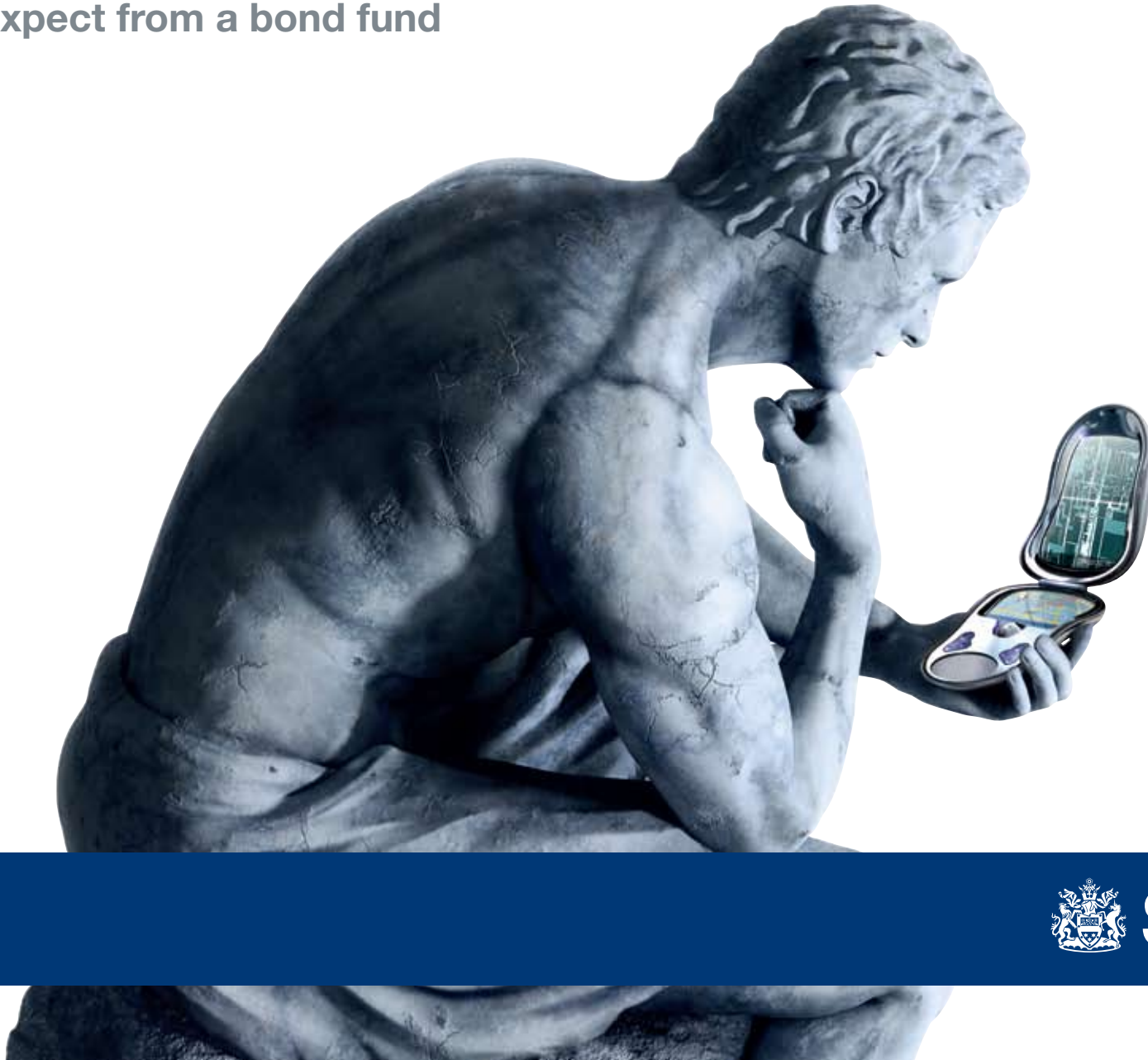


Schroders Navigator

Investor guide

What to expect from a bond fund



Schroders

This Schroders Navigator guide aims to give an overview of the pluses and minuses of different types of bond fund. There are several compelling reasons why you may consider investing in a bond fund:

- 1. It can provide you with a good level of income**
- 2. It can offer potential for capital growth**
- 3. The returns you get are likely to be less volatile than those of a stock market investment.**

However, not all bond funds are the same and as with any investment it's very important to understand what you're putting your money into.

