SCOTTISH WIDOWS
PENSION PORTFOLIO FUNDS
QUARTERLY UPDATE

QUARTER 4 2019

This information is for UK financial adviser use only and should not be distributed to or relied upon by any other person.
The Scottish Widows Pension Portfolio Funds are a range of risk-rated multi-asset funds. They can be held individually and used both when saving for retirement and for income drawdown during retirement. They are strategically managed by our Asset Allocation Team and are subject to a rigorous and ongoing governance process, ensuring that they maintain the potential to provide good investment outcomes for our customers at the intended risk profile.

ASSET ALLOCATION UPDATE AS AT 31ST DECEMBER 2019

In the fourth quarter of 2019, we completed the second tranche of a change in our medium-term asset allocation (the first tranche was completed in September 2019). We are shifting our underweight position versus Emerging Market (EM) equities to Developed Market (ex-UK) equities. Prior to this, we were relatively underweight UK equities in relation to EM equities. While the valuation of EM equities is still lower than that of UK equities, the difference is now more in line with its historical and we see far less potential value in underweighting the UK relative to EM going forward.

Further details about this are covered in the ‘Asset Allocation’ section later on in this document.

The Pension Portfolio Funds are constructed from eight* underlying passively managed funds; there are six equity funds, which are managed by State Street Global Advisors, and two bond funds, which are managed by Aberdeen Standard Investments. The Fund range therefore combines the benefits of low-cost passive investing with Scottish Widows' expertise in asset allocation. A summary of the current asset allocation for each Fund is provided on the next page.

*This doesn't include the funds that are used to construct Pension Portfolio Fund 5
## ASSET ALLOCATION UPDATE AS AT 31ST DECEMBER 2019

### SUMMARY OF ASSET ALLOCATION ACROSS THE SCOTTISH WIDOWS PENSION PORTFOLIO FUND RANGE

<table>
<thead>
<tr>
<th>Pension Portfolio Fund</th>
<th>Total Equity</th>
<th>Total Fixed Interest</th>
<th>UK Equity</th>
<th>North American Equity</th>
<th>European Equity</th>
<th>Japanese Equity</th>
<th>Asia Pacific Equity</th>
<th>Emerging Market Equity</th>
<th>Global Corporate Bonds†</th>
<th>UK Corporate Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scottish Widows PP One Pension Fund</td>
<td>100%</td>
<td>0%</td>
<td>32.3%</td>
<td>17.3%</td>
<td>19.2%</td>
<td>8.2%</td>
<td>10.0%</td>
<td>13.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Scottish Widows PP Two Pension Fund</td>
<td>85%</td>
<td>15%</td>
<td>27.5%</td>
<td>14.7%</td>
<td>16.3%</td>
<td>6.9%</td>
<td>8.5%</td>
<td>11.1%</td>
<td>6.0%</td>
<td>9.0%</td>
</tr>
<tr>
<td>Scottish Widows PP Three Pension Fund</td>
<td>70%</td>
<td>30%</td>
<td>22.6%</td>
<td>12.1%</td>
<td>13.4%</td>
<td>5.7%</td>
<td>7.0%</td>
<td>9.1%</td>
<td>12.0%</td>
<td>18.0%</td>
</tr>
<tr>
<td>Scottish Widows PP A Pension Fund</td>
<td>60%</td>
<td>40%</td>
<td>19.4%</td>
<td>10.4%</td>
<td>11.5%</td>
<td>4.9%</td>
<td>6.0%</td>
<td>7.8%</td>
<td>16.0%</td>
<td>24.0%</td>
</tr>
<tr>
<td>Scottish Widows PP B Pension Fund</td>
<td>50%</td>
<td>50%</td>
<td>16.2%</td>
<td>8.7%</td>
<td>9.6%</td>
<td>4.1%</td>
<td>5.0%</td>
<td>6.5%</td>
<td>20.0%</td>
<td>30.0%</td>
</tr>
<tr>
<td>Scottish Widows PP Four Pension Fund</td>
<td>40%</td>
<td>60%</td>
<td>11.6%</td>
<td>7.9%</td>
<td>8.6%</td>
<td>3.9%</td>
<td>4.7%</td>
<td>3.3%</td>
<td>24.0%</td>
<td>36.0%</td>
</tr>
<tr>
<td>Scottish Widows PP C Pension Fund</td>
<td>30%</td>
<td>70%</td>
<td>8.7%</td>
<td>5.9%</td>
<td>6.5%</td>
<td>3.0%</td>
<td>3.5%</td>
<td>2.5%</td>
<td>28.0%</td>
<td>42.0%</td>
</tr>
</tbody>
</table>

Strategic asset allocation as at 31st December 2019; Series 4 range charged at 0.1% Total Annual Fund Charge.

