

Investment Advisory Committee (IAC) Quarterly Meeting

Minutes of Meeting

Date

13/06/2017

Present members

Julius Pursaill (Chair)
Colin Taylor
Ewan Smith
Rachel Elwell
Andrew Carter
Isobel Langton

In attendance

Robert Dundas
Lorna Blyth
Ryan Medlock
Ryan Hamill
Niall Aitken
Piers Hillier
Trevor Greetham
Robert Whitehouse
Ashely Hamilton-Claxton
Mike Fox
Rebecca Stevenson

Owner

1. **REVIEW OF PREVIOUS MINUTES**

The minutes of the 28 February 2017 meeting were approved.

2. **PROJECTS**

Use of ESG factors in RLAM's investment process

The IAC had asked for an update from RLAM on ESG trends and how RLAMs voting and engagement strategy impacts RLI customers. MF presented RLAM's approach to ESG both within the Sustainable fund range and more generally how these factors are applied in RLAM's approach to investment and confirmed that this is an area of increasing interest for investors.

AHC provided an overview of RLAM's approach to governance and highlighted RLAM's voting record and examples of where they have engaged with the boards of certain companies.

Rebecca Stevenson, a member of Royal London's staff pension scheme, which invests in the Governed Range attended this section of the meeting as she has a keen interest in this area. The IAC agreed that RLI would work with RLAM to provide a summary



of governance action where it affects stocks held within the RLI funds, and consider how best to communicate to customers and advisors the work already undertaken in this area.

LB

GRIP Strategic Asset Allocation review

RLI has been working closely with RLAM and Moody's Analytics to review the GRIPs in light of the potential wider range of customer choices at retirement and has proposed a new set of GRIP SAAs. The modelling suggested that the proposed SAAs are more efficient than the current GRIPs for both real and nominal income profiles because of the wider ranging SAA optimisation. The proposed GRIPs also provide slightly improved tail performance for real incomes and a bigger improvement for nominal incomes. In addition, the proposed SAA's remove the concentration risk in IL Gilts by spreading the SAA across a greater range of asset classes to provide greater diversification benefits.

IAC were supportive of the direction of travel and asked for clarification of the risk metrics.

RD

Default end-point review

RD provided an update on the work to review the default and advised that RLI expect to present results at the 2017 Q3 IAC meeting. This work ties into the GRIP review noted above. RLI are investigating strategies that take more risk than the current default that targets annuity. The IAC discussed the default objective and the customers the default must serve. IAC agreed that the customer engagement strategy is key and asked to see further details.

RD

IAC effectiveness review

LB presented a paper on the IAC effectiveness review. This process involved gathering anonymous feedback from all IAC members and stakeholders on roles, responsibilities, composition of committee, objectives and outcomes of meetings, and the effectiveness of the Chair. Feedback was very positive however it was noted that it would be good practice to review membership, and terms of reference. This work will be progressed in conjunction with others across the Royal London.

LB

Rathbone Global Alpha

IAC reviewed the responses from Rathbones following the session on 28 February 2017 when David Coombs and Will Mackintosh provided a fund update. IAC confirmed they understood the reasons for the underperformance and were pleased with the attribution data provided however they have asked for additional look through data of the underlying funds. The IAC acknowledged the challenge of providing full look through data of the underlying fund and asked Rathbones to confirm their plans and timescales to provide this detail.

RM

Fidelity American

IAC had previously agreed at the February meeting to replace this fund. Following a quantitative and qualitative review of alternative funds, IAC agreed with the proposal to replace the Fidelity American fund with the Old Mutual North American equity fund. IAC said they were pleased with the improvements to the review and screening process and encouraged that the proposed fund aligned with the recommendation from Morningstar. RE noted that Royal London were undertaking a review of best practice on asset transitions and that the findings of this review would be applied to this change. Communications to customers and advisers will happen in Q3 to provide notice of the transition.

RM

3. CUSTOMER INVESTMENTS

STRATEGIC ANALYSIS

Governed Portfolios & Managed Strategies

No changes were 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)

Similar to previous quarters, the long-term risk measure for all GRIPs is triggering red, suggesting that the portfolios are not taking enough risk and are further outside their target range. The GRIP SAA review is expected to address this issue.

Lifestyle Path Analysis

The expected real income for annuity lifestyles has decreased compared to the previous quarter due to a decrease in the yield curve. In particular, the expected annuity incomes have decreased by 1.3% over 5 years and 1.0% over 15 years. The drawdown lifestyles are generating higher expected returns compared to the cash lifestyles, but have lower projected values at the 5% tails, due to the investment in riskier assets. The expected real fund value of the drawdown lifestyles has decreased by 1.28% over 5 years and decreased by 0.97% over 15 years. No changes were recommended as a result of these movements.

