Diversified growth funds

Balancing diversification and growth

In conversation:

Martin Dietz | Bernard Nelson | John Arthur | Fiona Gillespie
Yoram Lustig | Nick Ridgway | Sebastian Cheek

DECEMBER 2014 | PORTFOLIO INSTITUTIONAL ROUNDTABLE

Martin Dietz
fund manager,
LGIM

Nick Ridgway
researcher,
Buck Consultants

Sebastian Cheek
deputy editor,
portfolio institutional

Yoram Lustig
head of UK multi-asset investment team,
Axa Investment Managers

Fiona Gillespie
senior investment manager,
Aberdeen Asset Management

Bernard Nelson
senior investment consultant,
JLT Employee Benefits

John Arthur
managing director,
AllenbridgeEpic Investment Advisers

Balancing diversification and growth

Investing in multi-asset funds has been a favourite approach among investors for years in order to achieve diversification and manage volatility. Interest in multi-asset harks back to the days of traditional balanced funds which were seen as a relatively cheap way of accessing a little bit of everything.

These early balanced funds, however, housed a number of flaws, not least their relatively static nature and inability to react to changing risk appetites and market conditions, particularly when under periods of market stress.

Since the financial crisis however, multi-asset has seen something of a resurgence as investors have looked for better diversified portfolios and improved volatility management. Multi-asset funds have therefore had to adapt and a variety of different strategies and managers have come to the fore.

Indeed, diversified growth funds (DGFs) have increasingly become part of the institutional investment landscape. Heralded as offering investors the high probability of a reasonable return with relatively low volatility, DGFs have exploded onto the scene as investment houses big and small have flooded the market with products.

In the case of defined benefit (DB) schemes, some have chosen to allocate a section of their portfolio to DGFs whereas others, mainly smaller players, have outsourced their whole portfolio to a DGF manager. For defined contribution (DC) schemes meanwhile, DGFs have increasingly come to form the basis of their default funds - although that could change after April next year when pension savers will no longer be required to take an annuity at retirement.

Whichever way the landscape pans out, investors need to be cautious as the term 'DGF' covers a wide range of strategies and fee structures. In reality, DGF refers more to a heterogeneous group of funds and strategies, than an asset class and so investors really need to understand the nuts and bolts of what it is they are investing in before allocating to these strategies.

Another concern is that DGFs have not been fully stress-tested through the economic cycle. In their current guise, for example, they have not lived through a sustained difficult period in equity markets raising questions about their structure and robustness. Are DGFs only structured to deal with the current market conditions? What happens if the market environment changes drastically or if rates rise?

This roundtable assembles a panel of experts to discuss the issues around the DGF market and analyse the current environment for investing in this growing strategy.

Sebastian Cheek
deputy editor, *portfolio institutional*

Yoram Lustig

"We all agree we should be measured on the long term and investors should focus on the long term, but we are judged every quarter. So to survive the long term, you need short-term performance." Yoram Lustig

How should we define a diversified growth fund (DGF)?

John Arthur: DGF has developed as a way of providing a higher probability of achieving a reasonable return with relatively low volatility compared to a scheme's actuarial assumption. It was finally getting back to answering the question that trustees should be asking, which – as an industry – we've failed to focus on for far too long. It may be for a small scheme the only investment they have; for a large scheme it may be a base investment that just gives them some level of probability of hitting that actuarial assumption of their future returns and lowering the volatility of their overall pension scheme deficit.

Nick Ridgway: It is simply a solution because what you have is a collection of assets. It's not managers doing different things with different pension schemes, but a solution-led instrument.

Martin Dietz: One of the main challenges is to look at the wide range of funds on offer and decide on the one that fits best. A lot of the selection exercises, unfortunately, are not tailored to the requirements of the scheme. A small client that is fully invested into a DGF wouldn't want to use a derivative-heavy, very active structure, but something that is banking on diversification of asset classes. A large scheme using a core satellite structure would want a very different structure and people need to be aware of that.

Yoram Lustig: One of the differences DGF introduced is the outcome-oriented objective. So, while it's a very heterogeneous group of funds, one similarity is they usually target an outcome, such as Libor plus, or inflation plus 3%, 4%, or 5%, with two-thirds or one half volatility of equities.

Ridgway: Traditional balanced managers probably felt the shackles were released so they would be less constrained, so their multi-asset capability benefited them. Managers are coming out with much more


Martin Dietz

"The main challenge is you can only prove you've actually achieved your return target over long time periods. The only thing you can prove over shorter periods is a volatility target." Martin Dietz

sophisticated solutions, trying to be better defined – whether it be capital preservation or getting more equity return over the longer term. Historically, DGFs were put in front of clients and they weren't really any the wiser of what they were getting.

Do some treat it as an outsourcing tool, allocating their whole portfolio to a DGF?

Arthur: It depends on what their requirements and risk tolerance is. Different DGFs fulfil different needs. The consulting industry needs to look at understanding the nuances and the complexities of each offering.

Dietz: The main challenge is you can only prove you've actually achieved your return target over long time periods. The only thing you can prove over shorter periods is a volatility target. People put out return numbers but there's no real way of finding out if they can hit that target over a market cycle.

Fiona Gillespie: The time horizon is hugely important. The making or breaking of the DGF concept will be when equity markets have a sustained difficult period, not rising at the rate that we've seen. The industry's had a tail wind behind it to achieve some of these returns in the last five years.

