Goldman Sachs Conference 2015   Mark Gregory

Slide 1 (front)
Good afternoon, thank you for inviting me today…

Success at Legal & General is about deep thought, accurate analysis, and high-quality execution.

Identifying broad, long-term macro-trends that drive our business… aligning our strategy to deliver value to customers and shareholders… and delivering well on a day-to-day basis.

Today I will cover that through the lens of productivity…a topic currently absorbing a lot of attention in the UK.

Slide2 (forward looking statements)
There will be some forward-looking statements… the usual disclaimers apply.

Slide 3 (productivity puzzle)
Productivity is a hot topic in the UK … a public policy conundrum if you like. It's a source of huge frustration that in an average week, it takes a British worker until Friday to do what equivalent workers in Germany and France will complete by the end of Thursday afternoon!

"Productivity" is as troublesome an issue for the centre-right in politics as "aspiration" is for the centre-left. It's also attracted the attention of some ex-Goldman Sachs luminaries… Gavyn Davies has written on the subject… and Jim O'Neill has been made a government minister in order to deliver productivity growth through infrastructure investment.

You can see why it's so important:

- The UK suffered badly during the recent recession with a bigger drop in productivity than the average OECD country
- And productivity has been slow to recover from this recession… despite an economic strategy that has created around 2 million new private-sector jobs … but too many of these are low-grade, low-paid and on short hours.
- UK output per hour is 16% below its pre-crisis run-rate: perhaps because our high-productivity financial sector has shrunk… or because less productive firms have hoarded labour, making people take shorter hours rather than firing them… or because it was cheaper to keep people in low paid jobs than to invest in innovation and automation.

- This is not unique, but it is worse for the UK.
- And it filters through to households… most people don't talk about productivity, but they know real wage growth has been broadly flat.

Slide 4 (cyclical issue?)
The debate continues over whether the UK's low productivity is cyclical … short-term … or more structural. The Bank of England examined all these hypotheses in a recent paper, without reaching a definitive conclusion.

But we do see over time that there has been a disconnect between pay and productivity…these are US figures on the left by the way… And given that the components of output include both the size of the workforce and its productivity… and that population growth globally is slowing… we see the potential for downward pressure on GDP growth.

This increases the risk of a further drift towards "secular stagnation" … the idea that advanced economies have entered a prolonged state of economic paralysis, requiring low interest rates into the indefinite future.

Slide 5 (demographic change)
Here you see the changing UK demographic out to 2037 and 2087 … by 2087 there is forecast to be a 134% growth in the over 65s compared to a growth in working age people of just 16%.

This is resulting in a dramatic shift in the old age dependency ratio … i.e. the number of people above retirement age as a percentage of the labour force.

The effect is biggest in Japan… where there will be 69 old people for every 100 of working age by 2035 – compared to 43 in 2010. And where ageing costs an estimated 0.6% of annual GDP growth… but it is still significant elsewhere in the world.

The most obvious solutions … working longer and increasing working age immigration ... won't be popular with everyone.

Slide 6 (5 trends core to productivity)
Moving closer to home … a few years ago, Legal & General identified the five macro-trends which most impact our business and now drive our strategy: ageing populations, globalised asset markets, welfare reform, digital lifestyles and bank retrenchment.

Each is crucial to productivity… For example:

- Ageing populations are less productive ... with higher dependency ratios and more government money required to meet increased pension and care costs.

- Welfare reform becomes more difficult if unemployment is replaced by low-productivity and low pay work … in the UK, topping-up low paid workers through tax credits is now costlier than old-fashioned joblessness.

- Digital presents perhaps the greatest opportunity for productivity improvement… But not every employee benefits from the technology "bounty", others remain unproductive. Moore's Law, which states that processor speeds, or overall processing power for computers will double every two years, appears unstoppable, so this problem will not go away.

- Long-dated infrastructure investment has become more difficult for banks… and inefficiencies persist as banks have been unable to lend for plant and machinery purchases, but also unwilling to foreclose on unproductive businesses so as to avoid crystallising bad debts. The result is often lower productivity.

- Globalisation of asset markets offers a positive here – it could make capital allocation more rational, and investment cheaper by driving down fees.

Slide 7 (clear focused strategy)

But each of these 5 macro drivers offers potential positives, for broader productivity and specifically for Legal & General.

