

JPM Cazenove Conference

Title Slide

“Building the New Economy: Asset Creation in a World of Zeroes”

Good Morning, and thank you for the opportunity to speak today.

The picture here represents the plight of the Ancient Mariner – surrounded by salt water, but dying of thirst. We are surrounded by abundant money, but our real economy is equally dehydrated. We have the wrong sort of liquidity...

There are two aspects to the subject that I would like to cover:

- First, why the global economy needs much more long-term investment and in particular, why we need to invest in new assets for our physical and digital infrastructure, rather than inflating the price of old assets; and
- Second, why long-term institutions, with long-term capital, large balance sheets and long-term investment horizons like L&G are well-placed to create and manage these assets.

I will illustrate with L&G's own examples. We now have approximately £7bn in direct investments, and a focus on four areas: housing, urban regeneration, clean energy and alternatives.

Some of these assets are held in the asset portfolio backing our annuity book, and given the global concerns about credit markets, I would also like to comment on this.

Slide 2: High Performing Businesses

To quickly introduce Legal & General... we may be best-known as an insurance company, but around two-thirds of our business by operating profit is in asset management:

- investment and asset management through LGIM

- asset management and creation as the major component of our L&G Retirement business, and
- the management and creation of assets as part of the management of our own balance sheet in L&G Capital.
- in aggregate these businesses made £571 million in H1, an increase of 30% over H1's £439m in 2014.

You see also on this slide the direct investments - £6.2bn at the half-year.

Slide 3: Predictable Cash Generation

Our business actively managed to generate predictable – and hence high-quality - operating cash and net cash. This is in part driven by management actions – you can see what we did in 2015 on the right - but also by growing the stock of business and assets. These can be either AuM or Premiums, but in both cases the stock of business or the back book drives the cash – hence its predictability.

Slide 4: Clear and focused strategy

Our strategy as a business is not driven by short-term cycles, but by long-term macro-trends which drive growth and operate across and through the economic cycle.

Ageing populations drive saving by individuals and longevity de-risking by companies...

Asset markets are increasingly global, and for a scale player like LGIM, with \$1trn in AuM, there is scope to expand from our current 0.7% global market share...

Governments are short of money: welfare reform is inevitable and this will drive private provision...

The world is becoming more digital - we have entered the second machine age, and we, at L&G, intend to benefit by being our own disruptor.

And most relevant to our theme today, the unresolved problems of the banking sector mean there is scope for long-term investors to enter the real asset space.

Slide 5: Forecasting is difficult

We are living in turbulent times. The latest bout of volatility may, or may not, have been triggered by the Fed rate rise, and indeed there is a debate to be had about whether Janet Yellen made a policy error.

However, markets since 2008 have placed far too much importance on short-term decisions and commentaries of central bankers... as the slide shows, their forecasting record is no better than anyone else's... Alan Greenspan summed it up when he said:

“We really can’t forecast all that well, and yet we pretend that we can, but we really can’t.”

Slide 6: Forecast misses underlie fiscal deficit

This is not just a problem for the Fed... here we see the extent of the UK forecast miss on the deficit... it is a worry that economic policy is built on such flimsy forecasts. This is why our strategy is to stand back from the daily noise and look for the real signals and at the long term trends... like demographic change and technological progress.

Slide 7: World of Zeroes

So looking at the longer-term global economy, without bold changes we are trending towards a world of zeroes: zero growth, zero rates both nominal and real, zero inflation – even though all major central banks have a 2% target – and zero real wage growth. We have to take action to prevent this from happening.

As the credit cycle goes through another revolution and China is exporting deflation, growth is slowing towards zero and trade is slowing. With interest rates already low and in some cases negative - \$7 trillion sovereign debt has

a negative yield – there are limited policy levers left to pull. Governments are indebted and so fiscal stimulus is difficult if not impossible. There is competitive currency devaluation. The lessons of history tell us this is a sign of failure.

Slide 8: QE not a policy for growth

QE is a rescue remedy, but not a policy for growth. The QE exercise after the 2008 credit crisis was the only viable option at the time. It prevented a recession becoming a depression... The central bankers did save the world. But the new money created did not find its way into the real economy... it was for Wall Street, not main Street: as the charts from the 2008-2014 period show, fast money replaced slow money.

The “monetary methadone” had other side-effects. It was a policy invented by the rich, for the rich – it inflated the price of assets, including traded equities and debt, and London housing. Inequality widened: QE created windfall gains for the few: but not growth for the many.

Slide 9: Three routes to zero

Here we see the downward pressures – the “routes to zero”. This year, sovereigns have entered negative yield territory – most recently Japan. The “Draghi put”, or QE in the Eurozone, is a threat to banks which have not restructured enough since the 2008 crisis, unlike their US counterparts.

