

## Investment Diversity through Equity Index and Passive Funds

By Julian Harding, Associate Director - Index Funds

UK pension schemes have traditionally invested most of their portfolios in equities and bonds and this approach served them well in the bull markets of the last years of the 20th Century. However, in recent years pension fund trustees and their consultants have been considering how to meet the challenge of 'deficit repair' following on from the bear market at the start of the 21st Century. An emerging solution is a combination of revised pension benefits, increased scheme contribution levels and a more structured risk framework for managing the pension scheme's assets.

One approach to address risk within the pension fund is Liability Driven Investment (LDI), an area where Legal & General Investment Management (LGIM) has already launched several new products. Another is the adoption of more diversity among the growth assets of these portfolios. In deciding to adopt a more diversified approach, some clients are now actively considering and discussing with us the allocation of a proportion of their portfolio to investment alternatives that exhibit growth characteristics or risk premia versus bonds ('diversity assets').

More trustees started to consider diversity assets post the Myners Review in 2001 and more recently a number of US institutions, such as Harvard and Yale, are quoted to have successfully adopted greater diversification within their investment portfolios using such assets. These institutions enjoy large 'governance budgets', that is they can afford to spend

more time than their smaller counterparts in reviewing and researching new opportunities. Trustees of pension schemes with smaller governance budgets do not enjoy this luxury.

Diversity assets cover a range of investments and, among others, include Real Estate, Infrastructure, and Private Equity. Some clients, who have the benefit of sizable governance budgets, have already made modest allocations to such assets through direct investment. However, many other clients with smaller governance budgets have encountered certain 'barriers to entry'.

Discussions with clients and our own research have identified the primary barriers to be:

- lack of immediate market capacity
- high transaction costs
- low and uncertain liquidity on market entry and exit
- concentration of manager risk
- limited diversification of individual assets and geographical dispersion of assets within the funds

For some, these barriers appear to have manifested themselves in a hiatus, with clients finding it difficult to make significant progress in implementing an investment strategy that includes diversity assets.

Many of you will already have experience of our pragmatic approach to product development which has your needs at its root. Core to this process is engaging with you to develop and deliver the most appropriate solutions which are clear, simple to understand and workable.

During 2006, we researched the investment choices and developed a range of funds to meet your needs for diversity assets for pension scheme pooled funds. We are now pleased to announce the launch of three new funds:

- (i) Global Real Estate Equity Index Fund
- (ii) Global Infrastructure Equity Index Fund
- (iii) Global Listed Private Equity Passive Fund

These funds are simple in construction, in that they invest in the shares of listed companies that themselves have invested the majority of their capital directly in the underlying assets. In other words, they access pre-existing exposure to these assets, albeit indirectly. We have chosen the indices that these funds utilise carefully to ensure their integrity.

The benefits of investing in the pooled index / passive funds is summarised below:

- global diversification
- simple to understand and transparent valuation
- low governance requirement
- higher liquidity than direct investment in underlying unquoted assets
- swift and low cost entry / exit
- low index / passive fund management fees

In conclusion, these funds address the challenges that clients face when considering investment alternatives in an efficient and cost effective manner; for some clients, they will be a good first step in the direction that they want to go and will neatly sit alongside their other investments, for others, they offer a very attractive investment choice in their own right.

### What are Listed Real Estate Companies?

Real estate companies are those which own, develop or dispose of income producing property assets. The listed real estate universe is largely comprised of real estate holding and development companies and Real Estate Investment Trusts (REITs). To qualify as a REIT and benefit from tax transparency and lower taxation, the Trust must distribute the bulk of its taxable income each year. Therefore, an investment in listed real estate companies provides investors with:

- indirect investment in income producing physical assets
- a reliable and steady income stream under different market conditions

### What are Listed Infrastructure Companies?

Infrastructure is broadly defined as companies, facilities and networks that provide essential services to society, enable the smooth functioning of the economy, have long duration and have high barriers to entry. Listed infrastructure companies generate the majority of their revenue from these assets.

