

Skandia Diversified Fund

fourth quarter 2009 review

This document provides information about what has been happening with the Skandia Diversified Fund during the fourth quarter of 2009. However, please be aware that past performance is not a guide to future performance.

Terms in *italics* are explained in the glossary of terms at the end of the document.

economic and stock market environment

The UK equity market continued to make progress over the fourth quarter, although gains were much smaller than in the previous three months. After falling slightly in October, the market recovered in November and rallied strongly in December, with the FTSE All Share *Index* returning 5.5% over the quarter as a whole. At sector level, the basic materials sector performed extremely well, driven by strength in commodity prices. Following an impressive third quarter, the financial sector posted a negative return as concerns about debt and increased regulation resurfaced and investors took profits. Some of the more defensive sectors fared well as risk appetite dipped somewhat, notably consumer goods, utilities, and healthcare, while industrials and information technology lagged. The UK economy has lagged most other countries, with the economy officially remaining in recession in the third quarter. However, more recent data suggested that the economy grew in the final quarter of the year. Inflation remained below the Bank of England's target and interest rates were kept unchanged at 0.5%.

Continental European equities also rose overall during the quarter but performance across the region's markets varied widely. In local

currency terms, Norway recorded a double-digit gain while Sweden, the Netherlands, Germany and France also performed relatively well. In contrast, the Greek stock market fell sharply on concerns about the country's debt levels as several agencies downgraded its debt rating. Similar concerns affected the Irish equity market, while Austria was also weak. Both Greece and Ireland have had to sharply accelerate their plans to improve their countries' fiscal position. At sector level, basic materials outperformed, followed by consumer goods, while information technology and financials lagged. The MSCI Europe ex UK *Index* returned 3.1% in local currency terms, but with the British Pound strengthening against the Euro, the *index* returned just 0.6% in Sterling terms.

In the US, corporate news was broadly positive, with many companies reporting results that exceeded estimates. The economic backdrop continued to strengthen, with the US economy officially exiting recession in the third quarter, and more recent data suggested that the economy accelerated in the fourth quarter. Some of this strength is the result of the inventory cycle, with companies increasing production to stop inventories falling too low. There were pockets of strength elsewhere, with auto sales improving despite the end of the 'cash-for-clunkers' scheme and further signs that the worst has passed for the US housing sector. With inflation remaining low, the Federal Reserve kept interest rates unchanged in a range of between 0% and 0.25%.



The US stock market gained 4.8% over the quarter, as measured by the S&P 500 *Index*. In terms of sectors, information technology was the best performing area of the market, followed by healthcare and consumer discretionary, while financials were the clear losers.

Japanese equities continued to underperform other major stock markets over the quarter. After a weak October the market fell sharply in November as investors continued to worry about the strength of the Yen, which makes Japanese exports less competitive overseas, and that ongoing deflation could hamper the economic recovery. However, this trend reversed in December, when Japanese equities staged a strong rebound as the Bank of Japan announced it would pump more money into the financial system. This helped weaken the Yen and boost confidence that the central bank would take action to end deflation. The Topix *Index* ended the period as a whole broadly unchanged in Yen terms, but fell 5% in Sterling terms as currency movements pushed the return into negative territory. Corporate earnings and economic news were broadly positive. The economy expanded by more than expected during the third quarter; machinery orders and industrial production rose while unemployment eased.

Excluding Japan, Asia Pacific equities posted further gains for the quarter, with the MSCI AC Asia Pacific ex Japan *Index* returning 5.1%. The strongest-performing market was Singapore, helped by news that the country's economy grew by 14.9% in the third quarter. China and Taiwan also performed well on signs that their economic recovery is broadening. New Zealand was the weakest-performing market. Korea also lagged as investors took profits following a strong rally in the previous quarter, while Thailand was undermined by political tensions. The Asia Pacific ex Japan region's economic recovery continued, led by ongoing strength in China. While government stimulus measures were largely responsible for the strength