The key question is what does the fund invest in and what can that tell you about how it is likely to perform? The investment focus of the fund is likely to be even more important in determining the income and capital returns you're likely to get than the quality of the fund manager and the strength of their investment process.

Bonds are risk assets

As with any investment involving risk assets such as equities or property, an investment in a bond fund can go down as well as up in value so you may not get back the amount you put in. The upside is that over time you should expect to receive compensation for the risk you're taking in the form of higher returns than you'd get from a bank or building society account although there are of course no guarantees.

The returns you receive from a bond fund are made up of two elements, income and capital growth. The level of each that you're likely to receive will depend to a large extent on the type of bond fund you invest in.

The main types of bond fund

Bond funds can be divided into two broad categories, government bond funds and corporate bond funds. The corporate bond category can be further split into funds which are focused on higher quality bonds, which are categorised as 'investment grade' and funds focused on lower quality bonds, which are categorised as 'non investment grade'. Non investment grade bond funds are also sometimes known as 'junk' bond funds. Some bond funds have a wider investment focus, seeking to benefit from investment opportunities in bonds of all types in the UK and overseas.

Bond investments of all types are generally less risky than equity investments. The reason for this is that there is a degree of certainty about the returns they offer. However, different types of bonds have varying elements of uncertainty or risk and it's this which determines their specific investment characteristics. The key differences between government bonds, which are generally the least risky type of bond to invest in, and corporate bonds, which have additional risks are explained in the table overleaf.

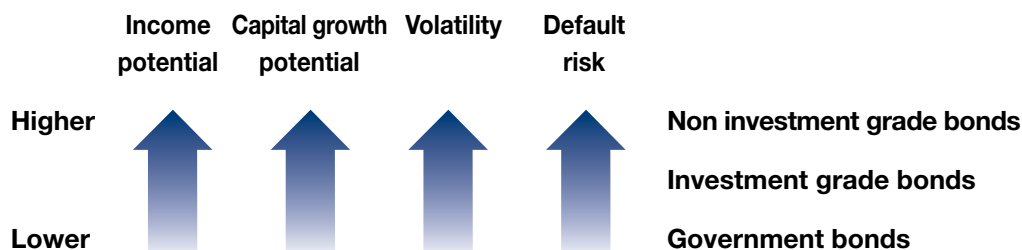
Bonds provide a degree of certainty... And a varying element of uncertainty or risk

