

# Investment Insights

The future of DGFs – have they done what they said and how will they perform in the future?

Over the past ten years the use of Diversified Growth Funds (DGF) by defined benefit (DB) pension schemes has increased significantly during a period when we have had a huge variation in market conditions; from the crash associated with the global financial crisis to a near six year equity bull market.

Does the rationale for holding DGFs still hold true a decade on and in the face of a changing economic environment?

## Lower returns – what are the options?

Before we go into the details of the DGF market we recall our views from last quarter's note on prospective investment market returns. As we set out, we are worried that returns could be lower in the future, reflecting our concern that Quantitative Easing (QE) has brought forward future returns and has artificially inflated returns over the past five years. How should schemes react to this?

- 1 assess what returns they need to pay benefits; both at an absolute level and relative to their liabilities;
- 2 assess whether their current investment strategy, along with the expected level of market returns, meets those objectives.



### Consideration for trustees

*Now may be a good time for trustees to assess their return targets and whether their investment strategy will achieve their objectives. Key to this will be ensuring a diverse source of potential returns.*

If market returns are insufficient to meet those objectives then there are fundamentally only three options open to investors:

#### 1. Manager skill

Trustees could make more use of active management. Whilst perhaps uncomfortable to many investors we feel this may be an environment where managers can play a greater part in return generation.

#### 2. Illiquidity

Whilst we could consider whether this is an independent risk premium, or an extension of the equity or credit risk premium, the fact remains that investors tend to be rewarded for investing in less liquid investments.

#### 3. Leverage

One option for generating the required returns if market returns are too low is to make use of cheap borrowing that is available and lever up those returns to the desired level.



## Consideration for trustees

*Whilst leverage may sound like a dirty word, anyone engaging in the 'search for yield' is effectively going down this route but the leverage is 'hidden' in choice of investment rather than being explicit. This is a topic in its own right for trustees to consider.*

### Why is the source of returns important?

Well, as we will come on to see when we examine the DGF universe, different managers have different philosophies and therefore aim to access different sources of returns in order to reach their performance targets. It is important for investors to consider the managers' philosophies in the context of their own beliefs on whether there is a sufficient level and diversity of return sources.

### So what are the different types of DGFs?

There is no standard categorisation of DGFs and in many ways each DGF is unique. It is therefore important for each investor to understand the type of approach that is right for their circumstances and beliefs. We believe the key is to differentiate managers by how they aim to generate their returns:

#### 1. Diversified Beta

The simplest, often lowest cost option, where the manager invests across a broad range of asset classes. There tends to be little, if any, active management of the portfolio, and it relies on diversification to reduce volatility. As a result returns will almost entirely be generated through exposure to market returns (the 'Beta' in the title of these funds).

#### 2. Active Asset Allocation

Here the manager expands upon solely relying on market returns and actively allocates between asset classes, with a bias towards growth assets. The manager will aim to add to market returns by successfully allocating towards the better performing asset classes. As a result, returns from this portfolio will be more of a mix between manager skill and market returns.

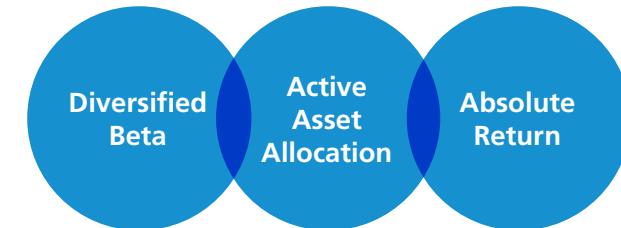
#### 3. Absolute Return

Whilst similar to 'Active Asset Allocation' funds, the crucial difference here is a focus on capital preservation; a desire not to lose money. The manager also is more likely to retreat into 'safe' assets, such as cash and government bonds amongst others, when they feel risk is not rewarded. A greater reliance on the manager's skill is present in this approach.

## Reducing volatility of returns

Market returns

Manager skill



As well as differences in fundamental philosophy and objectives, the implementation of the investment ideas in each category will again vary from manager to manager. Some will make heavy use of derivatives, some will use external as well as in-house funds, some will aim to add significant value through stock selection and some will utilise more esoteric asset classes and sources of return. Therefore, it is important for investors to choose a DGF whose approach is aligned with their own beliefs.

