Investment Advisory Committee (IAC) Quarterly Meeting

Minutes Of Meeting

Date
26/11/2014

Present members	In attendance	Apologies
Julius Pursaill (Chair)	Robin Herd	Phil Loney
Colin Taylor	Patrick McGrath	Isobel Langton
Andrew Carter	Lorna Blyth	
Ewan Smith	Robert Talbut	
	Robert Whitehouse	

Owner

1. **REVIEW OF PREVIOUS MINUTES** LB

The minutes of the 22 August meeting were approved with discussions on the following action points taking place during the meeting:

- Changes in default investment proposition in light of budget changes
- RLP Property
- RLP UK Smaller Cap Specialist (Investec UK Smaller Companies)

2. **PROJECTS**

Investment default design and budgetary impact LB

The project to review our investment default and proposition changes in light of the budget is progressing. We are investigating proposals for review and approval and hope to be able to put these for IAC approval before the next meeting.

Property – mandate review RD

Work is ongoing to widen the Property fund mandate to satisfy group governance requirements.

There was discussion about the impact of customer behaviour and the Governed Range rebalancing functionality on the cash level within the fund. This focused on how a downward equity market results in the portfolio rebalancing out of property and the impact this has on cash levels. This activity is monitored on an ongoing basis to ensure liquidity of the fund is maintained at an appropriate level.

3. CUSTOMER INVESTMENTS

STRATEGIC ANALYSIS

Governed Portfolios & Managed Strategies
No changes are recommended to the Governed Portfolio and Managed Strategy benchmarks this quarter. All the portfolios are reporting as efficient with the exception of Governed Portfolio 3 & 6. The expected real return difference is small and as increasing efficiency would require changes with a modest increase in return, the IAC were comfortable that no change would be made this quarter.

Governed Retirement Income Portfolios
No changes are recommended to the strategic benchmarks this quarter. The portfolios continue to be within both the long and short term targets.

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

TACTICAL ANALYSIS

Governed Portfolios & Managed Strategies
All portfolios remain within their tactical risk budgets. No tactical changes have been made since the last meeting. The portfolios remain overweight in equities and high yield bonds in favour of investment grade corporate bonds, index linked gilts and property.

Governed Retirement Income Portfolios (GRIPs)
All the portfolios are within their tactical risk budgets. No tactical changes have been made since the last meeting. The portfolios remain overweight in equities and underweight in investment grade & high yield corporate bonds, index linked gilts and property.

We are continuing to review the use of index linked gilts within the portfolios given our views on this asset over the longer term.

Subsequent to the meeting Robert Talbut made a minor tactical change to the GRIPs to remove some inconsistencies. This is effective from 8th December 2014 and the changes are as follows,

	Moved out of…	In favour of…
GRIP 1	0.5% Equity	0.5% Corporate Bonds
GRIP 2	0.5% Index Linked	0.5% Corporate Bonds
GRIP 3	0.5% Index Linked	0.5% Equity
GRIP 4	0.5% Corporate Bonds	0.5% Equity
GRIP 5	0.5% Corporate bonds, 0.5% High Yield bonds	1.0% Equity

Short term tactical view of the Chief Investment Officer

RT reviewed Q1 2014 and presented his rationale for his current short term tactical view:

"The third quarter of the year provided the now familiar curates egg of good and bad. This encompasses both the financial markets but also the underlying global economy. Since the financial crisis of 2008 we have seen cycles of optimism and pessimism reoccurring. It should be quite clear to any observer now that the period of 2007-09 did mark a decisive point of reappraisal in economic history from the belief in the fairly consistent benefits flowing from the effects of globalization, low and accommodative monetary policy, regulation that was designed to let relatively free markets function and where fiscal policy was generally designed to support economic growth. Post this period we are now living in a world where regulation is a growing influence, free-markets are not seen as wholly benign, globalization is starting to be seen in terms of winners and losers, monetary policy is being tested to its limits of stimulus and where the paying down of debt continues to dominate governments and consumers. However the fundamental question is whether the global economy can generate sufficient sustainable aggregate demand that will allow for real income growth in the personal sector, and to create sufficient jobs, and to allow the corporate sector to deliver earnings growth and that allows governments to repair their fiscal positions.

Our view is that the pattern of stuttering improvement which has emerged is highly likely to last for many more years into the future. The growth profile that existed prior to the crisis was less strongly based than was believed at the time and that the pay-back time will be extended. Hence we see the global economy delivering a level of growth less than is hoped for but better than might be feared. The major economies of the world all have some forms of structural problems which makes the degree of policy coordination that many believe is necessary for much stronger growth far more difficult. Hence we see countries using their exchange rates in order to boost activity or to counter deflation at the expense of others and where governments find it difficult not to be preoccupied by policies that are aimed at addressing national anxiety as opposed to boosting global integration. Correcting the imbalances that remain both within and between economies remains a multi-year process in our view.

