

# INVESTMENT ADVISORY COMMITTEE QUARTERLY MEETING

## MINUTES OF MEETING HELD ON 24/8/2010

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

### ACTION

#### 1. REVIEW OF PREVIOUS MINUTES

The minutes of the 7 June meeting were approved and the action points arising from the meeting were presented by NL.

- NL advised that the review of tracking error limits for the SL Fixed Interest fund would be taken into account as part of the wider exercise of reviewing the tracking error limits for other portfolios.
- RT advised that the tracking error of the SL Medium (10yr) Index Linked fund was now in line with the other index linked funds. Previously reported figures were the result of an error in the external performance measurement model which has now been fixed.
- NL confirmed that the Allianz RCM Global Equity fund was removed from the Scottish Life fund range on 20<sup>th</sup> August.
- NL advised that RLAM will present a report into the fund operational process.

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

- Historical performance review of governed portfolios relative to risk, and review of tracking limits
- Long Corporate Bond fund
- UK Midcap fund
- Worldwide fund
- Life property fund restructuring
- Invesco Perpetual UK Growth fund
- Artemis European Growth fund
- Fidelity International fund
- Close TEAMS funds
- Schroder UK Mid 250 fund
- Investec Global Free Enterprise fund
- Baillie Gifford funds.

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

The key points were:

### Economic outlook and asset forecasts

- Since the last meeting current inflation has increased slightly while projected inflation in one year's time has decreased by a similar amount. Projected inflation in five years time has fallen by slightly more. There has been a slight fall in nominal gilt returns, a proxy for the risk free rate, over the short term and more significant falls over the longer term. Corporate bond returns have fallen in line with nominal gilt returns. There has been a modest increase in the credit risk premium although this is only evident at short horizons.
- Short term equity volatility has increased significantly but increases at the longer term have been much smaller. B&H advised that this had no significant impact on the Governed Portfolios. The equity risk premium from equities is broadly unchanged. Overseas equity returns have fallen by up to 0.25% more than UK equity returns due to expected decreases in UK inflation relative to overseas inflation.

### Benchmark Analysis

- It was noted that while Governed Portfolio 1, 2 and the Cautious Medium and Balanced Short Term Strategies are close to their risk targets, all the Governed Portfolios and managed funds are within their benchmark risk targets, and the IAC confirmed that no changes were required.
- It was noted that some asset managers have increased exposure to overseas equities and to emerging markets in particular. While there was no recommendation to change the 55% UK equity/45% overseas equity split, the IAC agreed that further investigation into the reasons for this trend and the impact on risk and return profiles should be carried out.

NL

### Tactical Analysis

- The tracking error review was extended to show how the tracking error limits translate into a tolerance around benchmark asset allocation. The significant cash holding in Global Managed fund (11% at end July) was treated as an overweight in cash and a corresponding underweight position in equities. As a result the tracking error of each Governed Portfolio has increased since last time but all remain comfortably within their tracking error limits. It was noted that some tracking error occurs when asset allocation is neutral against benchmark because the underlying funds take active positions against their individual benchmarks. SM to review how the tracking error of each Governed Portfolios compares relative to each other.

NL

## HISTORICAL RISK/RETURN ANALYSIS OF GOVERNED PORTFOLIOS

- NL presented a review of the Governed Portfolios and confirmed that all have produced real returns above benchmark and within their agreed risk targets.
- The IAC requested a similar historical risk/return analysis on the Managed Strategies since 2004.
- B&H will review the figures.

NL

AB

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

- Robert Talbut confirmed that he was currently holding a neutral position on the Governed Portfolios and Managed Strategies but RT will consider making a change shortly. RT to confirm with NL.

RT

RT reviewed 2010 so far and presented his rationale for his current short term tactical view:

*Financial markets were faced with a combination of testing factors in Q2 which ultimately led to poor performance from equities and very muted returns from other assets. The first of the factors which caused some reappraisal of the relative optimism that prevailed at the end of Q1 was a run of real economic data which suggested that the global recovery was running out of steam. Looking to the US this saw consistently disappointing employment growth, unexciting real final sales and measures of forward looking confidence all rolling over as momentum appeared to be leaving the recovery. In China the authorities continued to instigate measures to slow growth in particular in the property sector and in the UK the data also failed to substantiate the optimist's view of continued robust growth. In Europe the focus remained upon the issue of sovereign debt strains and what this may mean for the banking sector and the overall chances for growth and the integrity of the Euro system. It remains the case that most banks are still not able to secure substantial private market funding and remain dependent upon central bank schemes. There still remains a very considerable amount of further funding coming due over the next 12-24 months and no real visibility on how this will be refinanced. In this context the European authorities announced that they were to undertake 'stress-tests' on the health of the banking sector as a way of rebuilding confidence. The results of these were not ultimately released until July and they did, at least for a while, improve sentiment with regard to the 'peripheral' countries.*

*Against such a difficult background equities had a very poor quarter as investors shied away from riskier assets and instead preferred the safer-haven of government bonds which exhibited positive returns. Corporate bonds performed better than equities helped by the strength from government fixed interest securities and property delivered positive returns helped significantly by income returns. For property there was a distinct tailing off in market activity as Q2 progressed as fewer buyers appeared ready to chase the market after the previous 12 months advances.*

