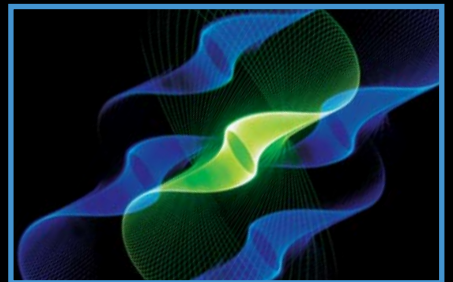
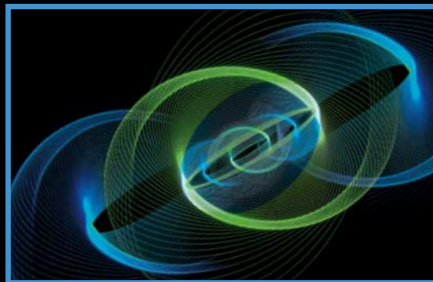
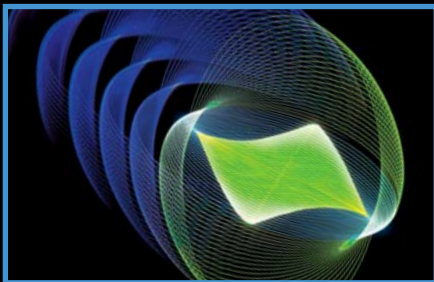
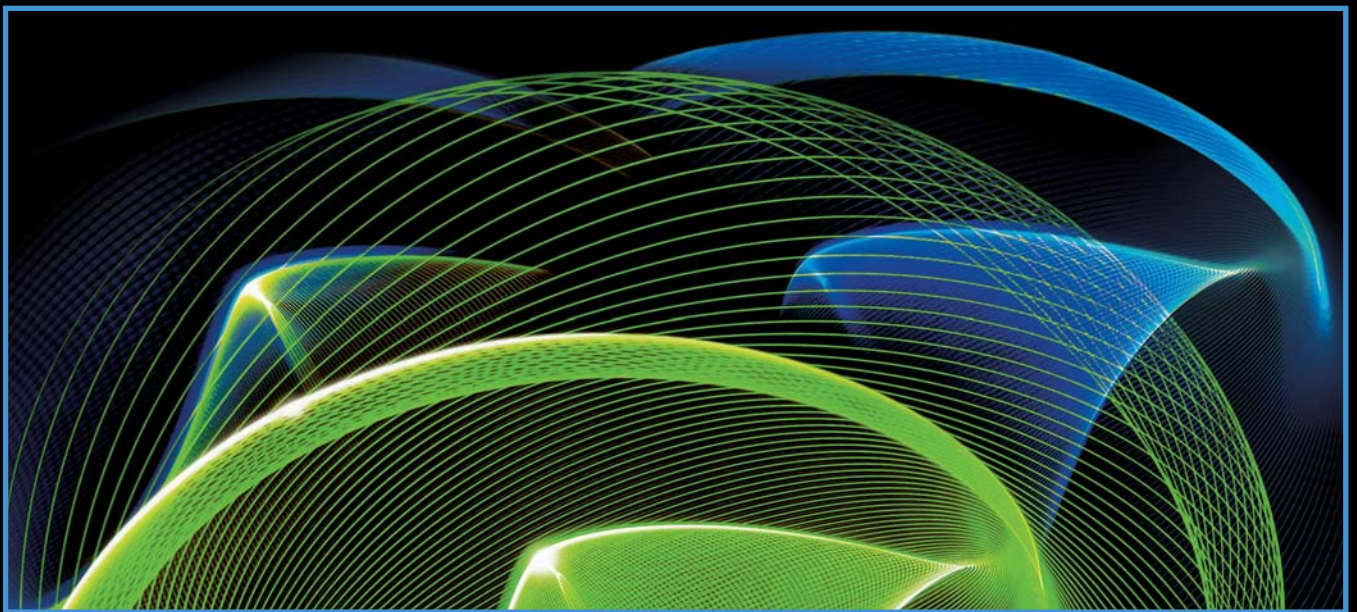


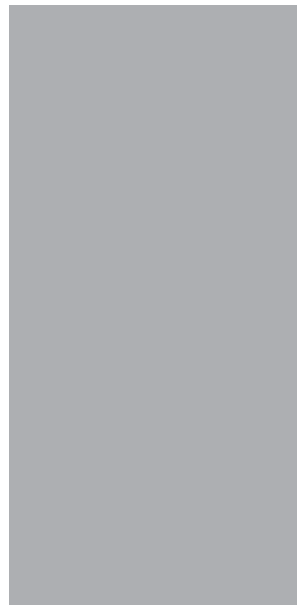
Guide to Fixed Income Investing





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ABOUT US

Since its establishment in 1988, BlackRock has grown to become one of the world's leading asset management firms with over US\$1.3 trillion in assets under management and operations in over 60 countries.

Following a series of successful mergers, BlackRock is now in a stronger position than ever to offer its clients a unique breadth of investment solutions across the equities, fixed income, money markets and alternatives arena. This impressive offering was recognised in 2007 with over 100 industry awards received globally.

With over 50 offices and 5,500 employees strategically located around the globe, BlackRock can offer in-depth local knowledge while leveraging the strength of its global infrastructure to deliver premier investment management, risk management and advisory services. This global strength has attracted an impressive client base which includes 21 central banks and a wide range of insurance companies, banks, charities, corporations, independent financial advisers and individual investors.

BlackRock maintains a vigorous focus on delivering the highest level of service for our clients by striving to combine first-class investment performance with comprehensive choice, acknowledged credibility and unparalleled expertise. In today's world, the increasing rate of change creates a distinct advantage for those who can spot opportunity early and react to it instantly.

At BlackRock, our combination of experienced professionals, powerful technology and global perspective uniquely qualifies us to take advantage of these opportunities by enabling us to understand and manage today's investment environment.

A global leader in fixed income

BlackRock offers an array of fixed income products designed to meet a variety of client risk/return profiles and to add value in all market environments. Our success speaks for itself; in just under 20 years we have grown our assets to an impressive US\$507 billion*, making BlackRock the second-largest fixed income manager in America.

The Team resource includes over 150 professionals dedicated to fixed income, operating from offices strategically located around the globe.

*Source: Institutional Investors America's Top 300 Money Managers 2007. Data as at 31 December 2006. This information is published yearly by the Institutional Investor Research Group, which develops detailed analysis of Institutional Investor Research Group, which develops detailed analysis of Institutional Investor magazine's published research team rankings covering the US, Europe, Asia and Latin America.

KEY POINTS

- ▶ Bonds offer stable returns and lower risk.
- ▶ With low correlation to other asset classes, bonds form a core investment for balanced portfolios.
- ▶ Due to their lower-risk status, bonds generally deliver lower returns than equities. This is particularly true in a low interest rate environment – new investment laws are, however, enabling investors to generate further performance.

