Investments at Scottish Life

INVESTMENT ADVISORY COMMITTEE

QUARTERLY MEETING

MINUTES OF MEETING HELD ON 24/2/09

Present	In attendance	Apologies
Mike Yardley Andy Carter Ewan Smith John Deane Andrew Barrie	Phil Mowbray (Barrie & Hibbert) Nick Leitch (Scottish Life) David Bird (Royal London) Robert Talbut (RLAM)	

ACTION

1. REVIEW OF MINUTES AND ACTION POINTS FROM MEETING HELD ON 26 NOVEMBER 2008

The minutes of the last meeting were approved.

NL confirmed that the minutes for the interim meeting which took place on 14th October had been circulated to the IAC.

An update on the action points arising from the meetings of 27/8 and 14/10 was provided as follows:

- RT confirmed that the tracking system is under review. The IAC asked RT to advise timescales, and agreed that a review of the risk budgets will be considered following this. RT

- Items to be covered in the meeting:
    - Fixed Interest fund benchmark.
    - Volatility of Corporate Bonds.
    - Life property fund structure.
    - JPM Japan.
    - UBS UK Equity.

- Enhancements to the investment proposition – NL advised that the new Scottish Life investment proposition was launched in January, and that customers invested in any of the Managed Strategy portfolios have received communications confirming the new strategic benchmarks and tactical positions.

2. REVIEW OF THE BENCHMARKS AND ASSET ALLOCATIONS OF THE GOVERNED PORTFOLIOS AND MANAGED FUNDS SO THAT THEY CONTINUE TO REMAIN SUITABLE

The key points that informed the IAC discussion were as follows:

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- During quarter 4 2008, significant changes in the financial outlook took place. Barrie and Hibbert advised that current gilt yields fell substantially by over 2%, whilst projected 'expected' yields in the future also fell. Short term inflation expectations reduced significantly, although long term inflation expectations actually increased. Corporate bond yield spreads increased significantly. It was also noted that current equity volatility was high (currently estimated at 21.6% for UK), although the longer term assumption is that equity volatility will gradually moderate to historic levels.

- The stochastic model was updated to reflect these new market conditions. The impact on asset class returns was, in summary, as follows:

    - Expected nominal returns from gilts and cash have fallen over both the short and long term.
    - Expected nominal returns for index-linked bonds have fallen over both the short and long term.
    - Corporate bonds have become relatively more attractive.
    - Expected real returns from equities are broadly unchanged, but in nominal terms have fallen. Due to the current high volatility, the risk associated with this asset class has increased in the short term.

- The "risk versus reward" analysis indicated that, over the timeframe for which the portfolios and funds are designed for;

    - The benchmarks and tactical positions for all nine Governed Portfolios continue to fall within their target ranges.
    - The benchmarks for all three Managed Funds continue to fall within their target ranges risk.
    - Of the four remaining Managed Strategy portfolios, three fell beyond their risk target and require further consideration (see below).

  It was noted that the analysis anticipates that, over the short term, the portfolios and managed funds are expected to have higher risk. This is due to equity volatility, which is currently high, but which is expected to moderate over time

  The IAC discussed the information provided, and made the following additional observations:

- There was agreement amongst IAC members that over the medium term, inflation pressure will emerge. Indeed the current economic measures being taken to revive the economy may, once they take effect, be difficult to moderate. For this reason the IAC believe it is appropriate for the portfolios to be designed with inflation protection in mind (and hence the benchmark will hold 'real' assets such as inflation linked bonds, equities and property rather than cash and nominal bonds). This judgement is in line with general market opinion.

  The alternative economic scenario is one where the economy enters a sustained deflationary period. This outcome would favour nominal assets. The IAC do not believe this will be the outcome due to the aggressive fiscal measures that are being taken across the world to reinvigorate the global economy. Nevertheless, the IAC asked that a 'stress test' be carried out to inform what the benchmarks might be under these alternative economic scenarios. DB and RT will identify scenarios, and B&H will provide analysis.

