INVESTMENT ADVISORY COMMITTEE (IAC)
QUARTERLY MEETING

MINUTES OF MEETING HELD ON 23/11/2010

Present	In attendance	Apologies
John Deane Ewan Smith Andy Carter Andrew Barrie Mike Yardley	Nick Leitch (Scottish Life) Helen Carter (Scottish Life) Peter Watts (Barrie & Hibbert) Emma Jones (Scottish Life) Scott Manson (Scottish Life) David Bird (Royal London) Robert Talbut (RLAM) Richard Romer-Lee (OBSR part only) Simon Molica (OBSR part only)	Phil Mowbray (Barrie & Hibbert)

ACTION

1. REVIEW OF PREVIOUS MINUTES

The minutes of the 24 August meeting were approved and the action points arising from the meeting were presented by NL.

- RT advised that on 9 September 2010 he had changed his tactical view to be underweight equity and property and overweight long dated gilts within Governed Portfolios and Managed Strategies. (Note: On 26 November an additional tactical change was made, to be also underweight index-linked bonds and overweight deposit)

- NL welcomed representatives from Old Broad Street Research (independent fund rating experts) to the meeting - Richard Romer-Lee, joint Managing Director and Simon Molica, Investment Research Analyst.

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

- UK/Overseas equity benchmark split
- Tracking error ranges.
- Historical risk/return of governed portfolios and Managed Strategies
- Long Corporate Bond fund
- Artemis European Growth
- Fidelity International
- BGI funds
- Close TEAMS
- Worldwide fund

2. Matrix funds

OBSR discussed their fund review process and how they apply this when rating or de-rating a fund. They then presented their conviction on specific funds previously highlighted as ‘on watch’ by the IAC, and a review of fund risk profiles.

An action was taken to add information on fund style bias into the reporting, and to include a note of other rated funds in the same sector. **NL**

After RRL and SM left the meeting, the IAC discussed and decided the following actions:

Artemis European Growth –The IAC decided at a previous meeting to replace the fund as they were concerned about the fragility of the investment process and the lack of any clear improved trend. The project team continues to communicate to existing investors & IFAs regarding the replacement. The new fund is AA rated and will be disclosed once existing investors are notified. **NL**

Fidelity International – Fund continues to underperform and has been identified for replacement. Work is ongoing to source a suitable replacement and a proposal will be presented at next meeting. **NL**

Investec American – The fund is concentrated and has a contrarian bias. Due to these factors, the fund has become more volatile relative to benchmark. The assessment was that it will remain more volatile than our appetite elevated for the foreseeable future, and that the appropriate action to ensure the risk profile is maintained is to replace the fund. Proposal will be presented at next meeting. **NL**

Schroder UK Mid 250 – Performance remains poor and the IAC had concern around the size of this fund in this area of the market. The IAC concluded that the fund should be replaced. A proposal for replacement will be presented at next meeting. **NL**

Invesco Perpetual UK Growth – Fund continues to underperform. Most of the underperformance stems from a previous fund manager and a poorly positioned portfolio when the credit crunch took effect. OBSR reapplied an A rating to the fund in May 2010. Whilst there were no suggestions that the fund would be replaced, the IAC requested a review other funds available in this sector to compare with the existing fund. **NL**

The following funds were highlighted as “on watch” and will be subject to further review at the next quarterly IAC meeting:

Invesco Perpetual Global Equity – Performance has worsened but only marginally underperforms the benchmark.

BGI funds – the review is ongoing and an update will be presented at next meeting. **HC**

Investec Global Free Enterprise – This fund had come off watch at last meeting but performance has worsened again. Sustained periods of high volatility have impacted this fund, but OBSR continue to AA rate the fund.

JP Morgan US – Fund performance has continued to worsen over 1 & 3 years. Market volatility has impacted the fund process. Detailed commentary will be sought from the manager. It remains AA rated by OBSR. **NL**

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

Close TEAMS – Significant improvement in fund performance across the funds particularly in UK. Global funds still need to improve but short term performance is encouraging.

Invesco Perpetual Japan – Fund was brought on as a replacement for JPM Japan. Long term track record of the fund is still affected by the original JP Morgan Japan. Over the quarter performance has worsened in the short term but as this fund is specialist, volatility within the fund performance is expected.

