NATIXIS
GLOBAL ASSET MANAGEMENT

Market Insight

Diversified growth funds:
Keeping an open mind

Dynamic diversified growth funds are designed to seek to respond to rapid shifts in markets and reduce risk

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Key Takeaways:

- Diversified Growth Funds (DGFs) typically allocating to a wide range of asset classes have enjoyed tailwinds since the financial crisis. When these tailwinds turn and become headwinds, diversification is better provided through active investment strategies rather than through passive market exposure
- Combining a dynamic model-based strategic asset allocation with discretionary tactical asset allocation can make a DGF strategy more active. This ability to move in and out of asset classes dynamically is not a feature found in traditional DGFs.
- A highly dynamic strategy requires considerable liquidity. This means a strong focus on liquid, listed instruments such as derivatives, ETFs and sovereign debt.
- For defined benefit pension schemes, a DGF strategy that is fully-diversified and provides inherent risk protection can be used for the growth part of a scheme's strategy. A DGF strategy also works well as a default option in the defined contribution world.

Diversified growth funds have grown from a standing start a decade ago to become one of the most widely-used strategies by institutional and retail investors alike. As a natural successor to balanced funds which employed largely static allocations to mainly equity and bonds, diversified growth funds (DGFs) typically allocate to a wider range of asset classes and respond to many investor needs. These needs include better diversification, reduced exposure to significant drawdowns and consistent returns.

The strength of inflows to DGF strategies suggests investors are satisfied with performance in recent years. But let's not forget that DGFs have enjoyed considerable tailwinds since the financial crisis. First, economic growth has been buoyed by a continuous decline in interest rates, which has acted as a powerful financial lever for households, corporates and governments. Second, after 2008, central banks opened the liquidity flood gates, driving all asset prices higher. Third, emerging markets – and particularly China – initially largely filled the growth gap vacated by developed markets in the aftermath of the financial crisis.

What if tailwinds turn?

The big question is: how will DGFs respond if these tailwinds turn and become longer term headwinds?

While it is hard to envisage a significant increase in rates, it is also difficult to imagine a prolonged fixed income miracle. In addition, there could be a sudden loss of faith in monetary authorities or forced selling triggered by systemically-driven investment strategies. And then there is China: the economic transition of China towards a more sustainable growth model has implications for a broad array of assets.

It will be interesting to see if traditional DGFs, which rely on passive diversification, will be able to hold their own when the headwinds take hold. Although traditional allocations often have strong hypotheses based on historical correlations, this approach lacks adaptability. When headwinds emerge, diversification is better provided through active investment strategies rather than through passive market exposure with its structural biases to particular asset classes and particular investment approaches. Opportunistic and selective diversification can identify and separate potential performance drivers and can unearth new sources of uncorrelated return, such as equity volatility, to further improve diversification.

Getting dynamic

So how can we make the DGF strategy more active, more dynamic? We think the answer is by combining model-based and discretionary analysis and by having a very disciplined approach.

The first building block for this is strategic asset allocation. This should be created using objective, unbiased analysis to identify the fundamental and technical drivers across each market. This analysis defines the optimal strategic allocation to bonds and equities, which is then risk-adjusted with reference to the current level of market volatility. When strategic allocation is identified and applied systemically, it leads to greater performance consistency and intrinsic risk management.

With a model-based approach, the effectiveness of the strategic asset allocation comes from its dynamism, by which exposures can be altered as soon as the strategic drivers change. All asset classes can be taken from zero to their exposure limits and vice versa, depending on the underlying analysis.

Super-charging the strategy

This model-based strategic asset allocation can then be combined with discretionary tactical asset allocation to effectively super-charge the strategy.

The aim of the discretionary tactical allocation is to adjust the portfolio over the short-term to take account of major changes in the economic or market environment. Thus, the strategic allocation does not automatically change when, for instance, the president of the European Central Bank vows to "do whatever it takes" to save the Euro. Equally it would not immediately respond to the US government shutdown (in August 2011), which generated considerable short-term stress in markets. Only a discretionary, tactical approach can change the asset allocation quickly enough to allow the portfolio to benefit from the subsequent market moves.

This ability to move in and out of asset classes dynamically is not a feature found in traditional DGFs. But it can significantly enhance the risk-return profile of the portfolio without significantly distorting the strategic allocation.

Liquidity proves its worth in crises

For a strategy to be highly dynamic requires it to have considerable liquidity. This means a strong focus on liquid, listed instruments such as derivatives, ETFs and sovereign debt. Derivatives, in particular, offer the potential to express views on broad asset classes quickly and cheaply.

Trading in many fixed income instruments, for instance, can be relatively slow, which makes it hard to adjust exposure fast and therefore reduces the flexibility of the strategy. So it is preferable to allocate to broad asset classes – mainly using derivatives - rather than to specific securities.

Like diversification, the worth of holding liquid assets only becomes evident in times of market stress. In the coming months and years, it is likely we will see the re-emergence of illiquidity in some markets. Some traditional DGFs are likely to encounter problems with some of their exposures in this scenario – particularly funds that have corporate credit and emerging market bond holdings.

A strategy that can be used for both DB and DC pension schemes

A diversified, liquid portfolio using both quantitative and discretionary analysis

can respond to a range of investors' needs, including alpha generation, diversification, stable income and capital protection. It can, for instance, provide the core of an investment portfolio, offering steady capital appreciation without strong correlation to traditional asset classes.

It also provides access to non-traditional asset classes, such as currencies and potentially even commodities and other alternatives, through the tactical allocation. For some investors, it is not possible or practical to gain access to satellite asset classes such as these, but the ability to do so increases portfolio diversification.

For investment vehicles with long-term liabilities, the strategy can help to manage inflation and longevity risk. It can allocate to nominal or real interest rates, and change the allocations as the macro environment changes. So, for instance, while initial rises in inflation may be positive for equities, a second phase of inflation may be considerably less positive.

For defined benefit pension schemes, a DGF strategy that is fully-diversified and provides inherent risk protection can be used for the growth part of a scheme's strategy. If the hedging assets hedge the liabilities of the scheme, and the trustees' appetite for risk is reflected in the percentage of the assets that are allocated to DGF, the overall strategy can reflect the needs, objectives and liabilities of a pension scheme.

The strategy also works well as a default option in the defined contribution world. It offers members the potential for a steady flow of capital appreciation and reduced probability of large drawdowns. Avoiding large losses is particularly relevant towards the end of the beneficiary's working life.

The search for true diversification

With 2008 in mind, investors are concerned that their portfolios are truly diversified and can withstand future bouts of market stress. A traditional multi-asset approach which uses passive diversification to manage risk may not prove effective when a crisis hits. A selective and opportunistic approach is more adaptive to different market environments, and more adept at managing beta exposure to enhance returns and reduce the risk of portfolio loss.

Written on 10 November 2015

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Limited liability company – Share capital €50,434,604.76
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