SCOTTISH WIDOWS
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official pensions and investment provider

*funds***talk**-bulletin

October 2009

Money market funds update

Following on from our *funds***talk** article in March 'Understanding our cash funds', we remind you about the impact of lower interest rates on money market fund returns. We also look at the current holdings of the money market funds available through Scottish Widows and give a brief summary of the ABI's recent review of the sector.

Key points

- All-time low interest rates are having an impact on the returns on money market funds.
- Money market funds aren't bank accounts, nor are they secure or guaranteed investments.
- The money market funds available through Scottish Widows products focus on security of capital and liquidity.
- The ABI is launching a new Deposit & Treasury sector for funds holding low-risk money market instruments to sit alongside the existing Money Market sector.

Impact of lower interest rates on money market fund returns

A key concern for some investors has been the impact of reduced interest rates on their money market fund investments. As interest rates fall, the return on the funds' holdings also falls. Therefore, with interest rates sitting at 0.5% since March of this year, some investors may find that the return on their investment doesn't cover the total charges (both fund and product charges).

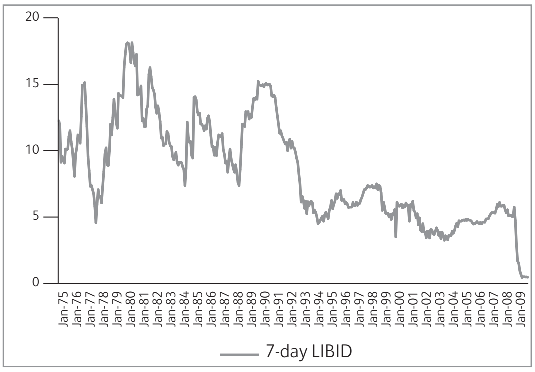
However, although many savers are finding the current low interest rate environment means low, nil or even negative returns, it's important to remember that cash still has a role to play in managing market risk* and can help to protect the value of portfolios in times of uncertainty.

* The possibility that an investment will fall in value as a result of changes in market prices.

A reminder of what has happened

Between September 2008 and March 2009, against a backdrop of financial and market turmoil, the Bank of England cut the base rate by four-and-a-half percentage points, taking it to 0.5 % – its lowest level in the bank's 315-year history. It has now been at this level for seven months (as at October 2009).

The chart below shows the pattern of interest rates over the long term, and puts the current historically low levels into context.



Source: Thomson Datastream, 7 Day LIBID from 2 January 1975 to 30 September 2009.

Outlook from SWIP's cash team

SCOTTISH WIDOWS INVESTMENT PARTNERSHIP

Government and central bank interventions have almost certainly averted a total banking meltdown, and the cash markets are now pricing as if the credit crunch is over, with the spread between official interest rates and interbank lending rates falling back to levels seen before the crisis. However, it's clear that banks remain reluctant to lend to each other and continue to have issues with the valuation of certain assets on their balance sheets. Until this situation is resolved, problems in the credit markets may return.

The Bank of England, while remaining confident that past rate cuts will in due course have a significant impact, has acknowledged that further stimulus is required to stave off the threat of deflation and is now well into its 'quantitative easing' support for the money supply. This measure involves the central bank buying up assets, such as government and corporate bonds, with money it has created. It's hoped that the financial institutions selling such assets will then have new money in their accounts, which will boost the money supply, reinvigorate lending and therefore boost the economy.

With the UK economy currently in recession, SWIP anticipates that the Bank of England will maintain low interest rates until recovery is firmly established. They believe that interest rates will begin rising again in the third quarter of 2010.

Scottish Widows money market funds

The following money market funds are available through Scottish Widows:

- Scottish Widows Cash Fund (available through all our pension products)
- SW SSgA Sterling Liquidity Fund (available through all our pension products)
- Clerical Medical Cash Fund (available through the Clerical Medical Investment Bond)

All of these funds are triple-A rated by one or more of the ratings agencies, such as Standard & Poor's or Moody's. These agencies regularly review fund portfolios to verify that holdings continue to satisfy the strict criteria necessary to qualify for a triple-A rating. One of the key requirements is that the average number of days to maturity of the fund's portfolio, known as the weighted average maturity (WAM), is no more than 60 days. Another is that funds can only hold up to 5% of assets from a single issuer (or sometimes 10% in the case of overnight deposits).