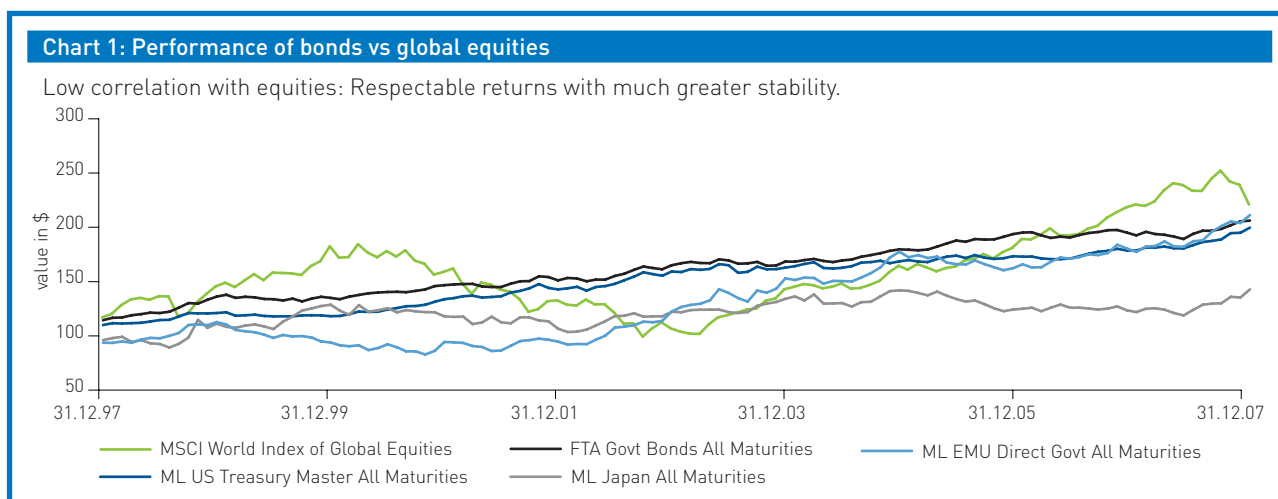
AN INTRODUCTION TO FIXED INCOME

Fixed income investments, or bonds, play an important role within financial markets, providing a vital source of financing for a multitude of companies. For investors, fixed income is a particularly important asset class, providing them with stable, predictable returns and a more-regular income.

Stable returns – a key characteristic of the asset class

Historically, bonds have generated greater returns than cash investments (see chart 1), and exhibited less volatility than equities (see chart 2).

In addition, the return on bonds has often offset the negative return on equities during periods of market downturn. As a result, adding bond investments to an all-equity portfolio generally lowers the risk of the overall portfolio.



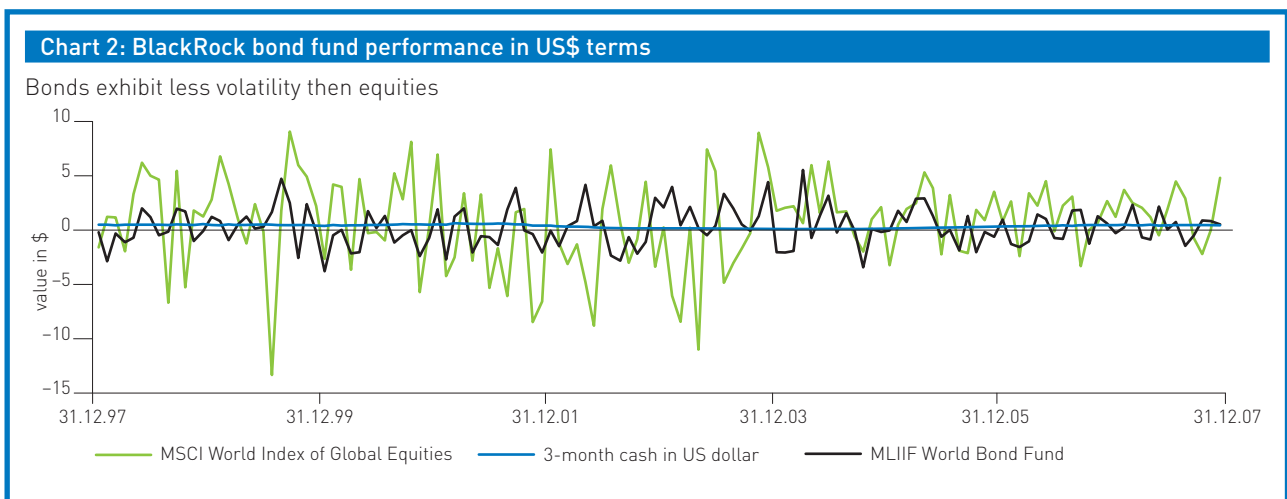
Low correlation with equities

While both equities and bonds are often similarly affected by market or macroeconomic events in the short run, there has been relatively low correlation between the two asset classes over the long term. This low correlation provides a portfolio with stability in times of stockmarket volatility. As chart 1 illustrates, at times of equity under-performance, fixed income has maintained its more-steady upward trend. Combining the two asset classes in one portfolio can therefore ensure greater long-term stability for an investor's portfolio.

RISK GRADE™ Bond markets



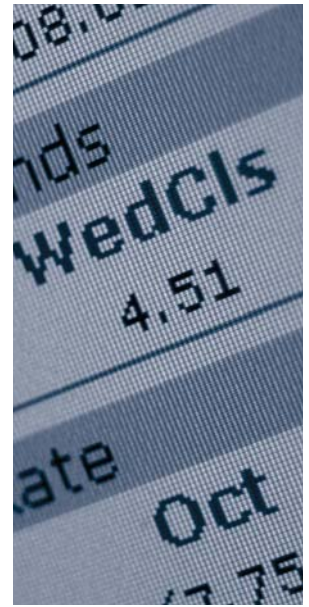
Chart 1 shows that the pay-off for lower risk means that fixed income products do generate lower returns over time. This has been particularly true in the current low interest rate environment. However, the development of new investment laws, such as UCITS III across the European Union, has allowed fixed income managers to utilise a broader and more diversified range of strategies to generate additional performance, rather than settle for these historically lower returns.



Adding bond investments to an all-equity portfolio generally lowers the risk of the overall portfolio.

KEY POINTS

- ▶ Bonds are debt instruments, issued by governments and corporates.
- ▶ They offer a regular stream of income, via known future cash flows.
- ▶ Bond exposure is also available through collective investment schemes.



WHAT ARE BONDS?

In the simplest terms, a bond is a loan, made by an investor, to a government or company that needs to raise additional capital for financing needs.

Bonds are issued globally by governments (known as “sovereign bonds”) or companies (called “corporate bonds” or “credits”), generally with the objective of raising capability to support business growth or opportunities.

