Investments at Scottish Life

INVESTMENT ADVISORY COMMITTEE

QUARTERLY MEETING

MINUTES OF MEETING HELD ON 21/05/09

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

ACTION

1. REVIEW OF PREVIOUS MINUTES

The minutes of the 24th February IAC meeting were approved.

The action points arising from the 24th February meeting were then reviewed:

- RT advised that the tracking system was still under investigation. AB will discuss possible options with RT. **RT/AB**

- NL advised that an interim workshop took place on 16th April to carry out a 'stress test', and also to review the benchmarks for the four Managed Strategy portfolios. The workshop conclusions were that:
    - If we enter a period of low or negative inflation the current IAC benchmarks are broadly still reasonable (based on the objective of minimising risk whilst delivering strong 'real returns')
    - The current high levels of equity volatility are likely to be a temporary feature, and the appropriate response is to let this market feature unwind naturally, rather than to change the benchmarks. The group recommended that only the Cautious Long Managed Strategy benchmark should change, as it was being impacted not only by equity volatility, but also by an increase in long term inflation volatility.
    - PM was asked to circulate details of the B&H equity forecasting method, and he confirmed that this information was contained in the methodology document provided to RT.

- PM advised that he had sent corporate risk premium analysis to RT. MY requested that the information be circulated to all meeting attendees. **PM**

- The discussion on the following action points took place during the meeting:
    - Fixed Interest fund benchmark
    - Duration bond funds
    - Life property fund structure
    - Close Teams
    - Invesco Perpetual UK Growth
    - JPMorgan Japan

Scottish Life
a division of Royal London

- Baillie Gifford
- Fidelity Special Situations
- Fidelity UK Growth
- Schroder Managed Balanced
- UBS Managed
- UBS UK Equity
- Société Générale funds
- United Friendly Far East
- United Friendly Managed

- NL confirmed that the work to replace the JP Morgan Japan fund with a suitable alternative and to communicate this to customers is in hand.

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

Information was presented by PM, RT and NL - the key points were as follows:

- Economic outlook - PM advised that following a period of considerable market volatility, the yield curves now appear closer to their historic shape. During quarter 1 2009, yields on short term bonds fell by around 0.5%, and future expected' short term yields also fell. Expectations for long term nominal yields (i.e. of terms over 20 years) increased. Inflation expectations fell, particularly longer term rates - expected inflation expectations in 15 years time decreased by around 1.8%. Current equity volatility continues to be high (currently estimated at 22.2% for UK), although longer term the assumption is still that equity volatility will gradually moderate to historic levels.

- The stochastic model was updated to reflect the new market conditions. The impact on the forecast asset class returns since the last quarter was, in summary, as follows:

  - Expected nominal returns from gilts and deposit in the short term have fallen but have increased over the long term.
  - Expected nominal returns for index-linked bonds have fallen over both the short and long term.
  - Expected nominal returns from corporate bonds have fallen slightly over the short term.
  - 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 continues to be high. It was noted that overseas equity currently appear to be more attractive on a risk adjusted basis than UK equities over a 12 month view – PM agreed to investigate the impact on the current IAC approved UK/Overseas equity benchmark split.

PM

- On 28th April RT made a tactical change – he became more favourable towards property and less favourable towards index-linked (see section 3). The increase in exposure to property within the portfolio has been achieved by a commensurate reduction in the exposure to index linked and where necessary corporate bonds (and in one portfolio equities)

- 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 and tactical positions for all three Managed Funds continue to fall within their target ranges risk.
- Of the four remaining Managed Strategy benchmarks, three continue to fall beyond their risk target (see below).

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

NL will extend the information provided for the next IAC by showing the asset class returns and volatilities in real terms, and by adding Gilts into the table. **NL**

- The IAC concluded this section of the meeting as follows:

  - The IAC agreed that the current benchmarks and tactical positions for the Managed Strategy portfolios continue to remain suitable, other than for the Cautious Long Managed Strategy.

  - The IAC agreed that the Cautious Long Managed Strategy benchmark should change - the current economic environment has increased uncertainty as to the path of inflation in the long term, and the current benchmark is now giving rise to higher risk. The IAC reviewed a number of proposals, before agreeing that the benchmark should be changed as follows:

Asset Allocation	Current Benchmark	New Benchmark
Equities	27.5%	22.5%
Corporate bonds (15 years)	30.0%	27.5%
Index-Linked (15 years)	25.0%	32.5%
Property	17.5%	17.5%
Total	100%	100%
Forecast volatility level (in real terms)	7.8	7.1

The new benchmark has a higher weighting towards index-linked bonds, and a lower weighting in 'riskier' asset classes, corporate bonds and equities. RT to advise tactical position for the new benchmark **RT**

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

RT presented his short term tactical view:

The first quarter can be split into two distinct phases: the first saw a sharp rise in risk aversion as concern escalated over the likelihood of the policy response working to assist some form of economic recovery. This saw a further sell-off in both equities and corporate credit and a flight to the perceived safe haven of cash and government bonds. News flow was dominated by further concerns over the health of the global banking sector and also the general scale and duration of any downturn. However during early March the mood seemed to switch relatively quickly to one dominated by a recognition that while the economic data remained poor it was deteriorating at a much slower pace. In addition there was concrete evidence out of China that the economy was definitely responding to policy actions. Further support to a change in sentiment was a growing belief that the banking sectors woes were relatively containable. Overall this led to a relatively sharp change in asset market preferences and also within markets in terms of favoured areas. Therefore during the final weeks of the quarter and into April we saw significant rises in equity and corporate bond markets whereas government bond markets started to struggle despite the authorities announcing commitments to the buying back of the latter asset class through quantitative easing.

