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## **GUIDELINES**

# **Selection and presentation of performance scenarios in the Key Investor Information document (KII) for structured UCITS**

### **Executive Summary**

The revised UCITS Directive (2009/65/EU) requires, for structured UCITS (including capital-protected and guaranteed UCITS) and other comparable UCITS, the use of prospective scenarios. Article 36 of the Commission Regulation No 583/2010 implementing the Directive as regards key investor information (KII) elaborates on this general requirement. In order to ensure comparability between structured UCITS, CESR has developed guidelines with a view to harmonising the selection and presentation of scenarios.

The guidelines cover the factors to be taken into account when choosing the scenarios, such as the features of the formula (e.g. a knock-out feature or a guarantee with a conditional floor) and on the link between the market conditions and the outcome for the investor. There is also guidance on how the scenarios themselves should be presented, including on the choice between using tables or graphs. Finally, the annex contains examples of performance scenarios using a table- or graph-based presentation.

## Introduction

The revised UCITS Directive (2009/65/EU)<sup>1</sup>, which must be implemented in all Member States by 1 July 2011, requires, for structured UCITS (including capital-protected and guaranteed UCITS) and other comparable UCITS, the use of prospective scenarios as presentation of past performance is not relevant<sup>2</sup>.

Article 36 of the Commission Regulation (EU) No 583/2010 implementing the Directive as regards key investor information provides that:

1. *"The [key investor information document] for structured UCITS shall not contain the "Past performance" section.*  
*For the purposes of this Section, structured UCITS shall be understood as UCITS which provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance or to the realization of price changes or other conditions, of financial assets, indices or reference portfolios or UCITS with similar features.*
2. *For structured UCITS, the section entitled "objectives and investment policy" of the [key investor information document] shall include an explanation of how the formula works or how the pay-off is calculated.*
3. *The explanation referred to in paragraph 2 shall be accompanied by an illustration, showing at least three scenarios of the UCITS' potential performance. Appropriate scenarios shall be chosen to show the circumstances in which the formula may generate a low, a medium or a high return, including, where applicable, a negative return for the investor.*
4. *The scenarios referred to in paragraph 3 shall enable the investor to understand fully all the effects of the calculation mechanism embedded in the formula.*  
*They shall be presented in a way that is fair, clear and not misleading, and that is likely to be understood by the average retail investor. In particular, they shall not artificially magnify the importance of the final performance of the UCITS.*
5. *The scenarios referred to in paragraph 3 shall be based on reasonable and conservative assumptions about future market conditions and price movements.*  
*However, whenever the formula exposes investors to the possibility of substantial losses, such as a capital guarantee that functions only under certain circumstances, these losses shall be appropriately illustrated, even if the probability of the corresponding market conditions is low.*
6. *The scenarios referred to in paragraph 3 shall be accompanied by a statement that they are examples that are included to illustrate the formula, and do not represent a forecast of what might happen. It shall be made clear that the scenarios shown may not have an equal probability of occurrence".*

In order to ensure comparability between structured UCITS, CESR has developed guidelines with a view to harmonising the selection and presentation of scenarios..

<sup>1</sup> Formally adopted by the Council on 22 June 2009 and published in the Official Journal on 17 November 2009.

<sup>2</sup> Article 78(3) provides that:

"Key investor information shall provide information on the following essential elements in respect of the UCITS concerned:

[...]

( c ) past performance presentation or, where relevant, performance scenarios;

[...]"



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References to a UCITS in the guidelines should be read as applying to each compartment of a UCITS umbrella structure. All references to a management company in the guidelines should be read as applying to an investment company that has not designated a management company.

## Guidelines

### Box 1

#### Definition

These guidelines apply to structured UCITS authorised under Directive 2009/65/EC which shall be understood as UCITS which provide investors, at certain predetermined dates, with algorithm-based pay-offs that are linked to the performance, or to the realization of price changes or other conditions, of financial assets, indices or reference portfolios or UCITS with similar features.

