



Inside:

Page 5

Market Overview: Oil slick

Page 7

Snapshot: Repossessions

Page 8

Forecasts: LGIM outlook gloomy - consensus beginning to agree

Can the pensions tide be turned?

Employer sponsored pension plans have been put under pressure as more and more safeguards to scheme member's accumulated pension entitlements are introduced. These developments are creating major challenges for employers and threaten to reduce future pension entitlements for many employees. Unfortunately, many fear that the worst is still to come, with Personal Accounts being introduced in 2012. Legal & General Investment Management's Head of Defined Contribution (DC) Strategy, Ian Richards, highlights some important concerns facing the future of UK pension schemes and what they might mean for employees and employers.

Paved with good intentions

In Imperial China, *Ling Chi* or 'death by a thousand cuts' was used as a form of execution. Despite each wound being small, they would ultimately kill a person. While outlawed in China in 1905, defined benefit (DB) pensions seemed to have met with a similar fate, far more recently. For it wasn't necessarily Robert Maxwell's misuse of assets or excessive risk taking with plan assets, changes in tax rules, over-regulation, or even inadequate plan contributions which led to the demise of DB schemes in isolation. It was, instead, a combination of all these factors. Today, with the introduction of

numerous safeguards and regulations, defined contribution (DC) schemes may be destined for the same fate. Whenever protective measures are introduced, great care is needed to ensure they do not end up destroying the very thing they were designed to protect. The good intentions of government, regulators and professional bodies may have caused more harm than good. Essentially, they have combined to turn pension provision from a simple part of the remuneration package, overseen by Human Resources departments, into a major issue for finance directors - with the potential to threaten the actual existence of many organisations.

THE CHANGING PENSION'S LANDSCAPE

1. Around two thirds of DB schemes are now closed to new entrants
2. Available statistics point to more active members in DC than DB
3. From 2001 to 2007 there were over 400 sets of pensions regulations published
4. Between 2005 and 2007:
 - Administration, communication, governance and other pension scheme running costs increased on average by 51%
 - Levies increased by 530%

Source: NAPF

Possible calls for cash injections, curtailment of corporate activity, impact on share price and even strike action now have to be taken into account when employers weigh up the ‘simple task’ of helping their employees have a better life in retirement. Many have decided to switch from final salary to DC arrangements to remove uncertainties over cost. However, in so doing, they have opened themselves up to the growing criticism that employees in DC schemes appear destined to suffer from inadequate pensions.

The danger ahead

The latest criticism comes from the House of Commons Committee of Public Accounts. In its review of the work of the Pensions Regulator, it commented that it feels that the Regulator should be doing more to improve DC arrangements. The consequence of those comments will surely lead to yet more demands and potential costs for those who run such schemes.

It should come as no surprise, therefore, that more and more employers are likely to start asking themselves why they should continue to have their own pension scheme at all, either final salary or DC. Without enough positive reasons, there is a significant risk of the progressive demise of all employer sponsored pension plans.

The launch of Personal Accounts (see Figure 2) could, in fact, serve as a possible opportunity for them to walk away without damaging employee relations too much. For it would be much easier for an employer to end their own plan during the launch of Personal Accounts – undoubtedly accompanied by a blaze of government publicity on the new pension deal.

What needs to be done?

To find arguments why employers ought to persist in keeping their existing schemes going, despite

increasing costs, it is necessary to think beyond reasons of paternalism, recruitment, and retention which, although still very relevant, have lost their power in recent years.

In today’s competitive world where cost control is key, employers need to see that they are getting value from their remuneration spend and that it does not generate unacceptable extra costs. If the cost of the provision is less than the value being added, then the scheme must be at risk, and employers may well decide to direct their spend to other parts of the remuneration package. That does not necessarily mean employers might opt out altogether, however, many may prefer to level down their contribution to the scheme and direct the saving onto something that is more appreciated by employees and does not come with the expensive baggage and bureaucracy.

