

## Investment Advisory Committee (IAC) Quarterly Meeting

### Minutes of Meeting

#### Date

1/12/17

#### Present members

Julius Pursaill (Chair)  
Colin Taylor  
Ewan Smith

#### In attendance

Neil Chapman  
Robert Whitehouse  
Ryan Hamill  
Niall Aitken  
Piers Hillier  
Robert Dundas  
Lorna Blyth

#### Apologies

Andy Carter  
Isobel Langton

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#### Owner

1. **REVIEW OF PREVIOUS MINUTES**

The minutes of the 29 August 2017 meeting were approved.

2. **PROJECTS**

**Investment Performance Audit**

A paper was presented outlining the findings of Group Internal Audit (GIA) who audited the information provided to the IAC over two quarters (Q4 2016 and Q1 2017). The paper focused on an error identified by GIA which affected the RAG status of Matrix funds. The error meant that some funds had been reported as Amber when they should have been RED. This meant that the correct oversight had not been applied in a minority of instances.

NA

The IAC agreed with the RLI belief that it wasn't possible to demonstrate that any customer detriment had occurred and were happy with the proposed improvements to the processes and controls surrounding the production of the IAC pack as a result of the audit. The IAC requested a paper be presented at the next meeting to confirm that all audit points have been dealt with and to provide more detail on the changes that have been made to address GIA findings.

**IAC Effectiveness review**

An update was provided on IAC membership and Terms of Reference. Following Rachel Elwell's departure, Neil Chapman, Interim Head of Investment Office will join IAC from January 2018 and after ten years on IAC Andrew Carter, CEO, RLAM will

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step down and be replaced by Piers Hillier, CIO, RLAM. Isobel Langton, CEO, RLI will also step down but has a standing invite to IAC. IAC thanked all three for their service to the Committee. Finally in line with governance best practice and to allow a period of crossover RLI agreed to identify replacements for both Julius Pursaill and Colin Taylor during 2018. This will allow both independents to step down at the end of 2019 after eight years of service.

In addition the Committee Terms of Reference have been updated to reflect focus on Governed Range and Matrix funds.

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### **JPM US Equity Replacement**

A paper was presented outlining potential replacements for the US Specialist Fund. It remains challenging to source an active fund in this space and IAC have requested a widening of the scope and investment style before a decision is made. Whilst the JPM US fund outperformed its benchmark for the year to end September 2017 there remain concerns about future performance and IAC have asked this work be progressed before the next meeting.

## **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)**

The IAC had previously approved the changes to the GRIP SAAs which were made with effect from 12 October 2017. At this meeting IAC discussed the two new risk metrics, income sustainability and 5<sup>th</sup> percentile maximum 1 year loss, which have replaced the previous risk metrics. The IAC were supportive of this new risk framework however requested that RLI be consistent in its description of the 5<sup>th</sup> percentile maximum 1 year loss to be clear that it is the 5<sup>th</sup> percentile loss and not the worst that could happen.

#### **Lifestyle Path Analysis**

The expected real income for annuity lifestyles has increased compared to the previous quarter due to an increase in the yield curve. In particular, the expected annuity incomes have increased by 1.0% over both 5 and 15 years.

The expected real fund value of the drawdown lifestyles has also increased by 1.0% over both 5 and 15 years.

### **TACTICAL ANALYSIS to UPDATE**

## **4. 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 September moved commodities exposure to a marginal underweight position, while remaining overweight Equity, High Yield and Corporates. In October, we marginally trimmed underweight in bonds to take advantage of the recent rise in yields. In November we trimmed our overweight position in High Yield and added to commodities at the margin.

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

### **Governed Retirement Income Portfolios (GRIPs)**

All portfolios remain within tracking error budgets.

There have been three tactical changes since the last meeting. The change in September increased the overweight position in Equities, trimming the bond exposure. In October, we utilised the TAA date to change to the new SAAs and TAA position relative to this. In November we trimmed our overweight position in High Yield, increased underweight position in Gilts and added to commodities at the margin.

The overall position as at end September, was overweight Equities and High Yield Bonds; underweight Corporate and Index Linked Bonds Commodities.

### **Short term tactical view of the Chief Investment Officer**

PH reviewed Q3 2017 and presented RLAM's rationale for the current short term tactical view:

#### **Positioning & activity**

- Overweight positioning in equities was increased in Q3 against a backdrop of accelerating global growth indicators whilst inflation data releases remained subdued. A temporary drop in investor sentiment on concerns over hawkish signalling from the US Federal Reserve early in the quarter provided an attractive entry point. This was funded from deepening the underweight in Bonds and Cash.
- For portfolios with Commodity holdings, exposure was reduced from a small overweight to marginally underweight on emerging signs that China's positive growth momentum may be starting to plateau. 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 increased as global growth indicators improved during the quarter at the expense of the UK and a reduction in the Europe ex-UK overweight where the recent earnings reporting season confirmed that Euro currency strength was now acting as a significant headwind.