Arthur: The issue of equity markets going through a tougher period is an interesting one. One of my concerns with DGFs is they are in the main structured to cope with the sort of environment we've seen in recent history, not to what potentially could happen in the future.

Dietz: Absolute market volatility has been quite low. But you can look at fund volatility relative to the equity market and you still get an idea whether you are on track to what you're trying to achieve.

Lustig: Over the last couple of years volatility has been artificially low. Now the US is at the end of QE, volatility is bound to increase. Interest rates will also go up at some point, so there will be a number of headwinds for DGFs. Equity markets have moved sideways for 12 years, since 2000 to 2012 you had the 2000 tech bubble burst and the 2008 financial crisis so it's been a very tough time for the industry.

Are DGFs a bit too geared towards the current environment? What other risks are there?

Dietz: DGFs have a risk and a return target, and after the credit crisis were very much sold on that risk target and risk reduction features. Many managers attracted a lot of money over the past years because their investment strategy happened to work well during the credit crisis – due to luck or skill. A challenge is that as memories of the credit crisis start to fade and people get more focused on returns given the equity rally.

Lustig: We did a survey a couple of months ago and one of the questions was: "What are the risks for the DGF industry?". The top three were a lack of transparency and understanding what DGFs are, then underperformance, bad performance or a blow up of one of the big funds. The last was a strong rise in bond yields coupled with a sharp increase in inflation.

Ridgway: There are more portfolios I've seen which are trying to have stabilisers around their portfolios, putting reducing assets in there, so if there is a rate rise issue then they're going to be protected or there's some sort of non-directional element to the portfolio that wouldn't be impacted by that. Or containing some hedges to stabilise from an equity market sell off. They're trying to be a bit more robust but can you mitigate all risk out there?

Gillespie: A lot depends on how correlations change. The heart of a DGF should be about trying to construct a portfolio of lowly-correlated assets which, over a market cycle, should stand the portfolio in good stead. However in certain environments, such as periods of significant market stress, assets classes can all move in the same direction and so finding lowly or uncorrelated assets is almost impossible. These environments are few and far between but where DGFs find themselves really struggling to make meaningful headway or indeed identify assets which can protect the portfolio when times get tough.


Nick Ridgway

Lustig: There's a very strong link between inflation and Libor. If inflation goes up, Libor will also go up because short-term rates will go up as the central bank will do something about it. Over a very long time period it probably still holds, the only question is, do people have that 20-year time horizon that actually works? We all agree we should be measured on the long term and investors should focus on the long term, but we are judged every quarter. So to survive the long term, you need short-term performance otherwise you won't stay in business.

Bernard Nelson: In reality clients do think longer than managers give them credit for. They're not chopping and changing every five minutes.

Dietz: DGFs can be so complex even consultants will, in some cases, struggle. They tend to be very opaque structures, managers may put the three trades that worked really well out of the 20 they did in front of clients and consultants. Sometimes there's not enough transparency possible in this market.

Ridgway: Once you've got client expectations managed, the next challenge from a researcher's perspective is how managers are expected to perform over the long term. Sometimes they don't know, but if they can think about those questions then when we speak about quarterly performance cycles you definitely have an information advantage. That will help us manage client expectations. If they think something's disappointing but it is in line with the manager's strategy, it then hopefully loops back to the solution. But there can be a disconnection between the simulation of the solution and running it because it's not really serving what the client's looking for in the first place.

Lustig: One of the challenges of the second or the third generation of DGFs is transparency to allow

consultants and also trustees to understand what's going on in the strategy. That's perhaps the reason that many big investors have disinvested from hedge funds. Not only because they're expensive and sometimes the performance has been disappointing, but because some of them are opaque. Here DGFs can offer something which is much more transparent and easy for investors to understand.

Gillespie: There are various challenges there, not least streamlining of reporting functions within the asset management company which results in a loss of the bespoke approach.

Dietz: I think that's important. There's the pure fund value: volatility that investors mainly worry about, but there are so many other dimensions that may be more important for trustees to monitor on an on-going basis. Did you just buy into that one person managing the fund? Is it a very derivative heavy structure and are you comfortable with that? That is a very important dimension of risk and often comes down to the size of clients, judging what the fund does versus the governance budget or the sophistication of the end client.

Arthur: There is also a life-cycle element to consider. DGFs have been so successful, competitors want to enter the space. Those fund managers who have a proven record of success are being enticed to join competitors and being offered an environment with a large amount of discretion and control. The number two or three in that team is also being bid up to head up another team elsewhere, so it's been very concentrated. It comes back to the questions that consultants must ask – is this a one-man team, what are the risks to us of personal changes, etc?

Gillespie: In the last year there have been some high profile fund closures and investment teams moving. It may be the natural cycle in the marketplace and that creates opportunity for funds in the sector.

Bernard Nelson

Nelson: Some of the more successful ones have closed to new business, so it's given an opportunity to new entrants, which is a good thing if they manage their capacity. The team event we've alluded to is causing a lot of rethinking of how to blend DGFs – do you move to a second or third one and how do you fit them in the portfolio?

Gillespie: Different styles of DGF that complement each other and blending of DGFs is becoming more popular. Investors tend to blend styles, e.g. a transparent fund investing in securities and/or pooled funds, so a cash-based approach to investing, with a more derivative or perhaps geared approach.

