Standard Life Global Absolute Return Strategy Fund

The Standard Life Global Absolute Return Strategy Fund (GARS) has been a main underpin to our portfolios since we launched them in 2009. The reason is that we feel that although this is not a fixed interest fund, it has the same characteristics in terms of volatility but provides the potential for equity type returns.

As with all the funds we constantly review and test them to ensure that the strategy remains sound. In this update we want to cover three areas, firstly recent performance, secondly recent changes to the team and thirdly capacity issues.

The last two points are entwined to some extent.

PERFORMANCE

<u>Strategy</u>

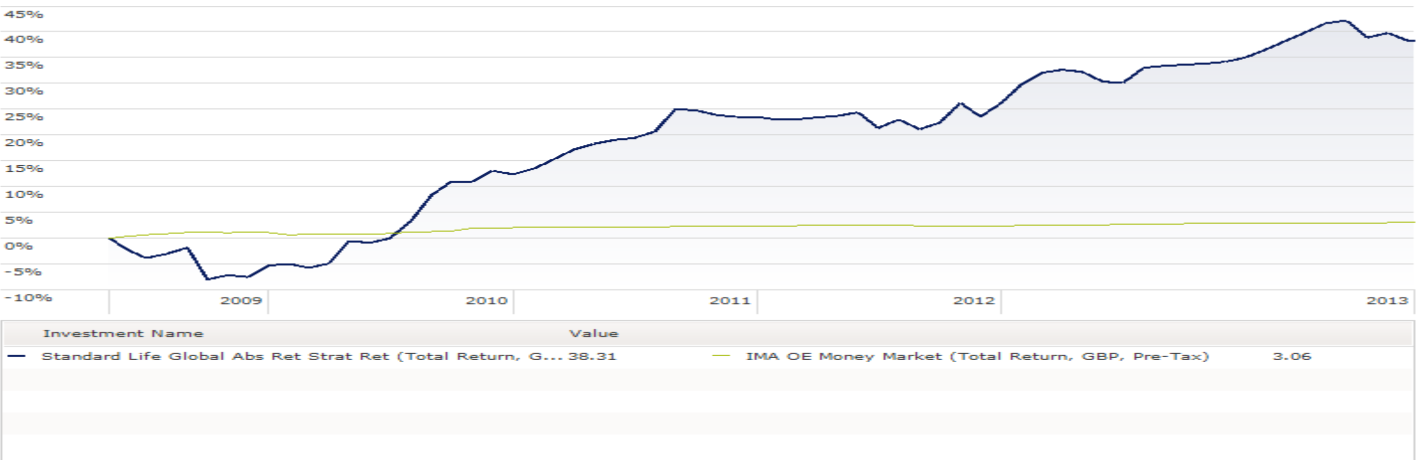
The strategy was established as a solution to a problem facing the Standard Life Staff Pension Scheme. The key was to target a good return but with less investment risk.

We have indicated that bonds are seriously challenged going forward and the recent Credit Suisse and Barclays reports indicate that global bonds will provide near negative returns taking into account inflation. This led us to using emerging market bond funds, and reducing our exposure to developed market bond funds.

However, to place all assets in emerging market bonds does not provide enough diversification in the lower risk portfolios and therefore to deliver sustainable long term growth alongside these funds we need to use a strategy that delivers the same characteristics as bond funds but has the potential to deliver equity type returns. The GARS fund offers that opportunity.

The aim of the GARS fund over a rolling three year period is to deliver a return of cash plus 5% a year but keep volatility similar to bonds (so low). This doesn't mean that some months will show negative returns but long term the outlook should be positive.

<u>Short-term performance</u>



2008	2009	2010	2011	2012	2013	Annualised Return
-5.26%	18.67%	9.90%	2.19%	7.02%	2.36%	6.26%

Special note to graph:
You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation, but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted

There is no doubt that the performance of the fund this year has been a game of two halves, up to May the performance was strong. However, the Ben Bernanke speech on QE in May had an adverse impact on the fund which has meant that the performance over the last few months has been weaker (although the fund is still providing a positive return for the year). Ironically the slowing of QE is a positive sign for the US economy but it had the reverse impact for the fund.

