Equities

The end of the road or full steam ahead?

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- UK's largest independent benefits consultancy
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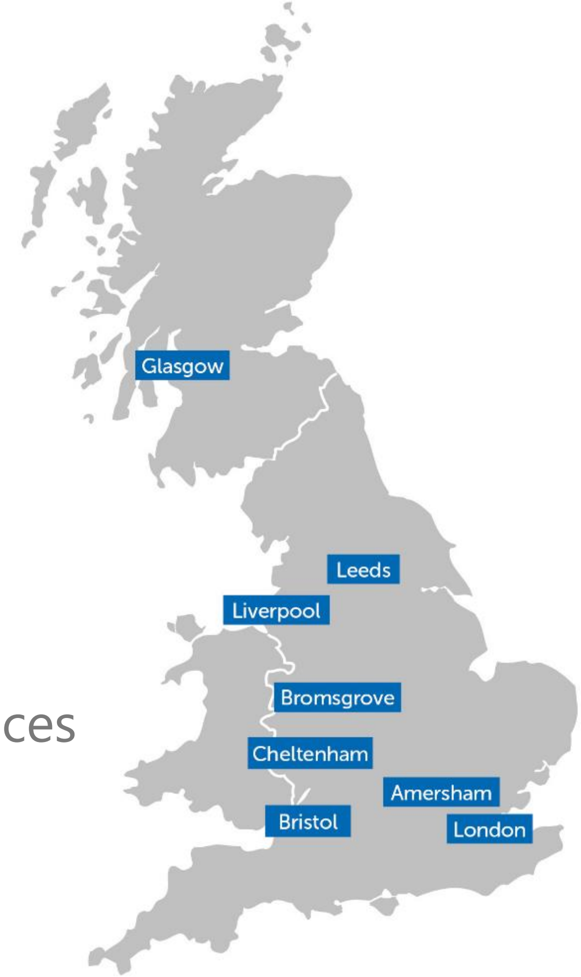
- 127 qualified actuaries
- Over 60 investment consulting
- Full range of Workplace, Health and Wealth services
- Established SIPP and SSAS provider



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The Equity Story

Long Term Outlook

We believe that long-term returns from equities will be lower than what has become the norm for many investors.

Equity returns depend on economic growth in the long run and growth in the future will be lower than it has been in the past.

Three trends form the basis of this outlook:

- Demographics
- Low productivity growth
- Debt

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Demographics

The issue of populations ageing across global economies has two implications that could restrict future returns from equities:

1. As the population ages, the workforce as a percentage of the total population diminishes, reducing the labour force. This affects the level of output and thereby impacts economic growth and future equity returns.

2. Secondly, the demand to access savings is higher in an older population as they prepare for retirement by focussing on safer assets rather than risky investments. This reduces the demand for equities, resulting in downward pressure on the price.

Productivity

- Ultimately, an economy grows through two sources:

1. An increase in the labour force (more labour creating more ’goods’); or
2. Labour and machinery being more productive (the existing labour force being able to create more ’goods’ for each hour worked).

Productivity growth in developed countries has been slowing for at least 30 years and this slowdown has become more pronounced over the past decade. In the late 1990s, productivity in the US was growing at 3% per annum versus 0.5% per annum over the last three years. Without a notable pick-up in investment to reverse this trend – which does not seem forthcoming - economic growth will be held back.

Debt

- Many argue the global financial crisis was a result of too much debt. Since the onset of the crisis, global debt levels have continued to rise, not fall.
- Whilst increasing debt is not necessarily prohibitive to economic growth, several studies of historical data suggest that in developed countries, high levels of debt relative to the country's Gross Domestic Product (GDP) tends to lead to lower growth rates. As the debt challenge has not been resolved, we believe it will act as a drag on growth.

The Equity Story

Short Term Outlook

We do not profess to be able to forecast short-term market returns.

We will set out some facts on where equity markets are priced and what that has meant for returns from these markets in the past.

What is the “Right” Price?