The future for UK pension provision

Flexible remuneration packages have, as yet, not taken off in any meaningful way in the UK, but perhaps what is happening to pension schemes could cause momentum to build. The future of pension provision in the UK is

delicately poised and it is easy to see how it might move to a three pillar regime from the current two pillars - state benefits and private provision (see Figure 3).

While the three pillar approach is not what the Government has intended, no other government has attempted what is proposed for the UK. Where other governments have introduced schemes similar to Personal Accounts they have been in markets without a significant employer sponsored pension sector. Or they have been in markets where private sector schemes have not been as onerous and costly to run as they have become in the UK.

Most open final salary schemes will be able to meet the requirements with minimal change or additional cost. Unfortunately, however, the number of such schemes has declined significantly in recent years. The real issue will be for those employers who now provide pension provision through a defined contribution arrangement. The government has promised that using an employer sponsored scheme to opt out will not be onerous, but the devil will be in the practical detail.

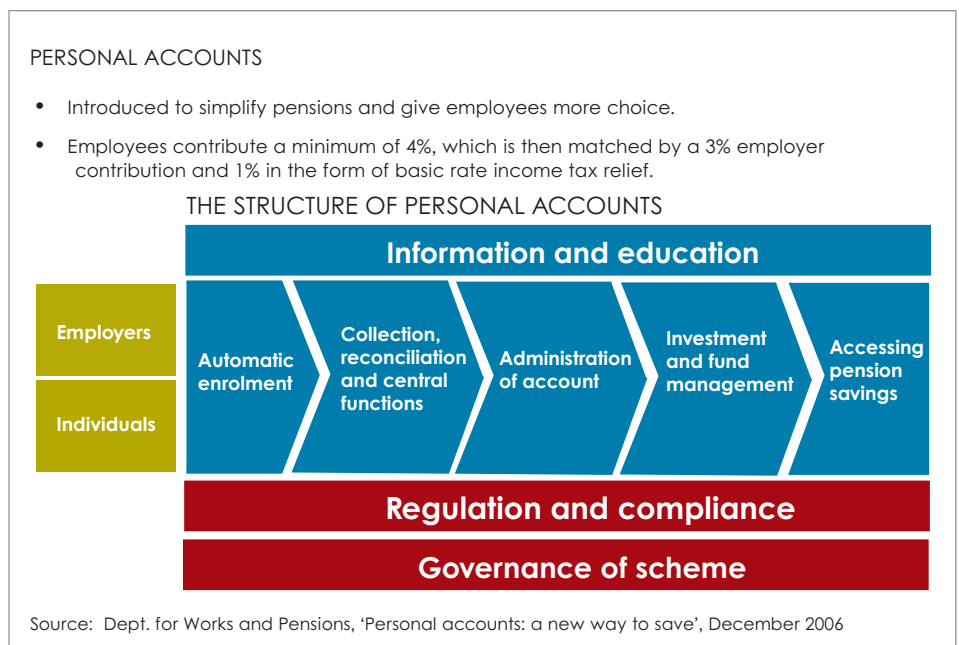


Figure 2

The costs and barriers ahead

Consider just two examples where the detail of the requirements could have a major impact on administration and associated costs: auto-enrolment and the definition of earnings.

1. Auto-enrolment

Auto-enrolment means all employees go into a scheme and then have to voluntarily opt out. However, bear in mind that the current proposal is for auto-enrolment to take place on the first day of employment. That immediately increases the amount of administration that has to be carried out and will, therefore, increase costs.

It raises a number of questions:

- What is going to happen to contributions paid in between someone joining, but before they opt out? Normally they would go into the default fund.
- Unless that default fund has a capital guarantee, will individuals and employers be happy if they lose money because of market movements?
- Do they, instead, change the default fund to a cash fund so that there is no prospect of loss and then find members who have decided to stay in the scheme permanently remaining in cash for all their working life?
- Will this need expensive communication exercises in order to get them to switch out?
- Alternatively, will employers or trustees be allowed to sit on contributions until after the opt-out period has expired but in the process keep those who want to join out of the market for potentially several months?

