KPMG

Diversified Growth Funds (DGF)

Stick or twist

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Executive summary

Over the past 10 years Diversified Growth Fund (DGF) investing has grown in popularity, however over the last 18 months in particular DGF manager performance has been disappointing.

In the first section of this paper, we find that over the past 10 years DGF managers have largely performed in line with a typical objective of LIBOR plus 3% p.a. but have failed to keep pace with global equities. Over the period during and following the financial crisis in 2008/2009 (Q4 2006 to Q1 2013), we find that DGF managers protected well on the downside, whilst producing better risk adjusted returns. However over the last c.4 years (Q2 2013 to Q4 2016) DGF managers have broadly failed to keep pace with equities, even on a risk-adjusted basis.

We find that the “style” of DGF manager has impacted their performance during the different periods. Absolute Return” DGFs, have demonstrated typically lower equity beta than “Strategic/Dynamic” DGFs, and tended to protect capital more in the downturn but did not capture as much of the upside that followed the financial crisis to now.

Over the last 18 months we find that the “Strategic/Dynamic” DGFs have tended to see their equity component being the key driver of returns, although many managers cited that equities were looking relatively expensive despite their continued strong performance. Absolute Return” DGFs have tended to see currency as their key driver of return, in particular their US dollar trades.

Despite this political events have dominated the markets, in particular over the last 18 months, and this has seen broadly muted performance from DGF managers. Whilst we do have some sympathy with how some DGF managers were positioned in 2016, we believe DGF managers need to deliver strong results in order to restore client confidence that they can deliver on their long term performance objectives.

Introduction

In this paper we review the ten year performance history of a sample of DGF managers and use techniques to analyse their performance and risk versus their objectives.

We also seek to address what has driven shorter term performance and discuss whether DGFs still warrant their place in a client portfolio.

Introduction

DGF is the term commonly referred to for an eclectic mix of multi-asset funds which all have a similar return objective that are cash or inflation plus "3-5% p.a." typically over five to seven years (akin to expected long term global equity returns). They aim to try and achieve this return objective with significantly less volatility than equities.

DGFs in totality have grown in popularity across institutional investors over the past ten years or so and in particular following the financial crisis of 2008 where several funds demonstrated significant downside protection relative to a traditional global equity mandate. In the years that have followed DGF managers had largely delivered on both their return and volatility objectives.

However, over the past 18 months in particular a large number of DGF managers have disappointed with flat or in some cases negative returns. Given the continued bull market across both equities and bonds this has led to questions as to why this has been the case, what have been the key drivers of returns and what is the likelihood of disappointing returns persisting.

Indeed those clients currently invested in DGF funds who have experienced a period of unsatisfactory returns of late may well be going through a period of reflection and determining whether DGF still deserves its place in their portfolio.

What does this paper address

Within this paper we consider DGF returns since the broad establishment of such funds and identify particular periods which demonstrate both their strengths and shortfalls. We also consider whether DGFs have met their performance and volatility objectives and how correlated this has been to the wider market. Finally, we consider in more detail any themes/strategies that have driven both positive and negative performance and whether any lessons can be learnt.

How to categorise DGF managers?

DGFs can be broadly categorised into those managers who have a long term strategic benchmark (passively managed with a static asset allocation) and those that are more dynamic who will use tactical asset allocation in an attempt to add value and manage risk. A sub set of the latter is more "Absolute return" focussed managers who will typically make greater use of alternative strategies (discussed later) and derivatives, using macro themes in their portfolios in order to both preserve capital and generate returns.

It is important to note that DGF is a style of management (not an asset class) and with such a vast range of funds and the heterogeneity of each, effective manager selection will play an important role in the success of such a strategy within client portfolios.

Market backdrop

Whilst there have been various events since 2009 that have resulted in sharp equity market falls, such as the Euro debt crisis of 2011 and more latterly concerns over a slowdown in Chinese growth during the summer of 2015 – global equities have in each period recovered quickly and largely exhibited a consistent bull run over the entire period.

More recently the dramatic depreciation of Sterling in the summer of 2016 following the EU referendum result, significantly boosted overseas equity returns for UK investors.