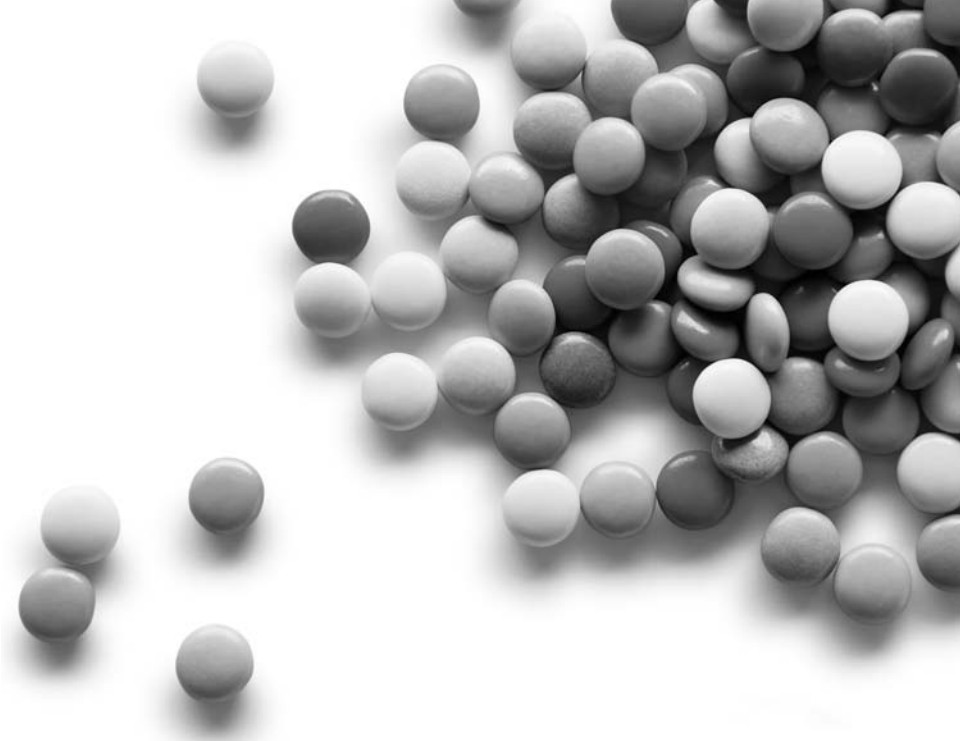
in the first half of 2009, domestic demand and exports have recently picked up. Australia became the first G20 country to raise interest rates since the financial crisis began, with the central bank announcing rate rises in each of the three months.

Global emerging market equities had another good quarter and continued to outperform developed equity markets. The MSCI Emerging Markets *Index* returned 7.5% over the quarter, with Poland, Russia, Brazil and Turkey among the best performers. Emerging European markets performed very well, supported by higher commodity prices and the region's attractive equity valuations. In an attempt to boost the recovery, the Russian and Turkish central banks cut interest rates. Latin American markets also continued to rally strongly, led by Brazil which is driving the region's recovery. Brazil's economy grew by 1.3% in the third quarter; retail sales strengthened, unemployment eased and industrial production surged. Within emerging Asia, China was the best-performing market as economic data continued to underline the strength of its recovery.

In fixed income markets, UK government bonds (gilts) posted a negative return for the quarter. Performance in December was particularly weak on concerns about the size of the UK government's budget deficit and the likelihood that the government may stop its programme of buying back bonds in the not too distant

future. Economic data also strengthened and investors favoured riskier assets. The FTSE British Government All Stocks *Index* fell 2.0% over the quarter. Corporate bonds continued to outperform, although weakness in the gilt market meant that gains were less marked than in the previous quarter. The Iboxx Sterling Corporates All Maturities *Index* returned 1% over the period. *Subordinated* financial bonds continued to perform well, helped by bond buybacks and exchanges, while lower-rated bonds outperformed higher-quality issues.

