

Bond Fund
UK
Credit Analysis

Diversification Notes Plc MTN Programme

Bond Fund Credit and Volatility Ratings

Series	Credit Rating	Volatility Rating
DN 5/8th	A-	V2
DN1	A-	V3
DN2	A-	V3
DN3	A-	V4

Analysts

Aymeric Poizot, CFA, CAIA
+33 1 44 29 92 76
aymeric.poizot@fitchratings.com

Abisodun Soetan
+44 20 7417 3552
abisodun.soetan@fitchratings.com

Keranka Dimitrova
+33 1 44 29 92 80
keranka.dimitrova@fitchratings.com

Summary Data

- *First Issuance: October 2004*
- *Return Distribution: Quarterly*
- *Subscription/Redemption: Twice a Month Subject to Notice Period*
- *Listing: Irish Stock Exchange*
- *Investment Manager: Banquo Credit Management LLP*
- *Trustee, Issue and Paying Agent and Listing Agent: Deutsche Bank*
- *Custodian/Administrator: Investors Fund Services, a State Street Company*

Summary

Fitch Ratings has assigned an 'A-' Bond Fund Credit Rating to the portfolio of assets of Diversification Notes plc (DN) actively managed by Banquo Credit Management LLP (Banquo). DN is an Irish registered company that issues debt through a medium-term note (MTN) programme. The proceeds received from the investors for these notes are used by Banquo to purchase a range of fixed-income instruments that are actively managed. It should be noted that the rating has been assigned to this underlying managed portfolio of assets and not to the credit strength of the note programme itself. The rating is based on a comprehensive analysis of the portfolio and Banquo's organisation and resources.

Where portfolios are rated in the 'A-' category, this indicates that the weighted-average default probability of the asset pool is, subject to certain minimum standards, roughly equivalent to the default probability of an individual security of the same rating. In this particular case, the rating also reflects the diversification of assets, the controls and limits applied by Banquo and the experience of the investment management team.

In addition, Fitch has assigned Bond Fund Volatility Ratings (Volatility Ratings) to the expected price volatility of the notes. The value and return of these notes is subject to that of the underlying portfolio and to the leverage factor specific to each note (see *Investment Objectives* section within the report). The Diversification Notes 5/8th (DN 5/8th) series have been assigned a 'V2' rating. The Diversification Notes One (DN1) and Diversification Notes Two (DN2) series have been assigned a 'V3' rating. Diversification Notes Three series (DN3) have been assigned a 'V4' rating. Portfolios rated 'V2' are considered to have low market risk. Portfolios rated 'V3' and 'V4' are considered to have moderate market risk. Total returns perform consistently over intermediate to long-term holding periods, but will exhibit some variability over shorter periods due to greater exposure to interest rates and changing market conditions. Since inception, until July 2007, the different note series had exhibited a modest level of price volatility. However, since July 2007, the market valuation of the DN portfolio has suffered from the significant spread widening impacting all segments of credit markets, even in the absence of any major credit event in the portfolio.

Key Rating Drivers

- Credit experience of Banquo's staff and strong analytical team.
- Stable investment process with a three-year track record.
- Diversified portfolio, with well-defined investment limits and compliance procedures.
- Market risks essentially limited to spread risk by virtue of hedging mechanisms and portfolio security restrictions.
- Maximum 2.2 times leverage for DN1 (3.267x for DN2, 4.33x for DN3 and 1.0x for DN5/8th) and subject to an overall leverage limit of 3.5x at the level of the total portfolio of assets.
- Returns actively sought through investment-grade investments only.
- Liquidity closely monitored and maintained through investment in higher-grade credits.

Organisation

DN, the note issuer, is organised as an Irish registered company whose MTN programme is listed on the Irish Stock Exchange. Under the terms of its offering circular, DN is not authorised to undertake any business other than the management of the assets it acquires in accordance with the discretionary management agreement.

Notes are issued either in bearer or registered form, with coupons attached, in multiples of EUR1,000,000 (minimum denomination EUR10,000). They constitute unsecured obligations of DN and will at all times rank pari passu and without preference among themselves. A negative pledge in the prospectus prevents DN from securing any debt or guarantee against the outstanding notes issued to investors.

The notes pay a three-month Euro Interbank Offered Rate (Euribor) flat return (the base return) (although investors can elect to receive a spread over Euribor) each quarter (the margin return). Portfolio returns above Euribor are generally paid quarterly. Any positive performance in excess of the base and margin return (the excess return) for the period is also paid out quarterly to noteholders with any negative performance reflected in the note value. Investors may opt for redemption twice a month subject to a notice period and redemption is limited to 10% of the total notes outstanding on any given redemption date for DN1 and 7.5% for DN2.