Monetary policy across central banks globally and the process of quantitative easing (printing money and buying bonds to stimulate growth) has been a key driver underpinning strong bond market returns over the past 18 months in particular. Likewise, such accommodative policies have also helped to support strong equity market returns despite low and relatively fragile economic growth.

Performance and risk analysis

Over the past ten years DGF managers have largely performed in line with a typical objective of LIBOR plus 3% p.a. but have failed to keep pace with global equities.

Dataset

There were a limited number of DGF products in the market during 2006/2007 and so for the first period (Q4 2006 to Q1 2013) we use a sample of nine different DGF managers. By Q2 2013 the number of products available had increased significantly and so for the second period (Q2 2013 to Q4 2016) the sample size increases to 20 different DGF managers. Our analysis over the "whole period" is based on the original nine DGF managers that were sampled.

The "Average DGF" manager performance is calculated by compounding the average manager return each quarter.

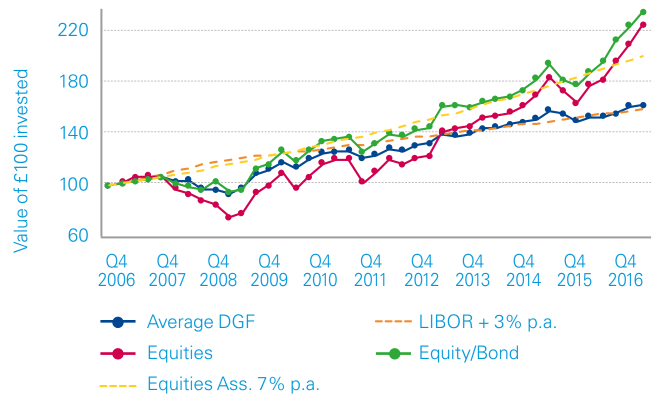
Performance over the ten years ending December 2016

For our analysis we have sampled a wide variety of different DGF managers to construct the "Average DGF". It should be noted that there was a large dispersion of risk and returns across managers which we illustrate later.

In the chart below we compare the Average DGF over the ten year period ending 31 December 2016 to a typical DGF objective of LIBOR plus 3% p.a. (net of fees), a long term equity return assumption of 7% p.a, a global equity index and a 60/40 equity/bond portfolio.

Over the period we can see that the Average DGF has achieved their LIBOR plus 3% p.a. target but has significantly lagged each of the other portfolios.

Performance comparison over 10 years



Source: Data Stream

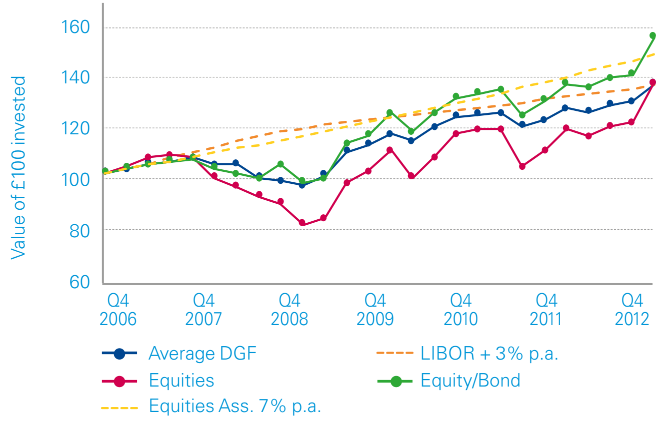
Performance from Q4 2006 to Q1 2013

As part of our analysis we also consider two distinct periods, the first is Q4 2006 to Q1 2013 and the second is Q2 2013 to Q4 2016. The first period begins just before the significant equity market drawdown that was seen during the financial crisis of 2008 and ends in Q4 2012, which broadly marks the quarter where global equity returns surpassed the Average DGF, following their falls during the crisis.

During the first period each of the alternative portfolios experienced losses in 2008. Equities experienced the largest drawdown during the period and as a result it took five years before returns surpassed those of the Average DGF.

