SCOTTISH WIDOWS

official pensions and investment provider

*funds***talk**-quarterly

Q1 2010

Quarterly fund monitoring and governance report

The Scottish Widows Guided Pension Fund Range

In this report we keep you up to date with the Scottish Widows monitoring and governance process and let you know how the Scottish Widows Guided Pension Fund Range is performing.

Fund updates

Risk rating review

Each year, we carry out a complete review of our investment approaches, which is how we define risk levels for the funds in our Guided Pension Fund Range. As a result, the following funds are moving to a new investment approach category:

Fund name	Old investment approach	New investment approach
Scottish Widows Property	Balanced	Progressive
Scottish Widows Diversified Assets	Progressive	Balanced
Scottish Widows Strategic Income Bond	Cautious	Balanced
SW Newton International Bond	Cautious	Balanced
SW Invesco Perpetual Global Bond	Cautious	Balanced

We will be setting up pages on both the consumer website and the adviser extranet with information on the investment approaches and showing which funds sit in which categories. We'll issue a *funds***talk**-bulletin with more details in due course.

Proposed changes to the SW Newton 60/40 Global Equity Fund

Newton is proposing to change the investment objective and policy of the underlying fund of the SW Newton 60/40 Global Equity Fund to enable it to move to a benchmark of 50% UK equities and 50% international equities. The purpose is to allow the fund to have greater exposure to potentially attractive international equity markets. As a result, Newton also proposes to change the name of the underlying fund to the Newton 50/50 Global Equity Fund. These changes are subject to the approval of shareholders in the underlying fund.

We'll write to investors in the SW Newton 60/40 Global Equity Fund in due course to inform them about these changes.

Source: Newton

Changes to the SafetyPlus® Fund

From 9 January 2010, the SafetyPlus® Fund's objective and the first two paragraphs of its policy have changed to clarify that it can use alternative strategies, when necessary, to achieve the fund's protection. For more details on these changes, see the *fund***talk**-bulletin: *SafetyPlus® Fund changes* at **www.scottishwidows.co.uk/fundstalk**

New manager for SW Fidelity European Fund

Sam Morse took over as portfolio manager of the Fidelity European Fund from Tim McCarron on 1 January 2010. Sam has more than 20 years' investment experience, 12 of those at Fidelity, and previously managed the Fidelity MoneyBuilder Growth Fund. For more information on the change, have a look at the *fund***talk**-bulletin: *Manager change – Fidelity European Fund* at:
www.scottishwidows.co.uk/fundstalk

You can also find information about the change on the Fidelity website:
https://www.fidelity.co.uk/adviserproducts/news-insights/management-change/management-change.page

Source: Fidelity

Fund rating changes

OBSR has upgraded one of our Fidelity fund links, the Special Situations Fund, to an AA rating. Commenting on the upgrade, OBSR said: "Since assuming responsibility for the management of the fund in January 2008 from Anthony Bolton, [manager Sanjeev Shah] has successfully navigated it through some of the most difficult market environments. Furthermore, he has demonstrated a thorough and detailed knowledge of the underlying stocks held in the portfolio. Mr Shah's contrarian investment style is in keeping with what investors have come to expect from this fund and he has offered investors an uninterrupted transition in performance terms following his appointment."

However, another Fidelity fund link, the European Fund, has had its AA rating suspended following a change of manager at the beginning of the year. For more information on the new manager, see the section opposite.

Last year, OBSR suspended the Artemis UK Growth Fund's rating following the change in manager from Adrian Paterson to Tim Steer. OBSR now say: "We have gained a sufficient level of conviction to enable us to re-introduce the Rating at A."

Source: **www.obsrfundratings.co.uk**

Investment partner updates

Artemis returns to owner management

The management team of Artemis has reached an agreement with Affiliated Managers Group (AMG) to buy 100% of the equity of Artemis from Fortis Bank. Following the completion of the transaction, AMG will own a majority equity interest in Artemis, with Artemis' management also acquiring a substantial equity ownership and continuing to direct the firm's day-to-day operations.

AMG is a global asset management company with equity investments in leading boutique investment management firms (known as its 'Affiliates'). AMG's partnership approach allows the management teams of its Affiliates to own significant equity in their firm and also maintain operational autonomy. As at 31 December 2009, the aggregate assets under management of AMG's Affiliates were approximately $231 billion.

