INVESTMENT ADVISORY COMMITTEE (IAC)
QUARTERLY MEETING

MINUTES OF MEETING HELD ON 12/3/2012

Present	In attendance	Apologies
Phil Loney John Deane Andy Carter Ewan Smith Julius Pursaill Colin Taylor	Nick Leitch (Scottish Life) Robin Herd (Scottish Life) Scott Manson (Scottish Life) Graham Carson (Scottish Life) Robert Talbut (RLAM) David Bird (Royal London) Peter Watts (Barrie & Hibbert) Richard Romer-Lee (OBSR) Simon Molica (OBSR)	

ACTION

1. OBSR

Richard and Simon from OBSR provided an overview of their ratings process, their assessment of the funds on watch within the Matrix range, and an overview of the benefit of the Morningstar tie-up. There was a short opportunity for Q&A. Julius and Colin asked to visit OBSR to follow up on the conversation, and this will be arranged. RH

2. REVIEW OF PREVIOUS MINUTES

The minutes of the 29 November meeting were approved and the action points were presented by NL.

- NL advised that the actions recommended from the annual evaluation were in place, and working well. In particular; a project task list had been issued; a summary paper for the executive group had been submitted; the minutes had been split into two to separate out the wider Royal London fund range; and a pre IAC meeting briefing had taken place.

- NL confirmed that the updated terms of reference had been circulated. JVD advised a small change to the reporting lines for various Royal London committees. Terms of reference to be reviewed and re-circulated. JD/NL

- NL advised that the standard conflicts of interest declarations had been received back from Colin and Julius. Julius asked for some clarification on what should be recorded, and may provide further information in light of this. JP/CT

- Unit Linked Committee (ULC) review – HC gave an update on progress with regard to the ULC box management process. Work is still progressing and further update to be provided to IAC by 31 March 2012. HC

- NL advised that the RLAM proposal to restructure the Index-linked life fund to an OEIC structure had been rejected on the basis that it was not clear that it would generate a benefit to customers versus the current, directly invested, structure.

- NL confirmed that there was a straightforward explanation for the difference between the Life and pension property fund performance –the merger of the life and pension funds on 1 November 2010 for diversification benefit resulted in the life fund changing from bid to offer basis, with a resultant increase in value.

- A review of the asset allocations of the managed funds against the governed portfolios concluded that the impact was modest and that no change to the process was recommended. Regular reporting will be added into the report. SM

- Updates for IAC sub-funds will be provided at the next meeting.

- The action to review the benchmark calculation approach for duration matched bonds is carried forward to the next meeting.

- NL confirmed that the Matrix replacement data in the report had been enhanced as requested. Work was ongoing to update the report to include net cash flows separating out tactical cash flows. GC

- Latest stats show that the IAC communications are regularly viewed by more than 2,500 advisers. It was also highlighted that the Scottish Life Governed Range won the Corporate Adviser Ultimate Default Fund for the third consecutive year.

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

- Governed Portfolios
- SL property pension fund
- Duration matched corporate bond funds
- SL/First State Global Emerging Markets Leaders
- SL/Fidelity Special Situations Blended
- SL/GLG Stockmarket Managed
- SL/Close Teams
- SL/Fidelity International
- SL/Investec Global Free Enterprise
- SL FTSE 350 tracker

3. GOVERNED RANGE REVIEW

Benchmark analysis

No changes were recommended to the Governed Portfolio and Managed Fund benchmarks this quarter. This recommendation was supported by additional analysis and a pre-IAC meeting,

- Governed Portfolios 3, 6 and 9 (the short-term portfolios) were highlighted for review - the IAC agreed that it was appropriate to maintain the exposure to index-linked bonds to provide inflation protection for customers at a time of uncertainty around future inflation.
- All the portfolios remain within or close to, their target risk ranges. It was noted that the forecast medium term volatility of all the portfolios decreased over the quarter (to end 31/12/11). Driven by a reduction in forecast short term equity volatility, and a reduction in forecast nominal and real returns. It was noted that inflation expectations for the medium term had increased since the last meeting,

Tactical analysis

All portfolios remain within their tactical risk budgets.

- Robert Talbut made a tactical change on the 1st of March, reducing both the overweight in equities and the underweight in index linked. These changes bring the asset allocation closer to the strategic benchmarks, and therefore reducing the estimated tracking errors.