By the end of the period equity returns were still behind their long term expected return assumption.

Performance comparison over first period



Source: Data Stream

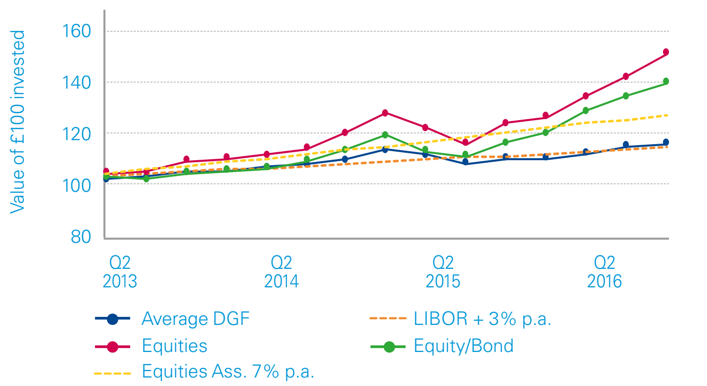
Performance and risk analysis

Over the past few years those managers with a more strategic focus and higher allocations to traditional equities and bonds have largely outperformed absolute return focussed managers who have been more defensively positioned and impacted by central bank policies.

Performance from Q2 2013 to Q4 2016

In the second period both global equities and bonds began to rally strongly and, following a short drawdown in 2015 caused by concerns over slowing Chinese economic growth, experienced exceptional returns by the end of the period.

Performance comparison over second period



Source: Data Stream

How have different styles of management faired lately?

Over the past 18 months or so, those managers who have a more fundamental valuation tilt to their process struggled as many asset classes (equities and bonds included) appeared expensive across common statistical measures.

Along with recessionary murmurs these managers had been more bearish in their outlook with a largely risk off approach and hence struggled to capture the upside from positive returns across markets.

Those managers that performed well over the period had either been better able to exploit the illiquidity premium through their use of alternative assets or likewise had increased exposures to both equities and bonds. In the case of the latter, the ability to protect from sudden market sell offs is somewhat questionable.

Those managers with a more "Absolute return" focus had in many cases been caught off guard by central bank policy over the past 18 months. With evidence of increasing economic growth towards the end of 2015, central banks started to brace the markets for gradual interest rate rises over 2016. However, despite some hiking in the US, the UK cut rates following the EU referendum. With many managers positioning their portfolios for more substantial rate rises over the year this weighed on performance.

Dovish comments from the US Federal Reserve around interest rate rises also led to US dollar weakness and so as a favored currency amongst many of the "Absolute return" focussed managers this also hampered performance.

How can we determine if managers are meeting their expectations?

Having reviewed the Average DGF performance above, we now consider several questions, in particular:

1. What was the dispersion of performance for DGF managers and is there a connection between performance and equity beta (a measure of volatility relative to equities)?
2. How have DGF managers performed on a risk-adjusted basis compared to equities and an equity/bond portfolio?
3. How much of the equity upside and downside has the average DGF manager captured?

Performance and risk analysis

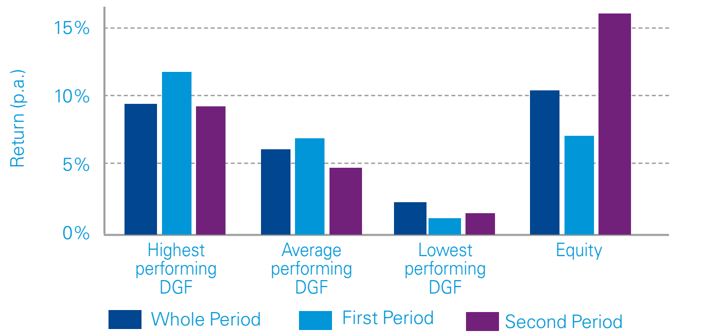
Over the past ten years Average DGF manager performance has been c.5% p.a. but there has been significant dispersion across managers.

There is a significant correlation between DGF manager performance and their equity beta in both the first and second periods.

1. What was the dispersion of performance for DGF managers and is there a connection between performance and equity beta?

