Capture not correlation

Trevor Greetham explains why it's time for a fresh look at diversified growth funds

The diversified growth fund (DGF) sector has fallen out of favour in recent years. High-profile active strategies have performed relatively poorly in rising markets and while relatively inexpensive buy and hold strategies have done well, expensive equity and bond valuations put a question mark over future returns. Some pension funds have abandoned the sector, seeking uncorrelated growth in less liquid asset classes such as infrastructure, leveraged loans and private debt.

We believe the use of correlation as a metric for diversification has drawbacks as asset classes that behave differently to equities in normal market conditions can fail to prove resilient when a recession hits. An alternative approach is for DGFs to seek to deliver an asymmetric return profile, capturing a portion of equity market upside but taking action to limit losses when markets are stressed. While there is obviously a place for illiquidity premium in a pension fund, 10 years into an economic expansion may not be the best time to give up on DGFs.

Two complementary sources of return

We believe pension funds shouldn't have to choose between managers offering participation in rising markets and those taking a safety first attitude when conditions deteriorate. A single DGF manager can invest in a diversified portfolio of liquid assets, including equities, to capture upside in positive market trends while limiting downside risk by shifting to a more tactical approach when markets are expensive or volatile.

An asymmetric return profile can be achieved by taking advantage of two complementary sources of return, each with in-built risk control.

1. Multi-asset core to capture market risk premia

A manager can capture upside during positive market trends with a core portfolio investing in a diversified mix of liquid assets, including equities, bonds and commodities. Risky assets should offer a premium over cash over the long run but they can suffer large losses during periods of market stress so it makes sense to reduce equity exposure at these times to prevent volatility – and downside risk – from rising too much.

2. Tactical overlay to exploit shorter-term opportunities

The manager can improve risk-adjusted returns by adding a tactical asset allocation overlay designed to exploit short to medium term opportunities irrespective of market direction. Active positions in this part of the fund should operate within a separate risk budget to limit downside risk when markets do not behave as the manager expects.

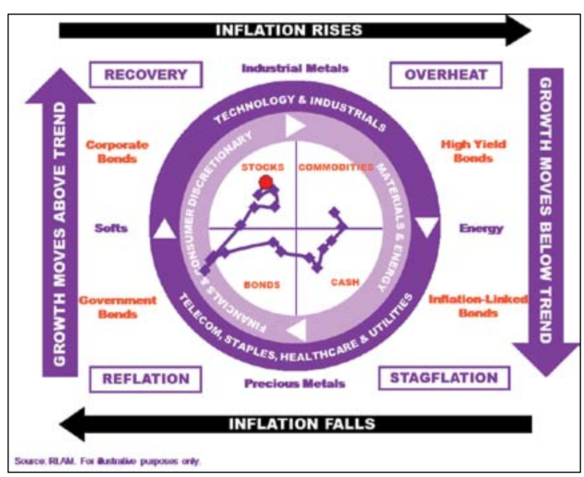
The risk budgets allocated to the core portfolio and tactical overlay should be a function of the growth needs and appetite for loss of the pension fund in question. For example, when valuations are expensive and prospective returns from the assets that make up the core portfolio are muted, as is the case today, tactical asset allocation positions may need to be larger than usual in order to target an acceptable level of return. Similarly, when markets are turbulent and downside risk is high, tactical asset allocation should also be the primary driver of returns.

A common criticism of volatility managed strategies is that they reduce exposure to stocks after a correction, leaving investors sitting in cash as markets recover. Using a separate risk budget for tactical asset allocation positions in the way described is one way to avoid this issue.

The Royal London Multi Asset Strategies Fund

This way of thinking was central to the design of the Royal London Multi Asset Strategies fund (MAST). The fund builds on the research-led investment process we apply to over £70 billion of assets managed for our parent company and a range of third party investors. MAST seeks to generate an average annualised return of 4 per cent in excess of cash on a rolling five-year basis gross of fees while managing volatility and downside risk. We operate the fund on an unconstrained basis, so we are able to reduce or remove exposure to risky assets when we deem it necessary to protect capital.

Figure 1: The Investment Clock is in Recovery



Note: The position on the Investment Clock diagram is based on a wide range of global growth and inflation indicators. The red dot represents the November 2019 reading; the trail shows readings over the preceding 18 months.

