



The Actuarial Profession

making financial sense of the future

CILA II Seminar
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Current Issues in Life Assurance II

An update on the economy and some answers to longer term questions

How do we see the world?

- Low
- Low
- Low
- High

In more detail!

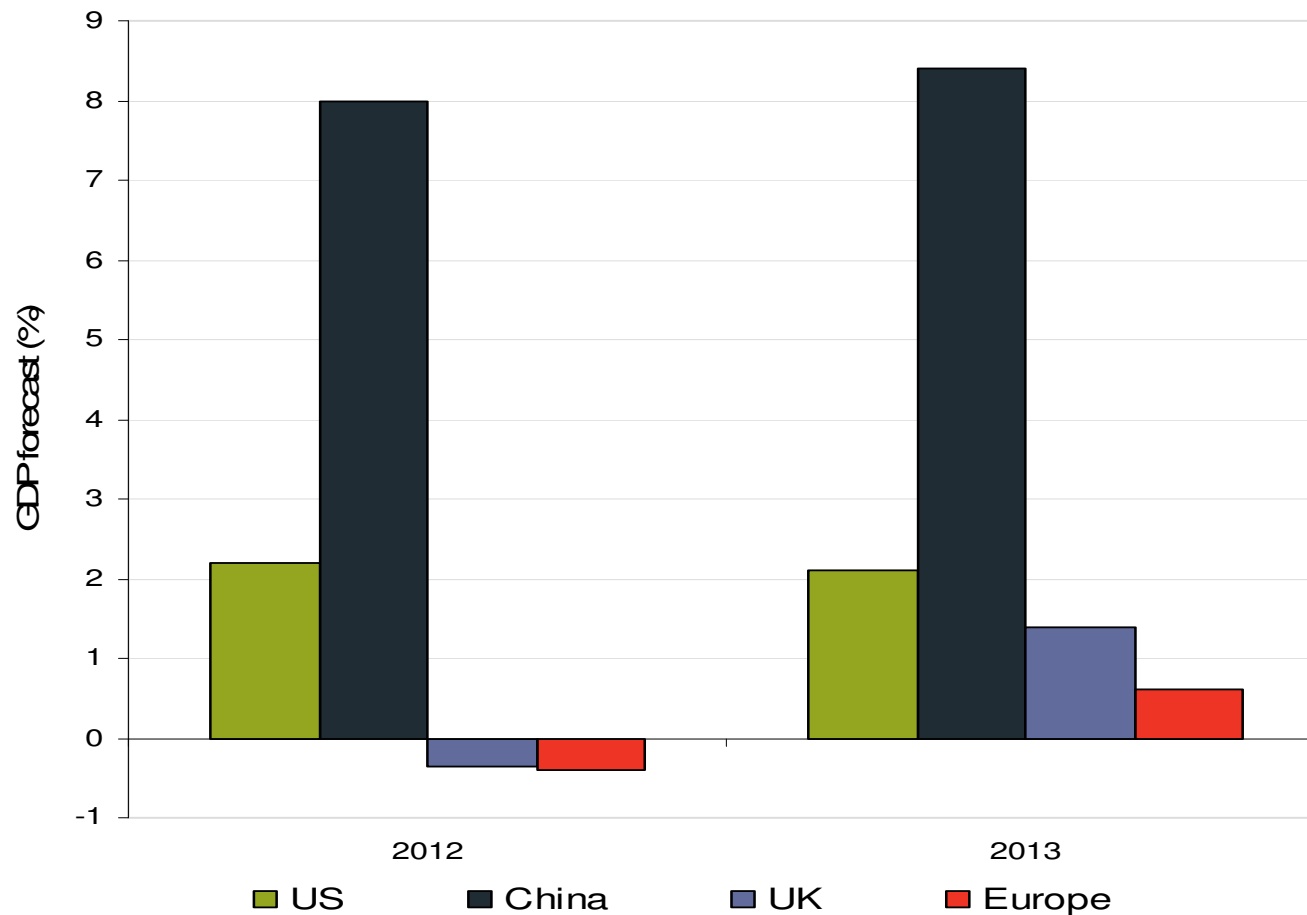
- A Low rate of growth
- A Low rate of inflation
- A Low level of interest rates
- A High degree of market volatility