Additional analyses

At the last IAC meeting, Scottish Life were asked to review various points:

1) Past performance of the Governed Range

Since launch all of the portfolios have delivered returns after inflation of 7-8% p.a.

2) What could the impact be of holding index-linked bonds versus corporate bonds within the benchmarks?

   A paper was presented to inform the IAC about the impact of holding index-linked bonds within the benchmarks. Informed by B&H data, the analysis brought to life the impact of the returns from differently constructed portfolios (holding corporate bonds versus holding index-linked bonds) under varying inflation scenarios. The likelihood of the scenarios arising was considered both on a market consistent view, and also based on Royal London's in-house view. After reviewing the outcome of this analysis it was clear that the return variance across the portfolios was marginal under most central views of inflation, and that only in extreme low or high inflation scenarios would larger differences arise with index linked bonds expected to perform better in high inflation scenarios– the IAC agreed with the conclusion from this work which was that inflation risk is skewed to the upside, and that there was strong evidence to support holding index-linked within the benchmark portfolios.

3) What is the appropriate response in light of a spike in short term volatility?

   In the second half of 2011, forecast short term equity volatility increased significantly above trend. This caused the forecast 1 year risk measure for the governed range to also increase. However the key point is that the portfolios are designed for pension customers with longer investment horizons – and that over these longer periods, the forecast volatility remains within the target ranges. The IAC concluded that the risk control is working effectively. It was noted that the historical data showed that significant spikes in short term volatility has tended to be temporary, quickly reverting to longer term trends – and that the impact on 5, 10 & 15 year volatility has been minimal.

4) Do the tactical risk budgets continue to be appropriate?

   The IAC conducted a review of the risk budgets around tactical decisions to test the effect of volatility. Scottish Life researched how taking a high risk tactical position affected the overall risk of the portfolio and how this changes as volatility changes. The review demonstrated that the tracking error framework was robust – it results in 'desirable' risk control features such as the maximum allowed tactical position reducing, as volatility increases. It also gave rise to a constant and small increase in "value at risk" across the varying market conditions. The IAC agreed that current risk budgets continue to be appropriate.

5) What is the optimal UK/overseas equity benchmark split?

   The IAC researched the effect of changing the allocation between UK and Overseas equity on the overall risk and return profile of the Governed Portfolios. They looked at the full range of possible asset allocations from 100% UK to 100% overseas equity and plotted the outcomes on a risk vs return chart. The analysis demonstrated that on the long term forecast the current 55:45 split continues to correspond to the efficient point where risk is at its lowest for the optimal return. No change was therefore recommended to the current split. The IAC requested further analysis to understand whether currency hedging of the overseas equity component would have any impact. SM

6) Should we add new asset classes into the benchmark?

   The IAC reviewed the impact of investing in alternative asset classes including commodities, emerging market equity, private equity, hedge funds and emerging market debt. The research started with the latest B&H data for these asset classes, and involved constructing new efficient frontiers including the new asset classes and comparing them to the current frontiers projected over short, medium and long investment horizons. Over the current range of target volatilities there was no material difference to the returns on each frontier and any extra returns that could be generated carried extra levels of risk. The IAC requested further research into other asset

classes such as infrastructure and to extend the analysis beyond 15 years to see if this changed the conclusions in any way. SM

4. SHORT TERM TACTICAL VIEW OF THE CHIEF INVESTMENT OFFICER

RT reviewed Q4 2011 and presented his rationale for his current short term tactical view:

"After an extremely difficult third quarter of the year driven by concerns over debt sustainability in the US and Europe as well as relatively poor economic data the fourth quarter was far better. There were a number of factors behind the improved environment for risk assets. Firstly, the economic data out of the US showed signs of improving trends in employment and overall business confidence. Given the fact that analysts were worried about a continual deterioration this helped to reassure. Secondly, we had signs out of some of the emerging economies, and in particular India and China that they were to start upon a path of monetary easing having tightened fairly significantly through 2010 and 2011. Thirdly, markets believed they saw signs that the plans to stabilise the economic and monetary situations throughout Europe were moving into a new phase. While there was still much talk around the need for further austerity measures there was also the start of thoughts turning to how the overall European economy was going to return to some improved growth path. Fourthly, the US central bank projected that interest rates would remain at effectively zero for the next 3 years. And lastly we had the announcement from the Bank of England of their intention to buy more gilts in the marketplace as a way of helping the UK economy. However we believe that the most significant shift occurred when the ECB announced that it was prepared to offer the banking system effectively a limitless amount of 3 year funding at a rate of only 1%. This appeared aimed at the situation where the banks were struggling to find funding in the open markets which was causing an intense retrenchment of balance sheets and a growing 'credit crunch'. Thankfully the ECB recognised the problem and moved to head off the problem that was likely to mushroom in 2012 given the amount of funding that banks were due to rollover.

