PSIT Independent Trustees

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Diversified growth funds: are they really the answer or just the latest fad?

As independent trustees acting for many pension schemes, we are always either evaluating the investment strategy in a new appointment or reviewing investments for an existing scheme. Over the past five years, a common theme has been the **increasing popularity of diversified growth and absolute return funds**.

Today, diversified growth funds (DGFs) are high on the list in a discussion about pension fund investment, and with good reason. Investment best practice has always been to follow a diversified approach – in other words, not putting all your eggs in one basket. However, what led us to diversified growth and have we been here before?

The balanced managed era

Having been involved in pension trusteeship for over 20 years, I have clear memories of the 'balanced fund mandate' that had its height of popularity throughout the nineties. Even today, we sometimes take on new appointments that still have an undisturbed balanced fund strategy. In many ways balanced funds look like the same animal as diversified growth, in that they have a spread of underlying investments. **In their day, balanced funds seemed to work well but, as they were swept along on a tide of good equity performance largely during the nineties, they seem like a fad in retrospect.**

Consultants were regularly recommending balanced funds, but putting forward only a small number of potential investment managers. A feeling of deja vu struck me recently in that exactly the same thing is happening with diversified growth. It made me wonder whether this is just another passing fad or whether diversified growth is built on firmer foundations. **Will whatever 'went wrong' with the balanced fund strategy do so again this time around?**

There are a number of significant differences between balanced and diversified growth mandates, the most notable being the performance objective. **The balanced fund approach was obsessed with beating the benchmark** of the time, the CAPS median. This led to considerable focus on what was, in retrospect, perhaps the wrong target, and often to trustee disappointment. In fear of under-performing the benchmark, investment managers herded and kept investments close to the median asset class weightings with a high exposure to equities. I cannot remember the number of times at a trustee meeting when I saw **an investment manager able to proudly boast that the median had been beaten, despite an inconvenient negative return**.

With the exception of one manager who swam against the tide – and attracted a lot of criticism for it – the final straw for balanced managed funds seemed to be in early 2000 when the TMT bubble burst and was followed by the investment fallout from 9/11. By this time, investment consultants and trustees were looking for something different to the roller coaster it had become.

The time of liability driven investment (LDI)

Along came LDI with a very sensible objective – to **de-risk a defined benefit pension scheme by matching the pension fund's liabilities with appropriate investments** (or to understand what those liabilities are and take an informed decision not to match them with full consideration of the downside).

However, this still didn't get us away from the increasingly inconvenient truth that, over time:

- buying gilts is an expensive game;
- investing in equities results in volatile investment performance; and
- if a bad patch coincides with a pension scheme's actuarial valuation date, the resulting deficit may create a headache.

Let's face the truth. **Most employers and trustees cannot afford to fundamentally match their investment risk with gilts and corporate bonds.** They still need some investment growth to keep funding requirements affordable, to meet rising mortality costs and/or to dig their way out of a scheme deficit. This means LDI is not currently the perfect solution.

Diversified growth funds – the long term answer to a trustee's prayers?

Not all diversified growth funds look the same. A DGF's investment objective is to attain a certain positive level of return, usually above a measure of cash or inflation. This target means the investment manager has the flexibility to create a portfolio genuinely based on his or her own convictions, but still with an eye on risk management. Managers create **a varied portfolio with a low correlation between investment classes**. It is this latter point that could perhaps offer the solid foundation that balanced fund strategies lacked.

Of course, not all diversified growth managers have the same approach, and some notable differences have already appeared. However, the sheer diversity of the underlying investments they can include (infrastructure and private equity, for example) **provides small and medium pension funds with the ability to gain exposure to investments previously only used by the largest schemes**.

Many of the diversified growth funds currently being recommend to trustees have track histories dating back as far as 2007, so they have been road tested through several market shocks. So far there have been no major upsets and performance has been in line with expectation.

Whether diversified growth is just another fad remains to be seen but, for the moment, their popularity appears to be justified. However, I can't help but think the investment experts are busy devising the next best thing.

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What do you think?

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