#### Explanatory text

1. The definition of structured UCITS for the purposes of the KII is based on the definition provided by the European Commission in article 36 of the Commission Regulation for KII. This includes certain types of capital-protected and guaranteed UCITS. These UCITS can have a difficult to understand risk profile and consequently the use of tables or graphs should help investors to understand their strategies.

### Box 2

#### Choice of the scenarios

1. Management companies when selecting, presenting and explaining the scenarios shall follow the overriding principle that the information is fair, clear and not misleading.
2. Management companies shall choose at least three scenarios of the UCITS' potential performance to illustrate how the payout works under different market conditions.
3. The scenarios shall illustrate:
  - the functioning of the formula under market conditions which lead to a unfavourable outcome, to a favourable outcome and to a medium outcome;
  - specific features of the formula, for instance a capped performance, or a level of leverage;
  - situations where some mechanisms of the formula have a favourable or unfavourable impact on final performance.

Depending upon the formula, and if it is appropriate (e.g. knock-out feature or guarantee with conditional floor etc), more than three scenarios may be required to adequately describe the possible range of outcomes.

4. The examples used in favourable and unfavourable scenarios shall be based on reasonable assumptions about future market conditions and price movements.
5. The unfavourable scenario shall always be explained first.
6. The selected scenarios shall have a narrative explanation of the advantages and drawbacks of the formula where these are not included in the *Risk and reward* section.
7. The scenarios shall represent information which is complementary to and consistent with the information in other sections of the KII.
8. When relevant, the scenarios shall be updated:

- Where market conditions have changed significantly since the launch of the UCITS;
- At least on a yearly basis;
- To reflect the time-dependency of a payoff, where relevant (e.g. where an anniversary date has passed).

#### Explanatory text

2. An investor can gain a better understanding of the merits and limits of a structured UCITS when provided with answers to ‘what if?’ questions. The regulations require at least three example scenarios which show a low, medium or high return, including where applicable, a loss of capital. The examples will therefore depend upon the characteristics of the UCITS and should give a balanced presentation of the positive and negative aspects of the formula. A fourth example may be necessary to illustrate a particular feature of the UCITS.
3. The low example should show an unfavourable outcome.
  - If there is no guarantee of the capital, the scenario will show that investors may suffer loss, where relevant, and how much this loss can be,
  - If there is a legally enforceable guarantee of the capital, this will show conditions where the guarantee will override the formula (return equal to zero),
  - If there is a conditional protection/guarantee barrier (conditional floor), it will be appropriate to show an additional example to illustrate how extreme conditions can breach the barrier and cause a loss of capital. This is to ensure that investors realise they could suffer substantial losses. These two examples would be categorised as ‘unfavourable’ and ‘very unfavourable’ respectively.
4. The high example should illustrate a positive return, but it should not be based on unreasonably optimistic assumptions that will exaggerate the likely potential of the UCITS.
5. The medium example should illustrate a moderate growth in capital.
6. A fourth example may be needed to show the operation of a particular feature of the formula, for example when there is a knock-out feature if a certain performance threshold is reached at a particular anniversary date.

#### **Box 3**

##### **Presentation of the scenarios**

1. The scenarios shall be called *Illustrative examples*. The narrative shall make it clear that they are not forecasts and that they are not equally probable.
2. Each set of scenarios shall be presented as either tables or graphs, whichever is the clearer way to present the characteristics of each structured UCITS. See the Annex for examples.
3. The illustrative returns in the various scenarios shall be displayed as an annualised rate of growth (with an appropriate explanation). However, the [capitalised/gross] rate of growth may also be shown.
4. To ensure the comprehensibility and the comparability of different graphs, the presentation shall avoid:
  - double scales (left and right) whenever possible;
  - artificially magnifying the positive aspects of the fund payout;
  - non-linear scales;
  - different scales depending on the scenario.
5. The narrative shall explain that investors can sell their units before the end date but it must include a prominent warning of the possible resulting loss on the investment.

