A new approach

Malcolm Jones explains how Standard Life Investments' Enhanced-Diversification Growth Fund (EDGF) provides more effective pension investment provision than standard DGFs

The search for equity-like returns with reduced volatility has long been a sought-after outcome for pension investors. Following the equity bear market at the turn of the century, Diversified Growth Funds (DGFs) were developed as a replacement for traditional balanced equity and fixed income portfolios. DGFs were seen as a way of avoiding the large drawdowns that resulted from an overdependence on equities as the prime source of return. They sought to address this flaw by diversifying the growth assets in a portfolio to include asset classes such as emerging market debt, high yield, real estate, private equity and commodities.

However, during the financial crisis of 2008, DGFs suffered more than anticipated. Rather than this broader spread of asset classes acting as a diversifier, many behaved in a similar manner at times of market stress. The lesson was that while DGFs' exposure to a range of conventional assets could add value in the longer term, their high dependency on growth or market risk premia could produce a volatile path on the way there.

In 2013, Standard Life Investments launched the Enhanced-Diversification Growth Fund (EDGF) in response to calls for more effective pension investment provision than that provided by DGFs. While the overarching aim of EDGF is the same as that of traditional DGFs – equity-like returns with reduced volatility – how we structure the portfolio has important differences.

EDGF aims to deliver an equity-like return over a market cycle but with only two-thirds of equity market volatility. In seeking to do this, several key factors differentiate it from a traditional DGF offering:

- it is not reliant on traditional asset classes alone to provide diversification
- return-seeking, enhanced-diversification strategies, are utilised to provide both return and provide the overall portfolio with greater resilience in times of market stress
- we construct the portfolio around our established process for:
  - combining diversifying strategies with conventional assets to mitigate risk
  - risk-based portfolio management and control

Greater diversification

While still investing in traditional growth and defensive assets (such as bonds), we aim to build a well-diversified portfolio by employing a range of return-seeking, enhanced-diversification strategies. These strategies are employed because of their potential to act as 'shock absorbers' in falling equity markets. Chart 1 highlights how this works in practice with strategies used in EDGF as examples.

The first three investment strategies are European equity, Chinese equity and UK property. These should provide good returns in the longer term but their high correlation to equities means they offer little diversification potential. The next three strategies are from the fixed income universe. While bonds have traditionally been effective diversifiers for balanced portfolios due to their low correlation to equities, history shows this is not always the case during times of market stress.

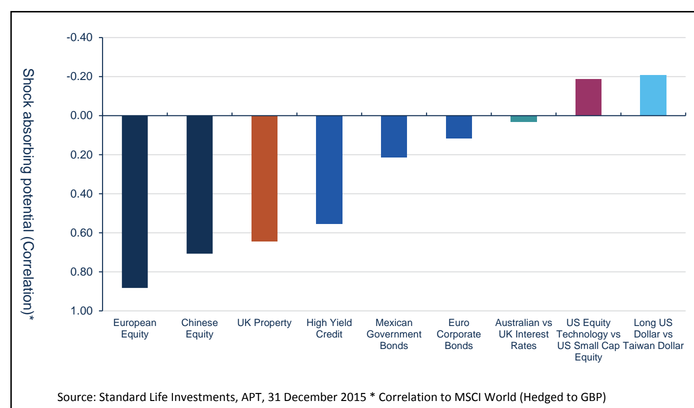
It is through the final three strategies (interest rates, relative value equities and currencies) that EDGF aims to achieve a greater level of diversification than would be possible by investing solely in growth assets. All three offer superior shock-absorbing potential in falling equity markets and help to lower the overall volatility of the portfolio. Importantly, we also strive to ensure that this diversification is profitable; each strategy is designed not just to diversify away risk but also to generate a positive return.

