Spotlight on volatility: Re-examining DGFs

Tristan Hanson highlights the importance of monitoring DGF strategies throughout the investment cycle

Pension schemes have used diversified growth funds (DGFs) for years for the dual objectives of lowering volatility in portfolios and generating attractive returns in a wide range of market conditions. However, the past two years have proved a challenge, both during the calm conditions of 2017 and in the turbulent 2018, when US interest rate dynamics and political uncertainty contributed to heightened market volatility and price declines across 90 per cent of asset classes[1].

As market conditions change, we increasingly see the assumptions behind many diversification models being challenged. This is arguably to be expected, as an investment portfolio is not inherently diversified because it uses a multi-asset or multi-strategy approach. Correlations between asset classes are not static and historical relationships change, as evidenced today in equity and bond markets.

Instead, it is essential to take a forward-looking view of correlations. Asset valuations, the nature of near term price action, and the prevailing economic regime can all provide information about how much genuine diversification is available, and provide an advantage over simple 'set-and-forget' collections of best ideas.

Managing volatility throughout the cycle

While valuation signals provide important signals around the prospects for long-term returns through strategic asset allocation, we believe this must be supplemented by dynamic asset allocation to deliver DGF-style objectives throughout market cycles. This is because valuations and correlation patterns can shift materially – and sometimes frequently – in the short term, providing opportunities to both capture potential upside and mitigate downside risk.

Dynamic asset allocation can be primarily achieved by investing in liquid asset classes such as equities, bonds and currencies to enable quick responses to changing market conditions. Position scaling and sizing can be an effective means of providing downside protection, and our overall equity exposure is scaled quite significantly up and down over time.

To protect capital in our target return proposition, our most conservative DGF, we target a nominal volatility limit and observe short-term drawdown thresholds rather than a volatility objective relative to equities. Through this we aim to preserve capital in volatile periods, while targeting a positive return over the longer term.

We believe appropriate use of alternative assets, such as ABS, infrastructure, private loans and property, can provide effective diversification – especially given today's correlated weakness among major asset classes. However, it is also important to recognise their limitations. Investors need to distinguish between assets that are genuinely less volatile and those that are simply illiquid or undiversified. Often illiquidity or concentration of positions can mask the fact that apparently alternative assets are still sensitive to broad factors like growth, interest rates and inflation.

What can schemes expect from DGFs in 2019?

The DGF investment universe is so broad that we believe each fund should be assessed individually and carefully. We expect continued divergence in realised outcomes should market volatility persist, and potentially fewer strategies being able to deliver DGF-style outcomes. Nevertheless, for investors looking to manage volatility in 2019, we believe a flexible, multi-asset approach still offers the widest range of tools to protect capital without excessively compromising potential returns.

For more information, please visit www.mandg.co.uk/multiasset

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The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested.

[1] **Source: Deutsche Bank, January 2019**

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