INVESTMENT ADVISORY COMMITTEE (IAC)
QUARTERLY MEETING

MINUTES OF MEETING HELD ON 28/11/2012

Present	In attendance	Apologies
Phil Loney Ewan Smith Julius Pursaill Colin Taylor Andy Carter Hugh McKee	Nick Leitch (Scottish Life) Robin Herd (Scottish Life) Scott Manson (Scottish Life) Lorna Blyth (Scottish Life) Robert Talbut (RLAM) Robert Whitehouse (RLG) Peter Watts (Barrie & Hibbert)	

ACTION

1. REVIEW OF PREVIOUS MINUTES

The minutes of the 28 August meeting were approved and the action points were presented by NL.

- SL met with Morningstar OBSR to seek further reassurance on the strength of their process. The meeting provided strong emphasis on the depth and quality of their research and the level of value they add to the process. SL will continue to engage with them to improve the level of reporting received on the matrix fund range. RH

- Cash flow figures for Governed Portfolios are to be added to the regular report. Work continues to define requirements and agree build to obtain appropriate data. SM

- Matrix changes – the 2 fund changes planned for December are progressing as agreed and communications plan is complete. Funds affected are Henderson Emerging Markets Opportunities and First State Global Emerging Markets Leaders. RH

- Internal fund review – SL are conducting an exercise to review all operational mandates for the SL pension funds managed by RLAM to ensure appropriate guidelines for each fund is in place. RW/NL

- FTSE 350 Managed & Tracker – Due diligence is ongoing with respect to the transfer of the underlying assets to more efficient large fund structures. NL

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

- Further analysis covering the use of infrastructure and currency hedging within Governed Portfolios
- GRIP analysis
- Operational fund review
- Duration matched corporate bond, gilt and index-linked gilt funds
- SL American pension & life funds
- SL Global Equity
- SL FTSE 350 Tracker life
- SL FTSE 350 Managed life
- SL/Close Teams
- SL/Fidelity International
- SL/Investec Global Free Enterprise
- SL/Invesco Perpetual Japan
- SL/Fidelity Special Situations Blended

- SL/UBS funds
- SL Fidelity UK Growth

2. PROJECTS

Currency Hedging Investigation

NL gave an update on the progress made since the last meeting. The cost of hedging was reviewed and the IAC agreed that a working party be set up to progress this further. NL

Infrastructure Investigation

RT explained that he would soon be meeting with the National Association of Pension Funds to discuss the new Pension Investment Platform for UK infrastructure investment, with a view to exploring the potential for Defined Contribution pensions to invest in this kind of asset. He also mentioned that Prudential had another proposal to allow UK pension funds to invest in UK infrastructure projects, which he would investigate. RT

ES reminded the IAC that the modelling exercise undertaken previously had shown that there was no benefit from including this asset class in the portfolios, but that this should not discourage further investigation because the future performance of this asset class was unlikely to be a continuation of past history. There was wide agreement among the IAC on this point.

AC explained that historic performance of infrastructure is tarnished by the failure of highly-leveraged funds in the 2008 downturn.

ES mentioned that there would be a necessity to ensure that any new kind of investment would fall within the FSA "permitted link" rules governing allowable pension investment.

RT cautioned that Royal London would need to undertake considerable due diligence before investing in this asset, because exiting the investment may be difficult.

3. CUSTOMER INVESTMENTS

GOVERNED PORTFOLIOS & MANAGED STRATEGIES

Benchmark analysis

No changes were recommended to the Governed Portfolio and Managed Fund benchmarks this quarter. It was noted that the efficiency measures for the shorter term portfolios (Governed Portfolios 3, 6 and 9) had improved since last quarter as the expected returns on index-linked gilts had improved, although GP3 still showed low efficiency. However the IAC agreed that it was appropriate to maintain the current asset allocation for the same reason as the previous quarter – that the exposure to index-linked gilts gives necessary inflation protection at a time of uncertainty about future inflation.
The efficiency of the Cautious Long managed strategy had worsened slightly. SM explained that this was not due to the same effect as the short term portfolios previously mentioned, but was a result of a reduction in the expected return of corporate bonds relative to other asset classes at the long end of the yield curve, which affected this portfolio in particular because it was had a large exposure to corporate bonds. The IAC asked for a more detailed investigation. SM

All the portfolios remain within their target risk ranges.

