Investment Advisory Committee (IAC) Quarterly Meeting

Minutes of Meeting

Date
01/03/18

Present members	In attendance	Apologies
Julius Pursaill (Chair)	Robert Whitehouse	Isobel Langton
Colin Taylor	Ryan Hamill	Robert Dundas
Ewan Smith	Robert Dundas	Piers Hillier
Neil Chapman	Khalid Khan	Lorna Blyth
	Fraser Chisholm	Niall Aitken
		Trevor Greetham

Owner

1. **REVIEW OF PREVIOUS MINUTES**
The minutes of the 1 December 2017 meeting were approved.

2. **PROJECTS**

Schroder Core UK Equity and Schroder UK Equity Replacement LB
A paper was presented outlining potential replacements for the two core UK funds. The IAC was happy with the intention to place the assets from both funds into one suitable replacement. The analysis conducted has not found a suitable replacement, illustrating the issues in sourcing an active UK equity fund which fits within the risk parameters and has a strong performance record.

The IAC was pleased that RLI have not proposed a sub-standard replacement but concerned that a suitable replacement has not been sourced. The IAC has requested a widening of the scope for the replacement funds. Furthermore, the IAC has requested further investigation regarding possible alternative short term solutions and if these might improve the fund replacement process going forward. The IAC requested that this work be progressed before the next meeting.

The IAC was concerned that the current Matrix fund range tracking error parameters are causing problems in finding suitable replacement funds. The IAC requested that a review of suitability of the parameters be carried out for the next IAC meeting.

Workplace Pension Default Investment Update NA

The purpose of the paper was to provide an update to the IAC on the progress made by RLI towards implementing the change in workplace pension default for existing business. The change has been implemented for new business with effect from February 2018. The IAC recognised the amount of work involved and was pleased with the progress being made.

RH

Performance RAG Update

The purpose of the paper was to provide the IAC with an update on the review of the RAG (Red Amber Green) system used when reviewing fund performance and the improvements being considered. In particular the improvements have focused on managing the sensitivity of the RAG to very short term underperformance, how we take risk into account and whether we introduce a buffer zone into the RAG.

The IAC was pleased with the improvements suggested and are keen to see a solution which can be implemented across the Royal London group through the performance working group.

The IAC asked that it is made clear how the RAG metric is used in practice.

The IAC requested that once further progress has been made on this that it will be brought back to the committee for further comments.

3. **CUSTOMER INVESTMENTS**

STRATEGIC ANALYSIS

Governed Portfolios & Managed Strategies

No changes are recommended to the Governed Portfolio and Managed Strategy benchmarks this quarter.

All portfolios remain within their target ranges for real volatility. The real volatility for the majority of the portfolios has remained broadly unchanged compared to the previous quarter.

Governed Retirement Income Portfolios (GRIPs)

No changes are recommended to the GRIP benchmarks this quarter.

All portfolios remain within their targets for the income risk metric (income sustainability) and the fund risk metric (maximum 1 year loss at the 5th percentile)

Lifestyle Path Analysis

The expected real income for annuity lifestyles has decreased compared to the previous quarter due to a change in the yield curve. In particular, the expected annuity incomes have decreased by 3.0% over 5 and 4.2% over 15 years.

4.

The expected real fund value of the drawdown lifestyles has decreased by 2.4% over 15 years but increased by 0.1% over 5 years.

TACTICAL ANALYSIS to UPDATE

Governed Portfolios & Managed Strategies
All portfolios remain within their tactical risk budgets.

There have been two tactical changes since the last meeting. The change in January added to commodities and marginally to high yield bonds, reducing our exposure to bonds and cash. In February, we increased our positions in equities and commodities largely out of bonds where available, property otherwise. We also deepened our underweight position in fixed income in favour of cash.

The overall position as at end December, was overweight Equities, High Yield Bonds and Corporate Bonds; underweight Absolute Return Strategies (inc. cash), Index Linked Bonds and Gilts; neutral Property and Commodities.

Governed Retirement Income Portfolios (GRIPs)
All portfolios remain within tracking error budgets.

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The overall position as at end December, was overweight Equities, Corporate and High Yield Bonds; underweight Index Linked Bonds and Gilts; neutral Property, Commodities and Absolute Return Strategies (inc. cash).

Short term tactical view of the Chief Investment Officer

FC presented RLAM's rationale for the current short term tactical view:

Positioning & activity

- Overweight positioning in equities was maintained in Q4 against a backdrop of accelerating global growth indicators and relatively subdued inflation data releases. Underweight positioning in fixed income through the quarter was increased marginally in November as the interest rate outlook grew slightly less benign.
- For portfolios with Commodity holdings, exposure was increased from a small underweight at the beginning of Q4 to a neutral position given the inflation protection the asset class gives. UK commercial property exposures were maintained at a neutral level over the period
- At the regional equity level, overweights in Japan and Emerging Markets were maintained throughout the quarter as global growth indicators improved; we remained underweight the later cycle UK and USA; we were neutral in Europe ex-UK where despite good economic recovery numbers, Euro currency strength (or USD weakness) was a significant headwind.