UK government bonds are also known as “gilts”, while in Germany these are “bunds”, and in the US these are Treasuries.

The distinguishing feature of bonds is that they provide an obligation on the part of the issuer (or the borrower) to make a series of specified payments (known as “coupons”) over a specific period of time, including the full repayment of the initial amount borrowed (the “principal”) at a pre-specified date (“maturity”).

In other words, as an investor you are investing in a regular stream of known future cash flows.

Another familiar term for bond investors is “yield”. This is used to describe the rate of income received from a bond relative to the bond’s market value, and is described in more detail later.

After issuance, bonds are traded in the secondary market, i.e. they are bought and sold between investors without the involvement of the issuer. However, investors may also

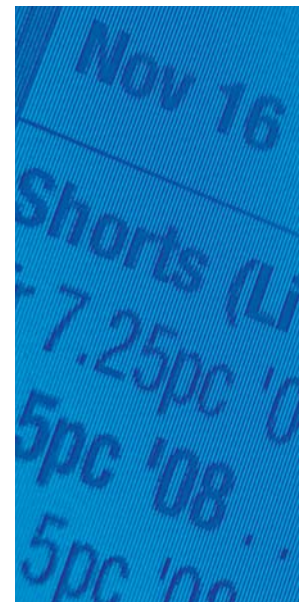
obtain bond exposure via a bond fund, the type that is offered by BlackRock, whereby benefit can be derived from the expertise of an experienced and highly regarded fixed income investment team.

UK government bonds are also known as “gilts”, while in Germany these are “bunds”, and in the US these are Treasuries.

A screenshot of a financial trading platform interface. The main display shows a list of bonds with columns for 'Firm Name', 'Bid Price / Ask Price', 'Bid Yield / Ask Yield', and 'Bid Size / Ask Size'. The top of the screen shows a search bar with 'POLGB 6 1/2 15' and a market price of '101.920/102.080'. Below the search bar, there are several rows of bond data, including 'CBBT BONDTRADER COMPOSITE', 'CBK COMMERZBANK AG GROUP', 'RZBA RZB AUSTRIA', 'VOLK VOLKSBANK AUSTRIA', 'DZAG DZ BANK', 'ABN ABN AMRO BANK', 'BMT BANCA IM AUTO EX', 'EFGX EFG Eurobank Trading', 'HSET HSBC EXECUTABLE', 'JPGX JP MORGAN LONDON GOV', 'HVBT HVB E-BOND TRADE', and 'NOMX NOMURA INTL PLC LON'. The interface also includes a menu bar at the top with options like 'TIME', 'F1-F12', and 'HELP'.

KEY POINTS

- ▶ A bond is a loan, or an “IOU” made out by the issuing government or company.
- ▶ In contrast, equity investors part with cash in return for a share of a company’s ownership.
- ▶ Stock selection remains key for investors in both disciplines.



HOW DO EQUITIES DIFFER?

While a bond is a loan, or an “IOU” made out by the issuing government or company, equity investors are parting with cash in return for a share of a company’s ownership.

Equities offer higher opportunities for capital growth, providing the company does well, but this is by no means secured and equity prices, or equity markets as a whole, can be more volatile.

With investors taking on specific company risk, equity investing is deemed more exciting than bond investing, with a focus on picking the right companies at the right time. In contrast, bonds experience lower price volatility and can be regarded as “protected” from equity market turbulence, to a large extent.

In addition, equity holders may share further in a company’s success by receiving dividends if the company is performing well. However, for bondholders, the coupon and the principal amount to be paid back upon maturity remains the same.

Of course, the reverse is true if an equity-issuing company is not performing well, and this will negatively impact equity owners directly, but not necessarily the bondholder. As long as the company is still capable of financing its debt, the bondholder is indifferent to the fact that the company is performing badly.

This perfectly illustrates why equity investing is regarded much more volatile than bond investing. As companies swing from making gains to losses from one year to the

next, so the share prices fluctuate wildly. For bondholders, returns on their investments are already fixed.

However, this is not to say that security selection is not of importance to bond investors. Remember, if a bond issuer defaults on its debt repayments, the bond holders could lose almost everything – a fact that isn’t lost on bond fund managers when scouring the market for suitable investments.



KEY POINTS

- ▶ Lower risk than equities.
- ▶ The bond price/yield relationship: prices rise when yields fall.
- ▶ Bond investors are deemed “creditors” and receive the appropriate claim rights over the issuer’s assets on default of payment.



SOME TYPICAL BOND CHARACTERISTICS

Fixed income has developed a reputation as a conservative asset class, when compared to more ‘exciting’ and higher-returning equities. This reputation is in many ways justified, with bonds delivering predictable and regular fixed income streams over their lives, sacrificing additional return for a lower risk profile.

Bond investors are lenders to the government or company that has issued the bond. As such, the investor is entitled to a regular coupon payment (paid semi-annually or annually) and repayment of the full principal amount when the bond matures, as illustrated below;

The “yield” of a bond is the term used to communicate the rate of income received when it is expressed as an annualised percentage and based on the bond’s value.

The coupon value divided by the bond’s market value, multiplied by 100, equals the yield in percentage terms.

$$\text{Bond Yield} = \frac{\text{Coupon Rate}}{\text{Current Market Price of Bond}} \times 100$$

The yield can be used to measure performance or to compare against different bonds or investments.

Generally speaking, higher-risk bonds offer higher expected yields as compensation for the additional risk incurred through ownership.

Price/Yield relationship

The yield on a bond can change quite substantially over time. This can be due to changes that are market-wide or specific to the bond issue (e.g. a change in credit quality).

However, as the cash flows from any standard bond are fixed, any changes in yield will result in a change in the price of the bond. It is crucial to note that bond prices and yields move inversely: when yields fall, bond prices will rise and when yields rise, bond prices will fall.

Duration

Duration measures the sensitivity of a bond’s price to any change in yield, as expressed in years. In other words, if a bond has a duration of five years its value will be expected to rise 5.0% for every 1.0% fall in yields, and vice versa. Given the time value of money, bonds with a longer maturity will have a higher duration, and hence a 1.0% change in yields will have a greater impact on the value of longer-dated bonds than that of shorter-dated bonds.

Cash flow to investor

For example, if you have purchased a 5.0% coupon bond with a principal value of £1,000, you will receive £50 annually. At the end of five years, you will receive £1,000.

