INVESTMENT ADVISORY COMMITTEE (IAC)
QUARTERLY MEETING

MINUTES OF MEETING HELD ON 29/11/2011

SCOTTISH LIFE

Present	In attendance	Apologies
Phil Loney John Deane Andy Carter Ewan Smith Julius Pursaill Colin Taylor	Nick Leitch (Scottish Life) Lorna Blyth (Scottish Life) Scott Manson (Scottish Life) Graham Carson (Scottish Life) Robert Talbut (RLAM) David Bird (Royal London) Phil Mowbray (Barrie & Hibbert) Peter Watts (Barrie & Hibbert)	

ACTION

1. NEW INVESTMENT ADVISORY COMMITTEE MEMBERS

Following the stepping down of Mike Yardley and Andrew Barrie as members of the Investment Advisory Committee, John Deane welcomed three new members at the November 2011 meeting. All three new members bring with them a wealth of experience within the UK financial services industry and will provide valuable, expert input to the Investment Advisory Committee discussions:

- Phil Loney (Group Chief Executive, Royal London Group)
- Julius Pursaill (Independent Member)
- Colin Taylor (Independent Member)

Details of the new members can be found on the Scottish Life website.

2. TERMS OF REFERENCE

The terms of reference were discussed and approved, subject to a few minor changes. Final version to be circulated post-meeting. Further review to be held in 6 months. NL

3. ANNUAL EVALUATION OF IAC

NL presented the annual evaluation paper. There were a number of actions agreed going forward :

- Meeting actions would be issued with a timetable to track progress.
- IAC papers to be issued one week before each meeting and pre-meeting briefings will be held as required.
- The minutes are to reflect the Scottish Life proposition only and separate minutes will be produced for Royal London funds.
- Details of website traffic to the IAC pages to be included in the report.
- Impact on customers of previous governance decisions to be monitored
- Register of interests to be included in the report. LB

4. REVIEW OF PREVIOUS MINUTES

The minutes of the 23 August meeting were approved and the action points were presented by NL.

The following actions are carried forward:

- Data for the difference in asset allocation of the Managed Funds and Governed Portfolios to be checked. RT/DR
- Review of Close Teams and Fidelity International. LB
- Process to calculate benchmark performance for duration matched gilt funds to be reviewed. SM
- RLAM to circulate a paper explaining their long-term house-view of the economic outlook and asset class returns RT

The following actions were completed following the previous meeting:

- Analysis showing the benefit of holding Governed Portfolios during the recent period of high market volatility was circulated.
- An update was provided by the unit linked committee with regard to the box management process, and a further update will be discussed at the next meeting. JD

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

- SL Property pension fund
- Invesco Perpetual UK Growth
- Duration matched corporate bond funds
- Impact of previous governance decisions on customers
- SL/Bailie Gifford High Yield Bond
- SL/Fidelity Special Situations Blended
- Index Linked life fund restructure
- SL FTSE 350 tracker

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

The key points were:

Economic outlook and asset forecasts

- In general there was a large reduction in the expected nominal and real returns for all major asset classes over a ten year horizon. Inflation expectations have also fallen on a short and long-term outlook.

- Expected US inflation has decreased more than UK inflation, implying an appreciation of the US dollar against sterling. In turn this has increased the relative returns of overseas global equity against UK equity.

- Projected equity volatility over the next couple of years is forecast to be high, but is expected to moderate back over the longer-term.

Benchmark Analysis

- There were no changes recommended to the Governed Portfolio and Managed fund benchmarks however this wasn't a straightforward conclusion and there was much discussion around the following factors.

    1. Expected returns from index linked bonds have worsened relative to other assets and a switch into corporate bonds was discussed. However the IAC agreed not to recommend this because :
        - the potential extra return from doing so would be small;
        - the efficiency measure is very sensitive to small changes in the relative risk and return of different asset classes and there is a risk that the situation could quickly reverse or become insignificant;

- index linked is strategically important and provides protection against inflation and the IAC believe it would be inappropriate to remove this protection in pursuit of slightly higher returns.

2. Projected real returns from all portfolios have reduced however this does not represent an increase in the risk faced by an investor relative to the risk free asset.
3. Expected short term volatility has increased significantly although this does not affect the long term risk position.