Examples of current enhanced-diversification strategies are:

- **Currency - long US dollar versus Taiwanese dollar**

This strategy reflects our preference for the US dollar versus the Taiwanese dollar and aims to guard against the effects of economic slowdown in China. Our view is that the US dollar should continue to strengthen, while Taiwan is overly reliant on exports and on Chinese demand. With China now decelerating, growth and earnings in Taiwan are slowing in tandem. In addition, the recent

Chart 1: Correlation of investments to equities



Source: Standard Life Investments, APT, 31 December 2015 * Correlation to MSCI World (Hedged to GBP)

devaluation of the Chinese yuan will exert pressure on the Taiwanese dollar to depreciate; weak global trade has a disproportionate impact on Taiwan, and therefore exchange rate competitiveness is a crucial factor in sustaining growth.

- **Relative value – long US technology vs US smaller companies**

Capex by cash-rich corporates plus consumer spending priorities should favour technology spending. Technology companies tend to be the early beneficiaries of capex. We believe this has yet to be reflected in earnings forecasts and valuations. The strategy uses the technology heavy NASDAQ market index, which has a high international exposure, so contributing to its risk-off dynamic when markets are stressed. By contrast, the Russell 2000 market index, which the strategy also uses, is highly US-centric (90% of earnings are derived domestically) and its growth prospects are more fully discounted; it is also regarded as a geared play on the health of the US economy. Furthermore, the market's profit growth expectations appear overly ambitious. Should US growth disappoint, the valuation of the Russell 2000 offers no protection.

- **Interest rates – holding 10 year Australian interest rates**

This investment is designed to benefit from interest rates falling in Australia. The market is expecting a strong rebound in the Australian economy; we believe this is too optimistic and the strategy should make a return as the market prices in slower economic activity. A postponement of the US Federal Reserve raising interest rates also supports this strategy, so from a diversification perspective it offers value as part of a wider portfolio.

We expect these enhanced-diversification strategies to contribute around one-third of the return of the portfolio over the market cycle, with the other two-thirds coming from our exposure to traditional growth assets. In light of this, we allocate our risk budget accordingly.

Risk management to the fore

Meticulous attention to risk is at the core of EDGF. While the portfolio managers are responsible for the overall blending of traditional growth assets and enhanced-diversification strategies, the portfolio is subject to regular review and discussion with our risk specialists. At all times the portfolio must adhere to our criteria regarding:

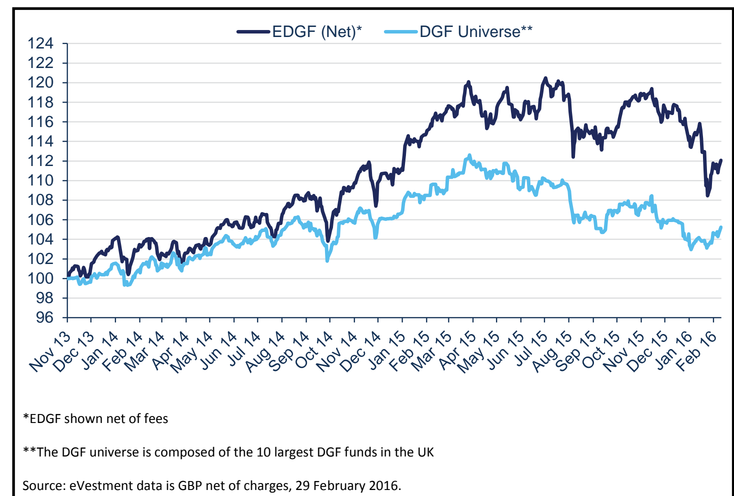
- our conviction in its overall return potential
- its effectiveness in mitigating risk
- its scalability.

Since inception, EDGF has performed strongly on both an absolute basis and relative to global equities, delivering 5.9% per annum (gross of fees). This has been achieved while still meeting its volatility objective of around two-thirds of global equity volatility. Meanwhile, a maximum drawdown of -9.7% relative to -18.2% for global equity further emphasises the effectiveness of our approach in dampening losses during times of significant market falls.