Default review

We continue to monitor exit behaviour of workplace pension customers and note no material change in trends. We remain comfortable that an annuity endpoint remains appropriate for a majority of our customers pending completion of the GRIP SAA and default review, as noted above.

4. TACTICAL ANALYSIS

Governed Portfolios & Managed Strategies

All portfolios remain within their tactical risk budgets.

There have been three tactical changes since the last meeting. The change in March saw us deepen our underweight position in Gilts in favour of Cash, while remaining overweight Equity and Commodities. In April, we decreased our overweight Equity position in favour of Global High Yield Bonds and Gilts, and marginally increased our overweight commodities position. In May we maintained the small overweight in equities and added positions in global high yield, slightly trimming the commodity exposure.

This leaves us overweight in equities, commodities, high yield and corporate bonds with underweight positions in government bonds, index linked bonds and absolute return strategies (including cash). The portfolios continue to be neutral in property.

Governed Retirement Income Portfolios (GRIPs)

All portfolios remain within tracking error targets, although GRIP 1 remains amber due to increased stock selection risk. However, we are at the lower end of the amber scale.

There has been one tactical change since the last meeting. The change in April saw us reducing our exposure to Equities, while increasing our exposure to Global High Yield, Gilts and marginally Commodities.

The current overall position is overweight in equities, high yield bonds and government bonds. We are neutral in property and underweight in index linked bonds and corporate bonds.

Short term tactical view of the Chief Investment Officer

TG reviewed 2017 Q1 and presented RLAM's rationale for the current short term tactical view.

Positioning & Activity

- We reduced the overweight position in equities towards the end of the quarter, following a long period of strong markets and as economic data began to point to weakening growth prospects in the US, China and the UK. Seasonality evidence also motivated some profit taking in equities in order to buy dips over the summer months.
- Regionally, the underweight position in Europe was reduced to neutral over the quarter as Eurozone political risks diminished post the French election. This combined with better economic data to make Europe more attractive. Global growth is positive for Japan and Emerging Markets and we have held modest overweights in those regions.
- Fixed income exposure remained underweight but with inflationary and interest rate pressures declining, we moved slightly less underweight (funded out of reducing equity overweights) given a more constructive environment for bonds. We maintained a preference for Credit, particularly in the UK, as central bank policies remained supportive.
- For portfolios with an allocation to Commodities, we took a small overweight exposure given positive global growth whilst Property was held around benchmark levels.

Q1 Market Background

- Global equities returned 5.6% over the first quarter of 2017 for sterling-based investors. In local currency terms, Asia Pacific excluding Japan equities generated the highest regional return of 11.2%. European equities returned 7.5%, while stocks in the US returned 5.0%. Japanese equities lagged, returning 3.6%. Hopes of reflationary US policies quickly faded during the quarter and sectors, which had had a 'Trumpflation' bounce, weakened.
- Over the quarter as a whole, sterling was broadly flat on a trade-weighted basis, but it remains in a historically low range versus other core currencies, having recovered somewhat against the euro since troughing last October. The oil price fell sharply in March in reaction to reports of record stockpiles in the US, ending the quarter roughly \$4 lower just below \$53 per barrel.
- Gilts outperformed US and European government bonds in Q1, returning 1.6% with markets focussed on political risk. Global yields diverged over the period.

Yields rose across core and most peripheral European markets, but fell in the UK and the US. The UK yield curve flattened, and longer dated gilts outperformed their short and medium -dated counterparts.

- Index linked UK government bonds (all maturities) returned 1.9%, outperforming conventional gilts. Real yields fell across the maturity spectrum, led by shorter dated bonds, amid expectations of higher inflation, along with persistently weak sterling and uncertainty over impending Brexit negotiations.
- Sterling investment grade credit returned 1.8%, outperforming UK government bonds by 0.6% (duration adjusted). The release of strong global data over the quarter provided a supportive backdrop for corporate bonds. Average sterling investment grade credit spreads narrowed by 2 basis points (bps) to 121bps, close to the 2016 low.
- UK property proved resilient with a 2nd consecutive quarter of positive capital growth, as reported by the IPD UK Monthly Index. A shortage of prime quality stock and renewed confidence from both domestic and foreign investors has led to some very competitive recent bidding. Total Q1 returns were 2.3% (income return at 1.4% / capital appreciation of 0.9%).
- Market rents grew by 0.3% on average, but were particularly strong in the Industrial sector (+1%), which saw growth of 1% but office and retail rents were flat over the quarter.