I suppose that depends on fund size as well.

Dietz: For a lot of large DB investors, DGF to some degree replaces what used to be a fund of hedge

Fiona Gillespie

"In the last year there have been some high profile fund closures and investment teams moving. It may be the natural cycle in the marketplace and what that does is create opportunity for funds in the sector." Fiona Gillespie

fund structure. They are providing relatively punchy investment views, maybe some exotic exposure to different alternative asset classes, so it's a core satellite approach to a large degree. DB schemes would be less likely to buy a beta driven fund perhaps, because they can buy all of the underlying elements directly.

Lustig: The big funds don't buy DGFs but manage a multi-asset portfolio. It is a very interesting point for the small schemes to say they can almost do what the big ones are doing in a relatively efficient way, if they buy a packaged solution and invest into one fund and get the benefit of diversification that the big ones have been using for a couple of years.

Gillespie: Large DB schemes have a different liquidity requirement compared to a small DB or a DC scheme. A large DB scheme can be more relaxed about liquidity and certain assets, which opens up another universe of assets for them to look at.

Ridgway: A larger scheme can take a bit more liquidity risk and be a bit more sophisticated. A portion of their growth passes into a DGF, something that's completely non-market directional, very alpha driven, etc. They probably target something quite specific and niche because they've got the budget to do so and it's probably replaced the hedge fund type of solution that was in there pre-crisis.

As consultants are you seeing DGFs being used as a de-risking tool as well?

Nelson: Yes. It's part of the process. We want to reduce equities but we don't like the price of bonds. DGF is a sort of halfway house that allocates some money from equities into DGFs. People who've taken money out of equities and put it into DGF thinking they're going to get the equity return will be disap-

pointed in the long term. Or are misunderstanding what they're doing in the first place.

Lustig: I don't think anything can beat equities if you want the high returns, depending on the time horizon. If you want high returns, just concentrate your portfolio and go full throttle with the equities. Forget about diversification. The cost is the downside risk. There is this assumption that, before DGF came long, people invested everything in equities, forgetting they did have other assets in the portfolio. But DGFs need to be transparent to improve their risk management. We tackle it by introducing risk factor analysis to ensure our fund is truly diversified across uncorrelated risk sources. That's one way to improve your risk management but in a very transparent way because we can explain it in a couple of minutes to trustees and their consultants. Everyone gets it, because it's not rocket science.

Ridgway: But it wasn't done much before, which is why there's been such a steep learning curve.

Lustig: Absolutely – 10 years ago, nobody spoke about risk factors or risk factor diversification, but asset allocation. We have seen a lot of innovation over the last decade, so there are ways to better manage your portfolio but without introducing unnecessary complexity.

Dietz: Another important dimension is the kind of risk people want to be protected against. The focus really needs to be not only on managing the volatility in benign environments, but extreme markets. People look a bit too much at the smoothness of the historic returns over a very short time period. What really matters is the adverse environments of 2000 or 2008 and protecting against them.

"Some managers have closed to new business. The team event we've alluded to is causing a lot of rethinking of how to blend DGFs – do you move to a second or third one and how do you fit them in the portfolio?" Bernard Nelson

Lustig: In addition to transparency and better risk management, everything needs to be cheaper now. There is pressure on charges and you need to do all the bells and whistles, be transparent and offer it at a very competitive price.

But some strategies will need to be more complicated and therefore more expensive.

Nelson: Using an external fund manager is often where the biggest cost is. Is there any evidence they're bringing down their fees?

Gillespie: We try as much as we can to keep everything in house. We have a budget – a TER budget if you like – and we have to decide how we spend that. It goes back to the point mentioned: we will use our in-house equity products that are actively managed but we now have a whole host of other options, because we have recently acquired a passive arm to our business. The more we can capitalise on our global reach, the lower we can keep the fee-base down while building an appropriate portfolio.

Arthur: Is that a disincentive then to invest in expensive asset classes?

Gillespie: Our budget only has to be used for those asset classes that we can't get in-house, so we can concentrate on using the TER budget on the alternative assets in the main.

Arthur: As the fees come under more pressure, there is a disincentive to invest in expensive asset classes.

Dietz: If you do that in a very strict way, yes. We don't see the point in going externally for asset classes we already have and you can do a very credible job doing indexation in all asset classes. Going externally has cost implications but also transparency issues, as you don't necessarily understand how the underlying managers are positioned.

Arthur: I think there should be scope to use direct exposure through ETFs of indexes, as well as that active management approach. You know what their philosophy and style is. There will be moments in the market where you think the market is going to act like x and that does not suit your manager.


John Arthur

"Certain styles of hedge fund and DGF can provide some match to interest and inflation rates over the long term. Others can be wildly different and totally inappropriate to matching a scheme's liabilities." John Arthur

Lustig: I think, as a manager of a DGF, our role should be to deliver the outcome for our clients and we shouldn't invest in anything we don't think is going to deliver on the objectives. We shouldn't be forced to invest in an internal fund if we don't have conviction it is going to meet its objective.

Dietz: If you're just doing an internal approach and you're forced to invest into what you perceive as weak parts of the business, that's a big challenge. The only way out of that is using indexation because you can credibly do indexation in every single asset class, without having some concerns about any of them.