The totals above may not equal 100% due to rounding.

The range also includes Pension Portfolio Fund 5, which invests in ‘money market’ assets, also referred to as ‘cash’ and ‘near cash’ securities. It is also available to be invested in individually.

†Please note that the Global Corporate Bonds are hedged to sterling.
PERFORMANCE

The table below provides the performance of the Funds over the most recent quarter and longer time periods. Past performance is not a reliable indicator of future results.

**PERFORMANCE OF THE SCOTTISH WIDOWS PENSION PORTFOLIO FUND RANGE**

<table>
<thead>
<tr>
<th>PERIODS TO 31ST DECEMBER 2019</th>
<th>Quarter (%)</th>
<th>1 year (%)</th>
<th>3 years (% p.a.)</th>
<th>5 years (% p.a.)</th>
<th>Since inception (% p.a.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scottish Widows PP One Pension Fund</td>
<td>3.0%</td>
<td>20.4%</td>
<td>8.7%</td>
<td>10.6%</td>
<td>9.3%</td>
</tr>
<tr>
<td>Scottish Widows PP Two Pension Fund</td>
<td>2.5%</td>
<td>18.7%</td>
<td>8.0%</td>
<td>9.7%</td>
<td>8.9%</td>
</tr>
<tr>
<td>Scottish Widows PP Three Pension Fund</td>
<td>2.1%</td>
<td>17.0%</td>
<td>7.2%</td>
<td>8.9%</td>
<td>8.7%</td>
</tr>
<tr>
<td>Scottish Widows PP A Pension Fund</td>
<td>1.8%</td>
<td>16.1%</td>
<td>6.7%</td>
<td>-</td>
<td>7.1%</td>
</tr>
<tr>
<td>Scottish Widows PP B Pension Fund</td>
<td>1.4%</td>
<td>15.0%</td>
<td>6.2%</td>
<td>-</td>
<td>6.6%</td>
</tr>
<tr>
<td>Scottish Widows PP Four Pension Fund</td>
<td>1.1%</td>
<td>14.0%</td>
<td>5.6%</td>
<td>7.2%</td>
<td>7.8%</td>
</tr>
<tr>
<td>Scottish Widows PP C Pension Fund</td>
<td>0.7%</td>
<td>12.9%</td>
<td>5.2%</td>
<td>-</td>
<td>5.6%</td>
</tr>
</tbody>
</table>

Performance as at 31st December 2019, net of fees (Series 4 range charged at 0.1% total annual fund charge). The inception date for Pension Portfolios One, Two, Three and Four is 31st December 2010. The inception date for Pension Portfolios A, B and C is 30th March 2015.

For comparison purposes only, please see below three mixed-asset ABI sectors. Please note that the Pension Portfolio Funds are part of the ABI Specialist Sector. Past performance is not a reliable indicator of future results.

**PERFORMANCE OF THE ABI (ASSOCIATION OF BRITISH INSURERS) SECTORS**

<table>
<thead>
<tr>
<th>PERIODS TO 31ST DECEMBER 2019</th>
<th>Quarter (%)</th>
<th>1 year (%)</th>
<th>3 years (% p.a.)</th>
<th>5 years (% p.a.)</th>
<th>Since inception of SW Pension Portfolio Funds (% p.a.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Flexible Investment Sector</td>
<td>2.6%</td>
<td>16.8%</td>
<td>6.3%</td>
<td>7.4%</td>
<td>6.6%</td>
</tr>
<tr>
<td>Mixed Investment 40% ~ 85% Shares</td>
<td>1.7%</td>
<td>15.3%</td>
<td>5.8%</td>
<td>6.7%</td>
<td>6.2%</td>
</tr>
<tr>
<td>Mixed Investment 20% ~ 60% Shares</td>
<td>1.3%</td>
<td>11.5%</td>
<td>4.0%</td>
<td>4.7%</td>
<td>5.1%</td>
</tr>
</tbody>
</table>

