PDL International

Protected Asset TEP Fund Review and Outlook

February 2012

2011 Market and Fund review

2011 was an eventful year to say the least. Equity and some bond markets were hit with a tremendous amount of bearish news from across the globe. Several of the Eurozone countries tinkered on the verge of bankruptcy, despite desperate measures being taken by the EU, the ECB and the IMF whilst the UK economy in particular exhibited signs of a "double-dip" recession. The outlook for the U.S was even bleaker with a record deficit, rising unemployment and political gridlock as campaigning begun ahead of an election year.

However, it didn't stop there. Even some of the BRICs, particularly China, were said to be on the way of a bursting bubble. It seems that there was nowhere to hide from the bad news. There was no real safe haven for investors except perhaps through alternative investments, such as TEPs. Considering this "near Armageddon" scenario a 5.5% drop in the FTSE 100 could be regarded as a very moderate drawdown.

In this continued bearish market environment and increased stock market volatility as described above, the Fund has continued to deliver stable, low volatile performance.

Q4 of 2011 saw PATF Original Sterling register a gain of 0.96%, whilst the Euro and Dollar classes exhibited 0.92% and 0.66% respectively over the same period. The PATF No.2 Fund registered gains of 0.46% for the Sterling class, 0.49% for the Euro class and 0.61% for the Dollar class respectively.

PATF Performance Attribution

With the majority of life offices only declaring twice a year, two insurers, in October, gave the market a hint of what was likely to transpire in January with regards to bonus rate announcements. Clerical Medical – who had reviewed their rates for a fifth time during 2011 - and the Co-operative reduced their terminal bonuses moderately, the effects of which remained favourable compared to the performance of other asset classes during the same period. Whilst neither feature in the top 3 of the Funds' holdings, combined they still amount to c. 14% of assets held within the respective portfolios. However despite the expected negative effect on fund performance, the Fund's performance was able to withstand this attributed to prudent management of the smoothing at fund level.

So far in Q1 2012, the larger life offices held within the Fund have modestly rebalanced their respective terminal bonus rates, whilst most smaller life offices have generally maintained rates or exhibited small increases most likely attributed to the positive performance of bonds and other fixed interest investments, which most tend to be significantly invested in by way of ensuring they are able to meet their future guarantees.

The exception however was Aviva (incorporating General Accident and Norwich Union), which is significantly represented within the Fund, who substantially reduced their rates beyond what the market had anticipated. That said, having had the opportunity of meeting with Aviva in May last year, we believe the manner and timing by which they formalise their bonus rates for year end firmly supports the particular experiences of 2011 where they decreased disproportionately to the market in January but exceeded increases compared to its peers during the summer.

The net effect of these bonus declarations will be negative, mostly attributed to Aviva's underperformance, although the full effect will be offset as a result of the Fund's smoothing approach which served investors well through the volatility experienced throughout 2011.

"In the low interest environment that we have seen over the past few years,…, it is expected that with profits policies will outperform lower risk investments (such as instant access or 90 days deposit accounts)."
Source: Money Management October 2011.

Top 5 January 2012 Life Office With-Profits Bonus Declarations (status: 1st February 2012)

	% held across Fund	Change in reversionary Rates	Change in 25 year Terminal Rates	Change in Formula Maturity Value
Standard Life	21%	No Change	10%	1%
Norwich Union	20%	No Change	-94%	-9%
Prudential	15%	No Change	-5%	-1%
Clerical Medical	10%	No Change	12.5%	2%
General Accident	8%	-50%	-55%	-6%

2012 Market Outlook

Despite a promising start we believe that the environment in 2012 will remain challenging and highly uncertain. A multi-decade global credit bubble has reached a critical juncture characterised by fragility, unpredictability and increasingly desperate central banking and monetary policy. In addition to the troubling macroeconomic and monetary issues confronting investors, geopolitical tensions in the Middle East continue to rise, and the possibility of a military confrontation with Iran is growing. It seems likely too that U.S. market's will be heavily influenced by the presidential election, with all the accompanying partisanship and posturing. Europe's debt problems have received most of the attention in recent months, but the state of U.S. government finances remains a major concern.

2012 Fund Outlook

The extent of Aviva's bonus declaration earlier this month has allowed us to offer an opinion as to what the market can expect with regards to further bonus declarations later this year. Of course this assumes calmer market conditions during the first half of 2012 compared to the extremely volatile period markets experienced over the summer months of 2011. Turning attentions to the summer round of bonus declarations, we would expect life offices to build on their ability, as demonstrated by the bonus announcements they have respectively made in 2012, to largely withstand volatile market conditions experienced at times during 2011. This should be achieved through the continued approach of diversifying what their portfolios are invested in, the results of which should transfer into positive performance when bonus rates are reviewed.

However, the Fund's performance does not entirely depend on changes in bonus declarations. Other factors include the Fund's cost base, trading opportunities as well as investors' subscriptions and redemptions. Whilst the Fund is still net redeeming with the associated redemption restrictions remaining, improvements with regards to the Fund's costs as a consequence of lower gearing, facilitated by an increased level of maturities continue to mitigate any negative effects. In addition, positive effects have been experienced through trading opportunities which are increasingly presenting themselves in frequency rather than volume. The level of natural maturities will continue to rise until 2014 and hence this represents an important factor for continuing positive fund performance.

Any questions?

If you have any questions on any of the issues discussed please contact us on +44 (0) 20 8282 8080 or email us at info@pdlinternational.com. Alternatively you can visit our website at www.pdlinternational.com