	What you know when you buy a bond	What you don't know	This depends on	Why this matters - the impact on the bond price
Government bonds	The fixed interest rate you'll get until the bond matures	Whether this will be good value or bad value over the life of the bond relative to other investments	What happens to interest rates	Changes in interest rates have an impact on the value of the yield offered by a bond. If interest rates rise, for example, other investments may provide better value, which will push the price investors are willing to pay for a bond down. The opposite applies if rates fall.
	The amount of cash you will get back made up of coupon payments and the repayment of your original investment at maturity	The real value, or spending power, of the money you will get back	What happens to inflation	Inflation has an effect on the spending power of money over time. If inflation is high, cash returns from a bond will be worth less in real terms
		How market demand for bonds of the type you have bought will change over the life of the bond	As well as what happens to interest rates and inflation, demand can be affected by other factors such as the level of supply in the market and the changing appetite of investors for taking risk	If there is high demand for bonds of a certain type, for example from pension funds, this can have a positive impact on their prices. Government bonds are seen as a safe haven for investors seeking to reduce risk in times of uncertainty. When markets are volatile prices can rise due to increased demand
Corporate bonds	The fixed interest rate you expect to get until the bond matures	Whether this will be good value or bad value over the life of the bond relative to other investments And , whether you will receive the fixed interest rate for the duration of the bond	What happens to interest rates The company's ability to meet coupon payments	Changes in interest rates have an impact on the value of the yield offered by a bond. If interest rates rise, for example, other investments may provide better value, which will push the price investors are willing to pay for a bond down. The opposite applies if rates fall. If the company is unable to make coupon payments and defaults, you may not receive interest for the duration of the bond. The risk is generally higher if a company's bonds are rated as non investment grade by the major ratings agencies such as Standard and Poor's, Moody's and Fitch.
	The amount of cash you expect to get back made up of coupon payments and the repayment of your original investment at maturity	The real value, or spending power, of the money you expect to get back And whether you will receive all the coupon payments and get back the full amount of your investment	What happens to inflation Whether the company will generate sufficient funds to make all the coupon payments and repay the investment	Inflation has an effect on the spending power of money over time. If inflation is high, cash returns from a bond will be worth less in real terms If the company is unable to make coupon payments or repay the investment amount at maturity, you may not receive the amount of cash you expect. Again the risk is generally higher if a company's bonds are rated as non investment grade
		How market demand for bonds of the type you have bought will change over the life of the bond	As well as what happens to interest rates and inflation, demand can be affected by other factors such as the level of supply in the market and the changing appetite of investors for taking risk	Higher quality corporate bonds can benefit from uncertain market conditions because they offer a stable income flow while less high quality bonds can suffer due to concerns about the ability of companies to make interest payments.

Bond fund characteristics

A fund which focuses on government bonds will generally deliver more stable returns than a corporate bond fund but it's likely that it will provide a lower level of income and have less potential for capital growth over the long term. At the opposite end of the risk spectrum, a fund focused on non investment grade corporate bonds will tend to generate a higher income and have potential for greater growth over the long term. However it will typically be significantly more volatile and the underlying bond investments will have a higher risk of default.

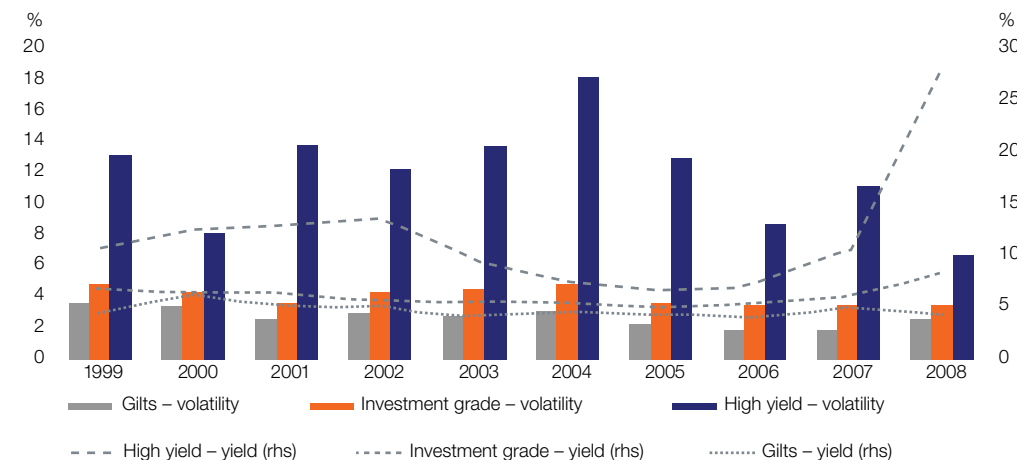
The characteristics of the three main types of bond in terms of income potential, capital growth potential, default risk and volatility – the key measure of risk – are illustrated below.



Comparison of volatility and yield over the last ten years

The bars in the chart below show the annualised volatility of returns of UK government bonds, known as gilts, investment grade corporate bonds and non investment grade corporate bonds over the ten years to 2008. In each year, gilts were the least volatile type of bond, and non investment grade bonds were the most volatile by a significant margin. This is very much what you would expect.