2. The definition of earnings

Contributions into Personal Accounts are based on a band of P60 earnings (that is earnings and tax deductions over the last tax year). Most DC

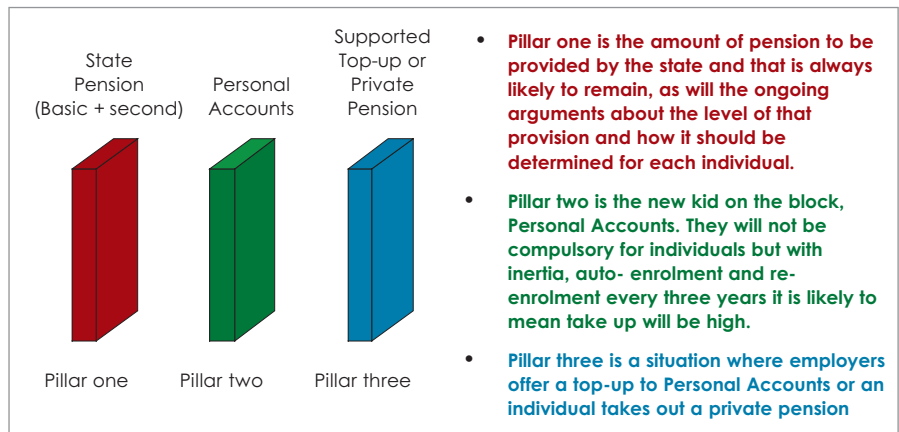


Figure 3

schemes, however, are based on basic earnings not P60. It is perfectly possible for an employer to be paying a contribution rate much higher than the required 3% but, because it is based on basic earnings, the monetary amount could be less than the minimum required in some pay periods.

Monitoring contributions to ensure minimums are met, especially where bonuses represent significant extra payments is going to require more administration. Switching to a scheme contribution based on band P60 may be an option but it could increase the employer contribution costs to unacceptable levels and force them to cut their contribution rate.

Motivating employers

No doubt solutions will be found to these issues but the unknown at this time is how onerous they might be and how much extra cost will they create. If the government does not get the qualifying terms right for employer schemes to opt out, the best solution for many might be to go into Personal Accounts and then decide how best to spend any additional contribution it might want to make. To ensure that additional spend is directed into pensions, it is essential that new ways be found to help employers get better value from their company schemes.

Perhaps the first area that they need to consider is how their pension arrangements fit with their employment policies for older staff. Schemes have made

a number of changes since the Pensions and Finance Act of 2004 and the changes in April 2006, but anecdotal evidence suggests many have still to take full advantage of the new flexibilities that became available.

Phased retirement

One area in which these flexibilities have not been maximised relates to phased retirement. As employees start to want to wind down into retirement there is no longer any need for them to leave an employer and take on part time employment elsewhere. It can all be done with the same employer using pension payments to progressively top up a reducing salary. By integrating pension scheme rules into employment practices employers should be able to engineer many win-win situations for both themselves and those employees whose skill and knowledge they might want to retain for as long as possible.

Engaging employees

An equally important area that also needs to be addressed is to find ways to get employees to be more appreciative of the company pension scheme. The very fact that auto-enrolment is needed to get people into schemes is indicative of how poorly pension provision is valued in the UK. We are now working in an instant gratification market where putting aside something today for tomorrow has been replaced with a culture of how can I get something for today from tomorrow's income. Perhaps the credit crunch will help restore some balance and change

THE SAVINGS PROBLEM

- Around 7 million people are not saving enough for retirement
- Only 40% of those who have not yet retired are saving for their retirement
- 80% say that they will need more than a State Pension to live on

Source: Dept. for Works and Pensions, 'Personal accounts: a new way to save', December 2006

Figure 4

attitudes but it is unrealistic to think that such a change is likely to the extent that is necessary.