US and European government bond markets also posted small losses as the economic backdrop continued to improve. Corporate bonds in both markets outperformed, with the *high yield* segment in particular continuing to rally. Emerging market debt also posted a positive return for the quarter as investors' risk appetite remained high.



about the Diversified Fund

Launch date	14 February 2003
IMA sector	IMA Cautious Managed
Initial charge	5%
Annual Management Charge	1.25%
Total Expense Ratio	1.79%
Minimum investment	Lump sum £1000, regular saving £50 per month
ISA eligibility	Yes
Type of share	Accumulation
Valuation point	12 noon
SEDOL number	3276392
ISIN	GB00B39V2C07
MEXID	SNMMC
Fund size as at 31 December 2009	£289.1m

asset allocation

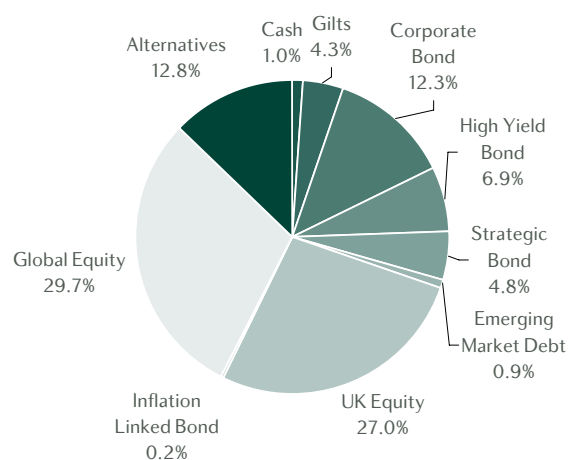
as at 31 December 2009

The Skandia Diversified Fund is a true multi-asset fund that has the ability to not only invest in traditional assets such as equities and fixed interest holdings, but can also hold alternative investments such as commodities.

The Fund has a strategic asset allocation as shown in the table below, but equally has a flexible approach that enables the Fund to be positioned towards particular assets when they look attractive.

holding	min	neutral	max	current*
cash	0%	0%	10%	1.04%
bonds*	30%	30%	40%	29.49%
equities	40%	50%	60%	56.68%
alternatives	10%	20%	24%	12.79%

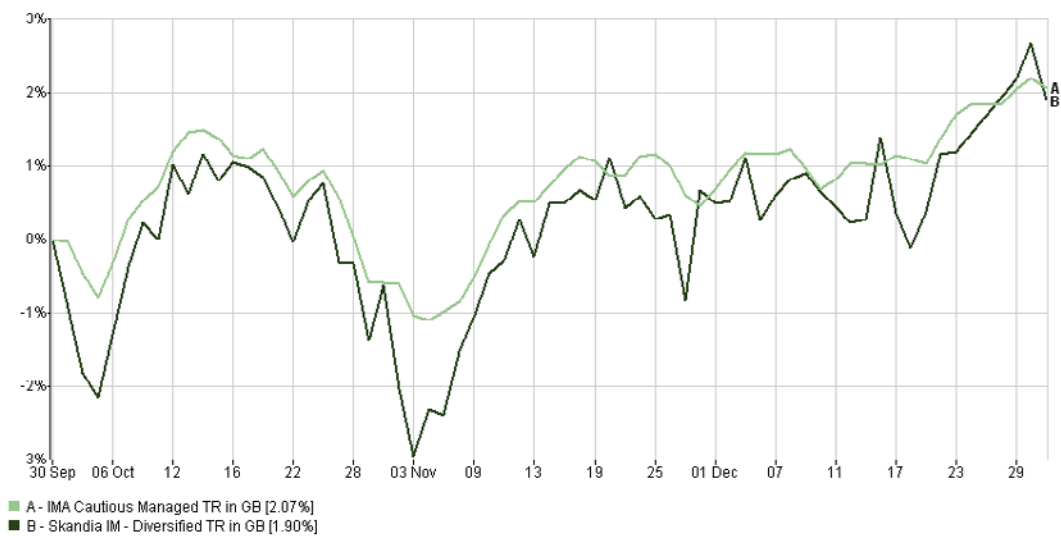
* the fund is currently operating at its minimum allocation to bonds. Given market movements, please note that there may be times when this weight falls below that minimum stated.



fund performance

Fund	year ending				
	31/12/09	31/12/08	31/12/07	31/12/06	31/12/05
Diversified Fund	18.29%	-14.10%	0.14%	5.06%	15.17%
IMA Cautious Managed sector	15.90%	-15.84%	1.39%	6.96%	12.57%

fund performance over the quarter



Source: Financial Express, Total return bid to bid with net income reinvested into the Fund. Performance is in Sterling terms. While Financial Express and Skandia Investment Group have used all reasonable endeavours to ensure the accuracy of the information contained in this document and neither accept any liability in respect of the investment decisions of investors nor any loss arising from such decisions.

