

Investment Advisory Committee (IAC) Quarterly Meeting

Minutes of Meeting

Date

05/06/18

Present members

Julius Pursaill (Chair)
Colin Taylor
Piers Hillier
James McCourt

In attendance

Niall Aitken
Lorna Blyth
Trevor Greetham
Ryan Hamill
Euan Craig
Janice Maclean
Robert Whitehouse
Candia Kingston

Apologies

Ewan Smith

Owner

1. **REVIEW OF PREVIOUS MINUTES**

The minutes of the 1 March 2018 meeting were approved.

All

2. **PROJECTS**

Schroder Core UK Equity and Schroder UK Equity Replacement

A paper was presented outlining potential replacements for the two core UK funds. This paper widened the scope following comments from the IAC at the previous meeting.

LB

The IAC were pleased that a replacement had been sourced and were supportive of the proposed replacement; the JPM UK Equity Growth fund.

Transaction Costs and Charges Update

This paper updated the IAC on the progress of the Group's Costs and Charges Disclosure Programme and discussed the transaction costs incurred by customers in the Governed Portfolios.

EC

The methodology surrounding slippage/implicit costs was discussed. RLAM use the 'arrival price' methodology to calculate the implicit costs – which is advised by FCA PS17/20 – meaning that the total cost being reported is equal to the difference between the execution price and the market mid-price at the time the order was picked up by the broker. PH sought confirmation that this was correct which has



been confirmed post meeting by the RLAM project lead.

The IAC appreciated that the immediate focus has been on meeting regulatory requirements and asked for more detail around what the governance framework will look like.

Furthermore the IAC asked RLI to provide a list of external fund managers who have not disclosed the methodology used to calculate implicit costs.

Moody's Model Change

The IAC were provided with an overview of important changes introduced into the Moody's Analytics model. These changes have been incorporated into the RLI proposition from mid-May. NA

Moody's Analytics have made some significant changes to their model which took effect from the end March 2018. The most significant change is how Moody's set interest rate and inflation paths over the medium to long term (10-30 years). This results in projections with lower inflation, lower nominal asset returns and higher real asset returns. The changes are a result of Moody's making greater use of economic data and insights from across their business.

The IAC noted the changes. They are supportive of the group wide discussions on model usage and the ongoing work on SAA framework.

Closet Trackers

This paper outlined the proposed methodology to identify and report on closet tracker funds. LB

The IAC supported the use of R-squared as a way of identification. The IAC were keen to be provided with more information on what actions will result from a fund being identified as a closet tracker.

RLP Property Update

An update was provided on the Property fund. This discussed the current cash levels of the fund, retail challenges and alternative cash options. NA

Widening the options under commercial property was discussed. PH highlighted that after recently considering student accommodation this was rejected as an option for the fund based on risk/return criteria.

At the last meeting the IAC requested more information on the funds exposure to struggling retailers. This was provided to the committee.

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.

The IAC have asked that we revisit the differences in return efficiencies providing more detail as to why very small differences in expected real returns are triggering non green RAG ratings.

Governed Retirement Income Portfolios (GRIPs)

No changes are recommended to the GRIPs strategic 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. In particular, the expected annuity incomes have decreased by 2.8% over fifteen years and 1% over 10 years.

The expected real fund value of the drawdown lifestyles has increased by 0.5% over both 10 and 15 years.

TACTICAL ANALYSIS

Governed Portfolios & Managed Strategies

All portfolios remain within their tactical risk budgets.

There have been three tactical changes since last quarter;

- In January, we added to commodities, funded out of bonds. We slightly increased the position in high yield bonds. We looked to maintain our overweight position in stocks; a short-term set-back was not ruled out and we would use such an opportunity to increase our equity allocation.
- In February, we added to our moderate overweight position in equities on market weakness, buying stocks in the emerging markets in particular, and deepening the underweight in government bonds. We also took this opportunity to move commodities further overweight.
- In March, we added to equities again, capitalising on stock market weakness and given that supportive world growth conditions remain in place. We also increased the allocation to index linked bonds and conventional UK gilts. The changes were funded out of high yield debt, government bonds, property and cash.

The overall position as at end March, was overweight Equities, Commodities, High

Yield Bonds and Corporate Bonds; underweight Absolute Return Strategies (inc. cash), Gilts, Property and Index Linked Bonds.