The effect of these factors together with the support that has been provided to economies and financial markets from exceptionally stimulative monetary policy settings is that economies are significantly dependent upon loose policy and that all asset classes have reached elevated levels. The implication of this is that global growth will remain unsatisfactory from governments, electorates and investors perspective and that financial returns from here will be quite muted.

During Q3 we continued to see good economic news-flow within the UK in terms of growth but this was accompanied by a continual trending down of inflation influenced by falling oil prices and also a price war in food retailing. The beneficial effect of this was to start to edge commentators towards expectations that the first interest rate rise would be further delayed into 2015. Employment growth continued at a good pace and there were even signs that the squeeze of consumer incomes was easing. The referendum in Scotland did cause some volatility in UK assets especially when markets saw the possible prospect of 'break-up'. This was a useful prompt to investors to consider the possible implications of any result in the UK general election in 2015 and the prospect of an EU referendum in 2017. Elsewhere the US saw largely in-line releases on the state of the economy, most of the Far East exhibited satisfactory export numbers, but Japan demonstrated the fragility of its latest recovery post the rise in sales taxes which then led to much reduced activity in the economy. However it was the Euro area which had the greatest impact upon sentiment within financial markets. A run of disappointing data on the economy which increasingly extended to previously stronger economies such as Germany encouraged the view that the area could re-visit a recessionary environment. These fears were compounded by persistently very low inflation numbers which caused investors globally to fear a shift to deflation. While the ECB continued to try to provide soothing words regarding their already accommodative monetary policy tool-kit, which now included a willingness to buy asset-backed bonds from banks and others, this was still seen as disappointing and far from presaging the hoped for QE in Europe. Our view was that the economic news was as yet not bad enough to overcome the obstacles in certain capitals to this next step.

While equities had traded largely sideways for the majority of the quarter the net negative real economy data had been supportive to bond prices. However towards the end of the period and into Q4 equities started to sell-off and government bonds, helped by the deflationary fears, rallied quite strongly. This also saw real yields on index-linked bonds fall further into negative territory at virtually all points along the curve. Corporate bonds which for the last few years have tracked government bonds higher stopped doing so and yield spread's widened at the end of the period as the potential negative effects from the growth-inflation mix caused concern. However the standout asset class was commercial property. The combination of relatively secure yields and capital growth saw further strong returns. Weight of money appears a considerable force behind the outsize gains as the limited amount of assets available is being chased by existing and new funds. Having been a buyer of assets over the last few years, and mindful of the costs of trading any positions, we are increasingly reluctant to do so now even though market forecasts are for further high single digit returns in 2015. The issue will be that if we decide to reduce exposure into what alternatives would we invest the cash?

During the quarter our high level asset allocation position has remained unchanged. The big surprise for allocators this year has been the further falls in government bond yields to historic lows and we have clearly been on the wrong side of this. We continue to believe that yields reflect too pessimistic a view of the global outlook and that a further leg down to growth is not inevitable and that policy makers could still counter any weakness. The minor wobble in credit recently should also be a useful signal that the asset class is not immune to the negative consequences of lower growth even if that leads to gilt yields falling. We also struggle to become positive on index-linked gilts given the negative real yields available and the inconsistency with the underlying purpose of the funds. We've also maintained the small underweight to property with the returns far in excess of our expectations for this year and now questioning of how much further the market can rise. In contrast equity markets have delivered the relatively low returns YTD that we expected. At a lower level we did shift our regional allocation within equities. At the start of the quarter we shifted out of the UK market and increased our overseas equity exposure to an overweight position largely through US equities. This was very largely a view on weaker sterling in part given the likely political risks around the UK over the next 12 months or so.

Our outlook view is for further global economic expansion led by relatively healthy growth in the US. In addition the Far East continues to progress well and while China is slowing we still expect the authorities to be able to carefully manage the trajectory to a more sustainable level. In Japan recent actions would show the determination that exists to try and elevate both growth and inflation. While we believe that Europe will continue to be at the back of the growth pack we expect that ultimately further monetary stimulus will be forthcoming to at least prop things up although fundamentally it is fiscal stimulus that is required for a healthier outlook. In the UK our view is that for 2015 while the economics will be unexciting, with steady growth and inflation a little higher, the politics could be very challenging. This reinforces our current view to remain underweight to the domestic equity market. At the overall fund level we hold to a low return world, certainly given current valuations, and that equities can provide the best returns against most potential scenario outcomes. A far more bearish view than we take currently would likely see index-linked perform the best which in part explains our reluctance to significantly sell down the asset class despite the valuation."

