We are proud of the strong long-term performance record of the Governed Investment Strategies and the value they have delivered for customers to date. The 2018 review was intended to help ensure they maintain their effectiveness over the long term and that they are optimally set up to aim to deliver good results while adhering to their defined strategy.

Past performance is not a reliable indicator of future results. The value of investments may fall as well as rise. Investors may not get back the full amount originally invested.
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INTRODUCTION

AT THE CORE OF THE SCOTTISH WIDOWS INDIVIDUAL PENSION INVESTMENT OFFERING ARE OUR THREE GOVERNED INVESTMENT STRATEGIES (GIS):

- CAUTIOUS
- BALANCED
- ADVENTUROUS

THEY ARE DESIGNED AS LOW-COST PENSION SOLUTIONS THAT REFLECT CUSTOMERS' DIFFERENT ATTITUDES TO RISK AND REWARD.

We carry out regular reviews of the GIS, undertaken with input from independent specialists, to ensure that they maintain effective strategic asset allocation (SAA) for each risk profile and are well placed to aim to achieve good investment outcomes for our customers.

We manage the SAA for the GIS based on a long-term investment horizon (5-10 years or longer) and review this regularly (every 1-2 years). While we may also on occasion take short-to-medium term asset allocation positions, these tend not to be part of the regular governance review and are therefore not part of this document. We only make SAA changes when we consider them materially positive for the long-term outlook of the GIS. This helps avoid the compounded costs over time associated with frequent turnover.

We conducted a review of the GIS in mid-2018, using stochastic modelling tools provided by Moody’s Analytics to test a number of investment scenarios. Stochastic modelling is a way to forecast potential outcomes by allowing for random variation in one or more inputs over time. Our Asset Allocation Team analysed the results, and their subsequent recommended changes were then presented to and endorsed by the Scottish Widows Unit Linked Investment Management (ULIM) Committee in October 2018. ULIM’s role is to govern all Scottish Widows unit-linked funds, ensuring they meet our commitments to customers.

Moody’s Analytics

The analysis presented in this report uses stochastic projections modelled by in-house applications provided under licence by Moody’s Analytics. The economic variables and asset returns that drive the projections are modelled by Moody’s using their Economic Scenario Generator (ESG). The ESG model makes a number of assumptions about the future distribution of different financial variables and bases these assumptions on a combination of many different sources of data. Along with our own modelling assumptions, we are reliant on Moody’s ‘Real World’ model structure and calibrations which are suitable for long-term projections.

While the Asset Allocation Team at Scottish Widows use the results generated by these tools, they do not use them without question but instead subject them to their own expertise and may make adjustments where they believe them to be appropriate.
SCOPE OF 2018 REVIEW

Below is the SAA of the four Pension Portfolio Funds (PPFs) which are the main components of the GIS, before any changes have been made as a result of this review.

**KEY:**
- UK equities
- Overseas developed markets equities
- Emerging markets equities
- Corporate bonds

Source: Scottish Widows, as at 30/09/2018

We are proud of the strong long-term performance record of the GIS and the value they have delivered for customers. The 2018 review was intended to help ensure they maintain their effectiveness over the long term and that they are optimally set up to deliver good results while adhering to their defined strategy.

On the broadest level, our SAA reviews take into consideration the equity-bond mix in the GIS. While we can’t rule out ever adding other asset classes, this is not currently being considered due to their often higher cost.

Focusing on the existing available asset classes helps us to maintain the simple, low-cost, transparent and liquid profile of the GIS.

Using the stochastic modelling tools previously mentioned, we assessed what the impact to the GIS (including any post-retirement income) could be over 15 and 25-year horizons as a result of changes to:

- the overall mix of equities and bonds
- the mix of UK and global equities
- the mix of sterling and global corporate bonds.

The structure of the glidepaths themselves are currently subject to their own review and any proposed changes will be communicated separately.
After analysing the results of the stochastic modelling, the only potential scenario determined to have a potential impact on the long-term outcome of the GIS was a shift in the bond mix – specifically, the mix of sterling corporate bonds and global corporate bonds within each GIS – Cautious, Balanced and Adventurous.

In the 2017 review available here, we took the decision to remove index-linked gilts from the GIS in favour of corporate bonds. Further, we decided to diversify the GIS’s corporate bond allocation by adding global corporate bonds (in practice, we reduced the GIS’s sterling corporate bond exposure from 100% to 75% and introduced a 25% allocation to global corporate bonds (fully hedged to sterling)). At the time, we signalled the possibility that this mix could be further adjusted in favour of global corporate bonds, and indeed that was the outcome of the 2018 review.

The details about the extent and timing of this change are outlined below.

WHAT HAVE WE DECIDED TO DO?