The House View

- Global economic growth has slowed significantly, but the three largest economies, the US, Japan and China, are forecast to recover in 2013
- Markets are pricing in successful action by central banks and governments to restore some economic health – risks are high if policy errors are made
- Structural problems continue to affect the medium-term recovery from the financial crisis, although there is some improvement in the USA
- Company balance sheets remain solid, but earnings growth is decelerating towards zero and needs to recover
- Our strongest conviction is to be Very Light in Government debt due to valuations, while Credit is becoming somewhat less attractive

Restrained enthusiasm

The global economy



Source: Bloomberg

Medium term outlook still dominated by structural headwinds

The global economy – ‘if’ and ‘but’

- US - moderate growth into 2013, as deleveraging has gone further and banks are healthier than elsewhere, but fiscal austerity is the next hurdle
- China - growth can stabilise about 7% a year supported by new policy measures but structural imbalances are becoming more noticeable
- Europe - taking some action to shore up the banking system, but deep recessions in too many member states and not enough action to boost growth
- UK - a slow recovery from stagnation but the economy faces major imbalances and government responses are piecemeal

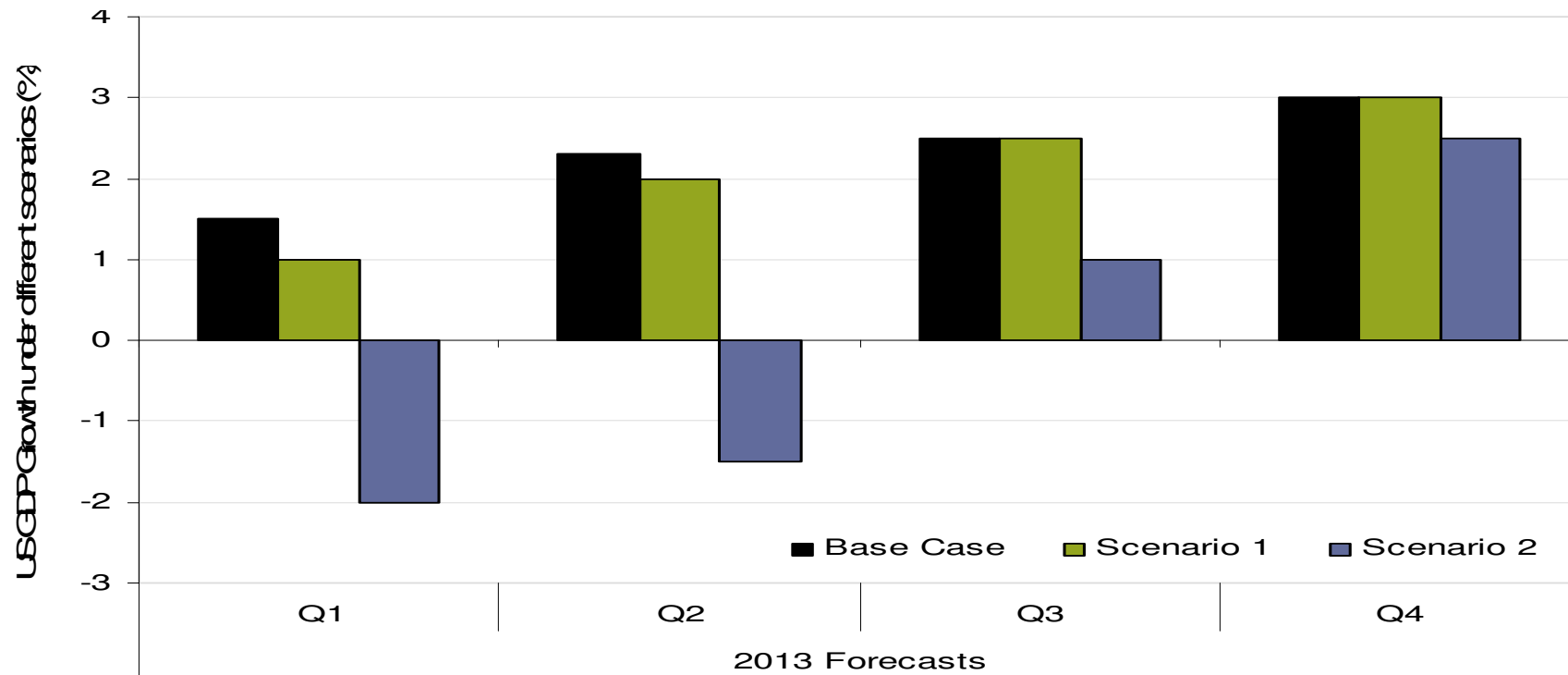
Medium term outlook still dominated by structural headwinds