Strong performance since inception

EDGF has also performed strongly against its DGF competitors. Chart 2 compares its performance (net of fees) against the median of the largest DGFs in the eVestment universe. As the chart shows, not only did EDGF outperform the DGF universe, but it did so without exposing investors to a material increase in risk (10% maximum drawdown relative to 9.5%).

Chart 2: Strong performance relative to DGF competitors



*EDGF shown net of fees

**The DGF universe is composed of the 10 largest DGF funds in the UK

Source: eVestment data is GBP net of charges, 29 February 2016.

Rising to the accumulation challenge

For UK pension investors, expanded investment options for accumulated pension assets have brought with them a challenge. Deciding on which asset classes to invest in as retirement nears is crucial. At Standard Life Investments, we believe traditional growth assets alone may not be optimal for members seeking reduced volatility and that multi-asset growth strategies should be considered. By seeking to maintain returns with reduced volatility, the consistency such products offer can prove extremely valuable. With its genuinely diversified approach and rigorous risk controls, we believe EDGF is well-placed to meet this challenge.

Written by Malcolm Jones, investment director, absolute returns and multi-asset investing, Standard Life Investments

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The value of an investment is not guaranteed and can go down as well as up. An investor may get back less than they originally invested. Past performance is not a guide to the future. EDGF makes extensive use of derivatives to seek its investment objectives.

Summary
- Pension fund demand for DGFs is still strong. Multi-asset investment strategies commonly try to achieve long-term equity-like returns but with lower volatility.
- According to data analysts Camradata, there are already 95 DGF products out there accounting for total assets under management of just over £135.5 billion. Inflows to this sector totalled £15.7 billion during 2015 alone.
- DGFs have their own performance and risk targets. They may, for example, aim to achieve cash plus 3% to 5% or inflation plus 4% to 5% and to be one third, half or two thirds as risky as equities.
- With DB schemes, which still account for the majority of DGF assets under management, the funds are viewed as a valuable stepping stone towards de-risking.
- The majority of new DC default funds have at least an element of DGFs in them, although in some cases this doesn't come into play until scheme members reach their 40s as equity funds can be preferred for younger people.

Defining the DGF universe

Edmund Tirbutt analyses the usage of DGFs among DB and DC pension funds and how these investment vehicles can affect scheme returns

Informed investors have traditionally been wary of anything that purports to allow you to both have your cake and eat it, but this certainly hasn't inhibited demand for diversified growth funds (DGFs) – many of which aim to do exactly that. By using multi-asset investment strategies they commonly try to achieve long-term equity-like returns but with lower volatility.

The approach is popular with both defined benefit (DB) and defined contribution (DC) pension schemes, although the drivers for each are slightly different. According to data analysts Camradata, there are already 95 DGF products out there accounting for total assets under management of just over £135.5 billion. Inflows to this sector totalled £15.7 billion during 2015 alone.

Appeal

A key appeal is the ability of DGFs to offer diversification via a broad spread of assets with different correlations. These can include infrastructure, property, emerging market debt, global sovereign debt, investment grade credit, high yield bonds, gold, derivatives and hedge funds.

Another attraction is that DGFs, unlike the old-style managed funds that had peer group benchmarks, have their own performance and risk targets. They may, for example, aim to achieve cash plus 3% to 5% or inflation plus 4% to 5% and to be one third, half or two thirds as risky as equities. But, because the term DGF encompasses such a broad church, it is essential to look under the bonnet to choose exactly the right fund.

PTL client director Melanie Cusack says: "You need to go through rigorous due diligence to select an appropriate DGF manager, and we would use an investment consultant to help us. They would do a buy list of the different funds on offer, and all have differences in charges and objectives. Some might just be tracking different indices but actively managing asset allocation, and some might be using derivatives and hedge funds."

According to Camradata, although average performance over three years has been quite respectable, for 2015 DGFs with an objective of cash plus less than 3% achieved a median return of -0.27%, those with an objective of cash plus 3% to 5% achieved a median return of over 1.82%, and those with an objective of cash plus 5% to 7% achieved a median return of over 0.81%.