#### **Q3 market background**

- Global equities returned 1.7% for Sterling-based investors over the third quarter of 2017. In local currency terms, EM equities performed best with a gain of 7.6%, followed by the US, Japan and Europe ex-UK with returns of 4.5%, 4.3%, and 4.2% respectively. Asia Pacific ex Japan lagged, returning 2.5%. Returns were crimped for Sterling-based investors as the Pound strengthened ahead of an expected increase in the Bank of England's (BoE) policy interest rate in November. UK equities outperformed the global average with a gain of 2.1%.

- Gilts underperformed US and core European government bonds in the quarter, returning -0.4% as markets priced in an expected rate rise from the BoE. Yields fell across most core and peripheral European markets, but rose in the UK with smaller gain in the US. The UK yield curve steepened as long dated gilts underperformed short and medium counterparts Index linked UK government bonds (all maturities) returned -0.7%, underperforming conventional gilts. Real yields fell at the short end of the maturity spectrum, while rising for longer dated bonds amid expectations of higher inflation and uncertainty over impending Brexit negotiations.
- Sterling Investment Grade Credit returned 0.2%, outperforming UK government bonds by 0.6% (duration adjusted). The release of robust worldwide economic activity data over the quarter provided a supportive backdrop for corporate bonds. Average Sterling Investment Grade Credit spreads narrowed by 2 basis points (bps) to 105bps.
- Sterling rose 1.1% on a trade-weighted basis during the quarter, the largest increase in nine quarters. The oil price advanced as the impact of supply controls continued to feed through into the market, ending the period almost \$10 higher above \$57 per barrel. Copper climbed above \$3 per pound for the first time in almost three years as global growth data remained firm and Chinese inventories fell.
- Despite a mixed picture for the UK economy, UK commercial property has seemingly taken much of this uncertainty in its stride. The market continued to deliver steady investment performance of 2.7% over the third quarter, taking the year-to-date total return to 7.6%

### **Relative positioning & TAA performance**

- TAA effects contributed positively over Q3 as performance benefited from an increased 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 from an overweight stance in EM and Europe, whilst the overweight in Japan detracted in Sterling terms after a rally in the Sterling Yen cross rate. Within the UK equity allocation, the mid and small cap bias continued to contribute positively over 2017 as UK large cap stocks underperformed on currency strength.
- In Fixed income, the outperformance of the overweight Global High Yield allocation in Q3 contributed positively to performance as the asset class extended outperformance against both Investment Grade Credit and the negative return for UK Gilts during the period.

### **Outlook & views**

- The RLAM Investment Clock, which guides our tactical asset allocation views, is in the 'recovery' phase which is positive for equities and benign for bonds, given relatively weak inflation and interest rate rise expectations. However, it is approaching the 'overheat' phase, which historically has been a more challenging environment for fixed income markets.
- Given longer term positive economic fundamentals, and interest rates not expected to rise sharply in the next year at least, we remain ready to buy stocks on dips in the market.
- The outlook for 2018 is for continued global growth with no obvious signs of strong inflationary pressures, and consequently no need for interest rates to rise sharply from current levels.

## 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, 4 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 high cash holding. There are a number of purchases in the pipeline and assuming all successfully complete, this cash level will reduce significantly.

### **RL pension funds**

The number of RLAM funds triggering for review over this reporting period is 18 however no funds have significantly underperformed.

RLAM funds on watch:

- Short (5yr) Gilt
- Medium (10yr) Gilt
- Long (15yr) Index linked
- Adventurous Managed
- Sustainable Leaders (previously UK Ethical)
- UK Opportunities
- American
- Far East (ex Japan)
- Japan
- Pacific
- Worldwide
- Global Equity
- International Govt Bond
- UK Government Bond
- Global High Yield Bond
- Global Index Linked
- Pegasus Safety
- Pegasus Cautious

### **Externally managed matrix funds**

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

#### **Schroder Core UK Equity**

The fund is underperforming over all time periods. RLI 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 over 1, 3 and 5 years. This fund is a concentrated portfolio and RLI customers

have £2m invested. The fund is not currently recommended by Morningstar. IAC have asked us to identify a suitable replacement for this fund.