US forecasts end in January 2013

- The fiscal cliff debate could hurt confidence in US assets
- Tax and spending uncertainty causing businesses to postpone investment decisions
- Congressional & Presidential election results need analysis

Fiscal uncertainty until the US election

US forecasts end in January 2013



Base case assumes all measures are extended for 6 months in 2013

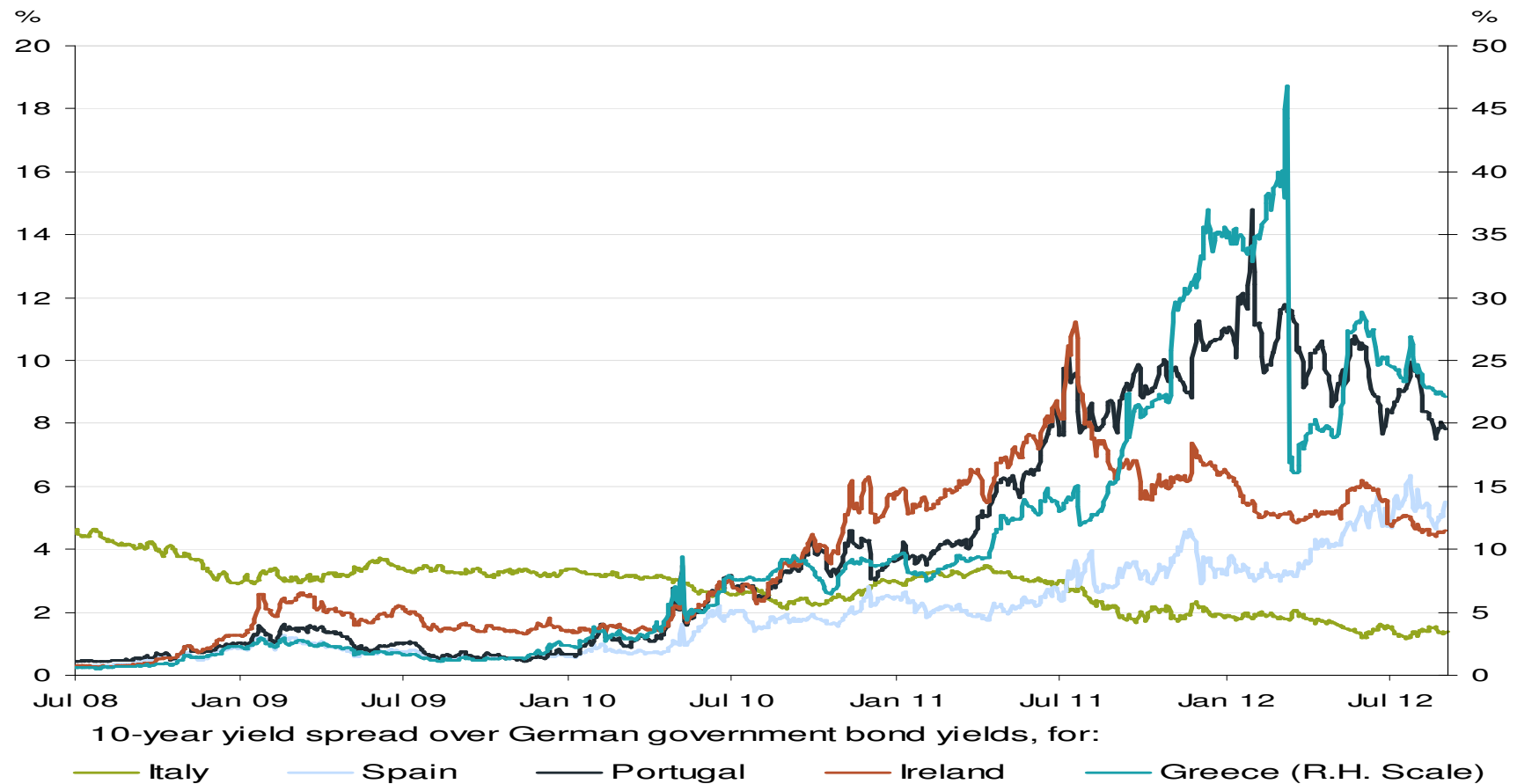
Scenario 1 assumes only the Sequestration spending cuts (worth \$98bn) expire