We have approved a long-term switch to a balance of 50/50 sterling and global bonds within the fixed interest element of the GIS, based on long-term projections. Specifically, Moody’s are forecasting that global corporate bonds will produce higher returns than sterling corporate bonds over the longer term and we are therefore adding to the latter.

In addition, by adding to global corporate bonds within the GIS we are improving their diversification, which in turn has the effect of reducing risk.

We did not find any other material changes that we wanted to make to improve the position of the GIS.

WHEN WILL WE MAKE THE CHANGE?

We have decided to phase in the switch gradually. The main reason is that, over the shorter term (1-3 years), we believe that the projected returns for global corporate bonds (hedged back to sterling) are less certain and that they may in fact achieve lower returns than sterling corporate bonds. Given this uncertainty, it would be hard to justify incurring transaction costs in order to realise the ultimate 50/50 revised bond mix. For this reason, we will initially use cash inflows to add to the global corporate bond position – i.e. we will not incur the transaction costs of selling sterling corporate bonds.

By using cash inflows to add to global corporate bonds, we expect to reach a 70/30 mix of sterling versus global corporate bonds within approximately six months.

After this time, the Asset Allocation Team will review the situation and consider how best to get to an allocation of 60/40 after twelve months (i.e. whether they will continue to use cash inflows or whether it would be appropriate to sell sterling corporate bonds in order to buy global corporate bonds).

They will then further review as to how best to get the ultimate target position of 50/50.

At all times, we will be carefully balancing the long-term benefit to the GIS of diversifying the global corporate bond/sterling corporate bond mix with the costs of doing so, aiming to achieve the best value for our customers.
SUMMARY

Our analysis of the GIS showed that a long-term shift in the fixed-interest allocation would improve the projected risk/return profiles for all our GIS – Cautious, Balanced and Adventurous. The recommended shift over the long term is 50% sterling corporate bonds/50% global corporate bonds (hedged back to sterling), with the first phase objective of 60%/40% over the next 12 months. Over the short term, we will initially use cash inflows to gradually move from the current 75%/25% split to 70%/30% over the next six months.

The projected aggregate benefits from this shift in improving both the risk and the return elements of the GIS are shown below.

A key step in the governance process is to analyse the current ‘ABI Mixed Investment: 40-85% Shares’ sector in order to model a representative asset allocation, including a 10-year ‘de-risk’ towards retirement, of what we consider the most appropriate risk benchmark for a ‘Balanced’ retirement journey. Our intention is to closely align the Balanced GIS to the projected risk of this sector. Our Adventurous and Cautious glidepaths are currently determined as 15% above and below the balanced position (85% equities) during the accumulation phase.

Following the changes, the Balanced GIS has an improved position versus the equivalent sector projections, which is central to guiding the risk of our retirement journeys. Specifically, the Balanced GIS improves projected returns with a limited impact to risk (value at the 95th percentile).

Please see footnotes overleaf.

The chart shows the projected impact of moving from 75/25 to 60/40 sterling vs. global corporate bonds for a ‘flexible access’ customer with 25 years to retirement (10 years’ growth and 15 years’ de-risking), improving the projected positions of the Cautious, Balanced and Adventurous lifestyles. Our analysis showed that the proposed changes would also have a beneficial impact for customers on ‘targeting annuity’ and ‘targeting encashment’ strategies.

All recommendations made in this review relate to a long-term horizon, rather than immediate tactical gains. We believe the recommendations discussed in this report will further enhance our GIS, which remain a simple, low-cost investment proposition for individual pensions.
Footnotes:

1. The modelling assumptions are designed to represent a typical saver based on a starting lump sum, consistent annual contributions linked to inflation over 25 years to retirement. While the quoted nominal amounts are the projected outcomes they should be considered as illustrative and not a prediction of amounts to expect.

2. We also sens check the Cautious and Adventurous GIS risk versus the ‘ABI Flexible Investment’ sector and ‘ABI Mixed Investment: 20-60% Shares’ sector. However, the perceived risk of these sectors does not necessarily drive how we position the GIS glidepaths.

3. It should be noted these lifestyle projections have been modelled on a gross of fees basis. The added cost of investing in typical ‘balanced’ funds from the ‘ABI Mixed Investment: 40-85% Shares’ sector, including more expensive asset classes such as property, has not been considered. We therefore predict the illustrative return of the ABI sector relative to the Balanced GIS is overstated.

ONGOING GOVERNANCE AND MONITORING

In addition to the SAA reviews of the GIS, the performance and governance of the underlying funds used in the GIS also fall under our fund governance framework. This monitoring can include assessing the realised volatility of the funds, identifying any tracking errors or underperformance triggers, and ultimately ensuring that they are properly aligned with fund mandates.

Our combined governance efforts help to ensure that the GIS and their underlying funds can continue to meet their aims and objectives, and maintain the potential to provide good outcomes for our customers.