Source: Scottish Widows, Financial Express, on a bid-to-bid basis, total return, tax default, in £s. As at 31st December 2019. Inception date is 31st December 2010.
Global equity markets recorded healthy gains in the final quarter of the year, as the geopolitical risks that drove markets for much of 2019 subsided – at least temporarily. The biggest news on a global scale was the announcement in December of a ‘phase-one’ trade agreement between the US and China, expected to be finalised in January 2020, which could potentially halt the economic slowdown that has resulted from the trade wars. Likewise in fixed income, corporate bonds performed well amid the improved investor sentiment.

**UK**

Shares in UK companies gained over the quarter as near-term uncertainty subsided after the 12th December general election, which saw the Conservative party take a decisive victory. With a reinforced majority, the party seemed set on taking the UK out of the EU by the end of January 2020, and starting the next stage of negotiations. As a result of the renewed clarity on Brexit, UK markets performed well – particularly domestically focused mid-sized companies – and the value of sterling rallied. In terms of the economic picture, the British economy managed to avoid entering a technical recession after having contracted in the second quarter; GDP growth figures for Q3 showed a gain of 0.4% quarter-on-quarter (compared to -0.2% in Q2).

**US**

Shares in American companies posted robust returns for the fourth quarter, supported by improving economic data, an interest rate cut from the Federal Reserve (Fed), and the prospect of an appeasement in the trade situation with China. Overall, US equities had a strong year and, after a series of cuts, the Fed announced it did not intend to make near-term interest rate changes or adjustments to its monetary policy if the economic picture continues to improve. Fed Chair Jerome Powell said the outlook “remains a favourable one, despite global developments and ongoing risks”.

**Europe**

Shares in Eurozone countries likewise advanced in the quarter, amid improved economic data from Germany and optimism about the US and China trade deal. China is one of Europe’s main trading partners, so better-than-expected Chinese manufacturing data added further support, as did the improvement in Spain’s economy, which grew by 0.4% for the second quarter. While difficult negotiations between Europe and the UK are still to come in 2020, the results of the December general election in the UK helped remove another source of uncertainty for European investors.

**Japan and developed Asia**

Japanese shares ended the quarter higher as the yen weakened slightly against the US dollar, although they underperformed other developed markets. Economic data indicated an ongoing disparity between the strength in service sectors and the weakness in manufacturing, as well as significant tightness in the labour market. The Japanese government introduced a substantial new budget package, focusing on economic stimulus via reconstruction, which was welcomed by investors. The possible resolution of US-China trade tensions boosted not only Japanese equities, but those in South Korea and Taiwan, particularly in the technology sector. Hong Kong’s market posted a solid gain but lagged the wider region.

**Emerging markets**

Emerging market (EM) equities enjoyed a strong quarter, on the back of easing geopolitical concerns, a weaker US dollar and lower US interest rates. (Many EM countries hold a significant amount of US-dollar-denominated debt.) China was a notable outperformer, as the US has tentatively agreed to suspend a tariff package on £160bn of Chinese imports, which was scheduled for December 2019, and to cut existing tariffs by half (from 15% to 7.5%) in exchange for China increasing its purchases of US agricultural goods. Russia and Colombia had a strong quarter on rising crude oil prices, while Brazil benefitted from stronger currency and a long-awaited pension reform bill. In contrast, Chile, Turkey and India underperformed.

**Fixed income**

As investors became more optimistic about the global trade picture and improving economic data, bond market returns reflected the increased appetite for risk assets (equities). Government bond yields rose across the board (i.e. prices fell) in light of a stronger macro environment, with several countries’ bonds coming out of negative yield territory. While high-yield bonds performed well, sterling corporate bond returns were moderately negative, and long-dated gilts (15 years or longer) posted losses.