The IAC debated methods that might be used to control benchmark volatility over the short-term. A paper with recommendations will be prepared. SM

The IAC requested a review of the potential of other asset classes to be included within the portfolios. SM

Tactical Analysis

- RT made a tactical change on 15 September 2011, reducing the overweight position in risk assets (equities & corporate bonds) and reducing the underweight position in index linked gilts and property. As a result the estimated tracking errors against benchmarks have reduced and are within risk budgets.

6. SHORT TERM TACTICAL VIEW OF THE CHIEF INVESTMENT OFFICER

RT reviewed Q3 2011 and presented his rationale for his current short term tactical view:

“The third quarter of 2011 was dominated by market participants views on the actions or probably more pertinently the inaction of policy makers in both the US and Europe. Focus early in the period centred around the ability of the US administration to agree a deal to raise the ceiling on US debt and hence prevent a ‘shut-down’ of government and potentially a default on US debt. The decision ultimately went right up to the wire exposing the very deep differences between the political parties which encouraged the view that the ability for the US to bring forward any additional measures to assist the economy were very unlikely at least until the Presidential elections at the end of 2012. The belief in policy paralysis contributed to the rating agencies reducing the US’s rating below AAA. In financial markets that understood the importance of full engagement from policy makers and with investor confidence shaken by the perceived lack of safe havens these events led to sharp falls in risk asset markets to the benefit of certain government bonds which were considered low risk (perhaps perversely this included the US).

For the remainder of the quarter the epicentre for the belief in insufficient and/or poorly thought through responses shifted to Europe. Through the period we saw a series of events ranging from governments struggling to devise restructuring measures, to fiscal deficits not falling as quickly as planned and open disagreement between policymakers as to the best way to address the unfolding events. The net result of all of this was a leeching away in confidence in European policy makers ability to provide a lasting solution to their sovereign debt crisis which was manifested in higher borrowing costs for an increasing number of peripheral countries. Ultimately investors questioned the sustainability of the current situation with Greece very much in the eye of the storm.

The increasingly problematic situation in Europe led through the quarter to market moves which reflected investors complete focus upon buying any asset which they considered to be safe while scaling back exposure to anything they considered risky. Hence we saw the 10-year bonds of safe governments at around or below 2%, we saw the virtual elimination of any real yield on UK index-linked securities while certain countries were having to pay 9%+ on their bonds. The period also saw weakness in corporate bonds and equities even though company finances remain extremely strong and trading in most instances is also resilient.

Our view remained that the stresses within the European system would have brought about a more marked policy shift. While we understand the arguments in favour of restructuring within a number of European economies we take the view that this had to be accompanied by far more assistance from the ECB through buying government bonds and therefore lower borrowing costs so creating the conditions more likely to create a sustainable situation. Clearly through Q3 this change in policy was not forthcoming and our portfolio positioning was not correct given the rising degree of risk aversion. However we retain the view that such a change will occur but judging when is still very uncertain. All we can say is that the pressure from both within Europe and from outside is growing almost daily. In addition we would question whether government bonds in the supposed 'safe' haven actually do provide the degree of insulation from risk that is reflected in their pricing given the difficulty of reducing fiscal deficits. The reality of lending money to the UK government for almost any time frame for a guaranteed real loss which would occur if we purchased IL gilts does not represent sound investment to us and would seem inconsistent with the objectives of the Governed Portfolios. Clearly there are risks that the uncertainties perpetuate and that investors continue to seek refuge in government bonds, but any change in policy would make these assets poor value especially given that company finances appear far superior to those of governments.

In light of the uncertainty of timing, the tactical position was moderated in September, but overall continues to remain positioned overweight risk assets and underweight index-linked gilts and property. "

7. SCOTTISH LIFE FUND REVIEW
Funds managed by RLAM

Far East ex Japan – Performance over 1 and 3 years remains poor, with fund under benchmark by 15% over 3 years. 5 year performance remains strong. It was recommended that this fund remains on watch and comment should be sought from the fund manager. RT

Property fund – Fund performance over 1 year has improved significantly with the fund now 14th percentile relative to peers over 1 year. It was agreed in the meeting to change the benchmark used for comparison purposes. The fund is currently benchmarked against the IPD UK All Property Monthly Index – this index does not include a cash element or any charges in relation to property purchases or disposal. Going forward performance will be shown against the ABI UK Direct Property sector average which includes elements of both of these items. LB

Corporate bond fund and duration matched corporate bond funds – investigation ongoing to the difference in performance. RT/DR

Duration matched gilt and index-linked funds – The duration matched gilt funds are under benchmark and the short and medium index linked gilt funds are also under benchmark over three years. There is an outstanding action point from the previous meeting to seek comment from the fund manager. RT

The following funds were discussed but no action was taken:

SL Managed funds and Governed Portfolios – Due to the overweight position in risk assets and the equity fund, it was noted that one-year performance is below benchmark to end September 2011 .

