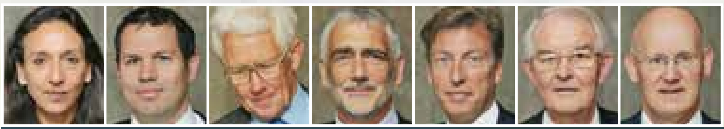
Diversified Growth Funds

Fit for purpose?



Vicky Kydoniefs | Craig Moran | Alan Pickering | Jonathan Reynolds
Ian Scott | David Weeks | Mike Weston

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Diversified growth funds: Troubling times

It has been a difficult year so far for diversified growth funds. Investor sentiment has cooled for the product pushed by marketing teams as providing equity-like returns with lower volatility.

The result is that pension schemes are among those who have pulled billions of pounds from such funds in the first seven months of 2018. One of the biggest victims of this change in strategy is Standard Life Aberdeen's Global Absolute Return Strategies fund (Gars). Its managers have handed around £6bn to exiting investors this year.

The problem is that for many DGFs, the returns have been nowhere near those generated in equity markets. Gars returned -3.9% in the first seven months of 2018, compared to a 3.5% gain by the MSCI World index over the same period.

Some DGF managers warn investors to judge their performance over years not months, but over the past five years Gars returned only +1.35%. Not great for a product that is focused on outcomes instead of beating benchmarks.

It is important to point out that not all of these funds have recorded such a disappointing performance (*see pages 26-29*), but it is clear that many DGF managers have failed to add value during a prolonged period of low volatility and when the S&P 500 and the FTSE 100 reached new heights. Trustees who bought DGFs are well aware that they could have collected higher returns if they had taken more risk by investing in equity funds. Hindsight is a wonderful thing.

So the six-fold increase in capital flowing into DGFs in the 10 years to 2015 has become a distant memory, especially as tougher times are on the way. Volatility is forecast to be on the horizon and earlier this year we had a sample of what is to come when there was a sell-off in bonds and equities.

There are those who rightly see volatility as an opportunity, not a problem, so tactical investing by DGFs may have already begun.

Another benefit is the diversity that the product offers. The right spread of assets could protect portfolios from falling markets.

The fund managers, consultants and trustees we brought together to discuss this market (*pages 6-21*) believe that it can provide a desired outcome while protecting portfolios, if investors pick the right fund. How these funds should be used in portfolios was also at the centre of the debate.

Some pointed out that quantitative easing has helped push asset prices higher in recent years, so could DGFs prove their worth when markets normalise? Who knows, perhaps the time of the DGF is yet to come.

Mark Dunne
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"You need to understand what is underneath the underlying strategy."

Vicky Kydoniefs, Aon

PI: What is a diversified growth fund?

Alan Pickering: The word should be 'are' not 'is'. The title has to fit on an advertising brochure and it has to tap into the current trend. The real challenge for someone like me is to look below the strapline and see exactly what components make up the products. It is a plurality rather than a singular model.

Vicky Kydoniefs: I would concur 100%. We tend to look at DGF strategies in three buckets as there are so many different types of strategies with that acronym. We categorise them either as capital preservation, total return or growth seeking DGFs. You need to understand what is underneath the underlying strategy.

David Weeks: Our defined benefit (DB) members agree with Alan's perspective. They are moving towards closing dates and they are looking at what products will take them towards that. For our defined contribution (DC) trustees there is a big marketing need to engage members and increase the level of contributions that they and their employers make. One of the detractors is that you might lose that capital, so they are looking for some security and a diversified growth fund points towards a solution to those needs.

Craig Moran: It is the focus on the solution that separates them from other types of funds. The traditional multi-asset fund is focused on the inputs. A DGF will focus on meeting a solution that focuses on the output. What the scheme or the investor needs is what the DGF is focused on.

PI: Ian, are you using DGFs?

Ian Scott: No, not at the moment. The way our growth portfolio is constructed is rather like a DGF in the sense that we have a diversified portfolio of assets which we use to generate growth over time. We have a target return for that portfolio, so we are a bit like a big DGF.

Mike Weston: That's the difficulty with DGFs. If you are running a pension scheme portfolio you have all the assets, so you are effectively a DGF.

PI: How are institutions using DGFs in their portfolios? Is it growth, risk or security?

Pickering: On a purely anecdotal basis, in DB land I'm using them to try and get some predictability of outcome in the late stage of the journey plan. In DC land schemes have bought the advert that it is equity-like returns with less volatility than traditional equities. The sad thing is that they have become popular at a time when quantitative easing meant that a monkey throwing a dart at a dartboard to get a bond/equity split has probably outperformed most DGF offerings.

There hasn't been that much volatility either. It's difficult for DC trustees where performance drops straight down to the bottom line with a member to determine whether quantitative easing has given a fatal blow to the whole concept of DGFs or whether once we get back to normality their day will come again.

Jonathan Reynolds: It's an interesting question. Whilst it's a cliché that every scheme is different, it is a valid observation that schemes use DGFs for different purposes. A lot depends on your funding position and your relationship with the employer and where you are in your journey. I've got DGFs to simply provide stability. Our main issue is risk management. Yes, we want return, but we want risk management more. That's what is driving us down that route. I've got other schemes where they are seen as an engine of growth in a time when growth is difficult to come by.

One thing we learned from the financial crisis is that diversity is your friend when things go wrong. One of the big issues that we have is that since the financial crisis things have been pretty good, markets have been remarkably stable in many ways and the returns are there. But what will happen when global equities trip up? Will they keep their head above water and do what we want them to do? That is going to be the real acid test.

