Investments at Scottish Life

INVESTMENT ADVISORY COMMITTEE

QUARTERLY MEETING

MINUTES OF MEETING HELD ON 7/6/2010

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

ACTION

1. REVIEW OF PREVIOUS MINUTES

The minutes of the 23 February meeting were approved and the action points arising from the meeting were presented by NL.

- NL reported that PM's note on fund tracking error calculations had been reviewed, and that an updated spreadsheet has been developed to combine asset allocation and stock selection risk. This has been signed off by RLAM and B&H.
- PM confirmed that he had produced a report on the difference between the property and equity 10 year spot risk and return, and that this dealt with the query raised at the previous IAC meeting.
- RT advised that a composite benchmark for the United Friendly Managed fund had been created.
- NL confirmed that the JPM Premier Equity Growth Matrix fund replacement had taken place on 7th May 2010 – with the replacement fund being Cazenove UK Growth & Income.
- NL confirmed that following the significant change to the investment mandate of the Allianz RCM Global Equity fund, the intention is that this fund will be removed from the Scottish Life range during August. Appropriate communications will be issued to our customers.

Discussion on the following action points took place during the meeting:

- Property Pension Fund
- Life Property Fund restructuring
- Long Corporate Bond Fund
- The ex-ante fund risk report
- Invesco Perpetual UK Growth Fund
- Artemis European Growth Fund
- Fidelity International Fund
- BGI Funds
- RLAM FTSE 350 Tracker Fund
- Baillie Gifford Funds.

2. GOVERNED PORTFOLIOS AND MANAGED FUNDS – REVIEW OF BENCHMARK AND TACTICAL POSITIONS

The key points were:

Economic outlook and asset forecasts

- Since the last meeting, inflation expectations increased by around 25 basis points in one year's time, with greater increases over the medium term. Nominal gilt returns, a proxy for the risk free rate, fell over the short term, but increased over the medium term. The projected real return on index-linked bonds decreased. In a change from recent quarters, projected corporate bond returns have fallen.

- Equity volatility continues to moderate towards its long term historical level. The equity risk premium from equities is broadly unchanged. Overseas equities have become relatively more attractive than UK equities - this is due to the increase in expected UK inflation with knock on expected movement in exchange rates.

Risk targets

- All the governed portfolios and managed funds were comfortably within their benchmark risk targets, and the IAC decided that no changes were required.

- AB requested information on the historical performance of the portfolios and funds relative to the risk limits, and MY asked that a small review of the continued appropriateness of the tracking error limits be conducted. **NL**

3. SHORT TERM TACTICAL VIEW OF THE CHIEF INVESTMENT OFFICER

Robert Talbut confirmed that he was continuing to maintain the neutral position on the Governed Portfolios and Managed Strategies.

He reviewed Q1 2010 and presented his rationale for his current short term tactical view:

The first quarter of 2010 was certainly eventful with sharp moves in many asset classes in both directions as markets struggled to digest some very variable news flow. Early in the period the focus was upon good economic data which allowed many to build a case that the year would turn out to be pretty positive for risk assets as corporate earnings expectations were revised up. However mid quarter there was a sudden reappraisal prompted by some monetary tightening in China and rising concern over sovereign debt issues principally in Europe. The monetary tightening was seen as relatively limited and unlikely to scupper the global recovery. In addition as a result of some strong words from European policy makers financial markets took the view that the debt issues were sufficiently addressed and again switched back to looking at economic and company figures resulting in renewed strength from risk assets. In contrast, the property market saw further capital appreciation but at a slower pace than in previous quarters. It was also true to observe that buyer's interest and capital growth was almost entirely focused upon prime properties and that secondary stock was still seen as unattractive.

