FOR PROFESSIONAL INVESTORS ONLY

The Opportunity and Challenges of Diversification; Dealing with the challenges of turbulent markets for DB and DC pensions

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Robert Hayes, BlackRock - Head of Strategic Advice Service

Emma Douglas, BlackRock - Director of Defined Contribution Pension Sales

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Introduction

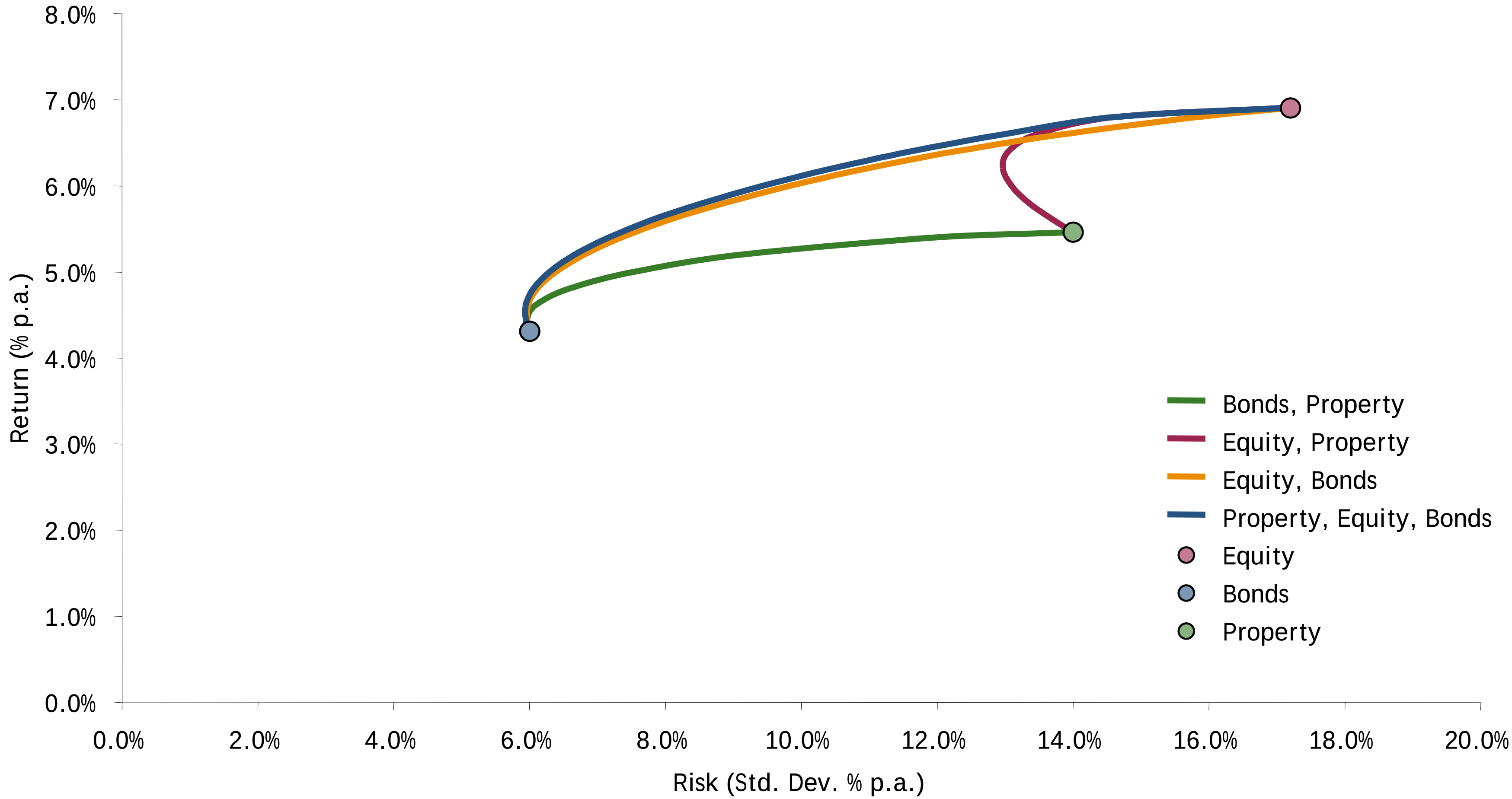
‘Events have not necessarily turned out as expected’

Why Diversify? – Common Sense Approach

Nobody wants all their eggs in one basket

Efficient Frontier - Benefits of Diversification

- **The greater the number of independent, diversified positions the better the risk/return trade-off**



Source: BlackRock

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How Can Risks Be Diversifed ?