TAA Performance

- TAA effects contributed positively over Q1 as performance continued to benefit from overweighting outperforming equities funded out of Fixed Income. Allocations to UK Property, Commodities, and Cash & Absolute Return were held at, or around, benchmark levels during the period.
- Regional positioning within equities detracted over Q1 with the overweight stance in Japan the largest factor. However, there was a positive contribution from the UK equity line up following the relative performance of small and midcaps stocks versus large caps as they returned to positive territory following last year's Brexit-related underperformance.
- Within Fixed income, the preference for corporate bonds over government debt continued to provide a boost to relative returns as credit spreads narrowed further over the period. This offset a negative effect from underweighting index-linked Gilts, which are now discounting UK structural inflation well above 3% over the medium and long term.

Outlook & Views

- We expect a positive investment backdrop for risk assets to continue with global growth stable and interest rates remaining at historically low levels.
- Politics could still affect markets. An unpredictable White House, Brexit negotiations and concerns regarding Chinese growth could result in a sell-off in risk assets over the summer.
- However, with global growth and the earnings outlook positive, we would view market dips as likely buying opportunities.
- With nominal global growth robust and inflationary pressures weakening, the environment is still positive for equities and less negative for bonds.

5. ROYAL LONDON FUND REVIEW

The following funds/portfolios were discussed:

RLI Governed Range

Absolute performance for both the Governed Portfolios and the GRIPs remain strong over 12 months. Despite this, the majority of the Governed Portfolios continue to marginally sit below the benchmark over 1 year with GP4 and GP7 also continuing to underperform since launch.

All nine portfolios show positive asset allocation attribution over one year, up from seven last quarter. Six portfolios have positive asset attribution over three years, up from two last quarter.

RLP Global Managed continues to underperform and this is the primary performance detractor for the Governed Portfolios –particularly in the higher risk and longer-term portfolios where there is a higher equity content and the tactical overweight to equities is greater. It was noted that with effect from 12 June the Global Managed Fund will change its benchmark for the overseas element of the fund from FTSE World Ex UK to FTSE All World ex UK, enabling an increased allocation (weight and breadth of countries covered) to emerging market equities.

All five GRIPs are outperforming over 12 months and since launch. These portfolios have benefited from the allocation to the RLP Sterling Extra Yield Bond fund, which has significantly outperformed its benchmark over the last year and offset the underperformance of Global Managed. All five portfolios are showing positive asset allocation attribution over one year, up from three last quarter.

RLI pension funds

There has been a slight decrease in the number of RLAM funds triggering for review this quarter. Indeed, over Q1, the majority of the RLAM funds either outperformed or returned in-line with the benchmark.

The main detractor of performance over 12 months in global and UK equity funds continues to be the underperformance of the underlying active UK equity strategies. The bias towards mid-cap equities continues to serve as a detractor over the last 12 months. Whilst large-cap counterparts have benefitted from their foreign currency earnings streams as the value of sterling plunged, the more domestically focused mid-cap sector has suffered and this has hurt the performance of a number of RLAM equity funds.

A number of sector calls have also worked against the funds, most notably underweight positions in energy and industrials as well as consumer staples.

As noted in previous IAC meetings, duration positioning continues to detract from relative performance in RLAMs fixed income funds. However, the funds are positioned for long-term interest rates to rise.

RLAM funds on watch

- Adventurous Managed
- Managed
- UK Equity
- UK Ethical
- UK Mid Cap
- UK Opportunities
- UK Smaller Companies

- European
- Worldwide
- Global Equity
- International Government Bond
- UK Government Bond
- Global Index Linked

Externally managed matrix funds

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

Fidelity American

Approval was given to replace this fund with the Old Mutual North American Equity fund.

Rathbone Global Alpha

Rathbones have now provided responses to all of the questions raised. The fund has had a good Q1 outperforming both RLP Global Managed and the Blackrock Aquila tracker option but it remains an underperformer over one and three years and continues to trigger for review.

The RLI proposition view is that although the fund has endured a disappointing three and a half year track record and has not beaten its performance objective, we are comfortable with the reasons given for the fund's underperformance.

JPMorgan US

The JPMorgan US fund has now been triggering for review for seven consecutive quarters. We are proposing to place additional scrutiny on this fund over the next quarter based on disappointing long-term performance and sector positioning on a risk-adjusted basis, a rating downgrade by Morningstar and a disappointing meeting with JPMorgan in Q1. We will engage with Morningstar and schedule a call with the fund manager in order to raise our concerns and will present our recommendation at the next IAC meeting.

