INVESTMENT ADVISORY COMMITTEE (IAC)
QUARTERLY MEETING

MINUTES OF MEETING HELD ON 25/02/2014

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

ACTION

1. REVIEW OF PREVIOUS MINUTES

The minutes of the 13th November meeting were approved with discussions on the following action points taking place during the meeting:

- GRIP risk target analysis
- Economic scenario testing within Governed Portfolios
- Efficiency triggers with Governed Portfolios / GRIPs
- Impact of cash dilution on asset allocation analysis
- Tactical asset allocation attribution analysis
- SL FTSE 350 Tracker life & SL FTSE 350 Managed life
- SL Property
- SL/Fidelity American
- SL/Neptune European Opportunities

2. PROJECTS

Infrastructure Investigation

The IAC continue to investigate the possible use of infrastructure as an asset class within the governed range. Robert Talbut remains engaged with the NAPF around potential inclusion in their infrastructure vehicle. RT

Scenario testing within Governed Portfolios

Following some initial work, the economic scenario planning work will be picked up later in the year to concentrate on the risk tolerance targets for GRIPs.

Criteria for assessing proposed changes to strategic benchmarks when they trigger "inefficient"

Work continues on this action to understand what factors should be included when considering a change to the strategic asset allocation of the GPs. It was outlined at the meeting that the most important element of the process is the qualitative discussion.

Risk tolerance targets for GRIPs.

Work continues with Moody's Analytics to review the risk tolerance targets for GRIPs. A formal proposal will be submitted at the May meeting. EFS/RD

Impact of cash dilution to asset allocation of the Governed Portfolios

Figures were presented to the IAC showing the average levels of cash within the sub funds that make up the portfolios. The biggest impact to the overall asset allocation is an approximate 2.5% cash holding within SL

Global Managed. SL are working to understand what level of cash is appropriate within the fund before submitting a proposal around adjusting the overall asset allocation to allow for cash dilution. SL property and the SL high yield funds also hold cash within them however, the allocation to high yield is small and therefore has a negligible effect. The property fund has to maintain liquidity therefore a cash holding is appropriate in this case. PMcG

3. CUSTOMER INVESTMENTS

GOVERNED PORTFOLIOS & MANAGED STRATEGIES

Benchmark analysis
No changes are recommended to the Governed Portfolio and Managed Fund benchmarks this quarter. All the portfolios are reporting as efficient.

Tactical analysis
All portfolios remain within their tactical risk budgets. Robert Talbut has made a tactical change within all of the portfolios since the last meeting.

On 13th February he increased his overweight in equities at the expense of investment grade corporate bonds with the exception of GP7 where he increased his underweight in Property.

GOVERNED RETIREMENT INCOME PORTFOLIOS

Benchmark analysis
No changes are recommended to the strategic benchmarks this quarter. They continue to be outwith the risk targets at the minimum level however this continues to be a consequence of the risk measures being too sensitive to small changes. This issue will be covered by the GRIP risk target review in progress.

Tactical review
All the portfolios are within their tactical risk budgets. Robert Talbut has made a tactical change within all of the portfolios since the last meeting.

On 13th February he increased his overweight in equities at the expense of investment grade corporate bonds.

LIFESTYLE PATH ANALYSIS

Each Governed Lifestyle Strategy continues to be appropriate for its risk profile and investment objective.

SHORT TERM TACTICAL VIEW OF THE CHIEF INVESTMENT OFFICER

RT reviewed Q4 2013 and presented his rationale for his current short term tactical view:

"The fourth quarter of last year was dominated by a rising trend of optimism over the economic outlook. This was evident in the US where signs of corporate capital expenditure picking up reinforced the view that growth in 2014 would be relatively strong especially given the fact that any 'fiscal drag' from the government sector would be significantly lower than was the case in 2013. In combination with employment continuing to pick up growth expectations rose through the period. In the UK the strength of the macro data took all analysts by surprise through a combination of consumer spending, a housing recovery and signs of a turnaround in corporate spending intentions. This led to the surprising view that the UK was the fastest recovering developed economy over the second half of 2013 and analysts continually had to up their expectations of recovery. Perhaps the biggest surprise was the improving sentiment regarding the EU where there were definitive signs that some of the periphery economies were firstly stabilising and indeed could see positive growth in 2014. While there were issues over the rate of growth in Brazil, China and India this was not seen as sufficient to destabilise the overall view of the global economy improving with increasing talk of a sustainable recovery.

Elsewhere on the macro front attention shifted to the emerging risk of inflation being too low and again to the prospect for the US Federal Reserve to start removing some of the monetary stimulus. In the former, concern was growing that European inflation was printing too far below the target 2% level and while the risk of 'deflation' was commented upon the view was that the ECB would act to address these concerns through further monetary stimulus of some variety which in turn would be taken as good news by financial markets. For the latter, following the wobbles that had occurred around mid-year on the potential for US tapering the consensus had shifted to a belief that any withdrawal of monetary accommodation would be both gradual and sensitive to the potential to affect the ongoing recovery.