Lustig: We have concerns about indexation because when you index to market capitalisation, for example in equities, you are concentrated in large caps in bubbly sectors, like the build-up of 2000. When you invest in credit you have a lot of weight in companies which issues a lot of debt and you're forced to sell a falling angel, so any company that goes below investment grade, you are forced to sell it, despite usually having a big recovery after they fall out.

Nelson: Clients do like the idea that a DGF manager can go external and is often put forward as a selling point, going internal where they have the capability.

Gillespie: I think it's having a sensible approach to that and saying there's not a hard or fast rule one way or another. Clients also appreciate that sensible approach.

Ridgway: Sometimes going external adds a layer of complexity because you don't know what the external manager is doing. But if that is the case, don't invest in it if you don't understand. It's that simple.

Gillespie: That's absolutely right, but from a market perspective that's maybe narrowing down the opportunity for smaller asset managers to get into the space. What will that do to the industry as a whole? Is it making it too concentrated on one particular type of asset manager?

Lustig: There is a consolidation trend in our industry. As the years go by, the smaller players disappear and a black hole probably swallows everything. The big ones get bigger and the small ones either disappear or, you have boutique houses.

Arthur: There will always be a regeneration of boutiques. There will always be a desire for managers to set up their own firms. Certainly the base cost – the barrier to entry is rising.

Gillespie: Not least in terms of risk management – that is a significant cost of the overall operation.

What impact will pension freedoms announced in the Budget have on DGF use in default funds?

Nelson: It has to be very positive, because the standard default, or lifestyle approach going into pension bonds has gone. You'll want there to be much more growth, equity, or DGF orientated for longer. Whether some of the DGFs will start to offer more income options within that remains to be seen.

Dietz: DC's an obvious growth market and until recently, DC schemes were too small to focus much on the most efficient investment structure. This is why you've seen default funds that are not very diversified or efficient. As DC funds get bigger there is more emphasis from an employer perspective, there is more advice from consultants coming, and that improves these structures across the full lifecycle. The big change is now people have full flexibility to do what they can do, what they want. It's probably going to require different DGFs than were used in the growth phase. Less ability to take risk, maybe a smaller return target, but we think you can design something that takes the specific characteristics of these people into account. They are not having such a long time period, they need some cash flows along the way, so

Fiona Gillespie and Yoram Lustig

it almost asks for new structures, new DGFs.

Lustig: There is a revolution in the retirement landscape, not only in the UK, but across the world. There is a demographic issue, DB schemes are disappearing and so there is a huge shift to DC. These people live longer, they need to be invested for a longer time period. Some of them, after retirement, may work half time, so we need to come up with new solutions. One of them could be DGFs, one of them could be a diversified income fund, or a combination of all these elements. We are living in very interesting times.

Ridgway: The changes certainly have been – or will be – positive for the DGF market, in one way or another. Who knows what will happen, but certainly I think it's a boon to the industry.

DGFs – looking under the bonnet is key

By Fiona Gillespie, senior investment manager on the investment solutions team, Aberdeen Asset Management

Diversified growth funds (DGFs) are, in a loose sense, one of the biggest success stories in asset management in recent years. The top half dozen account for £50bn, which is remarkable for a category which only got its name eight years ago. And there is competition, the golden circle of big funds is now under challenge from a host of rising stars.

DGF is a brand and not a product, according to Spence Johnson. The paradox of DGFs is that several of the big funds currently in this category have been placed there rather than sought inclusion. And so, the best definition might be as broad as "products that utilise a variety of liquid assets, strategies and investment horizons".

In relative positioning, DGFs sit between balanced managed funds on the one side and hedge funds on the other. But DGFs are flexible funds by nature in an equally flexible category. Several of the biggest do not call themselves DGFs and the label is nowhere in their branding. Some take refuge during difficult times in cash – not a growth asset in any textbook. There isn't even consistency in charges: annual management charges range from 30 to 120 basis points, according to Spence Johnson.

So how do investors compare apples with pears and does this matter?

Under some circumstances this heterogeneity could present a problem. Homogeneity helps consultants and clients to benchmark products conveniently. When hedge funds first came calling as suitors for institutional pension fund money in the UK, the difficulties of transparent comparability slowed their success. But the fortunes of DGFs and their clients have not been likewise impaired. Why? First of all, DGFs are far less numerous than hedge funds. At the wildest stretch there are less than 100 possible candidates for inclusion, although few comparison charts show more than 25. So for all the necessary caveats, the universe is manageable. DGFs also tend to emanate from well-known managers in the UK institutional market, saving interested prospects much labour on operational due diligence.

While there is a broad spread of fees, it is also worth pointing out the value of DGFs. Pension fund consultancy, Lane Clark & Peacock reckons 65 basis points is the typical annual management charge for a £50m DGF mandate directly contracted by a defined benefit plan. Given both the potential breadth of assets and dynamic allocation of DGFs, this charge appears attractive.

But, surprise, surprise: the backbone of the success of DGFs has been a sound track record. On this we should be clear that the risk characteristic is as important as the return. On a pure return basis, global equity indices have outperformed many leading DGFs over the past five years, but with far more volatility. So it is strong risk-adjusted performance by those products in the leading pack, over a number of years and variety of market conditions, which present a hefty obstacle to any weak new entrant now wishing to join the fray.