Insufficient investment meant no improvement to productivity, or real wages. Cheap labour, windfall gains not just from low tax and borrowing costs, outsourcing manufacturing to China, and hollowing-out layers of middle management enabled companies to avoid making capital investments and boosted short term earnings.

Many corporates are long of cash, and many have taken equity investment off the table through share buybacks, which are now running at a record. The week before last for example saw 47 new buyback authorizations for a total of \$42bn, the largest programs came from Cisco (\$15.0bn), Time Warner

(\$5.0bn), Amazon (\$5.0bn), AIG (\$5.0bn), Marriott Int'l (\$1.5bn) and Kellogg (\$1.5bn).

The irony – perhaps the tragedy - is that after almost a decade of corporate windfalls, there has never been so much money available to invest, yet so little of it being put to productive use.

Markets and commentators are looking in the wrong direction: obsessively watching central banks for signs of interest rate movements, while the central bankers obsessively watch the markets watching them back.

Slide 10: Are we ready for the second machine age?

Fed-watching misses the point, which is that the economic growth that benefits all can only be delivered through investment in new assets: not by inflating the price of old assets.

A strategy for growth requires much more investment. We must invest in the new to meet the challenges of the second machine age – and to replicate the growth in real wages and living standards achieved by the first industrial revolution... one of the real challenges we have in the UK is that, unlike in California, the lack of an equity culture inhibits the growth of start-ups into grown-ups, mid-caps into large caps. Partly this is because of differential tax treatment of debt and equity, and partly it is because of a misplaced view that raising equity to invest in the future is somehow a sign of failure by management.

Slide 11: Are we ready for a Greyer world?

We need to recognise the reality of demographic change. For Legal & General, this is an opportunity: it will drive growth in Defined Contribution pension saving, and it will drive global pension de-risking, which we estimate to be a \$10trn market. I have never met a CFO who wanted more pension risk...

Slide 12: Are we ready for less intergenerational support?

For governments, it will be a challenge as the dependency ratio worsens and the tax base shrinks. This drives the debate about intergenerational unfairness, but it is also one of the drivers of fiscal challenge and ultimately of the shifting of pensions and welfare from the public sector to the private sector.

We need intergenerational collaboration, rather than resentment...and one way to do this is to ensure that more of the savings of the boomer generation are invested in assets which actually benefit their children and grandchildren.

Slide 13: Investment is required

We also need to rebalance the developed and emerging economies to correct a long-term structural imbalance where emerging markets have over-invested and under-consumed and the developed world has borrowed too much from them.

Economists nowadays rarely talk about multipliers, but they should. The old-fashioned Keynesian multiplier from government spending is not politically fashionable. And now the credit multiplier is no longer feeding through to broad-based economic growth either.

Slide 14: Building Digital cities

By contrast, the UK government estimates the multiplier effect from physical infrastructure investment is between 2.5 and 3 times: every pound invested generates three pounds worth of economic activity. And for digital infrastructure investment, the multiplier is more like ten times.

Fortunately, the importance of long-term institutional investment is becoming increasingly widely recognised – for example the EU's Capital Market Union plan being implemented by Jean-Claude Juncker and Commissioners Kattainen and Hill has this at its heart.

More however is needed: a new European “Marshall Plan” – Juncker and his colleagues have the right idea – but are currently stuck in first gear.

Slide 15: Long term direct investments by L&G

Meanwhile we are just “getting on with it”.

Here are some of the investments made by Legal & General as part of our ambition to invest £15bn in UK real assets... Many of these have long investment horizons – out to 50 years.

We call this “slow money”, and we are uniquely well-placed to provide it.

Economies need both long term investment in real assets and short-term credit.

Short-term credit is best provided by banks... but when longer-dated investment is required, banks have to engage in maturity and sometimes credit transformation – these are inherently unstable activities. So the long-term is best left to institutions which can match long term assets to long-term liabilities.

Risk-adjusted returns are typically higher for real assets as they capture the illiquidity premium. Historical rating agency data also tells us that the risk of default is lower than for corporate bonds of the same credit rating. And recovery is enhanced... For example, if we consider one of our student accommodation investments, if the Imperial College defaults at any time in the next fifty years, we own 600 studio apartments in central London.

And because of the multiplier effect, long term investment is arguably more economically and socially useful than short-term banking activity...real asset investment is not funding corporate leverage.

Slide 16: L&G Investing as Principal and Agent

These factors are also important for Legal & General.