In the chart below we can see that there is a significant difference between the highest performing DGF managers and the lowest performing DGF managers during the different periods (c.6% p.a difference). The highest performing DGF managers have delivered returns in excess of long term equity return assumptions of 7 to 8% p.a. in all periods. However, there is a significant dispersion of returns with the lowest performing DGF managers returning c.2% p.a. over the entire period. Overall, what we can see is that the Average DGF manager performance has been relatively stable at c.5% p.a.

Dispersion of DGF performance



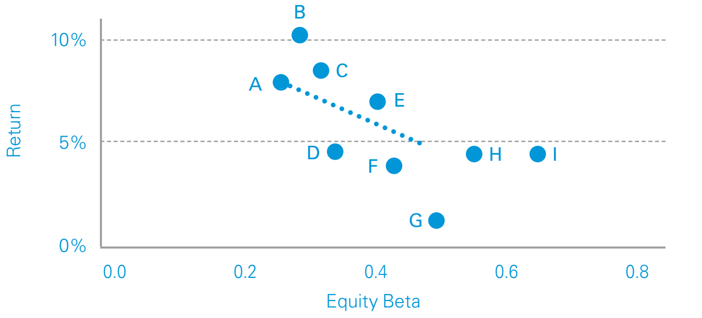
Source: Data Stream

Now looking deeper, we can see whether there is a connection between performance during the different periods and equity beta.

If we look at the first period (2006 to 2012) which encompassed the financial crisis in the chart, on the top right side of this page, we can see that the best performing DGF managers had a relatively low equity beta.

By contrast the lowest performing DGF managers had much higher equity beta.

First period: DGF performance versus equity beta

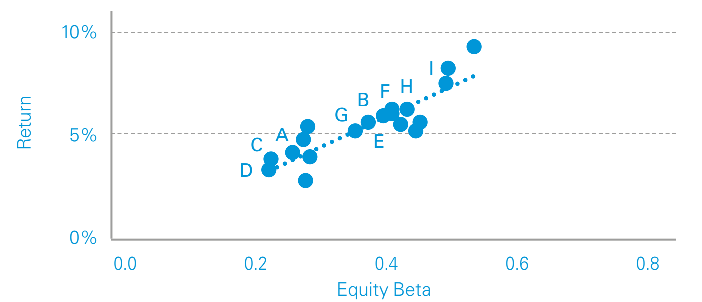


Source: Data Stream

In contrast to the first period, when we consider the chart below illustrating the second period (2013 to 2016) we can see that the converse was true, with the best performing DGF managers having high equity betas. This was during a period when equity markets rallied significantly. We have identified each manager in order that both charts can be compared

However, it is not obvious why the low equity beta managers (typically represented by the "Absolute return" managers) have necessarily exhibited lower performance, and consequently failed to achieve their target. We discuss this on page 7.

Second period: DGF performance versus equity beta



Source: Data Stream

Performance and risk analysis

On a risk-adjusted returns basis the Average DGF manager has outperformed equities over the first period, performed in line with equities over the whole period but underperformed equities over the second period.

2. How have DGF managers performed on a risk-adjusted basis compared to equities and an equity/bond portfolio?

In the chart to the right we consider the risk adjusted returns of the DGF managers i.e. what returns have they achieved relative to the risk they have taken during each respective period.

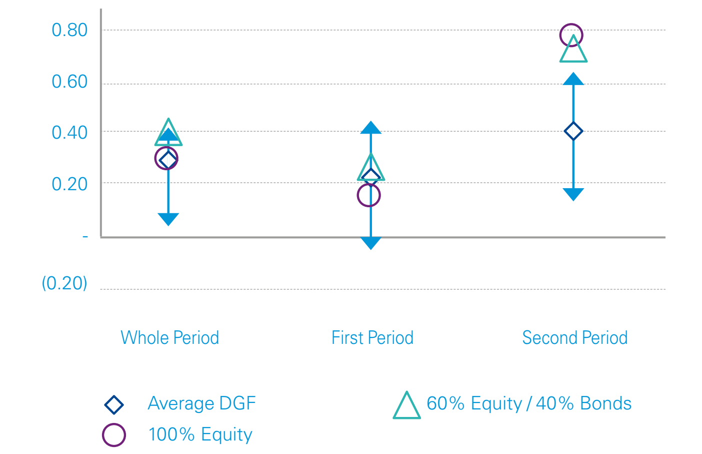
Over the whole period the Average DGF had risk-adjusted returns similar to that of equities and lower risk-adjusted returns than the equity bond portfolio.