‘In a market crisis only two things go up - blood pressure and correlation’

How? to diversify

In order to diversify something needs to be different!

Correlation is a measure of difference

Useful to remember the difference between correlation and causation

- Ice cream sales cause global warming ?

‘The past is a foreign country’

- not always a reliable guide to the future

Also need to allow for differences in measurement and ‘marking to market’

- ‘private equity is low risk because the value only changes once a year’

What? can give you diversification

Breadth	Depth
Credit – a return for lending capital	Credit – issuers, quality, structural position, collateral backing
Equity – a return for investing capital	Equity – company, sector, country, listed or private
‘Input to production’ – e.g. rent on property, infrastructure, commodities	‘Input to production’ – location, security, ’tenant’ quality, scarcity
Skill – the return from ‘out smarting’ others	Skill – long only, ‘shorts’, fundamental, quant
Liquidity – the return for giving up flexibility	
Insurance – a price for giving others protection	
Volatility – a return for taking on risk?	

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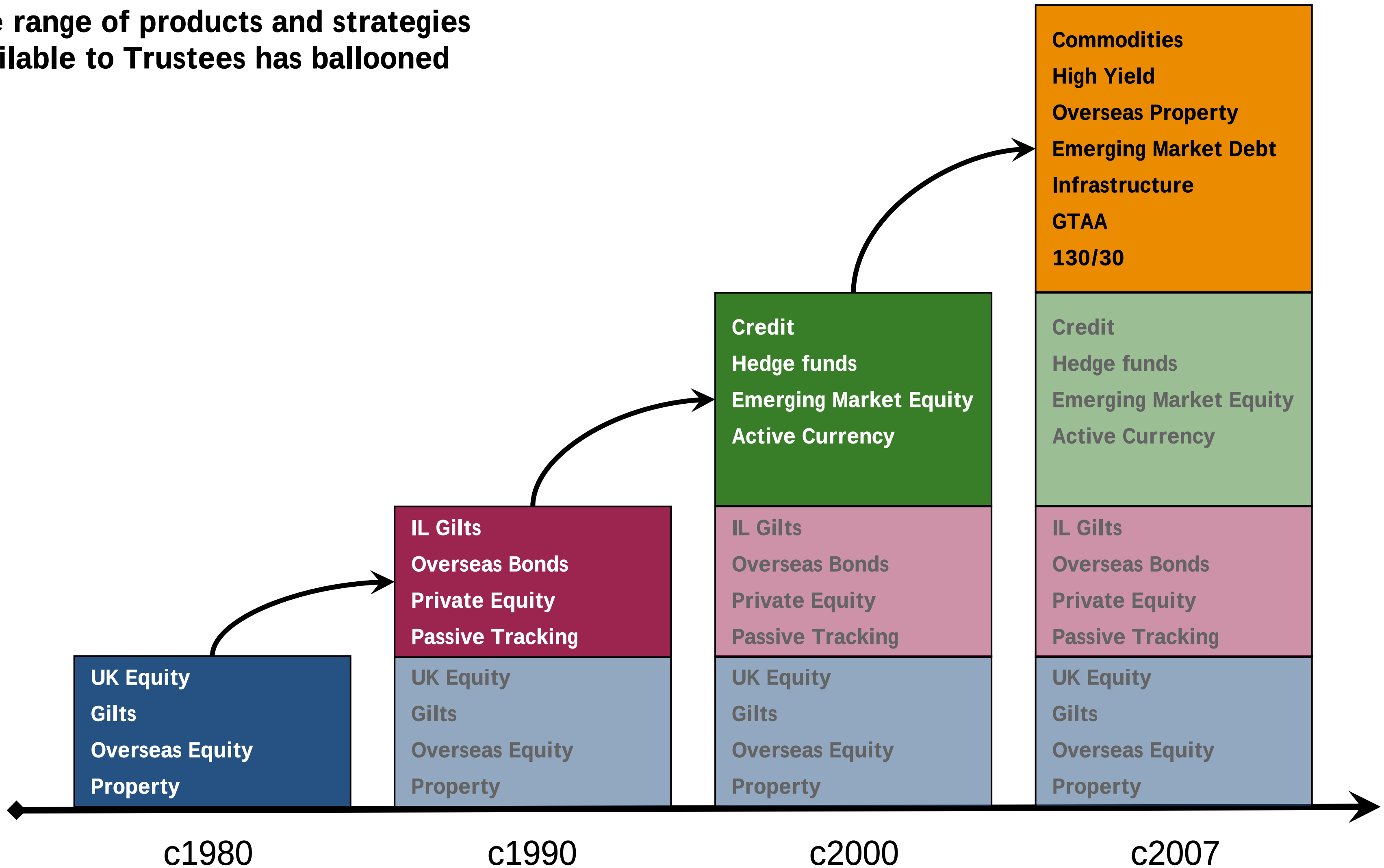
Diversification has got easier… but the decisions have got harder