Weston: When you look at DGFs, a lot of the theory rests on the statistical correlation of the asset classes. What we have seen historically is that when things go wrong, correlations go to one. We have had a period where it's been remarkably stable in the markets.

Weeks: Corporate finance directors need to be reassured that it's about reducing risk at the same time as delivering returns. Also, the scheme members want to know if their money is being put into something which sounds sensible. The DGF as a category has a resonance about it which does provide reassurance.

Moran: The challenge to the model is around correlation and diversification because those can change and using a quantitative risk model may serve you in one phase as we saw for much of that post-crisis era when equities were a little bit weak and bonds rallied, but earlier this year as bonds sold off, so too did equities. Your traditional risk parity strategy that relied on those historical correlations didn't work.

If we see an event where we truly get stress in financial markets, how are these diversifying properties going to hold up? How will some of these perceived to be diversifying illiquid strategies that maybe give you a lack of correlation behave if we enter a phase like that? It is dangerous to rely on those quantitative or statistical models when constructing DGFs.

Weston: Hedge funds were supposed to be hedging your downside and capturing equity upside. They haven't all proven to be what they were supposed to be and you feel that DGFs haven't really been battle tested yet.

Scott: If you look at long run correlations between equities and bonds, certainly since the financial crisis, returns have been negatively correlated. That negative correlation has been pretty well established for a decade or more. Go back over 100 years and that isn't the case. When you look at why you have had this shift in correlation over the last decade, it's because inflation has been low, interest rates have been low and so when interest rates go up that's a good thing for stocks because it means the economy is growing. You reach a tipping point and all of a sudden interest rates go up too far and equities begin to suffer. We have been in a peculiar time and it's difficult to know exactly how these funds will fare if we move into a period where stock and bond returns are more positively correlated.

PI: How have DGFs been performing? Have they been hitting their return targets?

Scott: In recent times the answer would be 'no'. It's been quite a difficult time, so it depends over what period we are talking about. Since inception the returns look good and have delivered equity-like returns with lower volatility. In the last six to 12 months, possibly longer, the returns don't look as good. Most of these funds will be in negative territory this year.

Kydoniefs: It depends on what type of DGF we are talking about. It's hard to put a broad-brush statement on all of them. It's a bit like hedge funds, some have tarnished the reputation of all and DGFs may suffer from that. Aon has got a DGF that has done extremely well since inception six years ago.

Moran: M&G's DGF has done well this year. As we know, it's been a tricky time in markets, but it is at this moment where maybe the DGF model is going to be challenged. As we go through this longer period of time where DGFs aren't delivering on their determined returns, people are going to start being disappointed when they could have got similar returns holding their money in cash or other assets.

So there is a challenge for the DGFs as they are currently set up or people are going to be more critical towards them if they can't generate some return because that growth part of the model is important. If you are a pension scheme and you are 15 years to maturity then you can afford to tolerate some of this short-term volatility and shouldn't pay away all of your prospective returns just by avoiding volatility, but of course it depends where you are in the lifecycle of your scheme.

Reynolds: That is an important point. If you are looking at growth and gilts are flat, you are not sweating the assets. You can be relatively comfortable, but if you are in a different position and you have a far more stretched target it's difficult, especially if you go back to old-style trusteeships where one of your major jobs is to outperform the markets. I'm glad to say that view is disappearing and you come across it much less.

Moran: The challenge, given where gilts are valued, is if you buy a 10-year gilt today and hold it to maturity, your return is guaranteed to be less than 2%. After inflation it's probably going to be a negative real return. I imagine those returns for many schemes aren't satisfactory; they are not going to be able to meet the needs of the underlying trustees. So just buying gilts today isn't a satisfactory answer if you want or need growth.


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Reynolds: On the DC front it's a different story. I had this mantra on DC that you want people to get in, stay in and pay in. That pay in bit is vital. There's no investment-led solution to DC schemes, you have got to have the contributions. The contributions will only come with confidence and without that confidence that I'm doing the right thing you won't get the contributions. The whole investment piece for DC is massively important and diversity plays a role in giving members and employers the confidence to say: "Putting our money into this scheme is the right thing for us to do." There is a real challenge for the industry to harvest diversity, to make sure that members feel comfortable and that confidence grows.

Weeks: Flowing from that, one of the key ingredients is the reputation and standing of the organisation which is providing the figures. That's where marketing and the reputation providers will come to the fore.

Pickering: It is quite a different challenge in DB land and DC land. Even in DB land trustees have got to be regularly reminded why they have brought a particular strategy, product or a particular mix and then test the output alongside what they want it to deliver rather than what the market or somebody else might deliver.

We have got trustees educated to a point where they will buy a product with an output focus, but when they come to measuring whether that product is doing a good job or not they forget why they bought it and they will use some other criteria to say: "It's done really well," or, "It's done lousily."

One of the hardest things for trustees to do is to sell something that has outperformed because it may no longer fit in with what they need. Traditional trustees would never have sold something that outperformed.

In DC land the challenge, is do you go with the inertia, in which case you try and stop members looking annually at what the fund has done and keep reminding them what it's intending to do. There are lots of members who won't check their balance sheets every year and if they do they will simply see whether what they paid in has actually added to what they had last year. That's often the focus more than whether they have outperformed the markets or not. In DC land one mustn't commit a confidence trick, but we do have to try and take members eyes away from some of the scarier features of being an investor.

That might sound paternalistic or duplicitous, but it is the challenge in the DC market to try and make sure that people hang-on in there for the long term and don't become day or annual traders because someone told them that this particular product is rubbish.

PI: What types of alternative assets are finding their way into DGFs?

