

# Skandia Shield Fund – An innovative protected fund offering

Technical guide for financial advisers only



## *The Skandia Shield Fund overview*

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The Skandia Shield Fund is a highly innovative fund solution which aims to provide long-term capital growth equivalent to that achieved by a diversified portfolio of international investments. The Fund also aims to limit the extent of any drop in value due to market falls, by providing a Protected Share Price. This aims to ensure that the price of shares will be at least 80% of the highest price (Net Asset Value) that they have ever achieved.

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This document explains how the different elements of the Fund work together to enable it to achieve its objectives.

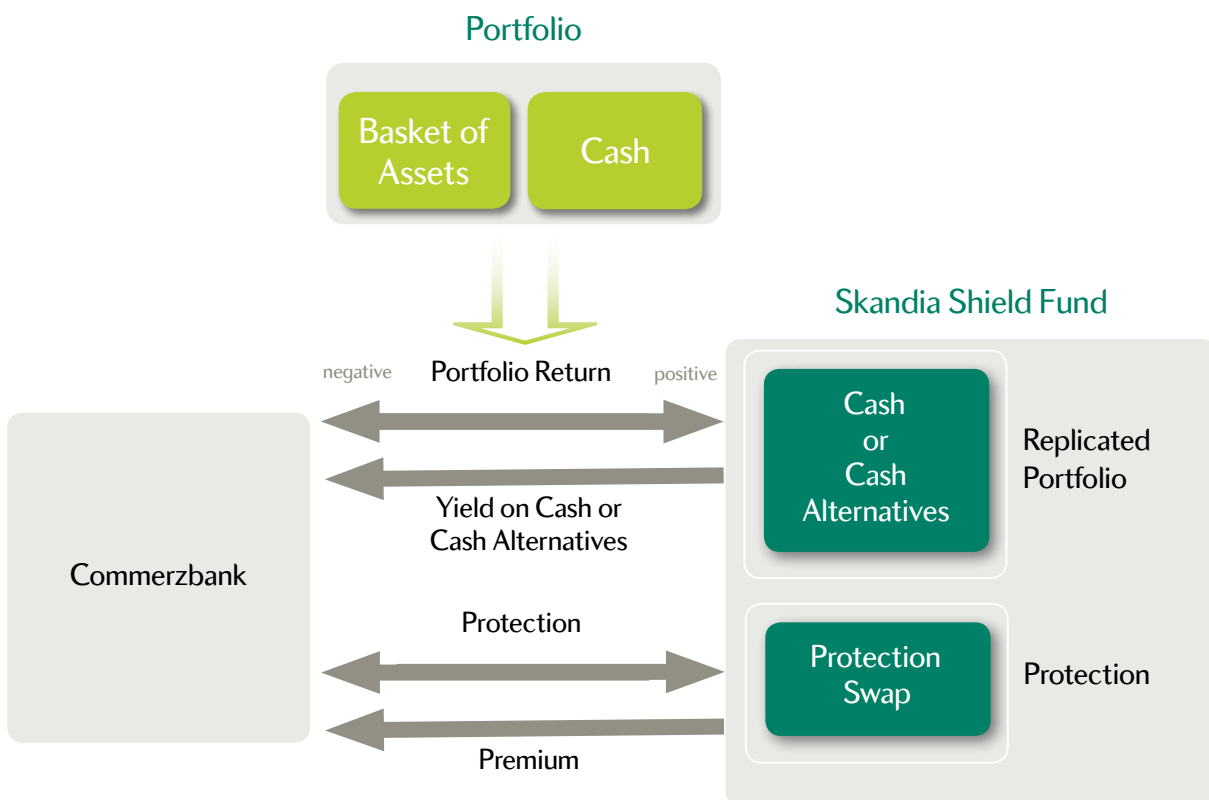
### Replication, replication

The Skandia Shield Fund does not invest directly into stocks and bonds. In order to offer the combination of portfolio performance and share price protection, it invests instead in a series of derivative contracts.

A derivative is a contract whose value, instead of being directly based on stocks and bonds or similar assets, is derived from those assets – in other words the Fund does not have to hold the assets themselves in order to benefit from their behaviour. As the value of the related assets goes up or down, the value of the derivative follows those movements.

