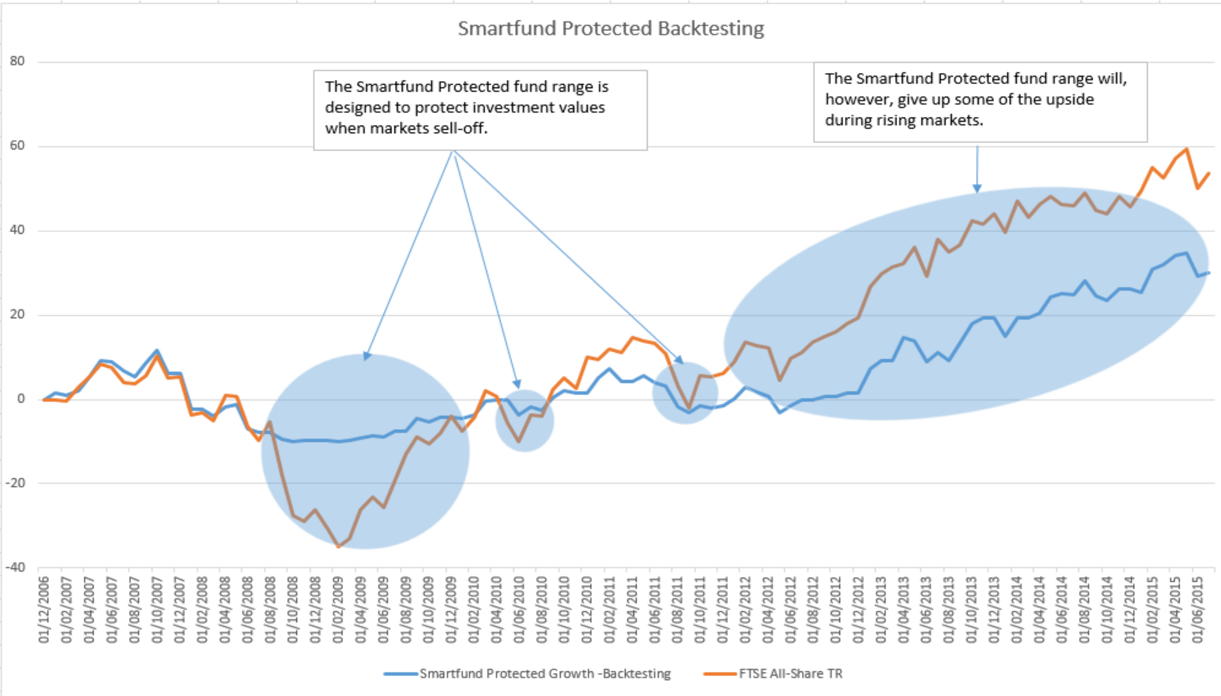
Smart[im]: Smartfund Note

16 October 2017
Smart Investment Management

Recent divergence of returns

Stock market cycles are an unavoidable part of investing but not everyone is able or wants to ride the waves of the market. The Smartfund Protected range of funds are designed to give investors the opportunity to participate in a significant proportion of the upside of equity market returns whilst at the same time limiting the downside. The existence of these funds means investors who would not otherwise consider investing in equity markets can now participate with the knowledge that 80% of the highest value of their investment is protected.

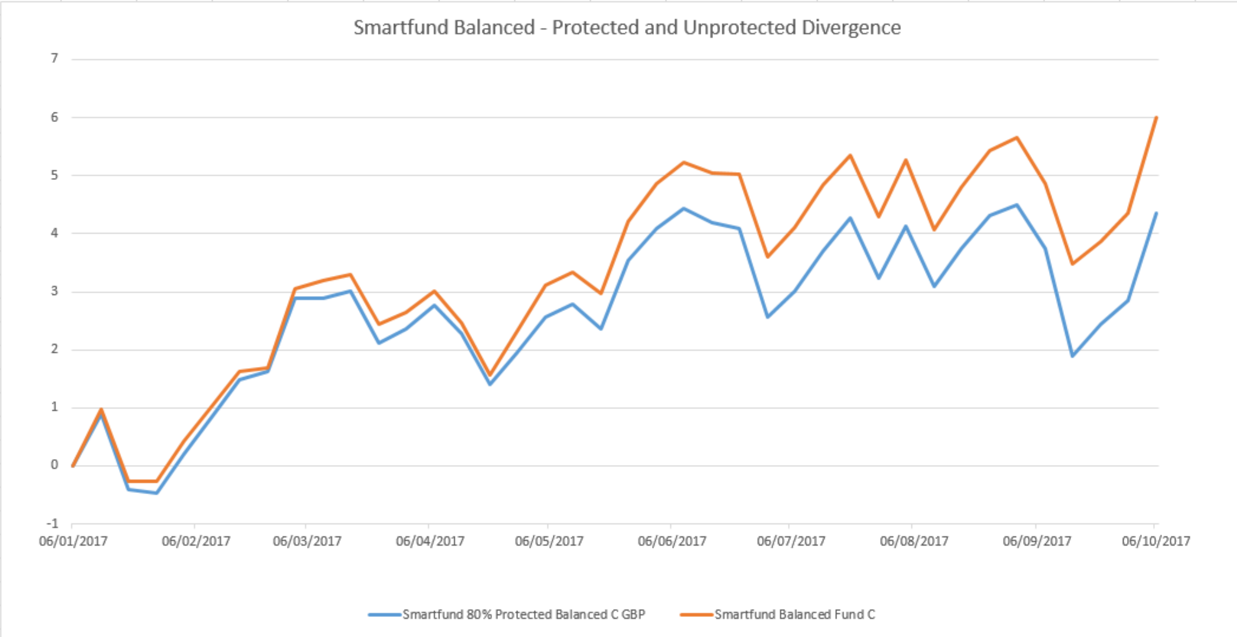
The chart represents a long-term back test of the 80% protected growth strategy and provides an illustration on how the fund is expected to behave in different environments. The chart shows the historical simulation of the 80% Protected Growth portfolio vs FTSE All-Share TR over the period 1/12/06 to 01/06/2015.



