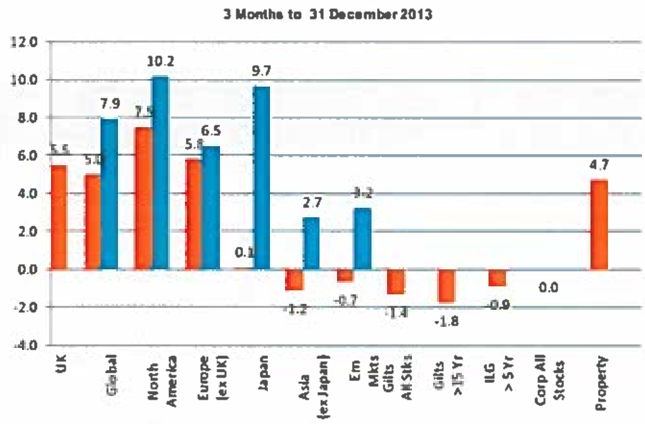
Market Background

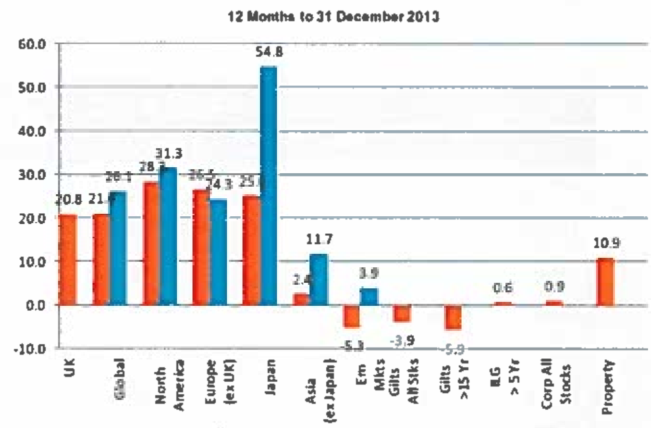
Introduction

This paper, addressed to the Officers and Advisers of the London Borough of Tower Hamlets Pension Fund ('the Fund'), discusses the market background over the fourth quarter of 2013 and subsequent events.

Market Background

The following charts show returns over periods to 31 December 2014:





Signs of the domestic and global economic recovery continued over the quarter, prompting the Bank of England to upgrade its economic forecast for the UK. Despite this, the Bank maintained that UK interest rates would remain unchanged in 2014. Meanwhile, further improvements in the US labour market led the Fed to announce it would begin tapering its quantitative easing programme from January 2014, although it reaffirmed a commitment to keep short-term interest rates low "well past" its 6.5% unemployment target.

Short-term interest rates in UK, US and Japan remained unchanged, while the ECB cut the Eurozone base rate from 0.5% to 0.25% as inflation fell below the Bank's 1% p.a. target.

Over the quarter, Sterling appreciated against the US Dollar, Euro and Yen. In Sterling terms, North America was the best region for equities (7.5%), followed by Europe ex-UK (5.8%) and the UK (5.5%). Returns on the Japanese market were buoyant at 9.7% over the quarter, but remained broadly flat in Sterling terms as the Yen continued to depreciate. The Emerging Market and Pacific ex-Japan regions lagged behind at -0.7% and -1.2% respectively.

Conventional and index-linked gilts struggled over the quarter as interest rates rose, returning -1.4% and -0.9% respectively. Corporate bonds benefited from narrowing spreads, with returns broadly flat.

Over 12 months, global equity markets have continued to deliver strong positive returns, with the exception of the Emerging Market regions which have lagged behind as fears over a reduction in capital investing led investors away. Rising interest rates over the last year have weighed heavily on bonds, with returns on conventional gilts pushed into negative territory and index-linked gilts and corporate bond markets struggling.

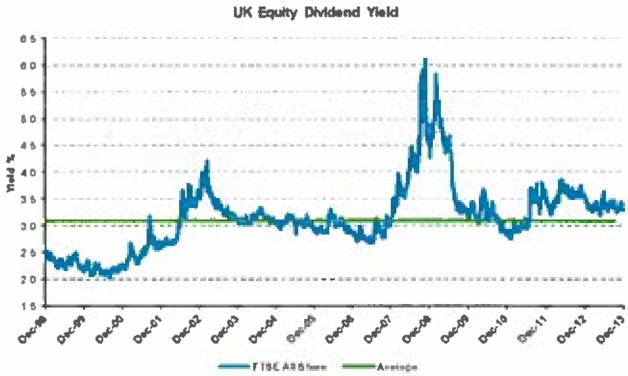
Property markets, represented by the IPD Monthly Property Index, were up by 4.7% since end September 2013 and by 10.9% over the last twelve months.