Nominal Value: £1,000

Coupon: 5%

Term: 5 years

£50

£50

£50

£50

£50

£1,000

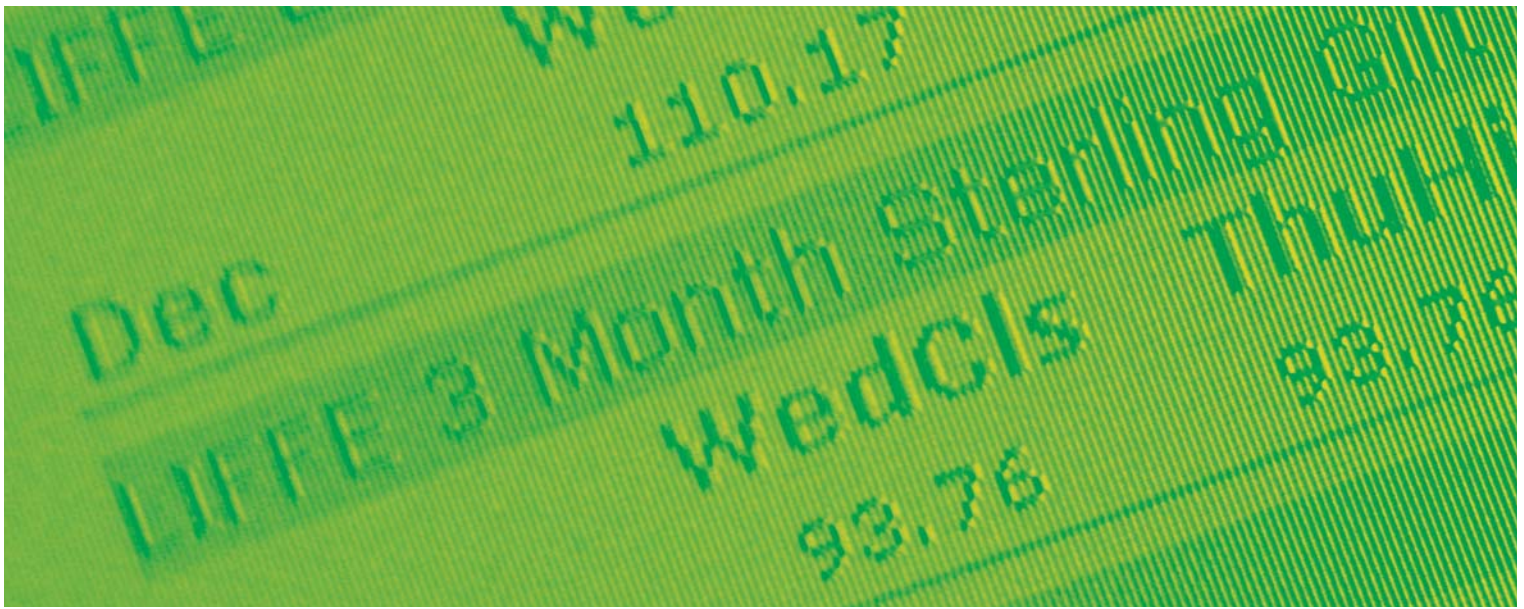
Year 1

Year 2

Year 3

Year 4

Year 5



It is crucial to note that bond prices and yields move inversely: when yields fall, bond prices will rise and when yields rise, bond prices will fall.

Managing duration is an important aspect of bond management, as it represents a considerable risk factor.

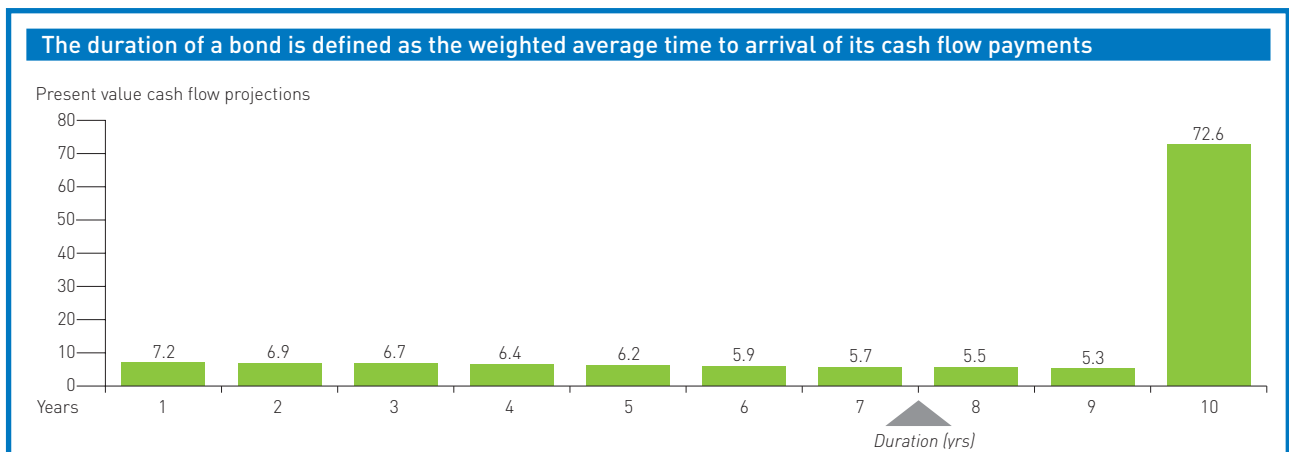
As a creditor of the bond issuer, the bond investor has a claim over the issuer's assets

Bond investors are creditors of the issuing government or company and bear a right of claim to the issuer's assets

should it go bankrupt and/or default on the ability to finance the interest and payment of its borrowings.

Hence, the credit worthiness of the issuing party (be it government or company) comes under much scrutiny by bond investors and is ranked by external rating agencies.

If an issuer is borrowing only a small amount in total, and makes more than enough revenue to finance its loan obligations or can call upon valuable assets to secure the loan, then bond investors will feel more secure in lending money to these companies. Such issuers, including many governments, are rated highly and are deemed to hold stronger credibility.





TYPES OF BOND

Bonds fall primarily into two broad categories, those issued by governments and those issued by corporations.

Government bonds

To familiarise yourself with some of the common terminology used by bond investors, it is worth noting that government bonds issued in the UK are also called gilts. Elsewhere, US government issues are known as Treasuries, and in Germany they are bunds, while the term Japanese Government Bonds (JGBs) is self explanatory. Collectively, government bonds are also known as sovereign bonds.

With the exception of financially troubled countries, government bonds are generally considered risk free because there is little chance of default as governments can levy their full tax power to serve their obligations.

Corporate bonds

Corporate bonds are issued by businesses. The details of a particular issue are formalised in the bond's terms and conditions. Corporate bonds carry an extra layer of risk when compared with government bonds, due to the increased possibility that the issuer may default on their obligations, leaving bond holders without the income and capital promised. This risk of non-payment is factored into bond prices so that instruments of lesser credit quality provide higher expected returns, or yields.

As mentioned earlier, credit rating agencies (such as Standard & Poor's (S&P)) analyse the credit quality of a corporation as a whole and/or of a particular bond issue. Ratings are assigned from "AAA" (the highest) to "D" (the lowest), which act as an indicator for investment risk. In simple terms, the higher the rating, the more likely it is that the issuer will be able to meet its obligations. Changes in the credit status of companies issuing bonds can have a significant impact on a bond's price.