4. **SCOTTISH LIFE FUND REVIEW**

Governed Range

The following funds/portfolios were discussed:

Governed Portfolios – The Governed Portfolios continue to perform well over 1, 3 & 5 years. Most of the short term underperformance from last quarter has been regained also improving the year to date numbers. Equity performance has bounced back and is reflected in the improved performance of the portfolios. The duration bond funds have impacted the quarter's performance albeit marginally.

Other funds managed by RLAM

The following fund was discussed:

RLP European – There was a change to one of the underlying funds within RLP European which significantly increased the risk exposure. To offset this risk exposure RLAM allocated some of the fund to a European tracker to bring the total tracking error back into line.

Matrix Funds

The following fund was highlighted as requiring action:

Investec UK Smaller Companies –This fund had been highlighted for review based on a manager change earlier in the year. After discussion with Morningstar OBSR it has been agreed that there is no compelling reason to replace this fund. Performance is strong and IAC are aware of capacity issues within many of the suitable replacements. RH

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

Fidelity European Blended – Fund performance has been broadly flat over the quarter however poor historic performance dropping away means the fund no longer triggers for review. The IAC will continue to monitor performance over the short term. RH

The following funds were discussed but no action was required:

Invesco Perpetual Japan - It has been highlighted in the past that this fund's performance can be volatile. Recent performance has illustrated this with the last 2 quarters being relatively flat but the fund has still underperformed by 3.9% year to date. Three year performance is strong however the fund still lags the benchmark over 5 years.

JPM US – This fund has regained some of the underperformance from recent quarters however it still underperforms over 3 & 5 years due to historic poor performance.

Schroder Core UK Equity (formerly Cazenove UK Growth & Income) - Fund is performing poorly year to date which is affecting the 1 year figure. Fund performance is marginally better over 3 years however historic performance is also affecting the 5 year track record. Performance was affected by some key sector calls in mining and food retailing but the manager remains positioned for a modest recovery in cyclically-focussed companies.

Other external managed funds

The IAC noted that funds triggered in 2013 that remain on watch should receive more extensive analysis and reporting. This will be included in the next IAC report. RH

The following funds were discussed but no action was required:

Fidelity Special Situations Blended - Fund performance has improved over the quarter outperforming the benchmark. The fund is outperforming over 3 years significantly however historical performance is affecting the 5 year track record.

Fidelity UK Growth - This fund has underperformed significantly over the quarter although is still outperforming over 1 year. Historic performance is also affecting the 3 & 5 year figures.

Investec Cautious Managed - This fund continues to underperform albeit at a lower level than last quarter. The fund is only marginally below benchmark over 3 years.

Investec Emerging Local Currency Debt - Performance volatility remains to be the case with this fund. After a good Q2, the fund has significantly underperformed the benchmark over Q3. The 5% drop relative to benchmark has impacted across all the time periods.

Investec Global Energy - The combination of poor Q3 performance and good historic performance dropping out means this fund is underperforming significantly over 1 & 3 years.

Jupiter Ecology - A very poor Q3 (-5.1% rel. to benchmark) has impacted the fund with 1 & 3 year performance being below benchmark.

Jupiter Merlin Worldwide Portfolio - Fund performance has subsequently improved over Q3 lifting the 1 year track record. Historic performance has worsened the 3 year track record. Having met with the manager earlier this year SL expect fund performance to continue improving.

M&G Global Basics - A further quarter of poor relative performance has affected the fund across all time periods. M&G were subject to our annual due diligence process in Q3 and any resultant action will be provided at the next IAC meeting.

M&G Recovery - The fund continues to significantly underperform the benchmark over all time periods following another poor quarter. M&G were subject to our annual due diligence process in Q3 and any resultant action will be provided at the next IAC meeting.

Neptune Balanced, Global Equity & Global Alpha - Fund performance has improved over the quarter across all three funds, particularly the Global Alpha fund. SL previously met with Neptune and expressed concern around poor performance and the support to these funds going forward. These funds will continue to be reviewed until early 2015 where a decision will be made on whether they should be removed.

Newton Balanced & Managed - These funds continue to underperform however peer positioning is not as poor. Newton previously intimated that they are re-engineering their multi-asset range and these funds will form part of their plans. We have subsequently received corporate actions for the funds and are working to understand the changes and whether or not SL will retain these funds.

Newton Global Higher Income - This fund is underperforming over 1 & 3 years however peer positioning is more positive.

Schroder Global Property Securities – The fund has worsened over the quarter and is underperforming over 1 & 3 years.

Threadneedle Latin America - Fund performance has worsened over Q3 having improved in the previous quarter. The fund continues to underperform over 1 & 3 years.

UBS Global Blended - This fund continues to underperform across 1, 3 & 5 years.

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

BlackRock UK Equity, Schroder US Mid Cap, Jupiter Financial Opportunities, UBS UK Equity.

6. DATE FOR NEXT MEETING

The next quarterly meeting is 24th February 2015.

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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