Past performance does not indicate future performance.



investment commentary

The Diversified Fund performed broadly in line with the IMA Cautious Managed sector during the fourth quarter, recording a small positive return. The commentary below provides further detail on the different areas in which the Diversified Fund invests.

UK equities

After a strong third quarter, performance of the UK equity component was mixed over the final three months of the year. The best-performing holding was the Mirabaud mandate, which continued to outperform the IMA UK All Companies sector. Aquarius Platinum, added to the portfolio during the quarter, and Rio Tinto were top contributors to returns, as commodity markets responded to surprisingly strong growth in China. Aggreko, which provides temporary power systems to countries with underdeveloped power infrastructure, performed well after releasing a better-than-expected trading statement.

The remaining holdings did not keep pace with the sector. The weakest performance was recorded by the relatively aggressively positioned Skandia UK Best Ideas Fund, which came under significant pressure in late October and November when investor risk appetite declined. Stock selection within financials, energy and consumer discretionary detracted from performance over the quarter as a whole, as did the lack of exposure to mining companies Anglo American, BHP Billiton and Rio Tinto (*underweight*).

The Lazard mandate, which significantly outperformed during the previous quarter, also struggled. Large positions in Lloyds Banking Group and Barclays were key detractors as both stocks suffered from a bout of profit-taking due

to capital raisings and regulatory concerns.

Insurer Hiscox was out of favour with the market as doubts lingered over 2010 premiums and pub group Enterprise Inns also undermined performance as the market focused on re-financing debt outstanding.

The Skandia UK Strategic Best Ideas Fund ended the quarter marginally in positive territory, but lagged the UK equity market. The *underweight* in mining companies had a negative impact, as did stock selection within the consumer discretionary sector, where pub group Enterprise Inns and British Airways were the main detractors. The Fund's *short positions* added value overall, with several featuring among the top contributors to performance for the quarter. The overweight exposure to Spirent Communications and Aggreko also proved beneficial.

There were two manager changes implemented within the remaining two UK portfolios – the management of the UK Assets mandate was transferred from Origin to Schroders and the UK Securities mandate, previously managed by UBS, was passed to Investec. Schroders' Richard Buxton is a talented and insightful investor who takes a pragmatic approach, seeking to add value not only through individual stock selection but also through thematic positioning. Meanwhile, Investec focus on stocks that have fallen substantially out of favour and with cheap valuations, and typically invest for the long term. Although we continue to rate UBS highly, we have a greater level of conviction in Investec's long-term potential.

Global Equities

The Diversified Fund gains exposure to global equities through investment in the Skandia Global Dynamic Equity (GDE) Fund. The GDE Fund continued to perform well over the quarter, outperforming the IMA Global Growth sector. Both manager selection and *tactical asset allocation* positions added value.

One of the highlights was MIR's Asia Pacific ex-Japan mandate, which significantly outperformed the Asia Pacific ex-Japan equity

market and posted the largest gain. Performance was aided by good stock selection within China and Korea and within the energy sector. The overweight exposure to the materials sector also added significant value. Gartmore's Emerging Markets ex Asia mandate also continued to perform well.

Performance of the US portfolios was mixed. The QMA mandate significantly outperformed its *benchmark*, helped by positioning within healthcare and the *underweight* financials, notably Citigroup and Bank of America. Epoch's portfolio also finished ahead of its *benchmark*, benefiting from good stock selection within industrials, information technology and utilities. The Marsico and Acadian mandates slightly lagged their respective *benchmarks* over the quarter.

