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Multi-assets focus:

The star of the show

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Income and growth: Can a single strategy yield both?

Trustees of many mature defined benefit pension schemes face the dual challenge of paying scheme members while trying to close funding gaps. Dynamic multi-asset funds, which are designed to deliver both asset growth and income, are well aligned with pension fund needs

The levels of underfunding across maturing UK DB pension schemes have become a national concern[1]. This underlines the significant challenges that trustees face to meet their cashflow requirements and generate the capital growth needed to improve funding levels. More than ever, trustees need solutions that can deliver both outcomes.

Dynamic multi-asset income approaches present an additional tool for trustees to use in a shifting investment environment where more traditional solutions to these challenges may not be as flexible or appropriate. This is because dynamic multi-asset funds share similar objectives to UK DB schemes but have the flexibility to respond to changing market conditions.

Today's challenge

Every scheme has to balance capital growth and the desire for certainty of cashflows to meet liabilities. Today, maturing defined benefit schemes are moving towards an emphasis on the latter. However, few schemes are in a position to fully immunise or cash flow match liabilities, due to liability uncertainty (created by shifting interest rates and member longevity) and current funding status.

The terms of the trade off between cashflow certainty and growth opportunity are always changing. In the 1990s the yield on inflation-linked 10-year gilts and the dividend yield on FTSE All share equity index were very similar.

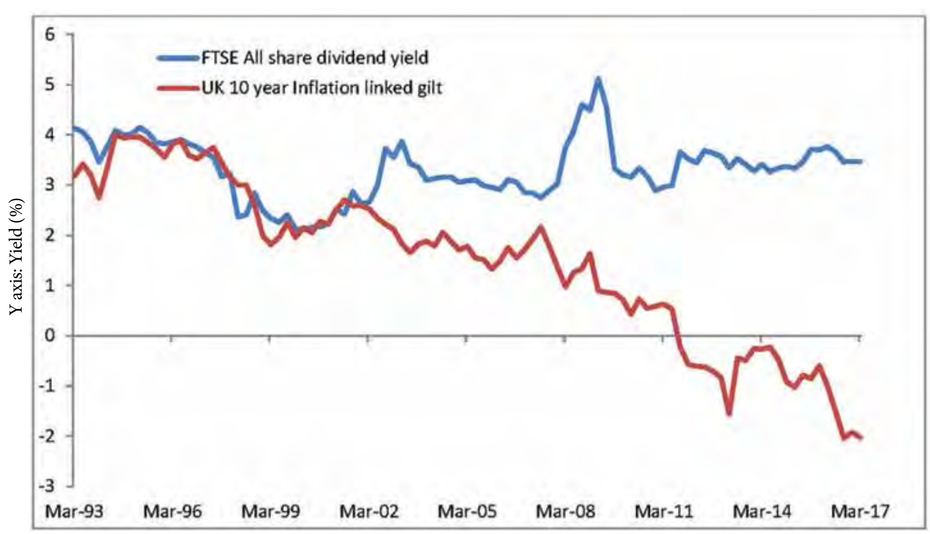
Today, traditional avenues for seeking stable cashflows such as gilts simply do not offer adequate levels of yields to meet plan objectives. While 'de-risking' is a pressing need for many pension schemes, the costs of doing so are at high levels. There is a sharp disconnect between the needs of many schemes and prevailing asset pricing.

Income multi-asset funds

A common concern is that this paucity of gilt yields is pushing institutional into riskier areas of the investment universe to meet the same objectives. Investors who look purely for income and target high levels of yield, irrespective of underlying risk, will certainly have fallen victim to this.

Multi-asset income funds can offer a possible solution to this challenge because they focus on both capital growth and income, in a similar way to many pension schemes. Targeting stable regular income payments that grow over time can help to meet regular payments in cashflow negative schemes. Funds that seek to generate cash flow through

FTSE All share dividend yield and UK inflation linked Gilts



Source: Bloomberg, April 2017

[1] https://www.theguardian.com/money/2016/sep/01/uk-defined-benefit-pension-fund-deficit-grows-100bn-one-month-pwc

'natural' income i.e. via the income stream from underlying assets rather than drawing from capital, will need to pay even closer attention to the capital base.

Income sustainability depends upon making sensible, dynamic asset allocation decisions for total investment return, while the added discipline of regular income generation/reinvestment can be thought of as providing an ongoing buffer against overall portfolio volatility.

Searching further afield

Multi-asset income funds also offer two advantages in pursuing a balance of stable income and capital growth: a broad investment universe to select from and the flexibility to respond if the risk/reward trade off shifts.

A broader investment universe

A growing global universe of income bearing assets means that multi-asset managers with an income objective actually have far more avenues to pursue today than in the past, even with the low yields on offer from many traditional income sources. The corporate bond market has become broader and deeper in the UK and overseas, more global companies are focusing on returning cash to shareholders via dividends and buybacks, and both alternative and emerging markets have also matured significantly.