Scenario 2 assumes all \$543bn tax cuts/spending cuts lapse for 6 months in 2013

Source: JP Morgan

Fiscal uncertainty until the US election

A European muddle



Source: Datastream, Bloomberg, Standard Life Investments

We remain very cautious on European assets

A European muddle

- We still consider it unlikely that Greece will imminently leave the EMU
- Problems in Italy and Spain are contained – for the time being – by OMT
- European growth is a concern, long term imperative to bring down debt/GDP ratios
- A growth compact would help, and implementation of the fiscal compact
- Major questions are starting to be asked about what is meant by banking union

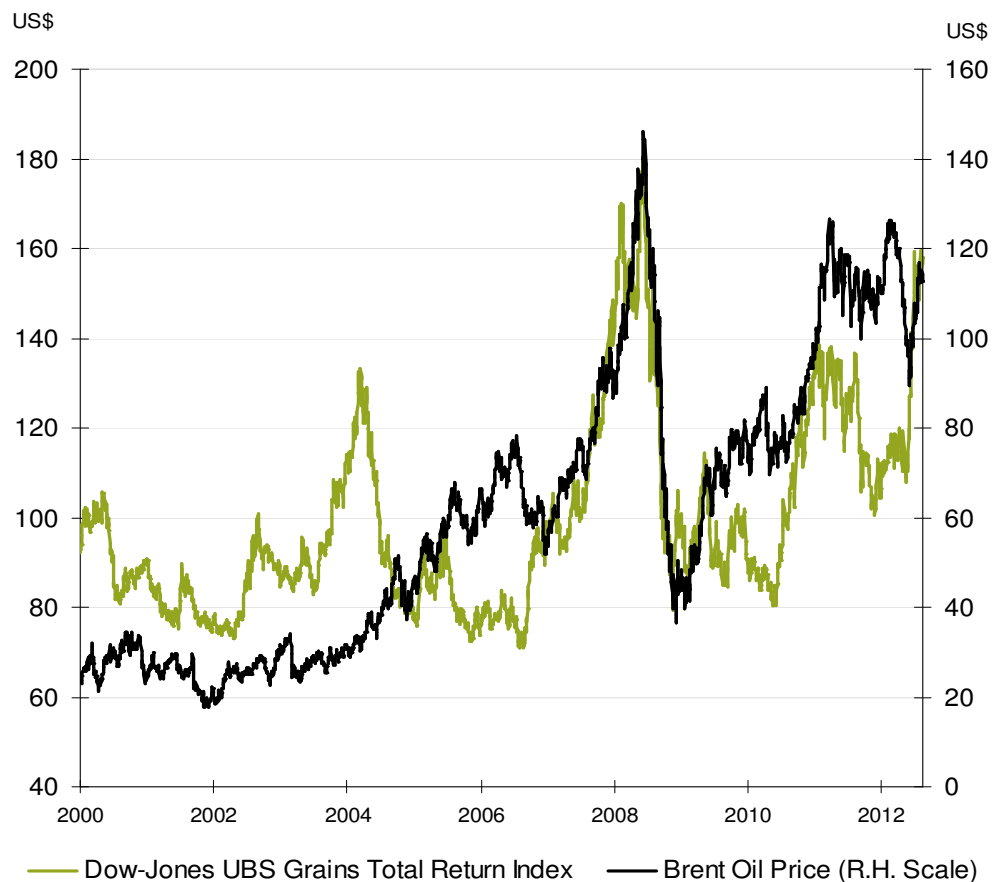
We remain very cautious on European assets

Further questions...

- China – the economy is as weak as back in 2008-09 – is it a question that the policy makers will not or cannot turn the situation around?
- Japan – inflation & deflation – will the government force the Bank of Japan to take more action to protect the currency and create inflation?
- The UK – the productivity conundrum – how can the rise in employment be squared with fall in output? What does this mean for the Bank of England?

See Global Perspectives for more questions!

Where next for food and oil?