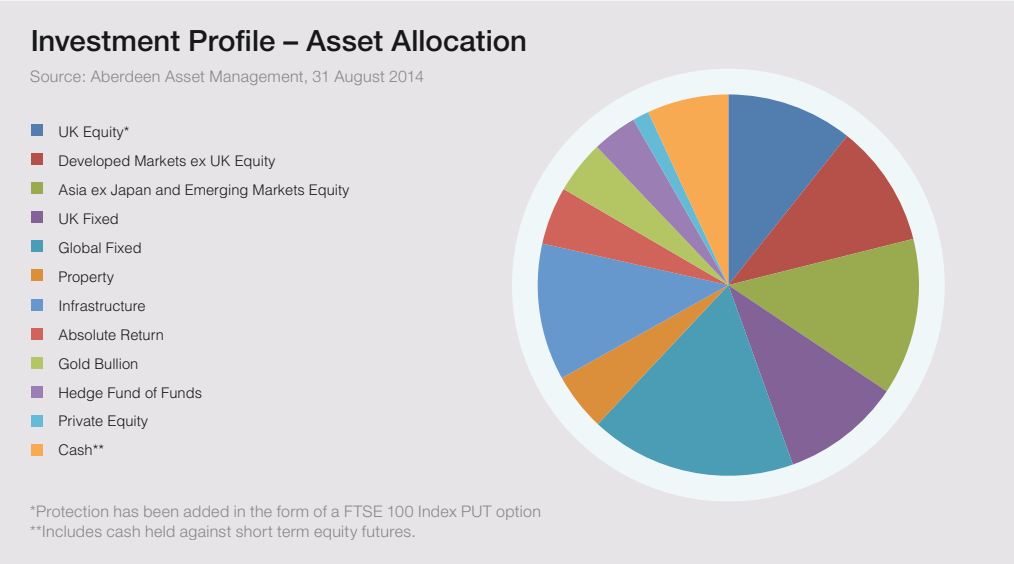
There are a few DGFs which have been withdrawn by their providers and others reformulated. The resultant survivorship bias, making returns of the universe look all the better, has only become part of the obstacle to new entrants.

Demonstrating ability to produce solid risk-adjusted performance is fast becoming the most important criterion for new launches. This is excellent news for prospective pension fund clients. Commercial asset managers can take advantage of the looseness of the definition of DGFs to shape products which best suit their strengths. But those strengths have to be readily demonstrable. This requires more work by all parties involved compared with simpler, single-asset strategies – especially from the manager, adviser and fiduciary.

Undoubtedly, DGFs have benefited from the power of brands (an obstacle even today for many hedge funds). The leaders of this particular pack are mostly names well known to pension fund trustees, who may be familiar with them running other mandates or individual investment products. Such reassuring recognition has no doubt helped their success. The danger otherwise for prospective clients is that they do not understand all the sources of risk and return in some DGFs and therefore make choices based on insufficient understanding. In other words, it is very important to check under the bonnet of a DGF.

To give you a flavour, our DGF product ignores the natural developed market bias inherent in so many products. Dynamic asset allocation means it can seamlessly switch investments, not just between asset classes but between regions too, following returns anywhere in the world to maximise them.

As DGF products vary widely it is important to check underlying allocations. The following asset allocation chart shows under the bonnet of the Aberdeen Diversified Growth Fund:



And so while DGFs may be a frustratingly loose category, with a range of constituents each of which merit time-consuming individual scrutiny, ultimately the winning products here share a similar trait to all successful investment products: an enduring ability to deliver on one's promise.

For those DGFs that can display this trait the future indeed looks bright.

Disclaimer: The value of investments and the income from them can go down as well as up and you may get back less than the amount invested.

For growth, we pick the hot spots.

Aberdeen Diversified Growth Fund

Our 30 years' experience in the world's fastest growing economies is what helps make the Aberdeen Diversified Growth Fund distinctive.

The Fund aims to achieve genuine diversification by investing across equities, bonds, property and alternatives to deliver growth with lower volatility.

We go straight to the heart of the economies driving global prosperity. Diversified growth with a bit of spice.

The value of investments and the income from them can go down as well as up and your clients may get back less than the amount invested.

For more information please visit aberdeen-asset.co.uk/DGF

Aberdeen
Simply asset management.

FOR PROFESSIONAL INVESTORS ONLY. NOT FOR USE BY RETAIL INVESTORS OR ADVISERS.

Issued by Aberdeen Asset Managers Limited which is authorised and regulated by the Financial Conduct Authority in the UK. aberdeen-asset.co.uk

Smart diversification

By Yoram Lustig, head of multi-asset investment team, Axa Investment Managers

Empirical studies demonstrate that traditional diversification techniques can be improved upon in a number of relatively simple, cost-efficient ways. Applying these newer techniques to DGFs, smart diversification can help to deliver an improved level of risk reduction while cost-efficiently harvesting systematic returns.

Upgrading the traditional approach

Since the concept of diversification was formalised in the 1950s, it has been recognised as one of the few proven ways to mitigate investment risk. When diversifying in a multi-asset context like a DGF, investors typically blend asset classes together to reach an efficient asset allocation with a certain level of expected return and risk in line with their objectives. Normally, each asset class is represented by a market capitalisation index whose historic returns are used for analysing the asset class' characteristics.