In other asset classes index-linked gilts had a good first quarter on the basis that previous fears over entering a deflationary environment were reassessed. Property continued to be weak on a lack of tenant demand due to some further forced selling and a general reappraisal of asset values.

During Q1 the tactical positions were defined on the basis that ‘recovery’ was likely to be the emerging theme rather than ‘depression’. Therefore during this period RT advised that he did not change asset preferences or even the views of the various equity markets. While this stance was tested early during the period it appeared more reasonable as we entered Q2, although there remains uncertainty both over the path and strength of the recovery.

During Q2 RT advised that he had increased exposure to property, and that he had become less favourable towards index-linked bonds. RT’s view is that we are approaching the trough in terms of property valuations. Index-linked have performed very well during Q1 and his view is now that there are better real returns to be had in the commercial property sector on a twelve month plus time horizon.

4. SCOTTISH LIFE FUND REVIEW

Funds managed by RLAM

The following funds were identified for follow-up action:

Fixed Interest pension fund – The fund performance is below benchmark - NL presented details of the fund’s investments, and was asked to prepare a proposal regarding the use of the risk budget associated with this fund. **NL**

Duration bond funds – RT to conduct a review of the benchmark calculation. Carried forward **RT**

Life Property fund – The IAC asked that DB carry out further research to establish if it possible to facilitate continued investment in direct property. **DB**

Matrix funds

The following funds were identified for follow-up action:

Close Teams – it was noted that a discussion had taken place with Close, and that performance has improved considerably in Q1 2009. The IAC decided that no further action was required.

Invesco Perpetual UK Growth - Old Broad Street Research met the new manager again in May, and they have continued to maintain the suspended rating (as opposed to un-rating it). The IAC will continue to keep this fund under watch. **NL**

Invesco Perpetual International Equity – it was noted that performance improved during Q1 although the longer term performance is disappointing. The IAC will continue to keep this fund under watch. **NL**

Investec Global Free Enterprise – 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 their belief in the manager. The IAC agreed that no follow-up action is required.

Artemis European – the performance during Q1 2009 continued to be below par. The underlying fund continues to be rated by Old Broad Street Research, however they previously identified that the fund manager's process has difficulties during periods of high market volatility. The IAC will continue to keep this fund under watch. **NL**

JP Morgan Premier Equity Growth – This fund was downgraded by Old Broad Street Research in Q1 2009 - they commented that "This fund is designed to provide investors with a core offering in the UK market and is managed to strict parameters in order to control risk. The recent environment has been challenging for the behavioural finance approach but while other funds have had the flexibility to respond proactively, the constraints and risk controls that apply to this fund have been a disadvantage" The IAC decided that further research should be carried out. **NL**

Investec American – The IAC identified that performance has been below benchmark, and requested further review. It was noted that the fund is rated by Old Broad Street Research. **NL**

Schroder UK Mid 250 – the fund performance has been poor since 2007, but better beyond this period. It was noted that the fund is AAA OBSR rated. The IAC will keep this fund under watch. **NL**

Other external managed funds

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

Baillie Gifford fund range - it was noted that a discussion had taken place with Baillie Gifford, and that performance has improved considerably in Q1 2009. The IAC decided that no further action was required.

Fidelity Special Situations – the global equity portion of this fund has underperformed recently. Fidelity have commented that special situation opportunities sometimes underperform during defensive times, although it was noted that longer term performance is better. The IAC requested further research. **NL**

Fidelity UK Growth – it was noted that performance continues to improve since the fund manager change in December 2007. The IAC decided that no further action was required.

Schroder Managed Balanced – performance continued to disappoint during Q1 2009 but it was noted that subsequent performance to end May improved significantly. The IAC will keep this fund under watch. **NL**

UBS Managed and **UK Equity**–The UK fund changed manager and moved to a new team-based process in March 2008. Nevertheless performance continues to be disappointing for both these funds. The IAC will continue to keep these funds under watch. **NL**

Société Générale funds – discussions with the manager are ongoing following the recent change in ownership to GLG. **NL**

5. ROYAL LONDON FUND RANGE

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

United Friendly Far East – DB confirmed that the fund performance differential from the equivalent Scottish Life fund was simply due to the varied investment mix within these funds.

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

MY requested that full commentary is provided for all highlighted funds within the Royal London range. **RT**

6. DATES FOR 2009 MEETINGS

Tuesday 25 August at 10:30am
Tuesday 24 November at 10:30am

All literature about products that carry the Scottish Life brand is available in large print format on request to the Marketing Department. All our printed materials are 100% recycled, supporting responsible use of forest resource. 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.