Goldman Sachs Conference 2014

Slide 1: Title

Good Morning…..The purpose of my presentation is to highlight key macro and demographic trends and their impact on society, our industry and L&G.

Slide 2: Forward looking Statements

Slide 3: From Monetary Methadone to Naked Economics 1.01 and Beveridge 2.0

Two years ago at this conference I took as my theme the "Triangle of Austerity" – economic, political and regulatory, that had been created following the credit crisis. Financial services have subsequently experienced consequential economic, political and regulatory repercussions.

Last year I talked about "Monetary Methadone". This was a shorthand way of arguing that the post-crisis experiment of ultra-low rates and QE had saved the life of the global economy, but had left the patient hooked on the drug of cheap and fast money, and suffering side effects.

This year I want to introduce the third concept: "naked economics". This is a little like the slow food movement or the "naked chef", who actually remains fully clothed but strips the food down to basic, high-quality ingredients. Our economic ingredients since the crisis have become too complex and too focused on the monetary policy side, with central bankers like Greenspan, Bernanke, Yelland, Carney and Draghi becoming rock stars, and everybody following market movements rather than impacts in the broader economy. Think how little attention the US and UK trade deficit received compared with Draghi's pronouncements on the Eurozone.

This diverts attention from the real economy and limits policy responses to important trends: ageing populations, burgeoning technology, a need for welfare reform and for investment in a massively improved physical and digital infrastructure.

Non-monetary aspects of economics and traditional components of growth like government spending, trade, and the balance between investment and consumption have been downplayed. This has delivered growth in the US and the UK, but not all growth is equal, and it is not a route for delivering high-quality, sustained growth.

What we need – and what we are seeing as we emerge from the recession – is a return to more balanced growth which:
- reforms pensions to reflect our ageing and under-saved population,
- facilitates investment to build more houses, and infrastructure
- reforms welfare and shares risk better through a new-model Beveridge settlement that replaces the one that is now seventy years old,
- and returns government deficits to manageable levels.

As Angela Merkel pointed out, it is unsustainable for Europe to fund 50% of global welfare spending from 25% of global GDP.

Slide 4: Our Businesses
Before we get into this, I should just remind you about Legal & General. We are an insurance, savings and investment management company with five business divisions:

- LGAS, which contributed £444m to operating profit last year
- LGR, which provides retirement solutions, contributing £310m
- LGIM, our investment management business, £304m
- LGC which invests our principal balance sheet, £179m
- And LGA a large US term life company, contributing £92m.

Making a total of £1.3bn in divisional operating profit in 2013.

Slide 5: Strategic and Financial Evolution
We are a company that has changed significantly since 2008. We focused initially on cash, then on cash plus organic growth, then on cash plus organic growth plus M&A, and over the last year we have made six acquisitions.

We are driven by a clear strategy, based on five macro-trends which play to our strengths: ageing populations, increasingly homogenous global asset markets, bank retrenchment, digital lifestyles and the emergence of new social welfare models. These create opportunities for us to expand: in pensions and longevity de-risking, international asset management, private welfare through risk sharing and direct investments.

Slide 6: Legal & General's Financial Performance has been strong
We have performed well as a consequence, strong, predictable and high quality cash has enabled us to pursue a progressive dividend policy... at this year's prelims we gave guidance that we would be moving from last year's cash cover of 1.8 times towards 1.5 times by 2015.

Slide 7: Consensus Dividend Expectations
The previous slide showed you analyst consensus for dividends...this slide shows how consensus forecasts for each year seem to move up consistently as the year in question approaches... and is a phenomenon that repeats itself.

The other point on this slide is the relative premium in prospective dividend yields. This is quite marked relative to the index, which I suspect is a sector phenomenon, born out of long years of investor frustration with the shocks from the insurance sector... dividend cuts, rights issues, including L&G.

Slide 8: UK is in a pre-election boom
Having had the commercial break, I will get back to the broader picture.

Our LGIM economists are forecasting 3% real growth for the UK this year. But this looks like a typical pre-election boom, driven by consumption and rising house prices, with investment lagging and sticky deficits for both the public finances and the balance of trade. In naked economics terms, we are missing ingredients.

The stated policy for interest rates in the UK is "lower for longer" and Mark Carney's forward guidance with its 7% unemployment trigger point has been quietly shelved.

This is perhaps unsurprising given we have an election next year... but I am increasingly coming round to supporting Charlie Bean's view that raising rates by baby steps ahead of an election may be wiser than waiting and delivering a greater shock next year.

Slide 9: Eurozone – Muddling Through

The Eurozone presents an interesting contrast. Here we are still in the depths of the addiction to monetary methadone... which may be getting worse. Draghi has signalled he will increase the dose; he will still "do whatever it takes".