## How has the DGF market developed?

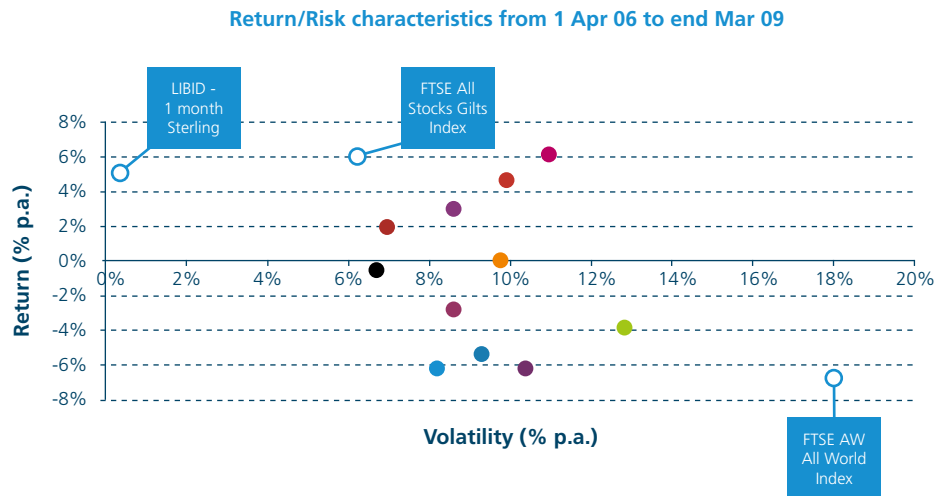
*DGFs have been in existence within the pension scheme market for a little over ten years now; Barnett Waddingham has been using them with our clients for the past ten years. Over that period the number of funds has grown, from less than ten at outset, to around 75 now in our database. Interestingly, of the 40 funds in our database 5 years ago around 20% have liquidated, merged or are no longer being marketed. In total, the DGF market is estimated at around £100bn, with the fastest growth having been experienced over the past 5 years, causing the market to more than double in size over that period.*

## How would we rate DGFs' performance over this period?

Given the market backdrop we consider performance over two distinct periods:

### 1 2006-2009

For those early-launched funds this was a test of their mettle – could they provide returns and downside protection in the face of one of the largest recessions seen since the 1930s? For a number of funds this proved too much, with some falling heavily and some ultimately closing. However, the majority fared reasonably well given the market backdrop and in general whilst they underperformed their targets during late 2007 and 2008 the falls were not significant. The absolute return funds fared best. The chart below illustrates the risk and return characteristics of the main DGFs from April 2006 to March 2009.



Source: FTSE, BBA, investment managers

### Consideration for trustees

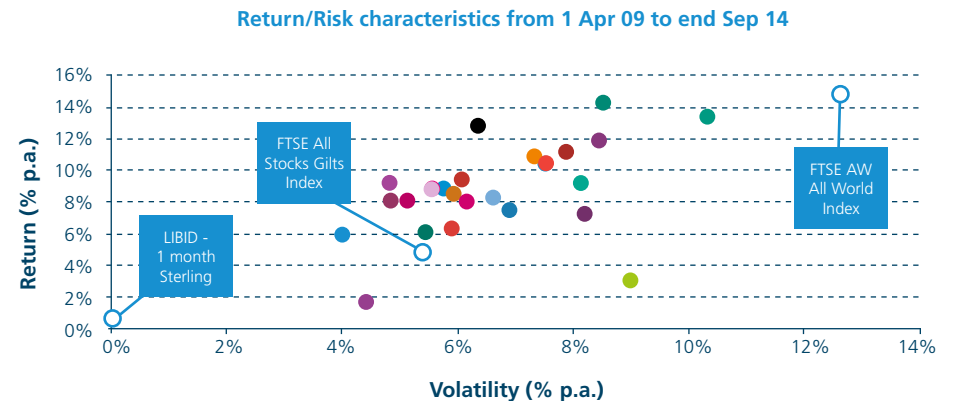
*Managers have focused on hitting their return target at a minimum level of volatility, is this right? Or do schemes really want managers to maximise returns available at a certain level of volatility? The distinction is subtle but important.*

### 2 2009-2014

This was a very different market environment, with equities currently nearly six years into a bull run despite the continued weak economic backdrop. With the benefit of hindsight this period proved an easy time to meet their targets – funds just needed to avoid cash and remain invested. As a result the vast majority met their performance targets, with those funds that focused on market returns tending to perform best.

However, almost all lagged equity returns. This is to be expected and it is 'correct' that at a time when equities soar DGFs are not designed to keep pace. Our criticism on their performance is that history may yet show that DGFs failed to make enough hay during the sunny times of the last five years to protect them during potentially fallow periods over the coming years; we comment why below. We say this with the benefit of hindsight, and with the assumption of perfect vision of the future, which we most certainly do not have. However, if we are right and market returns are lower in the next full ten year cycle some managers may struggle to meet their target returns. The chart below illustrates the risk and return characteristics of the main DGFs from April 2009 to September 2014.

We feel that in the past three to five years managers have shifted a greater focus onto their volatility target and less onto returns (although return targets in general have still been met). This seems in part to have been in response to the actions of investors who have favoured those managers with a greater focus on capital preservation; some of whom were still reeling from heavy equity losses on the back of the global financial crisis.