They range from pension de-risking, defined contribution saving and lifetime mortgages driven by ageing populations, to…

…international expansion of asset management and the growth in protection as state benefits are withdrawn…

…to opportunities to reduce unit costs and increase competitiveness by using digital – over 80% of our life business is fully automated –

and investment opportunities as we fill white space in long-term investment where banks have pulled back.

We are doing all these things.

Slide 8 (individual retirement solutions)

We've responded to these challenges, which have coincided with the move in the UK to end compulsory annuitisation, by growing our capacity to attract defined contribution funds during the accumulation phase and by offering our ageing population new products for decumulation, including cash out retirement plans, fixed term annuities and through what have become nearly compulsory workplace pension arrangements. The UK's baby-boomers have benefitted from house price appreciation and now own £1.6trn of housing equity: an opportunity for our newly acquired lifetime mortgage proposition.

Slide 9 (pension de-risking)

But they, or rather their former employers, in the UK and globally, have $10trn of defined benefit pension liabilities. We all know there are companies which are, in effect, a pension fund with a business on the side and who want to de-risk.

In pension de-risking Legal & General's business model, which combines asset management and longevity expertise, has the unique capability across the whole de-risking journey, from passive investment, to Liability Driven Investment and active fixed income, through longevity insurance to bulk purchase annuities, by way of buy-in or buy-out.

Last year, our annuity transaction volumes were £8.5bn… and the opportunities remain very significant …

Slide 10 (unaffordable welfare)

Turning to welfare reform…

Angela Merkel is… as usual… right about the disproportionate cost of European welfare commitments… especially at a time of fiscal constraint for governments.

Just in the UK, George Osborne has committed to cutting welfare spending by £12bn annually. This captures the public mood… younger people are less willing to fund universal benefits. So the system invented seventy years ago by Sir William Beveridge needs to be revisited.

We already have a retirement pension system which works well as a public-private collaboration, and working-age welfare is moving – inevitably – in that direction.

Slide 11 (4 steps to Beveridge 2.0)
This is how this could be achieved in the UK…

…In essence, government can make more than half its targeted cuts to welfare spend by introducing less regressive reliefs for pension saving – which disproportionately favours the wealthy…

…delivering higher income replacement by phasing-out historic "contributory benefits" and replacing them with low-cost, mass market protection from commercial providers.

…while still cutting the cost of National Insurance payments for low-paid employees and small businesses…

Slide 12 (welfare reforms)
This replicates for working-age benefits what we already have in pensions…government, employers, and employees are all beneficiaries… and the distribution mechanisms are already in place because they have been created for pensions auto-enrolment.

This may, or may not, be the sort of scheme ultimately adopted… but there is clearly a drive for change, as illustrated by the quote shown on this slide from the new Head of the Downing Street Policy Unit.

Legal & General is well positioned, having thought hard about this issue, and as one of the largest private sector providers of auto-enrolled pensions.

Slide 13 (investment spending)
Investment is another productivity factor.

Our recovery generated jobs, but investment fell, both for private- and public-sector reasons: in the private sector ... risk-aversion and the availability of cheap labour… and in the public sector the prioritisation of current over capital expenditure.

According to the UK government's National Infrastructure Plan, infrastructure investment has an economic multiplier effect of 2.8 times… a fact not lost on the EU, where Jean-Claude Juncker's growth plans recognise the importance of institutional investment including through a better Capital Markets Union.

Long-term institutions, with Legal & General at the forefront, are in a strong position to help.

Slide 14 (long term direct investments)

We plan to invest directly up to £15bn in UK infrastructure… including housing… and have already invested over £6bn as principal.

L&G is well-structured to deliver this: LGC… L&G Capital… is able to invest the surplus assets in our balance sheet… LGR… L&G Retirement… can use appropriate assets to match known and illiquid annuity liabilities… and LGIM has the ability to manage the assets we manufacture and to turn these into institutional asset classes that work for LGIM's broader client-base.

Student accommodation, where we have done £1.25bn, is a good example, as is urban regeneration, and private rental or 'build to let' is likely to follow.

Slide 15 (media city)

This is one example – Media City Salford, which is headquarters for the BBC and ITV in Manchester. This fits with our broader picture… commercial property alongside regeneration, build to sell, build to rent and affordable housing.