Slide 10: US – recovering from the storm

The US by contrast is some way ahead – if we factor out the seasonal disruptions, as we should. For the UK, this may be a glimpse of the future, with core inflation starting to rise, a tightening labour market and likely further upward movement in Treasury yields.

Slide 11: China forecasting bias

Turning to the global outlook, and China in particular, it is worth noting how we in the West tend to have an optimism bias for ourselves... and a compensating bias towards the pessimistic for China. We consistently undershoot...this slide shows Chinese forecasts by Asian economists.

Slide 12: World – Passing mid-cycle point

So the first noteworthy point here is about China. The economy may be slowing, but it has acquired critical mass and will still contribute more to world growth than it did before the financial crisis. In the West, we tend to look at China through strange spectacles when it comes to forecasting... I remain of the optimistic view that the Chinese economy will grow into its over-invested infrastructure. Its economy will overtake the US in terms of size, and the Remnimbi will continue on a journey to international reserve currency status.

The second point is that globalisation has probably achieved as much as it can for the moment, certainly pending the conclusion of new major trade talks. This means that the trade-off between growth and inflation is likely to be less favourable than over the last decade.

Slide 13: Private Domestic credit as % of GDP in here
The cause of the crash was very clear. This chart, from Reinhart and Rogoff, paints a sobering picture of the build-up of private domestic credit over fifty years, particularly in the developed world, and the dramatic acceleration from 1995.

Slide 14: Fast and Slow Money: what happened
Once the crash happened, nobody had a better idea than ultra-loose monetary policy and QE.

So I'd like to move now to the aftermath of QE and its side effects.

QE in one sense doesn't really have an end. The £375bn of money created in the UK, which now effectively sits on the Bank of England balance sheet, does not need to be repaid. There doesn't have to be any reversal, or, short of rampant inflation, any quantitative tightening. In effect the government has issued perpetual zero-coupon bonds with no currency debasement.... real alchemy at work.

The slide has an interesting pair of charts for naked economists. Here you see, on the left, the creation of narrow money through QE... and on the right, the destruction of broad money. So if indebtedness was the cause of the crisis, this was not going to be the solution, especially as narrow money works less hard in the economy than the broad variety. The result, as we know now, was two-speed money – fast and slow – with the fast money chasing asset bubbles on Wall Street, and the slow money doing very little for Main Street.

Slide 15: Fast and Slow Money: Winners and Losers

The result was a new set of winners and losers. These lists, help explain some of the economic and political tensions we are seeing today…QE favoured assets over incomes, richer people over poorer people, hence older people over younger people, and of course it worked for countries who can control their monetary policy, but not for those in monetary unions.

It is no surprise that the politics of envy has re-surfaced... and that a number of clever writers like Stiglitz, Chang and Piketty have re-discovered inequality.

Slide 16: QE: A Policy for the rich, by the rich

Here you see some of the data behind that statement...on the left, the FTSE 100 and London house prices tracking the UK QE volumes...and on the right the correlation between the S&P and the Fed's balance sheet...

Slide 17: Rich are Getting Richer

...And here you see the widening of the gap in income increases in the US since 1980...note the gap opening up since 1995 and the effect of QE in reinforcing that since 2008.

This takes us into Thomas Piketty's recent book. One can argue about the data and about what is meant by inequality – is this about the division between the top 50% and the bottom 50%... the top 1% versus the other 99%...or even the top 0.1% versus the rest. And of course whether you do this within a country, across a continent or globally, including emerging markets, makes a big difference.

Does the politics of envy mean we resent the guy across the street who earns a bit more than us? What about Roger Federer who earns a fortune because he is the best tennis player of all time? What about someone who had great business ideas and delivered them, Steve Jobs?

These are interesting questions, but cut the data however you like, the gaps are widening, and this is part of a longer-term trend which causes political concerns: it is part of the general negative sentiment towards "the elite" which was a feature of the recent EU elections.

Slide 18: Why Piketty is wrong

Piketty's thesis is however not just a complaint about widening income disparity. He asserts that capital is growing versus income, and will continue to do so until most wealth is inherited wealth – here is the key graph from his book.

But the growth of capital is no bad thing... capital is what drives growth... new businesses like Facebook and Google create growth as well as creating capital...and that when capital is being deployed for philanthropic purposes, as through the Bill and Melinda Gates Foundation, the effects can be far more productive than any government intervention.

Piketty is really just re-inventing Marx and Engels. He is wrong simply because he fails to appreciate that more capital is, per se, a good thing. But capital has to be put to work.

Slide 19: Private Capital/National Income

This is a crucial point. If you look at it on a country basis, you can see that where capital becomes too important versus income, where it is too disconnected from working in the real economy to deliver productivity, like in the Japanese property bubble from 1985 to 1990 in this chart, the US from 2000 to 2005, a slump follows.