Bond ratings

Bond ratings are expressed as letters ranging from 'AAA', which is the highest grade, to 'C' ("Junk"), which is the lowest grade, and 'D', which symbolises a bond that has defaulted.

- ▶ AAA and AA: High credit-quality investment grade
- ▶ AA and BBB: Medium credit-quality investment grade
- ▶ BB, B, CCC, CC, C: Low credit-quality (non-investment grade or "junk bonds")
- ▶ D: Bonds in default for non-payment of principal and/or interest.

KEY POINTS

- ▶ The two main types of bond are government and corporate, however, there is an increasing variety of bond instruments available in today's market.
- ▶ Bonds are graded by their credit-worthiness.



Other investments available within fixed income

In addition to the most simple government and investment grade corporate bonds, described above, there is an increasing variety of debt instruments available to investors. Some of these are detailed below:

Index-linked bonds' coupons and redemption values are adjusted periodically with changes in the rate of inflation. These adjustments are linked to a particular index, such as the Retail Price Index (RPI) in the UK.

High yield bonds, often called "junk bonds", are sub-investment grade issues, i.e. with a rating of BB+ (S&P)/Ba1 (Moody's), or lower. These bonds offer a higher return potential than government or investment grade corporate bonds, but are considerably more risky as the probability of default is higher.

Convertible bonds come with an option to convert the bond into a specified amount of equity stock at a later date. Usually, the price of convertibles will be higher than similar non-convertible bonds, reflecting a premium for the right to convert.

Mortgage-backed securities (MBS) make up the largest capital market in the world, standing at over US\$8 trillion in value. Asset-backed by a mortgage, or a collection of

mortgages, these highly traded securities are of high credit quality, due to their collateralisation and guarantees structure, and boast an historic growth rate of 8.0%. By investing in an MBS, you are effectively lending money to a home-buyer or business in return for a pro-rata share of the principal and interest from a pool of single-family home mortgages.

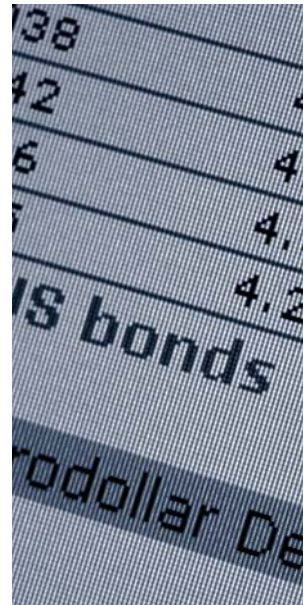
A financial security that is backed by a loan, lease or receivables that isn't real estate is known as an **asset-backed security (ABS)**.

For investors, both mortgage-backed and asset-backed securities are an alternative to investing in corporate debt.

The 1990s saw the growth of **emerging market debt (EMD)**, which is a term used to define bonds that are issued by less-developed countries. EMD is primarily issued by governments, although corporate EMD does exist, and bonds of this nature are typically issued in foreign currencies (either US dollars or euros). EMD generally attracts lower credit ratings than other debt because of the increased economic and political risks associated with the issuing countries.

KEY POINTS

- ▶ The use and acceptance of derivatives has enhanced fixed income markets in the last 10 years.
- ▶ Derivatives can be used tactically in bond portfolios to isolate particular risk metrics.



USING DERIVATIVES IN BOND PORTFOLIOS

A derivative as an instrument whose value is dependent on the value of another security: it 'derives' its value from an underlying security or commodity. BlackRock uses derivatives tactically as a means to replicate the risk of their respective underlying securities and isolate particular risk metrics.

When permitted in a client's investment guidelines, BlackRock may use derivatives, such as futures, options, and/or swaps (interest rate and credit). All derivatives are incorporated into our risk management systems, and holdings are reflected in our daily reports. Client restrictions on derivatives are monitored on a daily basis as part of our overall compliance process.

Swaps

Over the past 10 years, fixed income markets have undergone significant enhancements due to the acceptance and use of swaps. The inaugural swaps used were interest rate swaps. These were followed by total return swaps and, later, credit default swaps.

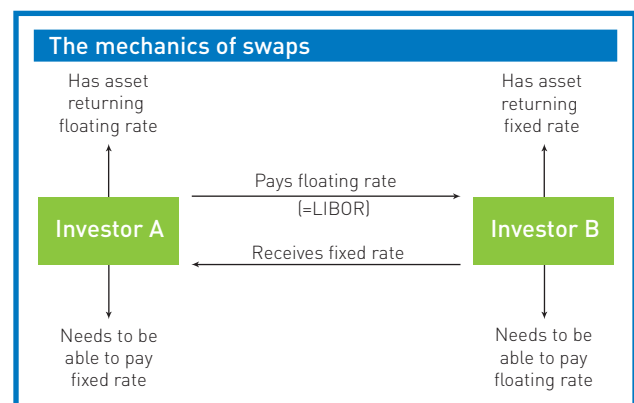
More recently, the growth in the use of swaps has accelerated. Due to flexibility and liquidity, investors are increasingly turning to swaps as an important tool in managing their fixed income portfolios.