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Short term tactical view of the Chief Investment Officer

TG reviewed Q1 2018 and presented RLAM's rationale for the current short term tactical view:

Positioning & activity

- Overweight positioning in equities was maintained in Q1; market volatility gave our multi asset funds the opportunity to add significantly to equities at more attractive prices. Underweight positioning in government bonds was sustained through the quarter as the interest rate outlook grew slightly less benign.
- For portfolios with Commodity holdings, overweight exposure was retained given our Investment Clock is in its early 'overheat' phase (growth continuing but with more inflation evident) which favours commodities.
- At the regional equity level, overweights in Japan and Emerging Markets were maintained in the quarter as global growth indicators remained solid; we remained underweight the UK, as it still faces some Brexit uncertainty, and remained cautious on the sustainability of growth in Europe ex-UK.

Q1 market background

- Q1 was turbulent for equities (Global Equities fell more than 4.2% in sterling terms) with sentiment being hit by concerns including over bond yields rising, geopolitics and tech companies like Facebook facing greater scrutiny. Our multi asset funds took the opportunity to buy equities when markets were weak.
 - Gilts returned around 0.2% over the quarter as expectations of interest rate rises gradually began to be moderated;
-

- Sterling investment grade credit underperformed UK conventional and index linked government bonds. The average sterling investment grade credit spread widened by 10 basis points (bps) to 1.14%.
- Commodities were relatively strong over the quarter led by more gains for oil, but copper lagged.
- UK commercial property continued to be resilient, delivering 2.8% over the quarter (after a strong 2017).

Relative positioning & TAA performance

- TAA effects in the short term look mixed but while the fall in equity markets hurt performance in Q1, it was more important as an opportunity to significantly increase exposure to equities at more attractive prices, in order to generate longer term returns.
- Being underweight Fixed Income was a negative over the three month period but remains our long term position in a rising interest rate environment.
- Property was maintained around benchmark during the quarter and was resilient.
- Regional positioning within Equities had benefited significantly from an overweight stance in Japan and EM but in Q1, the UK and Europe had some relief from long periods of underperformance. We remain relatively cautious on the UK, given Brexit negotiations are ongoing, and on Europe given some growth indicators are rolling over.

Outlook & views

- Our Investment Clock is in its later cycle ‘overheat’ phase, with global growth looking robust but more risk of inflation concerning markets; commodities historically have tended to outperform in that kind of environment.
- We are modestly overweight equities, commodities and short duration high yield bonds in our multi asset funds, but underweight government bonds given more evidence to be concerned about inflation and interest rate increases than in the last few years.
- We maintain an overweight position in Japan, a global growth beneficiary, a neutral position in European and US equities, and stay underweight UK equities while Brexit uncertainty remains.

4. ROYAL LONDON FUND REVIEW

The following funds/portfolios were discussed. All data is at end March 2018.

RLI Governed Range

All of the Governed Portfolios are below benchmark over 1yr. Governed Portfolios 1, 2, 4, 5, 7 and 8 are below benchmark over three years. All of the Governed Portfolios are outperforming over five years. Governed Portfolios 1, 4, 7 and 8 are underperforming since launch. Absolute returns remain very strong. The property holding continues to remain a key performance detractor due to the high cash holding. As at the end of March cash was at 11.7%, assuming all current purchases successfully complete, this cash level will reduce to 6.3%.

All five GRIPs continue to outperform over one, three and five years and also since launch. GRIP4 has returned almost 10% above benchmark since launch and GRIP5

nearly 9% since launch.

RL pension funds

The number of RLAM funds triggering for review over this reporting period is 13 however no funds have significantly underperformed.

RLAM funds on watch:

- Adventurous Managed
- Managed
- UK Opportunities
- American
- Far East (ex Japan)
- European
- Japan
- Pacific
- Worldwide
- Global Equity
- International Government Bond
- Global High Yield Bond
- Global Index Linked

Global High Yield

The Fund's underperformance against the index was due to its sector exposure. Regional exposure had a mixed impact upon performance. Underperformance over Q1 and the 1-year period remains marginal.

Global Equity

Main contributor to underperformance is a significant timing difference in the US equity market component caused by the Easter vacation. US and Asian markets were open on Good Friday but the fund priced on Thursday evening and therefore failed to capture the performance of the US markets on the last trading day of the quarter.