What matters as much to me as widening inequality within a cohort or generation, are the issues of fairness between savers versus those who borrow to consume... and of intergenerational fairness – consuming now and leaving our children to pick up the bill.

Slide 20: Real Yields to maturity on UK Index-linked Gilts

This graph tells part of that story, with low or negative real yields for those saving in low-risk assets, but the other half of the story is the consumption fuelled in the UK by the £28bn in interest savings for those on variable rate mortgages... a key component of UK growth during the recession. Spending today, creates debt tomorrow.

Slide 21: Economic Austerity leads to political unemployment

QE only works if you control your own monetary policy: if you have your own currency. That means for the US, the UK, and perhaps also for Japan. The effect is patchy inside a monetary union... This political casualty list shows how: with almost the unique exception of Angela Merkel, European governments have paid the price of widening inequality. The surprise is that, with youth unemployment so high in peripheral Southern EU member states, it hasn't been worse.

Slide 22: UK Suffers from a Lack of Investment

Back to naked economics... we were all taught that investment is as vital a component of aggregate demand as consumption... but in the UK investment has fallen, back down to levels more akin to the 1950's. This is despite the low cost of borrowing. Investment lags consumption in a recovery, and there is some pick up, but it remains far too low given the liquidity that is available in the system...a question again of fast money versus slow money.

Slide 23: Capital Investment outsourced to China

Here is the other side of the coin –a neat pair of graphs which show financial asset prices rising in line with QE in the West... and on the right, investment in China rising as a share of GDP while Chinese equities went down.

This in naked economics terms is a clear imbalance in "I".

Slide 24: Annual US Share Buyback activity

Western companies – even technology companies like Apple - sit on large cash balances which earn them very little, and which they can't decide how to deploy. One consequence is the temptation to generate illusory as opposed to real economic value through share buybacks – here you see the rise in activity in the US.

Companies with innovative intellectual property are also often just as innovative in financial engineering and tax management.

The share buyback does not generate real economic value... although of course it does generate personal financial wealth for anyone remunerated on a per-share metric.

This seems fundamentally wrong, and as a big institutional shareholder – around 4% of everything in the FTSE - we are advising investee companies that our clear preference is to invest in real growth and value rather than buying back shares.

Slide 25: Migrants account for a large share of net job creation
One of the mysteries of the recession at least in the UK and US was that unemployment did not soar. One reason was the proliferation of "40 percent", part-time or low-paid jobs. Hiring people on low wages was easier than investing.

This has knock-on effects. I have been told this is a controversial slide. But it is simply a statistical fact that since 2007, and until very recently, new jobs in the UK have been filled by people born overseas – some British nationals, some not. Where it becomes controversial is in the hands of politicians... part of the rationale for the rise in anti-EU parties in the UK and Europe more broadly.

Slide 26: Forecasting is difficult...
One effect of the monetary experiment has been to raise the status of central bankers. I have huge respect for them... some of my best friends are central bankers... but they do not have a monopoly on wisdom, as the quotes from Bernanke and Greenspan show. Mervyn King's incidentally show a highly

optimistic outlook for English cricket, too. He was right that year, but mainly wrong since.

Slide 27: Forecast misses underline a stubborn deficit
Forecasting the UK's budget deficit has proved particularly tricky, as the size of the shaded undershoot shows.

What the facts are telling us is that the deficit is more stubborn than anybody expected. George Osborne has done a great job in convincing bond markets that the austerity programme would get the national accounts back under control.

It is politically quite tough making speeches about austerity... but even tougher actually delivering it. In the UK the government routinely spends £100bn per year more than we take in taxation... with a GDP of £1.6 trillion and a tax take of around £600m, it requires a considerable lift in GDP growth to start to make a dent in the deficit. Assuming a stable rate of taxation, economic growth at anything less than 5% nominal does not do very much to replenish the state's coffers.

Slide 28: Falling UK dependency ratios...
This is partly due to demographics, with an ageing population and falling dependency ratios that make demands on welfare...this is not a uniquely UK phenomenon – but the changing shape of the population pyramid creates new demands on governments and individual pension savings.

Slide 29: Long term demographic trends...
This is replicated across almost every continent – Africa is an exception – and incidentally the greying world is very good for Legal & General...

Slide 30: A growing intergenerational burden
In naked economics terms, a stubborn deficit indicates a problem with the "G", or government expenditure component of aggregate demand.

This was exacerbated during the recessionary period, as growth disappeared and the "automatic stabilisers" kept government spending high. You can see this on the graph at the top left.

High public spending is an issue not just for the current generation. We are the consumers... our children and grandchildren will be picking up the bill.