Source: Smart Investment Management, Lipper. All returns are in sterling and include reinvestment of dividends. The table shows historical simulation of the 80% Protected Growth portfolio vs FTSE All-Share TR over the period 1/12/2006 to 01/06/2015.

As illustrated above, the fund when compared to equity markets represented here in the example by the FTSE All-Share, delivers a low beta experience to equity investment. So, in addition investors can expect a smoother, less volatile journey where the risk to the value of their investment is far less than they would experience if they invested directly into funds exposed to equity markets. Whilst the 80% protected strategy protects the fund against extreme falls, an element of the upside will be given up during rising markets.

Recently the Smartfund 80% Protected Growth and Balanced funds have experienced a divergence of returns from the Smartfund Growth and Balanced funds, their unprotected counterparts. This is illustrated in the chart below over the period 06/01/2017 to 6/10/2017 Source: Smart Investment Management Limited, Lipper.



*Source: Smart Investment Management Limited, Lipper. All figures are total return in sterling. This information has been prepared solely for information purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any security or instrument or to participate in any particular trading strategy. Additional information is available on request. Past performance is not necessarily indicative of future results. Price and availability are subject to change without notice. Unless stated otherwise, the material contained herein has not been based on a consideration of any individual client circumstances and as such should not be considered to be a personal recommendation. *Data shown as at 6 October 2017.*

This divergence of returns is likely to occur periodically and is driven by a number of factors including the protected fund's sensitivity to interest rates resulting from the put option held by the fund. The put option is the holding within the fund that protects against drawdowns, the protection component; it is a form of insurance and like all insurance policies it carries a cost. The put option can be actively traded and thus has a value in the open market and any fluctuation in the price is reflected in the portfolio returns. The recent increases in the 5-year overnight interest rate swap rate (the rate from which the put option is priced) has caused the value of the put option in the funds to fall. There are however, circumstances when the value of the put rises, one being the prevailing rate environment as we touched on earlier and if the inverse happens and rates fall, this will lead to a rise in the value of the put option. In addition, any fall in the value of the assets within the portfolio will lead to a rise in the value of the put option. Please note there are of course other factors which affect the value of the put option and pricing for these instruments is often quite complex.

Important changes to the fund

We look to manage the cost of protection in the fund where possible. We believe that introducing some flexibility into the fund's prospectus around the key factors that influence the returns of the put option will allow us to manage the cost of protection more effectively. Therefore, we have applied to make some changes to the fund supplements.
This additional flexibility will take effect from 18th October 2017 or such later date as the Central Bank of Ireland notes the revised supplements in respect of the funds. The changes to the funds include:

Protecting against interest rate movements
We have introduced the option to hedge against interest rate rises which mean that if we believe interest rates are likely to increase we can protect against some of the impact of this on the fund's performance.

Varying the Target Volatility

During periods of consistent low volatility in equity markets, like the one we are currently experiencing, we will be able to reduce the volatility target level of the fund within an agreed range. For example, the current volatility target of the balanced fund is 8%. At the discretion of the fund managers we may now reduce that target volatility to a level between 6% and 8%. The impact of this should be to reduce the cost of protection as the funds need to 'pay' to protect against extreme volatility is reduced.

Introduction of a range for the performance cap

In addition to varying the volatility target of the fund we have introduced the option to vary the monthly performance caps of the funds within a prescribed range. These caps represent the maximum the fund can rise in any given calendar month. In low volatility environment, like the one we are experiencing, where we would not expect to see performance in a single month breaching the monthly performance cap; lowering the level of that cap reduces the cost of protection to the fund.

It is important to focus on full market cycles as it is not unusual to see a divergence in returns between the protected and unprotected strategy during the short term. The additional flexibility from the introduction of these changes provide the managers with the ability to adapt to changing market conditions and minimise the divergence between the two strategies.