While this was not the direct funding of governments that we had thought was going to be necessary to try and alleviate the European crisis it did remove quickly the risk of severe problems for the banking system which was at the nexus of the problem and therefore was seen as removing significant 'tail risk' from financial markets. This was bolstered by the encouragement to banks to use some of the funding to buy government bonds (and hence drive down governments funding costs) and the promise that another round of funding was to be made available in February 2012. Lastly there appeared to be further moves towards trying to provide a next stage funding program to Greece which was seen as at the biggest risk of being forced out of the Euro with unknown consequences.

The combination of some improvement in economic data but particularly from a growing sense that the authorities were embarking on further monetary injections into the global economy led to an increased risk appetite and equities started upon a strong upward move through November and December. Corporate credit also started to perform much better and there was a mild sell off in government bonds. It was interesting to see that the size of the sell-off was quite mild given the rising optimism which may be explained by the fact that many investors feel compelled to hold onto government bonds for regulatory and liquidity reasons which will continue to limit any price falls irrespective of 'fundamental' pricing views.

This improved appetite towards risk continued into 2012 helped by another deal regarding Greece finances, some improved economic data and the continued amounts of excess liquidity in the system. Through the fourth quarter we did not alter our asset allocation stance remaining overweight equities and corporate bonds and underweight index-linked and property as this was appropriate given the improved tone to financial markets.

Of course after such a strong move in risk assets the key question is whether this heralds the start of a more sustained rise accompanied by a return to healthy rates of economic growth. Our view is that given the persistence of still very significant imbalances in the global economy and the continual need for deleveraging in many developed economies that the fundamental outlook, despite the continual injections of money into the system, is still one of heightened uncertainty over economic and financial market conditions with the most likely pattern remaining one of periods of strength and optimism followed by relapses and fears over the degree to which the excesses which lead to the credit bust have been adequately addressed."

With this in mind, RT took the decision to crystallise some of the profit from his previous overweight position in risk assets, when he made a tactical change on the 1st of March. This had the effect of reducing both the overweight in equities and the underweight in index linked. These changes bring the asset allocation closer to the strategic benchmarks.

5. SCOTTISH LIFE FUND REVIEW

Funds managed by RLAM

The following funds were highlighted as requiring action:

Far East ex Japan – Performance over three years remains poor against benchmark, but is above over five years.

Scottish Life will map the pension fund for this against the underlying investment vehicle and report back at the next meeting. PL requested that this exercise should be widened to incorporate the full SL range. RH

Property –The fund is now benchmarked against the ABI UK Direct Property sector average. This is a fairer comparison in that the sector will assume a certain amount of cash is present within the fund and will include any charges in relation to property purchases or disposal. There remains some work to be done to continue tracking the fund against the original IPD Index purely for information purposes. It was noted that on either measure the property fund is now performing well, over the short term. GC

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

UK Mid Cap – The fund continues to perform poorly having been over-exposed to economically sensitive stocks. The recent rally in this type of asset has brought performance back up and this trend should continue provided some form of confidence in the market remains. Remains on watch and manager update to be included in report for next meeting. RH

The following funds were discussed but no action was taken :

Duration matched corporate bond funds – SL were to investigate why performance from the corporate bond fund and the duration matched corporate bond funds was so different. The three duration funds are segregated holding specific duration corporate bonds in line with their objectives. The Scottish Life Corporate Bond Pension fund, on the other hand, holds approximately 70% in the RL Corporate Bond OEIC and 30% in RL Sterling Extra Yield. Hence the risk profile and mandate is different, which explains the deviation.

