Do Diversified Growth Funds solve the diversification problem?
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Diversified Growth Funds (DGFs) have proved popular with investors because they offer a simple low governance way of adding diversification to growth portfolios. However, simple is not always best and other solutions may be more suitable. The aims of this paper are to bring out that:

1. DGFs are not an asset class but a product; before selecting a DGF manager, it is important to consider which type of DGF is most appropriate and to keep this under review.
2. DGFs may not provide as much diversification from equities as we might think.
3. Manager skill is extremely important; it is difficult to expect managers to be successful in all areas of the market and execution.
4. When looking to increase diversification, within asset portfolios, it is important to evaluate other approaches alongside DGFs.

Introduction

The variability of a pension scheme’s deficit is a key concern to Trustees and Companies alike as it impacts the security of member benefits and contribution rates. Schemes usually rely on equities to close deficits as these are expected to outgrow the liabilities over the long term. But there is no guarantee this will be the case and the value of equity portfolios can rise or fall significantly from year to year. This can make for a very uncomfortable journey when equities are falling while liabilities are growing. How are pension schemes addressing these issues? There are essentially two broad themes:

1. Schemes are structuring their bond portfolios in such a way that they move more in line with the value of liabilities.
2. Schemes have been introducing other asset classes into their return seeking portfolios, known as diversification, to reduce dependence on the uncertain direction of equity markets.

Pension schemes have focused on the second of the two themes above, ‘desperately seeking diversification’ as a way to bring greater stability to growth portfolios. There are a number of routes pension schemes have taken from investing in a number of funds each specialising in a particular area through to allocating to a single fund offering exposure to a range of asset classes. There are also numerous solutions in between. The focus of this paper is on the merits and challenges of using Diversified Growth Funds (DGFs) as a way to increase diversification within a scheme’s growth portfolio.
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. However we do not expect DGFs to keep pace with equities over shorter periods when the latter are performing very strongly.

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

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

What is their appeal?

Of significant appeal to investors is that DGFs are considered 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 with, fund and monitor a collection of managers? A DGF also enables Trustees to delegate the decision of how much to hold in different asset classes at any one time, limiting asset allocation decisions to a smaller subset of the portfolio (for example, growth versus matching allocations). But this is not a free lunch...

1. There are different kinds of DGFs. Which type do you have?

We think about the universe of DGFs as belonging to three broad sub types and each play 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, which will depend on the proportion of total assets that will be invested and the scheme’s wider investment strategy.

<table>
<thead>
<tr>
<th>Approach</th>
<th>Correlation with equities</th>
<th>Importance of strategic asset allocation</th>
<th>Importance of tactical asset allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Absolute return</td>
<td>Deliver positive absolute return over the medium to long term regardless of market conditions</td>
<td>Low to Medium</td>
<td>Low</td>
</tr>
<tr>
<td>Capital preservation</td>
<td>Lower allocation to equity/ greater role for bonds and cash</td>
<td>Medium to High</td>
<td>Medium</td>
</tr>
<tr>
<td>Growth</td>
<td>High equity allocation/ often with small allocations to range of alternatives</td>
<td>High</td>
<td>High</td>
</tr>
</tbody>
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*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.

Typically, when equity markets are very strong, DGFs may significantly underperform equities. But they should provide returns with greater stability and perform better when equity markets are falling. Correlation to equity markets does differ significantly from product to product and this is why DGFs are not an asset class in their own right; some products will be highly correlated to equities (typically those with a higher equity content) and some less so. Additionally, the way each product moves with equities will vary over time depending on the mix of assets and how ideas are implemented. This makes it difficult to predict the risk profile of DGFs over time which can make flightplanning more challenging. All should however produce a more stable return profile than equities.

DGFs will appear quite volatile against their performance objectives as these are typically cash or inflation based which are relatively stable from period to period. Performance can only reliably be judged over a suitably long period, typically three to five years.
2. **How much diversification do DGFs really offer?**

DGFs offer some diversification benefits by virtue of not all of their assets being invested in equities. However, they are not a panacea of diversification; how much additional stability they give to a scheme’s asset portfolio depends on both the asset allocation of the fund and of the wider pension scheme. In some cases, DGFs may be offering less diversification than investors might assume. We look at DGFs’ diversification myths below.

**Myth 1: My DGF invests in a number of asset classes including alternatives. Therefore, it must offer a high level of diversification.**

Alternative asset classes usually require investors to lock their money up for longer periods (they are illiquid) but most DGFs offer investors easy access to their investments (they are liquid). A DGF offers a one-size-fits-all approach to investing and some investors (like insurers) need to be able to deal on a daily basis. DGFs therefore need to hold investments they can sell quickly. Much of their alternatives exposure is often through holding instruments listed on a stock exchange e.g. property or infrastructure listed investment products, as these are easy to sell. However, when equity markets fall, these investments are also likely to fall and they therefore offer less diversification than illiquid asset classes. Combined with their core holding of equities (for most DGFs), returns can still be highly variable. Absolute return strategies will be less affected by this dynamic.

**Myth 2: My DGF has a high allocation to bonds which should mean it behaves more like the scheme’s liabilities.**

Many DGFs allocate to corporate bonds of various types. These tend to be much less sensitive to changes in interest rates than pension scheme liabilities and tend not to provide protection against changes in inflation. Some types of corporate bonds can also have a high correlation to equities. Where government bonds are held, these are rarely in a form which move in line with the value of a scheme’s liabilities but may add some stability to the fund’s return.

**Myth 3: It would be beneficial to invest in three or four DGFs to improve diversification.**

The benefit of investing in DGFs is to access 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. Investors are unlikely to experience a material improvement in diversification by having more than two DGFs. Where two DGFs are desired, they should be suitably complementary.

DGFs will offer some diversification for schemes which previously invested all or most of their growth assets in equities.

3. **Fund manager selection is key**

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

a. Tactical asset allocation
b. Fund manager selection
c. Financial instrument selection
d. Risk management
e. Intelligent trading

Having expertise in all areas is difficult and so investing with a DGF can be less effective than some other routes. A major criticism of DGFs is therefore that many attempt to be a master of all trades, but are unlikely to have the resources to master every area. In addition, with DGFs allocating across a range of asset classes, the impact of staff turnover on a fund is higher now than it used to be. We have seen this recently, with some DGFs losing specialists in particular areas. DGFs often charge no entry or exit fee when the volume of investments and disinvestments is low. However, when lots of money is exiting these funds (for example following team changes), investors are charged transaction costs. While this is also true of other asset classes, DGF investors may face significantly higher transaction costs if outflows pick up. This is because, after meeting initial redemption requests, the resultant portfolio may be left with those assets which are relatively more costly to sell. In extreme cases, DGFs can limit disinvestments to a certain level, which will help to manage costs, but it means investors do not have the flexibility they had envisaged at the outset.

There also tends to be a bias towards the use of in house funds rather than appointing ‘best in class’ external managers. This can help to increase capacity of funds, keep down fees and allows more revenue to flow into the wider business.

A focus on costs, particularly in defined contribution solutions, is also leading DGFs to allocate a greater part of their portfolios to very liquid investments which reduces their diversification qualities.
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.

Where growth portfolios are dominated by equities, DGFs can provide a simple way to add diversification. But the level of diversification may not be as high as some believe due to the types of instruments such funds invest in. DGFs are not the only option and other solutions may allow greater diversification. Which approach is best very much depends on a pension scheme’s specific circumstances and future direction.

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