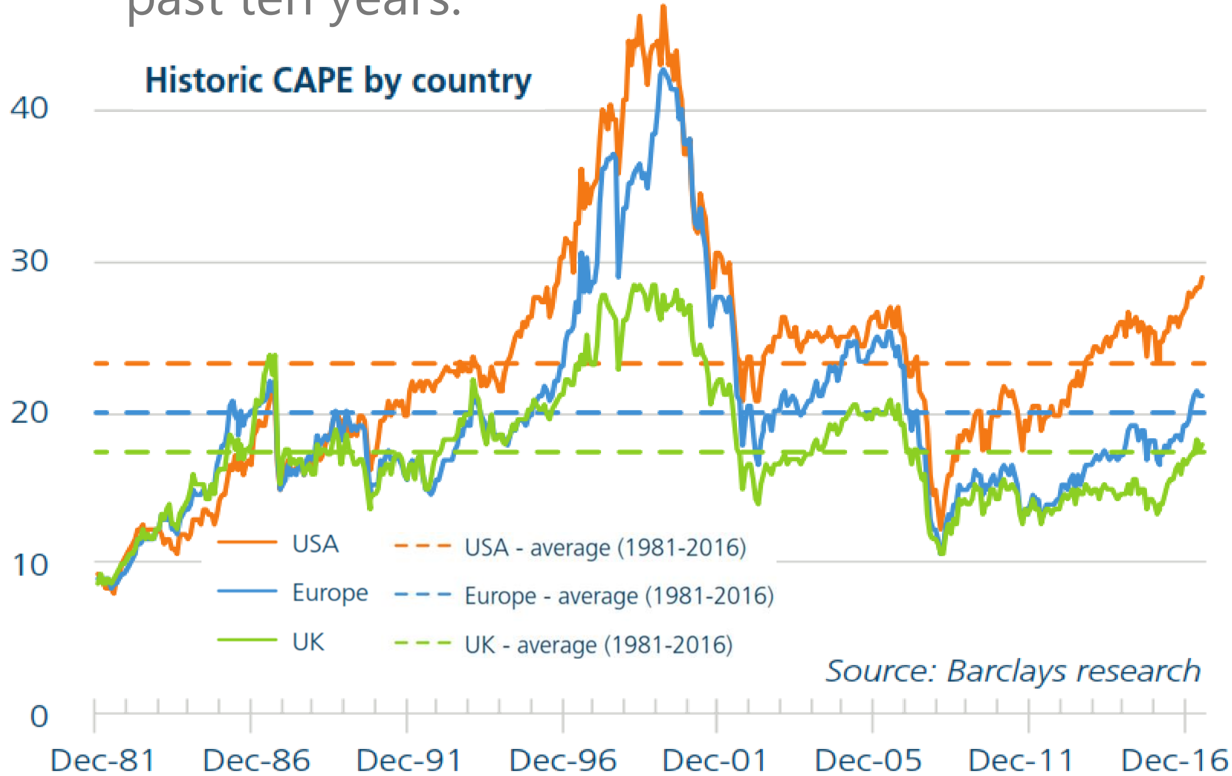
- Bonds are straightforward as the returns are known and once you consider the risk of default, you can decide whether you feel you are paying a ‘fair price’.

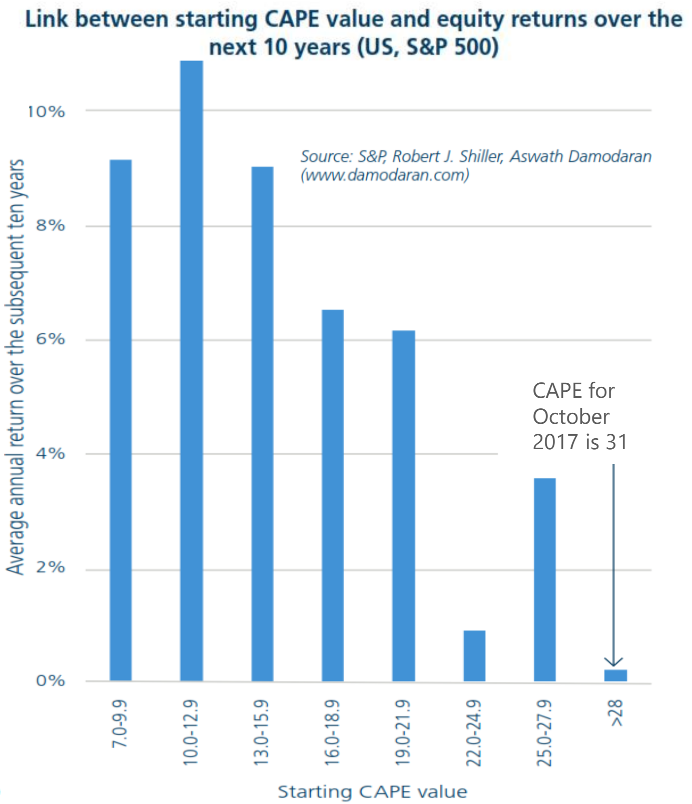
- Equities have no guaranteed return. Dividend payments and growth in the value of the company – which are generated by the company’s actual and expected earnings – cannot be known in advance.

- Comparing a company’s earnings and output to its share price are common ways of forming a view on whether it is overpriced. Expanding this to the whole equity market helps us form a view on whether equities on aggregate are expensive.