Today, academics and practitioners agree that traditional diversification approaches suffer from a number of weaknesses. For example, while portfolios may look balanced across assets, their risk is often dominated by the equity component. Similarly, portfolios that are diversified based on market capitalisation indices can suffer from a bias towards unrewarded systematic risks, and a tendency to be concentrated in overpriced sectors.

A number of modern diversification approaches have been introduced in response to these weaknesses.

Technique 1: Dynamic diversification

Uncertainty is a defining characteristic of recent financial times. DGFs need to be responsive to a number of unfolding developments, such as the end of quantitative easing (QE) and the uncertainty over returns from bond markets that are distorted by policy makers.

In this environment, static diversification does not offer investors the responsiveness they require. DGF allocations that are actively managed through dynamic diversification can react to development in financial markets. Instead of holding allocations constant or rebalancing to a set target, dynamic diversification responds to the changing characteristics and roles of asset classes in portfolios, and counters the shifting correlations among them.

Technique 2: Risk factor diversification

Risk factor diversification reduces the risk of perceived diversification. The devastating effects of this risk were seen during the 2008 financial crisis, when the correlation among equities, corporate bonds, and commodities jumped up towards unity and multi-asset investors discovered that their portfolios were not really divided among uncorrelated investments.

Using risk factor analysis, each asset class is evaluated as a combination of different risk factors. For example, the risk and return of global developed equities consists of inflation, developed growth and commodity risk factors. The risk and return of investment grade credit is made up of real term, inflation, developed growth and credit spread risk factors. Even though global developed equities and investment grade credit are two different asset classes, risk factor analysis shows that they have some risks in common.

This technique can reveal the changing exposures of asset classes to risk factors. Accordingly, DGFs can shift their asset allocation to ensure that diversification across risk factors is maintained over time.

Technique 3: Smart beta diversification

Smart beta diversification can improve the efficiency of a portfolio's risk-return combination by correcting for the biases of market capitalisation indices. By weighting securities to remove these biases, smart beta strategies eliminate a structural drag on diversification and return.

While market capitalisation indices are often used as default choices for investment benchmarks, they suffer from two distinct weaknesses. First, they create a bias to large cap stocks and growth stocks. These biases are often unrewarded, whereas small cap and value biases tend to capture additional return. Second, market capitalisation indices offer poor diversification of unrewarded and specific risks. The concentration in large caps results in an excess exposure to the idiosyncratic risks of the large companies that issue these stocks. The index is also prone to having a large concentration in sectors that have strong recent performance and are experiencing bubble effects.

DGFs that include smart beta strategies in their core holdings can generate improved diversification by correcting for these biases through simple tilts towards targeted premia.

Technique 4: Risk premia diversification

By assuming exposure to a basket of systematic risks that attract different risk premia, DGFs can avoid reliance on a single source of return. Using this insight, risk premia diversification not only reduces the portfolio's risk, but also expands its investment opportunity set and harvests a large crop of return generating sources.

Equity, credit and maturity risks are the traditional systematic risks that attract a risk premium. DGFs should tap into systematic risks beyond the traditional ones. Empirical evidence demonstrates that style factors such as value, size, momentum, and low volatility all attract risk premia.

Through risk premia diversification, DGFs can eliminate dependence on individual risk premia, reducing portfolio risk and extracting return from a wider range of sources.

Smart diversification

As demonstrated in Table 1, a DGF that combines these newer techniques offers a number of value-adding characteristics.

Table 1: The principles of smart diversification applied to DGFs

Source: AXA Investment Managers. For illustrative purposes only.

Smart diversification	Dynamic diversification	Risk factor diversification	Smart Beta diversification	Risk premia diversification
In the past	• Static	• Across asset classes	• Market capitalisation indices	• Traditional risk premia (equity, credit, maturity)
Modern	• Dynamic • Adaptive • Consider changing nature of assets • Dynamic universe of assets	• Across risk factors • Better understand the changing characteristics of assets	• Smart Beta strategies • Cost-efficient added value	• Traditional risk premia • Additional risk premia (value, size, momentum, low volatility)
Application in DGFs	• Dynamic asset allocation	• Risk factor analysis	• Smart Beta equity and credit at the core	• Introduce a process that biases portfolio to value, size, momentum and low volatility style risks

By merging these strategies in an integrated framework, smart diversification can enable DGFs to implement the latest diversification techniques in a structured and cost efficient way.

AXA INVESTMENT MANAGERS
redefining / investment solutions

Managing risk by mixing growth assets together in a smart way

Talk to **AXA Investment Managers** about our Diversified Growth Fund, an outcome-oriented solution that uses smart approaches to mitigate unwanted risks and keep costs low.

Lisa O'Connor | +44 (0)20 7003 2016 | lisa.oconnor@axa-im.com

www.axa-im.co.uk

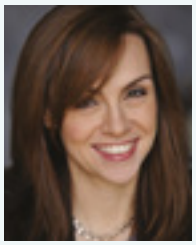
This document is for professional investors only and must not be relied upon or distributed to retail clients. Circulation must be restricted accordingly. The value of investments, and the income from them, can fall as well as rise and investors may not get back the amount originally invested. Telephone calls may be recorded for quality assurance purposes. Issued by AXA Investment Managers UK Ltd registered in England No. 01431068. The registered office address is 7 Newgate Street, London EC1A 7NX. AXA Investment Managers UK Ltd (119368) is authorised and regulated by the Financial Conduct Authority under the account shown. 19163 London 08/14.

