SMART BETA

AN ALTERNATIVE APPROACH

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SCOTTISH WIDOWS

The strong performance of the Premier Pension Portfolios in 2016 can be attributed to various factors, including strong returns from emerging markets and global equities. However the use of smart beta strategies was an essential element and a crucial driver of performance.

Smart beta is an alternative to the traditional approach of weighting stock market indices on the basis of market capitalisation, and it is a key differentiating feature of our Premier range of multi-asset funds.

Smart beta is an approach to passive investing that was once the preserve of sophisticated institutional investors, but which is now becoming increasingly mainstream. Scottish Widows had some £5.7bn invested in smart beta strategies as at the end of January 2017.

And as the Premier pension range's 2016 performance shows, these strategies are producing positive results for investors.

WHAT IS SMART BETA AND HOW DOES SCOTTISH WIDOWS MAKE USE OF IT?

MARKET CAPITALISATION

Most equity indices weight their components according to market capitalisation. This means that stocks are included and ranked according to the total value of their shares. So a company that has recently enjoyed strong share price performance will be heavily weighted in a standard index, and this will be replicated by a passive tracker fund. This is often seen as a drawback to passive investment, as it entails 'chasing the winners' – buying more of stocks that have performed well in the recent past, rather than taking profits when those shares look fully valued.

But there can be drawbacks to active investment too. In well-known and widely researched equity markets, active managers can struggle to convincingly demonstrate specialist knowledge or unique insights. Some active managers appear unable to exploit inefficient or under-researched niche areas – in emerging markets, for example – and they can therefore find it difficult to beat benchmark indices in the mainstream equity markets.

SMART BETA

Smart beta is an umbrella term for passive investment strategies that use a systematic, rules-based process to determine the relative stock weightings of an index, and are designed to deliver higher returns than traditional market-capitalisation-weighted indices. One of the most popular types of smart beta strategies involves weighting component stocks based on metrics that measure the fundamental value of each component stock rather than market capitalisation.

All of these approaches aim to sell stocks that appear fully valued and buy stocks that look undervalued. These transactions are triggered automatically when the smart beta indices are rebalanced.

SCOTTISH WIDOWS AND RAFI

Scottish Widows invests in the smart beta strategies managed by Research Affiliates (RAFI), in the form of its FTSE RAFI Index Series. Rather than weight companies on market capitalisation, the RAFI approach measures the relative size of companies using four fundamental measures:

- Sales (total annual sales, averaged over 5 years).
- Cash flow (operating income + depreciation and amortisation, averaged over 5 years).
- Dividends (total annual dividends, averaged over 5 years).
- Book value (total common equity, at most recent fiscal year ending).

Securities are then selected based on the average fundamental size. This is determined by equally weighting the average of the four measures (dividends are excluded for companies that are non-dividend payers). So, for example, the FTSE RAFI US 1000 index is comprised of the 1,000 largest US companies ranked by overall fundamental size. This methodology breaks the link between market cap and portfolio weight, giving the RAFI indices a natural value tilt. In other words, the approach seeks to deliver returns in excess of a market-cap weighted index by purchasing stocks that are out of favour.

SMART BETA IN THE PREMIER RANGE

The two smart beta strategies that we employ in the Premier Pension Portfolios are Fundamental Index and Low Volatility.

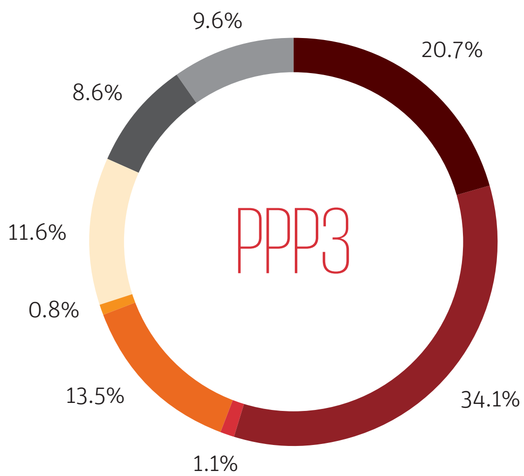
- **Fundamental Index** – Two of the four smart beta funds in which the Premier Pension Portfolios invest are based on indices that weight their components according to fundamental measures, such as sales or dividends. Smart beta indices based on fundamentals will sell stocks when their price has overtaken their fundamentals and instead rebalance into undervalued stocks, whereas traditional indices rebalance into stocks on the basis of their size.
- **Low Volatility** – The other two funds are based on indices that weight their components according to low historical volatility (as well as fundamental measures). This method distributes the components of an index according to their recorded levels of volatility, giving a weighting towards stocks that historically have been the least volatile. Low volatility indices can also take fundamental factors into account.