Schroder Core UK Equity

Schroder Core UK Equity is another fund that has triggered for review over a sustained period despite a recent improvement in short-term performance. We recommend another meeting with the fund manager over the next quarter to discuss the investment process and fund positioning to determine whether the recent short term performance can be addressed. An update will be provided at the next IAC meeting.

RM

Matrix fund governance

We continue to work with others in the Royal London group to strengthen our oversight process and have now included quantitative scorecards on each of the matrix funds triggering red, these have been produced following a series of fund manager interviews and the adoption of a quant scoring process which aims to identify consistent outperformance.

Other external funds

There are a few fund groups with a significant number of funds triggering for review.

Schroders have the most funds triggering for review with six. The six funds consist of various asset classes and strategies and are in addition to the Schroder Core UK Equity fund, noted in the above section. We will provide a further update on these funds at the next IAC meeting following an update meeting with Schroders in Q3. RM

M&G continue to have a number of funds triggering for review. Relative performance has improved over the last 12 months but the funds continue to suffer from poor longer-term performance. We will continue to monitor these funds to determine whether the improvement in relative performance is maintained. RM

Fidelity has four funds triggering for review (two are fixed income and two are equity funds) in addition to the Fidelity American fund. Fidelity has attributed the underperformance to a number of different sector positions and in the case of the Fidelity Moneybuilder Income fund, an underweight Sterling duration position. The relative underperformance of the Fidelity funds is not significant but we will continue to monitor these funds. RM

We provided an update on the Jupiter funds at the last IAC meeting. We held a series of conference calls with Jupiter fund managers in Q1 following five funds triggering for review. We gained confidence from the calls and the reasons given for underperformance. The Jupiter Merlin Income fund is now no longer triggering and it is pleasing that relative underperformance has improved across the suite of the 'red' Jupiter funds.

The following funds remain on watch:

- 7IM AAP Balanced
- 7IM AAP Moderately Cautious
- Baillie Gifford High Yield Bond
- Baillie Gifford UK Equity
- BMF Balanced
- BMF Defensive Income
- Fidelity Emerging Europe, Middle East and Africa
- Fidelity Moneybuilder Income
- Fidelity Strategic Bond
- Fidelity UK Select
- GLG Balanced Managed
- GLG Stockmarket Managed
- Invesco Perpetual Corporate Bond
- Invesco Perpetual Distribution
- Invesco Perpetual Global Bond
- Investec Emerging Local Currency Debt
- Investec Global Energy
- Investec UK Special Situations
- JPMorgan Cautious Managed
- JPMorgan Natural Resources
- Jupiter Ecology
- Jupiter European Special Situations
- Jupiter Financial Opportunities
- Jupiter Merlin Worldwide
- Legg Mason US Smaller Companies

- M&G Corporate Bond
- M&G Global Basics
- M&G Global Leaders
- M&G Recovery
- M&G Strategic Corporate Bond
- Neptune Global Alpha
- Neptune Global Equity
- Neptune US Opportunities
- Newton Balanced
- Newton Global Higher Income
- Newton Real Return
- Rathbone Enhanced Growth
- Sarasin Food & Agriculture Opportunities
- Schroder European Opportunities
- Schroder MM Diversity Balanced
- Schroder MM Diversity Tactical
- Schroder MM UK Growth
- Schroder Global Cities Real Estate
- Schroder Income Maximiser
- Columbia Threadneedle Absolute Return Bond
- Columbia Threadneedle Latin America
- UBS Global Blended (50:50)

6. DATE FOR NEXT MEETING

The next quarterly meeting is 29 August 2017.

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.

June 2017

The Royal London Mutual Insurance Society Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. The firm is on the Financial Services Register, registration number 117672. It provides life assurance and pensions. Registered in England and Wales number 99064. Registered office: 55 Gracechurch Street, London, EC3V 0RL. Royal London Marketing Limited is authorised and regulated by the Financial Conduct Authority and introduces Royal London's customers to other insurance companies. The firm is on the Financial Services Register, registration number 302391. Registered in England and Wales number 4414137. Registered office: 55 Gracechurch Street, London, EC3V 0RL. Royal London Corporate Pension Services Limited is authorised and regulated by the Financial Conduct Authority and provides pension services. The firm is on the Financial Services Register, registration number 460304. Registered in England and Wales number 5817049. Registered office: 55 Gracechurch Street, London, EC3V 0RL.