The Investment Clock

In order to reduce downside risk the tactical overlay must be dynamic, not simply adding to market exposure as can often be the case. Our disciplined model-based approach has a good long-term track record and tends to add most value going into and out of recessions when downside risk is at its highest. At its core is an Investment Clock linking returns to the global business cycle *[figure 1]*. Market leadership passes from one asset class to another as the world economy expands and contracts and as inflation trends higher and then lower.

The Investment Clock helps us to take a defensive position when recession risk is rising but leads us to move rapidly back into stock markets as the outlook improves, as we've seen over the past year.

Heading into the fourth quarter of 2018, global growth was slowing but inflation was rising and the Federal Reserve was raising interest rates, a bad combination. Our indicators pointed to stagflation and we sold equities in our multi-asset funds. The subsequent slump into year end allowed us to buy them back again at lower prices before a sharp drop in inflation moved the clock into reflation and central banks began to cut interest rates. Stocks rebounded and, while geopolitical risks remain, our indicators suggest we are now moving into equity-friendly recovery. This may be the longest US economic expansion on record but it looks set to last a few years yet.

Focus on capture not correlation

While MAST is a newcomer to the sector, the model-based process we apply allows us to simulate the core portfolio and tactical positions since 1995 so we have a good idea of how the fund might have coped with historic market conditions. Our analysis suggests MAST would have achieved its return target over most rolling five year windows with maximum peak to trough losses of less than 10 per cent. The more tactical approach MAST takes when volatility is high should have resulted in a gradual rise in price over both the 2001-3 and 2007-9 bear markets.

At first glance, MAST appears to offer a pension fund little diversification as it would have had an average correlation with equities of about 0.7 over the period. However, correlation focuses on short-term fluctuations, which are of little interest to long-term investors like pension funds. The value of our approach becomes obvious if we look separately at calendar quarters in which stocks went up and calendar quarters when they went down *[figure 2]*.

Figure 2: Historical MAST simulation in up and down markets

1995 Q2 to 2019 Q3	Quarters when Stocks Rose	Quarters when Stocks Fell	Average Quarter
% Time	73%	27%	100%
FTSE All World (£)	5.9%	-7.7%	2.1%
RL MAST	3.2%	-0.3%	2.2%
Multi Asset Core	*2.4%*	*-1.2%*	*1.4%*
Tactical Overlay	*0.7%*	*0.9%*	*0.8%*
Correlation with Equities	0.7	0.4	0.7
Equity Return Capture	54%	4%	106%

Source: RLAM. For illustrative purposes only. Data from 1995 Q2 to 2019 Q3 using simulated returns prior to the MAST inception date of November 2018. Net of estimated transaction costs. Simulated data or historical data are not a guide to future performance. Correlation based on quarterly returns versus FTSE All World Total Return Index (£).

Looked at this way, MAST would have returned an average 3.2 per cent during a typical up-quarter for stocks, capturing just over half of the upside with the multi-asset core delivering the majority of the return. However, a combination of diversification, volatility management and a positive tactical asset allocation contribution suggests MAST would have lost just 0.3 per cent in the average down-quarter, capturing only 4 per cent of the drop in stock markets.

This behaviour stands in contrast to higher yielding, exotic or illiquid asset classes that have benefited from the reach for yield in the low interest rate backdrop since the financial crisis. These asset classes may appear to offer a low correlation with equities in normal times but have often encountered large losses and liquidity problems going into a recession.

Pension fund applications

We believe the asymmetric return characteristics and liquidity profile of this kind of diversified growth fund are well-suited to pension fund applications. For defined benefit schemes such a DGF can provide a liquid growth engine that can be scaled up or down without incurring large transaction costs when meeting redemptions or liability-driven cashflow requirements. For defined contribution schemes, a DGF that can limit downside risk could play an important role in decumulation applications where losses early in retirement, compounded by constant withdrawals, can lead to a rapidly shrinking pension pot.

While we expect loose monetary policy to keep the economic expansion going another year or two, geopolitical risk is high and there are plenty of reasons to be nervous. Long-term investors still care about short-term losses. While there is a place for illiquidity premium in a pension fund, 10 years into an economic expansion may not be the best time to give up on diversified growth funds.

RLAM head of multi asset, Trevor Greetham