AXA INVESTMENT MANAGERS

redefining / investment solutions

Macroeconomic regimes and multi-asset investing

By Michela De Nicola, asset allocation product specialist, Legal & General Investment Management



Equities and bonds have long formed the backbone of multi-asset investing. We believe that successful asset allocation, that is helping investors to navigate through different economic regimes, can be achieved by recognising macroeconomic influences and tilting portfolio positioning accordingly.

Equity returns have historically proven sensitive to the prevailing growth environment, but relatively insensitive to inflationary environments. Meanwhile bond returns have historically been sensitive to inflation, but relatively insensitive to the growth environment. These macroeconomic scenarios can have significant influence on the prospects of different asset classes and, in turn, successful asset class selection in multi-asset investing.

The implications of different macroeconomic regimes for asset returns

Perfect foresight on the macroeconomic outlook would make asset allocation relatively easy. For example, economic downturns are typically associated with falling corporate earnings, rising defaults and rising risk premia - all of which tend to be negative for risk assets such as equities. We might also expect such episodes to be associated with safe haven flows that support government bond prices.

Investors have the potential to enhance risk-adjusted returns by anticipating the start and end of major downturns and dynamically altering their multi-asset strategy as a result. A commonly held assumption is that those able to correctly anticipate the start of a recession and therefore alter positioning towards government bonds for example, should enjoy excess returns. And conversely, investors should gain excess returns by correctly anticipating the end of a recession and allocating to riskier assets.

By dividing the last fifty years into three regimes according to whether growth was rising, falling or stable; and performing a similar exercise for inflation, we can plot how average real returns for US equities and US treasuries reacted in those regimes (see figures 1 & 2).

Figure 1: Equities and bonds: growth sensitivity

Source: Bloomberg L.P., Shiller, Cecchetti, US Federal Reserve

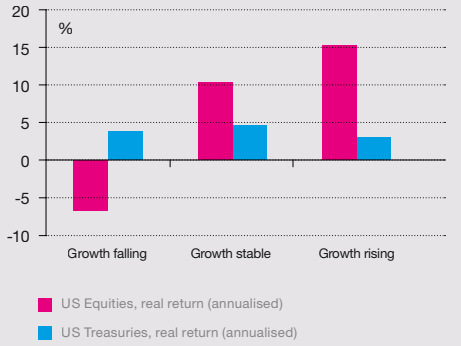
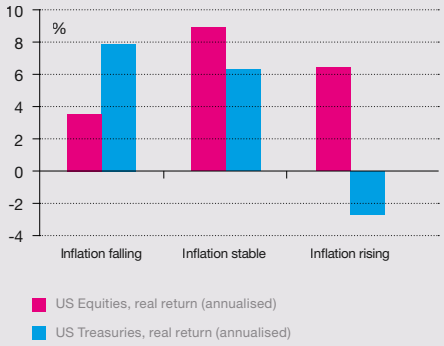


Figure 2: Equities and bonds: inflation sensitivity



What emerges from this exercise is:

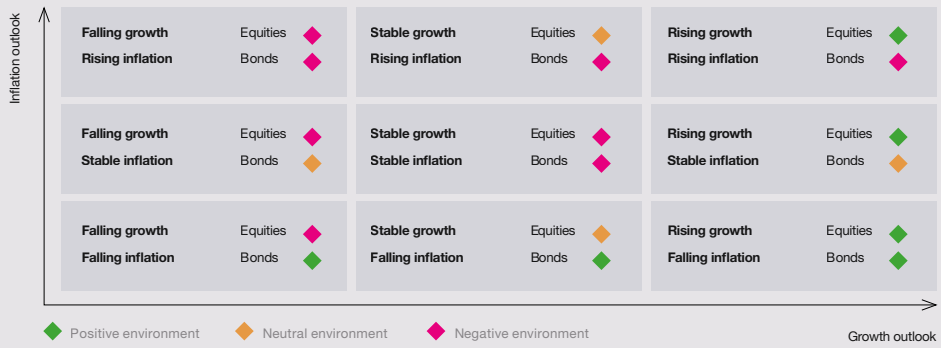
- US treasuries are sensitive to the inflation environment but (surprisingly) indifferent to the growth environment.
- US equities are sensitive to the growth environment but (surprisingly) indifferent to the inflation environment.

At the macroeconomic level, equities are driven more by the growth outlook; bonds are driven more by the inflation outlook. That simple observation has important implications for many aspects of a multi-asset portfolio: from how we think about risk to what kind of indicators are likely to be important for tactical asset allocation.

We summarise such regime-dependent returns in figure 3. As different growth and inflation regimes can exhibit markedly different patterns of asset returns, being able to identify periods of falling growth and rising inflation are particularly important when looking to mitigate losses to investors in a multi-asset environment.

Figure 3: Inflation/growth matrix

Source: LGIM



An unstable relationship

The relationship between equity and bond returns is unstable and regime-dependent. This means investors should be wary of portfolio construction techniques that place emphasis on single estimates of cross-asset correlations, as correlations are not constant across all macroeconomic backdrops. Mean variance optimisations are good examples of this type of approach. They are likely to underestimate the risk of outlier outcomes which is particularly dangerous in a 'weak growth and rising inflation' regime that is corrosive for real returns across both equities and fixed income assets (see top left hand corner of figure 3).