- the 'essential' and 'semi-monopolistic' nature of infrastructure assets provide listed infrastructure companies with stable long term cash flows.

### What are Listed Private Equity Companies?

Private equity is broadly defined as the provision of medium to long term capital to potentially high growth unquoted companies in return for an equity stake. The listed private equity companies use their balance sheets and expertise to this effect. Therefore, investors in a listed private equity company enjoy the benefits of:

- the skill sets of private equity managers working for the company
- indirect exposure to enterprises within the unlisted equity universe

#### Note:

As each of these funds give exposure to only one particular sector of the global listed equity market, they will provide investment returns that could be different to those achievable from an investment in the broader global listed equity market; these returns may be significantly higher or lower.

## The Global Real Estate Equity Index Fund

### The Fund

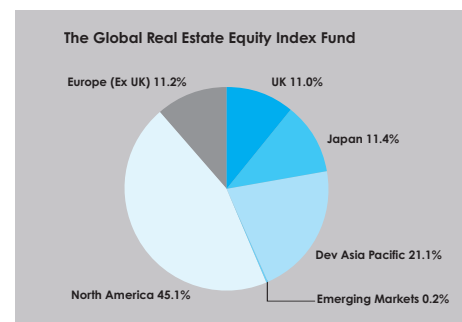
The Global Real Estate Equity Index Fund is benchmarked against the FTSE EPRA/NAREIT Global Real Estate Index which provides a representative global coverage of listed real estate companies and REITS. This Fund has the benefit of reducing the impact of the cyclical nature of property by investing in many countries around the world.

### The Index

The index is compiled by FTSE International in co-operation with the European Public Real Estate Association (EPRA) and the National Association of Real Estate Investment Trusts (NAREIT). EPRA is a common interest group, which aims to promote, develop and represent the European public real estate sector, while NAREIT is the trade association for REITs and publicly traded real estate companies with an interest in the US property and investment markets.

The Index is designed to represent the performance of listed real estate companies and REITs worldwide. The Index is market capitalisation weighted, liquidity and size screened, free float adjusted, and is reviewed annually in September. At the end of December 2006, there were 338 stocks in the Index with a total market cap of £463bn.

### Geographical Index Distribution



### Index Top 5 Holdings

| Constituent           | Country   | Weight % |
|-----------------------|-----------|----------|
| Westfield Group       | Australia | 3.2      |
| Mitsubishi Estate     | Japan     | 2.9      |
| Simon Property        | Japan     | 2.5      |
| Mitsui Fudosan        | USA       | 2.4      |
| Sun Hung Kai Property | Hong Kong | 2.4      |

Data as at 31 December 2006

## Global Infrastructure Equity Index Fund

### The Fund

The Global Infrastructure Equity Index Fund is benchmarked against the FTSE/Macquarie Global 100 Infrastructure Index which provides a representative global coverage of listed companies with infrastructure related activities.

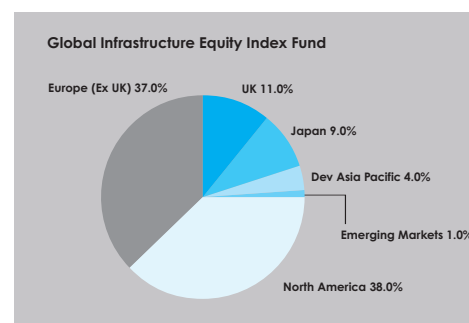
### The Index

The FTSE/Macquarie Global 100 Infrastructure Index is a partnership between FTSE International and Macquarie Bank. Macquarie Bank uses its expertise in Infrastructure to identify appropriate stocks for the Index and FTSE compiles the Index using their standard methodology.

The Index is market capitalisation weighted, free float adjusted, and is reviewed semi-annually in June and December. The number of constituents in the Index is fixed at 100. Additions to the Index need to be within the top 80 companies by market capitalisation, whilst deletions will have had to fall outside the top 120 companies. This rebalancing rule is aimed at reducing Index turnover.