During the first period the Average DGF had better risk-adjusted returns than equities and was similar to the equity bond portfolio.

In the second period the Average DGF had much lower risk-adjusted returns than equities and the equity bond portfolio.

Whilst the DGF managers delivered lower risk adjusted returns than equities during the second period, equity returns of 16.3% p.a. were particularly exceptional and has somewhat skewed the results.

Risk-adjusted returns over the different periods



Source: Data Stream

Performance and risk analysis

DGF managers with a high equity beta have typically experienced more of the downside in a falling equity market than they have captured on the upside when equity markets have rallied.

DGF managers with a low equity beta did much better at protecting the downside during the first period. In the second period this position reversed with lower upside capture and experiencing more of the downside.

3. How much of the equity upside and downside has the Average DGF manager captured?

Equity upside capture asks the question, when the equity market has a positive quarter, how much of that upside does the Average DGF capture. Likewise, equity downside capture asks, when the equity market has a negative quarter, how much of that downside does the average DGF capture.

In order to undertake this analysis we have split our DGF sample between those with high equity beta (> 0.5) and those with low equity beta (< 0.5).

From the chart to the right, looking across all periods, we can see that the high equity beta DGF managers captured more equity upside (c.38%) than the low equity beta managers (c.23%) but also captured significantly more downside (c.73% vs c.23%).

During the second period both high and low equity beta managers experienced more of the downside than they captured on the upside.

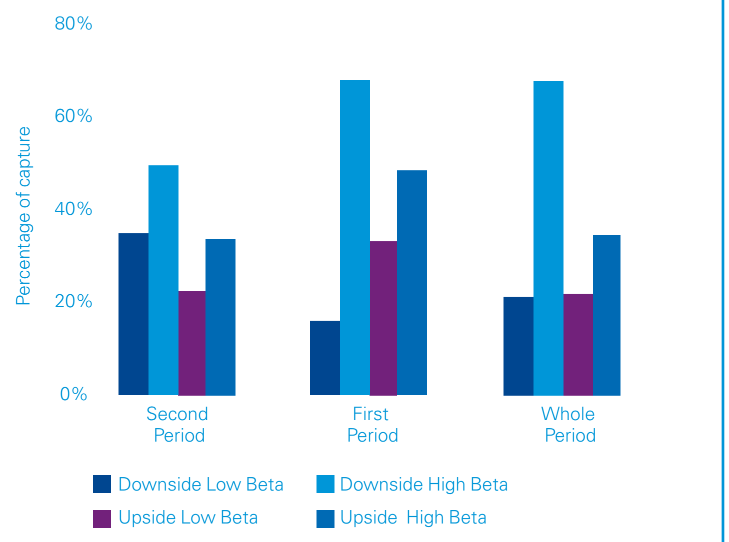
The chart to the right illustrates the much better level of protection achieved by the low equity beta DGF managers during the first period (which encompasses the financial crisis), albeit then struggling to capture as much of the upside during the second period.

Overall, the analysis highlights the large dispersion between the different types of managers, based on their equity beta, and the effect that this can have during different economic environments.

One point to note regarding the second period is that there were only two quarters where equity markets had negative performance and hence why the effect of DGF downside protection appears lower than both the whole period and first period, which had 11 and 9 quarters of negative equity market performance respectively.

On the next page we consider the underlying strategies that have contributed towards the DGF manager performance.

Equity upside and downside capture



Source: Data Stream

Strategies and themes

"Strategic/Dynamic" DGF managers primary contributor to performance over the past 5 years has been their equity allocations.

How have underlying strategies performed?