We have moved from the position where once around 40 to 45 years of earned income was needed to be stretched across 50 to 55 years of living expenditure, to one where the same amount of income is expected to provide for a further 5 years – and at a higher standard than pensioners have enjoyed in the past. This situation, a result of higher life expectancy assumptions, is simply unattainable without significantly higher contributions being paid. Better presentation of just how valuable employer sponsored pension plans are has to be the key to improving appreciation and encouraging higher contribution levels.

A paradigm shift

Unfortunately, however, regulatory disclosure and risk warning requirements has made communicating the key value messages to employees more difficult as they can so easily be lost amongst the mountain of paper that has to be provided. It can be done, but it does need a change of emphasis in how

employer's contributions, tax and national insurance savings are treated.

For best results, these payments need to be treated as part of a scheme return, not a contribution – and ways need to be found to demonstrate that fact. The basis of Personal Accounts will effectively be buy one get one free before any investment return is added (i.e. 4% employee contribution is matched by 1% basic rate income tax relief and 3% employer contribution). In employer sponsored plans it is likely that the added benefit is even greater. This also removes some of the concerns about short term volatility of investment returns, as markets have to fall a long way before a member starts to see a negative return on his own contribution (once the benefit of these additional payments are taken into account).

Another means of making pensions more appreciated is trying to move employees more towards the US 401K mentality and trying to make managing your pension feel more “sexy”. This is not something for every employer or employee, but in many instances it could result in greater

engagement. The risk of inappropriate investing could be overcome through the promotion of core and satellite investment strategies as used by many final salary schemes. That is, putting the core of your investment into something more secure and less risky, while taking extra risk on the margin.

The path ahead

There are signs that a number of companies are starting to recognise these issues. These companies are beginning to look at their pension arrangements in a new light to find ways to better help both their business and their employees. For example, we are seeing a number taking steps to leverage their pension plans into the wider savings arena through the introduction of group Self Invested Personal Pensions (SIPPs) designed to be used in conjunction with share save schemes to take advantage of the tax efficiency of pension saving.

The doomsayers predict that the trend of employer sponsored schemes moving from DB to DC will progress on to Personal Accounts. This is far from certain. However, unless the obsession with risks and disclosure is met by all associated with pensions working harder on helping employers get better value from the schemes, the benefits of these schemes will not be understood – ultimately leading to their demise.

Market Overview

Oil slick

The rise in the price of oil has been relentless. The oil price (as measured by the West Texas Intermediate in US\$) rose more than \$13 per barrel during May and has spiked again in June leaving it bubbling around \$140. Less than a decade ago, a barrel of oil was only just over \$10.

As higher energy costs feed through the global economy, a number of investment markets are suffering. By increasing the cost of items such as petrol and food - higher energy costs make food production, transport and so forth more costly - they reduce the amount of money people have in their pocket to spend on other goods and services. Lower consumer spending (all other things equal) will mean slower economic growth. In fact, the most recent spike in energy prices threatens to offset the positive effects of the current US Government tax cuts - keeping the US economy in decline. Secondly, a higher cost of energy also squeezes company profits. Airlines are a perfect example – with many companies forced to scrap flights due to the price of fuel.

A third negative effect of higher energy prices is their influence on a central bank's ability to promote economic growth. With UK inflation sitting around the upper limit of their target range (3%), the Bank of England has been unwilling to cut interest rates to the extent it would ordinarily, in order to stimulate the economy. Also, above target inflation has meant that government bond yields have moved higher – making riskier assets such as equities less attractive.

London

Bear market rally

In May investor sentiment spiked to around the same levels as back in October 2007. This typically signifies an equity rally is running out of steam. Indeed, UK equities, as measured by the FTSE 100, ended May half a percent lower.

The economic backdrop was particularly poor during the month. Coupled with the release of shocking inflation data, a survey from the Royal Institute of Chartered Surveyors (RICS) pointed to a sharp decline in the housing market. This was confirmed later in the month with a 2.5% fall in the Nationwide house price index.

The best performing stocks in the local equity market continued to be found within the oil and commodity sectors. Conversely stocks within the financials sector (in particular banks) continued to weigh on the market as the fall-out from the credit crisis spreads. With increased evidence of slower consumer spending and difficult credit markets (which are hurting corporate profits), we expect UK equities to remain volatile in the short-term.