#### Explanatory text

7. Regarding the presentation, the scenarios should be called ‘illustrative examples’ to indicate that they are not forecasts. This should also be emphasised in the explanatory narrative.
8. CESR believes that management companies are best placed to decide between tables or graphs. There should be a separate graph or table for each scenario.
  - Tables may be appropriate when the investment strategy and the formula for the payout is easy to explain or when the payout depends on the performance of a basket of shares.
  - Graphs may be appropriate where a table becomes complicated or where the payout cannot be properly illustrated; for instance, UCITS based on a path-dependent payout, or one based on the average performance over time of an index.
9. The narrative shall explain that investors can sell their units before the end date. But it shall include a prominent warning of the possible resultant loss on the investment because the value will not be calculated using the formula but will depend on the market value of the underlying assets at that time.
10. Since structured UCITS have extremely varied risk/return profiles, these guidelines cannot address all potential situations. For instance, where the formula averages the performance of underlying assets such as indices or shares, the fund’s growth or loss is generally more limited. In this situation, the narrative should clearly explain that the investor will not receive the full benefit of the growth in the underlying nor suffer the full loss of the decline in the underlying.

## ANNEX

### Examples of scenario selection and presentation

These examples are designed only to illustrate these guidelines; they should not be taken as templates for the design of KII documents.

#### Choice of scenarios

##### **Example A**

A fund indexed to the average performance of a benchmark will require scenarios illustrating:

- the payout under favourable conditions
- the positive impact of the formula if the benchmark declines at the end of the fund's life, and
- the negative impact if the benchmark performs strongly near the end date.

#### **Use of tables**

##### **Example B**

Illustrative tables may be most appropriate for a structured UCITS with a payout based on the average performance of a basket of shares over time. For instance, a UCITS with an investment strategy to achieve a payout based on the yearly performance of a basket of 5 shares calculated over 2 years.

The final payout is the average of all the performances of each share in the basket. The performance is calculated as the underlying value of each share in the basket after 2 years with any growth capped at 9.5%. There is a legally enforceable guarantee of the return of the amount invested.

##### **Unfavourable conditions (low return):**

| Share | Underlying performance | UCITS performance |                                             |       |
|-------|------------------------|-------------------|---------------------------------------------|-------|
| 1     | -4%                    | -4.0%             | Average performance of the basket of shares | -8.2% |
| 2     | -2%                    | -2.0%             | UCITS performance                           | 0%    |
| 3     | -12%                   | -12.0%            | Equivalent annual growth rate               | 0%    |
| 4     | -23%                   | -23.0%            |                                             |       |
| 5     | 0%                     | 0.0%              |                                             |       |

At the end date, the average performance of the basket is -8.2%, so the guarantee will apply.

If units are sold before maturity: the price will be based on the market value of the financial derivative instruments used and not the value of the underlying shares.

##### **Favourable conditions (high return):**

| Share | Underlying performance | UCITS performance |                               |       |
|-------|------------------------|-------------------|-------------------------------|-------|
| 1     | 10%                    | 9.5%              | Basket of shares performance  | 11.2% |
| 2     | 11%                    | 9.5%              | UCITS performance             | 9.5%  |
| 3     | 12%                    | 9.5%              | Equivalent annual growth rate | 4.65% |
| 4     | 10%                    | 9.5%              |                               |       |
| 5     | 13%                    | 9.5%              |                               |       |

Therefore, an investment kept until the end date, would pay out only 9.5% of the amount invested.



### **Medium conditions (medium return):**

| Share | Performance | Performance Retained |                               |       |
|-------|-------------|----------------------|-------------------------------|-------|
| 1     | 2%          | 2.0%                 | Basket of shares performance  | 3.2%  |
| 2     | 0           | 0.0%                 | UCITS performance             | 2.9%  |
| 3     | 8%          | 8.0%                 | Equivalent annual growth rate | 1.44% |
| 4     | -5%         | -5.0%                |                               |       |
| 5     | 11%         | 9.5%                 |                               |       |

At the end date, the average performance of the basket is 3.2%, and the UCITS performance will be only 2.9% because of the cap on one of the shares in the basket. This corresponds to an annual growth rate of 1.44%.

In these scenarios it would be difficult to use several graphs for each share in the basket and also to illustrate the final payout by the UCITS.

### **Use of graphs**

#### **Example C**

For a structured UCITS designed to last for up to 8 years, but with an early 'kick-out' feature.