The range of products and strategies available to Trustees has ballooned



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When to diversify – a question of timing

‘Markets can remain irrational longer than you can remain solvent’

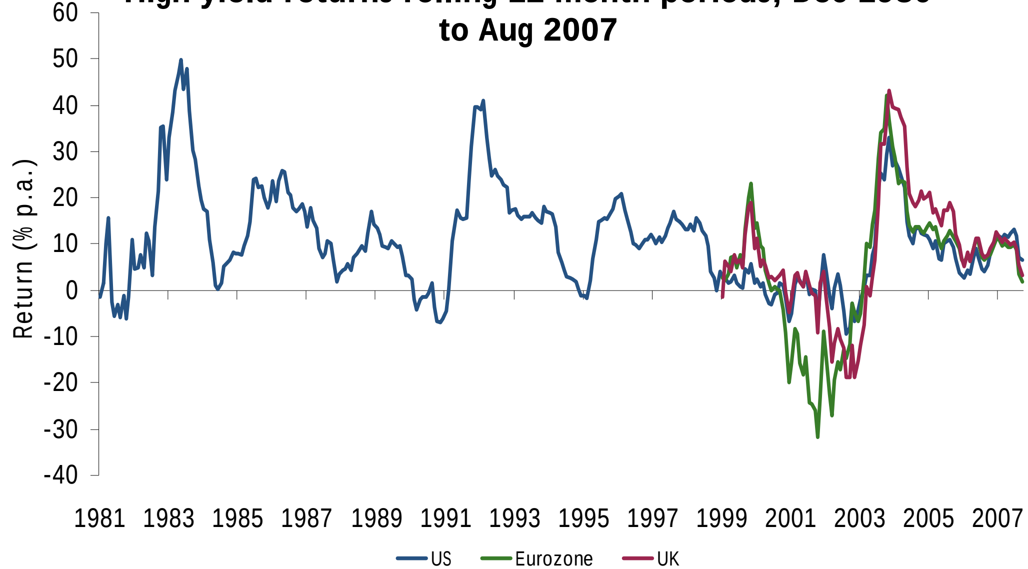
‘Sometimes, when they say you are ahead of your time, it's just a polite way of saying you have a real bad sense of timing’