The diversification benefits of this greater range of regions and asset classes today is a highly valuable tool for managing capital in an environment in which traditional 'safety' assets offer extremely low returns. A wider investment universe offers scope to combine assets that will be less correlated over the shorter term, increasing the likelihood of lower fund volatility and a smoother investor experience.

The benefits of dynamic asset allocation

While a greater range of available assets means that there is a greater opportunity for diversification, investors cannot afford to rely on this diversification in all scenarios. Static 'set and forget' portfolios may help reduce 'eggs in one basket' risk over the very long term, but are less helpful for shorter term capital management.

The relationships between assets can change and correlations may spike in periods of stress, leading to the potential for short-term drawdowns. In seeking stability of capital from which to make income distributions, multi-asset income funds will need to make forward looking assessments of correlation, as well as adjusting exposures to respond to a changing opportunity set.

The need for active and experienced management

While the nature of multi-asset income funds means that they are well placed to deliver the type of objectives that are increasingly valuable for pension schemes, delivering these objectives will require active management. Assessing the risk/reward trade off, managing capital in the short term, and evaluating the right times to make dynamic shifts to asset allocation involves a robust investment framework and experienced management. Backward looking risk models and static asset allocations are not always well placed to navigate a changing environment.

Conclusion: The benefits of multi-asset investing for sustainable income

Income investing has become relatively fashionable since the financial crisis, in now small part due to the success of income investing as a 'style'. However, for many institutional investors it is income investing as an 'outcome' that is most attractive. Many multi-asset income funds have been designed with retirees in mind and the types of the outcomes that they seek will have much in common with many pension trustees today.

A regular, stable and growing income stream is a useful tool for pension schemes managing cash flows, while the commensurate need for stability and growth in the capital base mirrors the requirements of schemes which need to improve funding levels. Achieving these dual objectives requires experienced and disciplined active management. The flexibility of multi-asset income mandates and the evolution of the investment universe mean that these managers have a range of tools at hand to deliver on their targeted objectives.

Written by Steven Andrew, fund manager, multi-asset team, M&G

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Summary
• DGFs are used extensively by pension funds to achieve diversification across a range of asset classes. Broadly speaking, most approaches seek to generate equity-like returns but with lower volatility and combine longer-term strategic views with shorter-term tactical allocations. Some make extensive use of derivatives.
• The market can generally be segmented into two categories: traditional DGFs and absolute return DGFs. The former relies largely on directional market exposures with long-term strategic asset allocation targets. The latter focuses on relative value to generate returns.
• Funds holding a range of market return investments such as equities, bonds and real estate across the globe, in combination with enhanced diversification strategies, can provide both additional sources of return and higher levels of portfolio diversification, resulting in greater resilience in times of market stress.

A vital role

Andrew Williams analyses the latest levels of DGF usage and how the investment vehicles are proving to be an integral part of any investment portfolio

In recent years, diversified growth funds (DGFs) have emerged as an increasingly-popular choice for pension funds. So, what role do these multi-asset funds play within the typical pension fund portfolio? Why have they continued to be an attractive option? And what have been the key recent trends and developments in the use of DGFs by institutional pension fund investors?

Lower volatility

DGFs are used extensively by pension funds to achieve diversification across a range of asset classes. Broadly speaking, most approaches seek to generate equity-like returns but with lower volatility and combine longer-term strategic views with shorter-term tactical allocations. However, beyond these high level similarities, Standard Life investment director, UK institutional business, Len Currie, explains that the investment approach can vary widely – with risk management central to the approach driving some funds but not an explicit focus for others.

"Some DGFs make extensive use of derivatives, whilst others are focused on traditional instruments. Pension funds can use DGFs as core equity replacement or satellite alternatives allocations," he says.

"The ability of DGFs to deliver diversification benefits and improve risk-adjusted returns has made these funds an appealing option for pension funds. The potential for volatility reduction has been appealing during what has proved to be a turbulent period in the global economy and markets. The lower returns available from more traditional investment approaches today make DGFs' stated objectives more attractive still," he adds.

Elsewhere, M&G Investments global head of institutional distribution Ominder Dhillon says DGFs are often used by pension schemes as a core strategic holding to deliver growth, helping to "close funding gaps in a single solution that is relatively easier for trustees and their advisers to monitor".