### **Schroder UK Equity**

The fund is underperforming over 1 and 3 years although not to the same extent as the Core UK Equity fund, it sits in the same sector as the Core UK Equity. The fund is not currently recommended by Morningstar. IAC have asked us to identify a suitable replacement for this fund.

The following funds were also discussed during the meeting:

### **Schroder UK Alpha Plus**

The fund is underperforming over 1 and 3 years although not to the same extent as the Core UK Equity fund. This is a specialist fund. The fund is not currently recommended by Morningstar. We will continue to monitor this fund.

### **Investec UK Smaller Companies**

This fund has had a change of fund manager since the last meeting. Matt Evans from Columbia Threadneedle is now at the helm and has a strong track record in managing UK small and mid-cap equities. The 4Factor process has now been removed – a decision not taken lightly - and replaced by Matt's Quality framework for analysing companies – focus on valuation, financial model, business model, capital allocation, challenge and debate. The investment decisions are implemented through a disciplined 3 stage framework - Idea generation - Fundamental research & analysis - Portfolio construction. Their process for analysing companies is bottom –up with a focus on quality and value companies. They aim to maintain a diversified portfolio and achieving risk adjusted returns driven by stock selection with no style bias. We will continue to monitor this fund.

### **First State Global Emerging Markets Leaders**

The fund had a disappointing quarter and is suffering from poor performance over one year and three years. It continues to outperform over five years but the relative position has slightly worsened. In the last 12 months, the fund has lagged the benchmark by nearly 10%. Given the fund's distinct style, performance divergence of this magnitude are 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 (32% of the fund versus 7.5% of the index) has been detrimental although it has largely been offset by positive stock selection within the sector. 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.

The fund's poor short-term performance is consistent with Morningstar's expectations for the strategy. The fund's elevated cash weight (around 7.5% on average) in the past twelve months 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's tracking error has been too low over the last 12 months although it is above 5% over two and three years and the fund continues to sit bottom quartile on a risk-adjusted basis over one, two and three years. This fund remains soft-closed to new investors and is experiencing net outflows. IAC were comfortable that we investigate alternative solutions for investors looking to access exposure to emerging markets.

### **First State Asia Pacific Leaders**

The fund has underperformed over all time periods and trend is worsening. 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. 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. Such returns have placed the fund in the bottom quartile of its peer group over one and three years. 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 (c600bps impact). 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 September 2017 stood at 7.2%. In this context, the fund's poor short-term performance is consistent with our expectations for the strategy. We will continue to monitor this fund.

#### **Fidelity European Blended**

The fund had a poor quarter and remains under benchmark over 1 and 5 years. This fund consists of the Fidelity European and Fidelity European Opportunities fund. The European opportunities component has breached the 5% tracking error limit but risk has been dampened within the portfolio by the more cautious European fund. The funds are third quartile on a risk-adjusted basis. Morningstar do not recommend the European Opportunities fund and have a bronze rating for the European fund. Our quantitative analysis confirms the fund manager's comment that he tends to outperform weaker markets more than rising ones. We have a further meeting with the fund manager lined up for January 2018 as part of our ongoing review.

#### **Invesco Perpetual Japan**

Performance is significantly over benchmark over 5 years and under over 1 and 3yrs. The fund's allocation to energy stocks and cash have been the largest detractors from performance. 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.

#### **Schroder Tokyo**

The fund outperformed the benchmark over Q3 and is now underperforming over three and five years. The fund continues to outperform over one year. The longer-term underperformance is marginal and the fund continues to sit first and second quartile over three and five 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. We will continue to monitor this fund.

#### **Artemis UK Special Situations**

The fund marginally outperformed over Q3 but underperforms over 1, 3 and 5 years. RLI held a meeting with the fund managers Derek Stuart and Andy Grey during

November. Whilst on a cumulative basis the fund shows underperformance it was just an 18 month period of underperformance that has negated the other periods of outperformance. Longer time periods have suffered from Brexit effects; the fund didn't own the USD earning stocks which benefited from the fall in sterling. They've been underweight banks and mining so it's been a tough second half of the year. Artemis admitted that stock selection hasn't been great and there's been a lack of momentum, which has contributed to underperformance.

The rise and success of passive funds and ETFs has been a challenge. Value style of management, which the fund adopts, has been out of favour for a while. Investors are paying big for growth stocks at the moment but not sure how long this will last. When shift happens, the stocks they have at the moment have the potential to add a lot of value. Artemis have confirmed there haven't been and won't be any fundamental changes to the fund. They are being careful where they take positions and still have a focus on self-help companies. We will continue to monitor this fund.

## 6. **DATE FOR NEXT MEETING**

The next quarterly meeting is 1 March 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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