Given the above the trend over Q4 was towards improving confidence that the corporate sector would experience very encouraging headwinds for trading in 2014 and that earnings expectations of a rise of around high single digits was well founded and even that upgrades could be in evidence as the year progressed. This was generally seen as important given the degree of re-rating that had occurred within equities over the last 1-2 years and that the prospect of a further significant re-rating was unlikely given the likely trend towards higher interest rates. However using historical comparison data of both the straightforward PE ratio or looked at in terms of the cyclically adjusted figure the valuations of global equities while no longer signalling cheapness did not suggest fundamentally overvalued markets. Our equity portfolios performed well through the period especially helped by our pro-cyclical stance.

Credit markets continued to grind higher over the period given the twin forces of increasing risk appetite towards credit and liquidity looking for a home in corporate assets. It is remarkable how spreads over government bonds which reached around 80bp prior to the financial crisis, which then ballooned to around 1000bp at the worst have now retreated back to around 110-120bp. While we still see the potential for some small further tightening our portfolios can also benefit from our preference for asset backed issues. However the overall market will have to face, we believe, a gentle rising trend in government yields over 2014 which will be a significant headwind to returns, but within the wider asset class we see the best returns from high yield given the better carry available.

The property market continued to improve overall but as in previous periods this was focused almost entirely in prime property which attracted further investor interest from home and overseas attracted by the perceived stability of the sector. We continued to run down our cash weighting through the acquisition of some good quality assets where we also see the potential for our traditional asset management skills to add value over time. Overall the portfolio performed well despite the cash drag and our expectation is that we will see further upwards progress in 2014.

Index-linked assets saw a rise in real yields due to the combination of rising growth expectations and the prospect of reduced monetary stimulus. However they still remain in negative territory and we expect that as a more 'normal' economic/financial market environment develops that yields will return to positive territory. However given the still considerable imbalances that exist within the global economy and in many government finances we see real yields remaining lower than historical levels into the foreseeable future.

Throughout the fourth quarter our asset allocation remained unchanged with our overweight towards equities balanced by underweights in all other asset classes. Within credit we retained the preference for high yield over investment grade which is a trade that has worked well for the funds. With equities the best performing asset class our positioning was a positive while all the funds remained well within their risk parameters. Our expectation is that economic growth will be very respectable in 2014 to the extent that debate over the date of the first rate rise in the US and UK will be constantly debated. This should be seen as a sign of success, in that the exceptional monetary stimulus can at last be gradually removed. However we think the authorities will continue to err on the side of slower withdrawal especially given the very low levels of global inflation which provides all the cover they need for a very cautious approach for fear of interrupting the growth progress. The result of the authority's policy stance and the moves in financial markets means that there are now no 'cheap' asset classes available. Given our view that we face a benign growth/inflation mix we remain of the view that through 2014 equities will be the best performing asset class, although crucially we think that returns will be far more modest than in previous years given valuation levels and the changing monetary policy stance. We believe that government bonds will sell off which will inhibit the returns from credit and that property can provide further positive returns. Hence we intend to retain our overweight towards equities and indeed use the recent weakness (and bond strength) based upon a 'growth scare' to add to our positions in the portfolios."

JP queried that equities seem fully valued and therefore was it a good time to be moving further into the asset class. RT replied that although on a short term valuation basis they do appear to be at or full value, over the long term there was still capacity for growth and that they expect 2014 to be a positive year for equities albeit at more modest levels. Most developed economies have spare capacity for growth and therefore they dont see any need for monetary policy to tighten and choke further growth.

It was also noted that Europe could be moving to a deflationary environment and that the ECB may introduce further stimulus to avoid this situation. This would further help equity markets going forward.

4. FUND OPERATIONS REVIEW

FTSE 350 tracker and active funds – Work continues to migrate these funds over to collective investments. RH

5. SCOTTISH LIFE FUND REVIEW

Governed Range

Attribution analysis – extended attribution analysis was presented to the IAC and this will be produced going forward. This will show the asset allocation and fund selection contribution to performance over each tactical asset allocation period. This will give the IAC insight into how the portfolios have performed over the various tactical positions that have been applied. PMcG

The following funds/portfolios were discussed:

Governed Portfolios – The Governed Portfolios are performing strongly. All are outperforming over 1 year with 7 portfolios also outperforming over 3 years. GP7 and GP8 are only marginally under over 3 years. Outperformance has broadly come from the underlying funds over the last 12 months as opposed to asset allocation positioning which is broadly flat.

Rathbone Global Alpha – Although this fund was only launched in August 2013, performance on this new fund remains strong. It is above benchmark since launch and feedback has been very positive. The largest contributors have been the UK sub funds and only 2 positions within the entire fund are detracting from performance.

Property – The cash level within the fund has dropped significantly and now sits at approx 10%. This is due to the team making £400m worth of purchases and commitments within the fund over 2013. The void rate has also lessened to 7.1%. These factors have continued to help performance in the fund with it being 7th percentile within the sector.

Other funds managed by RLAM

The following funds were discussed and no action was taken:

Duration matched Index Linked Gilts - Fund performance on these funds has improved to the point where they are on benchmark over 1 year and are only showing marginal underperformance on a 3 year basis.