Weston: It's quite difficult for DGFs to cradle alternatives correctly because they are illiquid. You don't have a lot of derivatives in them. You get some proxy from alternatives but then it's quite a difficult play because essentially the liquid bits are equities and bonds and they fill up the majority of DGF portfolios and the other bits are around the side in whatever format you can get. So it's difficult to keep alternatives in DGFs.

The point is, if you have a DGF element in a portfolio do you have an alternatives element as well alongside a slightly broader allocation? Is it part of the DGF or just part of the broader portfolio allocation? What we could talk about is the growth of diversified real asset funds. Are they DGF Version 2 or DGF Mark 3? There are moves to do diversified real asset funds which have their own challenges.

PI: Have any been launched yet?

Weston: They are at the marketing phase. A number of major fund houses are effectively restructuring

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their internal alternative teams to bring them together under a diversified real assets banner.

Pickering: We do have this problem with the name. You think of a name first and then decide what to populate that product with. That is the wrong way around. As schemes are on different points of their journey plan and as they get larger, it's a case for the sponsor and the trustee to say: "What do I want my portfolio to deliver and how do I build the portfolio that's going to help me deliver it."

It may well be that there are existing products or if I'm big enough I will ask somebody to build me a product that will do exactly what I want it to do rather than get Google to give me a list of everything that's got diversified growth in it.

Weeks: There may be a difference too between big schemes and small schemes. Big schemes, which have a range of advisers, can evaluate these things for themselves. Small schemes quite often do not have a full range of advisers and have to rely much more on reputation. There may be different factors to bring in to bear there.

Reynolds: It is difficult to replicate the returns that you can get from direct investments in a lot of alternative areas, whether it is infrastructure, farm land or private equity. It's difficult to replicate those returns through derivatives, through ETFs or any listed vehicle. We have a pretty big alternative portfolio of direct investments that allows us to access those illiquidity premiums without the volatility that you get with listed so called proxies.

"In DC land one mustn't commit a confidence trick, but we do have to try and take members eyes away from some of the scarier features of being an investor."
Alan Pickering, BESTrustees

Alan Pickering

Craig Moran

"It's a challenge having people understand that volatility and risk are not the same thing."

Craig Moran, M&G Investments

Kydoniefs: Perhaps playing devil's advocate, medium and smaller-sized schemes don't have the governance or the time to achieve this.

Weston: Why outsource a particular portion of your portfolio to be run on a DGF basis? Arguably, outsource the whole of the portfolio to be run as an entire DGF where you are looking to deliver the returns needed to pay members' pensions. You are doing it holistically rather than saying: "I'd like 40% equities, 20% bonds and I'll have 10% DGF. I will fill up the rest with something else." That to me is not a particularly holistic way of doing it because you have one element of return from a DGF but you have all of this other stuff around the side that is going to deliver different things. If you are not careful the stuff that's delivered by the bulk of the portfolio may counter the returns that are coming out of your DGF. You have to be careful what the entire portfolio's risk and return characteristics are like rather than focusing on one little bit.

Moran: You either treat the DGF as your core and doing the bulk of the return generation or, if you are going to strip out a component of your portfolio to allocate towards DGFs, it should be something genuinely different that you can't do yourself or replicate through a traditional fund model or has access to parts of the market that you don't. Otherwise you are duplicating your work or potentially offsetting it. It should be one or the other. The whole portfolio or a different part of your periphery, but it has to be meaningful in either way.

To the point about the illiquidity premium, we have a high hurdle in terms of the illiquidity premium that we earn from an infrastructure asset or from some of these other asset classes because the opportunity cost of tying-up our capital on a semi-permanent basis is high. The liquidity consideration is a big one and you need to be healthily compensated to take that on.

PI: How do you assess the suitability of a DGF manager?

Pickering: Investment consultants add value and I expect my investment consultant to keep bringing me new ideas. One of the ways I do that is to ask them to pitch to me as if I was a new client because you can drift into a comfort zone where a consultant thinks they know what you want and you know the limitations of what they can do with that. You want to get them into a mind-set where they will bring new products and strategies to my attention, but then debate whether any of those strategies or products have a part to play in my holistic approach to scheme investment. I will ask them to bring to me a couple of the most appropriate ideas so that we can see whether there is a real fit.

I always say to them if you are taking me down this route, please tell me what the exit hurdle might be if and when this particular product no longer meets my needs because there are some schemes where the illiquidity premium might not be there all the way through and the diversification might not be in the form that you want it in. With all these products you want to know what the escape route is just as much as how do I get into it.

Weeks: Our members look at a number of things. There's the standard checklist and then there is price, and, yes, they do understand the difference between price and value. Reputation of the provider, performance and compatibility with the scheme are generally thought to be important.

One that I hadn't really thought of, but Alan brings to my attention, is the exit hurdle. If you have made a mistake how would you get out of it? Those are the standard things that schemes consider.

Weston: I'm quite surprised that you put price at the top. My perspective is that price is key in the liquid public markets, but as soon as you move away from the mainstream asset classes price drops significantly down the decision making criteria. It's all about the manager and the potential returns. Price seems to be much lower.

Weeks: They understand value and price. Price is important, but price is part of value and not an end in itself.

Reynolds: The smaller schemes are reliant on consultants and that relationship is hugely important. That understanding as to where the scheme is, where it's going and what the trustees do and do not like. I am dubious about anybody who tells me that they can tactically manage this fund and will do so on a regular basis. When you look longer term, how much value do these little tactical shifts add? It's going to cost me a lot of money and I'd probably rather not go there. I would tend to give that steer to the consultant and hope that they would come back with firm recommendations.