Over the next two pages, we illustrate the drivers of performance for both 'Strategic/Dynamic' and 'Absolute return' funds over the last five years, across the different underlying asset classes.

Within the charts we illustrate the best and worst contributors to performance as well as the positive and negative contributions.

Looking through at the underlying asset class level, a significant proportion of strategies have contributed positively each year.

Strategic/Dynamic funds

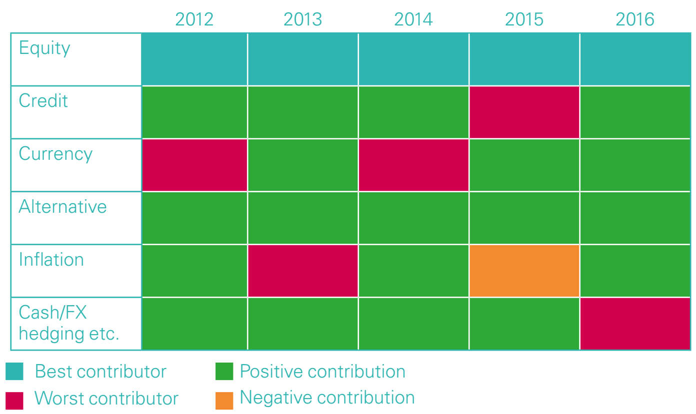
The 'Strategic/Dynamic' funds have to a large extent relied on equity market performance as a significant contributor to their overall returns.

Given equity markets have performed extremely well over the last five years (16.3% p.a. for the MSCI World in Sterling to the end of December 2016), it is not surprising that 'Strategic/Dynamic' funds will have sourced a significant proportion of their returns from this rally, which has been the case.

It is interesting though, that many managers over the past 18 months/ two years have been positioned defensively. A large proportion of these managers over this period have felt that equity market valuations looked stretched and expensive, particularly in the US. As a result most 'Strategic/Dynamic' funds have either avoided markets that have continued to rally strongly, such as the US, or had limited exposure. Equity allocations have typically been expressed using sector or thematic views e.g. US Mid-cap or US Financials.

As a result of the lower equity allocations the performance from 'Strategic/Dynamic' funds equity allocations have been muted in comparison to the wider market. Therefore comparison against a simple passive DGF (e.g. typically higher equity and bond allocations) can be especially stark. However, we would envisage that should the market performance of equities reverse, it would be expected that 'Strategic/Dynamic' funds would provide more downside protection than a simple passive DGF, given their slightly bearish stance, and ability to dynamically allocate between the underlying asset classes.

"Strategic/Dynamic" DGF manager performance across asset classes



Source: Investment Managers

Strategies and themes

For "Absolute Return" DGF managers the primary contributor to performance over the past 5 years has been their Currency allocations.

Absolute return funds

'Absolute return' funds' performance has been much less reliant on equity markets over the same period. Currency positions have been a strong contributor, particularly in the last few years (where it has been the largest contributor to returns). As central bank monetary policy has diverged, 'Absolute return' funds have used relative value trades (i.e. expressing a view between the relative valuations of two currencies) to add value. A common portfolio theme for currency used by managers has been Long USD vs EUR, which has performed well over the last few years.

However, it is clear that the last two years have proved to be testing market conditions for such funds. A common theme for the disappointing performance for such strategies seems to centre on being on the wrong side of central bank action. One clear example here is the US Federal Reserve's anticipated interest rate hikes for 2016 which did not occur as the market had expected during the year. In particular some "Absolute return" funds suffered as multiple positions (across a number of asset classes) performed poorly when anticipated interest rate rises did not materialise.

A second challenge has been positioning for political events that had quite significant macro-economic implications, such as the EU referendum and US presidential election. Both events had unanticipated results, that translated into uncharacteristic market movements relative to the general expectations. An example here is the US stock market, which was expected to suffer a significant drawdown on the back of a Trump victory, however the reaction was a significant rally in US stocks to year end.