The use of derivative contracts is typical for investments that involve commitments such as share price protection. The benefits of using derivatives instead of direct investment for this type of fund include greater efficiency and potentially lower costs.





The above diagram shows how the elements of the Skandia Shield Fund are combined. The left-hand box shows Commerzbank AG as the provider of the total returns on the portfolio and the protection asset. The larger right-hand box shows how the portfolio is replicated and held in the Fund along with cash or an alternative to cash. This cash alternative could take the form of short-term bonds, money market funds or a combination of options that has a pre-defined payoff, that equates to cash.

To account for the portfolio's returns, the Fund replicates it by entering into a swap agreement. Swaps are transactions between two parties with a legal commitment to an exchange of cash flow over a pre-specified period.

By combining the swap and the cash or cash alternatives, the Fund replicates an investment in the portfolio. In order to limit the portfolio's losses, it is necessary to enter into another swap. The Fund enters into a protection swap with Commerzbank AG. For an upfront and regular premium, the Fund receives protection against any fall of more than 20% from the highest ever NAV. The swap provides the protection and can be exercised at any time prior to its expiry date. This means that the protection is available all of the time, and not just at the end of a set term, as is the case with many other similar funds that provide capital protection.

# The Skandia Shield Fund portfolio

The portfolio to which the Fund's performance is linked is made up of a 'basket' of 16 different UK and international asset classes and a cash holding.

Any growth, dividends or interest paid on the assets and cash within the portfolio are reinvested to boost the value of the Fund. Many protected funds do not offer this benefit.

The asset allocation of the basket is reviewed and adjusted on at least a monthly basis. This aims to keep the Fund's performance in line with its desired growth and risk level.

The balance between the cash holding and the basket of assets is also adjusted on at least a monthly basis depending on its volatility over the previous 50 business days, with more weight being given to more recent data through what is known as exponential weighting.

In order to follow the performance of the Skandia Shield Fund portfolio, the Fund invests in:

- » A total return swap with Commerzbank AG to deliver the growth from the portfolio, plus,
- » Cash or cash alternatives, such as bonds, money market funds or a combination of derivatives that may be listed on an exchange, provided by Commerzbank AG or other third parties.

## The Skandia Shield Fund portfolio





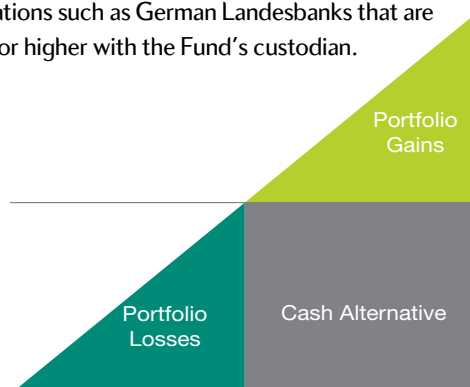
### The portfolio – total return swap

A total return swap is a financial contract which transfers the market risk of an underlying asset from one party to another. Commerzbank AG replicates a portfolio consisting of a basket of assets and a cash holding which periodically gives interest and dividend payments which are reinvested. Tax will need to be paid on the dividend and interest payments.

There is a potential liability for both capital gains and income tax for investments in the Skandia Shield Fund. Skandia's interpretation of the law and HM Revenue & Customs practice relating to personal investors in non-UK domiciled funds is as at the date of producing this technical guide. We believe this interpretation is correct, but cannot guarantee it. Tax relief and the tax treatment of investment funds may change.

To replicate the portfolio, the Skandia Shield Fund enters into a total return swap whereby it receives the performance of the portfolio from Commerzbank AG.

According to this contract, Commerzbank AG is paying any positive price changes in the portfolio over the payment including any reinvested dividends and interest income from the portfolio period to the Fund. Meanwhile, the Fund is paying the returns from the cash or cash alternatives, as well as any negative price changes on the portfolio and any other costs. Commerzbank's potential liabilities are collateralised (secured) by placing bonds issued by UK, French, Italian, Canadian, United States, Japanese or German governments or quasi-government organisations such as German Landesbanks that are rated A or higher with the Fund's custodian.