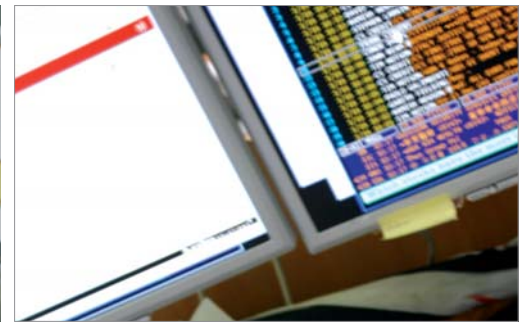
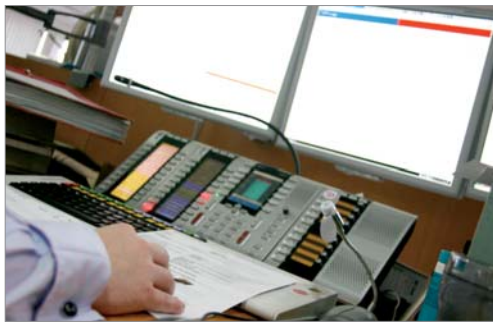
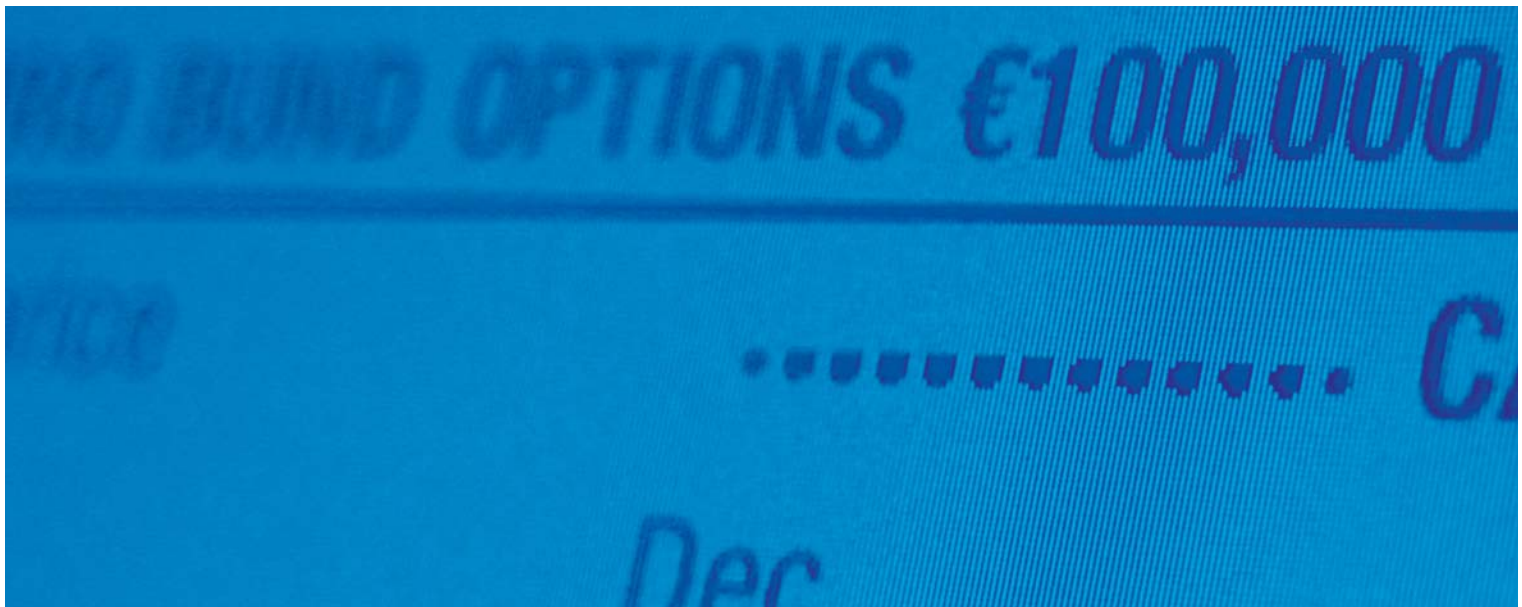
Swaps are often more liquid than traditional cash investments and can enable investors to achieve exposures that are not readily available through the use of traditional securities. They can also be used to effectively manage and fine-tune interest rate, currency, and credit-related exposures.

As an over-the-counter derivative that affords a tailored exposure to specific securities, markets, or sectors, swaps see one cash flow (or return) traded for another over a specified interval of time. Swaps come in many forms; some of the most commonly used include interest rate swaps, currency swaps and credit default swaps.

Different types of swaps

An **interest rate swap** trades a series of cash flows from a floating rate bond for the coupon cash flows of a fixed rate bond. This exchange, or swap, is carried out over an agreed-upon time period based on the notional principal amount.





Derivatives can be used to isolate particular risk metrics including duration, yield-curve exposure, convexity, spread risk and volatility risk.

Interest rate swaps are useful in managing exposure to interest rates by adding duration to, or subtracting it from, a portfolio. Similar to an interest rate swap, a **currency swap** involves the exchange of cash flow streams in one currency for the same in another currency. Currency swaps are used to increase or decrease exposure to foreign currencies.

The most commonly used credit derivative, the **credit default swap (CDS)**, is designed to transfer credit risk from one party to another. In a CDS agreement, each party exchanges credit risk on a reference entity, often a corporate bond issuer, without explicitly buying or selling a fixed income security.

The buyer of a CDS receives credit protection by paying a fixed periodic premium to the seller for the life of the agreement. In exchange, the seller takes on the credit risk and commits to reimbursing the buyer for losses if the specified credit event occurs (e.g. default, bankruptcy, debt restructuring).

CDS can be used in combination with cash instruments, such as Treasury bonds, to replicate another security not readily available in the cash market. This allows users to create synthetic versions of corporate debt, as a very high percent of the corporate market is owned by "buy and hold" investors.

CDS also provides dramatically superior liquidity compared to cash bonds and enables an investor to express a positive or negative view on a credit (i.e. sell or buy protection).

For all of these reasons, portfolio managers consider CDS an essential tool for managing a fixed income portfolio.

Currency futures can also be used to manage and even eradicate certain risks surrounding currency exposure.

For example, the ability to use a foreign exchange (FX) future would make it easier for an investor to implement an asset allocation view between European and UK industrial stocks.

In this scenario, corporate bond allocations within a euro-denominated portfolio could be altered by selling European industrials in favour of UK industrials, then using an FX future to sell sterling versus the euro to get back to a neutral currency position, without having to adjust other underlying bond and cash positions.



WHAT FACTORS AFFECT THE PERFORMANCE OF BONDS?

Bonds issued by a government or a company will have a fixed life, or a period until “maturity”.

A bond is issued at a face value, which will form the repayment amount that the investor receives at the time of maturity, along with the regular income through the life of the bond.

Note, however, that the face value may be different to the amount that the investor actually paid for the bond, as the purchase may have taken place on the open market after the original issue date.

Bond prices fluctuate throughout their lifetime and are affected by several factors. In government-issued bonds these factors include inflation and interest rates, while in corporate bonds influences can include the fortunes of the issuing company along with prevailing macroeconomic factors.

Interest rates

The movement of global interest rates has a significant impact on the performance of bonds. For example, if the Bank of England’s Monetary Policy Committee (the body that sets official UK interest rates at monthly meetings) increases the UK’s base interest rate, generally speaking, UK bond prices fall.

This rule of thumb applies to rate-setting central banks across the world and is a result of yields on existing bonds looking less attractive when compared with the income rate available from banks and building societies on “risk free” savings accounts, causing demand for bonds to diminish.

As with rising interest rates, any decision to reduce the official cost of borrowing will also affect the attraction of bonds. In this instance, demand levels rise, particularly in short-dated issues (i.e. those that have a shorter length until maturity), and prices go up in unison.

Inflation levels

Given that inflation erodes the value of money, rising inflation levels can severely detract from the value of a bond investment, where, by the nature of the investment, returns have been agreed and locked-in in advance.

The “real return” of a bond investment is inflation adjusted (i.e. if a bond is yielding 5.0% and the rate of inflation is 2.0%, the real return is 3.0%). As such, lower or falling inflation levels are better for bond investors.