I'm not a massive fan of the beauty parade. In a way they are presenting an opportunity for the trustees

David Weeks

"Price is important, but price is part of value and not an end in itself."

David Weeks, The Association of Member Nominated Trustees

to make wrong decisions because people are good at presenting and you get three or four excellent presentations, but does it actually take you any closer to choosing the right one? You have got to talk with your consultant and work out exactly what you are trying to achieve and then rely on them to come back with a tight selection saying this does this, this is why we think it suits.

That would be my preference, but I'm talking about a smaller scheme with a restricted governance budget and you are trying to get the best value for your sponsors. I'm the custodian of their budget. I've got to spend it wisely. I've got to look the FD in the eye and say: "I'll look after your budget."

Pickering: Mike mentioned the 'f' word earlier and a number of trustees who might not be comfortable with the 'f' word are increasingly comfortable with a shortlist of one for the reason that we have just heard. "Given your objectives, I as your consultant think that there is only one credible player in town that ticks most of the boxes, if not all of the boxes." So you avoid the gut-aching process of sitting through six presentations when you know a couple of them have been put in for light relief. People have got better things to do with their time now, so a shortlist of one might not be good in politics, but it's quite good from a trustee's point of view.

Weston: At the risk of being devil's advocate, I was a bit unsure, Jonathan, when you talked about not liking managers who claim they can tactically do this, that and the other. Isn't that the whole point of a DGF that they are forever tactically shifting around? If I took you literally, you are almost saying: "I don't want DGFs because it's all tactical twiddling around with the portfolio on a short-term basis."

Reynolds: It depends where you draw the line between strategic and tactical. What I don't like to see is significant movement each quarter. It destroys value.

Weston: It is activity-based management rather than value-based management.

Reynolds: It will be interesting come next January when we have our first full year of real visibility on transactions and whether that will have an impact on how much tactical stuff goes on. The reason I feel that way is one of my schemes has a fiduciary manager where on a quarterly basis we get a measure of the success of the manager in terms of its selection of managers and its own tactical input. These are tiny slivers. Each quarter they are tiny contributors or detractors. They make little difference. What I don't want over the longer term is to be paying for stuff that is just tossing a coin.

My view is that, generally, if you are paying for that stuff and people are doing it, you are probably increasing your risk. I'm talking here at the smaller end. When you have a large fund it's different. You have the resources, you have the advice and you have the governance budget. With smaller funds of sub £100m you are not going get any segregated mandates, you always import funds and you have to choose carefully. You have to choose something that you feel comfortable with in the way it's being managed and is providing you with good value.

Pickering: In large schemes an investment has to pass the 'so what' test. If it's such a small proportion of my portfolio and it's only going to contribute to such a small proportion of my needs, considering the governance burden and the risk, is it really worth it? I always apply the 'so what' test no matter how big or small the scheme might be.

Moran: Your observations around the tactical aspects are regime dependent. You had that fantastic phase post the crisis up until 2015/16 where the tactical element of what people did didn't matter too much. You could have happily bought a lot of equities, a lot of bonds, the correlation patterns and everything else gave you quite a nice overall return pattern. Whether you changed your asset allocation meaningfully over that phase probably didn't lead you to particularly different results from just having a static portfolio.

Then when you hit that 2016 phase, as volatility picked up it was much more important to be tactical given some of the movements in bonds that we hadn't seen previously. Then last year the tactical element didn't matter because you didn't really have those tactical opportunities in the markets. Most asset classes went up pretty nicely last year. This year, with volatility picking up, there are more opportunities to be tactical, but as a fund manager it's a challenging environment because there are a lot of things going on.

There's a lot of movement so the tactical opportunities are there and there's volatility to be exploited, but at the same time you need to identify from a buyer's perspective that a fund manager has skill in being able to do that tactical asset allocation and there's two components to that. One, are they good at it? That is debatable from fund manager to fund manager and reasonably difficult to assess. Also, if they are good at it, are they doing it in a sufficiently meaningful way so are those tactical shifts material enough, do they address the 'so what' issue. If you are just adding 1% here and taking off 0.5% there, that's not really going to change your outcomes versus those big tactical shifts that are going to occur in those periods of volatility or you get onto those more strategic structural shifts where potentially one asset class might do significantly better than another for the subsequent decades.

Reynolds: Never say never. You have to have a healthy scepticism otherwise you can pay a lot for what is basically a portfolio of relatively cheap funds and the 'lot' comes from all the management that is going on. You then have to question for whose benefit is this.

Weeks: That comes back to price and value having a role.

Reynolds: If I'm looking for gilts plus 2% and the fund manager delivers it, I've got value. I'm delighted. It's a lot easier in DB. DC is somewhat different. Value and price is an important issue, but we particularly owe it to DC members to educate them on value and to educate them that it is long term. We don't want to second guess markets and predict the future. It is a dangerous tale: "This fund here does all these wonderful things, really clever," but the reality is at some stage it will be proved not to be so clever and we can all think of examples of that from history. Diversity is massively important and the way it's marketed is also hugely important.

Weston: Arguably, if you are focused in DC on the long term you can set a strategic asset allocation based on long-term correlations and just leave it. Build it with low cost funds, don't trade much and you just run it for 20 or 30 years and deliver those returns to members.

Reynolds: If there was an option to do that, I'll tick that box. Most people would have it.

Pickering: As long as I have something that the employer is engaged with, that the employer is sharing the input burden with and everybody is doing their best to make sure it's well governed, I don't want a lot more engagement from my DC members until later in life when they have got to make some personal decisions that are output focused rather than input focused.