Standard Life Investments investment director David Bint says: "Funds have mixed track records, and many have satisfied the low volatility requirement but not the return requirement. They are not able to generate enough diversification benefits to get the growth. This was all highlighted by the recent Cambridge Associates report but we knew it all along.

"We addressed this problem via the launch of our Enhanced Diversification Growth Fund (EDGF) a couple of years ago. This can invest in traditional DGF assets but also employs enhanced diversification strategies, using currencies, interest rates and relative value equities. It has managed to produce annualised returns of around 6% whilst limiting volatility to around two thirds of equities."

DB schemes

With DB schemes, which still account for the majority of DGF assets under management, the funds are viewed as a valuable stepping stone towards de-risking.

"They are seen as quite a good combination with LDI (liability driven investment)," LCP investment department partner Kevin Frisby comments. "Because the LDI takes care of the liability side of the equation, if you are well hedged against interest rates and inflation you want stability from the rest of the portfolio."

It is not unusual for DB schemes to be 30% to 50% invested in DGFs but many have no holdings at all and a small minority are 100% invested in them. Because DGFs can differ so markedly, it is fairly common practice to use more than one fund.

Punter Southall Investment Consulting head of manager research Katherine Lynas reports that the one client she has 100% invested in DGFs splits its investment between three different funds and that her normal approach to DGFs generally is to select two different ones alongside each other, with different styles, return targets and managers.

DB allocation to DGFs can be at its highest with SME schemes. JLT Investment Management, for which SMEs are a core market, reports that most clients have over 50% in them.

JLT Investment Management director of investment Paul Chapple says: "A lot of our trustee boards find that their quarterly investment reports become much easier as DGFs are a lot more consistent in their returns, so there are less unknowns involved."

Because there is no charge cap issue and because large DB schemes can secure favourable terms for high volumes of money, DGFs tend to take a more sophisticated approach than on the DC side. In some cases annual charges are north on 1.2%, but in the majority of cases they are between 0.5% and 0.8%.

DC schemes

The majority of new DC default funds have at least an element of DGF in them, although in some cases this doesn't come into play until scheme members reach their 40s as equity funds can be preferred for younger people. The DGF can also continue to form a component of a portfolio for those wishing to take drawdown at retirement, although it may be supplemented by bond funds and cash funds.

But DC schemes often have to settle for slightly dumbed down versions compared to DB schemes because keeping within the 0.75% charge cap is the key consideration.

First Actuarial senior investment consultant Richard Lunt states: "In the majority of structures that we experience DC schemes are normally asking for trouble if the DGF costs more than 0.5% because 0.25% is often taken up with admin costs. In certain cases employers can pay these fees and allow the DGF to go up to 0.75% but in our view you can often get better quality funds at 0.5% than at 0.75%."

There has been a great deal of recent product development addressing this fundamental issue of finding a DGF fund that has keen enough charges to enable it to be used as a default fund but also offers sufficient diversification to be fit for purpose.

"There are a few DB-only products but most have launched DC variants which are not quite as good," Willis Towers Watson head of DC investment Nico Aspinall says. "Funds aimed at DB know investors don't need to deal every day with illiquid assets, so they might only permit them to deal monthly or even less often. But with DC they must allow you to deal daily, which raises cost a bit and the quality of the investment is worse."

Additionally, as an alternative to using the lower-cost DGFs, a lot of DC schemes are adding passive global equity and/or bond funds alongside DB-style DGFs to ensure they don't exceed the charge cap. It is not unusual for default funds to have a 50/50 split between passive and DGF funds.

A further notable area of product development on the DC side is being aimed at scheme members who reach retirement and want a suitable fund to be able to draw down on to achieve a long-term income.

"Charges on income-producing DGFs tend to be more like 0.75% because the charge cap doesn't apply after retirement. These tend to feature more with SIPPs (self-invested personal pensions) because a lot of the big institutional players have no experience of producing income," Aon Hewitt principal consultant Jo Sharples concludes.

Written by Edmund Tirbutt, a freelance journalist

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