**Pension Portfolio Fund performance**

In this market environment, the Scottish Widows Pension Portfolio Funds recorded positive returns for the fourth quarter of 2019.

Equities strongly outperformed bonds amid a more positive outlook for riskier assets. As a result, the Pension Portfolios with the largest exposure to equities (i.e. Pension Portfolios One and Two) had the highest returns. Portfolios with a heavier weighting in bonds (i.e. Portfolios A, B, and Four) had more moderate returns, although they still ended the quarter with positive returns.

Returns cited in this report are for total returns in sterling, unless otherwise stated. Source: Financial Express, unless otherwise footnoted.
Overview
The first quarter is rarely a dull period for financial markets, particularly on the evidence of recent years. In 2019, markets staged a dramatic rebound from a difficult end to the previous year, as the US Federal Reserve reversed course on its plans to increase interest rates. In 2018, a strong January was derailed by the largest-ever intra-day move in the Dow Jones and markets ultimately ended the quarter lower.

This year starts on a markedly different footing to last. In December, Christmas came early for investors with news of a ‘Phase One’ Trade Deal between the US and China and progress on Brexit. Can the wave of positive sentiment continue?

No Fed surprises
If investors are looking for a repeat of 2019’s first-quarter rally, this time around, central bankers are unlikely to be the catalyst. At their latest meeting in December, the Fed indicated that there will be no further changes to interest rates until 2021 and such expectations are now priced into markets. At this stage in the cycle, there is plenty of scope for surprises in economic data and if the outlook should deteriorate again, the Fed may be forced to alter its guidance. However, no change will be as significant as the pivot last January.

Geopolitics remain in focus
December’s General Election in the UK yielded a pro-business, majority government, while easing trade tensions between the US and China were another important development. However, as always with geopolitics, it’s a fragile balance. Boris Johnson’s hard deadline for Brexit has re-introduced the risk of a ‘no deal’, while President Trump could easily return to his trade offensive if he should deem it beneficial to his chances of re-election.

There is also the issue of President Trump’s impeachment. The balance of power in the Senate dictates that, despite being impeached, the President will be free to remain in his role. However, if ‘Super Tuesday’ (the early US primaries held in March) should favour a Democrat candidate who would reverse many of the current administration’s pro-growth initiatives, the issue of Trump’s impeachment and its impact on his chances of re-election may impact the market.

In short, the balance of risks has shifted in positive fashion but investors are still faced with uncertainty.

There’s no such thing as a free lunch
There’s no such thing as a free lunch but bonds have offered the next best thing in recent times. In the UK, government bond funds have outperformed equity funds over the past two years as a mixture of economic uncertainty and investor demand has driven yields to historically low levels. More than 30% of all investment grade debt globally now costs investors to hold it.

However, as the economic outlook improves and recessionary pressures decrease, bonds offer asymmetric risk and return. In December, yields increased and prices fell sharply in response to upgraded growth expectations (there is an inverse relationship between a bond’s yield and its price). If investors should start to move their money elsewhere, there’s risk of a sustained sell-off.

A brighter outlook benefits equities
Despite expectations of a more stable growth outlook, earnings expectations in some areas of the market remain cautious. Renewed optimism over the US-China trade relationship is good news for exporters in particular, and a number of European businesses stand to benefit following a challenging year. Share buybacks also remain close to record levels and ought to support the stock market. Returns of the magnitude experienced in 2019 are unlikely but there’s no reason that the bull market can’t continue into an eleventh year.

Overall, the outlook for the first quarter is like a summer’s day in Scotland – reasonably bright, but you can never be sure it isn’t going to rain.
THE REASSURANCE OF ROBUST GOVERNANCE

WE BELIEVE IN THE IMPORTANCE OF GOVERNANCE IN HELPING TO DELIVER GOOD OUTCOMES FOR OUR CUSTOMERS.

CONFIDENCE AND TRUST
You can trust in our expertise to look after our customers’ investments.

The Scottish Widows governance framework’s key role is to ensure our investment offerings are well positioned to meet our customers’ requirements and expectations, and ultimately to help them enjoy a secure retirement.

You can be assured that our experienced teams conduct robust monitoring and governance every day, notably for our multi-asset portfolios and the underlying funds that comprise them.