Slide 16 (energy opportunities)

Another example is solar energy. We already have some solar assets, and believe that advances in 'capture and storage' give solar the potential for real growth.

It's key for us that infrastructure investments have to be economically sound on a stand-alone basis. Public infrastructure has a history of political projects… the UK's £25bn Hinkley nuclear power station project is one… but the economics is what matters here…, the ability of solar to generate electricity that is cheap as well as clean.

Slide 17 (digitalisation)

Digital is an important productivity driver in the broader economy, and an important strategic component of our business at Legal & General.

As the DESI figures show… Europe still has a way to go on connectivity… and as the McKinsey chart shows, digital is having a profound impact on businesses. Digital presents investment opportunities… again the economic multiplier effect is strong… and we are in the process of making significant digital changes in our business.

For example in retail protection, we now have over 80% straight through processing, which drives down unit costs and enables us to compete effectively on price without eroding margins… while in workplace pensions we are successfully rolling-out a digital self-service for SMEs.

Slide 18 (bounty & spread)
The broader issue of productivity and digital is interesting… digital drives growth… think of the effect of the browser on the US economy in the Clinton era. The most digital firms are the most productive… WhatsApp sold for over $300m per employee.

This is the digital bounty… but WhatsApp had only 55 employees, so the spread is very small. This contributes to the disconnect between productivity and median family income.

The broader issue here is the risk of “technological unemployment” – the leisure ... as Keynes pointed out ... is much longed-for but less pleasant in reality … it doesn’t pay well! The narrower issue for financial services companies is that we are all tech companies now. Big banks, and insurers, have legacy systems which are expensive to upgrade and even to maintain.

We are no exception here: it has to be closely managed.

Slide 19 (achievements to date)
Identifying trends is one thing … but it's our management actions and execution which ensure that we make the most of those macro-trends, in a way that is consistently rewarding for our shareholders.

Here you see some strong double-digit growth in assets from pension saving, de-risking and decumulation … asset growth driven by an ageing population.

Likewise, strong growth in international assets in LGIM as we ride the trend of global asset homogenisation: and we have many international mandates in our “hopper”.

Welfare reform is driving Protection, and the risk-sharing model for pensions is working well… John Lewis was another significant win for L&G in 2015. This segment will grow as the law requires the minimum contribution rates to rise from 2% today to 8% by 2018 ... Our UK DC pensions business is already at £40bn in assets.

Digital continues to transform business, with our platform assets rising 16% and continued process improvements driving down unit costs in insurance…

And as I have mentioned, we've now made £6.3bn of direct investments in the UK, against a target of £15bn… we are one of the biggest property owners in Manchester.

Slide 20 (FY14)
Focusing on the financial results in 2014: annuity assets, LGIM assets and protection gross written premiums, were up 28%, 16% and 5% respectively…

Growth in stock drives growth in net cash and operational cash, both over £1.1bn…and growth in operating profit and profit before tax, both over £1.2bn.

The nature of our business and the focus of our management execution means operational cash is highly predictable for large parts of the business.

Return on equity was 16.9%, and our full year dividend 11.25p – up 21% and 1.65 times covered by net cash.

2014 was not a blip, but another year of consistent delivery… by way of comparison four years previously in 2010, net cash was £760m versus last year's £1.1bn. Dividend was 4.75p per share versus today’s 11.25p.

Slide 21 (Q1 2014)
These were our Q1 numbers for 2015… again on trend … with Operational cash up 11% to £330m, Net cash up 8% at £326m – in the whole of 2008 Net cash was £320m. Growth in assets – LGIM assets up 17% to £737bn and annuity assets up 19% to nearly £46bn.

Slide 22 (key metrics)
Some people – particularly on the sell-side - enjoy the historical complexity of the life insurance sector. We don’t. The four metrics here are straightforward ones, easily usable by generalist investors.

Progress used to be envisaged as a series of profit and cash J-curves, with business written at a loss in return for future profits expressed through Embedded Value accounting or MCEV.

Many non-specialist investors didn't understand it – why should they? And it potentially results in big swings from assumption changes. Moreover, the J-curves have a habit of moving away from you… the tipping-point is so often "not quite yet".

