Diversifying your diversifiers

Greg Skinner explains how a blend of dynamically managed traditional beta sources, mixed with a range of alternative assets and strategies, can deliver the returns required by pension scheme investors

Diversified growth funds (DGFs) have long been a staple in the portfolios of pension schemes, and there has historically been good reason for this. Trustees can delegate the asset allocation decision to investment professionals, as well as increasing the probability of more consistent returns.

Addressing the challenge of investing prudently for high returns

A primary consideration for pension schemes is to implement a suitable hedging strategy to manage the current liabilities. Trustees then need a way of accessing growth markets to try to reach the target return level set by the scheme actuary in order to provide enough capital to cover future liabilities. Of course, trustees have a fiduciary duty to pension scheme members to invest contributions prudently and this provides the challenge of meeting what is likely to be a relatively high annual return target whilst aiming to ensure that volatility and capital loss are minimised.

Traditional allocations have fallen short of expectations

Trustees have generally had the choice of 'traditional' DGFs, which typically have a high correlation to equity market movements, or market neutral DGFs that aim to produce a return regardless of the prevailing market conditions. The latter have, in the main, lagged growth markets including traditional DGFs in recent years. Whilst traditional DGFs have provided better returns, they have also served up a relatively high level of volatility and some large drawdowns – neither of which fit the smooth return profile desired by pension schemes. And there are questions going forward on the probability of achieving returns due to asset class valuations.

Performance has also disappointed in some cases in absolute terms as although producing higher returns, traditional DGFs have largely fallen short on delivering their performance targets – some as high as cash plus 5 per cent – and this had pushed many investors to look at other growth avenues, frequently moving to less liquid alternatives, such as private debt.

Two considerations for managing volatility

We absolutely advocate diversification but it needs to be true diversification. We believe that there are returns to be generated from harvesting equity, inflation, credit and nominal bond risk premia. Volatility and the potential for drawdowns still need to be controlled, and we believe the best way to do this is to dynamically manage your traditional allocations as well as diversify across 'non-traditional' investments.

Taking the first point, dynamic for us means assessing the strategic allocation on a quarterly basis so that portfolios are correctly positioned for the economic cycle. Our strategy also combines this with monthly tactical positioning to ensure that short-term pricing anomalies are either exploited for gains or avoided to reduce losses.

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Moving on to the second consideration, non-traditional investments do not necessarily have to mean tying money up in illiquid assets. Allocating to alternatives is about diversifying across investment styles, time frames and return drivers. By harnessing sources of returns from assets as diverse as insurance-linked securities and renewable energy infrastructure, as well as relative value strategies, you can reduce the element of economic-specific risk and achieve real uncorrelated returns. Such 'true' diversification is achieved on multiple levels, which invariably means more short-term tactical management is required.

A dynamic solution

By considering the pension fund requirements of steady gains without large volatility and drawdowns, it is clear that a diversified approach makes sense. We believe a blend of dynamically managed traditional beta sources, mixed with a range of alternative assets and strategies, has the best chance of delivering the specific return targets required by pension scheme investing.

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As always, investment values may fall as well as rise and capital is at risk.