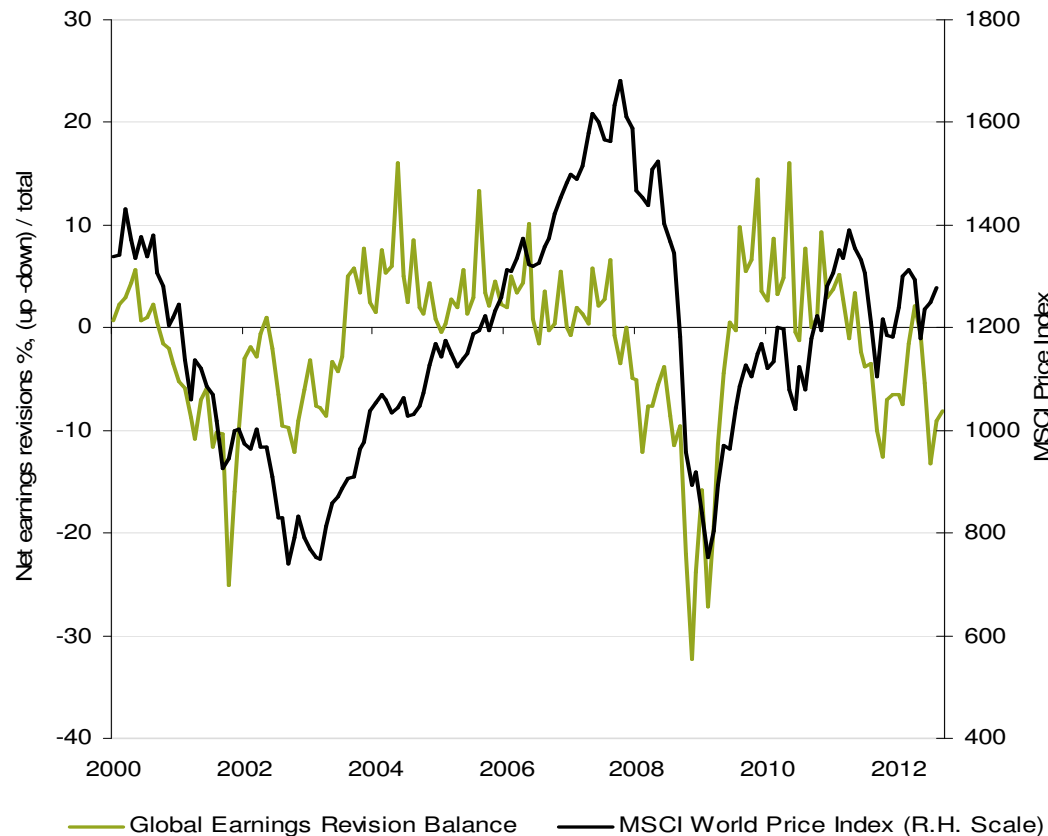


Source: Bloomberg

- Complex Middle East tensions affecting the oil price
- Droughts in the US impacting on grain and soybean prices
- Higher food and energy costs contentious again for businesses, consumers and policy makers

