INVESTMENT ADVISORY COMMITTEE

QUARTERLY MEETING

MINUTES OF MEETING HELD ON 23/02/10

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

ACTION

1. REVIEW OF PREVIOUS MINUTES

The minutes of the 24th November and 15th December meetings were approved.

The action points arising from these meetings were presented by NL:

- Benchmark and associated tactical changes to five Governed Portfolios and two Managed Strategy portfolios were agreed during the December interim meeting, and implemented with effect from 12th January 2010.

- The correction to the Close TEAM benchmark was implemented, and NL confirmed that no other funds were impacted by this issue. Performance of the Close Team funds have improved significantly this quarter and have been removed from 'watch'.

- **Fidelity European Blended fund** has improved significantly this quarter and have been removed from 'watch'.

- PM confirmed that he has reviewed the fund tracking error calculation routines. He described a way to overlay these for asset allocation tracking error, subject to some input information being passed from RLAM or Scottish Life. NL confirmed that he would review PM's note on the subject and respond. **PM/NL**

- PM will produce a one-off report on the difference between the property and equity 10 year risk/returns. **PM**

- RT advised that one of the **United Friendly Managed funds** do not have a published benchmark, although the underlying funds do. The IAC asked RT to consider the creation of a composite benchmark for internal reporting purposes. **RT**

- PW advised that the ex-ante fund risk report is nearing completion. **PM/NL**

- DB confirmed that he was progressing changes to the life pension property fund structure to enable it to benefit from greater diversification. These changes are scheduled for Q2. **DB**

- NL confirmed that the **JPM Premier Equity Growth** Matrix fund replacement was scheduled for 7th May 2010 and that appropriate communications had been made.

- Discussion on the following action points took place during the meeting:
    - Pension property fund
    - BGI funds
    - Schroder UK Mid 250.
    - Fidelity International
    - Investec Global Free Enterprise
    - Artemis European Growth
    - Baillie Gifford funds

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

Information was prepared by NL, PM and HC - the key points were as follows:

- Economic outlook – since the last meeting, short term inflation expectations increased significantly by around 110 basis points, and there was a reduction in the projected real returns on index-linked bonds over this period. Over longer projection horizons (e.g. 10 years) the real returns and volatility of index linked bonds were broadly unchanged. There was a reduction in the credit risk premium across all credit classes and maturities.

- Current equity volatility has reduced to align more closely with its long term historical level. The change in UK inflation assumption has resulted in slightly higher projected real returns from overseas equities relative to UK equities in the short term.

- 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 over all terms increased.
    - Expected nominal return from corporate bonds increased reflecting an increase in nominal returns and a reduction in the credit risk premium.
    - Expected real returns for equities are broadly unchanged, although nominal returns have increased.

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

3. SHORT TERM TACTICAL VIEW OF THE CHIEF INVESTMENT OFFICER

Robert Talbut changed his tactical position on the Governed Portfolios and Managed Strategies to neutral with effect from 9th December 2009. He reviewed Q4 2009 and presented his current short term tactical view:

The fourth quarter of 2009 was another good quarter for returns from risk assets. The principle factors behind this were continuing expansionary policy from governments and central banks, combined with further improvements in news flow on a turnaround in economic activity and company trading fortunes.

In the UK the Bank of England continued with the policy of buying up government bonds as a way of injecting liquidity into the economy whereas the weakening of sterling was seen as a useful way of assisting an improvement in the growth outlook for the economy. From the company perspective there were the first tentative signs that trading conditions were gradually improving albeit from very depressed levels. This all continued to take place against a background where the chances of higher interest rates was negligible and hence returns on any cash deposits remained extremely low.

Overall therefore global equities and corporate credit bonds had another good quarter, but the standout performer was commercial property. From a relatively slow improvement in sentiment around the mid-year there was a very strong inflow of funds into the sector in Q4. This influx was met with very limited supply of buying opportunities and therefore prices were forced up into year end. Clearly the yields that were on offer were attractive but property was also seen to have significantly lagged the rises seen in other asset classes earlier in the year. Outside of this index-linked bonds provided very low returns given the elevated valuations that the stocks were trading on, while UK government bonds provided negative returns on the quarter.

Performance over the quarter was helped by my asset allocation stance which remained overweight towards equities and corporate bonds but I failed to participate fully in the property rally given my underweight position. In addition performance will also have benefited from my negative views on government bonds. The funds also benefited from good stock selection within our corporate bond portfolios.

The portfolios asset allocation stance remained essentially unchanged during the quarter as I tried to take advantage of the rally in risk assets. The view I am adopting is that after such a strong move upward in the valuations of a range of assets I am concerned that the outlook for the whole of 2010 may not be as straightforward as many would like. For instance if the recovery continues then there will be some tightening of monetary policy and in addition I hold concerns over the strength and durability of the recovery once the initial spurt has occurred. Therefore I see that there are more risks around the second year of recovery and hence prospects for assets will be more volatile than has been seen for the last 9 months.

