

Rathbone Ethical Bond Fund

Quarterly investment report, February 2010 to end April 2010



Overview

We are pleased to report that during the three months to the end of April 2010, the Rathbone Ethical Bond Fund returned 2.78% versus a return of 2.70% from the IMA Sterling Corporate Bond sector. The FTSE All-Gilt index returned +1.08% against a return of +2.53% from the Iboxx Sterling Non-Gilt index.

Apart from a jolt to confidence in February on default fears in Greece and the pace of the global recovery, investors flocked to risk assets during the period. Broadly speaking, economic data out of the US were positive. In the UK, however, Sterling weakened versus the Dollar, and despite looking like it was owed a technical bounce, fundamentals remained fragile. Improved economic data and the spectre of a hung parliament cast a shadow over gilt markets, driving the 10-year benchmark yield up nine basis points (0.09%) on to 3.91% by year-end.

Past performance should not be seen as an indication of future performance.

Changes to the portfolio

For us, this quarter was all about risk reduction, and thus an increase in our AAA weighting. Despite the market's predilection for risk, we took the view that underlying gilt yields remained vulnerable to upward pressure from the likelihood of a hung parliament and the risk of contagion from Greece. Consequently, we maintained our underweight duration position – the sensitivity of the bond price to a change in interest rates – at around five years. Debt shenanigans in the PIIGS (Portugal, Ireland, Italy Greece and Spain) also drove us to shave our exposure to Euro-denominated assets. This included the sale of long-term holding *Breeze*, the wind farm

securitisation, where we also held concerns about limited future increases in profitability and potentially reduced income payments. We exited our ECN holdings (Enhanced Capital Notes, also dubbed CoCos) in *Lloyds* and *Yorkshire Building Society* after the bonds were converted. We also sold out French banks on concerns about their exposure to Greece. On the buy-side, we added to our *EIB* and *KFW* on attractive valuations.

Outlook

In many respects, the fate of the UK bond markets relies heavily on the ability of the new government to push through, decisively, a credible plan for fiscal reform. Needless to say, the gilt market will be watching this development very closely. Until firm action is taken, gilt yields will remain vulnerable. Since period-end, any semblance of moral hazard has been thrown out of the window in Europe in favour of massive policy intervention by the European Union and International Monetary Fund, as well as an agreement involving the US Federal Reserve to provide dollar swap-funding with the European Central Bank and the Bank of England. This effort to draw a line under the mess in Europe should be supportive of credit in the short term.

Hung parliaments and impending European debt crises have certainly pushed economic data to the sidelines; however, most data, particularly out of the US, remain positive. Should this trend continue into the third quarter, we expect it to benefit our long financials and short duration positions.

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The value of investments and the income from them may go down as well as up and you may not get back your original investment. **Past performance should not be seen as an indication of future performance.**

Source performance data, Financial Express and Bloomberg, bid to bid, net income re-invested.

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