Within Europe, the Alliance Bernstein mandate performed very well compared to the broader European equity market. However, in a reversal on the previous quarter, Schroders' UK mandate and Argonaut's European mandate both underperformed their respective equity markets. Argonaut was hampered by a large *underweight* in healthcare and stock selection within financials. For Schroders, overweight positions in several major banks – Lloyds Banking Group, Barclays and Royal Bank of Scotland – were behind much of the underperformance as all came under pressure due to capital raisings and regulatory concerns. Stock selection within the oil and gas sector also detracted.

The FuNNeX Japan mandate significantly outperformed the Japanese equity market, but posted a small loss as market conditions in Japan remained challenging for much of the quarter.

Fixed Income

All but one of the fixed income holdings recorded positive returns. With riskier assets still in favour, the JP Morgan High Yield Bond mandate recorded the largest gain for the quarter, performing broadly in line with its *high yield* market *benchmark*.

Stock selection within the chemicals, automotive and homebuilder sectors enhanced performance compared to the market. The manager still sees value in the *high yield* market, despite its very strong performance over the past year, as the economic and corporate backdrop continues to improve.

The M&G Optimal Income Fund performed well, benefiting from its high weighting in corporate bonds, including an allocation to the *high yield* segment of the market. GSAM's Global Emerging Market Debt Fund and PIMCO's Global Real Return Fund continued to add value and both outperformed their respective *benchmarks*.

The Royal London mandate outperformed the IMA Sterling Corporate Bond sector. Both security and sector selection was positive, with the portfolio's bias towards higher-yielding *investment grade* corporate bonds, notably *subordinated* financial debt, making a strong contribution to returns. GSAM's Sterling Bond mandate lagged the sector over the quarter but performed well compared to its corporate bond market *benchmark*. Security selection within *investment grade* and *high yield* financials contributed positively to performance, with holdings in RSA Insurance, Barclays, Pearl Group and Standard Life adding value.

The main drag on performance was the BlackRock Gilt portfolio,

which recorded a negative return for the quarter, reflecting weaker conditions in the UK government bond market.

Alternatives

Asset classes are explained in the glossary.

The Alternatives component added value overall, driven by a double-digit gain from the Morgan Stanley Commodities Active GSLE Fund as almost all commodity markets strengthened over the quarter. This more than offset the small loss for the JP Morgan Highbridge Statistical Market Neutral Fund. Meanwhile, Commerzbank's UK Premia Fund continued to make good progress over the quarter.

glossary

alternatives asset classes

fund of hedge fund replacement

Hedge funds typically have a low correlation to conventional assets and hold the potential for attractive returns with lower risk, which makes them beneficial within balanced portfolios. However, they are often thought unsuitable for retail investors due to high fees and a lack of transparency or regulation. Fund of hedge fund replacement is a strategy which seeks to harness the benefits of funds of hedge funds in a transparent, accessible and regulated form, and at significantly lower cost than funds of hedge funds themselves.

equity market neutral

Based on mathematical modelling, this strategy seeks to exploit opportunities arising from the fact that share (equity) prices do not always reflect all information flows.

Markets are not perfect so pricing 'inefficiencies' can be exploited. By having a roughly equal exposure to shares expected to rise and those expected to fall (via derivatives) it aims to generate positive returns regardless of the direction of the stock market.

currency

The ease of buying and selling currencies allows skilled investment managers the opportunity to profit through a disciplined, risk-controlled approach, exploiting the tendency for higher interest rate currencies to outperform lower rate currencies.

volatility

This strategy is designed to capture the systematic mispricing of options in the UK stock market. An option is a type of agreement that gives the buyer the right, but not the obligation, to buy or sell an investment at an agreed price by a specified date. The strategy is based on the premise that actual variability of returns, or '*volatility*' of shares, is almost always lower than expected *volatility*. The strategy aims to deliver a return with low volatility and low correlation to the stock market.

global macro-economic allocation

Global macro-economic allocation seeks to evaluate the attractiveness of a range of asset classes across all regions and countries, and to position a portfolio to benefit from pricing

inefficiencies. Analysis of global economic conditions determines which assets are expected to perform best and the portfolio is weighted accordingly. The strategy looks to make consistent returns regardless of stock market direction.

