Summary
- In recent years, diversified growth funds have increased in popularity amongst pension funds; £117bn of pension fund assets are now in DGFs.
- In particular, DC schemes are offering them as part of their default option as a way to appease members who are risk averse.
- However, charge cap limitations, cost and lack of diversification are criticisms of DGFs.
- Future product innovation is vital as they take on a bigger role in the accumulation and decumulation phase of DC schemes.

The perfect blend

Diversified growth funds have increasingly grown in popularity since their introduction 10 years ago. Natalie Tuck examines why they are becoming commonplace in defined contribution schemes and how they have a bigger role to play since the introduction of the pension freedoms

The success of a perfect cocktail depends on the right mix of ingredients. Overindulgence of one part can result in a recipe for disaster. In that respect, a mixologist is much like an asset manager of a diversified growth fund (DGF). Both are required to mix together a dynamic range of ingredients to create the perfect blend, in order to generate a successful return on investment.

Of course, cocktails have been around a lot longer than the term DGF, which is only about 10 years old. Quilter Cheviot executive director Tim Horrocks describes DGFs as multi-asset funds with a mix of different financial assets, such as equities and fixed interest as well as other esoteric investments.

Standard Life investment director Andy Dickson notes multi-asset pooled strategies have been around for many years. But, says Standard Life investment director David Bint, DGFs rose to prominence after the NASDAQ bubble burst in the early millennium.

"It was believed that by investing in a broader set of assets than those balanced funds were able to do they would achieve a higher level of diversification and therefore more protection for investors," he adds.

Redington senior vice president, manager research, Aniket Das says the term is more of a 'marketing moniker' but labels the key characteristics of a DGF as having a wide range of asset classes, varying levels of dynamism and liquidity in the underlying investments. He notes the latter is the most constraining element of a DGF.

In recent years, DGFs have rose to prominence, much to do with the lower levels of volatility, because of the wide range of diversification they offer. Figures from Punter Southall released earlier this year show assets in DGFs saw a fivefold growth in almost five years.

Over a three year period, DGFs achieved monthly returns of between -3 per cent and 4 per cent, providing a much smoother ride than the FTSE All Share, which achieved monthly returns of between -7 per cent and 7 per cent. Punter Southall's research also revealed UK pension schemes currently hold £117 billion of assets in DGFs.

The default DGF

There is no doubt of the increasing number of defined contribution schemes using DGFs; figures from Towers Watson show the proportion of FTSE 100 schemes offering DGFs as a default option increased from 10 to 70 per cent between 2009-2014.

Wolseley DC plan chairman of trustees and PSIT managing director Wayne Phelan says their scheme widened its investment option to include a DGF option in 2014, as well as including one in its default fund.

"The rationale for this was that pure equity investment is volatile, at times extremely volatile. For many members they would not want to experience volatility and prefer a smoother return rather than a chance at timing equities right for a slightly higher pension," he explains.

Phelan says he is "comfortable" that the DGF has performed as expected, especially as a pure equity investment carries a lot of downside risk. However, he notes that they do still see a role in equities, both in directly investing and because DGFs will invest substantially in equities.

Charge cap limitations

Dickson notes DC schemes are in some ways limited to the DGFs they can use as their default option, because of the introduction of the charge cap. It is worth noting that the charge cap of 75 basis points includes both administrative and consultancy fees, which can add up to around 55 basis points.

With DGF funds averaging fees of 50 to 80 basis points, according to Das, DC schemes are forced to blend DGFs with passive equities, principally because of the fee pressure rather than an investment view, says Dickson.

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However, Das notes since the introduction of the charge cap some investment firms have launched DC charge cap friendly products and others have cut their fees.

Horrocks however, argues that offering a DGF as a default option in the growth phase means people are not getting enough equity. He does acknowledge that members do not want to see their value of money fall, otherwise they may opt out.

A bigger role to play

With the introduction of the freedoms, Dickson believes DGFs have a bigger role to play in the future of defined contribution pension schemes. Since it is no longer compulsory to buy an annuity, many people instead are choosing to draw down.

"If it is (the money) used for its original purpose to provide a pension then the characteristics of a DGF and the analysis that we have done illustrates that DGFs in particular are extremely helpful in preserving the value of an individual's pension, who has decided to draw down," he explains.

Horrocks and Das also note that a DGF could be used in this stage because of the reduction in volatility. However, Horrocks says whether to choose a DGF or a 'proper' diversified portfolio depends on the size of the members' pot. Das adds there needs to be better wrappers on DGF products to offer better protection to people.

Criticisms

Phelan says a criticism of DGFs is that they are not all like-for-like, some are more like hedge funds, whilst others are like equity funds.

"They are a way of investing and there should be greater emphasis placed on the risks of investing in these funds. Picking the right one is key; focus should be on the range of investments, how much of this range is used and the number of changes made across these ranges for any active managers," he explains.

In addition, Bint adds that when looking around the market he does not think the level of diversification that they achieve is as much as could be done. Das explains that DGFs can appear visually diversified on a pie chart but in reality are not.

"If you have five different types of equities, they're probably going to go up or down at the same time. That might be visually diversified but it's not truly diversified. We try to dig into what are truly the major risk factors the funds are exposed to and how diversified those risk factors are," he says.

Phelan also criticises the higher costs compared to equities. He says this is because there is often a fund wrapper which then invests in other funds or assets, hence increasing the costs.

"We have already seen some evidence of manager's reducing their fees (albeit by exception rather than as a rule) and I expect that there will be greater pressure on the management charges for these fees in future," he adds.

The future of DGFs

Previously there have been suggestions for the need of a benchmark but there is somewhat of a consensus that for DGFs it would be hard to achieve. This is because they are all targeting different returns, says Horrocks.

Bints says introducing a benchmark is difficult to do and encourages bad behaviour among asset managers because it creates the possibility where you might have to own something even if you think you are going to lose money. This is because if you want to be compared to a strategic benchmark then you need to invest relative to the benchmark.

Bint does, however, predict there will be continued demand for multi-asset products generally. He says it is therefore likely we will see a growth in the fund available and the types of funds leading to product innovation.

Das sees the use of systematic strategies being brought in to help reduce the cost of DGFs. He says there are ways to bridge both gaps on the fee issue and sophistication of products without having to compromise, perhaps providing a 'happy hour' for investors.

Written by Natalie Tuck