Q4 market background

- Global equities returned 6.7% for Sterling-based investors over the fourth quarter of 2017. In sterling terms, Japanese equities performed best with a gain of 8.8%, followed by Asia Pacific ex Japan (7.2%) and the US (6.69%). The FTSE All Share returned 7.2%.

- Sterling weakened slightly overall over the quarter, having been strong in Q3, despite the slight increase in the Bank of England's (BoE) policy interest rate in November. Sterling was weaker against the euro but stronger vs the USD.
- Gilts returned 1.97% over the quarter and yields fell, even though the Bank of England raised its policy rate to 0.5% for the first time since 2007 in a widely anticipated move. The UK yield curve flattened as the short end reacted to higher base rates.
- Index linked UK government bonds (all maturities) returned 3.52% over the quarter, outperforming conventional gilts. Shorter dated maturities underperformed significantly with the increase in base rates. UK breakeven (implied) inflation rates were broadly flat as official forecasts for economic growth were lowered and wage growth continued to trail inflation
- Sterling investment grade credit returned 1.83% in the quarter, underperforming UK government bonds, which returned 1.97%, supported by a robust global economy and still subdued inflation. The average sterling investment grade credit spread ended the quarter 1 basis point (bp) narrower at 104bps. Sterling credit issuance tailed off towards the end of quarter, although overall remaining broadly in line with the robust levels witnessed over the rest of the year, bringing total issuance for 2017 to a post-financial crisis high.
- Commodities were strong over the quarter led by oil with Brent up over 39%; Copper was up 22% while Gold was up 3.9%.
- UK commercial property continued to be resilient, delivering 4.6% over the fourth quarter, taking the year-to-date total return to 9.7%

Relative positioning & TAA performance

- TAA effects contributed positively over Q4; performance benefited from an overweight in Equities, funded out of Fixed Income and Cash. Both Commodities and Property were maintained around benchmark during the quarter.
- Regional positioning within Equities benefited significantly from an overweight stance in Japan and EM, while being underweight the UK and US slightly detracted.
- In Fixed income, the underweight position had a neutral impact on the portfolio; the position UK Gilts detracted slightly during the period, while being underweight UK index linked gilts was beneficial.

Outlook & views

- Our Investment Clock is in the later cycle 'overheat' phase, with strong global growth and more risk of inflation; commodities historically have tended to outperform in that environment. Because inflation is still at a low level and interest rates are only rising gradually, led by the US, the environment is still positive for equities and relatively benign for bonds even if the market is now more concerned about inflation and interest rate increases than it was last year.
- We maintain an overweight position in stocks and global high yield bonds and an underweight position in UK bonds. We maintain overweight positions in Japanese and emerging market equities, a neutral position in European equities, and underweight positions in Pacific excluding Japan, UK and US equities.
- Given longer term positive economic fundamentals and with interest rates not expected to rise sharply in the next year at least, we remain ready to buy stocks on dips in the market.

5. ROYAL LONDON FUND REVIEW

The following funds/portfolios were discussed:

RLI Governed Range

Governed Portfolio 7 is minimally below benchmark over 1yr and Governed Portfolio 1 and 7 are below benchmark over three years. All of the Governed Portfolios are outperforming over five years. Only Governed Portfolios 4 and 7 are underperforming since launch. Absolute returns remain very strong.

The property holding continues to remain a key performance detractor due to the higher cash holding. This analysis is based on end Q4 data, since then the cash position has improved significantly and now sits around 8%.

The IAC noted the relatively high cash holding within the property fund and asked if the cash balance could be used to gain property exposure through other instruments to help manage any future high cash holdings.

All five GRIPs continue to outperform over one, three and five years and also since launch. Absolute returns remain very strong.

The IAC noted the very strong performance of the GRIPs over the last year. The IAC advised caution around the structure of the GRIPs, specifically that they are designed for income sustainability rather than capital growth, and that advisers need to be aware of this.

RL pension funds

The number of RLAM funds triggering for review over this reporting period is 16 however no funds have significantly underperformed.

RLAM funds on watch:

- Long (15yr) Index linked
- Sustainable Leaders (previously UK Ethical)
- UK Opportunities
- American
- Far East (ex Japan)
- European
- Japan
- Pacific
- Worldwide
- Global Equity
- International Government Bond
- Global High Yield Bond
- Global Index Linked

The IAC asked for detail around the underperformance of the Global High yield fund and Commodity fund. The only two core Governed Range funds (except Property) underperforming their benchmark over 1 year. The IAC also raised concerns around the retail property sector, in particular how the current retail market conditions are affecting property prices and default rates.