When to diversify? - The need for flexibility

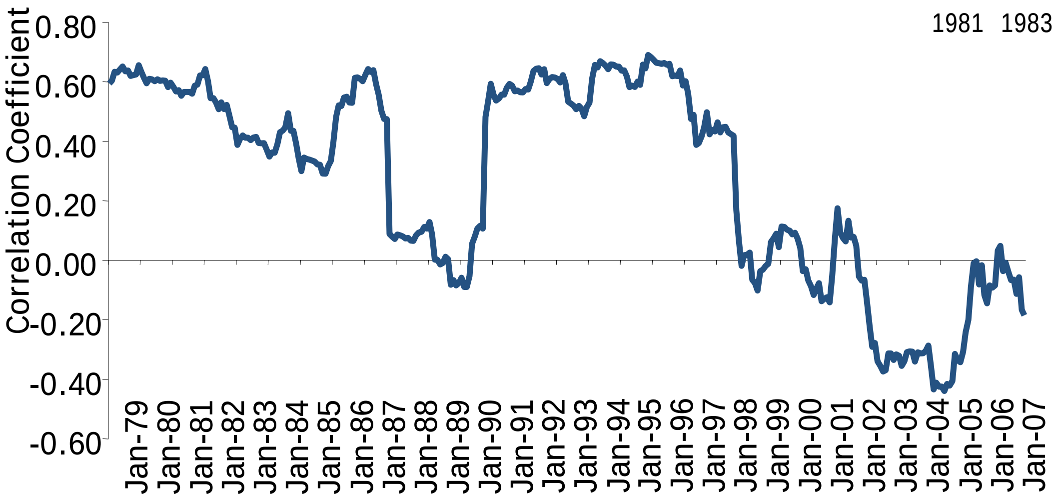
Two basic issues:

- Timing of entry (and exit) matter
- Relationships are not stable

High yield returns rolling 12 month periods, Dec 1980 to Aug 2007



UK Gilts vs. Equity Correlation



Source: FTSE, Thomson Financial - Datastream

Fund of Alternatives

‘Events have not necessarily turned out as expected’

Alternatives

Hedge Funds

Tactical Asset Allocation

Currency Overlay

Property

Private Equity

COMMODITIES

Bespoke bond strategies such as structured debt

Private Finance Initiatives

Liability Benchmarks

Why Consider a Portfolio of Alternatives?

Issues for Direct Investors	Benefits of a Portfolio Approach
High Governance	Simple access - “one stop shop”
Liquidity	Full skill set in alternatives
Static allocations	More scope for active asset allocation
Timing of entry & exit	Ability to implement tactical views
Risk Management	Low governance
Reporting	Cost efficient
Valuation (transparency and regularity of pricing)	Streamlined reporting
Taxation issues	Transparent fee structure

BlackRock Diversified Portfolio of Alternatives - Portfolio Structure

Core Assets	+	Rotational Assets
Fund of Hedge Funds	Opportunistic Allocations	Single Strategy Hedge Funds
Private Equity Fund of Funds		High Yield & Emerging Market Debt
Property		Commodities
Infrastructure		Overlay & Alpha Strategies / Cash

= **Diversified Portfolio of Alternatives**

Minimum 6 strategies

Flexible allocation policy

- Core and opportunistic rotational portfolio crucial
- Not high turnover strategy

Focus on:

- Diversification
- Combining alphas and betas
- Management of tail risk
- Payback periods

Managed Architecture

External Managers	vs	Internal Managers
2/3		1/3

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Summary

- Diversification is 'a good thing'
- More diversification is better
- Beware of 'black boxes'
- Think about the fundamentals
- Be aware of market and economic conditions
- There is much more you can do now

Moving on to DC

- **Let's define our terms**

- **Why the concept works for DC members and sponsors**

- **What are the issues?**
  - Communication
  - Cost
  - Can the funds deliver what they promise?

- **Creating a new standard for default options**

What's in a name?

Absolute Return

- Aims to avoid a negative return
- High proportion of lower risk assets i.e. bonds, cash
- No guarantee

Target Return

- Targets a fixed return – normally cash + 3-4% or RPI + 2%
- Multi-asset portfolio, actively managed asset allocation
- May be managed with an eye to capital preservation (more like Absolute Return)
- No guarantee

Diversified Growth

- Aims for equity-like returns with reduced (2/3rds) volatility
- Targets a higher return e.g. RPI + 5%
- Multi-asset portfolio, actively managed asset allocation but greater bias towards higher risk assets
- No guarantee