Absolute return DGF manager performance across asset classes

	2012	2013	2014	2015	2016
Equity	Positive contribution	Best contributor	Positive contribution	Positive contribution	Positive contribution
Credit	Best contributor	Positive contribution	Positive contribution	Positive contribution	Positive contribution
Currency	Worst contributor	Positive contribution	Best contributor	Best contributor	Best contributor
Alternative	Positive contribution	Positive contribution	Positive contribution	Positive contribution	Worst contributor
Inflation	Positive contribution	Worst contributor	Worst contributor	Worst contributor	Positive contribution
Cash/FX hedging etc.	Negative contribution	Positive contribution	Negative contribution	Positive contribution	Negative contribution

Best contributor / Positive contribution / Worst contributor / Negative contribution

Source: Investment Managers

Alternatives to DGF

For clients who can afford to take a degree of illiquidity then a Private Market Fund combined with an allocation to passive global equities could be a viable alternative to DGF, however the number of funds available is extremely limited.

What are the alternatives to DGF?

When we consider alternatives to DGFs the key considerations will largely come down to governance and liquidity. From an operational perspective DGFs are relatively simplistic with pooled fund structures and often have daily if not weekly dealing.

For clients who can afford to take a greater degree of illiquidity then an allocation to Private Market Funds alongside an equity only mandate (in order to provide a similar risk/return blend) might be one consideration. Private Market Funds invest in non-publically traded assets which typically cover themes across debt, real estate and infrastructure and have traditionally exhibited lower correlation to publically traded assets. Such an investment could for instance sit alongside a cost effective passively managed equity mandate which will provide the market beta exposure.

The challenges with such an investment are that you do not get exposure to such a wide array of asset classes and ideas that DGF managers can invest in. There are also a limited number of managers operating in Private Markets, overall risk and return could vary quite differently (e.g. possibility of alternative assets selling off at the same time as equities) and it requires a greater degree of governance. For clients that are happy to accept the challenges but have become frustrated with their DGF manager(s) then this could be a viable consideration.

Over the past few years the multi-asset universe has seen a proliferation of new ideas come to fruition such as 'Smart Beta' which seeks to combine different risk premia e.g. momentum and value attributes within a cost effective index-tracking portfolio. Our principle concerns with such strategies is that there is increased emphasis on more quantitative based processes and ultimately less human input – hence the ability for performance to disappoint could be even greater!

Summary

DGF managers will in the most part need to deliver strong results in order to restore client confidence that they can deliver on their performance objectives.

Given strong returns from both equities and bonds over the past few years, any increase in volatility or a significant draw down could present opportunities for DGF managers.

Summary and KPMG Investment Advisory View

As 2016 ended and the New Year was ushered in, markets appeared to be in confident mood that signs of economic growth will continue and investor confidence was buoyant. However, with aggressive spending plans in the US and inflation globally ticking up, significant economic growth will need to materialise in order to justify current valuations and avoid a reversal in investor sentiment.

With key European elections, continued monetary tightening and potentially tough Brexit negotiations in 2017, there are a lot of factors that could create market volatility and instability this year.

From our analysis we have seen that those managers who have had muted or negative performance over the shorter term, in particular "Absolute return" managers, have historically demonstrated the greatest ability to protect capital in market downturns and hence reduce losses – starting from a higher base when markets begin to recover.

Whilst we do have some sympathy with how some DGF managers were positioned in 2016 relative to market valuations and fundamentals, it does not take away from the fact that DGF managers will in the most part need to deliver strong results in order to restore client confidence that they can deliver on their long term performance objectives.

Following strong returns from equities and near record low bond yields it would be hard to envisage a reoccurrence of the past 5 years performance over the next 5 years. With this in mind DGF managers may experience a market environment which will better suit their skillsets – helping to seek out opportunities and utilising their alternative strategies in order to generate returns.

We continue to review the DGF market in order to identify those managers that we believe will deliver on their risk and return objectives over the longer term.

Ultimately the confidence in a DGF manager to deliver on their performance objective going forward will be very client specific based on their own experience and views. However, we would stress that an assessment of any alternative approaches should be well thought through if a decision is taken to review an existing DGF mandate. We would be happy to assist in this matter.

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