PI: What returns are your clients generally asking for?

Kydoniefs: Typically, cash plus 3% to 5%.

Weeks: Yes, that seems to be about where a lot of schemes are coming out.

Reynolds: Ultimately it's bit like when I first played league cricket as a lad. The captain told me to score runs and don't get out. It's a bit like that with investment. Get me returns, don't lose any money. People always want the best return in theory for no risk. We all know that's not going to happen, so it comes down to specifics for this scheme, particularly in DB, what is it trying to achieve? That's crucial and comes before saying this fund does this, that's not the way we are looking to do it and what we are trying to achieve with this particular scheme.

Weston: The real positive is when we are talking about Libor plus we are talking about a real level of return, not: "I want to beat the market, or I want to beat this index or that index." That's irrelevant. The only index I need to beat is what I need to generate to pay the pensions. I don't care what the markets are doing. If I hit my target and I can pay my pensions there may be an opportunity cost, but how relevant is that? As long as I can pay my pensions that's the critical thing and that's a real level of return, not I need to beat the market.

Scott: The other variable is risk. It is fine saying we want to do 3% to 5%, but what risks are you going to take to get that return. Clearly, there's a world of difference between having a fund that's running 10% volatility versus one with 4%. You are going to experience a lot more ups and downs so it is going to be a more painful ride the higher the volatility of the fund. If it is a target return there needs to be a risk associated with that and an acceptance of that level of risk.

Moreover, one important caveat is the last five years of volatility may not be a good representation of how volatility is going to be in the future.

Reynolds: That point on risk is hugely important and it comes down to the position the scheme is in. I've got one scheme that's well-funded. We are looking to get it self-sufficient. We are happy to take some risk because we have margin for risk that we know the employer can bear, the employer understands, so we can take a different approach. For other schemes it's different. You are working with a restricted level of affordability and contributions and you want to narrow your range of outcomes as much as you possibly can. All these feed through into, hopefully, choosing a good holistic portfolio that helps you keep all these issues in place.

Mike mentioned that you have to pay the pensions, but we have got to keep an eye on the employer covenant, the contribution level, what is affordable and what we can reasonably expect when our next valuation is.

There are all of these points that you have to bring in to hopefully get that right and that's back to the point I made earlier about choices and you are reliant on your consultant. That is hugely important and, in my view, far more so than the beauty parade. You can't expect those six people to understand the particular nuances of your scheme, whereas you can expect your consultant to fully understand it and, hopefully, maybe cut it down to a shortlist of one, maybe two. It's difficult, but risk is ultimately what we are all looking to try and manage.

Moran: It is important to distinguish between volatility and risk. Short-term volatility of the fund or of markets is not necessarily what I define as risk. Genuine risk is the permanent loss of capital or not being able to meet your pension obligations.

That short-term volatility is, if anything, potentially a source of good returns prospectively, but in the context of managing that overall portfolio how much can the client tolerate? The client needs to be educated around the difference between risk and volatility and to ultimately get to the returns and outcomes they want.


Ian Scott

"We have been in a peculiar time and it's difficult to know exactly how these funds will fare if we move into a period where stock and bond returns are more positively correlated."

Ian Scott, Pension Protection Fund

It's a challenge having people understand that volatility and risk are not the same thing.

Weeks: The significance of the consultant cannot be underestimated. Schemes are heavily dependent on those. In a sense the chemistry between the consultant and the board is of much more significance than the provider of individual services.

Pickering: I'm old enough to have learnt that volatility is more my friend than my enemy, but as schemes move towards self-sufficiency, whatever that means for them, the sponsor finds volatility an anathema. Then if you try to batten down the pension scheme, minimise the effect that the pension scheme has on the accounting numbers, has on the way that Wall Street views their particular operation, then volatility can assume a high significance.

Anecdotally, I'm finding that even American employers, who always wanted to make every asset sweat whether it was a human asset or a financial asset, even they are now tolerant of the use of a journey planning and end game and self-sufficiency. You don't need to put a dollar in the swear box every time you mention journey plan any more. While volatility and risk are different for some people, volatility is as important as risk.

Mike Weston

"The only index I need to beat is what I need to generate to pay the pensions. I don't care what the markets are doing."

Mike Weston, Pensions Infrastructure Platform

PI: How are DGFs evolving? Are you seeing trends such as factor investing moving into these products?

Weeks: It will evolve when it doesn't perform well. Number two is if quantitative easing comes to an end will it respond to that. I suppose the third is Brexit and will its uncertainty have any impact on the climate in which this operates.

I seem to recall taking part in one of these discussion on factor investing and one of the thoughts that came from that was it depends which factors you put in and which weighting and there are so many variations on that that you come up with more or less whatever answer you want.

Scott: It's another marketing gimmick to call these things smart beta, but people have had growth biases, value biases and quality biases for decades. It's the ability to offer these things at relatively low cost which has changed and has spawned this kind of industry. I'm not sure there's an awful lot that's new in terms of the techniques, but what's new is the availability of these factors at relatively low costs and they are more accessible than in the past in a pure form.

Reynolds: Understanding what you have got is a key issue for DGFs. I'm sure we are all aware of DGFs when we look at the strategies that are being employed, but it wouldn't take long until you came across one and you have no idea what it means. That's fine if that's in your ISA or in your personal pension, but when it's somebody else's money and a pension scheme that you are looking after as a trustee, it's a different thing. That is one of the challenges with DGFs; it's making sure that you understand what it is you have bought and what you are trying to achieve with it.