If you turn the attention to the three lines on the chart, the yield, or income, produced by the three types of bonds each year is shown. What you can see is that gilts produced the lowest but most stable yield each year. Investment grade bonds delivered a slightly higher yield, with slightly more variation from year to year while non investment grade bonds produced a significantly higher yield with significantly greater variation.

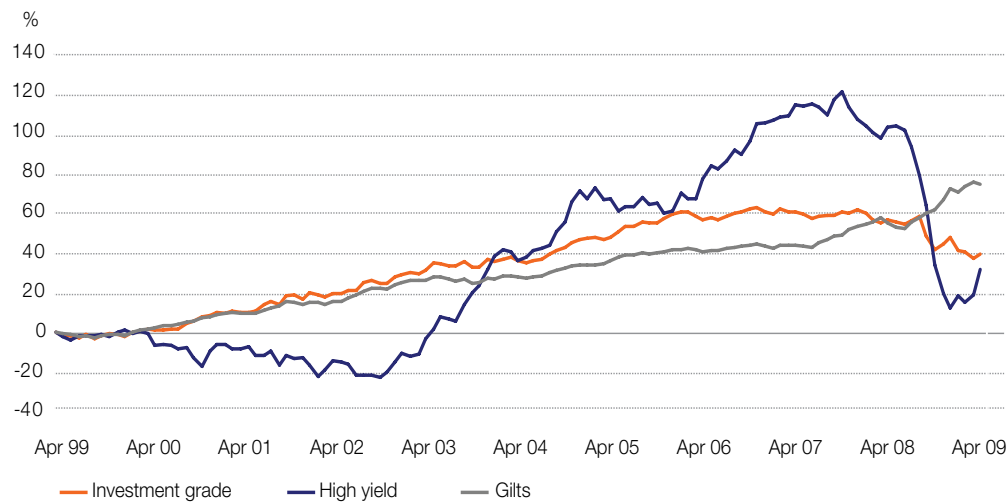


Source Hindsight to 31/12/08. Indices used are Merrill Lynch Sterling Corporate Bond, Merrill Lynch Sterling High Yield and Merrill Lynch UK Gilts 1-10 year. Volatility is measured by standard deviation.

The sharp spike in the yield of non investment grade corporate bonds over 2007 and 2008 reflected a re-rating of the risk associated with non investment grade bonds as the economic background deteriorated and the outlook became clouded. Investors justifiably expected to receive a massively higher yield if they were going to invest in bonds where they perceived a soaring risk of not getting all their money back due to default. Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get the amount originally invested.

Bond returns over the past ten years

The chart below shows the returns from gilts, investment grade corporate bonds and non investment grade corporate bonds from April 1999 to April 2009. If you look at the returns achieved between 2002 and 2007 you can see that non investment grade bonds have potential to outperform by a significant margin when conditions are benign. However looking at the period 2007 to 2009 you can see that as a more volatile type of asset they also have potential for significant price falls when investors lose their appetite for risk. In comparison, you can see that returns from gilts are steadier over time than returns from both types of corporate bond and can also actually benefit from a deterioration in the economic climate as occurred between 2007 and 2009. The reason for this is that investors regard government bonds as a safe haven in times of uncertainty.



Source Hindsight to 30/04/09. Indices used are Merrill Lynch Sterling Corporate Bond, Merrill Lynch Sterling High Yield and Merrill Lynch UK Gilts 1-10 year.

Please note that this chart provides a snapshot of one particular period in time which includes the extraordinary market conditions of 2007 and 2008. While it can help to illustrate the characteristics of different types of bonds, it does not provide a guide to likely performance in the future. Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get the amount originally invested.

Selecting the right bond fund for you

You should aim to select a bond fund that fits your particular investment requirements. The right bond fund for you is likely to be one that offers a good balance between your need for income, your appetite for risk and your long-term capital growth objectives. If you're thinking about making a new investment or changing your investment strategy, speak to your Financial Adviser. If you do not currently have a Financial Adviser, you can find one near to where you live by visiting www.unbiased.co.uk.



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