If at an annual measurement date, Eurostoxx is at least at its level on the start date, the payout is the original investment increased by 8% for each of the years since the start date. If this happens at the end of the second year onwards, the equivalent annual growth rate will be less than 8%.

If at each annual measurement date, the performance of the Eurostoxx index remains below its level at the start date, the payout after 8 years depends upon the CAC 40 index.

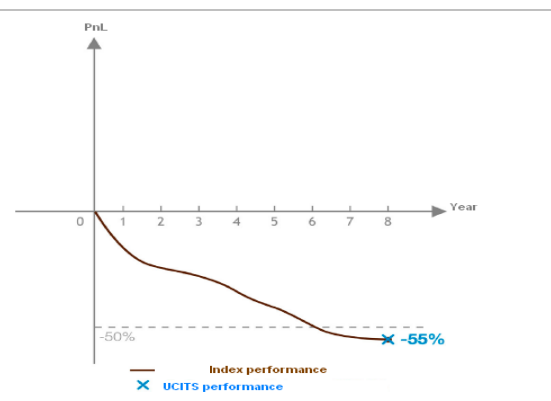
- If the CAC 40 index has dropped by 50% or less since the start date, the original investment is paid back.
- If the CAC 40 index has dropped by more than 50% since the start date, the payout is the amount originally invested reduced by the percentage decrease in the Eurostoxx index.

Investors' capital is therefore at risk.

### **Very unfavourable conditions (low return):**

The Eurostoxx index remains below the level at the start for 8 years so the plan does not pay out early.

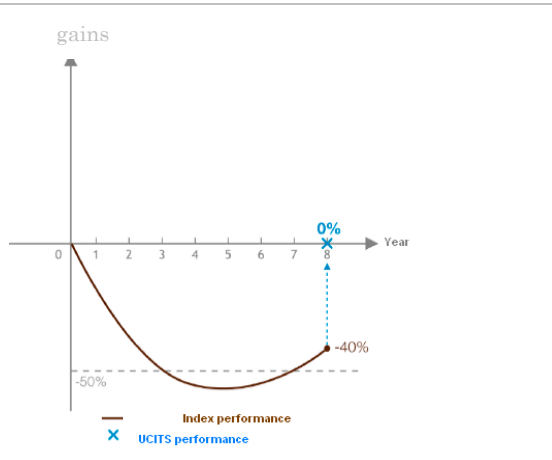
After 8 years, the level of the CAC 40 index is less than 50% of its level at the start date, which means that the payout is less than the amount originally invested.



### **Unfavourable conditions (low return):**

The Eurostoxx index remains below the level at the start for 8 years so the plan does not pay out early.

But after 8 years the CAC 40 index has not reduced by more than 50% of its level at the start, so the payout is the amount originally invested.

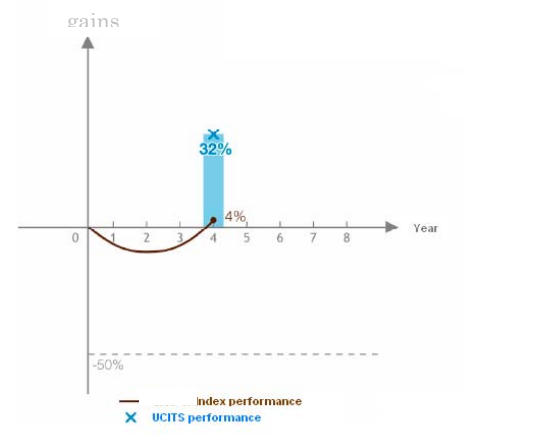


### **Favourable conditions (high return):**

The Eurostoxx index goes above its level at the start date for the first time at the 4<sup>th</sup> measurement date.

The plan will then pay out the original investment plus 32% ( $4 \times 8\%$ ), so a €1,000 investment would grow to €1320

The equivalent annual growth rate would then be 7.18%.



If units are sold before the end date: the price will not be calculated using the formula but will be based on the net asset value of the UCITS which will include the market value of the financial derivative instruments used.