Price to Earnings Ratio

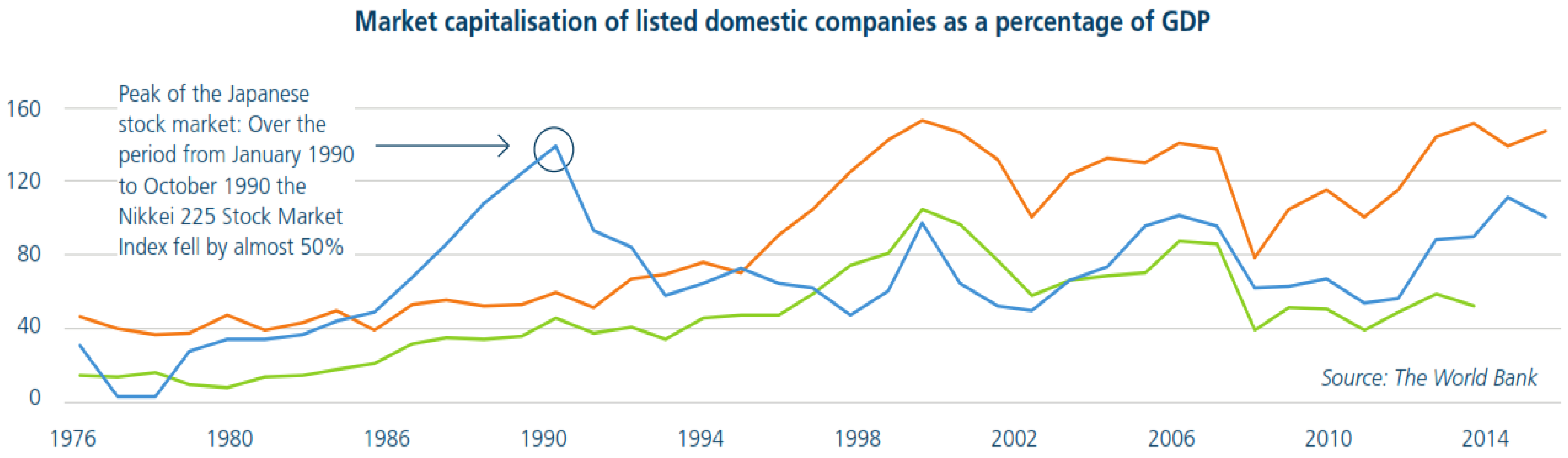
- The cyclically adjusted price-earnings ratio (CAPE) compares the current price of equities to the earnings of the corresponding companies over the past ten years.





What does history tell us?

- We have focused on CAPE as the measure of equity values but other metrics show a similar story. One of Warren Buffett's favoured measures is the size of the equity market compared to GDP of that country.



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How might we be wrong?

- In developing our view on equities, we have given significant consideration to how we might be wrong:

1. **Timing** – We have been pessimistic for some time, yet over the last eighteen months the equity market has continued to rally; so at best, our concerns were too early.

2. **Impact** – We may have misjudged the impact of the economic factors discussed or how political or regulatory changes could affect markets. Technological change could yet reverse the long-term decline in productivity and growth.

Protecting against market falls

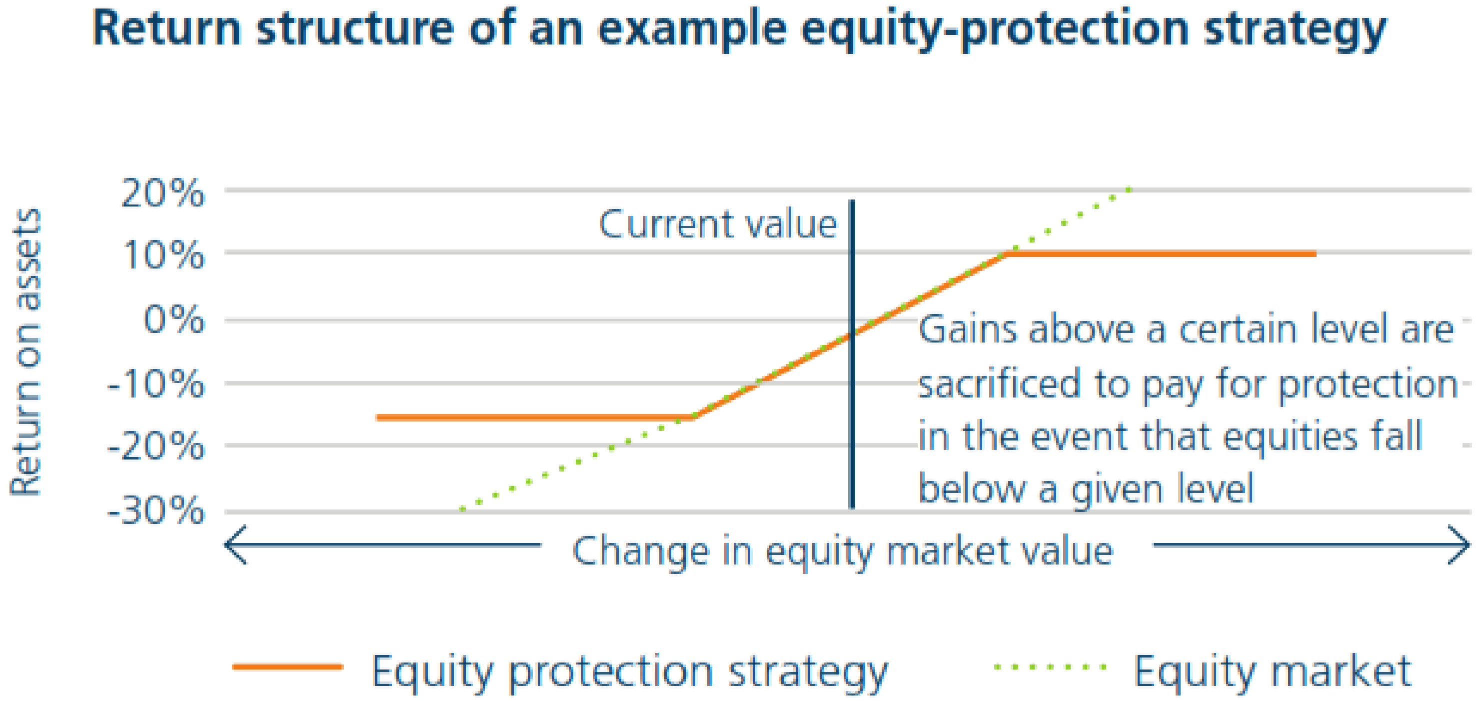
The most obvious way to protect yourself against falling equity markets is to sell your equities and transfer into another asset class.