Wall Street

Unemployment spikes

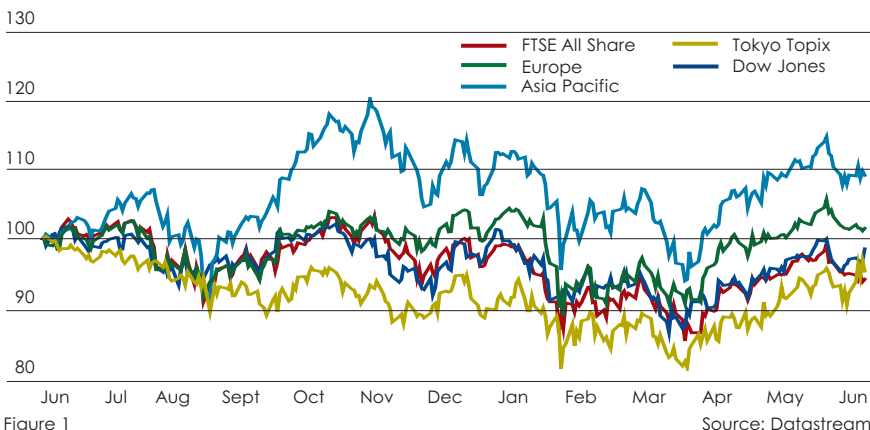
On the whole, recent US economic data has been better than most market participants expected. However, the May labour market report showed a shock jump in the rate of unemployment, from 5% to 5.5% and consumer sentiment data fell to the lowest level since 1982.

The US equity market, as measured by the S&P 500 Index, traded higher mid-way through the month and then fell back at the end of the month – ending May around 1% higher.

In recent months the best performing sectors of the US equity market have come from within energy and information technology. US companies have had to contend with an operating environment plagued by write downs from within the financial sector, tightening credit availability and the likelihood that the economy is sliding into recession. The fall-out from the credit crisis which began late last year continues to plague the banking sector – as more US investment banks were downgraded by analysts during the past month. Investors generally remain sceptical about how realistic banks are being in disclosing the extent of the financial problems they are facing.

Both the US central bank (the Federal Reserve) and the US Government are both aggressively trying to stimulate the economy, however we believe that rising unemployment will undermine the effectiveness of their policies. It is our view that tighter lending requirements that are resulting from the fall-out from the credit crisis, coupled with higher energy prices has pushed the US economy into recession.

MAJOR EQUITY MARKETS – TOTAL RETURNS £ 2007/2008



MAJOR WORLD BOND MARKETS – TOTAL RETURNS £ 2007/2008

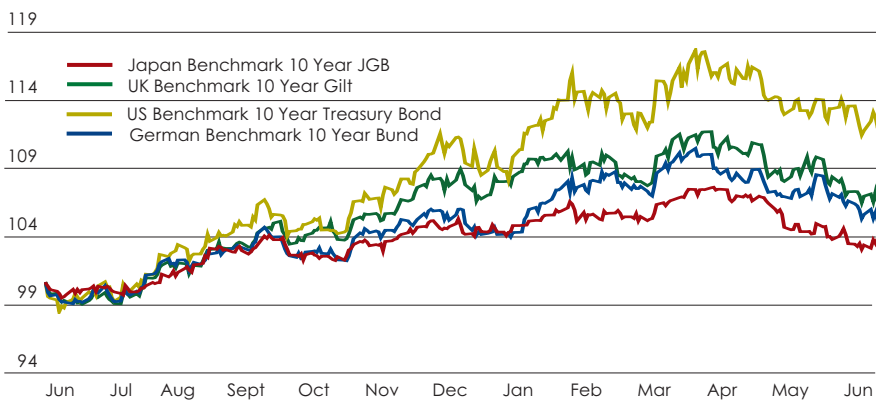


Figure 2

Source: Datastream

Europe

Euro 2008

According to the European Central Bank (ECB), European economic fundamentals remain sound (free from major imbalances) and data continues to point towards moderate, but ongoing real GDP growth. European equity markets, however, have been volatile. In May the German equity market, as measured by the DAX Index, rose 2.1% and the CAC 40 Index in France was almost 0.4% higher.