## *Managing risk in the portfolio*

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In low volatility conditions, when markets are generally rising, the portfolio contains a greater proportion of equities and bonds than cash, and in more volatile markets it contains a greater proportion of cash.

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The proportion of the portfolio that can be held as cash can be up to 100%. The proportion held in the form of assets can be up to 150%. This is because when markets are rising, the fund can leverage up to an additional 50% of the value of the basket of assets in order to take advantage of the additional growth opportunities. It is important to note that the downside effect of leveraging could multiply any loss by up to 1.5 times.

The allocation between the basket of assets and cash in the portfolio is adjusted at least monthly, based on the level of volatility for the portfolio over the previous 50 days. When the portfolio makes use of the ability to leverage, any profit or losses may be larger than the those which can be made when the portfolio is not leveraging.

The aim of adjusting the asset allocation, and the balance of cash and assets in the portfolio as a whole, is to stabilise the volatility of the portfolio's performance, around an annualised level of 8%.

An innovative feature of the Skandia Shield Fund is that unlike many other protected funds it relies on a separate derivative to provide the protection, rather than just cash. This means that the Fund can retain exposure to the portfolio and thus benefit when an upturn occurs.

# *The cash or cash alternatives*



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## The fund manager is able to invest in cash or cash alternatives

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The Fund may invest the cash proceeds from sale of units in deposit accounts with a diverse range of banks.

The Fund may also invest in a selection of money market funds to generate a cash return.

The Fund may purchase a diverse holding of short term bonds issued by companies or governments to achieve the same goal.

Alternatively, the Fund may also invest in a combination of derivatives in the form of options in order to replicate the cash element of the portfolio. These options may be listed on a recognised exchange and held with a recognised clearer.

An option is a financial instrument that gives its owner the right, but not the obligation, to receive a return linked to any positive (call) or negative (put) performance of the underlying asset. Options are derivative instruments, as their fair price is derived from the value of an asset. The asset is commonly a share, a bond, a currency or an index or futures contract, and options can in principle be created for any type of liquid asset.

## *The Protected Share Price – swap*

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The Skandia Shield Fund also aims to limit the extent of any drop in value due to market falls, by providing a Protected Share Price. This aims to ensure that when shares in the Fund are sold, the price of the shares will be at least 80% of the highest Net Asset Value (NAV) that they have ever achieved. If the Fund share price is higher than the Protected Share Price when shares are sold, the higher value will be received.

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The Fund achieves price protection by investing in a derivative contract with Commerzbank AG. The derivative contract is in the form of a swap.

The Fund pays upfront and regular premiums and receives protection against the Fund price falling below 80% of the highest ever daily share price. The premium payable for the protection is reflected in the share price. This means that in constantly rising markets, the Skandia Shield Fund may not perform as well as similarly priced funds that do not have the benefit of protection. If markets are falling, however, the extent of any potential loss to investors is limited by the Protected Share Price.

The swap can be cashed in or exercised by the Fund on any trading day. The swap means the Fund will receive the shortfall (if any) between 80% of the highest ever daily Fund NAV and the value of the portfolio. This means that if shares in the Fund increase in value beyond the Fund's highest ever price, 80% of that increase is 'locked in' for the benefit of investors. For further information on the Protected Share Price, please see our [Skandia Shield Fund – the Protected Share Price](#) document.

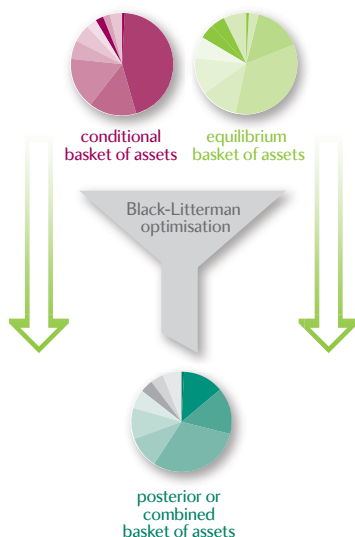


# The Black-Litterman approach

The Skandia Shield Fund uses the Black-Litterman model to produce its asset allocation model. The basket of assets is optimised using a Black-Litterman asset allocation model that addresses investment managers' practical issues when using Modern Portfolio Theory (MPT), by allowing the portfolio manager to express views about individual assets, rather than just using expected return data for all assets.