Commenting on the deal, Mark Tyndall, a founding partner of Artemis and its Chief Executive, said: "Artemis is returning to owner-management in partnership with AMG. Our affiliation with AMG will allow us to continue to attract and retain talented staff and to develop our business in the best interests of our clients. We have a strong, team-oriented culture and a focus on linking our fund managers' interests with those of the firm and our clients. By partnering with AMG, we will become part of a high-quality organisation with global scale and a proven partnership approach. This will provide both the management team and successive generations with meaningful equity stakes that align our interests with those of our clients. At the same time, this structure will preserve the successful characteristics and core elements of our business. We believe that this is an excellent outcome for our clients."

The transaction remains subject to regulatory approval, and is expected to close at the beginning of the second quarter of 2010.

Source: Artemis

BlackRock merger with Barclays Global Investors now complete

BlackRock completed its merger with Barclays Global Investors on 1 December 2009. The combined firm will operate under the BlackRock name, although the iShares brand (exchange-traded funds) will be retained. BlackRock manages approximately $3.2 trillion on behalf of institutional and retail investors worldwide.

Source: BlackRock

New chief investment officer at Jupiter

John Chatfeild-Roberts has taken over as Jupiter's chief investment officer (CIO) from Edward Bonham Carter. Edward Bonham Carter has been both chief executive and CIO since 2000. John Chatfeild-Roberts joined Jupiter in 2001 as head of its fund of funds team, having previously been at Henderson and Lazard. Commenting on John's appointment, Edward Bonham Carter said: "In recent years John has been involved with me in many aspects of my work as CIO. With Jupiter's business enjoying strong growth, it is the right time for John to take on the full CIO role."

Source: Jupiter

Fund stories

Kevin Hogg, Performance and Risk Manager in the Fund Monitoring and Governance Team, gives some of the performance stories from the Scottish Widows Guided Pension Fund Range.

All performance stated is at 31 December 2009.

Multi-asset funds

- The Balanced Managed sector grew by 20.4% in 2009 on the back of recovering equity markets. After a sluggish start markets rallied strongly from March lows.
- With over £3 billion invested, the **Mixed** Fund retains a good track record against its Balanced Managed sector peers. Although slightly below the median in 2009, the fund has performed consistently well over the longer term having bettered the median performance in each of the previous four years. As a result, it is above median over both three and five years. In terms of 2009, although the fund underperformed the sector in the first half of the year, it recovered well in the second half and was comfortably above median for that period. Looking forward, manager Scottish Widows Investment Partnership (SWIP) aims to continue their current position of being overweight equities and property at the expense of cash. Within equities they're slightly reducing US exposure whilst adding to positions in Japan.
- The **SW Schroder Managed** Fund performed exceptionally well over the last year, which has boosted the longer term performance. The fund is now ranked in the top quartile of the Balanced Managed sector over five years. In the last year, the fund benefited from the strong performance of many of the underlying Schroders funds held in the portfolio. These included the Schroder UK Alpha Plus Fund, Schroder Asian Alpha Plus Fund and Schroder Income Fund, which outperformed their respective benchmarks by considerable margins. Asset allocation also made a positive contribution. The combined result was a fund that beat the sector by 10% in 2009.

  The portfolio is currently overweight equities and corporate bonds, and underweight government bonds. Within equities there is an overseas bias.
- The story of 2009 for the **SW Newton Managed** Fund is a little different. While it too has good long-term performance, as demonstrated by an above median ranking over both three and five years, it has underperformed the Balanced Managed sector in the last year. The equity market rally that started in March has not benefited the fund as much as some of its peer group competitors, with Newton taking a more cautious approach. Looking ahead, the manager expects to see a degree of rotation by investors back into more defensive assets, as investors look to take profits after the risk rally witnessed in 2009. In this environment, the manager will maintain the fund's emphasis on investments that have the potential to generate an attractive level of yield, such as the Newton Global Dynamic Bond Fund and the Newton Higher Income Fund.
- Ranking in the top quartile over five years, the **SW Invesco Perpetual Managed** Fund had a solid 2009, beating the median fund over the period. Good returns from emerging markets, Asian and corporate bond exposures helped the fund to outperform its peer group over a strong half year for global markets. The fund's highest exposure is to UK equities, where the fund manager is focused on companies which they believe have resilient earnings and can deliver sustainable dividend growth. The manager is of the opinion that a market rally is quite possible this year, although it is unlikely to be of the magnitude seen in 2009. They expect global economic growth and improved demand to aid corporate profitability and increase returns for shareholders.
- The **SW BlackRock Managed** Fund outperformed the sector by 4.8% in 2009. Sub-asset class allocation decisions, notably the decision to overweight more cyclically sensitive equity regions, such as emerging markets, and the more attractively valued fixed income instruments, such as corporate bonds, supported performance relative to the benchmark.