As we mentioned earlier, one of the key strengths of fundamental indices is being able to avoid being overly exposed to particular share price bubbles – when a stock's market capitalisation rises to levels unjustified by its economic fundamentals. Rather than rebalancing into overvalued stocks, as traditional indices tend to do, fundamental indices rebalance out of overvalued stocks and into those that have fallen from favour.

The table below shows how much of each Premier Pension Portfolio is invested in smart beta strategies. The composition of the asset mix and the asset allocation may change at any time and exclude cash unless otherwise stated. Information correct as at 31st March 2017.

	PPP1 (%)	PPP2 (%)	PPP3 (%)	PPPA (%)	PPPB (%)	PPP4 (%)	PPPC (%)
Fundamental Index Equities	51.3	41.6	34.1	24.6	13.8	9.1	5.5
Low Volatility Equities	17.5	15.1	13.5	11.9	10.4	8.1	6.1
Total	68.8	56.7	47.6	36.5	24.2	17.2	11.6

The proportion invested in equities decreases as we move from left to right along the range, from almost all of PPP1 to 20% in PPPC. PPP5 is a fund investing primarily in money market assets and therefore is not included in the table on the previous page. The chart below shows a representative weighting for PPP3.



Information correct at 31st March 2017

- Other Market Cap/Active Equity
- Fundamental Index Equities
- Commodities
- Low Volatility Equities
- Cash
- Absolute Return
- Property
- Bonds

Please note that funds and managers may change at any time.

WHAT ARE THE STRENGTHS OF RAFI?

Research Affiliates launched the first RAFI Fundamental index in 2005.

The FTSE RAFI indices are designed to automatically take underweight positions in overpriced stocks and conversely be overweight in underpriced stocks. The FTSE RAFI Low Volatility indices similarly weight their constituents according to metrics of fundamental value, but the resultant indices are then also screened for historical volatility, so that volatile stocks can be excluded.

SALES

Total annual sales, averaged over 5 years

CASH FLOW

Operating income plus depreciation and amortisation, averaged over 5 years

BOOK VALUE

Total common equity, at most recent fiscal year

DIVIDENDS

Total annual dividends, averaged over 5 years

The RAFI indices have low turnover and, consequently, low turnover costs. They rebalance annually for the optimal combination of high efficiency and low costs.

We believe RAFI's fundamentally based approach offers the potential for outperformance. Since their inception more than ten years ago, the broadest FTSE RAFI indices have outperformed their corresponding cap-weighted indices. More recently, the performance of the RAFI indices has lagged that of their cap-weighted peers. But this does not mean that the strategy is no longer fit for purpose. On the contrary: overweighting underperforming and undervalued stocks with sound fundamentals is exactly what the RAFI indices are designed to do. Recognition of this fundamental strength by markets would lead to outperformance.

We chose the FTSE RAFI Fundamental indices because they offer the potential for excess returns from the equity markets, with reduced correlations and costs for the portfolio. The RAFI low volatility indices complement the RAFI Fundamental indices by combining volatility and fundamental screens. In our view the RAFI Low Volatility indices also offer the potential for superior risk-adjusted returns from the equity markets, but with lesser downside exposure.

PLEASE REMEMBER PAST PERFORMANCE IS NOT AN INDICATOR FOR FUTURE RESULTS. INVESTMENT MARKETS AND CONDITIONS CAN CHANGE RAPIDLY AND, AS SUCH, ANY 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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