Global Managed & Global Equity - Performance of the funds is under benchmark over 1, 3 and 5 years. During 2011 the funds were positioned overweight in cyclical stocks and underweight in typically more defensive stocks. Whilst this impacted performance, the recent short term performance has improved in light of this position.

SL Managed funds and Governed Portfolios – Short term performance improved in Q4 2011 due to the overweight position in risk assets, particularly equities.

Worldwide – The fund performance has worsened since the last report and is now underperforming over 1, 3 & 5 years.

Matrix Funds

The following funds were highlighted as requiring action:

Fidelity International – Work is ongoing to review the matrix sector benchmark to allow us to source a suitable replacement. LB

Close Teams – Outline concept for replacement was discussed and next step is to refine the detail and present a proposal to IAC. LB

First State Global Emerging Markets Leaders – there is some evidence that this fund may continue to show an annualised tracking error against benchmark above 5%. Accordingly it may be appropriate to consider placing this strongly performing fund in the Specialist category of the matrix. Work will begin on validating the evidence, and of investigating the impact of this change and the subsequent materials required to communicate this change to customers and advisers. RH

Henderson Global Emerging Markets Opportunities - Fund performance remains under benchmark over all reported periods. The fund was downgraded to an A rating in August 2011 and OBSR commented that although they had confidence in the manager they felt the lack of research support in Asia was hindering the fund. They pointed out that there are other funds that may be more suitable in the emerging markets universe. Work to begin on sourcing a replacement fund for approval at the next IAC meeting. RH

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

Artemis UK Special Situations - The fund significantly underperformed the FTSE All Share index and IMA UK All Companies sector average over the fourth quarter of 2011. Over five years the fund is behind the index but ahead of peers, however over the last three years the performance has fallen behind both measures, primarily as a consequence of a poor 2011. OBSR continue to have conviction in both the process and the manager and feel the fund will come round when markets have settled. OBSR continue to rate the fund AAA. Fund remains on watch.

Investec Global Free Enterprise – The fund continues to underperform. OBSR remain comfortable with the manager and the process, and continue to rate the fund as AA. Fund remains on watch.

The following funds were discussed but no action was taken :

Invesco Perpetual Japan – This fund was a replacement for the JPM Japan Fund but has underperformed the benchmark since the replacement. OBSR continue to have conviction in the manager and the process. They remain optimistic that the fund will perform going forward and it remains 'A' rated.

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:

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. A new manager has recently been appointed to run the Global Special Situations fund, with a strong reputation. The IAC recommended the fund is placed on watch and await feedback from OBSR once they have interviewed the manager. Separately the 50:50 split for the fund will be reviewed. RH

GLG Stockmarket Managed – Performance improved marginally in Q4 2011. The fund remains positioned in UK financials and industrial cyclical.

The following funds were discussed but no action was taken:

JP Morgan Natural Resources – OBSR recently downgraded the rating from AA to A following the replacement of the lead manager. OBSR remain confident in the process and the departing manager continues to help the new lead manager with the handover.

UBS UK Equity - Performance is below benchmark over 1, 3 and 5 years. The one year position appears to be improving however with the fund sitting 2nd quartile amongst its peers.

Other Scottish Life funds

The following funds were discussed but no action was taken :

Index linked life fund – This fund had been highlighted as there was significant deviation from the pension fund equivalent. The difference was suggested as due to the different make up of the Index Linked life sector where there are far less funds in the sector than in the pension sector. Further investigation to confirm this was requested. RH

European Life fund – The fund is underperforming the benchmark over 3 and 5 years however the underling fund in which the SL fund invests has performed better. Suitability of the benchmark is to be reviewed. RH

FTSE 350 Managed – The fund is underperforming the benchmark over 1 & 3 years. Fund remains on watch and manager comment to be sought. RH

FTSE 350 Tracker and US fund – Investigation into the tracking against benchmark continues. RH

Worldwide and Global Managed Life – It was noted that these funds are small. A proposal was requested from RLAM as to whether any funds would benefit from restructure. RT

6. DATE FOR NEXT MEETING

The date for the next quarterly meeting is to be confirmed.

IMPORTANT INFORMATION

Past performance is not a guide to the future. Prices can fall as well as rise and you may not get back the full amount of capital invested. Investment returns may fluctuate and are not guaranteed.

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