In 2009, the investment horizon shifted significantly, with sizeable negative returns experienced from equities during the first quarter and a prolonged rally after that. The manager became increasingly positive on risk assets in April and adjusted the underweight equity allocation to an overweight accordingly. Stock selection from the fixed income and UK equity managers was also positive. Overall a successful year for the strategy – the fund manager continues to believe an active asset allocation strategy will be rewarding to investors in 2010.

- The ABI Cautious Managed sector median returned 17% in 2009, much improved after a difficult year in 2008.
- The **SW Investec Cautious Managed** Fund underperformed the sector in the final quarter of 2009. The previous five quarters had all been positive relative to the sector, demonstrating an impressive ability to outperform during periods of both falling and rising markets. The fund outperformed the Cautious Managed sector by 7.1% in 2009, returning 24.2%. The strong relative and absolute performance in 2009 was driven by stock-picking across a range of different sectors, in particular gold mining, building and construction materials, banking, retail, pharmaceuticals, gambling and IT services. Longer term performance against the sector has been boosted by the good performance in the last 12-18 months – the fund has above median performance over both three and five years. Looking ahead, the fund manager continues to believe that many of the very largest stocks in the market remain cheap. For example, investor interest in pharmaceuticals remains fairly low despite attractive valuations.
- The **SW Invesco Perpetual Distribution** Fund performed very well in 2009. A rise in risk appetite, following the stabilisation of the banking sector and evidence of improvement in the global economy, saw strong performance from those areas that had been weakest at the height of the financial crisis. The fund's credit strategy was positive, with strong performance from high yield and bank debt as well as a number of recent new issues. Within equities, the more defensive sectors that the fund remains biased towards have trailed the return of the wider market over the past year. The fund has outperformed the sector by 14.9% over the period. The very good returns in 2009 have boosted the fund's longer-term performance, with the result that the fund now sits in top quartile over three years and since launch in November 2005.
- The **SW Newton Managed Income** Fund posted positive returns relative to the sector in 2009 despite a sluggish start in the first quarter, with outperformance in each of the remaining three quarters. Looking ahead, the manager believes that the rate of growth in equity markets is likely to moderate considerably. Furthermore, although the global economy is showing signs of improvement, there remain serious risks to the recovery. For this reason the manager has bought some protection for the equity portion of the fund via some simple derivatives transactions.
- The **SW Fidelity Multi Asset Strategic** Fund was launched in April 2008 and has performed well, beating the sector median by 7.7%. It is comfortably ranked in the top quartile over the period. The portfolio's aggressive stance proved beneficial in the most recent quarter as returns from riskier assets surpassed those from bonds and cash. Security selection in the fixed income segment of the portfolio also added value as exposure to assets further down the credit risk spectrum boosted performance. Looking ahead, the fund manager is of the opinion that the macroeconomic backdrop is favourable for risky assets as growth indicators continue to improve. On the other hand, he believes government bond prices are likely to come under further pressure.
- The **SW JPM Cautious Total Return** Fund, which has a 'cash plus' benchmark, performed well in 2009. In the short term, the managers of the fund remain positive on risk assets. However, as they have contended for some time, they believe this to be a bear market rally and, after significant gains from the lows, they feel we are in the latter stages of the move. Accordingly, they are starting to increase the hedges in the portfolio, while taking only very focused positions, often with a known downside.

UK equity funds

- The **UK Opportunities** Fund, managed by SWIP, performed very well in 2009, outperforming the UK All Companies sector median by 16.4% and posting a return of 44.7%. The fund was underweight the banking sector for much of 2009, a position that continued in the fourth quarter. This proved beneficial to performance as investors were reminded of the risks still inherent in owning the banking stocks when the European Commission again made it clear it was going to force changes on those banks that had received state aid.

The fund manager has turned his attention away from the more cyclical stocks and increased exposure to 'reliable growers', adding holdings in the major pharmaceutical stocks, utilities and tobacco stocks. He remains positive on the UK equity market where he sees attractive valuations both in absolute terms and relative to other asset classes. Longer-term performance is very good, with top quartile performance over three years.