The tables below provide a summary of key financial indicators over recent periods:

	31.12.12	31.03.13	30.06.13	30.09.13	31.12.13
UK Equity yield	3.57	3.35	3.53	3.41	3.28
UK Equity P/E ratio	12.32	15.20	13.50	15.87	14.89
Over 15 year gilt yield (p.a.)	3.00	3.02	3.43	3.41	3.58
Over 5 year index linked gilt yield (p.a.)	-0.05	-0.41	-0.02	-0.02	0.05
iBoxx Over 10 year Non-gilt yield (p.a.)	4.14	4.13	4.62	4.48	4.61

	Year to 31.12.09	Year to 31.12.10	Year to 31.12.11	Year to 31.12.12	Year to 31.12.13	Quarter to 31.12.13
FTSE All Share	30.1	14.5	-3.5	12.3	20.8	5.5%
Global Equity	21.2	16.7	-6.6	12.0	21.0	5.0%
Over 15 year gilts	-4.8	8.8	26.3	2.9	-5.9	-1.8%
Over 5 year index linked gilts	5.6	9.0	23.3	0.5	0.6	0.9%
All Stocks Non-Gilts	10.8	8.4	6.9	13.1	0.9	0.0%
IPD Monthly Index	2.2	14.5	8.1	2.4	10.9	4.7%

Equity Markets



- In sterling terms, global equities were positive over Q4 (as measured by the FTSE All World index). The strongest returns came from North America (+7.5% in sterling terms). The weakest region was Pacific (ex, Japan) (-1.2% in sterling terms, but 2.7% when denominated in local currencies).
- In Sterling terms, Developed Markets outperformed Emerging Markets by 6.3% over the quarter. The pattern is similar over the last 12 months with Developed Markets having outperformed by approximately 31.4%.
- Despite the dividend yield remaining 20bps above the long-term average, the pace of growth in average dividends continues to slow, with growth over the last 6 months of only 1.9%.

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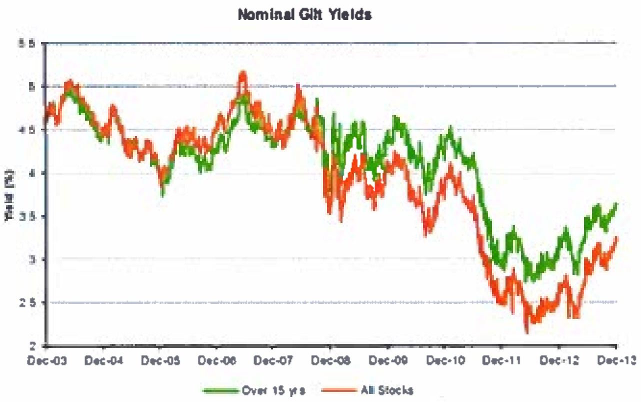
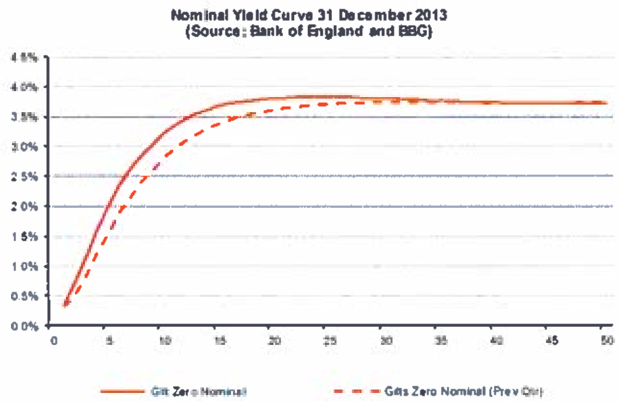
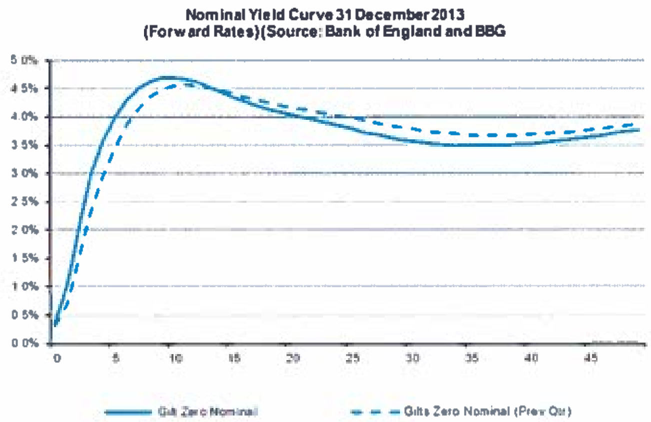
UK Interest Rates