Tactical analysis

All portfolios remain within their tactical risk budgets.

Robert Talbut made a tactical change on the 25th of October, removing the overweight position in corporate bonds and moving the balance to cash.

Robert explained his preference for small asset allocation bets. He believes equities will outperform on a fundamental basis but he is not confident that markets will behave rationally, and being too aggressive is therefore a high risk strategy that he doesn't want to pursue.

GOVERNED RETIREMENT INCOME PORTFOLIOS

The IAC reviewed the analysis of risk and reward for the new Governed Retirement Income Portfolios. SM explained the objectives of the portfolios – to support customers withdrawing a regular income from their pension savings over an uncertain time horizon. Given this objective, the governance of the portfolios should focus on the income that a customer can expect to receive over their lifetime. SM explained how the figures presented to the IAC were produced – by projecting the income of a representative customer over 1000 scenarios. The risk measure to be used is the lower 5% tail (this is the income amount which the customer has a 1-in-20 chance of receiving less than) over their lifetime.

Benchmark analysis

No changes were recommended to the Governed Retirement Income Portfolios. All of the portfolios are close to their long-term risk targets.

JP asked for some more information on tolerance bands and efficiency measures for each portfolio. SM

Tactical review

All the portfolios are within their tactical risk budgets.

NL explained that the Governed Retirement Income Portfolios receive the same tactical overlay as the Governed Portfolios, although the tactical risk budgets were smaller to reflect the more stringent risk objectives of the portfolios. The lower risk portfolios have particularly tight risk budgets, which the estimated tracking error of the portfolios is close to. Most of this tracking error was a result of stock selection decisions of the individual funds within the portfolios. The IAC agreed that the risk budgets should be reviewed to ensure that the manager has sufficient tactical freedom while not exposing customers to excessive short term risks.

LIFESTYLE PATH ANALYSIS

The IAC reviewed the analysis of risk and reward for the various lifestyle options offered by Scottish Life.

For lifestyles targeting the purchase of an annuity at retirement, the analysis showed the expected annual income from that annuity and the lower 5% tail (an annuity amount for which the customer has a 1-in-20 chance of receiving less) for customers 15, 10 and 5 years from retirement.

For lifestyles targeting a cash lump sum at retirement, the analysis showed the expected average return and the average volatility experienced by a customer over the last 15, 10 and 5 years to retirement.

It was noted that the risk and return from different lifestyles were spread appropriately over the spectrum of risk over each time horizon. No action was recommended.

PL asked that future reports include detail on the factors contributing to risk and reward. SM

SHORT TERM TACTICAL VIEW OF THE CHIEF INVESTMENT OFFICER

RT reviewed Q2 2012 and presented his rationale for his current short term tactical view:

"The zig-zag trend to financial markets referred to last quarter with good periods following bad continued in Q3 with the weaker previous quarterly performance from risk assets reversing in the latest period. The principle cause of this was again policy intervention from central banks with the US announcing a further round of monetary injection and the ECB strongly signalling its intention to buy up peripheral country bonds of governments which have limited or no access to financial markets. This latter move in particular was seen as quite significant by financial markets so seemingly reducing further some of the more extreme risks within the Euro area and the fact that the ECB was taking on more of the characteristics of other central banks which have moved on purely from providing liquidity to directly altering market prices as an object of policy. This is but another sign of the way in which monetary policy is becoming subservient to fiscal policy, with the former having to try and counteract the inability of the latter to positively impact upon economic activity. This will not be the first time that history has seen this develop.

However in the real economy the trends were not so favourable. While the US picture remained one of low and relatively stable economic growth, in Europe the trend was definitely for the news-flow to deteriorate with the core as well as the periphery economies showing softening data as austerity continued to bite. Elsewhere the Far East saw falls in exports and general softening in the growth outlook and even in China releases suggested that the trend towards a lower level of expansion was continuing given lower global activity numbers and the authorities desire to see some easing of the domestic property markets. Against such a backdrop it should be no surprise that company earnings forecasts saw a deteriorating trend which was particularly apparent in sales estimates. However numbers for the remainder of the year and for 2013 remain at ambitious levels and we expect further lowering of expectations as revenue trends will be more pedestrian and the ability to force margins even higher looks that much more difficult given the progress made to date and relative to historical levels.

