customers.

This has meant that credit has been difficult to come by for individuals and companies, causing difficulty for consumers to gain approval for mortgages and depriving businesses of the credit lines necessary for them to operate. The reduction in credit made available between banks and to customers has been the reason that governments and central banks have found it necessary to inject large amounts of cash into the banking sector and also reduce interest rates. Both these measures were designed to increase lending by the banks.

CREDIT DEFAULT SWAP
A credit default swap (CDS) is essentially an insurance policy against a bond defaulting on its payment. In return for a regular premium the 'insurer' agrees to pay the bond principal in full to the bondholder should the bond default in payment.

EQUITY
This basically refers to company shares. The ownership of equity in a company may give the holder entitlements such as voting rights and dividend payments.

FLIGHT TO QUALITY
This describes the actions of investors who sell out of holdings that they consider risky e.g. corporate bonds and company shares, into less risky assets such as government bonds and cash.

HEDGE FUND
A fund that seeks to generate absolute (i.e. positive) investment returns using a wide variety of investment instruments and strategies regardless of whether the markets are rising or falling.

LIBOR
This stands for London Inter Bank Offered Rate. This is the rate at which banks will lend to each other. During the 'credit crunch' LIBOR increased alarmingly as banks lost faith in each others' ability to repay loans.

PRIVATE EQUITY
Private equity is an asset class consisting of equity capital that is not publicly quoted on a stock exchange. Investment in private equity usually consists of direct investment into a private company, or a buy-out of a public company previously quoted on a stock exchange.

SHORT SELLING
The selling of a security that one does not own with the expectation of buying it back at a future date for a lower price. To facilitate this strategy the seller has to borrow the asset that is to be sold and return it once they have repurchased it. The short selling of 29 financial stocks was banned in the UK between September 2008 to January 2009, as regulators argued that whilst short selling was a legitimate practice in normal market conditions the extreme conditions had given rise to 'disorderly markets'.

SUB-PRIME LENDING
This involves lending to people with poor credit ratings or those who cannot prove their incomes. Due to the higher level of risk involved it also means that the rate of lending for sub-prime mortgages is higher than that of 'prime' lending. The increase in levels of defaults on sub-prime mortgages was one of the major factors behind the recent financial crisis.