Commodities

The fund is marginally underperforming over the quarter and over one year.

Property

The fund continues to underperform over the recent quarter and one year as the cash drag impacts short term performance. Three and five years continues to be strong. The fund's cash rate was 11.7% at the end of March, which is a reduction from end of October's rate of 21%. RLAM have advised there is no let-up in the competitive nature of bidding for prime assets.

UK opportunities

A new manager (Craig Yeaman) assumed stewardship of the fund in January 2018. Fund held Saga which fell 37% and Ultra Electronics which fell 32% in Q4 2017.

Externally managed matrix funds

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

Schroder Core UK Equity & Schroder UK Equity

Please see commentary earlier in the minutes.

The following funds were also discussed during the meeting:

Rathbones Global Alpha

The fund is narrowly underperforming on a 3 and 5 year basis, however on a risk adjusted basis is third decile over these periods, respectively. The fund has been flagging red for three consecutive quarters and is ahead of benchmark over Q1 2018.

This underperformance was primarily driven by weak relative returns in 2016, when the fund underperformed the benchmark by almost 9%. 2016 performance was negatively affected by the fund's significant UK exposure. Ahead of the June 2016 Brexit vote, exposure was increased to large cap holdings while reducing active UK exposure. This decision was based on the belief that the FTSE 100 would benefit from a devaluation of sterling. Due to the tracking error upper limit of 5%, this call was not able to be made with as much conviction as management would've liked. As a result of this, the fund missed out on significant gains posted by its benchmark.

The IAC were concerned by the fact that the fund manager has felt constrained by tracking error requirements. They highlighted that this is the second time that Rathbones' have raised this issue and the last time they were comfortable to maintain the fund's tracking error limit. IAC asked for Rathbones to provide more detail on how and where risk budget is being allocated in order to better understand the issues and constraints.

First State Global Emerging Markets Leaders

The fund had a poor quarter, finishing 3.5% below benchmark. The fund underperforms over the one, three and five year periods. In the last 12 months, the fund has lagged the benchmark by 10.4%.

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 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. Poor performance of Indian positions Tata Power (Utilities) and Idea Cellular (Telecom Services) negatively impacted the fund over the quarter. Both declined following strong performance in the fourth quarter of 2017. On the positive side, Klabin (Brazil: Materials) gained as domestic paper demand and global prices have improved and Mediatek (Taiwan: Information Technology) rose on market share gains and improving margins. Standard Bank (South Africa: Financials) contributed positively on the back of improved confidence in South Africa as Cyril Ramaphosa replaced Jacob Zuma as President. 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 9.5%) 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. This fund remains soft-closed to new investors.

The IAC commented that they were concerned by the effect that last year's retirement

of Angus Tulloch may have had. They requested a review of the First State matrix funds in light of this change with particular emphasis on continuity planning and investment leadership.

First State Asia Pacific Leaders

The fund has underperformed over the 1, 3 and 5 year periods to the end of March 2018. Performance over Q1 2018 was ahead of benchmark.

It invests predominantly in a portfolio of large-cap companies within the Asia Pacific (excluding Japan) region. The team at Stewart Investors places significant emphasis on capital preservation. They follow a long-term bottom-up approach, seeking to invest in well-managed companies with sustainable business models, predictable growth and low valuations. The portfolio is primarily built from the bottom-up and sector and geographic weights may therefore deviate significantly from the index, resulting in a high active share. Consequently, fund performance may at times deviate substantially from that of the index and peers. Given the fund's distinct style, divergent returns of this magnitude 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%.

See above comment concerning the other First State Matrix fund.

Invesco Perpetual Japan

The fund is underperforming across all time periods.

The biggest detractors from relative performance came from the more economically sensitive areas of the market, to which the strategy is tilted. The fund's exposure to steel manufacturers was the biggest detractor. Hitachi Metals reported slightly weaker than expected earnings and was the biggest detractor, while Nippon Steel pulled back from recent highs after it reported a production shortfall for the most recent quarter, although growth is expected to recover later this year. Other notable detractors included banks such as Mitsubishi UFJ Financial Group, Cosmo Energy and Inpex. Meanwhile, exposure to real estate companies such as NTT Urban and the Invincible Investment REIT contributed positively, thanks in part to an uptick in inflation expectations. Precision ball bearing manufacturer Tsubaki Nakashima also added value, benefiting from the supportive macro backdrop and positive expectations for synergies from a recent acquisition. Finally, Japan Post Holdings proved relatively resilient thanks to a robust set of earnings, with the company revising FY earnings guidance upwards for its postal business.