- In 2009, the **SW BlackRock UK Dynamic** Fund comfortably outperformed its benchmark, the FTSE All Share Index. It is ranked in the top quartile of the ABI UK All Companies sector for 2009 returning 34.7%, 6.4% above the median fund. Over the period the key drivers of performance were positions within the oil and gas sector, and support services sector. Looking ahead, the fund manager describes his portfolio as having a blend of attractively valued cyclical recovery stocks, as well as cheaper stocks with more stable earnings and some quality growth opportunities. Over three and five years, performance is good, above median in both instances.
- The **SW Schroder UK Alpha Plus** Fund performed very strongly during 2009, delivering a return of 49.3%, compared to 30.1% from the FTSE All-Share Index. Outperformance was driven by strong stock selection. The fund manager expects equities will be volatile in the run-up to the general election but believes the portfolio remains well positioned, combining cyclicals and more 'defensive' stocks, with the bias still towards the former. The fund has significant exposure to companies operating in faster-growing markets than the UK. The fund is ranked in the top quartile of the UK All Companies sector over one year, three years and five years.
- The **SW Fidelity Special Situations** Fund had a positive start to 2009, outperforming the sector over the course of the first three quarters, although performance lagged the sector in the fourth quarter. The net result was performance just above the median fund in the UK All Companies sector in 2009. The fund is ranked in the top quartile over three years. Read more about this fund in *Feature funds*.
- The **SW Jupiter Growth** Fund's performance was much improved in 2009 after underperforming during 2008. The fund has outperformed the sector by 4.7% over the last 12 months and, although below over three years, five-year performance is above median.

  Jupiter's view on equities remains positive going into 2010, although they do not expect to see particularly strong economic growth, and an environment of low interest rates is likely to drive good returns from financial assets. The recent equity market rally was led by stocks that had been sold off in the falling market. Jupiter took substantial positions in the banking sector in early 2009 as bank shares were trading at large discounts.
- In the UK Equity Income sector, despite gaining 18% over the six months to the end of December, the **SW Invesco Perpetual High Income** Fund's returns trailed the benchmark FTSE All-Share Index. This was largely due to the fund's focus on quality growth companies during a period when more cyclically orientated stocks led the market. Invesco Perpetual has maintained a cautious outlook on the UK economy, but is optimistic on the fund's prospects. They believe that the companies which dominate the fund can deliver earnings and dividend growth, even in difficult economic conditions, and are significantly undervalued in their view. Despite a difficult 2009, this fund has an excellent long-term track record and remains above median over three years and ranks in the top quartile over five years. You can read more on this fund as it is one of our *Feature funds*.
- In the same sector, the **SW Schroder Income Maximiser** Fund returned 29.8%, 8.3% more than the sector median during 2009, while the underlying fund delivered its target yield of 7% for a fourth year in succession. Schroders continues to see plenty of growth potential in financials, domestic cyclicals (economically sensitive names), pharmaceuticals and telecoms. They adapted their income enhancement strategy accordingly, taking just enough income on their holdings to fulfil the 7% annual target, whilst leaving as much opportunity as possible to benefit from the capital gains that they are confident they can deliver.