With known long-term liabilities, we are a natural investor in matching long-term assets. We have a wide range of illiquid liabilities, for example through pensions and annuities, which determine the characteristics of the corresponding asset: in terms of duration – which can be out to fifty years – structure (for example index-linked), credit quality or covenant.

We can invest in economically and socially useful new assets and also derive a higher risk-adjusted return than is achievable from traded assets – by capturing the illiquidity premium.

And our model enables us to invest as a principal or an agent... from shareholder funds or surplus capital... from the annuity book, to which shareholders have exposure, and by developing asset classes for our investment management clients and indeed co-investing with them.

Slide 17: L&G Retirement

The L&G Retirement business, as you can see from the slide, has nine profit sources.

Real assets can be held as part of the portfolio that matches the back book of existing business, or can be assigned to potential new business. In the former case, capturing the illiquidity premium and the enhanced risk-adjusted returns allows us to improve the cash generation from the back book. In the latter case, these enhanced returns can improve pricing for customers.

The composition of the asset portfolio is not the only factor determining our appetite for pension de-risking business. This is a complex dynamic: the model has to be both risk-efficient and capital-efficient. But our asset strategy gives us a high degree of optionality: to enhance cash delivery from the back book, and to price to win for new business.

Slide 18: Strong Credit Portfolio

Naturally our asset portfolio – and here I am talking about the assets to which shareholders have an exposure - consists only in part of direct investments. £39bn of assets backing our annuity book are in traded bonds or credit instruments. Indeed, in light of recent concerns about spread-widening, especially in oil and gas, we recently published this breakdown of the component parts of this portfolio.

What this shows is that we have not been chasing yield by investing in weaker credits or overweighting sectors such as oil and gas or banks. We don't need to pursue those strategies given our ability to create and structure long-dated assets to match liabilities – in practice that means sterling real assets – and to capture illiquidity premium.

Slide 19: Sustained Disruption

Asset creation and investing in the new involves taking a disruptive view of what is required for a digital age. We work hard on being a disruptor.

UK housing is ripe for disruption – there is constrained supply, a rising market, and a shortage of innovation and competition. That is why we are working to expand the private rental sector through our £600m fund with PGGM, and planning to enter modular construction.

Energy is likewise changing fast: the technology is becoming cheaper – Moores' Law used to apply to processing: it now applies to everything – subsidies are being removed and the demand is there for assets that create energy that is clean, green and cheap.

And in health and wellbeing, the internet of things will create new opportunities for our sector: I am particularly interested in digital interventions for mental health conditions – these conditions are behind 40% of sickness claims.

Slide 20: Building businesses

We have to disrupt ourselves, by entering businesses that were not traditionally within our sector... and expanding geographically. Here you see four examples of our “J-Curve” businesses: expanding LGIM into the US, where we now have \$120bn of AuM, becoming a top ten UK housebuilder through CALA, positioning ourselves for expansion in workplace savings, with 2m auto-enrolled customers ahead of the increases in statutory contribution rates... and growing in commercial property.

Slide 21: Successful digital disruptor

Here you see how disruption has paid off... but there is more to do. LGIM’s AuM has grown fivefold in the last decade – there is much more headroom as we have only a small global market share: we are ranked 15th globally for fund management, but aspirations are for top five as the industry continues to consolidate and globalise over the next few years.

In retail protection, the disruption was to automate – 85% of all business is straight-through processing, giving us a unit cost and pricing advantage that underpins our 25% market share in the UK. Growing from 25% is difficult unless the market grows – welfare reform and reducing state provision will be the catalyst for that. It requires political courage, but financial pressure from bond markets can strengthen a government’s determination.

Slide 22: Culture

Culture is the glue that holds our business together.

We are strong believers in connecting what happens in the broader world to our strategy, being informed, thinking deeply, working in constructive collaboration and acting decisively. As well as being commercially successful, we want to be economically and socially useful.

Part of this – the insurance side of our business – is about managing risk for our customers. For our asset businesses: LGIM, LGR, and LGC, it is about delivering the investment that will help offset the drift towards the “world of zeroes”.

Our real assets and our investments in the new are the most visible manifestation of what we do. It is highly motivating for our people when they see a city being regenerated, and when we can actually see the savings of an older generation being put to work to build something for their successors.

Slide 23: Dividend

As this is an investor conference, let me finish by showing you what this has meant for investors. Since we made the link between net cash and dividend much more explicit following the financial crisis, and began to use cash, dps and RoE as the driving metric for our business, we have seen significant dividend progression...including 19% in the first half of this year...

As you can see, we believe that there is therefore a strong connection between addressing the “world of zeroes” and rewarding our shareholders.

Thank you very much, I'd now be delighted to take any questions.