A squeeze on consumer incomes would be bad news

Markets pricing in good news

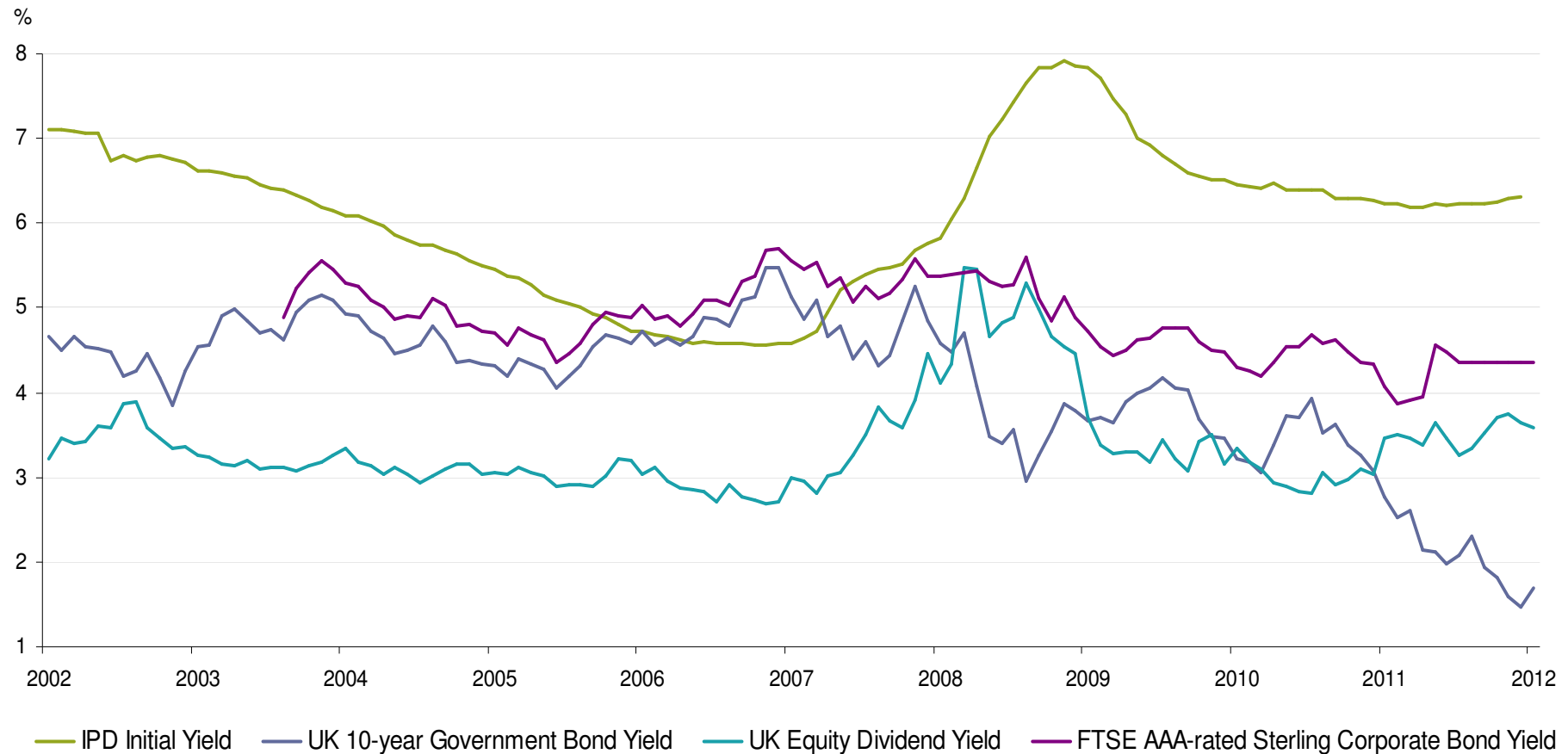


Source: Nomura, Datastream

- Most countries seeing downward revisions to corporate earnings
- Global equity markets appear to be pricing in a more optimistic outlook
- Cash distribution has been supportive – so far

Equity markets at odds with earnings trends

Sustainable yield remains the main driver



Source: Datastream

Look for income opportunities, but be wary of valuations

House View convictions

➤ **Government Bonds**

- x QE and safe haven flows have driven core government bonds into expensive territory
- x Central banks will not wish to see steeper yield curves

➤ **Credit**

- ✓ Positive corporate cash flow plus low levels of defaults
- x Valuations are less attractive, plus risks from a sharp spike in government bond yields

➤ **Equities**

- ✓ Positive free cash flow, high dividend yields and solid company balance sheets
- x Fiscal austerity, constrained credit availability, growing amount of regulation

➤ **Real Estate**

- ✓ Valuation arguments and attractive yields support better quality property
- x Risks from: recession, rental pressures, forced sales by commercial banks

House View conviction: Light duration

Thinking further ahead

- Q – What do these changes in the investment environment mean for longer term investors, and the use of investment models, especially for those responsible for with profits investing