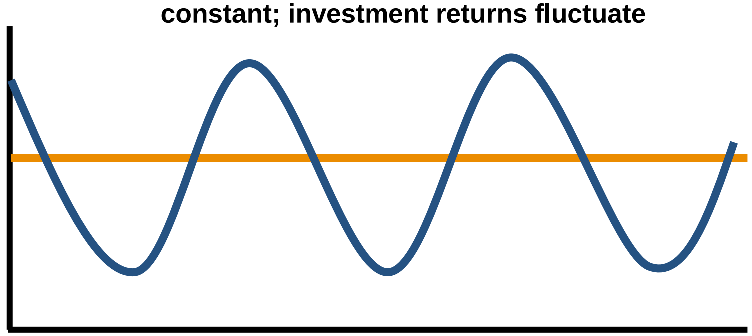
Possible default options?

Comparison of Traditional Balanced and Target Return investing

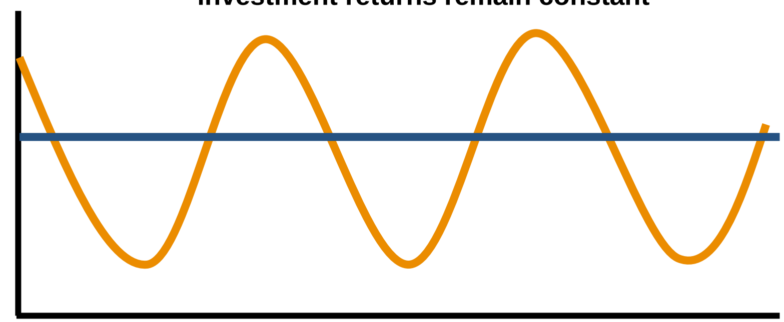
Traditional Balanced Approach Static Benchmark		
		Ranges
Equities	70	65 - 75
UK	40	35 - 45
US	10	8 - 12
Europe	10	8 - 12
Japan	10	8 - 12
Bonds	30	25 - 35
Cash	0	0 - 5

Target Return Approach	
	Ranges
Equities	0 - 75
Bonds	0 - 75
Alternatives	0 - 20
Cash	0 - 100

Traditional benchmark approach: asset allocation remains constant; investment returns fluctuate



Target Return approach: asset allocation fluctuates; investment returns remain constant



Asset Allocation   Investment Returns

Source: BlackRock

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Why Target Return / Absolute Return products meet member needs

Members…	Investment issue	Lifestyle	Absolute Return Product
Hate seeing their investments fall	Volatility	✗	✓
‘Building Society mentality’	Absolute Return	✗	✓
Want to know what they are going to get	Guarantee	✗	(✓)
Want ‘an expert to make the decisions’	Discretionary Management	✗	✓
Want the best possible returns but don’t want to take any risk	Free lunch!	✗	✗

What are the issues?

1. Communication to Members

- **How much do you need to say?**
- **The concept is simple BUT**
- **Execution can be complex!**

2. Costs

- **Managers need to be aware of the cost consequences of their decisions**
- **Using external funds gives access to 'best in class' but can be expensive**
- **May be worth paying extra for manager skill – but only in certain asset classes**

3. Does it work?

Target Return investing: Does it work?

GBP Composite data - 31 December 2003 to 31 March 2008

	Annualised Average Return (%)	Annualised Absolute Volatility (%)
FTSE All Share	**10.4%**	**9.1%**
BlackRock Target Return	**9.2%**	**4.3%**

	Best monthly return (%)	Worst monthly return (%)	# of negative months
FTSE All Share	4.3%	-8.7%	17/48
BlackRock Target Return	2.8%	-2.2%	12/48

Source: BlackRock, Mellon CAPS.
Performance figures are calculated gross of annual fees. Past performance is not a guide to future performance.

But what about the big DC problem?

How much do DC members need to save for a pension of 50% of final salary?

15%	Age 25
25%	Age 35
44%	Age 45

What are they saving?

11% Average (7% employer, 4% employee)

8% Personal Accounts

Age	Fund
Younger ages - up to 40	Diversified Growth
Over 40	Target Return
5 Years before retirement **OR**	Lifestyling
5 Years before retirement	Stay in Target Return if Income Drawdown

More certainty overall but increasing risk / reward in the early years

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