Overseas equity funds

- The **SW Fidelity South East Asia** Fund performed very well in 2009, returning 57%, 3.4% above the median fund in the Asia Pacific ex Japan Equities sector. The fund has been positioned to take advantage of the healthy domestic demand in the region and a global economic recovery. Positioning at a sector level is the result of bottom-up selection and it has been overweight in consumer discretionary, financials and information technology. Stock selection within consumer discretionary and information technology has driven the fund's outperformance. Longer term, the fund also has a great track record – over five years the fund has returned 187%, 68% above the sector median.
- The **SW Fidelity Japan** Fund performed well within the sector last year, returning 9% more than the median fund, although Japanese equity investments had a relatively poor year in absolute terms. Returns did not bounce to the same extent as witnessed in other markets. In fact, in sterling terms the median fund within the sector fell by 3.7% in 2009. Fidelity reports that although there were no significant changes to the structure of the portfolio in December, the fund manager has reduced some of the bank stocks that were picked up at oversold levels in the summer and shifted positions to more undervalued insurers. They also added to positions in cyclical stocks, as these appear well placed to benefit from a recovery in global demand. Despite the good performance in 2009, the fund remains below median over three and five years.
- The **SW Investec American** Fund returned 29.4%, comparing very favourably with its benchmark the S&P 500 (12.6%) in 2009. Comparing the fund against the North American Equities sector, the fund is ranked top quartile over one year and since launch in April 2008. The fund benefited from holdings in a number of areas – technology, consumer staples, consumer discretionary, energy and telecom stocks all contributed to the portfolio's strong performance. The fund manager also made select investments in bonds during the credit crisis, primarily to help manage risk in the fund. However, these assets were actually very strong performers, further boosting the portfolio's returns. Looking forward, Investec sees the potentially less friendly regulatory and interest rate environments being offset by what appears to be unusually attractive equity valuations. Although stocks are sharply up off the bottom, they are still down significantly from their peaks and Investec says it is possible that corporate profits will hit record levels in 2011.
- Good stock selection helped the **SW Schroder US Smaller Companies** Fund return 24.0% in 2009, compared to 13.2% from the Russell 2000 Index. Schroders remains cautious on the US outlook but believes that investors will continue to reward companies with strong fundamentals. At present the fund manager favours 'steady eddies', with dependable earnings and revenues. These companies tend to do better in uncertain times, so should be well positioned to withstand economic challenges ahead. Longer term, performance over five years is also very good, outstripping the benchmark by 25.7% and returning 47.6% over the period.

Other funds

- The **SW JPM Natural Resources** Fund performed very well in 2009, returning 95.3%. Despite the stellar returns of late, the fund remains 9% down since we launched it in April 2008 as commodity prices were in sharp retreat for much of 2008. J.P. Morgan believes natural resources investors still have plenty to look forward to as global stimulus measures continue to turn economies round. The International Monetary Fund is projecting further commodity price increases in 2010 and J.P. Morgan would concur. They note that the agriculture sector has seen some strong price rises and this should be reflected in better pricing for fertilisers. In addition, they hope to make some gains in other sectors that are still low on their recovery path, including steel and uranium.

Fixed interest funds

- The **SW Invesco Perpetual Corporate Bond** Fund delivered strong performance after both investment-grade and high-yield bonds rallied strongly from their March lows. Bank bonds in particular underwent a remarkable recovery, with the lowest ranking debt clawing back the heavy losses from the previous six-month period. The fund also had good exposure to a number of new issues that have performed well. Finally, the low exposure to government bonds was also a benefit as they underperformed corporate bonds by a significant margin. The fund compares very favourably with the Sterling Corporate Bond sector, ranking as it does in the top quartile over one year, three years and five years.

- The **Fixed Interest** Fund, managed by SWIP, benefited from holdings in corporate bonds, where credit spreads tightened over the quarter as risk assets continued to perform well. Another significant driver of performance came through the fund manager's short duration position – gilts were generally well supported through quantitative easing measures for much of 2009, but as risk assets gained favour, so too the market started to price in the end of the quantitative easing and prices fell sharply in the final part of 2009. The fund is top quartile over one year, three years and five years in the ABI UK Gilt sector.
- The **Indexed Stock** Fund, also managed by SWIP, benefited from holdings in corporate bonds, where credit spreads tightened over the quarter as risk assets continued to perform well. SWIP reports that the fund was generally short duration too, and as real yields rose towards the end of the year, this added to performance. They add that Japanese inflation bonds significantly outperformed the UK in the final quarter, after the newly elected government said they would not tolerate deflation over the longer term – overseas holdings in Japan were a strong contributor to performance in the fourth quarter. The fund is ranked in the top quartile over one year and above median over both three and five years in the UK Index-Linked Gilts sector.

The Scottish Widows fund range governance process

To find out more about the Scottish Widows fund range governance process, visit **www.scottishwidows.co.uk/governance**

The CMIS fund range governance process

For information about the governance process and to view investment committee reports for the Clerical Medical Investment Solutions (CMIS) fund range, visit the Investment Solutions section of the Clerical Medical Literature Library, **https://ifa.clericalmedicalsecure.co.uk/Content/literaturelibrary/literaturelibrary.aspx**

Past performance is not a reliable indicator of future results.

Views, opinions and forecasts expressed in this document are those of the fund managers as at February 2010. Investment markets and conditions can change rapidly and, as such, the views expressed should not be taken as statement of fact, nor should reliance be placed on these views when making investment decisions.

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