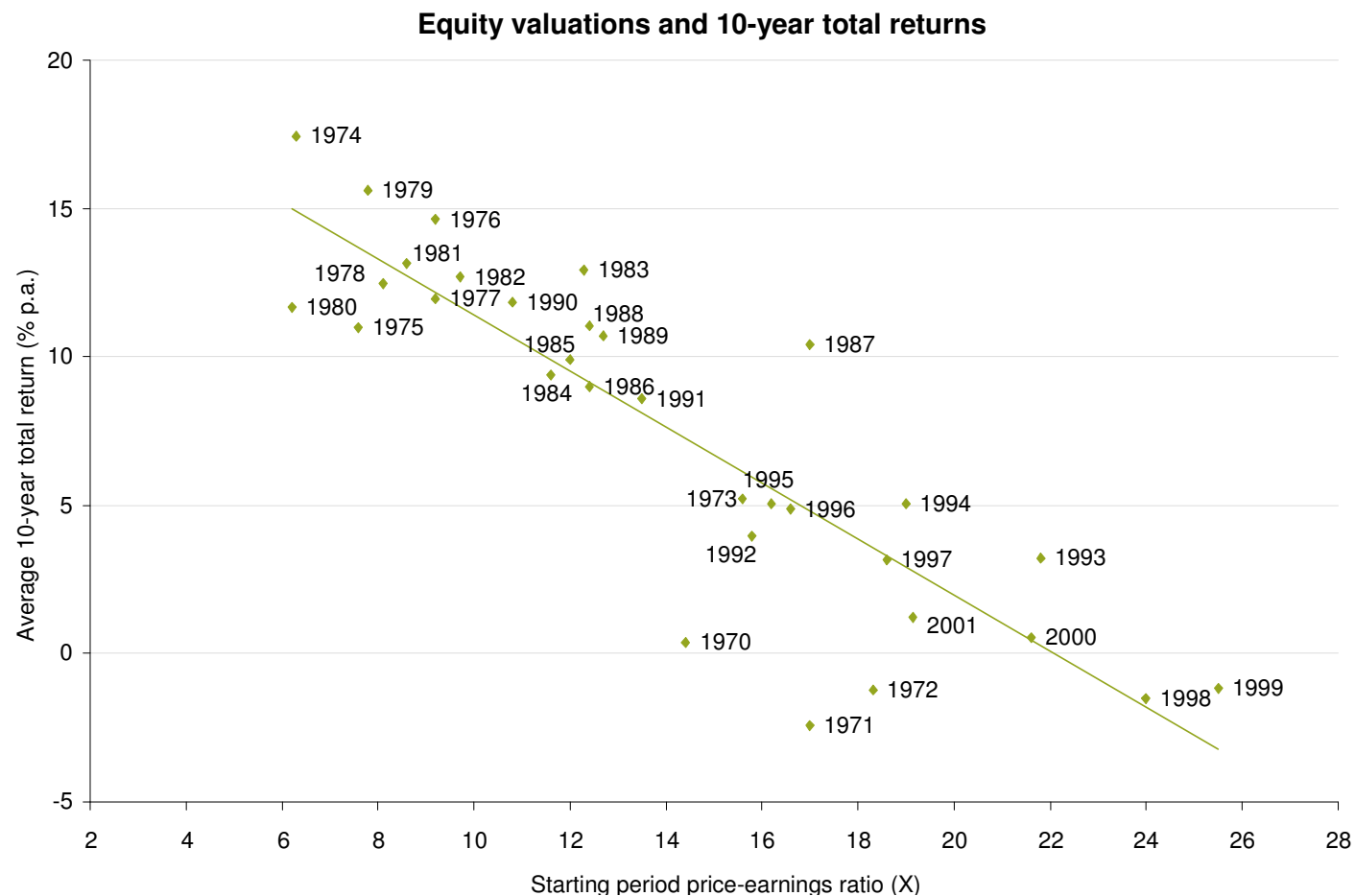
Focus on Change

Question 1

- Q - From an investment strategy perspective, is there anything in the current and recent past that would mean that long-term strategies for with-profits funds should be changed?
- A – Absolutely. QE has pushed valuations of some government bonds to an extreme vs other assets such as corporate bonds or equities
- Q – Do you buy US 30 year bonds yielding 2.9%, or Philip Morris 30 year bonds yielding 3.8%, or Philip Morris shares yielding 3.8% (at the time of writing)

Focus on Change

Valuations matter



Source: Oriel Securities Limited

The starting point for an investor is important

Question 2

- Q - Are we seeing forces at work in the market that mean that current benchmark portfolio strategies for accumulation and drawdown need to be re-thought?
- A – Absolutely
 - The forward looking equity risk premium is lower than the past
 - Higher levels of correlation between markets mean a wider investment universe becomes more attractive
 - Higher levels of market volatility can force some investors to de-risk when they should be buying risk
 - Options include absolute return style investing and/or more sophisticated risk modelling