Against such a background risk assets, and particularly equities and corporate credit performed well benefiting in particular from the reduction in perceptions of risk emanating from the central bank intervention. Conversely we saw a gradual sell-off in government bonds given the lowered risk aversion and the record low yields reached earlier this year. Commercial property saw falls in capital values as further falls in secondary market values started to seep into some of the prime areas. The only areas continuing to perform well are central London offices and out of town retail.

Throughout the third quarter we retained the asset allocation stance which was to be underweight property and index-linked bonds to be neutral in equities and to concentrate the risk asset bet into corporate bonds.

As we look into 2013 there are clearly a whole range of uncertainties around from the US fiscal negotiations, the prospects for growth in China under a new leadership through to the continual travails in the Eurozone as they battle the demands for austerity versus the absence of economic growth. Clearly with all of these, let alone geo-political tensions in the Far and Middle East, the prospects for a smooth ride appear very unlikely. However we take the view that because of all of this we can expect that central banks will have to remain very, and most likely even further, involved in providing monetary ‘soothing’ to the financial system and the real economy. In additional while we have started to see some fatigue with austerity as a policy, if as we expect economic growth remains pretty low, then this sentiment from both politicians and the electorate will grow, which will likely mean the postponement of the pain. Overall this appears a situation where the central banks cannot tone down their policy stance for the exact reason that without it the situation would become more unstable which is not acceptable to either politicians or central bankers.

Therefore we take the view that while not an ideal environment for equities, it may prove to be reasonably constructive and that with government bond yields at close to record lows the latter asset class is unattractive unless we assume a very disruptive outcome. As for corporate credit with spreads over government bonds down to post-crisis lows, and in absolute terms the lowest ever, we should take off the positive position as we did do in October. Given the tough environment for the UK economy we see further downside to capital values for commercial property which may not be made up by the income yield payable. We don’t expect that the future path for equities will be smooth but we take the view that other asset classes are increasingly richly valued and that with the prospect for further monetary stimulus almost certain, with one central bank already suggesting that it is prepared to tolerate greater inflation risks, and with the potential with even more explicit monetisation of debt being spoken about, that the asset class can produce reasonable returns.”

4. FUND OPERATIONS REVIEW

Benchmark review – 25 external funds were identified for further investigation. SL are currently working through these funds with the managers to ensure consistent benchmarks are being adopted. Update to be provided at the next meeting. RH

Tracking differential update – Robert Whitehouse provided an update on the review of the box management process.

5. SCOTTISH LIFE FUND REVIEW

Governed Range

The following investments were highlighted as requiring action:

Close TEAMs – SL have conducted a full tender exercise to agree a new manager to replace the Close TEAMs global funds. Having held in depth meetings with 2 managers SL have decided to proceed with one manager. The next steps are to plan the operational aspects of the new mandate and progress with legal agreements. RH

The following funds were discussed :

Governed Portfolios – The IAC noted an improved in performance and all of the governed portfolios are outperforming over 1 year. The IAC discussed the current modest tactical position which reflects Robert Talbut's view of market uncertainty.

SL Global Managed – Fund performance has improved since the last quarter but is still underperforming over 1 & 3 years. Fund remains on watch. Robert Talbut provided comment – *"The fund had suffered over the longer time periods from an underweight position relative to the benchmark in the US. The market had performed better post the crisis due in large part to the more pro-growth policies that had been adopted in the country. Conversely European equities had performed less well despite valuation of the market being significantly more attractive. In addition performance within the Far Eastern portfolio had been a further drag, due in large part to the higher beta nature of the fund during the sharp sell-off in 2011 and then secondly a reorganisation of the geographic spread of the fund which was poorly timed."*

Other funds managed by RLAM

The following funds were highlighted as requiring action:

American Pension & Life – The IAC agreed that the benchmark is to be adjusted by one day to bring it into alignment with the fund's valuation point. LB

Sterling Extra Yield pension – The IAC agreed to change the benchmark for this fund to 75% Markit iboxx Sterling non gilts BBB, 25% Bank of America Merrill Lynch European Currency HY(hedged) to be consistent with the benchmark index used for this fund in the Governed Retirement Income Portfolios. LB

Worldwide life – this fund is to be merged into Global Managed Life as part of the fund restructures work. LB

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

Worldwide pension – The fund performance has improved over the quarter but continues to underperform over 1, 3 & 5 years. Historical underperformance is affecting the track record.