DB/RT/PM

- The IAC agreed that Corporate Bonds look relatively attractive. They believe that some of the extra yield is attributable to higher default rates and is therefore not 'added value'', but they also agreed that some of the extra yield is liquidity premium, and therefore represents 'added value' for long term investors. The tactical positions on the portfolio reflect this view, and the benchmarks also reflect this position. The IAC asked Phil to provide additional analysis on Corporate Bond yield spreads as background. **PM**

- The IAC asked for further analysis to be provided on the trend in equity volatility, and for analysis on how this may impact the four Managed Strategy portfolios. The IAC indicated that if the equity volatility is likely to remain high for some time, then it would be appropriate to change the strategic benchmarks for these portfolios.

NL

- It was noted that the current strategic benchmarks reflect the IAC's view that property is an illiquid investment, and a lower weighting for investors close to retirement is therefore appropriate.

The IAC concluded that:

- The current benchmarks and tactical positions continue to remain suitable.

- In light of the exceptional market conditions, the IAC should meet in circa 6 weeks time to review the results of the stress test.

3. SHORT TERM TACTICAL VIEW OF THE RLAM CHIEF INVESTMENT OFFICER

RT presented his short term tactical view:

It would be true to say that the economic news has been unremittingly negative in the early weeks of 2009. Data releases would appear to be signalling that this economic recession will be the worst for over 50 years. Not only will the slowdown be severe but there appears to be no hiding place, with both the developed and less-developed nations badly affected. At the same time, headline inflation numbers are falling rapidly with widespread expectations of negative inflation occurring later on this year. In turn, the corporate sector is experiencing a significant fall off in business, and the subsequent job losses - together with the constant stream of bad economic headlines - is leading to consumers taking a very cautious approach to any financial decisions.

However, policy response from both governments and central banks has continued to develop. Interest rates are trending in on close to zero and, in fact, the authorities are moving into gear certain 'unconventional' measures aimed at improving liquidity in many markets and even to start directly injecting liquidity into the economy. Governments themselves are combining further direct-stimulus measures, together with added assistance to the banking sector in order to improve the supply of 'credit' to both businesses and individuals who need it in order to offset some of the deleveraging process which is still seen as a longer-term necessity.

He explained that those who claim to see any sign of a gradual thawing in financial conditions are generally ridiculed, but believes that there are some modest signs that some improvements are flowing from the plethora of policy measures that have emerged over the last 18 months. For instance, money markets are working better and new issues are returning to the corporate bond market. In addition, the economic news is getting worse at a slower pace. All may be seen - in a few months - as marking the start of a long and gradual improvement in the outlook for economies.

RT advised that he remains of the view that at some stage in 2009 financial markets will start to take a little more confidence in the outlook, but predicting when this will happen is extremely difficult. However, given the degree of negative news flow and also the amount of cash which appears to be in circulation, his expectation is that when such an improvement occurs the rally in risk assets could be very sharp.

Therefore, his view is that it is appropriate to maintain an overweight position to both corporate credit and equities in the belief that both asset classes will benefit from any improvement in sentiment. Within equities, his recommendation is to retain an overweight position in overseas markets relative to the UK. While RT is of the view that the bulk of the relative loss of value in Sterling versus other currencies is over, he saw few reasons why the UK should dramatically outperform other equity markets. RT is of the view that it is appropriate to maintain an underweight position in property and while he thought that the bulk of the adjustment in values will have happened through 2009, his view is that any recovery will lag that from corporate bonds and equities. RT suggested an underweight in index-linked bonds as he saw these as being relatively richly valued at present. Cash levels, while modest, are all above the benchmark allocation.

4. SCOTTISH LIFE FUND REVIEW

Funds managed by RLAM

The following funds were identified as requiring follow-up action:

Fixed Interest pension fund – the fund invests in both Corporate Bonds and Gilts, and is measured relative to a 100% Gilt benchmark. The fund is below benchmark due to an underperformance of the Corporate Bond part of the fund. The IAC requested further analysis of the investments. **NL**

Duration bond funds – the IAC asked for a review of the benchmark calculation to be conducted. **RT**

Life Property fund – the life fund is small, and Andy explained that the direct property investment structure may need to be reviewed to ensure the most efficient approach. The IAC asked that the investment mandate is reviewed. **NL**

Matrix funds

The following funds were identified as requiring IAC discussion:

Close Teams – despite recent improvements in Q3 2008, performance worsened in Q4 2008. Commentary from the manager has been requested. **NL**

Schroder UK Equity – discussions with Old Broad Street Research confirmed that the track record since the new manager was appointed in 2007 remains solid, despite a poor Q4 2008 due in part to positions being affected by hedge fund selling. The IAC agreed that no follow-up action is required.