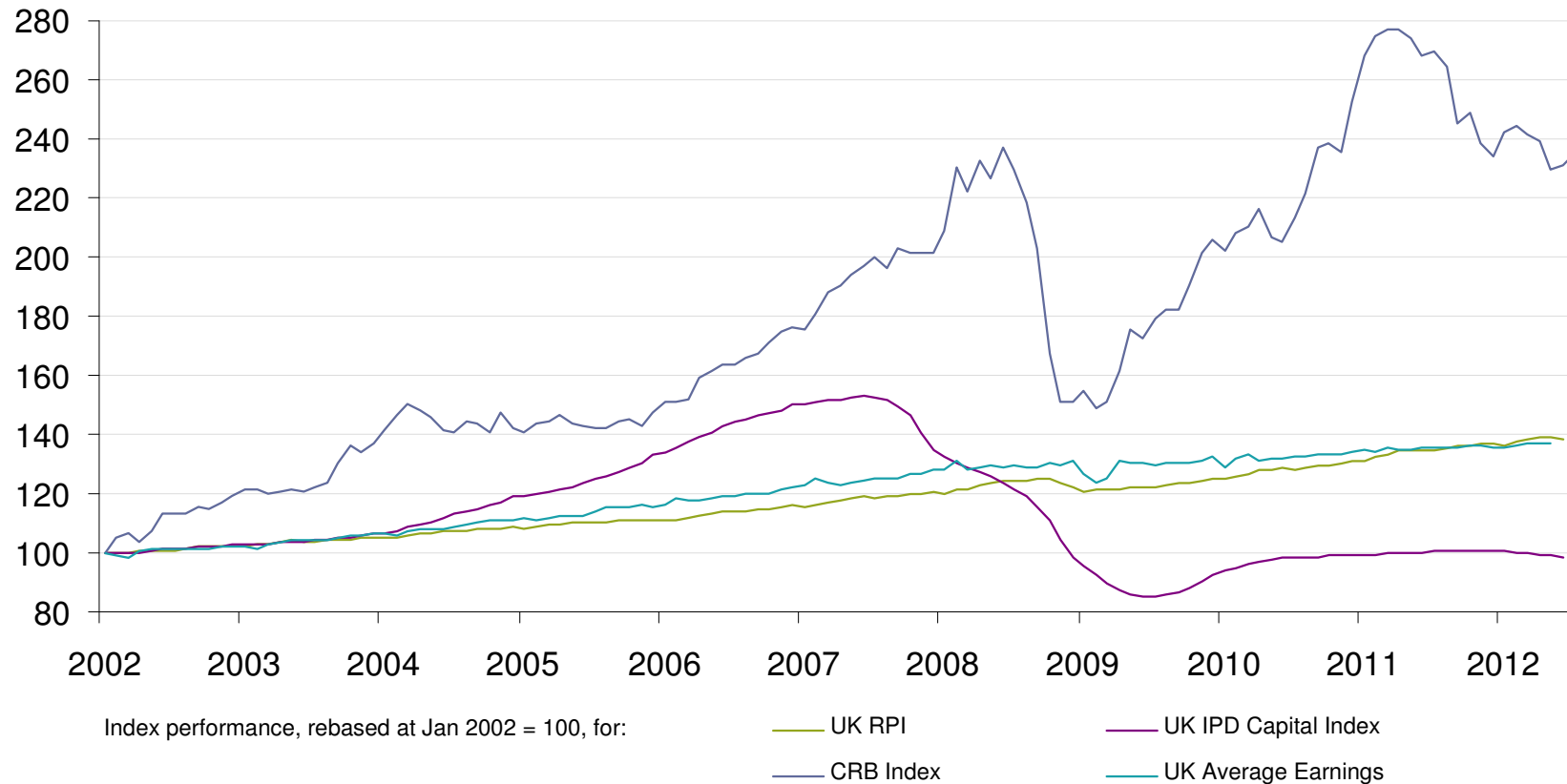
Focus on Change

Question 3

- Q - Has the long-term economic framework fundamentally changed, or are the investment return models we used several years ago still valid?
- A – Absolutely
- A prime example is the inflation outlook. QE3 matters in the USA as the Fed has decided that there is no time limit for ending its purchases of MBS
- A second example would be the regulatory framework underpinning the corporate sector. ‘Free market economics’ has died

Focus on Change

What sort of inflation worries you?



Source: Datastream

Different types of inflation matter

Conclusion

- The US, Japan and China can lead a moderate global economic recovery into 2013
- Macro-economics and politics dominating portfolio risk – policy decisions or policy errors will decide how investors next move tactically
- Strategically, sustainable yield remains the core approach for investors
- Our strongest conviction is to be Light in Government debt on valuation grounds, while Credit is becoming a crowded trade

Focus on Change

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