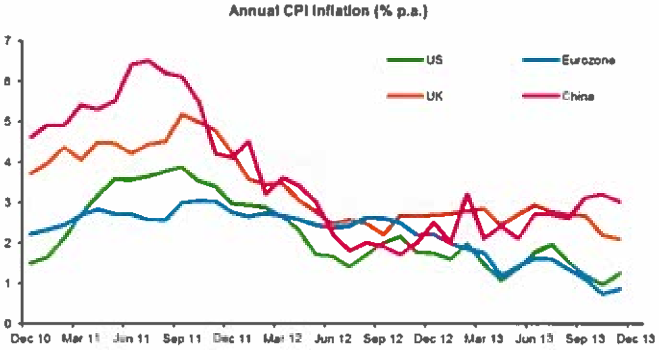




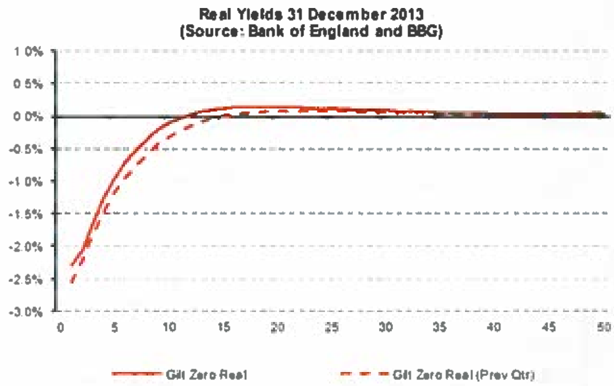


- Nominal gilt yields rose at all maturities below 40 years, beyond which there was a slight decrease.
- Markets continued to price in expectations of interest rate rises, with forward rates reaching 4% p.a. in 5 years' time (down from over 6 years) and implying a return to 'normalised' levels over between 5 and 10 years.

Inflation and Real Rates

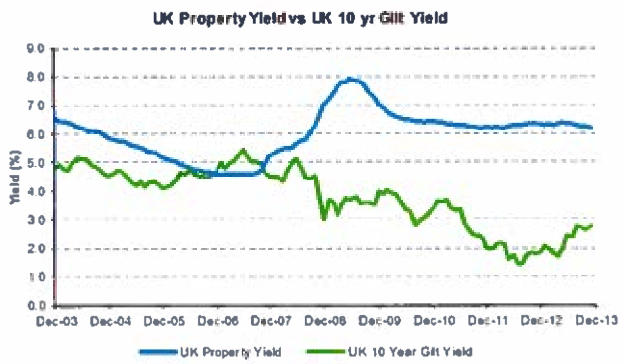


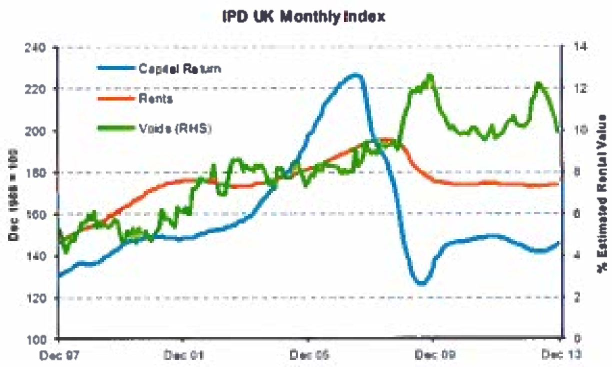
- Global inflationary pressures remained somewhat subdued over the quarter. In the US and Eurozone, inflation remains under the 2% p.a. target, with a further drop in Eurozone inflation to below 1.0% prompting the European Central Bank to cut interest rates in November.
- UK inflation fell to 2.0% in December, bringing it in line with the Bank of England's target for the first time since November 2009. RPI remains higher at 2.7%, still materially lower than long-term inflation protection which remains priced well over 3.5% p.a.



- The UK's long-term inflationary outlook was virtually unchanged over the quarter, having been largely stable over the last year.
- At maturities below 25 years, real gilt yields rose over the quarter in response to rising gilt yields and relatively stable implied inflation.
- Real gilt yields are now positive at durations above 12 years, although swap yields remain negative at all maturities.

UK Property





- UK property delivered a return of 4.7% over the quarter as capital values continued to rise. For the first time since June 2010, capital growth became the driver of returns, with capital growth outstripping income by around 1.3% over the quarter (capital values increased by 3.0% over the quarter, while income remained steady at around 1.7%).
- Void levels fell during the three months to end December, with the most noticeable changes in the office and industrial sectors.

Prepared by:-

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For and on behalf of Hymans Robertson LLP

General Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.