Through the first quarter of the year our asset allocation strategy was limited to further sales of equity and corporate credit in the early weeks of the year. This followed sales that we'd made in Q4 and reflected the view that the risks faced by the economy and market were more severe than was assumed by the consensus. Historically the second year of recovery is more problematic than the first and in today's case the debt issues which had caused the crisis had not been resolved but merely shuffled around. In *addition I took the view that there were sufficient uncertainties over the strength and duration of the recovery that scaling back the risk bet was appropriate.*

While April was another good month for risk assets May is currently turning into a very testing period. Sovereign debt issues have arisen again but to a greater extent than previously with contagion a present condition as policy makers appear to struggle to find lasting solutions. In addition there has been some further tightening of monetary policy outside of the developed markets and more recently some chinks in the run of universally positive economic data. Most recently the view is being expressed that the fears over sovereign debt may in itself cause some loss in economic momentum later in the year and into 2011. This then fuels the real concern that without relatively strong economic growth the prospect of any resolution of the debt overhang will be extremely challenging. As risk assets have come under pressure so government bonds have found further favour. The latest news from the property market is that activity is slowing again and that inflows into property funds have now dried up. This may well suggest that further capital appreciation from the asset class could be much more difficult for the remainder of the year. Commenting on the pending emergency budget scheduled for June 22nd, RT indicated that he would not anticipate needing to change his current asset allocation stance.

4. SCOTTISH LIFE FUND REVIEW

It was noted that the IAC fund governance review includes oversight of the new suite of funds launched by Scottish Life earlier this year.

Funds managed by RLAM

The following funds were identified for follow-up action at the next quarterly IAC meeting:

UK Mid Cap fund – Like the majority of funds in this sector, the fund is underperforming the index (although in absolute terms returns are strong, 51% in one year to end March). The reason for the underperformance is due to the concentrated nature of the fund relative to the index - due to current market conditions some mid cap companies are subject to takeover activity, and the index will benefit. The manager continues to avoid low quality highly geared recovery stocks and is comfortable with his holdings being positioned for a global recovery.

NL asked if there was any merit in combining this fund with a similar vehicle managed by RLAM – RT agreed to review. **RT**

Worldwide fund – Fund underperforming benchmark over 1, 3 and 5 years. RT to provide comment at next IAC meeting. **RT**

Long corporate bond – At the last meeting there was an action to consider ways to increase the duration of both the fund and the benchmark to 15 years. Rather than convene a special IAC meeting, it was subsequently decided that the most effective way to consider this was via discussions between RLAM and Scottish Life. RT reported that the conclusion was that SWAPs could be a suitable instrument to meet the duration requirement. The IAC asked NL to investigate whether the fund objectives allow the use of swaps, and also to confirm the requirement for the benchmark. **NL**

Bond funds – NL presented the results of an ex-ante fund risk review – the conclusion was that despite some extreme movements in recent years the risk profile of the Fixed Interest fund on a forward looking basis appeared to be reasonable relative to other bond funds within the range. The IAC asked that the fund be added to the wider check into the continued appropriateness of the tracking error limits. RT agreed to investigate the tracking error of the 10 year index-linked fund relative to its benchmark. **NL/RT**

The following funds were highlighted but it was agreed that no further action was required:

Pension property fund – The manager is reviewing opportunities and commented that there is a general lack of good quality stock available in the market currently at attractive prices. Helping slightly, two properties from the Long Term Fund have been transferred into this Fund which has benefited the Fund's overall income profile. The property team believe that the market will soften in H2 2010 and that this may present better buying opportunities later this year/early 2011. AC believes that secondary property will outperform prime property over a two year view. AC advised that two alternative benchmarks (that include cash) were reviewed but on investigation they are not suitable for purpose.

Index linked fund – Fund continues to be marginally below benchmark over 1 year.

Matrix funds

The following funds were identified for follow-up action or reassessment at the next quarterly IAC meeting:

Invesco Perpetual UK Growth – On 13 May 2010 OBSR reinstated an A rating (previously suspended A). OBSR have advised that whilst performance has been mixed since the new manager appointment in 2008, the manager has a longer track record managing a similar fund since 2003. The portfolio construction is influenced by the team's overall macro views which have been relatively bearish and this has contributed to the underperformance. After debate the IAC agreed that no action was yet required, and to review the fund again at the next IAC meeting. **NL**

Artemis European Growth – whilst short term performance has improved slightly, the longer term fund performance is poor. The fund is currently AA OBSR rated and OBSR continue to have a high opinion of the team and process. The manager uses a primarily quantative process and the success depends upon predicting market trends – but since the mid 2007 few clear trends have been evident. The fund was downgraded by OBSR from AAA to AA in Dec 2008 in recognition of the deterioration of the risk/reward profile and the fragility of the investment process during times such as these. Having met the manager early May, OBSR retain the expectation that the fund may outperform during trending market conditions, and have noted that during the past 9 months the process is starting to work again and performance has improved slightly. After debate the IAC agreed that no action was yet required, and to review the fund again at the next IAC meeting. **NL**