Source: FTSE, BBA, investment managers

## How have DGFs generated their returns?

In a way, this is another area that provides us with concerns over the future returns of DGFs. Having analysed the returns from a number of DGFs it is clear that a large part of returns in many funds have been generated through equity returns and duration plays, predominantly bets on falling government bond yields.

As referenced earlier the last five years have seen very strong equity returns and has also seen government bond markets returning nearly 10% per annum. On the one hand it is hard to criticise DGFs for taking advantage of this opportunity and making good returns simply by being exposed to traditional areas of investment. And we do not. However, the question remains as to whether this is repeatable going forward; where are DGFs going to get their returns in the future if bond yields do not continue to plummet and the equity bull run ends? They are going to need to change their focus. We have most concern for those managers who focus on traditional market returns, with little flexibility or active management. However, we could consider a slightly different question – in such a scenario how would schemes' investments perform if they invested themselves instead of across DGFs. Trustees would face the same challenges that the DGF manager is facing, arguably without the governance budget to be able to effectively tackle the question and without the range of flexibilities that some of the DGF managers have available.

## What of the illiquidity premium and its role within DGF portfolios?

DGFs do not seek to invest heavily in illiquid assets in order to maintain returns. The main reason is that the investor base is too diverse for this to be appropriate. A daily, weekly, or even monthly dealt fund is not best placed to hold a significant proportion of its assets in illiquid securities that could take a long time to trade. Therefore investors who feel now is an opportune time to access the illiquid part of the market will need to do so outside of their DGF holdings.

Private, less liquid, credit or equity markets offer poor diversification from their publicly listed cousins e.g. credit risk is credit risk. Therefore you should only invest in less liquid markets if you feel you will receive a higher return to compensate for the illiquidity. Pension schemes as investors are ideally placed to take advantage of the illiquidity premium, but to do so they will need to be comfortable with the implications of holding truly illiquid assets in vehicles where access to investments is, in reality, limited to annual or less frequent timings. DGFs are not structured in this way and it is important that trustees are aware of this.



### Consideration for trustees

*Making sure you understand your investments and sources of returns was highlighted as a key issue in our last quarterly note. Whilst DGFs in theory have wide freedoms to invest anywhere, many will restrict their focus on core areas.*

*Trustees should discuss with their managers how they expect to meet their return objectives over the coming years.*

## What are the challenges facing the DGF market?

Aside from the challenges of how to generate future returns are there any other challenges facing the industry?

Commercial interests will always play a role and there are a number of areas here for investors to be wary. A number of funds have closed, taking in no further investments. This is generally to preserve the investment opportunities for the fund and so is to be applauded. However, this creates different incentives for the manager of the closed fund as their focus may become more on not losing clients rather than making the 'best' investment return. Similar issues befell the balanced fund sector in the 1990s. Is this the real reason managers have focused more on volatility over recent times?

Managers are currently grappling with how to tackle the DC market, a growth area for DGFs. Investors should be wary of the DC charge cap watering down investment opportunities for their DB investment where managers offer a single fund for both markets.

Turnover of personnel at managers is inevitable and, following the growth in the DGF industry, seems to have become more commonplace in recent years. Trustees will need to consider how important individuals are in the process and whether a change in personnel is a cause for a change in their investments. This will need to be considered on a case by case basis, but trustees will need to factor this into the governance of their DGF managers.

## So where does this leave our view of DGFs for the future?

DGFs have allowed many schemes to gain access to parts of the market that until now they have not had the governance budget to access. As a result, over the past five to ten years schemes have generally been able to still achieve the returns assumed in the recovery plans for their growth assets at lower levels of volatility.

Despite highlighting some concerns throughout this note, looking forward we continue to believe that DGFs should form a core part of growth portfolios, although we would not suggest holding a single DGF as the sole growth asset. Investors should consider the nature of the particular DGFs held and the role that each is playing in meeting the overall objective for the scheme's funding and investment strategy. Many schemes may choose to use more than one DGF so as to access differing styles. A number of schemes will also include additional types of funds alongside their DGF managers to access return sources missed by the DGFs.

Whilst the DGF characteristics each scheme needs will vary, we feel the following are desirable across the board if a particular fund is going to generate the desired returns in the future:

- **Flexibility** – We feel it will be necessary in the future to be dynamic. This is a characteristic that's not been required over the past 5 years but feel it will be needed over the next 5.
- **Wide opportunity set** – Being able to invest in areas outside of the traditional equity and bond markets may be crucial in being able to deliver required levels of returns.
- **Greater focus on manager skill** – Given our concerns over the level of market returns, and linked with the two points above, we think this will be key.

Trustees should re-assess their overall return requirements, how these are going to be achieved and the role their DGF manager or managers play within the portfolio.

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Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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