Investors may wish to consider richer empirical modelling when constructing multi-asset portfolios. This allows simulations to be run across several thousand potential scenarios drawn from the overall historical distribution rather than averaging out across different regimes which is more suited to the unstable relationships.

Today's macroeconomic regime

We have established that different growth and inflation regimes can exhibit markedly different patterns of returns in bond and equity markets and that correctly timing dynamic asset allocation alterations can have a significant influence on risk-adjusted returns. This awareness is particularly relevant today because we are arguably at a macroeconomic regime inflection point – which will have implications for asset allocation decisions.

There is increasing evidence that global core inflation (adjusting for the Japanese VAT hike) stabilised in 2013 and the last four months' readings are higher than the average of the last year. This suggests global core inflation has troughed. In addition, there has been a reassuring stabilisation of euro area core inflation since last October, suggesting the economy will avoid a plunge into outright deflation. Of course, euro area inflation remains dangerously low so the European Central Bank stands ready to ease policy further.

But for global investors, it is the US picture that is most relevant. It is noticeable that US core inflation has picked up in recent months, which has already triggered a hawkish change in language by the Federal Reserve towards rate rises. If US core inflation continues to grind higher, the Fed should get even more hawkish over the next year, following the Bank of England in ending forward guidance and ultimately raising interest rates. So far, the Fed has tried to minimise market reactions to its policy thoughts, but if the Fed does consider hiking interest rates soon, this could cause an increase in global financial market volatility.

What this means for multi-asset funds

So how should a multi-asset portfolio be successfully positioned in today's environment? Assets which perform well when inflation is rising and when growth is low are likely to be valuable diversifiers in a multi-asset portfolio at this point in time.

Inflation-linked bonds may be one of the (less considered) primary candidates that can help to reduce risk in multi-asset portfolios in this macroeconomic environment. Although they have limited history, we know such securities can pay off most emphatically when inflation expectations rise and hence real interest rates drop. Such securities are therefore an important building block within multi-asset funds despite low real yields on such assets at present.

We believe that multi-asset portfolios are best managed with a thorough understanding of current and prospective economic dynamics. Distinguishing in advance (or even in real-time) between minor bumps in the road and major economic potholes is fundamentally difficult, but it is hard to overestimate the importance of such an assessment for asset allocation strategy.

ON THIS DAY 14.03.13 THE UN HUMAN DEVELOPMENT REPORT HIGHLIGHTS GROWTH IN EMERGING MARKETS

The UN Human Development Report shows emerging market GDP grew at an average of 6.5% compared to just 1% for developed markets over the ten years to 2013.

As these economies continue to develop, their capital markets are broadening, with growing government bond markets and companies issuing equities and bonds. Successful investment strategies will benefit from in-depth research and the manager's ability to balance long-term potential against any short-term factors.

LGIM recognises that change will be a constant factor as emerging markets develop. Its multi-asset range has the flexibility to target the opportunities that this change will bring.

When the world changes, do you change with it?

To make the most of opportunities in global markets, diversified strategies must evolve.

MULTI-ASSET FUNDS

At LGIM we believe in delivering risk-controlled diversification in the most transparent, cost-efficient manner. We offer the excellence in macroeconomic analysis and specialist portfolio construction you'd expect from one of Europe's largest investment managers. But we make it easy for our clients to understand what we're doing and how we're doing it – and clients tell us they like this approach.

For more information please contact:

Michela De Nicola
Asset Allocation Product Specialist
+44 (0)20 3124 3606
michela.denicola@lgim.com
www.lgim.com

Authorised and regulated by the Financial Conduct Authority.

Legal & General
INVESTMENT MANAGEMENT

portfolio
institutional

Editor: Chris Panteli
Deputy editor: Sebastian Cheek
Contributing editor: Pádraig Floyd

Contact:
Sidra Sammi
Phone: +44 (0)20 7596 2875
E-mail: s.sammi@portfolio-verlag.com

Printer: Buxton Press
Pictures: Richie Hopson
Layout: Wani Creative

Publisher:
portfolio Verlag
Suite 1220 - 12th floor
Broadgate Tower
20 Primrose Street
London EC2A 2EW

ISSN: 2052-0409

This publication is a supplement of *portfolio institutional* and sponsored by:

Aberdeen

AXA INVESTMENT MANAGERS
redefining / investment solutions

Legal & General
INVESTMENT MANAGEMENT

© Copyright portfolio Verlag. All rights reserved. No part of this publication may be reproduced in any form without prior permission of the publisher. Although the publishers have made every effort to ensure the accuracy of the information contained in this publication, neither portfolio Verlag nor any contributing author can accept any legal responsibility whatsoever for any consequences that may arise from errors or omissions contained in the publication.

Are you interested in participating in future roundtable discussions?

Investors and investment consultants are invited to share their opinion and can be offered a complimentary place in future roundtable events. Asset managers interested in joining the panel can secure one of the limited sponsorship packages.

Contact us to find out more:
Sidra Sammi
Phone: +44 (0)207 596 2875
E-mail: s.sammi@portfolio-verlag.com

The next portfolio institutional roundtable will be held on Friday 21 November
Fixed income

Topics for upcoming roundtable discussions:
Exchange traded funds
Absolute return strategies
Infrastructure investment

portfolio
institutional