Matrix Funds

Invesco Perpetual UK Growth – Performance continues to improve and for the one year period to end of September is 7th percentile amongst its peers. The fund retains it OBSR A rating and ✪✪✪ Morningstar rating. It was decided to remove this fund from watch.

First State Global Emerging Markets Leaders – Performance against benchmark for this fund has been very strong. However the IAC noted that volatility of this fund was high given the expected risk profile, and this will be discussed with OBSR. GC

It was noted that two fund replacements had recently been made – Schroder UK Mid 250 with Franklin UK Mid Cap, and Investec American with Fidelity American.

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

Henderson (previously Gartmore) Emerging Markets Opportunities - Fund performance is below benchmark over 1 year but substantially under over 3 year period. The fund has recently been downgraded from OBSR AA to single A following a period of underperformance and team changes that have impacted upon the Asian component of the fund. Fund placed on watch. GC

Investec Global Free Enterprise – It was recommended at the last meeting that this fund should be removed from watch. However since then fund performance has worsened and the fund is under benchmark over 1, 3 and 5 years. The fund is part of our Specialist offering so high volatility should be expected. The fund retains its OBSR AA rating. GC

Net cash flow data – The IAC requested that the net cash flow data shown in the report separates tactical movements from new customer money and shows fund values/flows in respect of GPs and Managed funds. GC

Other external managed funds

SL/Baillie Gifford High Yield Bond – The reported underperformance at the last meeting was attributable to an incorrect benchmark within the reporting system – this has now been corrected.

SL/Fidelity Special Situations Blended – The Fidelity Special Situations Blended fund invests in two underlying funds, the Fidelity UK Special Situations and Fidelity Global Special Situations funds. Both of these underperform their respective benchmarks over 1, 3 and 5 years. The UK fund performance has been held back by its overweight position in banks, while the global fund has been held back by its position in energy services. The fund manager has lowered exposure to the mining sector in view of the uncertain demand outlook and increased exposure to US healthcare stocks. The IAC decided the fund should be placed on watch and comment will be sought from OBSR and a recommendation proposed. LB

SL/GLG Stockmarket Managed – Performance is disappointing with the fund under benchmark over all reported periods. Fund placed on watch and comment to be sought from the fund manager. GC

Other Scottish Life funds

Index linked life fund – This fund is being discussed outwith the IAC. An update will be provided at the next meeting. EFS

European Life fund – Performance remains under benchmark over 1, 3 and 5 years. Robert Talbut to provide comment. RT

FTSE 350 Tracker – Investigation into the tracking against benchmark continues. RT

FTSE 350 Managed – The fund is below benchmark over 1 and 3 years, but around benchmark over 5 years. Comment from the manager will be sought. GC

Property fund – A review of the performance of this fund versus the equivalent pension fund was requested. DB

8. IMPACT OF PREVIOUS GOVERNANCE DECISIONS

At the last meeting it was agreed that the IAC report would review the impact of previous IAC Matrix Governance decisions. The following 3 fund replacements were discussed:

Neptune European Opportunities (replaced Artemis European Growth) – since replacing the Artemis European Growth fund on the 2nd May 2011 the Neptune European Opportunities has significantly outperformed its predecessor.

Cazenove UK Growth & Income (replaced JPMorgan Premier Equity Growth) – since replacing the JPMorgan Premier Equity fund on 3rd May 2010 the Cazenove fund has outperformed its predecessor.

Invesco Perpetual Japan (replaced JPMorgan Japan) – since replacing the the JPMorgan Japan fund on 10th October 2009, the Invesco Perpetual Japan fund has significantly underperformed its predecessor. This fund remains on watch.

Fund Size Data – details of fund size at point of switch to be added to report. GC

9. DATES FOR 2012 MEETINGS

Next quarterly meeting is 6th March 2012.

Please note that the full minutes of the Royal London Investment Advisory Committee meeting have been split into two sections. These minutes relate to the Scottish Life funds.

IMPORTANT IMFORMATION

Past performance is not a guide to the future. The value of an investment can fall as well as rise and you could get back less than the amount paid in. Statements about future performance are based on our own forecasts and should not be relied on as giving any indication of future return.

5M1123 December 2011