Investment Company Management

DN has appointed Banquo to manage its assets. Incorporated as a limited liability partnership in England in March 2004, Banquo is regulated and authorised to conduct investment management business by the UK regulatory authority, the Financial Services Authority (FSA). In June 2004, Banquo established a strategic relationship with XL Capital Ltd, a leading provider of insurance, reinsurance and financial products and services. XL Capital Ltd is a significant minority partner of Banquo and invests in DN.

Fitch regularly conducts on-site analysis of Banquo's organisation and resources. Five managing partners are in charge of research, marketing, operations risk and trading. The partnership currently has 22 other partners and five employees. Four committees are established covering risk, investment (systemic risk decisions), research and audit. Investment professionals include two bond traders, three dedicated swap and repo traders, five fundamental analysts and two quantitative analysts.

Trading and cash management as well as controls of limits are supported by a leading software solution, Principia. Proprietary applications are also used for portfolio modelling and market analysis.

Net portfolio value (NPV), as well as note prices, are calculated bi-monthly by the administrator, Investors Fund Services, and limited scope procedures are performed by the auditor, PricewaterhouseCoopers, at each month end. Banquo also provides investors with an indicative NPV on a daily basis. Transparency is emphasised through these daily NPV reports and monthly reports that cover portfolio performance, holdings, activity and risk reports - all these reports are accessible via a restricted website.

Compliance and internal controls are handled by experienced staff and the business continuity plan appears robust.

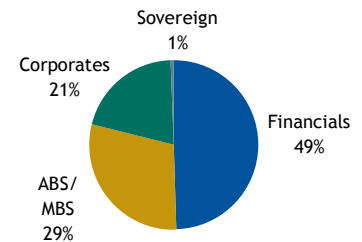
Banquo has set up a sturdy platform based on market-leading systems, top-tier service providers and very experienced staff. This platform now has a two-year operating track record (the asset manager became operational with the launch of DN). An on-site review is conducted at least yearly.

Investment Objectives/Guidelines/Strategy

The issuer's principal investment objective is capital preservation and returns in excess of the risk free rate over the medium and long term based on a portfolio of 'AAA' to 'BBB' rated corporate, senior ABS and bank loans that are substantially hedged against interest rate and currency risk. Credit derivatives and short sales of cash securities may be used to hedge a specific exposure or to hedge against spread widening in a few instances. DN pool of assets consist of corporate, financial and sovereign debt and senior ABS assets subject to numerous limits by asset sector and country.

Portfolio Composition

As of December 2007



Source: Banquo Credit Management LLP

Investors in the note programme may elect to receive a return that is either floating or fixed rate and/or denominated in a currency other than Euro on the series of notes issued to them. The foreign currency and interest rate risks are appropriately hedged on behalf of the investor in each instance to three-month Euribor via the swap market. The return attributable to each note series is a function of the return achieved by the DN portfolio and of a leverage factor specific to each series (1.0 for DN1, 1.333 for DN2, 1.67 for DN3 and 0.625 for DN5/8th).

Credit Quality and Counterparties

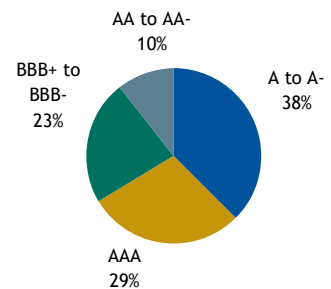
DN's portfolio of assets has an average investment-grade credit quality of 'A-'. According to the prospectus, all assets must be a minimum 'BBB'/'Baa2' investment-grade credit quality at the time of purchase and any that are downgraded below this level are not expected to remain in the portfolio over the long term. Written rules and procedures clearly define the credit, country, asset class and rating exposures.

All credit counterparties are highly rated and any exposure to these is included in the overall credit quality composition, which is to be monitored by Fitch. Counterparties other than brokers must be rated at least 'A' by Fitch or must be considered to have an equivalent credit standing.

DN's overall credit quality remained stable and consistent with the fund credit rating of 'A-'. All portfolio assets are of investment grade. Over 2007, the downgrades-to-upgrades ratio was at around 0.25 (one downgrade for four upgrades). Upgrades in the portfolio slowed at the end of the year, while downgrades accelerated. The affected securities were predominantly from the banking and finance sector. In January 2008, the portfolio experienced 7 downgrades in total which accounted for only 2.4% of the total portfolio.