Pacific pension – Fund performance has worsened over 1 & 3 years although the long term track record remains strong.

Far East ex Japan pension – The fund continues to underperform the benchmark particularly over the last quarter. In light of recent poor stock selection the manager is restructuring some of the portfolio.

The following funds were discussed but no action was taken :

Global Equity pension – Robert Talbut has aligned the overseas weightings of this fund to be in line with the FTSE World ex UK Index.

Matrix Funds

The following funds were highlighted as requiring action:

Fidelity International – This fund will be closed and assets switched into the new mandate as per the Close TEAMs global funds update. LB

Investec Global Free Enterprise & Invesco Perpetual Global Equity – These funds sit within the Global Managed Equity sector of the matrix. The benchmark for this sector is not consistent with the funds' underlying benchmarks. Work will take place in 2013 to revise this part of the matrix and measure these funds against a more appropriate FTSE World benchmark. LB

Invesco Perpetual Japan – This fund was a replacement for the JPM Japan Fund and performance has been extremely volatile. Morningstar OBSR is comfortable that the behaviour of this fund is in line with the manager's approach. SL will investigate circumstances in the economic cycle in which the fund is likely to outperform and present a proposal to IAC. Separately SL will review the categorisation of the specialist sector within the matrix. RH

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

JP Morgan US – Fund performance has improved but the fund still underperforms over 1, 3 & 5 years. The fund remains "Silver" rated by Morningstar OBSR and the peer positioning of the fund is much stronger.

The following funds were removed from watch :

Artemis UK Special Situations – Fund performance has improved significantly and the fund no longer triggers. Fund remains gold rated by OBSR.

Artemis Income - Fund performance has improved significantly and the fund no longer triggers. Fund remains gold rated by OBSR.

The following fund was discussed but no action was required :

Schroder Tokyo – The fund has been upgraded to a "Gold" rating by Morningstar OBSR.

Other external managed funds

The following funds were highlighted as requiring action:

UBS funds –These funds have had a steady history of outflows and overall fund sizes are now small. . The IAC discussed the attractiveness of these funds and approved the SL proposal to close the funds. SL will progress with the closure and update the IAC at a future meeting. RH

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

Fidelity UK Growth – The fund is performing poorly over one and three years. It was noted that the fund experienced large net outflows in recent years and the IAC discussed whether the fund remains attractive going forward. SL will carefully monitor progress of the fund over coming quarters. RH

Fidelity Special Situations Blended – The Global Special Situations fund had a change of fund manager. Morningstar OBSR has met the new manager and will meet him again before making a rating decision. SL will seek further reassurance from both the fund manager and Morningstar OBSR. Longer term performance is under benchmark but shorter term is stronger. RH

JPM Cautious Total Return – This fund was added in October 2009 and has underperformed since then. SL to seek further information from the fund manager. RH

PL asked that future reports include industry context on how our fund view recommendation compares with others. RH

6. ANY OTHER BUSINESS

SL duration bond funds – IAC discussed the proposal for performance benchmarking but there was no clear consensus and further investigation has been requested. SM

SL fund restructures - IAC agreed with the proposal to merge the SL Global Equity pension fund into the SL Global Managed pension fund and the SL Worldwide life fund into the SL Global Managed life fund due to the similarities in investment aims and benchmark. They also agreed with the conclusion that it was not appropriate to merge the SL Worldwide pension fund into the SL Global Managed pension fund due to the differences in mandate. LB

IAC membership changes

EFS confirmed that Julius Pursaill has accepted the position of chair for the Investment Advisory Committee. Hugh McKee was also welcomed onto the Committee to replace John Deane.

7. DATE FOR NEXT MEETING

The next quarterly meeting is 5th March 2013.

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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