The more useful approach is to see progress in the same way that any other company might, using metrics common in other industries.

Thus: a sustained upward progression of Net cash generation … EPS … RoE and Dividend.

Slide 23 (focused businesses)

Looking at our business in the way shown is part of becoming a simpler business in a more complex world.

And alongside greater strategic clarity, we are creating a higher level of organisational clarity … de-cluttering the business if you like. We think of it in these terms.

First, we have a series of asset businesses:

- LGIM, Legal & General Investment Management, with over $1 trillion of assets, and generating £262m of net cash and £336m of operating profit in 2014.

- LGR, Legal & General Retirement, with £44bn of assets, £343m of Net cash and £428m of Operating Profit last year.

- LGC, Legal & General Capital, which runs the surplus assets in our principal balance sheet, and generated £162m of Net cash and £203m of Operating Profit.

The asset businesses work closely together, for example on pension de-risking, urban regeneration, housing and property.

These businesses are being internationalised: through LGIM's expansion in the US and Asia, and also in time through international pension buyout or buy-in business.

Collectively, this is about asset creation and asset management – including new asset classes like student accommodation, distribution warehouses and build to rent accommodation. And beneath those businesses we have our holdings in CALA Homes, our UK top-ten housebuilder and Pemberton, which provides SME finance.

Second, on the right of this side, we have insurance - including a "clean" and now united UK insurance division covering:

- Retail Protection, with premiums of over £1bn, up 7% year-on-year
- Group Protection, with premiums of over £350m, up 4.5% year-on-year
- General Insurance, with premiums of £377m, up 1% year-on-year

and

- LGA, Legal & General America, which generated $76m of net cash last year, up 10% on 2013.

The third box, bottom right, has our Savings businesses. Total savings assets are £113bn, with operating profit of £105m and net cash of £113m. These broadly fall into two categories: Mature Savings and Digital Savings.

- Mature savings assets were £36bn, and include our With-profits business, which is now closed to new business and in long-term run-off.

- Digital Savings which consists of Cofunds, the UK's largest funds platform, and our SIPP business, Suffolk Life.

Slide 24 (de-cluttering the business)

Strategic purchases and investments in the last few years have included: housebuilders CALA and then Banner Homes; Lucida, where we bought a closed stock of bulk annuity business; Cofunds where we bought out other shareholders; GIA in the US DC asset management segment and NewLife, the UK lifetime mortgage provider.

The "de-cluttering" process has also involved a programme of exits and disposals where businesses are non-core, uneconomic, sub-scale, where the markets have moved on.

That includes: our “historical” business in Germany; our estate agency businesses which were non-core; our international retail investment bond business; our venture capital business, LGV. And we have closed our With-Profits fund to new business.

More disposals of non-core businesses are in progress.

Cost discipline has long been an important part of our daily work at Legal & General. Tight control of costs – for example unit costs of protection products – enables us to compete on price effectively and profitably.

We have been at the forefront of reducing costs for customers – for example through the charge cap in Workplace pensions, currently 75bps, but which we hope the new Pensions Minister Ros Altmann will reduce to 50bps.

Slide 25 (further progress)

Our cash has high levels of quality and predictability… here is the Operational cash guidance for 2015 for all our businesses except LGIM and General Insurance. Historically we have been good at that predictability being just £2m out on last year’s equivalent guidance of £765m.
… we are on track … our 2015 management actions are being delivered… There will be no relaxing of the pace in the second half of the year.

Slide 26 (progressing the strategy)

Looking further forward, we are ambitious. This slide sets a high bar for the management team and shows ambitious growth targets from here through to 2019: doubling of US assets in investment management, growing insurance in the UK at twice GDP, growing our DC position to market leadership as it gradually replaces DB saving, reducing operating costs in nominal as well as real terms.

Legal & General is a company which has delivered on its last mid-term plan – and delivered market-leading returns for investors as it did so. My colleagues and I are flattered that our approach to cash and growth is now becoming an industry norm.

We have a plan also for the next five years… As Nigel, our CEO likes to say we see ourselves as being on just the third floor of a building … we were on the ground floor … but we plan to move to the top of a high-rise.

Slide 27 (dividend)

Finally, the result of deep thinking and analysis, focus on key metrics, and quality execution… a progressive dividend.

I'm now very happy to take questions.