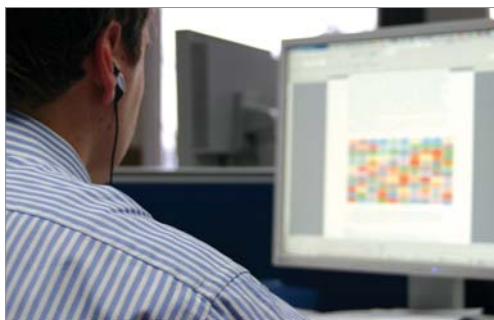
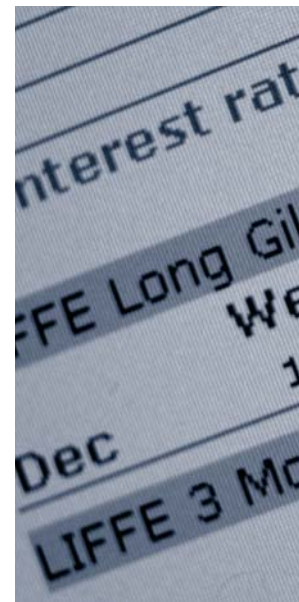
Health of the economy

A booming economy, with higher tax revenues and lower social security outlay, puts the government in a healthy financial position, thus the need to raise cash via the issue of government bonds diminishes. The simple “supply and demand” theory supports higher bond prices in this instance.

In contrast, an overheating economy brings the spectre of rising inflation, which as described above, negatively impacts bonds.

KEY POINTS

- ▶ Bonds benefit from lower interest rates, low inflation, a healthy economy and financial market volatility.
- ▶ In contrast, higher interest rates, rising inflation, or an overheating or recessionary economy, detracts from the attractiveness of bonds.



A slower economy also presents something of a double-edged sword. On the one hand, lower inflation and falling interest rates bode in favour of fixed income investing. On the other, any sign of a recession generally sees a government extending its budget to subsidise unemployment etc..., resulting in increased bond issuance and, therefore, lower bond prices.

Bond prices fluctuate throughout their lifetime and are affected by several factors. Depending on the type of bond these can include inflation, interest rates, the fortunes of issuing company and prevailing macro-economic factors.

A safe haven in times of uncertainty

Bonds, and the steady returns/low volatility investment traits associated with the asset class, are regarded as something of a safe haven in times of uncertainty. History shows that when financial markets are turbulent, investors reduce exposure to equities and increase fixed income positions.

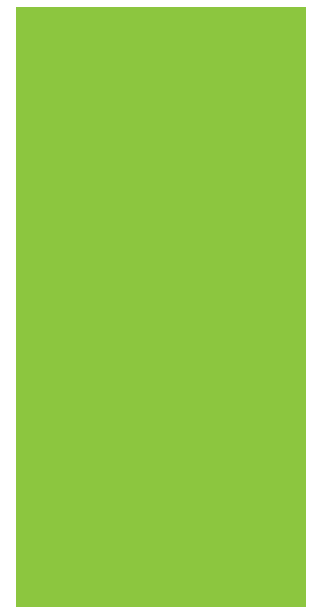
In addition, any increase in financial market uncertainty, caused by the likes of geopolitical tension, natural disaster, or any other global or local event, fixed income asset classes attract inflows, causing bond prices to rise.

The opposite is, of course, true as positions are unwound once turbulence or uncertainty subsides.

A downgrade in credit worthiness

If a bond issuer, government or company, finds itself in a position where meeting the financing of its debt becomes difficult, they will find themselves on the receiving end of a credit downgrade, indicating that the risk of default on payment of interest or face value has increased.

If this occurs, the price of bonds undertaken specifically by this issuer will decrease, and yields will rise, reflecting the additional risk accepted by the investor (lender).



CONSERVATIVE OR AGGRESSIVE – THERE'S A PLACE FOR BONDS IN YOUR PORTFOLIO

A typical bond owner will be an investor with a need for regular income. This income is a known future cash flow (hence, the association bonds have with pension funds) and can compete favourably with returns offered by banks or building societies, particularly in times of low interest rates and inflation.

In addition to the above, broader and more-aggressive investment portfolios also benefit from the diversification properties offered by fixed income, smoothing volatility levels associated with equities and other "riskier" assets.

When equity markets and other assets, such as commodities and property, are soaring in value, the important role that bonds play in a diversified portfolio is often forgotten in the pursuit of higher returns. However, a rapid turn in fortunes is often the reminder investors need, and many regret not maintaining a certain level of exposure (or protection), even when other assets are rallying.

Understanding how interest rates, inflation and the state of the economy influence bond prices is only the beginning. Other complex considerations must also be analysed to stay ahead of the curve - literally and figuratively. To this end, BlackRock aims to ensure that all the variables are carefully factored into the management of clients' fixed income portfolios.

Advantages of bonds

- ▶ Fixed returns over a known period.
- ▶ Priority claim over issuer's assets on wind up.
- ▶ Little default risk on highly rated issues (i.e. gilts) – better returns on riskier issues (i.e. non-investment grade/high yield).
- ▶ Higher levels of income.
- ▶ Highly liquid market – led by demands from institutional clients, pension funds, and investors with income or diversification needs.

GLOSSARY OF TERMS

Asset class

The main types of investment available: bonds, equities, real estate, commodities etc...

Balanced fund

A fund invested in a range of asset classes, particularly equities and bonds.

Barbell strategy

An investment technique, typically related to a bond portfolio, under which a manager holds a combination of both shorter-dated and longer-dated bonds relative to the benchmark, but where overall duration is broadly in line with the benchmark.

Bond

A form of loan. Typically, the investor should receive a regular coupon and the return of the principal originally lent when the bond matures. Note: Not all bonds are interest bearing (see zero coupon bonds), and not all bonds are fixed rate (see index linked, floating rate bonds).

Conventional bond

A bond where the coupon and principal are fixed (as opposed to an inflation-linked bond).

Convertible

A security, usually a bond, which the holder has the option of exchanging for other securities, such as a company's ordinary shares.

Corporate bond

A bond issued by a company. Often used as a generic term for all bonds except government bonds. The issuer might be a company, a financial institution or a supranational (such as the World Bank).

Coupon

The regular interest payments on a bond.

Credit rating

A rating of how much investment risk is associated with a debt issue. Ratings are provided by agencies such as Standard & Poor's, Fitch, and Moody's.

Credit risk

The risk that a bond issuer will default on their obligations, therefore, a function of the credit quality of the issuer. Government bonds of developed countries are assumed to have no credit risk. Credit risk is usually associated with corporate bonds.

Debenture

In the UK this is a bond secured by a prior claim on the assets of the issuer or, in some circumstances, by specific assets of the issuer. A debenture holder is entitled to appoint a receiver if necessary.

Debt/Equity ratio

A company's borrowings divided by the market value of its equity. It is a measure of the amount of gearing of a company, and an indicator of financial strength.

Default

Can be a) the failure to pay interest or principal promptly when due, or b) the failure to meet payments on a futures contract as required by an exchange.

Default risk

The risk that an issuer will not be able to make future interest (coupon) or capital (principal) payments. Bonds issued by the governments of most developed countries are generally regarded as having an extremely low default risk (AAA).