It's important to remember that money market funds aren't bank accounts, and so aren't secure or guaranteed investments. The Scottish Widows Cash Fund and the SW SSgA Sterling Liquidity Fund have a Cautious investment approach. These investments are expected to have a relatively modest risk to the capital value and/or income. They have the potential to provide income and/or relatively modest capital growth over the medium to long term. In addition, the capital value may fluctuate. The Clerical Medical Cash Fund sits in the Foundation section of Clerical Medical's risk spectrum. Foundation funds provide the core building blocks of a portfolio, offer a moderate outperformance potential and give a low-risk exposure to individual markets and asset classes relative to their benchmark indices.

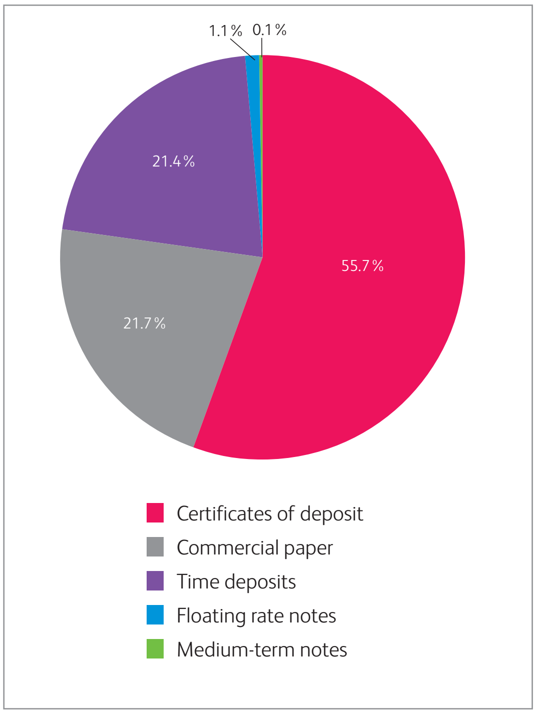
Scottish Widows Cash Fund

The Scottish Widows Cash Fund invests in the Sterling Sub-Fund of the SWIP Global Liquidity Fund.

As a result of concerns within the money markets and longer-term credit markets, SWIP will continue to monitor existing exposures, both in terms of counterparties and length of maturities. However, liquidity in the money markets has started to improve, particularly in shorter-dated assets. There has also been an increase in the number of investors coming to the market in recent months. That said, the dispersion of rates currently being quoted remains extremely wide, making active trading difficult.

As SWIP has often stressed, one of the key attributes of a money market fund, aside from liquidity, is capital preservation. In order to achieve this, the fund has focused mainly on high-quality credit – a practice that will continue while turbulence remains. Although the tentative improvement in market sentiment seen over the last few months is welcome, the mood remains fragile and vulnerable to any sudden economic or company-specific shocks. Therefore, SWIP will continue to adopt a prudent approach to running the fund, both in terms of maintaining liquidity and in the quality of assets traded. They will also continue to have high exposure to overnight deposits and short-dated certificates of deposit, which will enable them to meet any reasonable cashflow requirements from investors. As at 30 September 2009, the fund's WAM was 44 days.

Asset allocation



Source: SWIP, as at 30 September 2009.