At the end of December 2006, the 100 stocks had a total market cap of over £725bn.

### Geographical Index Distribution



### Index Top 5 Holdings

| Constituent | Country | Weight % |
|-------------|---------|----------|
| E.ON        | Germany | 6.3      |
| Suez        | France  | 4.6      |
| Endesa      | Spain   | 3.5      |
| ENEL        | Italy   | 3.3      |
| RWE         | Germany | 3.0      |

Data as at 31 December 2006

## Global Listed Private Equity Passive Fund

### The Fund

The Fund aims to provide diversified exposure to the listed private equity market around the world. The Fund characteristics will be broadly comparable with those of the LPX Composite Index. This Index captures the performance of a wide range of listed companies that specialise in private equity investment. The Index tends to have higher turnover than customary because of its semi-annual capping regime and the developing nature of the underlying market which can lead to a larger number of entrants. To reduce this turnover and the associated cost, the Fund is managed passively rather than as an Index fund. In other words, the Fund aims to provide exposure to a diversified range of companies in a cost effective manner rather than targeting a specific index return.

### Note:

The Global Listed Private Equity Passive Fund may also invest in less established small and medium-sized companies; these shares may be less liquid than those of more established companies. Often less established smaller and medium sized companies are still evolving, and while this may offer better growth potential than larger, more established companies, it may also make them more sensitive to changing market conditions and subject

### The Index

The LPX Composite Index is produced by LPX GmbH, a Swiss Company, and is a popular benchmark amongst Continental European investors. LPX undertakes extensive research on the globally listed private equity market with the aim of producing an investable Index with genuine revenue from private equity investment. There are currently some 300 companies in the universe from which the Index constituents are selected. The selection is primarily based on size and liquidity.

The Index, which is rebalanced semi-annually in June and December, is market capitalisation weighted with the stock weights being capped at 10%.

At the end of December 2006, the LPX Composite Index consisted of 60 listed companies with a total market capitalisation of £37bn.

to volatile price movements; this Fund may, therefore, be exposed to greater risk than is customarily associated with investing in the broader global equity market.

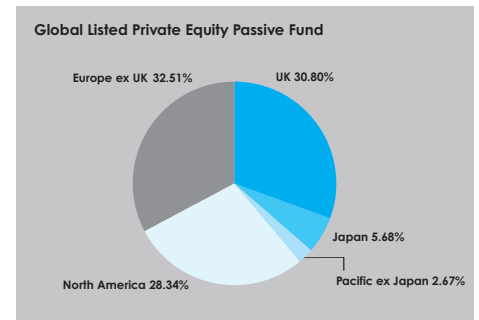
As the Global Listed Private Equity Passive Fund has investments in some small/medium size companies for which deep liquidity may not be assumed at all times, it is important that large investments/redemptions are handled with care to minimise transaction costs.

Management Limited provides investment and marketing services to PMC. Both companies are authorised and regulated by the Financial Services Authority.

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The FTSE EPRA/NAREIT Global Real Estate Index is calculated by FTSE International Limited ("FTSE™"). FTSE™ does not sponsor,

### Geographical Index Distribution



### Index Top 5 Holdings

| Constituent                 | Country | Weight % |
|-----------------------------|---------|----------|
| Eurazeo                     | France  | 10.1     |
| 3i Group                    | UK      | 10.0     |
| Wendel Investment           | France  | 9.8      |
| American Capital Strategies | USA     | 9.2      |
| KKR                         | UK      | 7.3      |

Data as at 31 December 2006

Therefore, policyholders are encouraged to consult Legal & General to plan such transactions.

The organisation LPX GmbH is smaller, younger and less known than other index providers, it is difficult to determine if they are more or less likely to cease to exist as a company or to stop publication of the Index. In the event that the Index ceases to be published, a comparable alternative would be sought.

## Important Information

Investment overseas involves exposure to currencies other than the sterling. Investors are warned that changes in the rate of exchange prevailing at any given time may cause the value of the proportion of the fund exposed to that currency to go down as well as up.

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