Diversification

Holding a range of assets to reduce risk.

Dividend

The portion of company net profits paid out to equity investors.

Downgrade

When a bond's credit rating is lowered. This might be caused by an event, such as a negative trading statement by the issuer, which in turn increases the risk that the issuer might be unable to meet its future payment obligations. If the downgrade reduces an issuer's credit rating to high yield status, funds which only invest in investment grade bonds may need to sell the bond.

Duration

The (Macaulay) duration is a measure of the average time until a bond's cash flows occur, and of the sensitivity of its price to interest rate changes.

Technically speaking, the Macaulay Duration is the sum of the time-weighted discounted payments (coupons and principal) of a bond. Another way to think about duration is the average time period over which you will receive your payments. Hence, if two bonds have the same maturity, the bond with the higher coupon will have a shorter duration (the average time of repayment is less heavily weighted to the repayment of capital (principal) at maturity).

Equity

The shares in a company. Investors in equities are a company's owners and are entitled to its profits after other claims on the company have been met.

Fixed income

Bonds and related investments.

Fixed interest

See fixed income.

Fixed-interest / Fixed-income securities

An interest-paying security, where the interest is calculated as a constant specified percentage of the principal amount and paid at the end of specified interest periods, usually annually or semi-annually until maturity.

Floating rate note (FRN)

A bond whose coupon varies with (short-term) interest rates. Floating rate bonds are generally issued by banks or companies whose earnings are closely tied to interest rate fluctuations as a way of more closely matching interest payments to earnings.

Gilt (-edged)

Name sometimes given to government bonds issued by the Irish, South African and UK governments.

Gilt strips

Investors can buy separately either individual coupons or the ultimate principal repayment due on a specific gilt. These separate elements are referred to as principal or coupon strips and are identified by the payment date. The separation process is achieved by 'stripping' the gilt. A key benefit is that the duration of a strip is equal to its term, thus making it easier for pension funds to find securities to match fixed liabilities. See also strips.

Government bond

A bond issued by a government.

High yield bond

A bond whose issuer has a credit rating of BB+ or lower with Standard & Poor's, or Ba1 or lower with Moody's. They are also known as junk bonds or sub-investment grade bonds.

Index-linked gilt

A bond issued by the UK Government (gilt) whose interest (coupon) and capital (principal) payments are linked to the UK Retail Prices Index (RPI).

GLOSSARY OF TERMS CONTINUED

Inflation

A measure of the rate of increase in general prices, e.g. the movement over time in the Consumer Prices Index (CPI).

Inflation-linked government bonds

Government bonds whose payments are linked to inflation.

Institutional investor

An investor such as a pension fund, insurance company or charity.

Investment grade bond

A bond with a credit rating of at least BBB- (Fitch) / Baa3 (Moody's) / BBB- (S&P).

Junk bond

See high yield bond.

Liquidity

The extent to which an asset can be bought and sold quickly and cheaply. Liquidity can be measured by the daily trading volume in a security.

Maturity

1. For a bond, the time at which the principal of the bond is repayable and it ceases to exist.
2. For a pension fund, broadly the average age of the membership and the time until benefits are payable.

Nominal

1. This often means 'before allowing for inflation'. If inflation is positive the nominal return on an asset is greater than its real return.
2. For a bond, see principal.

Nominal amount / Value

The value stated on the face of a security.

Principal / Face value / Nominal amount

The amount inscribed on the face of a security, exclusive of interest or premium, due to a security holder at maturity and it is the amount used in the computation of interest due on such security.

Redemption yield

Calculation of the return that investors will earn on a bond if they hold it to redemption, taking into account income and any capital gain or loss that will be made at the maturity date.

Retail prices index (RPI)

This is an index published by the government that is used to measure the rate of inflation on standard goods and services. Index-linked bonds and pension payments are linked to the RPI.

Running yield (or current yield)

The current income from an asset divided by its price.

Safe haven

Investment strategy which minimises future uncertainty.

Secured bond

A bond for which the issuer has set aside assets as collateral to ensure principal repayment and encourage timely interest payments.

Short bond / Short dated bond

A bond with a term to redemption of less than five years.

Sovereign debt

Bonds issued by a central government.

Speculative grade

A credit rating below investment grade.

Spread

The difference in yield between two different bonds. It is typically used to describe the extra yield offered by corporate bonds over gilts.

Strip

Strips (separately traded registered interest and principal securities) are zero-coupon bonds created from the individual cash flows of a coupon-paying bond.

T-Bill / Treasury bill

A US Government debt security with a maturity of less than one year. They are sold at a discount to par – where the difference between purchase price and redemption value represents the investor's return.

Term (of a bond)

The time remaining until the final payment on the bond.

Treasuries

Central government bonds, often US government bonds.

Treasury bill

A type of zero-coupon government debt security, typically with a maturity of less than one year.

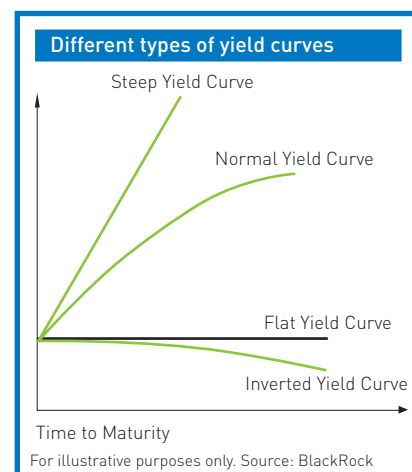
Yield

A measure of the income return earned on an investment. In the case of a share the yield expresses the annual dividend payment as the percentage of the market price of the share. In the case of a property, it is the rental income as a percentage of the capital value. In the case of a bond the running yield (or flat or current yield) is the annual interest payable as a percentage of the current market price. The redemption yield (or yield to maturity) allows for any gain or loss of capital which will be realised at the maturity date.

Yield curve

A curve showing the relationship between the time to maturity of a bond and its redemption yield. The yield curve can take different shapes:

- ▶ Normal, or positive. In this case yields rise as maturities lengthen, since lenders would normally expect to be paid more for the greater uncertainty of lending money for a longer period.
- ▶ Flat, when similar yields are observed for all maturities.
- ▶ Inverted, or negative, when long bonds offer lower yields than short or medium bonds. Yields at the short end are influenced by interest rate expectations. Yields at the longer end are influenced by inflation expectations and the supply/demand balance.



Yield gap

The difference in yield between different assets; the most frequently quoted yield gap is that between gilts and equities.

Yield spread

The difference in yields available on different types of bonds, for example government and corporate bonds.

Yield to maturity

The annualised return that would be earned on a bond if held to maturity.

Yield to maturity

See redemption yield.

Zero-coupon bond

A bond which does not pay interest (coupon). It is issued at a discount to face value, and is redeemed at face value when held to maturity.

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