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

The key points were:

Economic outlook and asset forecasts

- Since the last meeting projected medium term inflation has decreased. There has been a slight fall in medium term nominal gilt returns, a proxy for the risk free rate. Corporate bond returns have fallen in line with nominal gilt returns. There has been a modest decrease in the credit risk premium.

- Short term equity volatility reduced, less so for longer horizons. B&H advised that this had no significant impact on the Governed Portfolios. The equity risk premium is broadly unchanged. Expected overseas equity returns have fallen relative to UK equity returns, due to expected appreciation of Sterling.

- EFS asked about the impact of a negative real yield on index linked gilts, as recently experienced in the US. B&H will investigate the impact of this on their model and report back to IAC. **PW**

Benchmark Analysis

- It was noted that all the Governed Portfolios and managed funds are within their benchmark risk targets, and the IAC confirmed that no changes were required.

Tactical Analysis

- The tracking errors remain comfortably within the risk budgets for the portfolios.

- NL presented analysis on the risk budgets of each of the Governed Portfolios and how they relate to each other. Overall risk budgets are coherent and they currently provide a reasonable level of freedom. The IAC requested that this analysis be repeated periodically to continue giving comfort that the risk budgets are appropriate. **SM**

- SM presented a review of the past performance and volatility of the Governed Portfolios and Managed Strategies. On the whole, portfolios have performed as desired.

- NL presented analysis on the continued appropriateness of the UK/Overseas equity split. The conclusion was that the current 55% UK/45% Overseas equity split was an efficient allocation, i.e. based on the Barrie and Hibbert analysis it is not possible to improve returns to any significant degree by adjusting this split without introducing extra risk.

- NL presented further analysis on introducing an explicit allocation to Emerging Markets equity. This concluded that there would be only a negligible improvement to the risk/return trade-off, and only at higher levels of risk from that currently taken within the equity portion of the portfolios. The IAC concluded that the current 55% /45% equity benchmark split should be maintained.

3. SHORT TERM TACTICAL VIEW OF THE CHIEF INVESTMENT OFFICER

"RT reviewed quarter three and presented his rationale for his current short term tactical view:

The third quarter of the year was essentially becalmed for most of the period before the start of a rally in risk assets which started in late August but continued through September which turned into one of the strongest months for equities in quite some time. The earlier quieter period saw the now familiar balance between uncertainties over the economic data and the likely future trend countered by decent corporate earnings news.

Through August, bonds continued to rally (yields fall) as fears on deflationary risks increased while equities were volatile, driven by short term views on the back of the latest economic release. Within the UK news flow was further supplemented by speculation on the location and extent of the Governments spending cuts and what effect these may have upon activity levels in 2011. However the mood in the latter stages of the quarter changed as various speeches out of the US Federal Reserve convinced the markets that another dose of Quantitative Easing was being planned given that growth was insufficiently quick in order to reduce unemployment and that inflation was too low. Interestingly while the previous dose of QE was specifically designed to alleviate a severe liquidity crisis within the banking sector, this latest amount appeared much more focused upon simply attempting to raise asset prices and also lowering the exchange rate. Many would say therefore that monetary policy has crossed the Rubicon in terms of its usage within the economy. While economists disagree as to whether such a policy will actually work, there is very real debate as to how much more of QE is needed and what will be its impact upon asset prices, inflation and the economy more generally.

It is also interesting to hear the near universal chorus of approval that greeted QE1 being replaced by near universal criticism of QE2 from other countries and particularly their central banks. Within financial markets risk assets have responded favourably to the announcement while bond prices have started to sell off (yields rising). It does appear that many within government bond markets are concerned with the deliberate targeting of higher inflation and whether this might get out of hand. There can certainly be no guarantee that the US consumer will restart spending or that the housing market will turn given the still relatively poor fundamentals that still exist and hence it remains doubtful whether growth will appreciably pick-up. If this was to be the case it is very unclear as to whether we would then be presented with QE3 or some other policy. Whatever the case, we now have the prospect that over the next 6-9 months the Federal Reserve will be monetising the budget deficit. A further fly in the ointment is the fact that we now have a split US government which probably means that fiscal policy will at best remain on hold irrespective of the economic growth outlook.