Companies within resources, chemicals and utilities sectors have tended to strengthen in recent months while banks and financial services firms have struggled despite making significant improvements to their balance sheets.

Exporters in the region have felt the pressure of an appreciating Euro coupled with rising input prices. However, demand from emerging markets has grown during 2008, somewhat offsetting the decline from the US and Western Europe.

The economic outlook for Europe is a mixed bag. While German economic confidence remains solid thanks to its exposure to emerging economies, economic data in Spain and Italy have been poor. The ECB is more concerned by continued high inflation and warned it might hike rates in July.

Japan

Foreign money flows

We have seen a marked improvement in the Japanese economy during the first half of 2008. Signs of inflation have begun to emerge (a positive for a country that has not seen general price rises in almost a decade), housing and construction activity has picked up and consumer confidence is high.

After rallying in April, the Japanese equity market, as measured by the Topix Index, rose again in May, by approximately 1.8%. This strength has come from a general consensus from investors that the worst is behind us. Companies have been optimistic, believing that they will be able to offset the rising costs associated with commodity inflation by cost cutting. Much will also depend on companies' ability to pass on higher costs through higher prices – last month Asahi Brewery raised the price of their beer for the first time in 19 years.

As a result of the changing economic environment, the outlook for Japanese equities has improved. For the past decade the majority of Japanese investors have sought the safety of Government Bonds rather than investing in the struggling equity market. However, with expectations of inflation to move to levels between 3-4%, the 2-3% average return on Government Bonds is no longer attractive. Also, after avoiding the Japanese market for many years, many foreign investors are now scrambling to gain exposure to a market that may be poised for growth. In April, we saw the largest inflow of foreign investment into Japan since the 1970's.

Higher oil prices have been positive in some regards for Japan also. Dominated by exporters, the Japanese equity market has benefited from strong share price gains from Japanese automakers. Share prices for Honda, Toyota and Nissan all rose off the back of high fuel prices – as these companies are pioneers in energy efficient cars

Pacific Basin

Indonesia up, India down

Economic growth in Asia remains strong. This is despite the growth engine of the region, China, experiencing the worst earthquake disaster in nearly 50 years. As a result of the disaster which hit last month, China's government will inject an estimated Rmb 300 billion (or 1% of GDP) into reconstruction.

As measured by the FTSE AW Asia Pacific ex-Japan Index (in £), Asian equity markets fell by 1.6% in May. Regional performances were mixed. While Indonesia gained 5.5%, Australia rose 2.5% and Singapore was up 1.7%, the Thai equity market lost -3.5%, Hong Kong equities fell -3.1% and Taiwan dipped -2.8%.

Last month Taiwan's President Ma Ying-jeou made an inauguration speech that reiterated his agenda of relaxing investment restrictions for companies and working towards a mutually beneficial relationship with China. Investors in Taiwan are eagerly awaiting his plans to introduce direct chartered flights allowing more Chinese tourists to visit Taiwan which are scheduled to start from July.

With the Indian Rupee depreciating 3.8% against sterling in May, India was the worst performing market in Asia as inflation hit a three and half year high of 8.0%.

The biggest threat to the region remains inflation. The higher cost of inputs has put pressure on companies' margins and revenues and rapid economic growth continues to drive the risk of monetary policy tightening (higher official interest rates).

Snapshot

Repossessions

The proportion of mortgages entering into foreclosure in the US has more than doubled over the past year, to now stand at a record high (Figure 1). The biggest increase has been in sub-prime, adjustable rate mortgages. Low credit quality consumers were encouraged to take out mortgages without perhaps fully understanding the implications of what would happen when their initial ‘teaser’ rate expired. But this is not the only story. The effective rate of interest paid by US mortgage holders has actually fallen since the third quarter of 2006. But we’ve seen continued increases in foreclosure rates. Even prime fixed-rate foreclosures are at a record high. So other factors are to blame, namely falling house prices and rising unemployment.