INVESTMENT OVERSIGHT
For us, Governance means being vigilant in ensuring the investments we offer are suitable for a wide range of customers’ needs.

Our investment governance includes independent oversight and regular formal reviews by key committees, made up of some of our most senior and experienced executives and investment specialists:

- **INSURANCE & WEALTH INVESTMENT STRATEGY COMMITTEE (IWISC)**
  Responsible for our overall investment strategy.

- **UNIT LINKED INVESTMENT MANAGEMENT COMMITTEE (ULIM)**
  Considers the application of IWISC’s views at the individual portfolio level.

Additionally, the Independent Governance Committee independently ensures that funds are regularly reviewed and provide value for money. The Investment Management Operational Review Committee ensures we are prepared for the operational aspects of fund management.

FUND GOVERNANCE EXPERT TEAMS
A strong governance and control framework lies at the heart of what we do, to help ensure our funds are compliant with regulations, perform in line with their intended aims and risk profiles, and deliver good customer outcomes.

The Fund Manager Assessment Team assess the funds in which we invest using qualitative and quantitative analysis.

And our dedicated **Asset Allocation Team** take the vital asset allocation decisions for our range of multi-asset funds. They decide strategic long-term and medium-term asset allocation, and oversee the implementation of shorter-term tactical asset allocation decisions, where appropriate.

OUR FUND GOVERNANCE DELIVERS:

✓ Thorough and stringent fund manager selection.
✓ Clear instructions and parameters for fund managers through mandates.
✓ Careful monitoring of performance and risk profiles to ensure funds remain aligned to customer expectations.
✓ Fund ranges which meet regulatory requirements.
✓ Long-term and medium-term asset allocation decisions for our key multi-asset funds.
✓ Oversight of tactical asset allocation, where appropriate.

You can find more detail on our Governance webpage – adviser.scottishwidows.co.uk/funds/fund-governance

The information contained in this update has been derived from sources which we consider to be reasonable and appropriate. It may also include our views and expectations, which cannot be taken as fact. Investment markets and conditions can change rapidly and, as such, the views expressed in this update should not be taken as statements of fact nor be relied on when making investment decisions. Forecasts are opinions only, cannot be guaranteed and should not be relied on when making investment decisions.
Ensuring that all of our multi-asset funds, including the Pension Portfolio Funds (PPFs), have appropriate asset allocation is vital and something that we pay great attention to. For the PPFs, we undertake asset allocation at two principal levels: 1) long-term strategic and 2) medium-term ‘house view’.

We have a dedicated Asset Allocation Team which seeks approval for any proposed changes from our Unit-Linked Investment Management Committee (ULIM) or our Insurance & Wealth Investment Strategy Committee (IWISC), depending on the nature of the decision.

1. LONG-TERM STRATEGIC ASSET ALLOCATION

Long-term strategic asset allocation is the main determinant of the performance of our PPFs, in accordance with their long-term nature. The purpose of long-term strategic asset allocation is to determine the optimal mix of asset classes for the risk profile of a Fund, based upon the modelled returns of those asset classes over the long term. For the PPFs specifically, we factor in our core commitment to using passive investment funds as the main vehicles for implementation, recognising their value as low cost solutions.

We aim to undertake a comprehensive periodic review (indicatively every 1–2 years) of the long-term strategic asset allocation within our PPFs. The purpose of this review is to refine the asset allocation, with the aim of improving projected returns, while ensuring that the Funds retain their intended risk profile. We always aim to manage changes within a modest overall level of change as we’re very conscious of the cost of turnover within a Fund and the impact that this can have on investment returns.

The table below highlights the key decisions made over the last five years. At each review, we used stochastic modelling to run a large number of different scenarios, testing different mixes of asset classes based on their projected returns. This was done in conjunction with Barrie & Hibbert and subsequently Moody’s Analytics, which both provide risk modelling solutions to the financial services industry around the world.

The changes we made were those that we believed had the potential to have a sufficiently material impact on the returns from the Funds, while keeping within their risk parameters.

