Protecting against volatility

Matthew J. Bullock discusses how diversified growth funds can protect against volatile markets

Diversified growth funds (DGFs) are popular with many pension schemes because they aim to deliver growth while limiting risk. However, our research suggests many DGFs aren't truly diversified. This may have supported impressive recent performance, but risks a substantial sell-off when markets – particularly equities – fall.

Brexit turmoil challenged many DGFs

Recent months have provided ample volatility to test the performance of DGFs. We specifically conducted some analysis on the sector's performance during the Brexit turmoil.

There isn't a strict definition of the sector, and we looked at UK funds with a sterling share class that are commonly labelled as DGFs – excluding balanced and multi-manager funds – which left a population of 27.

Nearly all the funds in the population suffered losses immediately following the Brexit referendum[1], struggling in exactly the volatility they were designed to protect against. Of the 27 funds, 25 experienced drawdowns in the five days following the vote, more than 6 per cent in the worst case.

Not all DGFs are the same

A rigorous evaluation of DGFs should assess not just performance but also funds' diversification, in our view. We subdivided DGFs into 'traditional' (predominantly long-only) and 'alternative' (deploying a more diverse set of strategies) categories since this is how consultants often view the market.

We found that traditional DGFs follow market movements to a large degree. Over 72 per cent of volatility can be explained by equities and bonds, compared with 37 per cent for alternative DGFs[2].

Returns and diversification

There is no perfect benchmark for DGFs; we took a blend of 60 per cent global equities and 40 per cent gilts.

Our analysis shows:

- Alternative DGFs outperformed traditional funds and were far less volatile
- Returns from traditional DGFs have predominantly been driven by equities and bonds
- Alternative DGFs experienced far shallower losses than traditional funds
- Alternative DGFs demonstrate far greater diversification, which we believe makes them more resilient against stressed markets
- No single fund offers the complete package. We favour blending at least two alternative DGFs to achieve diversified growth with downside protection.

Protecting against volatile markets

In an environment of low market returns, many traditional DGFs risk significant capital losses in volatile markets, although we believe alternative DGFs can provide an attractive complement to existing portfolios. Our analysis highlighted the following characteristics of funds that best protected capital through the Brexit volatility:

- Low dependence on equity and bond returns
- Employing both fundamental and systematic methods
- Employing both active and passive components
- Balancing risk across the portfolio
- Managing the portfolio to a volatility target to smooth returns.

Surprisingly few DGFs in our analysis exhibited many of these characteristics, suggesting that the choice available to investors is limited just when DGFs might be needed most.

A different approach to diversified growth

We believe that true diversification can protect pension funds against losses in falling markets. However, this demands a new approach to portfolio construction, for example, by allocating across broad, uncorrelated categories, such as:

- Market exposures: looking to capture broad market movements
- Manager alpha: pure stock selection while removing broader market exposure
- Alternative strategies: capturing inefficiencies in markets, for example, relative value or market momentum.

This diversification strategy successfully protected capital after the Brexit vote, and produced positive returns over the period.

Learn more: www.wellington.com/nextgeninvesting/insights

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[1]Bloomberg, Wellington Management, June 2016

[2]Bloomberg, Wellington Management, April 2008 - August 2016

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