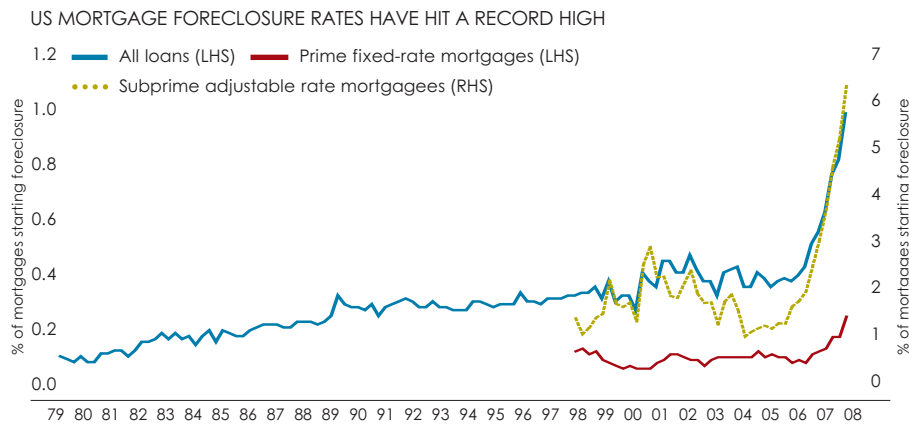


Figure 1

Source: Reuters EcoWin

In the UK, the proportion of mortgages entering repossession has also started to rise, but remains less than at the peak during the early 1990s. It is less likely we will see the same surges in repossessions in the UK as we have seen in the US because it is more difficult for UK consumers to walk away from their debts. If they enter negative equity and default on the loan, they are still liable for the difference between the outstanding value of their loan and the final selling price. So they should have more incentive to keep paying off the loan. But we still believe repossessions have further to rise in the UK. Based on our forecasts for interest rates (coming down at a gradual pace), unemployment (rising by one percentage point over the next year) and house prices (falling by 10% year-on-year in both 2008 and 2009), we see the proportion of mortgages entering repossession doubling from 0.1% now to 0.2% end 2009. While this remains below the 0.4% peak in 1992, there is a danger of a self-reinforcing negative spiral. An increase in mortgage repossessions will discourage banks from lending and increase the supply of unsold property on the market. This will put further downward pressure on house prices. If consumers decide to save more money as a result of falling asset prices, this will hurt consumer spending, leading to further rises in unemployment.