BGI funds – DB confirmed that he had reviewed and updated the box limits for these funds as part of the overall annual box review to ensure continued effective dealing process. NL advised that RLAM were conducting a review of the sources of difference between performance and benchmark, and agreed to report back to the IAC following the completion of this review. JD also requested an assessment report into the fund operational process for presentation at the next IAC meeting. **AC/NL**

The following funds were highlighted as "on watch" and will be subject to further detailed scrutiny at the next quarterly IAC meeting:

Artemis UK Special Situations – Fund is underperforming the index but peer performance remains stronger over the longer term. Fund continues to be AAA rated by OBSR. In April Artemis announced they intend to return to an owner management structure. OBSR do not anticipate that this will have significant impact on the way the funds are managed.

Schroder UK Mid 250 – Fund has suffered recently relative to index (whilst still gaining >50% in absolute terms in the year to end March 2010). Again the reason for the underperformance is due to current market conditions where the mid cap stocks find themselves ripe for takeover activity. If the manager does not hold the stocks that are being bid on then they miss out on specific share price increases. The fund remains AA rated by OBSR.

Fidelity International – Fund performance over short term has improved. Scottish Life met with Fidelity recently and the conclusion was that underlying fund is performing broadly in line with benchmark. The fund is monitored by SL using a 55/45 UK/Overseas benchmark making performance look slightly worse.

Investec Global Free Enterprise – Performance has improved over both 1 & 3 years but underlying fund still remains slightly below benchmark mainly due to 2008 performance. The fund is monitored by SL using a 55/45 UK/Overseas benchmark making performance look slightly worse.

Close Teams Global Equity and Close Global Alpha funds –The funds are now underperforming and a meeting is scheduled with manager for mid July.

The following funds were highlighted but it was agreed that no further action was required:

Invesco Perpetual International Equity – the fund recently changed name to Invesco Perpetual Global Equity. It was noted that this has been communicated to customers. It was also noted that the fund will now be managed by a newly formed Global Equity Group. Up until now the fund has been operating by setting asset allocation via a top down approach, and outsourcing the regional sub portfolios to the regional managers. In future the process will be driven from the bottom up, but all stocks will be debated by the Global Equity Group. The number of holdings within the fund is anticipated to reduce significantly from circa 300 to less than 100. OBSR have commented that they would expect the fund's risk level to remain broadly unchanged.

Other external managed funds

The following funds were identified for follow-up action:

Baillie Gifford fund range – Performance continues to be poor. The IAC requested that a meeting take place with the house to discuss. **NL**

Other Scottish Life funds

The following fund was identified for follow-up action:

Property Life fund – DB confirmed that the process to improve the structure of this fund to benefit from greater diversification was ongoing – he commented that some complicated taxation aspects were being worked through. **DB**

The following funds were highlighted but it was agreed that no further action was required:

European Life fund – It was noted that the fund was underperforming.

RLAM FTSE 350 tracker fund– AC confirmed that the deviation from benchmark was attributable in part to the impact of new stock issues within the index.

5. ROYAL LONDON FUND RANGE

The following funds were highlighted but it was agreed that need no further action was required:

RIL Property Life and pension funds – it was noted that the fund benchmark had recently been replaced, and these funds were now being reported on the same basis as other property funds in the range.

UFLA Index Linked Gilt - Fund is marginally below benchmark.

RLPPC Overseas Bond - Fund is marginally below benchmark.

6. DATES FOR 2010 MEETINGS

Next quarterly meeting is 24 August 2010 and then the 23 November 2010.

IMPORTANT IMFORMATION

Past performance is not a guide to the future. Prices can fall as well as rise. Investment returns may fluctuate and are not guaranteed.

All literature about products that carry the Scottish Life brand is available in large print format on request to the Marketing Department. Full details of Scottish Life branded products can also be obtained from the Marketing Department at Scottish Life, St Andrew House, 1 Thistle Street, Edinburgh, EH2 1DG.