Portfolio by Credit Rating

As of December 2007



Source: Banquo Credit Management LLP

Diversification

The portfolio has very high standards of diversification and related operational controls. The total portfolio comprises in excess of 250 single obligors and is diversified across country, industrial sector and type of collateral in the case of asset-backed securities.

Hedging

The overall hedging strategy is designed for the purposes of risk reduction rather than speculation. The portfolio has minimal exposure to interest rate or currency risks. Tight limits on residual interest rate and foreign exchange sensitivities are stipulated in the offering circular. The principal hedging instruments are interest rate and currency.

Liquidity

Liquidity is maintained by investing in higher-grade credits. Associated risks are also mitigated by the notice period stipulated for investor early redemptions. Beyond the notification period, investors bear the cost of unwinding any individual hedge where they have elected to receive a return based on a fixed rate and/or a currency other than Euro. Ultimately, leverage can be used as a buffer when redemptions occur under illiquid market conditions. Financing is also managed very conservatively.

Leverage

Leverage is achieved mainly through repurchase agreements, although other instruments may be used from time to time, all of which are conducted with highly rated credit counterparties ('A' or better). DN may borrow up to a maximum ratio of 3.5:1, measured as total borrowings to investors' funds. However, the portfolio is further restricted by the levels of leverage authorised for each note series. DN1 and DN2 notes' leverage are subject to a hard limit of 2.2x and 3.267x compared to a ceiling of 4.33x for DN3 and 1x for DN 5/8ths notes. On a monthly basis, Fitch monitors the level attained and its compliance with the individual notes' leverage limits.

Funding risk is managed carefully by diversifying the repo counterparties, by staggering maturities and by securing repo terms at three- to six-month horizons.

Investment Process

Systemic risk decisions (including leverage, credit duration, hedging and asset mix) are made by a weekly investment committee. Market timing and issue selection (issuer specific risk) are ultimately the responsibility of two senior portfolio managers (who each have 20 years' experience in fixed-income trading and sales). Issuer selection is essentially based on the output of the research department. Banquo's credit research team produces the migration probabilities and recovery estimates to calculate expected returns that are used to evaluate investments. All research output is discussed at a research committee.

First Loss Reserve

Some notes benefit from a first loss reserve mechanism that accrues part of Banquo's management fees. This reserve is available to investors if, at maturity, the note has achieved a total return below three-month Euribor. The reserve is forfeited should the note be redeemed prior to maturity, except in case of reinvestment into another series.

As the first loss reserve is available only at maturity, the Volatility Ratings assigned to the various series do not take this feature into account.

Historical Return

The different note series have exhibited a modest level of price volatility since inception. However, since July 2007, the market valuation of the DN portfolio has suffered from the significant spread widening affecting all segments of credit markets, even in the absence of any major credit event in the portfolio.

Monitoring

To maintain the Bond Fund Credit Rating, the company must provide Fitch with monthly information, including details of the portfolio's holdings, credit quality and transactions, and a risk management report. Information on portfolio holdings is also provided by the fund administrator.

Fitch analysts monitor the credit composition of the portfolio, the credit counterparties used by the manager and the overall market risk profile of the investments. Any changes in the approved list of counterparties, or in the credit quality or market risk profile of the investments, are monitored and approved by the agency.

Fitch Rating Definitions

Fitch's Bond Fund Credit Ratings range from 'AAA' (the highest) to 'C'.

The agency's Volatility Ratings range from 'V1+' (the most stable) to 'V10' (the most volatile).

Credit Quality Ratings

Fitch's Bond Fund Credit Ratings are an assessment of the security of a fund's invested principal and the ability to maintain a constant market value for the fund's shares. Ratings are based on an evaluation of several factors, including the credit quality, diversification and maturity of the assets in a portfolio, as well as management's strength and operational capabilities.

Funds rated 'A-' by Fitch comprise investments with appropriate credit levels and involve the use of counterparties of similar credit quality.

Bond Fund Credit Ratings do not examine any risk other than credit risk. In particular, these ratings do not address the risk of loss resulting from changes in market interest rates and other market conditions. Bond Fund Credit Ratings do not comment on the adequacy of the market price. Moreover, they do not address the extent to which fund expenses and costs could reduce distributions to shareholders. Bond Fund Credit Ratings are complemented by Volatility Ratings.

Volatility Ratings

Volatility Ratings provide an opinion as to the relative sensitivity of the total return (including price) of an investment vehicle to a broad array of assumed changes in interest rates, portfolio liquidity, spreads, exchange rates and other market factors. The Volatility Rating also takes account of leverage.

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