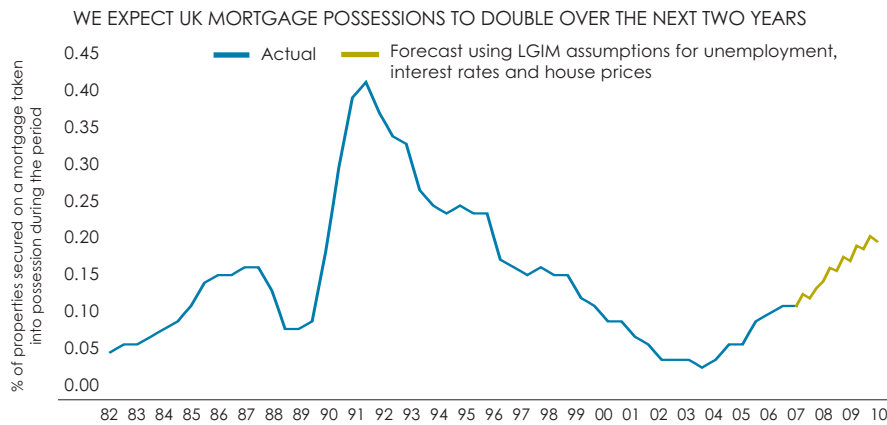


Figure 2

Source: CML, LGIM estimates

Views Commentary

LGIM outlook gloomy - consensus beginning to agree

	Price Inflation (HICP)		GDP (Growth)		Earnings (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro		FTSE 100	
	End 2008 %	End 2009 %	End 2008 %	End 2009 %	End 2008 %	End 2009 %	End 2008 %	End 2009 %	End 2008 %	End 2009 %	End 2008	End 2009	End 2008	End 2009	End 2008	
ABN Amro	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Citigroup Smith Barney	-	-	1.70	0.80	4.80	11.00	4.84	-	4.75	-	1.90	-	0.83	-	6200	
CSFB	3.20	1.70	1.60	2.50	-	-	4.65	4.75	4.50	4.50	1.92	-	0.78	-	6000	
Deutsche Bank	2.60	-	1.80	-	6.00	-	4.85	-	4.50	-	1.94	-	0.77	-	7200	
Goldman Sachs	3.60	1.80	1.00	2.60	-	-	4.30	4.70	4.50	4.50	1.95	1.95	0.72	0.72	-	
HSBC Securities	3.60	1.50	1.20	0.50	0.00	5.00	4.20	4.80	4.50	3.50	1.75	1.69	0.77	0.77	6200	
JPMorgan	4.10	2.10	1.70	1.20	-	-	5.12	-	-	-	2.03	-	0.67	-	-	
L&G Investment Management	3.70	2.30	0.80	0.80	4.00	-2.00	4.50	4.40	4.50	3.50	1.91	1.88	0.81	0.85	6000*	
Merrill Lynch	3.30	2.50	1.70	1.60	4.00	6.00	4.45	-	4.75	4.00	1.87	1.75	0.79	0.76	6500	
Morgan Stanley	3.40	2.30	1.70	1.80	-7.00	-3.00	5.10	5.30	5.00	5.25	1.84	1.76	0.76	0.75	6300	
UBS	3.20	2.40	1.60	1.30	13.60	11.90	4.40	4.60	4.75	4.25	1.90	1.91	0.74	0.70	6500	
Median (ex L&G Inv Mgt)	3.35	2.10	1.70	1.45	4.40	6.00	4.65	4.75	4.63	4.38	1.90	1.76	0.77	0.75	6300	
Last Month	2.70	2.00	1.65	1.80	4.00	5.50	4.60	4.70	4.50	4.50	1.92	1.76	0.77	0.75	6300	
Actual end :																
2007		2.10		2.90		6.20		4.51		5.50		1.98		0.75		6453
2006		3.80		3.00		12.20		4.74		5.00		1.96		0.67		6220
2005		2.00		2.00		22.70		4.10		4.25		1.72		0.69		5618

KEY Median figures indicate change over previous month **0.00** increase **0.00** decrease **0.00** no change

*This is our estimate of fair value at end 2008, not a point forecast.

We have revised our UK growth forecast lower, again. Falling housing prices, rising energy costs and higher unemployment continue to lead us to be more cautious on the outlook for UK economic growth. Our model points to growth of 0.8% in 2009. While this is significantly lower than the consensus forecast of 1.45%, it is worth noting that the median consensus figure has also been revised down considerably this month. Last month, consensus pointed to growth in 2009 of 1.8%.

Our gloomier-than-consensus outlook hinges on our expectations that private consumption (-0.3%), total investment (-4.1%) and employment (-0.5%) will all fall in 2009. Consensus, on the other hand, points to private consumption growth of 1.5%, total investment at 1.9% and employment growth at 0.1%.

Our Bank of England model currently suggests interest rates will stand at 4.5% by the end of 2008 and fall to 3.5% by the end of 2009. As a consequence of the sharp rise in inflation (which is currently tracking at the Bank of England's upper limit of 3%) there are lower consensus expectations of rate cuts. The base interest rate forecast for consensus in 2008 moved higher this month – from 4.5% to 4.63%.

For further information on Fundamentals, or for additional copies, please contact Harriet Moore at harriet.moore@lgim.co.uk

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