Outside of the US the emerging nations including many in the Far East have performed the best benefiting from their superior structural and fiscal fundamentals and the ultra-loose US monetary policy. Within Europe the overall growth improvement has masked an increasing divergence between in particular Germany and an increasing periphery of countries with the former doing well but with the latter barely growing at all. It will be interesting to see how sustainable this is or whether the regular bouts of periphery sovereign problems will at some stage lead to wider problems.

Throughout this period the managed funds have maintained a relatively cautious asset allocation stance. The view remains that we are not at the start of a new strong upswing in risk assets due in large part to the fact that the underlying issues which caused the credit crisis have still not been rectified. Therefore we still foresee periods of optimism and pessimism continuing to dominate. In sum we remain overweight cash, have an in-line position in corporate credit and are underweight equities and property. The latter has continued to see the wind taken from its sails as the yields on ultra-prime assets have fallen but with little or no demand for anything of a secondary nature. Our off-benchmark bet in long *bonds remains in place as a partial hedge against many of the risks which still remain within the economic outlook."*

RT advised that he was proposing an additional tactical change (effective 26 November) to be also underweight index-linked bonds and overweight deposit. NL confirmed that the tactical changes had been assessed as still within the agreed risk budgets.

4. SCOTTISH LIFE FUND REVIEW

Funds managed by RLAM

Governed Portfolios – The portfolios are underperforming over the short term but are outperforming over three years. RT advised that the recent underperformance is due to the allocation to Far East and Europe within the Global Managed fund, and the underperformance of the Property fund.

The following fund was identified for follow-up action at the next quarterly IAC meeting:

Long corporate bond – Information was presented to the meeting on the use of interest rate and credit derivatives to achieve the required duration exposure. The IAC requested that further work be conducted to review any risk associated with using derivatives and how this might impact the fund. **DB**

Worldwide fund – at a previous meeting RT confirmed that fund has a relatively conservative geographical mix and has suffered due to lack of emerging market exposure. NL also advised that any cash balance should only be used for liquidity, although it was agreed that alternative approaches would be investigated. **NL/RT**

NL confirmed that should RT require exposure to emerging markets in Worldwide, Global Managed, Global Equity or the Managed Funds, Managed Strategies and Governed Portfolios, Exchange Traded Funds (ETFs) could be used to achieve this as part of efficient portfolio management.

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

Property fund – fund continues to underperform benchmark over 1, 3 and 5 years but the team have made significant moves to address this. The cash balance within the fund has been significantly reduced through recent property purchases, and the new purchases have been focused in the primary market to address the secondary bias to the portfolio. Other work also continues to improve the tenant grading and void rates within the fund.

American fund - the tracking will be reviewed. Report to be presented at next IAC meeting. **NL/RT**

Other external managed funds

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

UBS UK Equity – Fund continues to underperform over 1, 3 and 5 years. Detailed commentary to be sought from manager. **NL**

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

UBS Managed Equity – Performance has worsened and is slightly under benchmark over 1 & 3 years.

Fidelity Special Situations Blended – Fund performance has weakened and is slightly under benchmark over 3 years.

Other Scottish Life funds

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

American life fund – Fund performance is below benchmark over 1, 3 & 5 years. The tracking will be reviewed in line with pension fund version

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

Property life fund – The assets within this fund switched into the bigger SL Property Pension Fund with effect from 1 Nov 2011, in order that the fund benefits from more diversification by accessing a wider pool of assets.

European life fund – Fund performance is below benchmark over 1, 3 and 5 years. RT confirmed the fund has a conservative approach to stock selection, and the fund held little exposure to low quality cylical stocks which have recently outperformed.

Pacific life fund– It was noted that the fund is marginally below benchmark over 1, 3 and 5 years.

5. ROYAL LONDON FUND RANGE

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

UTD Friendly Life UK Fixed Interest – Fund is marginally below benchmark over 1 and 3 years.

RIL Property Life and pension funds – Fund below benchmark over 1 and 3 years for the same reasons reported for the pension fund.

UFLA Index Linked Gilt - Fund is marginally below benchmark over 1 and 3 years.

UFLA Life Fixed - Fund is marginally below benchmark over 1 and 3 years.

UFLA Pension Managed – Fund has underperformed the benchmark over 1 and 3 years.

6. AOB

MY requested the terms of reference for the committee be reviewed to ensure Scottish Life expert input into the process is appropriately documented. **NL**

7. DATES FOR 2010 MEETINGS

Next quarterly meeting is 1 March 2011.

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.

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