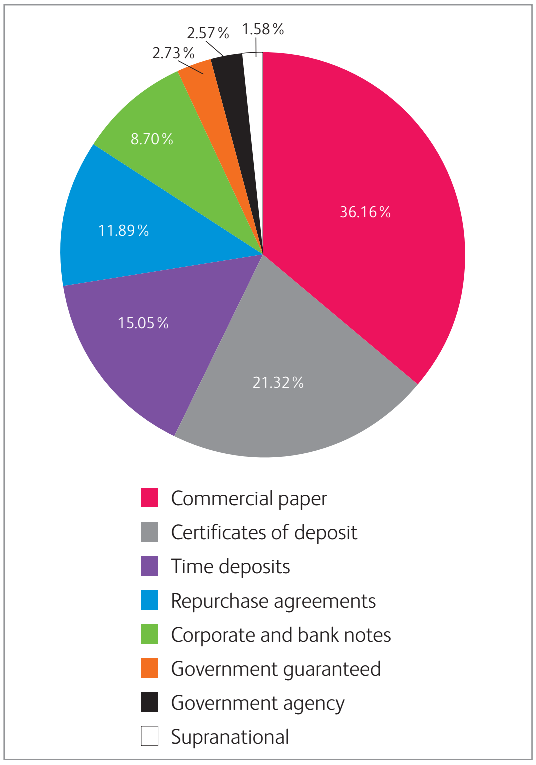
SW SSgA Sterling Liquidity Fund

The SW SSgA Sterling Liquidity Fund invests in SSgA's MPF Sterling Liquidity Fund, which in turn invests in the SSgA GBP Liquidity Fund, a Dublin-domiciled OEIC.

The underlying SSgA GBP Liquidity Fund aims to earn an income that outperforms the 7 Day LIBID rate (gross of fees), consistent with the preservation of capital and liquidity. As at 30 September 2009, the fund's WAM was 43 days, with 29.51 % of holdings maturing in seven days or less.

The fund's strategy continues to be focused on careful positioning, exposure to supranational names and conservative credit choices. This strategy ensures that the fund remains highly liquid while prioritising stability of capital.

Asset allocation



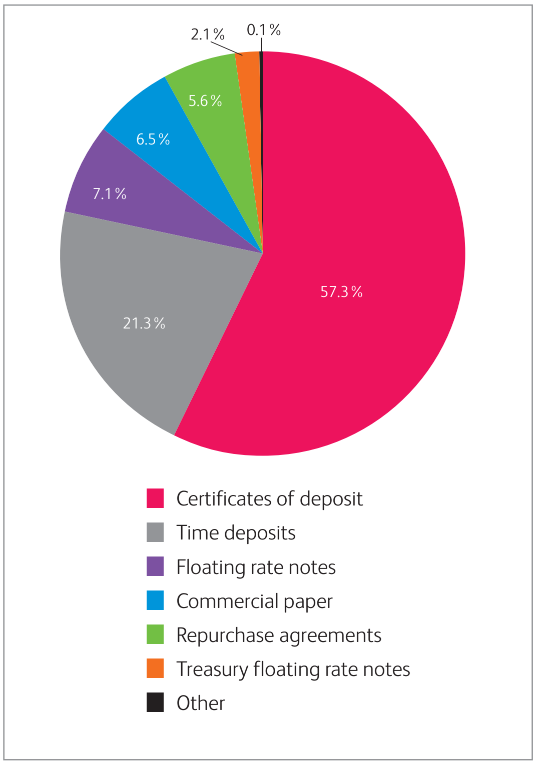
Source: SSgA, as at 30 September 2009.

Clerical Medical Cash Fund

The Clerical Medical Cash Fund invests 100 % in the Insight Liquidity Fund, a Dublin-based OEIC.

The underlying Insight Liquidity Fund continues to focus on security and liquidity, generally looking at certificates of deposit of up to three months maturity. As at 30 September 2009, the fund's WAM was 37 days.

Asset allocation



Source: Insight, as at 30 September 2009.

The ABI's Money Market sector review

The ABI commissioned a review in February 2009 to look at the issues facing the Money Market sector, and what could be done to help consumers better understand what money market funds invest in and more easily identify funds which meet their risk preferences.

The outcome of the review is a new Deposit & Treasury sector launching on 1 November 2009 to sit alongside the existing Money Market sector. The principal and overriding objective of funds in the new sector must be stability of capital, with the investment quality of permitted instruments closely matching this objective.

As a result, they'll be expected to be lower risk than funds which invest in other money market instruments with higher yields. However, they won't be 'no risk' funds, as they'll still be exposed to credit risk and a degree of liquidity risk.

Scottish Widows' money market funds sit in the ABI Money Market sector and, if unchanged, are likely to remain so. We'll let you know if we're going to make any changes to them as a result of the ABI's review.

For more information, read our ABI Money Market sector review article in the upcoming fundstalk-quarterly (available to download from 5 November at **www.scottishwidows.co.uk/fundstalk**).

Past performance is not a reliable indicator of future results.

Views, opinions and forecasts expressed in this document are those of the fund managers as at October 2009. Investment markets and conditions can change rapidly and, as such, should not be taken as statement of fact, nor should reliance be placed on these views when making investment decisions.

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