Pickering: The frightening thing is not a lack of understanding on your part. The frightening thing is when the person selling it to you can't explain how it works. I've been in situations where I keep asking questions to the person that's sold me a black box and in the end he doesn't know why it works and comes to the conclusion that black boxes are wonderful, it's the world that's a bit cock-eyed. If he's at such a loss what hope have we got that members' will understand it.

Moran: If you can't explain it to your grandmother in one minute with a simple explanation then the product is probably over complicated or they don't understand what they are trying to do.

Weeks: It is the role of the member nominated trustee to ask these questions.

Reynolds: It's a fantastic thing. It's one of the reasons trusteeship works. People in the industry live in this bubble with all this terminology and it gets easy to get caught up in it. Everything gets reinforced because other people talk the same way and then you sit down in a trustee meeting and the great thing is you have other people there who aren't in that bubble. They sit there and say: "Hang on, can you explain that to me?"

It is one of the real powers of the trusteeships. I have a few small portfolio sole trusteeships where it's me and a colleague and you do miss the member nominated. You do miss the people that bring that sense check at times. It can be valuable.

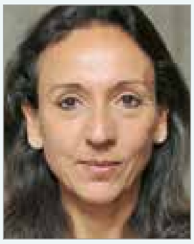
"Whilst it's a cliché that every scheme is different, it is a valid observation that schemes use DGFs for different purposes."

Jonathan Reynolds, Capital Cranfield Pension Trustees

Jonathan Reynolds

Diversified growth funds

Vicky Kydoniefs, a Partner at Aon



Diversified growth funds (DGFs) have proved popular with investors because they offer a simple, low governance way of adding diversification to growth portfolios.

What are DGFs?

DGFs invest across a wide array of asset classes, changing their asset allocation in response to a change in markets and generally aiming to make (over a period of three to five years) equity-like returns with lower volatility.

Each DGF differs markedly in how its portfolio is constructed and so DGFs do not fit neatly into a generic box. The only common characteristics these funds have is that they typically aim to reduce absolute volatility compared to equities and have a return target in excess of either cash or inflation. The target return differs by product but there are typically three drivers of returns:

- Longer term strategic asset allocation (getting the mix of assets right to achieve their return target while lowering risk).
- Shorter term tactical asset allocation (being in the right areas of the market at the right times).
- Implementation of ideas (buying the right instruments at the right price).

What is their appeal?

Of significant appeal to investors is that DGFs are perceived to be a 'one stop shop' for diversification of the growth portfolio, since they usually allocate to a range of asset classes. If a single manager can do everything, why select, negotiate and monitor a collection of managers? A DGF also enables switching to hold different percentages of asset classes at any one time, limiting asset allocation decisions to a smaller subset of the portfolio (for example, growth versus lower risk allocations). Another potential benefit is access to a range of investments, including some which investors may not ordinarily be able to gain access to due to high minimum investment sizes, with a low governance burden.

Types of DGF

We think about the universe of DGFs as belonging to three broad sub types with each playing a different role within a scheme's growth portfolio. It is important to consider which type of DGF is most appropriate, before selecting a DGF manager this will depend on the proportion of total assets that will be invested and the scheme's wider investment strategy.

	Approach	Correlation with equities	Importance of strategic asset allocation	Importance of tactical asset allocation
Absolute return	Deliver positive absolute return over the medium to long term regardless of market conditions	Low to Medium	Low	High
Capital Preservation	Lower allocation to equity/ greater role for bonds and cash	Medium to high	Medium	Medium to high
Growth	High equity allocation/ Often with small allocations to range of alternatives	High	High	Medium to low*

*Broad indications of the importance of strategic and tactical asset allocation have been given but, in practice, these can be very specific to each strategy. Before allocating to a particular type of DGF, investors should be comfortable with how returns are expected to be derived at the product level.

Fund manager selection is key

To be successful, DGF managers must demonstrate the following skills:

– Strategic and tactical asset allocation

– Financial instrument selection or implementation method

– Risk management

– Intelligent trading

Having expertise in all areas is difficult and this may, in part, be the cause of the underperformance of some these strategies. DGFs offer access to a range of asset classes but with a low governance burden. However, the choice of the underlying provider needs to take into account which type of DGF is most appropriate as each can play a different role within the portfolio.

Our offer

Aon's Managed Growth Fund focuses on strategic asset allocation as a key driver of returns. It aims to provide exposure to a diversified portfolio of assets to deliver consistent returns of 4% p.a. (above three-month sterling LIBOR net of fees). It provides access to a wide range of specialist solutions and selects best of breed managers from standard and niche strategies. The fund has consistently delivered strong performance over the long term. It has outperformed its benchmark by 6.8% p.a. since inception (18 May 2012) by 29 March 2018. Diversification across asset classes, strategies and managers helps to reduce volatility.

Summary

DGFs are a suite of products, not an asset class, and so fund selection is extremely important. It is important to be aware of the different types of strategies pursued and how these are expected to perform in different market environments. Investors in DGFs should consider whether they have been performing as expected and whether they remain suitable for the investment strategy being pursued. There may sometimes be grounds to allocate to more than one DGF provided they are suitably complementary. A periodic review of how they fit together is recommended.

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Now is the time to assess the value DGFs offer

Craig Moran, Fund Manager at M&G Investments

Diversified Growth Funds (DGFs) have grown in popularity and in number since the financial crisis. They are a variety of multi-asset portfolio, but differ in that they typically have objectives focused upon absolute return-driven outcomes, rather than being measured relative to a benchmark or sector.