*Risk assets started Q3 in far more optimistic stance helped both by a good corporate reporting season and also by markets taking the results of the stress tests as being better than feared. However the trend of macro data out of most regions continued to soften with the trend likely to continue. It should be seen as a worrying development than post the largest amount of fiscal and monetary stimulus ever seen in peace time we are faced with the recovery running out of steam within a year. While there is talk of further quantitative easing many will question whether this will be more effective than the previous dose. Q3 has continued to see government bonds perform well despite the equity rally which might have been seen by some as a good excuse for a sell-off in the asset class.*

*We intend to retain our cautious approach to asset allocation as we believe that a continued run of relatively soft macro-data will check any further progress from equities and may well encourage a pulling back in the still strong expectations for corporate earnings in the second half of 2010 and into 2011. In addition we still do not believe that issues relating to sovereign debt have been resolved and could well resurface before too long.*

### 4. SCOTTISH LIFE FUND REVIEW

#### Funds managed by RLAM

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

**Long corporate bond** – NL confirmed that the fund mandate allows swaps to be used within the fund. NL to circulate report to include specific wording on use of swaps for IAC to approve and RLAM to supply draft investment mandate for SL approval

NL/AC

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

**UK Mid Cap fund** – Fund continues to underperform the index but has made significant improvement over the last 12 months. Since the change in manager the fund has improved and is positioned to benefit from a cyclical recovery. The fund manager is rated A by Citywire.

RT advised that combining this fund with the RL Midcap fund would result in much greater issues of market liquidity for individual stock positions. IAC agreed to continue with two funds.

**Property fund** – Fund has underperformed benchmark over 1, 3 and 5 years but compares relatively better against its sector. The team are currently tracking four properties within the prime market to reduce the cash balance and address the secondary bias within the fund.

**Worldwide fund** – Fund has underperformed benchmark over 1, 3 and 5 years. RT confirmed that fund has relative conservative geographical mix and has suffered due to lack of emerging market exposure. NL to confirm investment mandate of fund.

NL

**Long dated gilt fund** – Fund is marginally below benchmark over 1 and 3 years.

**Index Linked fund** – Fund is marginally below benchmark over 1, 3 and 5 years.

### Matrix funds

The following funds were identified for follow-up action :

**Artemis European Growth** – Since the last meeting the fund has continued to underperform benchmark and sector. Despite the fund's rating from OBSR it has been consistently underperforming for some time. The IAC decided to replace the fund as they were concerned about the fragility of the investment process and the lack of any clear improved trend. A suitable alternative fund will be sourced.

NL

**Fidelity International** – Fund continues to underperform. Scottish Life met with Fidelity recently however the IAC were not convinced that the investment process would lead to improved performance and decided to replace the fund. A suitable alternative fund will be sourced.

NL

**BGI funds** – Underperformance against index due to time lags in dealing process. Further investigation required to understand process.

HC

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

**Close Teams Global Equity and Global Alpha** – Marked improvement across UK funds and marginal improvement on global funds. One of their global managers went through an extensive review and site visit and Close were happy that manager will perform going forward. Scottish Life met with Close on 16<sup>th</sup> August and Close have agreed to provide

more detailed reporting going forward. Information will be received in time for the next IAC meeting.

NL

**Invesco Perpetual UK Growth** – Fund continues to underperform but has shown some improvement since last quarter. Most of the underperformance stems from a previous fund manager and a poorly positioned portfolio when the credit crunch took effect.

**Schroder UK Mid 250** – Performance has improved since the last meeting although fund continues to suffer relative to index due to specific stock reasons. The fund remains AA rated by OBSR.

**Investec American** – Performance has worsened since last meeting. Fund volatility over the last quarter was high and NL will investigate whether this fund continues to have an appropriate risk level. Fund remains AA rated by OBSR. The manager is focused on stock selection and remains positioned for a cyclical recovery.

**JP Morgan US** – Fund underperforms index over three years and marginally underperforms over one year. Fund remains competitive against peer group and remains AA rated by OBSR. Like many other funds the manager is positioned for a cyclical global recovery.

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

**Investec Global Free Enterprise** – Performance has improved over both 1 & 3 years and fund now outperforms over one year.

The IAC requested OBSR attendance at a forthcoming meeting to present on their ratings process.

NL

### 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 has underperformed over 1, 3 and 5 years, although it has improved over the shorter term.

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

**Baillie Gifford fund range** – Performance has greatly improved across the board.

### Other Scottish Life funds

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

**Property life fund** – DB confirmed that the business had given agreement to go ahead with the restructure of this fund for the benefit of customers. It's anticipated this will be implemented at the end of September.

**American life fund** – Fund performance is significantly below benchmark over 5 years and marginally below benchmark over 1 and 3 years. The fund moved to a tracker basis in 2007.

**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. The fund has little exposure to low quality cyclical 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.

**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 - Extension of IAC governance

NL presented a paper requesting an extension of IAC governance, which was accepted.

## 7. DATES FOR 2010 MEETINGS

Next quarterly meeting is 23 November 2010.

## IMPORTANT INFORMATION

Past performance is not a guide to the future. Prices can fall as well as rise. Investment returns may fluctuate and are not guaranteed.

5M1118

August 2010

The Royal London Mutual Insurance Society Limited. Registered Office: 55 Gracechurch Street, London EC3V 0RL United Kingdom. Registered in England No 99064.

Royal London Group consists of The Royal London Mutual Insurance Society Limited and its subsidiaries. The Royal London Mutual Insurance Society Limited provides life assurance and pensions and is a member of the Association of British Insurers and the Association of Financial Mutuals. Royal London Savings Limited provides the Individual Savings Account. Royal London Unit Trust Managers Limited provides unit trusts. All these companies are authorised and regulated by the Financial Services Authority.