UK Smaller Companies – Fund performance has been poor over the last 12 months. Robert Talbut commented that this was due to the manager's style. He prefers to hold high-quality, long-term growth stocks however the market in 2013 embraced distressed, poorer quality stocks which the manager does not invest in.

Matrix Funds

The following funds were highlighted as requiring action:

Invesco Perpetual Income – SL continue working to assess this fund and its ability to outperform going forward. Colin Taylor and Robin Herd met with the new manager in January to discuss the manager's process and style. There was a degree of comfort that Mark Barnett is a capable manager and that Invesco Perpetual have put in place a manager who is familiar with the fund and has a strong track record running UK Equity Income funds. There does remain doubt over how Neil Woodford's departure will affect the fund and the news that he is launching a similar mandate in the market could have significant impact. SL are investigating the various options available looking at which action would be in the best interest of customers and will submit a proposal to the IAC as a priority. RH

Investec UK Smaller Companies – The existing manager is leaving this fund. SL are currently engaged with Morningstar OBSR around whether a replacement fund is appropriate or not. A proposal will be submitted at the next IAC meeting. RH

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

Fidelity American – The fund is significantly outperforming the replaced fund however it is struggling against the benchmark. It is common that the majority of US funds have some periods where they collectively fail to beat the index. Relative performance of -1.6% vs benchmark compared to a peer positioning of 49th percentile suggests the fund is performing within the sector but less so against the index.

Neptune European Opportunities – The fund is outperforming the benchmark strongly over 6 months and since it replaced the Artemis European Growth fund in May 2011 although 1 year performance remains below benchmark.

JPM Emerging Markets – Fund is significantly underperforming both the benchmark and the replaced fund. A poor Q4 2013 has impacted the track record.

Other external managed funds

The following funds were highlighted as requiring action:

Investec UK Blue Chip - This fund is to be merged with Investec UK Alpha in March 2014. SL are currently producing a proposal around whether their customers' investments should be merged into this fund and what action is required. RH

The following funds were discussed but no action was required:

Investec Emerging Local Currency Debt - Fund performance has again been poor over the quarter although less than the previous quarter. Currency exposure and specific regional bets have continued to harm performance.

Investec Global Energy - The fund has underperformed over Q4 2013 by 3.5% relative to the benchmark however the longer term peer positioning is strong with the fund sitting in 12th percentile within the sector.

Jupiter India - Fund performance has improved considerably over the quarter, outperforming the benchmark by 3.6%. Historical performance is affecting the 1 & 3 year track record.

Jupiter Merlin Worldwide Portfolio - The fund has marginally outperformed the benchmark over the quarter however the longer term track record has also improved due to poor performance dropping out of the track record.

Legg Mason US Smaller Companies - The fund again marginally underperformed over the quarter but longer term performance has worsened due to historic figures affecting the track record.

M&G Global Basics - The benchmark for this fund is the IMA Global sector average. Compared to this benchmark the fund continues to significantly underperform over 1 & 3 years having a particularly poor Q4 2013. The fund also lagged its peer group as stock selection within consumer goods, consumer services and financials detracted. This negative impact outweighed a positive contribution from the basic materials sector. The lead fund manager, Graham French is retiring so the fund will be managed by the deputy manager Randeep Somel.

M&G Recovery - This fund still continues to underperform albeit marginally over this quarter. In a market that has been driven by a flight to quality the stocks held by this fund have been out of favour. Given the fund is compared to the UK All Companies sector the fund is underperforming.

Neptune Global Equity - The fund has again outperformed over the quarter improving the shorter term performance. Historical performance is still affecting the 3 year track record.

Newton Balanced - Fund performance has been poor over the quarter with the longer term figures also worsening. The 5 yr track record is also being affected by some very poor performance at the start of the period.

Newton Managed - The fund has significantly outperformed the benchmark over the quarter with the longer term numbers also improving.

Schroder Global Prop Sec - The fund has again outperformed the benchmark which has subsequently improved the longer term figures albeit marginally.

Schroder US Mid Cap - The fund was flat relative to benchmark over the quarter with the longer term figures improving although still underperforming significantly.

Threadneedle Latin America - The fund has marginally underperformed however good performance dropping out of the 3 year track record has worsened the longer term performance.

UBS Global Blended - The fund is strongly outperforming the benchmark over 1 year however historical performance dropping out has affected the 3 & 5 year numbers.

UBS UK Equity - The fund has outperformed over the quarter and is only marginally underperforming over 1 & 3 years. The 5 year track record is poorer.

The following funds have improved and are no longer on watch:

BlackRock UK Equity, Fidelity Special Situations Blended, Jupiter Financial Opportunities, Neptune Balanced, Neptune Global Alpha, Newton Real Return.

6. DATE FOR NEXT MEETING

The next quarterly meeting is 28th May 2014.

IMPORTANT INFORMATION

Past performance is not a guide to the future. Prices can go down as well as up. Investment returns may fluctuate and are not guaranteed so you could get back less than the amount paid in.

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