The graph at the bottom left shows another aspect of this, student debt. In the US, this now exceeds credit card debt outstandings... the UK is now £50bn, US $1trillion The impact will be felt by younger people if they repay... and by government or the taxpayer if they don't...

The rise in house prices is shown in the top right, the expansion of the Green Belt in the bottom right, showing the determination of my generation not to let others build new houses near them. For the younger generation, or at least those who don't have "the bank of Mum and Dad", this will drive greater private leverage...

Slide 31: Shifting leverage back to the private sector

This is another matching pair of graphs to illustrate the point – this time from the UK's Office of Budget Responsibility. What you see here is the projected return of leverage to the private sector and individuals as the government (hopefully) gets its deficit under control.

So the roller-coaster continues – think back to the graphs that illustrated indebtedness in the run-up to the crisis – precisely because we are still seeing a lack of focus on those aspects of naked economics which aren't part of the monetary experiment.

Slide 32: The UK will find increasing borrowing from abroad more difficult

Naked economists of the old school also paid close attention to trade figures. And in the UK at present we have a stubborn goods deficit of £110bn around

6% of GDP – in another era this would have been a crisis, but which now hardly gets a mention.

We export services well with an improved trade surplus of £80bn , but not goods, and we have a poor export infrastructure in China, India, Africa and South America.

This deficit matters because it impacts borrowing from overseas...further evidence for the argument that we need to move toward a gradual return to more normalised interest rates.

Slide 33: Q1 Highlights

Bringing this back to Legal & General, we see here how, driven by our five macro-trends and by strong execution, we delivered strong Q1 results across all our businesses, and a rise in net cash and operational cash of 21% and 6% respectively...

Slide 34: LGIM

This includes LGIM, growing internationally, driven by the increasingly homogenous nature of global asset markets...LDI and well-positioned for growth in DC markets including through our acquisition of GIA in the US...

Slide 35: L&G Capital

...and LGC, which is stepping up its direct investment to improve risk-adjusted returns...

Slide 36: LGR

LGR... which earlier this year executed a £3bn BPA deal and is well positioned to provide a range of pension de-risking solutions for corporates, and to re-adjust to the new changes for individual annuities and decumulation in the UK...

Slide 37: LGAS

In LGAS, our protection business achieved 56% growth in Q1, we have a market share of around 25% and this scale enables us to continue to digitalise the offering and drive down unit costs...

Slide 38: LGAS

...while our acquisition of the Cofunds Platform, the UK's biggest at £66bn positions us strongly for an increasingly digital savings world.

Slide 39: L&G America

We have a strong business in the US, and it continues to grow, with sales in Q1 up 12%, as does its dividend to group - $69m in 2013. This is very typical of the clean, predictable cash model that we have built... around 90% of cash is dividended up to Group to support growth, strengthen the balance sheet and pay shareholder dividends.

Slide 40: Clear Strategy, Outstanding Results

Legal & General's strategy is well-aligned to the trends that we see in the broader economy: ageing populations...digital...falling state benefits and the growth of protection...internationalisation of asset management... and retrenchment of banks.

In a sense this is not complicated – it is naked economics or reliance on understanding long-term fundamentals.

And the results in Q1 this year again bear out that we have made the right decisions and implemented them well: for example annuity assets up 15%, UK protection premiums up 9%, LGIM's international AUM up 21% and strong inflows to our digital platforms.

Slide 41: Acquisitions

Our acquisitions are similarly built around these themes and are turning out well... We expect substantial capital to be returned from the Lucida acquisition... GIA gives us a further bridgehead in DC investment management... and CALA and Banner Homes opens up direct investment in UK housebuilding.

Slide 42: What we have done – slow money

As we emerge from the great monetary experiment, we see more clearly than ever the difference between fast and slow money. We are slow money specialists, operating in the area where banks are retreating. Here you see some of the £1.25bn invested in student accommodation, a new asset class. Note the tenors: 50 years, 43 years, 40 years and inflation linking.

And this is not the only new asset class which presents opportunities – retirement living is an obvious next step, especially as we are already branching out into affordable housing and care homes...

Slide 43: What we have done. More slow money

...as you can see here...

This is in effect "back to the future" – long-term institutions providing long term capital which provides us with rewarded as opposed to unrewarded risk and plays a role in creating more sustainable economic growth.

Slide 44: Every Day Matters

Delivering growth is part of our mission... back in the depths of the crisis Lord Adair Turner memorably said that much of what banks did was socially useless... he then added for good measure that it was economically useless, too.

I like to think we are different, not least because we try to look beyond immediate short-term market trends and use more fundamental macro-drivers – naked economics – to direct our business.

Slide 45: EDM Back Cover

Thank you.