The fund is managed with a value / contrarian approach and this can lead to performance differing from the benchmark by significant margins – both on the upside and downside. This fund sits in the specialist sector and we are comfortable to continue to hold. We will continue to monitor this fund closely.

Artemis UK Special Situations

The fund has underperformed benchmark over 1, 3 and 5 years. Performance was above benchmark over the last quarter, but still negative.

Relative performance benefited from the underperformance of the beverages and tobacco companies (to which it has no exposure) and the banking sector (to which it only has modest exposure). Technology holdings performed well over the quarter with Spirent and Computercenter being star performers. The portfolio also saw good contributions from its holdings in IG Group and EasyJet. As in the previous quarter, the biggest negative contributor to returns was Capita, having bought into the stock too early, but they believe there is still long-term potential there. The fund also suffered from a fall in SIG's shares following the announcement that there had been some modest overstatements of cash and profits in prior years. In Q4 2017 we held a meeting with the fund managers Derek Stuart and Andy Grey and the decision was taken to continue to monitor the fund.

Fidelity MoneyBuilder Dividend

The fund had a positive quarter, finishing ahead of the benchmark but remains behind benchmark over the one and three year periods. The fund is ahead of the benchmark over the five year period.

Underperformance was primarily down to poor sector selection with the fund's underweight to materials a notable detractor from relative returns. However, security selection within financials was a key positive. At a stock level, key detractors included support services group Capita and sub-prime lender Provident Financial. Provident is a UK focused specialist lender, providing door to door loans, and nonstandard credit cards. The company issued two profits warnings in the summer of 2017. A change in the compensation model for their collection agents resulted in a significant negative impact on the home credit business. At the second profits warning, the company additionally announced that the FCA had launched an investigation into its Vanquis business. Telecommunications company BT also detracted from returns due to a profit warning, driven primarily by fraud discovered in its Italian business and weakness in its public services division announced in January 2017. Energy stocks such as BG Group, Royal Dutch Shell and BP also weighed on returns. On a positive note Altria was a notable contributor as the ongoing restructuring in the US tobacco industry benefited its shares. Among others, the holding in gourmet sausage maker Cranswick contributed to returns. Financial holdings such as Barclays and Amlin were also notable positives.

Schroder Tokyo

The fund is underperforming benchmark across all time periods, although performance was broadly in line with the benchmark over 5 years.

The fund has been managed by the same fund manager for over 10 years and he has added value against the benchmark and peer group over that time. Performance was more subdued in recent years as investors largely shunned the type of undervalued company that Andrew Rose seeks. However, Schrodgers believe once their potential has been more broadly recognised, their share prices could benefit. The fund was also held back by a lack of exposure to the strongly-performing technology and automation sectors, but the manager currently sees less value in these areas. The fund also experienced some company-specific issues, including an investment in KDDI Corporation, the telecoms operator. Shares in the company performed poorly when a new competitor entered the market. The manager believes investors overreacted to

this news and he retains his investment. We will continue to monitor this fund.

Schroder UK Alpha Plus

The fund is underperforming over 1, 3 and 5 years and has been marginally underperforming over the quarter. This is a specialist fund.

The fund is not currently recommended by Morningstar. In March the fund management structure changed with Bill Casey and Nick Kissack now co-managing the fund. Tesco was the fund's top contributor over the period on the back of strong full-year results. Specialist retailer of low-cost short-haul holidays to the UK consumer On the Beach (OTB) was another top contributor. International infrastructure specialist Balfour Beatty also delivered double-digit share price returns. Not owning healthcare and household goods manufacturer Reckitt Benckiser was a positive after the shares performed poorly on the back of a disappointing first-quarter trading update. A zero weighting in diversified mining group Glencore was also beneficial. On the negative side, Lloyds Banking lagged the market rally. New positions were taken in Diageo (growth) and Next (value).

We are comfortable to hold this fund and wait to see if the management actions taken result in an improvement in returns for customers.

5. **DATE FOR NEXT MEETING**

The next quarterly meeting is 29 August 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.

June 2018

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