Global High Yield
The fund has underperformed its benchmark by 2.2% over 2017. This is mainly down to underweighting the energy and financial sectors, which have performed well over the year. The fund manager sees these sectors as higher risk, but has trimmed his underweight positioning throughout the year in response to the strong performance. The fund manager continuous to look for good opportunities on a case by case basis.

Commodities
The fund has underperformed its benchmark by 1.1% over 2017. This difference is being driven by issues around timing differences between pricing the RLP fund and the benchmark pricing point. Additionally how quickly the cash flows can be invested, has created a slight cash drag on the fund

Property
The fund is a balanced fund with exposure to a range of sectors and a wide geographical spread. The Fund Manager monitors tenant concentration risk on a regular basis. The Fund Manager and all of the Sector Heads regularly monitor macro and micro factors that could impact on any given asset. With the current well publicised difficulties in some parts of the retail market, arrears and tenant trading performance are scrutinized regularly. Individual asset managers consider options to mitigate any perceived risk across all assets and take any necessary action as required. There is an ongoing dialogue with retailers regarding how their businesses are trading and whether specific units are suitable for current requirements.

Externally managed matrix funds

The following funds are under review and are subject to further action before the next meeting:

Schroder Core UK Equity
This is another fund which has suffered from poor performance. We have held two interviews with the investment team over the last 18 months and had taken comfort from a turnaround in short-term performance however the fund has dipped below benchmark again this quarter and over 1, 3 and 5 years. We propose to close this fund and identify a suitable replacement. We also hold Schroder UK Equity which has also underperformed over 1 and 3 years, this fund will be merged into the Core UK Equity replacement fund.

Schroder UK Equity
The fund is underperforming over the quarter, 1 and 3 years. It was decided at the last IAC meeting that this fund, along with the Schroder Core UK Equity would be closed and customers moved to a suitable replacement. Please refer to the Schroder replacement project section.

The following funds were also discussed during the meeting:

First State Global Emerging Markets Leaders
The fund had a successful quarter, outperforming the benchmark by 1.6% and placing in the top quartile. The fund underperforms over the one and three year periods, however continues to outperform over the five year period.

In the last 12 months, the fund has lagged the benchmark by 7.7%. Given the fund’s distinct style, performance divergence of this magnitude is not unexpected. The fund's quality growth style has been a major headwind as the value segments of the market have performed strongly. The very large overweight exposure to consumer staples (36.5% of the fund versus 6.2% of the index) has been detrimental. Stock selection in technology has been the most hurtful, with the preference for IT services names like Tech Mahindra, Infosys and Tata Consultancy Services over the likes of Samsung, Alibaba and Tencent proving costly from a relative standpoint.

In pursuing an investment philosophy based on quality, the fund has lagged rising markets over the last year or so. The fund's elevated cash weight (currently 8.3%) has been a clear headwind in a rising market. High cash levels are a function of the managers struggling to find attractively valued opportunities at this stage. The fund is currently soft closed. We will continue to monitor performance closely.

First State Asia Pacific Leaders
The fund has underperformed over the 1, 3 and 5 year periods to the end of December 2017. Given the fund's distinct style, divergent returns are not unexpected. Overweight exposures to consumer staples and healthcare have been detrimental as they have markedly underperformed other parts of the market. The best illustration of the fund's approach has been the performance headwind from stock selection within technology, where the preference for IT services names like Tata Consultancy Services, Asustek and Tech Mahindra over the likes of internet-related Alibaba and Tencent proved very costly from a relative standpoint.

The fund's elevated cash weight (around 8% on average) in the past few years has been a clear headwind in a rising market. The high cash level is a function of the managers struggling to find attractively valued opportunities at this stage. Cash at the end of December 2017 stood at a more beneficial 4.7%.

This is the 2nd consecutive quarter in which the fund has flagged for underperformance. We will continue to monitor performance closely.

Invesco Perpetual Japan
The fund outperformed its benchmark over the quarter. It is however underperforming its benchmark over 1, 3 and 5 years.

The biggest contributors came from a range of sectors – Inpex Corporation benefitted from rising oil prices, Don Quijote made strong gains in the retail sector and Cosmo Energy benefited from improving refining margins. Detractors included Mazda Motors, Casio Computers and Murata Manufacturing.

There were some changes to the positioning of the fund during the period, with a shift further towards more cyclical areas of the market where they are able to find the most attractive valuations. Invesco are confident they will see robust corporate earnings and have an optimistic view of Japan's economy and equity market.

6. DATE FOR NEXT MEETING

The next quarterly meeting is 5 June 2018.

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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