FUND RANGE UPDATE

MEDIUM-TERM ASSET ALLOCATION WITHIN SCOTTISH WIDOWS’ MULTI-ASSET PENSION FUND RANGES

SEPTEMBER 2019

SHIFT TO UNDERWEIGHT DEVELOPED MARKET (EX-UK) EQUITIES VERSUS EMERGING MARKET EQUITIES

In September 2019, we successfully completed the first tranche of a significant trade to shift our underweight position versus Emerging Market equities to Developed Market (ex-UK) equities. Prior to this, we were relatively underweight UK equities.

As is our usual policy, we are making this shift over a period of time to mitigate against any particularly adverse price movements*.

This new medium-term asset allocation position follows several adjustments implemented in recent years.

During 2015 and 2016, we took the view to underweight UK equities versus Emerging Market equities due to a number of factors. These included the attractive relative valuation of Emerging Market equities, investors’ aversion to the region which we considered to be overdone and, linked to this, poor relative performance of Emerging Market equities leading up to our decision. It also reflected our negative view of the UK market at the time.

This position worked well, with Emerging Market equities outperforming UK equities, reflecting a return of investors’ confidence in the region, despite the short-term volatility being caused by the trade tensions between China and the US.

Towards the end of 2018, we made a small increase to the UK equity allocation within our multi-asset pension funds. This was funded by slightly reducing exposure to equity markets in North America, Japan and Europe ex-UK.

While the valuation of Emerging Market equities is still lower than that of UK equities, the difference is now more in line with its historical average. This means we now see far less potential value in underweighting the UK relative to Emerging Markets going forward.

However, Emerging Market equities are still trading at a substantial discount to the other developed markets of North America, Japan and Europe ex-UK. In large part, this reflects the particularly strong performance of North American equities over recent years.

So we have decided to leave in place the overweight exposure to Emerging Market equities but this time at the expense of Developed Market (ex-UK) equities rather than UK equities, the size of the new position being broadly consistent with the previous one.

*This information is for UK financial adviser use only and should not be distributed to or relied upon by any other person.
BULLISH ON UK EQUITIES

Historically, the UK equity market has typically been undervalued when compared with other developed equity markets. Last year, this discount reached an exceptional level compared with its long-term average, driven in part by political uncertainty in the UK, as well as a slower rate of economic growth. We believed that the size of the discount was unjustified and, therefore, took the opportunity to add to UK equities.

Against the backdrop of Brexit, the continued underperformance of UK equities and Sterling means that this position hasn’t yet added value. However, this underperformance means the market is now even cheaper, and, as such, we think offers a very attractive opportunity to long-term investors such as ourselves.

It should be remembered that while Brexit is a key concern for the UK economy, the FTSE 100 is largely comprised of global companies whose fortunes are much more aligned to the global economy than to that of the UK. In addition, those that are more domestically-focused tend to be relatively ‘defensive’ (e.g. tobacco, utilities), meaning that their sales and profits tend to remain reasonably stable regardless of the underlying economy.

As such, our view is that the market’s reaction to Brexit has been overdone. So in September, we began to increase our position in UK equities, which we believe will add value over time.

*As the Premier Pension Portfolio Funds were launched after our original decision to overweight Emerging Market equities relative to UK equities, the new position will be put in place slightly differently for the PPPFs. However, the end result will be broadly the same.

The table below shows the impact of the medium-term asset allocation (MTAA) positions on our long-term Strategic Asset Allocation (SAA) benchmarks. This is applicable to our Pension Portfolio Funds (PPFs), used to build our Pension Investment Approaches (PIA) and Governed Investment Strategies (GIS), and our Retirement Portfolio Funds (RPFs).

<table>
<thead>
<tr>
<th>Equity region</th>
<th>Strategic Asset Allocation</th>
<th>Asset allocation (adjusted for MTAA positions)**</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>30%</td>
<td>34% (+4%)</td>
</tr>
<tr>
<td>North America</td>
<td>21%</td>
<td>16.5% (-4.5%)</td>
</tr>
<tr>
<td>Japan</td>
<td>10%</td>
<td>7.8% (-2.2%)</td>
</tr>
<tr>
<td>Europe ex-UK</td>
<td>21%</td>
<td>18.8% (-2.2%)</td>
</tr>
<tr>
<td>Asia Pac</td>
<td>10%</td>
<td>10% (0%)</td>
</tr>
<tr>
<td>EM</td>
<td>8%</td>
<td>13% (+5%)</td>
</tr>
</tbody>
</table>

Notes:
**The Asset Allocation percentages represent ‘end state’ once all trading has taken place and may fluctuate over time to reflect market movements.

While the SAA for the Premier Pension Portfolio Funds is different, because they invest in a greater number of asset classes, the scale of the adjustment to the regional equity positions as a result of the MTAA positions will be broadly the same as for the Pension Portfolio Funds.

PREMIER PENSION PORTFOLIO FUNDS – DOWNSIDE PROTECTION STRATEGY APPLIED TO US EQUITY EXPOSURE

In late 2016, we began to have some concerns about the level of equity markets. They had risen significantly over previous years, valuations were higher, and there was elevated political risk. So we decided to introduce a downside protection strategy on the UK and US equity exposure in our Premier Pension Portfolio Funds.

This strategy is implemented through derivatives and is actively managed to reflect prevailing market conditions. For example, protection on UK equities was removed during phases of market weakness in 2018 – and currently remains removed.

The protection on US equities remains in place because of our concerns that valuation levels are excessive following the very sharp rise in US equities so far this year.
AN EXPERIENCED TEAM

The Scottish Widows Asset Allocation Team is composed of five investment experts, whose role is to take asset allocation decisions that are applied as relevant* to our range of Multi-Asset Funds, including those within our core pension propositions** and our new Retirement Portfolio Funds. The team is run by Gavin Stewart, Scottish Widows' Asset Allocation Director.

A DYNAMIC APPROACH TO ASSET ALLOCATION

Ensuring that our Multi-Asset Funds have appropriate asset allocation is vital and something to which we pay great attention. For all our Funds, we undertake asset allocation at two principal levels: 1) long-term strategic and 2) medium-term ‘house view’.

Long-term strategic asset allocation is the main determinant of the performance of our Multi-Asset Funds, in accordance with their long-term nature. However, we also look to identify significant medium-term market opportunities in order to create additional value, and it is these which are outlined in this document.

Please note that while our two-level asset allocation process applies to our original Pension Portfolio Funds (which are used within Pension Investment Approaches (PIA) and Governed Investment Strategies (GIS)), they will inevitably be subject to fewer asset allocation changes than our Premier Pension Portfolio Funds due to the nature of their design as simple solutions for the corporate and individual pensions markets.

Please note that our medium-term asset allocation decisions will be applied to different extents depending on the current asset allocation within a fund (and in some cases may not be applied at all).

** Pension Investment Approaches (PIA), Governed Investment Strategies (GIS), Premier Pension Investment Approaches (PPIA) and Premier Governed Investment Strategies (PGIS).

* Please note that our medium-term asset allocation decisions will be applied to different extents depending on the current asset allocation within a fund (and in some cases may not be applied at all).