<table>
<thead>
<tr>
<th>DATE OF REVIEW</th>
<th>DECISION MADE</th>
</tr>
</thead>
</table>
| 2014 | • Switched the equity allocation from 50%/50% global equities/UK equities to 70%/30% global equities/UK equities for PPFs 1-4.  
• Introduced an allocation to emerging market equities within PPFs 1, 2 & 3.  
• For PPF 4, take 10% of the Fund out of equities and add to corporate bonds. |
| 2015 | • Introduction of alternative glidepaths in the five years to retirement to reflect the ‘Pension Freedoms’ legislation; ‘Targeting Annuity Purchase’ was maintained while ‘Targeting Encashment’ and ‘Targeting Flexible Access’ were introduced. |
| 2016 | • We changed the default glidepath from ‘Targeting Annuity Purchase’ to ‘Targeting Flexible Access’. |
| 2017 | • Removed index-linked gilts (ILGs) in favour of corporate bonds for PPFs 3 & 4 (PPFs 1 & 2 did not hold any ILGs).  
• Switched the corporate bond allocation from 100% sterling corporate bonds to 75%/25% sterling corporate bonds/global corporate bonds (hedged to sterling) for PPFs 2, 3 & 4 (PPF 1 did not hold any corporate bonds).  
• Introduced a small allocation to emerging markets to PPF 4 in line with other portfolios. |
| 2018 | • Switched the corporate bond allocation from 75%/25% sterling corporate bonds/global corporate bonds (hedged to sterling) to 50%/50% for PPFs 2, 3 & 4 (PPF 1 does not hold any corporate bonds).  
• We decided to phase in this switch gradually, initially using cash inflows to add to the global corporate bond position (therefore not incurring the transaction costs of selling sterling corporate bonds).  
• As at 31st December 2019 we have set the corporate bond allocation at 60%/40% sterling corporate bonds/global corporate bonds (hedged to sterling). |
2. MEDIUM-TERM ‘HOUSE VIEW’ ASSET ALLOCATION

Medium-term asset allocation involves making adjustments to the strategic asset allocation (SAA) weights of individual asset classes within a Fund based on the expected medium-term performance of those asset classes. We generally consider the medium term as indicatively 18 months to five years.

Our aim is to add value by reflecting our current views of the relative value and attractiveness of asset classes. However, as with SAA, we only make changes when we believe them to have the potential to be materially significant. We believe in the benefits of investing for the long term and do not believe that it is in the interests of our customers to make frequent changes to our Funds.

The table below highlights the medium-term asset allocation positions taken over the last five years.

MEDIUM-TERM ASSET ALLOCATION DECISIONS

<table>
<thead>
<tr>
<th>DATE</th>
<th>DECISION MADE</th>
<th>OPEN/CLOSED</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>Add to emerging market (EM) equities (by reducing UK equities)</td>
<td>Closed - but in process of moving from overweight EM equities vs. UK equities to overweight EM equities vs. developed market equities (see end of table)</td>
</tr>
<tr>
<td></td>
<td>We believe that the long-term growth prospects for EM companies are attractive and that their valuations are also appealing relative to companies in other parts of the world. While President Trump's decision to raise tariffs on US imports has led to concerns about the impact that this will have on emerging markets, and China in particular, we believe that the longer-term attractions of investing in emerging market equities remain in place.</td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td>Add to UK equities (by reducing developed market equities)</td>
<td>Closed</td>
</tr>
<tr>
<td></td>
<td>Historically, the UK equity market has typically been undervalued when compared with other developed equity markets. This discount has now reached an exceptional level compared with its long-term valuation, driven in part by political uncertainty in the UK, as well as a slower rate of economic growth. We believe that the size of the discount is unjustified and therefore took the opportunity to add to UK equities.</td>
<td></td>
</tr>
</tbody>
</table>

Looking forward, we are committed to regularly reviewing the PPFs and how they are invested, from both long-term and medium-term perspectives.

Since the launch of the PPFs, we have strived to maintain them as a low-cost, transparent investment proposition, with a belief that over a long-time horizon the most efficient pension customer outcomes will result from a growth strategy that is predominately invested in equities, followed by a long (15-year) period of gradual ‘de-risking’. We believe that the PPFs continue to offer very good value for investors.