But there are problems with this approach:

1. Other assets also have high valuations
2. Regret risk – Timing the market peak
3. Equites could remain the best performing asset class over the long-term, regardless of short-term concerns

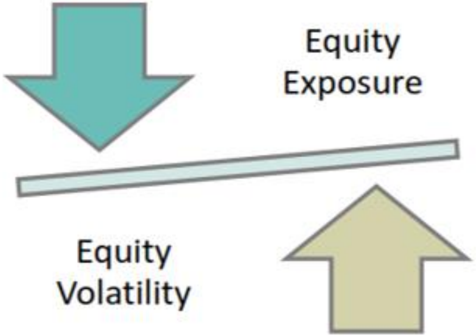
Structured Equity Strategies

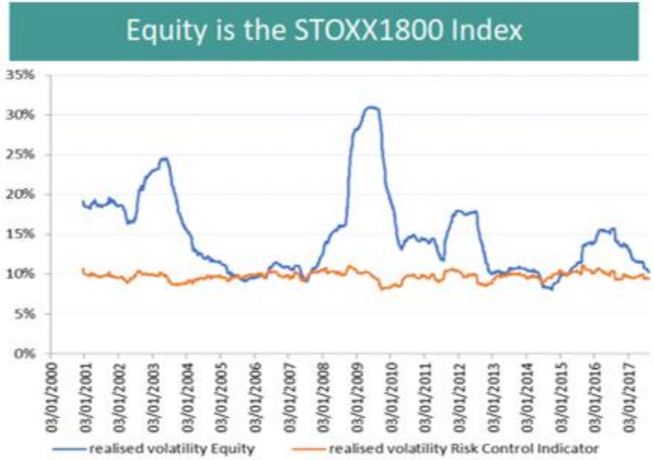
- A product for those that want to retain their equity exposure but have concerns over the short term and therefore wish to protect against some of the downside risk.



Or you could reduce volatility

- Vary allocation between cash and equity to control volatility
  - Volatility increases, reduce equity exposure and increase cash
  - When volatility falls, increase equity exposure and reduce cash





Source: SSgA

- Can add downside protection
- Various ‘off the shelf’ products now available

What are the benefits and challenges?

- Impact on expected return - The amount by which it is reduced depends on the specifics of the strategy, but expect a drag on performance of 0.5% to 1% p.a.
- Control - The real advantage of these strategies is control; you can maintain your exposure to equities, whilst removing the risk of significant falls. They may be used long-term strategies to control risk or as a short-term tactical play.
- Governance – The governance needed is significant and from our perspective, the biggest drawback to using them. This is because the value of the strategy changes as equity markets move and requires ongoing monitoring.
- Costs – These will typically be higher than passively managed equities, but in line with or lower than many actively managed equity funds or DGFs.
- Pooled Funds - Relatively new and still only a limited number in use. The key drawback is that they are not tailored to the client's risk appetite, return requirements and timescales removing one of the key attractions.

Conclusion & Questions

There are some schemes with very specific scenarios when using derivatives to remove possible losses on equities would be suitable.

For most investors, we think a better way to protect against the impact of equity market falls is to reduce the size of their equity holdings and look to hold a diverse portfolio of assets that will perform well in different market conditions.

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