Invesco Perpetual UK Growth – Old Broad Street Research confirmed that they had met the manager in Q4 2008, and have maintained the suspended rating (as opposed to un-rating it). A follow up meeting is scheduled shortly from OBSR, and the IAC will keep this fund under watch. **NL**

Fidelity International – the fund outperformed in the last quarter, and the longer term (5 year) record remains strong. The IAC agreed that no follow-up action is required.

Invesco Perpetual International Equity – the longer term performance is disappointing and the IAC agreed that the fund should be placed on watch.

Investec Global Free Enterprise – discussions with Old Broad Street Research confirmed that whilst the investment process of the manager has struggled during current market volatility, the longer term track record remains solid, as does belief in the manager. The IAC agreed that no follow-up action is required.

Artemis European – This fund was downgraded by Old Broad Street Research in November 2008 from AAA to AA, to reflect the fragility in the process to identify stocks with good growth/value/revision upgrades and for this to be in sync with current short term market movements. Nevertheless the rating remains a strong one, and the IAC agreed that the fund would be reviewed and reported back in 6 months.

JP Morgan Japan – Following analysis and discussions with Old Broad Street Research, the IAC concluded that this fund should be replaced. The manager running the fund has a small and mid stock bias, during a period when large stocks generally outperformed. The IAC recognised that this will lead to fund underperformance, but importantly the analysis also identified concerns around the stock selection process and turnover levels within the fund. A replacement fund was identified and approved by the IAC, and details will be communicated in due course, subject to the completion of the fund due diligence process. **NL**

Other external managed funds

The following funds were identified as requiring follow-up action:

Baillie Gifford fund range – performance is disappointing and commentary has been requested from the manager. **NL**

Fidelity Special Situations – performance is disappointing and commentary has been requested from the manager. **NL**

Fidelity UK Growth – the fund manager changed in December 2007. Since then the fund has delivered above peer performance. The IAC agreed that the fund should continue to be reviewed and reported on in 3 months. **NL**

Invesco fund range – the IAC reviewed the recent performance and concluded that no follow up action was required.

Schroder Managed Balanced – performance over the short term is disappointing, whilst longer term performance is better. The IAC agreed that the fund should continue to be reviewed and reported on in 6 months. **NL**

UBS Managed – performance over a one and two year view is above peers, but recent performance has been disappointing. The IAC agreed that the fund should continue to be reviewed and reported on in 6 months. **NL**

UBS UK Equity – The fund changed manager and moved to a new team-based process in March 2008. Since then performance has been in line with the benchmark. The IAC agreed that the fund should continue to be reviewed and reported on in 6 months. **NL**

Societe General funds – the manager has recently announced that the UK operation will be sold to GLG, a European investment manager with a hedge fund specialism, and with limited UK presence currently. The IAC reviewed the performance of this range and discussed the recent announcement and its potential impact for customers. Further discussions with the manager will take place and an appropriate communication and notification process will be instigated to customers currently invested in these funds in due course. **NL**

5. ROYAL LONDON FUND RANGE

The following funds were identified as requiring follow-up action:

United Friendly Far East – the fund performance is different from the equivalent Scottish Life fund, and an explanation was requested by the IAC. **AC**

United Friendly Managed – the IAC asked for the reported benchmark performance to be reviewed for accuracy. **NL**

6. DATES FOR 2009 MEETINGS

Thursday 16 April at 1.00pm (Interim IAC meeting)
Thursday 21 May at 10:30am
Tuesday 25 August at 10:30am
Tuesday 24 November at 10:30am

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