The fund uses different strategies. One the strategies was a protection strategy on the basis that the US dollar would strengthen, in reality the reverse happened and the Euro strengthen against the US dollar.

Other strategies which should have helped were some emerging market trades. We have indicated the danger of seeing emerging markets as one homogeneous group, so for example the fund has trades in Mexico on both the currency and government bonds. Mexico is one of the strongest Latin American economies and it was dragged back with the sell-off in emerging markets. Although they expected it to fall back a little, it was not expected to fall back as much. This should reverse

They also had a small trade on the Indian Rupee on the basis that there would some internal changes, these changes are just starting to come through and therefore the timing of this was not right but they feel the long strategy remains right and this has been demonstrated in recent days with a rebound in the Indian Rupee.

One strategy they have unwound is in Russian Equities which was a play on potential rising global oil prices; this has been moved to more of a global equity oil play.

These are only a small part of the fund; the fund has a large number of different strategies doing different things but together like a team they deliver the long term target performance. Many of these are set in place as long term strategies and there is no doubt that the speech in May had a negative impact on the fund. Where the US dollar was expected to provide some protection the reverse happened and other strategies suffered under this.

However, speaking to the team they remain positive that the fund will recover over the next few months to deliver strong returns for the year. Following a conference call with one of the members of the team I do not see any reason why this should not be the case however what I can’t predict is how the market will react to unknown events.

RECENT CHANGES TO THE TEAM

Last year a small number of people left the team, at the time we indicated that we would only be concerned if the architect of the fund left the team. In July it was announced that Euan Munro who set up the fund was to leave the company. We have been monitoring developments carefully and we feel that his leaving is more of an impact for the group than the fund itself.

To explain, Euan has left to become the CEO at Aviva Investments. This means that he is moving away from the portfolio management to running an investment company. This indicates a number of things but clearly at SLI he had moved away from day to day management of the fund and more to overall strategy for the group and product development. The product development side is where SLI may be hit in the short term.

On the fund it appears that Euan only introduced one strategy over the last three years, and most of the day to day management rests with Guy Stern who was brought in to the team five years ago and has recently been appointed to the board.

In addition each key member of the team has two understudies and therefore should people leave in the future there are people there to assume their roles. When David Millar left last year the team was 27 people. This has now increased further to 32. They brought across emerging market debt specialists from Threadneedle, a new economist who had previously worked for the Central Bank of Australia and a volatility expert.

To put this in context we talked to the manager of a small fund which is similar to this and this has a team of five people, the feeling from the discussions with the team is that breadth and depth of the team provides the protection needed should members leave the team.

CAPACITY ISSUES

We indicated that we removed the M&G Recovery Fund because the size of the fund had made it difficult for the manager to continue to deliver sustainable above average performance, and in fact over the last three years had significantly underperformed the market.

The GARS strategy manages £30 billion which is significantly higher than the M&G Recovery Fund. The first sign of stress tends to be long periods of underperformance and although the short term performance has taken a knock we believe these strategies will work long term and therefore we do not believe the size is hindering performance.

We are aware of a strategy managed by a US fund manager in the bond market that has over $100 billion and they do not feel they have a capacity issue. Clearly with a diversified portfolio like GARS we can see that the strategy still has some way to go before it becomes so big it cannot deliver on its aims.

There are of course regions it cannot invest in because it would swamp the market but it is a multi-asset strategy and therefore not restricted in terms of assets and geography.

SUMMARY

In summary the short term performance is something for us to monitor but clearly they believe in the long strategies, and our research indicates that these strategies will deliver and they are starting to see this already. SLI have indicated that the fund could deliver upwards of 5% this year which in a volatile market would be a good return. Although there have been changes to the team, clearly the new blood have strengthened and broadened the team which helps to identify opportunities especially as the fund grows.

Therefore we continue to believe that as part of the portfolios alongside the emerging market debt funds this remains a good long term strategy. The only change we may make is to reduce our global bond exposure which we started to do in the last review.

Special note: This is not a recommendation to but the fund. The note is based on information supplied by SLI, Barclays and Credit Suisse. Past performance is no guide to future performance and investments can fall as well as rise.