A portfolio constructed according to MPT will appear on an 'Efficient Frontier' where for every level of risk there is a portfolio with the highest expected return and for every level of return there is a portfolio with the lowest anticipated risk.

A Black-Litterman optimisation operates within a mean-variance framework, but combines two portfolios, an equilibrium portfolio and a conditional portfolio, to generate a new posterior or combined portfolio which has a higher certainty of outcome.



In respect of the Skandia Shield Fund, the equilibrium basket of assets has a weighting reflecting a market participant's views on the assets, therefore according to MPT, it is efficient. The conditional basket of assets is mainly driven by the investment manager's discretionary views on assets, therefore its weighting reflects the manager's vision on the expected asset's performance. In the traditional mean-variance approach the user inputs a complete set of expected returns, and the portfolio optimiser generates the optimal portfolio weights. However, users of the mean-variance approach often find that their specification of expected returns produces output portfolio weights which may not agree with their market views.

For further information please see our [Skandia Shield Fund – optimisation and asset allocation philosophy](#) document.

## *Cash-lock*

By using a separate derivative contract to support the Protected Share Price, the Skandia Shield Fund does not rely upon cash investment to provide the protection. The exposure between the basket of assets and the cash holding can be reallocated irrespective of whether the markets are rising or falling.

Other protected funds need to maintain a high cash exposure (up to 100%) in falling markets to provide the Protected Share Price and so cannot take advantage of upturns in the markets as effectively as the Skandia Shield Fund. This inflexibility can result in what is known as 'cash-locking' where the price, in effect, stagnates. This means that when the market recovers, they are not in a position to benefit.



# Taxation of investments in the Skandia Shield Fund

The following information is based on Skandia's understanding of the current UK tax legislation applicable to personal investors in non-UK domiciled funds. The tax position may change in the future and investors should seek tax advice specific to their circumstances.

The Skandia Shield Fund is a Luxembourg-domiciled Société d'Investissement a Capital Variable (SICAV) which will potentially generate both capital gains and 'notional' income. HM Revenue & Customs (HMRC) has confirmed that the Fund was accepted into the Reporting Fund regime with effect from 1 October 2010, meaning gains will be taxed under the more favourable capital gains tax regime for individual investors and on the same basis as for UK-domiciled unit trusts and OEICs, when held within different tax wrappers (products) on the Skandia Investment Solutions platform.

## Taxation of the specific Skandia products

**Collective Investment Account (CIA):** Individuals resident in the UK investing via a Collective Investment Account (CIA) will be liable to capital gains tax (CGT) on any realised gains. Whilst no income will be distributed, if the fund were to benefit from the value of any reinvested dividends within the portfolio, an income tax liability may arise. In this event, that value will be treated as a notional income, Skandia will include details of these 'notional' dividend payments in the consolidated tax voucher sent to CIA investors at the end of every tax year.

**Collective Retirement Account:** There is no liability to capital gains or income tax for UK residents, if investment is made through a Collective Retirement Account (CRA).

**Offshore and Onshore Bond:** Income tax may be payable where withdrawal or encashment exceed the levels determined by HMRC as detailed in the relevant product terms.

**Stocks and Shares ISA:** Individuals investing through an Individual Savings Account (ISA) will have no personal liability to tax on capital gains or notional income payments. It should be noted that ISA eligibility may be suspended, depending on fluctuations in the Fund's NAV share price, in accordance with HMRC ISA regulations.

If this scenario should arise, Skandia will not accept new lump sum ISA investments or top-ups to existing ISAs until the fund becomes eligible for ISA investment again. Please note that any suspension of the Fund's ISA status will not affect existing ISA investments in the Fund. These will remain invested within the ISA and receive all the usual tax benefits. Tax rules may change and are dependent on individual circumstances.

[www.skandia.co.uk](http://www.skandia.co.uk)

Calls may be monitored and recorded for training purposes and to avoid misunderstandings.

Skandia provides you with access to its investment platform, known as Skandia Investment Solutions. Within this platform you can open an ISA and Collective Investment Account provided by Skandia MultiFUNDS Limited and a Collective Retirement Account and Collective Investment Bond provided by Skandia MultiFUNDS Assurance Limited.

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