Meanwhile, Cambridge Associates UK and Europe practice head Alex Koriath reveals that, while most DGFs aim to achieve equity-like returns with significantly reduced volatility, the market can generally be segmented into two categories: traditional DGFs and absolute-return DGFs. Traditional DGFs have more straightforward strategies that rely largely on directional market exposures. These strategies tend to have long-term strategic asset allocation targets with moderate ranges around those targets to facilitate tactical positioning. Unlike traditional DGFs, absolute-return strategies focus primarily on relative value to generate returns. Leverage and shorting are integral to these strategies, which are often implemented using derivatives. By diversifying risk across a range of active bets with limited embedded sensitivity to overall market direction, Koriath explains that absolute-return DGFs seek to generate returns that are less reliant on overall stock and bond markets.

"A number of pension schemes had used DGFs as a core component of their growth portfolio or even as a complete replacement of a growth portfolio," he says.

Huge expansion

Since the first real incarnation of the DGF strategy in the mid 2000s, Dhillon reports they have seen a huge expansion – with over £170 billion already allocated to these strategies and assets expected to rise to over £289 billion by 2020.

"Over this time, there has also been an extensive development of DGF funds to include income, higher risk and capital preservation strategies. Ultimately they offer a comprehensive set of strategies for both DB and DC schemes with different funding levels, time horizons, risk budgets and need for income," he says.

Threadneedle Dynamic Real Return fund manager Toby Nangle adds that DGFs have been central to pension schemes' investments in recent years because they specifically aim to achieve good total returns with low levels of volatility.

"In an uncertain investment climate, where volatility is heightened, managing risk is key to achieving a successful investment outcome. But the universe of funds is large and diverse, making it difficult for investors to pinpoint the exact fund and strategy that matches their aims," he says.

"We have seen some degree of manager turnover within DGFs, where investors have been disappointed with their incumbent managers who have not participated in recent strong market returns. Many DGF managers have been overly cautious in previous years. In addition given cost pressures across the board, we have seen a reduction in overall fee levels," he adds.

For Koriath, the primary benefits of replacing the entire growth portfolio with one or more DGFs are twofold: reducing the governance burden on trustees and simplifying the portfolio. In his view, the fact that DGFs can provide diversified multi-asset exposure in one packaged fund means that they can ease trustees' governance burden – particularly since they do not have to oversee a multi-manager growth portfolio of asset class specialists.

"This simplification is most beneficial to very small schemes with limited resources that choose not to outsource portfolio management responsibilities to a fiduciary manager," he says.

However, whilst the growth portfolio replacement role offers a simple solution for small schemes, Koriath still warns that there are some drawbacks with this approach. To begin with, he argues that replacing the entire growth portfolio with DGFs reduces the available set of investment opportunities, particularly with regard to illiquid assets. Secondly, he believes that pension schemes limit the potential sources of alpha to the selected DGF managers, who may not have top skill across all asset classes.

Future trends

During the financial crisis in 2008, Currie reveals that some of the traditional DGFs suffered more than anticipated, and turned out to be less diversified under stress than had been hoped. Although he admits that many DGFs offered broad exposure to conventional market assets likely to add value in the longer term, he argues that their high dependency on growth or market risk premia alone produced a volatile path, dependent upon the investment environment.

"Typically at that time, the absolute return subset of DGFs, that access a broader investment universe, performed more in line with expectations," he says.

More recently, Currie observes that very strong performance by equity markets has proved a challenging comparator for DGFs that by definition have a lower exposure to a single asset class. In recognition of this fact, he believes that DGFs are likely to lag equities in such periods, but make up the relative shortfall at different times in an investment cycle.

"Longer-term pension fund investors are used to short, sharp equity rallies and are generally not deflected from their broader goals by such events. We expect pension funds to increasingly turn to DGFs that use a wider range of tools in achieving their investment returns. Some DGFs are not wholly reliant on different growth assets to provide return and diversification benefits," he says.

"Funds holding a range of market return investments such as equities, bonds and real estate across the globe, in combination with enhanced diversification strategies, can provide both additional sources of return and higher levels of portfolio diversification, resulting in greater resilience in times of market stress," he adds.

Dhillon has also observed a recent trend for schemes to blend two or more DGFs in their investment portfolio, a development he believes provides the opportunity to diversify manager concentration risk and, ultimately, provide a smoother return profile. After a period of low market volatility, he also reveals there has been a big shake up of the DGF players following the events of 2016, which he says led to the 'biggest disparity of returns' since DGF managers came to prominence, highlighting the need for DGF managers to be dynamic in their asset allocation.

"The new regime of market volatility is likely to continue and will no doubt provide challenges for some managers and opportunities for others," he says.

On balance, Koriath says that Cambridge Associates has recently tended to see pension schemes focusing more on absolute-return DGFs, which can serve as a diversifier in the investment strategy, than on traditional DGFs.

"Looking ahead, we see traditional DGFs being most useful to smaller schemes, while we expect high-quality absolute-return funds that can credibly deliver an uncorrelated return stream to continue to grow and have a place in pension scheme's portfolios," he adds.

Written by Andrew Williams, a freelance journalist