These outcomes are typically attractive to pensions and other institutions in that they focus on delivering growth-like returns with lower-than-equity volatility and possibly an emphasis on shorter-term capital preservation. For more mature pension schemes with less tolerance for volatility but which remain underfunded, these characteristics are extremely valuable as an alternative to equity holdings.

Beyond this, the DGF label covers a wide variety of different strategies for achieving these goals. Approaches can range from strategies that resemble traditional multi-asset portfolios to those more traditionally associated with hedge funds.

This makes comparing DGFs a challenge at any time, but this challenge is arguably compounded by the market environment over the past decade. A background of very strong performance from fixed income assets and negative short-term correlation between fixed income and equity in volatile periods has meant that a wide range of multi-asset strategies, including more traditional variations or heavily fixed income-weighted approaches, have been able to achieve DGF-style objectives.

However, the absolute return nature of DGFs means that they are designed to deliver their target risk-return outcomes over all conditions, not just those supportive for static, long-beta multi-asset portfolios. And today, there are real signs that the environment is beginning to change, and DGFs seem likely to be properly tested.

The first challenge has been on the ability of DGFs to deliver the 'G.' Traditional 'safety assets' like government bonds still provided protection in the period of equity market weakness in the first half of 2016, but total returns on US 10-year Treasuries are close to flat since the start of 2015 and so are those on UK Gilts over the last two years, even before inflation. At such low yields, many 'safety' assets have far less scope to deliver capital gains.DGFs which have relied on this factor will have disappointed in terms of absolute returns in recent years.

Institutional investors with a greater emphasis upon short-term capital preservation may have been prepared to accept the lower absolute returns from some DGFs on the basis that they offer possible protection in tougher times. However, even this diversification seems less likely to be achievable through traditional means. We have already seen in 2018, and previously in 2013, how rising interest rate expectations can be negative for returns on fixed income and growth assets.

If we are to enter an era of materially higher rates and less supportive policy in general, then those assets which have been safe havens throughout much of the last 10 years could be at the very heart of broader market risk. In such environments the scope for diversification among long exposure to traditional asset class beta would be much reduced.

Finding diversification and delivering attractive returns uncorrelated to existing positions in pension portfolios will require the use of less traditional approaches. These might include the ability to seek a wider universe of asset classes and regions, to take short positions, and to be highly dynamic in changing portfolios to capture opportunities as they emerge. Management of such strategies will need to be highly active either in the ability to take off-benchmark bets, to manage holdings in alternative assets, or make frequent big shifts in asset allocation.

DGFs will therefore have to show that they are not merely traditional multi-asset portfolios with new branding, and that they can genuinely offer return profiles that are not available elsewhere. DGFs emerged in response to the real needs of pension funds, but their success has come against a background that – with hindsight – has been supportive to achieving these goals. The need for the outcomes that DGFs promise has not gone away, but with signs that recent tailwind to achieving those outcomes could become a headwind, DGFs will have to prove their worth.

For more information, please visit www.mandg.co.uk/multiasset

M&G INVESTMENTS

DGFs: Testing times

With many diversified growth funds under-performing during the equity bull market, how will the product that claims to offer high rewards for lower risk fare in the face of upcoming volatility? *Mona Dohle* reports.

The range of diversified growth fund (DGFs) strategies is as varied as the investment strategies they offer, from absolute return through to dynamic and strategic funds. The one thing they have in common is that they target equity-like returns with lower exposure to volatility. This appeals to pension schemes who are fearing the effects that tapering will have on inflated equity and bond markets.

While DGF returns have often been disappointing when compared to the performance of equities, the litmus test now is how will they perform in volatile periods like those witnessed earlier in the year?

Since the 2008 financial crisis, institutional investors have warmed to DGFs with inflows into multi-asset funds increasing six-fold between 2005 and 2015, according to Henderson Global Investors.

A PARADIGM SHIFT

Historically, defined benefit (DB) schemes have been one of the main drivers behind multi-asset's growth, yet research firm Spence Johnson predicts a paradigm shift is happening.

It expects defined contribution (DC) schemes to become one of the key drivers of DGF growth, accounting for £27bn of inflows by 2020, compared to a mere £3bn from final salary schemes.

There are two key factors behind this trend. The first is the introduction of the DC charge cap, which has caused a growing focus on fund costs among schemes. The second is the introduction of auto enrolment, which has dramatically increased the assets of DC schemes. Demand for DGFs from DC funds is going to accelerate even further with plans to lift contribution rates to 8% from April 2019, up from 5% today. According to one consultant, DC scheme assets will reach £612bn in 2030 from £377bn in 2016.

Providers have responded to this shift in demand by tailoring DGF funds to the needs of the DC market by making them charge cap compliant. Examples include Blackrock's Dynamic Allocation Fund and Fidelity's Diversified Markets Fund.

Yet the shift to DC presents the industry with new challenges, argues Jonathan Reynolds, an independent professional trustee at Capital Cranfield Pension Trustees.

> **"If there is one thing we learnt from the financial crisis it is that diversity is your friend when things go wrong. The day of the DGF is perhaps yet to come when markets trip up, that is when you can really see if they do what they say."**
>
> Jonathan Reynolds, Capital Cranfield Pension Trustees

Rather than merely having to convince a board of trustees at a DB scheme, fund providers increasingly have to win over scheme members, he explains. "Defined contribution schemes are a different story from defined benefit schemes because they are more reliant on contributions, which require confidence. This makes the investment bit so important as DGFs can play a role in giving members that confidence."