commodities

This investment gives indirect exposure via derivatives to real commodities such as wheat, sugar, oil and cotton and therefore has low correlation to shares.

benchmark - a standard against which the performance of a security or fund can be measured. The *benchmark* could be an *index* or the average for all similar funds, also known as the sector average.

high yield - the generic name for bonds rated as below *investment grade* by the major credit rating agencies. High yield bonds offer higher interest payments to compensate for the perceived greater default risk.

index / indices - an imaginary portfolio of securities representing a particular market or portion of it, often used as a *benchmark*. An *index* is usually expressed in terms of change from an arbitrary base value, so the percentage change is generally more useful than the numeric value.

investment grade - a bond rated BBB (Standard & Poor's) or Baa (Moody's) or higher and traditionally regarded as being of sufficient quality for long term investment.

overweight - refers to an investment position that is larger than the generally accepted *benchmark*.

underweight - refers to an investment position that is smaller than the generally accepted *benchmark*.

short position - the purchase of a contract against a security, commodity or currency, with the expectation that the asset will fall in value.

subordinated - debt which ranks after other debts should a company fall into receivership or be closed.

tactical asset allocation - a strategy where asset allocations within a fund are modified based on short-term forecasts of changing valuations of one asset class relative to another.

volatility - *volatility* is a statistical method that measures how much a series of values has moved up and down around its average. The higher the *volatility* number, the less consistent the historical performance has been.

availability

The Skandia Diversified Fund is managed by Skandia Investment Management Limited (SIML)

The Fund is available for ISA, ISA transfer or direct investment through Skandia Investment Group or through Skandia Investment Solutions. It is also available as fund links from Skandia and Royal Skandia life companies. You should note that the performance of the life company funds will not mirror the performance of the underlying fund because of the life company fund charges, taxation adjustments and the life company investment process.

how we invest

Our approach to MultiManager investment is to offer well-diversified, carefully constructed portfolios, run by a range of highly rated investment managers.

Managers are selected for their expertise in particular areas - where they are free to deliver strong performance - while the overall portfolio is managed to offset the risks taken by each individual manager.

Managers are then monitored closely to ensure they remain the optimum choice, while the overall make-up of the portfolio is kept under constant review with the aim of delivering more consistent performance within each area.

We seek outperformance primarily by using the most skilful managers rather than trying to 'second guess' markets or take major 'bets' on any particular sector (type of company), size of stock or investment style as we believe that this can introduce unnecessary risk into the portfolios. Each fund is therefore carefully constructed by our team of experts - one of the largest in the industry - to provide a well-balanced and high quality investment portfolio.



important information

Past performance does not indicate future performance.

What you get back will depend on investment performance and is therefore not guaranteed. The value of investments and any income from them can fall as well as rise due to stock market movements.

Where the Fund invests in securities designated in a different currency to the Fund, the value of the Fund may rise and fall purely as a result of exchange rate fluctuations.

The source for all performance figures is Financial Express. Fund performances are bid to bid, net income reinvested. Unless otherwise stated, performances are from 30/09/09 to 31/12/09 in Sterling terms.

All opinions expressed are those of Skandia Investment Group and are not a recommendation to buy or sell.

for further information

If you would like further information about our Diversified Fund, please contact your Financial Adviser.

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Royal Skandia Life Assurance Limited (an incorporated company limited by shares) Registered number: 24916. Registered and Head Office: Skandia House, King Edward Road, Onchan, Isle of Man, IM99 1NU, British Isles Phone: +44 (0) 1624 655 555 Fax: +44 (0) 1624 611 715. Authorised by the Isle of Man Government Insurance and Pensions Authority. Authorised and regulated by the Financial Services Authority for business conducted in the UK. Some of the FSA's rules do not apply to non-UK based insurers. FSA Register number: 142309.

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The Authorised Corporate Director for the Skandia Diversified Fund is Skandia Investment Management Limited.