4. SCOTTISH LIFE FUND REVIEW

Funds managed by RLAM

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

Pension property fund – AC advised that in the immediate future he would expect the fund to be managed so that the cash balance was not significantly above 20%. This provides good liquidity within the fund and an ability to respond quickly to opportunities. The IAC asked if property shares could be an alternative vehicle to cash, however RT and AC explained that property shares would have a number of disadvantages as a short term investment – lower correlation to direct property, potentially high gearing, and currently the view is that property shares are expensively priced relative to the value of the underlying assets. NL commented that the property fund benchmark assumes 100% full investment in property and asked whether a more reasonable benchmark for internal measurement might include some deposit. AC agreed to investigate. **AC**

Long corporate bond – RT explained that the fund's underperformance was due to duration mismatch caused by a lack of sufficient quality long dated issuance. The fund is designed with a 15 year duration outlook however at the present time the modified duration of the index used to measure performance (iboxx non-gilt over 15 year index) is 12.5 years, and the modified duration of the fund is 14 years. The IAC discussed the use of "swaps" as a means of increasing the duration of the fund to 15 years. JD commented that the IAC should also consider ways to increase the duration of the benchmark to 15 years to ensure that customer expectations are met. The IAC requested an interim meeting to discuss and asked RT to prepare options. **RT**

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

UK Mid Cap fund – Short term performance is disappointing. The underperformance was attributable to the period March 09-July 09, when the portfolio was cautiously positioned and missed a rally into low quality highly geared recovery stocks. Since the new manager appointment in August 09 the fund has been restructured towards a global recovery and the fund has performed broadly in line with the benchmark.

The following fund was identified as needing no further action:

Index-linked fund – it was noted that the fund is marginally below benchmark over one and three years to end 2009.

Deposit - it was noted that the fund will sit within the new ABI Treasury and Deposit Sector.

Matrix funds

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

Invesco Perpetual UK Growth - It was noted that the fund had a manager change in 2008 but performance remains poor. The fund currently has a suspended OBSR rating. The IAC asked for potential alternative funds to be sourced and a proposal discussed at the next meeting, along with further OBSR comment on this fund. **NL**

Artemis European Growth – whilst short term performance has improved slightly, the fund performance is still poor. The fund is currently AA OBSR rated and OBSR have advised that they have a high opinion of the team and process. Nevertheless the IAC asked for potential alternative funds to be sourced and a proposal discussed at the next meeting. **NL**

Fidelity International – Fund performance has weakened. The manager has commented that the fund is run to a long-term mindset and remains overweight in sectors that are expected to benefit from a longer term global recovery. Nevertheless the IAC noted that the fund has been on watch for four consecutive quarters and the IAC asked that a meeting with the manager take place to review performance and options. **NL**

BGI funds – a report was presented by NL analysing the sources of differences between performance and benchmark.

- DB agreed to review the box limits for these funds. He also agreed to review the spreadsheet analysis prepared by Scottish Life. **DB**

- AC will investigate the benchmark choice relative to that used by other large tracking houses. **AC**

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

Schroder UK Mid 250 – Fund performance has weakened over the short term but it is noted that most UK mid cap funds within the sector are underperforming the mid cap benchmark. The underlying fund is top quartile within peer group for 2009 and remains AA OBSR rated.

Investec Global Free Enterprise – Fund performance is below benchmark over one and three years, however underlying performance is better. The fund continues to be AA OBSR rated.

Other external managed funds

The following funds were identified for follow-up action:

Allianz RCM Global Equity – Allianz have advised that with effect from 28th February 2010 they are changing the investment mandate from a global equity fund to a multi-asset diversified growth fund. NL advised that this is a significant change and that Scottish Life are considering whether this fund should remain within their proposition. **NL**

RLAM FTSE 350 Tracker – AC agreed to review the tracking performance for this fund. **AC**

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

Baillie Gifford fund range – Performance has improved since last quarter. **NL**

5. ROYAL LONDON FUND RANGE

No funds in this range required to be placed "on watch".

6. AOB

NL commented that Scottish Life's Governed Range investment proposition had recently won a prestigious award, the "Corporate Adviser Ultimate Default Fund". He thanked everyone involved in the IAC review process for the delivery of the effective governance which underpins this proposition.

7. DATES FOR 2009 MEETINGS

Interim meeting 16th March 2010 at 1.00pm.

Next quarterly meeting 25 May 2010 at 10.30am.

IMPORTANT INFORMATION

Please note that 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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