Alan Pickering, chair of independent trustee specialist BESTrustees, adds that in DC the challenge is do you go with the inertia in which lots of members won't check their balance sheets every year or with members looking annually at what the fund has done. If anything, scheme members will be more likely to measure a fund's performance by how their savings have increased compared to the previous year, rather than considering how a certain fund has performed against the benchmark, he warns. "The challenge is to encourage members to hang on for the long term, rather than becoming traders."

RETURN CHALLENGES

Indeed, DGFs are increasingly being challenged on whether they are able to uphold their risk and return offering. One key criticism is that solid DGF returns since 2008 were largely driven by equity and credit beta, while tactical management decisions were more likely to detract value, as a 2016 report by Willis Towers Watson found.

In other words, DGFs were riding the wave of overall stable equity markets with lower volatility.

"The question is, how much value have managers actually added through their asset allocation strategy?" questions Paul Berriman, global head of fund business at Willis Towers Watson.

"Producing alpha in any asset class is difficult enough but doing so in DGFs is arguably even tougher given the skill required to produce alpha from both stock selection and asset allocation," the Willis Towers Watson report stresses.

Indeed, as global equity markets became more volatile from 2016 onwards, the inconsistencies in DGF performance came to the fore. As a KPMG report in 2017 highlighted: "Over the last four years (Q2 2013 to Q4 2016) DGF managers have broadly failed to keep pace with equities, even on a risk-adjusted basis."

The study also shows that divergence in DGF fund performance can be understood by considering the volatility of returns of a company's stock against those in the broader market, otherwise known as its equity beta.

While funds with low levels of equity beta were among the best performing funds between 2006 and 2012, and funds with high equity beta tended to be the worst performers, the situation reversed in the subsequent three years, as DGF funds with high levels of equity beta became some of the best performers while low beta funds tended to underperform.

Moreover, strategic and dynamic funds, which represent about 70% of the DGF market, according to Spence Johnson, tended to rely on equities as a key factor in their overall returns, while absolute return-oriented DGFs capitalised more on currency trades.

A key challenge for managers of strategic and dynamic funds was that they were relatively defensively positioned, avoiding US equity markets, which they considered to be overvalued. So subsequently they missed out on sectors which rallied strongly.

Meanwhile, the main difficulty for absolute return DGF funds appeared to be that they found themselves on the wrong side of central bank action, as many managers overestimated the pace of tapering measures, the KPMG report highlighted.

Craig Moran, a fund manager at M&G Investments, warns that the sector's inability to offer returns means that it might start to come under pressure.

THE VOLATILITY TEST

The problems for DGF funds became particularly tangible at the beginning of this year, when equity and bond markets faced high levels of volatility, in other words, precisely when DGF funds should have been advantageous for investors.

For example, Standard Life's Global Absolute Return Strategies fund has performed -3.5% over a six month period this year. Throughout the same period, the MSCI World was up 0.43%. Similarly, Blackrock's Dynamic Allocation fund offered a -0.49% return, while JP Morgan's Diversified Growth Fund dropped to -4.01% over the same period, according to Morningstar.

While not every DGF fund performed badly, for example, Fulcrum's Diversified Growth Fund offered +3.05% in the year to date, the broad variety of strategies available means that it is complex to compare the performance of individual DGF funds against their peers. Nevertheless, pension scheme investors acknowledge that it would be unfair to directly compare DGFs to the performance of equity markets.

Ian Scott, head of investment strategy for the Pension Protection Fund, believes that the real test for DGFs could yet lie ahead. "We've been in a peculiar period and it is difficult to assess how these funds will fare," he adds.

Reynolds takes a similar view. "If there is one thing we learnt from the financial crisis it is that diversity is your friend when things go wrong," he says. "The day of the DGF is perhaps yet to come when markets trip up, that is when you can really see if they do what they say."

TRADING BETS

A key challenge for DGF fund managers will be how to respond to the increasingly short-term nature of bouts of volatility without turning into traders. Trustees, particularly those of smaller schemes, are often reliant on consultants when making the decision on whether a DGF fund is worth investing in or not.

Moran argues that increased market movements could still offer opportunities. "Last year the tactical element didn't matter because you didn't really have those tactical opportunities in the markets. Most asset classes went up pretty nicely last year. This year, with volatility picking up, there are more opportunities to be tactical, but as a fund manager it's a challenging environment because there are a lot of things going on," he says.

Reynolds remains cautious of tactical trades. He is dubious of anyone who claims that they can tactically manage a fund, especially if those tactical shifts will cost him a lot of money.

Another issue with responding to short-term volatility is that it requires relatively high levels of liquidity, which in turn restricts fund managers to traditional asset classes such as bonds and equities while precluding investments into higher returning less liquid investments.

But Berriman questions whether DB funds in particular need daily liquidity. "A lot of small and medium-sized schemes think that they are getting great levels of diversification," he adds.

"What they actually get is exposure to equities and credit, with a risk that the performance of both asset classes correlates."

> **"A lot of small and medium-sized schemes think that they are getting great levels of diversification. What they actually get is exposure to equities and credit, with a risk that the performance of both asset classes correlates."**
>
> Paul Berriman, Willis Towers Watson

On the other hand, the growing shift towards inflows from DC schemes suggests that liquidity will remain a key concern for DGF fund managers, as access to a DC platform requires daily pricing. Going forward, the challenge in responding to growing volatility will have to be addressed simultaneously with a changing investor structure, as more inflows into DGFs will come from DC schemes with a variety of risk/return requirements.

A 2017 report by Aon argued that this challenge could also represent an opportunity. Compared to DB schemes, which invest in DGFs at the end of their cycle, for DC schemes more growth-oriented funds could play a vital role. Because of the variety of strategies on offer, DGFs might be able to flexibly address DC members changing risk and return requirements.

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