Survival of the Fittest

The Evolution of Investment Strategies

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Evolution of Investment Strategies

• What has changed since 1990?
• Where are we now?
• Where are we headed?

Any views expressed in this presentation are my own and do not necessarily reflect the views of my employer.
Pension Scheme Asset Allocation
1990 to 2010

UK Equities
-32%

Overseas Equities
+10%

Gilts – Fixed & Index Linked
+18%
The Decline of UK Equity Allocations

• Diversification of return seeking assets
  – Overseas equities
  – Global equities including emerging markets
  – Alternatives

• Concentration risk
  – Top 10 companies represent c. 40% of the All Share Index


• Increasing scheme maturity and risk awareness leading to increased allocations to bonds
Gilt Yields 1990 to 2011

Fixed Interest Gilt Yield 10 year
Index Linked Gilt Yield
Gilt Yields and Inflation
1990 to 2011

Fixed Interest Gilt Yield 10 year
Retail Price Inflation
Effective Decision Making

The investment world has become much more complex for trustees

<table>
<thead>
<tr>
<th>Year</th>
<th>Description</th>
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<tbody>
<tr>
<td>1990</td>
<td>Balanced mandates; one or two investment managers; UK equities over 50% of assets; peer group benchmarks</td>
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<tr>
<td>2000</td>
<td>Specialist mandates; larger number of managers; peer group benchmarks</td>
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<td>2011</td>
<td>Increased awareness of risk – especially relative to liabilities; greater diversification; “alternative” asset classes; Liability Driven Investment, including use of derivatives; scheme specific benchmarks</td>
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Where are we now?
Risk reducing assets

• Liability Driven Investment
  – To implement or not to implement, that is the question?
    • Fixed interest gilt yields lowest they have been since 1950s
    • Real yields on index linked close to all time low
    • Economic recovery and unwinding of Quantitative Easing may lead to higher yields and higher inflation
    • Long dated swaps yielding less than gilts

• What are people doing?
  – Setting triggers for implementation at higher yields
  – Gilt repos or gilt total return swaps
  – Switching swaps to gilts
Yield Curve – Fixed Interest Gilts

Redemption Date

Gross Redemption Yield %

0.00% 0.50% 1.00% 1.50% 2.00% 2.50% 3.00% 3.50% 4.00% 4.50%

Redemption Date

Gross Redemption Yield %
Where are we now?

Equities

- “Unconstrained” equity portfolios
  - Best ideas stock selection – little or no attention paid to index weighting of stocks/sectors/region
  - Global
  - Emerging markets

- Passive management returning to favour?
  - Have active managers earned their fees?

- Fundamental indices
  - Based on economic fundamentals of companies (eg sales, balance sheet size) rather than market capitalisation
  - Avoids overweighting overvalued stocks and underweighting undervalued stocks
  - Outperformed market cap indices by 2% pa over 5 years and by 2-4% p.a. in back tests (Source: Research Affiliates)
Where are we now?
Alternatives

- Hedge funds
  - More correlated to equities than we thought?
Alternatives (continued)

• Private equity
  – Shortage of credit for heavily geared deals
  – Less reliance on “financial engineering”

• Property
  – Going global

• Infrastructure
  – Theoretically ideal for pension funds
  – How to implement? Finding the right vehicle

• Gold
  – Win/win? Some say it will do well in economic recovery as an inflation hedge OR in economic slump due to safe haven status
Alternatives (continued)

• Commodities
  – Inflation hedge?
  – Diversification
  – Emerging market growth esp. China
• Emerging market local currency debt
  – High yields; scope for lower spreads
  – Currency appreciation
• Mezzanine debt
• Distressed debt
• Insurance linked products eg catastrophe insurance
  – Uncorrelated to other markets
Where are we headed?
Fiduciary Management

• aka Implemented Consulting, delegated consulting, delegated investment ……..

• Difficulties for trustees
  – Need to get back to full funding BUT
  – Lack of time
  – Lack of expertise
  – Increasing cost and complexity of advice and implementation
  – Don’t meet often enough
  – Need for more dynamic implementation
    • “Don’t miss the boat”
Fiduciary Management

Trustees:
- Set the strategic objective
- Set the risk budget
- Set the permitted asset classes
- Monitor Fiduciary Manager’s performance

Fiduciary Manager:
- Implements the strategy
- Tactical asset allocation
- Risk management ➢ derivative overlays
- Selects & monitors investment managers

Consultant to help set strategic objective?

Consultant to help monitor Fiduciary Manager?

Investment Managers
Where are we going?
DC – Target Date Funds

• National Employment Savings Trust (NEST) will have target date funds as default

• Similar to traditional Lifestyle structures – but:
  – Three phases compared to usual two
  – Transition between the different phases will be dynamically managed “on the basis of what is happening in financial markets and the economy ….” *

* Quote from “Developing and delivering NEST’s investment approach” published by NEST
NEST Target Date Funds
3 Phases - illustrative

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<th>Foundation</th>
<th>Growth</th>
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<td>Income seeking assets</td>
<td>Return seeking assets</td>
<td>Annuity matching assets</td>
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Age
22  30  38  46  52  60  65
NEST’s Investment Beliefs

- Understanding member characteristics, circumstances and attitudes is essential to developing an appropriate investment strategy
- Incorporate Ethical Social and Governance (ESG) factors into investment process
- Taking investment risk is usually rewarded in the long term
- Diversification is key tool for managing risk and return
- Risk derived asset allocation is the biggest determinant of long term performance
- Analysis of economic conditions and market regimes should drive strategic decisions
- Passive management generally delivers better value for money than active security selection

Paraphrased from “Developing and delivering NEST’s investment approach” published by NEST
Survival of the Fittest

• Adapt and survive
  – More diversification of assets
  – Implementing LDI
  – Is Fiduciary Management the answer?
  – Are Target Date Funds the future for DC?