PiRho
INVESTMENT CONSULTING

Which Diversified Growth Funds navigated the 2017 hurdle race?

Highlights

- In another strong year for equities, the average Diversified Growth Fund (DGF) returned 6.2% in 2017, capturing less than 50% of equity return.
- Unsurprisingly, given the strength of equity markets, PiRho's 'Capital Preservation' and 'Hedge Fund Lite' categories dominate the bottom half of the 2017 performance table, since these funds - for very different reasons – tend to avoid high exposure to equities.
- Over the five years to December 2017, the divergence between different types of DGF is more muted: most DGFs have achieved returns better than Cash +5% p.a., a typical DGF target, though average 'equity capture' has been below 50%.
- However, DGF fund managers have done a good job of managing risk; all but one DGF in the PiRho universe delivered less than two thirds of equity volatility over the last five years.

Performance in 2017

During 2017, economic growth was present almost everywhere. The Fed raised its federal funds rate three times as the US economy showed signs of strength and OPEC agreed to extend oil output cuts until December 2018, potentially putting further upward pressure on inflation. Nonetheless, geopolitical tensions between the US and North Korea were a cause of concern across the markets, causing volatility (measured by the VIX Index) to spike nearly 50% on one day in August; however, the VIX ended the year at historic lows, suggesting a degree of confidence (complacency?) by investors. For a sterling investor, global equities returned an exceptional 20.3% (hedged) and 13.8% (unhedged), the sixth year of positive returns in a row. Government bonds, however, had a relatively poor year; yields rose at the short end of the curve with the first rise in Bank of England interest rates for a decade, from 0.25% to 0.5%. At longer maturities, UK Gilt yields were little changed, with the yield on 10 year Gilts ending the year at almost unchanged at 1.23% and on 20 year Gilts at 1.74%.

The average DGF in the PiRho 'core' universe returned 6.2%[1]. As in 2016, dispersion between funds was again relatively large, with a gap of over 13 percentage points between the best and worst performer (-2.0% to +11.4%), though this was lower than the 19 percentage point range seen in 2016. The PiRho universe currently includes 22 DGFs; more than two thirds (15 funds) exceeded their own performance targets. Those that did not do so fell into two different categories: one group that has made extensive use of defensive and protective strategies ('Capital Preservation' funds) and many of the funds which seek to generate return irrespective of the direction of markets through derivative based strategies ('Hedge Fund Lite' funds).

[1] All DGF performance quoted are net of stated institutional fees

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Fig 1 DGF and Market Performance

2017	5-years to Dec 2017
20.3%	13.3% p.a.
13.1%	10.3% p.a.
11.4%	9.1% p.a.
9.8%	7.9% p.a.
9.6%	6.7% p.a.
9.6%	6.3% p.a.
9.5%	6.3% p.a.
9.0%	6.2% p.a.
8.6%	6.2% p.a.
8.1%	6.1% p.a.
7.9%	5.7% p.a.
7.8%	5.6% p.a.
7.3%	5.6% p.a.
7.2%	5.3% p.a.
7.0%	5.2% p.a.
6.7%	5.1% p.a.
6.3%	5.0% p.a.
4.4%	4.3% p.a.
4.3%	4.1% p.a.
2.5%	3.8% p.a.
2.4%	3.3% p.a.
1.3%	3.0% p.a.
1.2%	
1.2%	
-2.0%	

Capital Preservation | Sharpe | Growth | Hedge Fund Lite | Global Equities (£ Hedged) | UK Equities | UK Corporate Bonds

Source: PiRho, Thomson Reuters Datastream

Fig 1 on the left shows returns for both DGF and mainstream asset classes in 2017 (far left column) and over the last five years (right hand column), sorted from best to worst.

Many 'Capital Preservation' funds (shown in yellow in Fig 1) invested in hedging strategies (either via physical assets or by using derivatives), which failed to pay off in 2017 and only one delivered returns above the UK CPI (3% in 2017).

Funds in the 'Hedge Fund Lite' category (shown in green) generally make a virtue out of diversifying away from equity exposure, and instead rely on absolute return and long/short 'relative value' trades. In an environment of almost relentlessly rising equities and low volatility, many of these funds struggled to perform and one even lost money. However, as we expect from this category, which depends significantly on manager skill and judgement, the dispersion of returns was high (a gap of nearly 12% between best and worst).

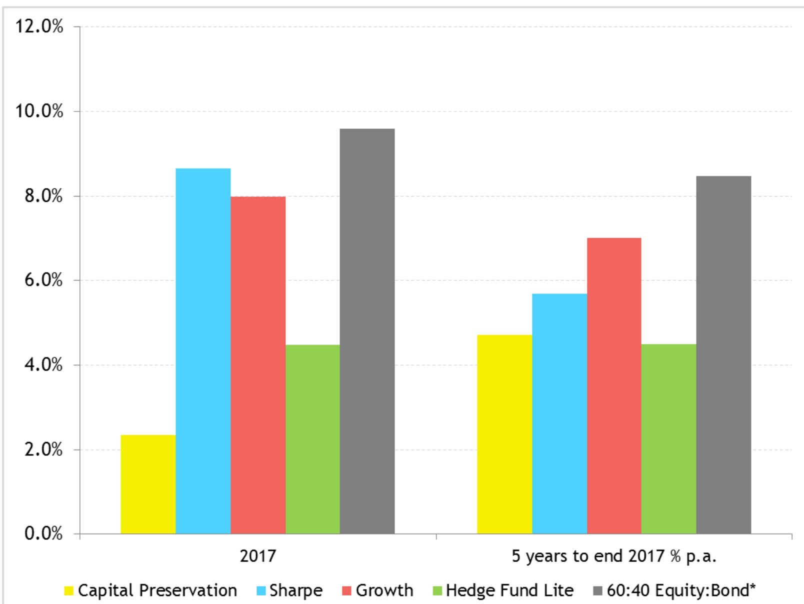
By contrast, DGFs that have a predisposition to high equity weightings ('Growth' funds) as well as those which focus particularly on the risk return trade-off ('Sharpe' funds), have outperformed their stated return targets comfortably over the last few years. *All* of these funds outperformed the average return in 2017.

The picture is not dissimilar over the most recent five years. The average DGF returned 5.5% p.a., while 13 of the 19 DGFs with a full five year record delivered an annualised return equal to or better than Cash +5% (close to the long term equity risk premium). 'Growth' funds dominate the top of the table between 2013-2017, benefiting from the strong performance of equities and other growth assets.

In terms of risk management, over the period 2013-2017 the median DGF displayed less than half the volatility of UK Equities, although the Sharpe Ratio (which measures risk adjusted return) was only slightly better than that of equities, reflecting the low volatility environment. Put another way, investors have struggled to find sufficient reward for minimising risk in this period of high equity returns and declining volatility.

The bar chart in Fig 2 below compares DGF performance by PiRho category over one and five years. In both periods 'Growth' and 'Sharpe' funds have been the top two performers, while the extent of the poor performance of 'Capital Preservation' in 2017 is evident, adversely affecting this category over the longer period. However, it is also notable that the average fund (both for the universe and within each category) has failed to outperform a simple 60:40 allocation, though the 'Growth' category did manage to deliver better risk-adjusted returns over the five years.

Fig 2 Growth funds lead DGF performance over the period 2013-2017



*Equity:Bond Portfolio (60% FTSE All-Share Index : 40% iBoxx Non-Gilts All Maturities Index)
Source: PiRho, Thomson Reuters Datastream

For many investors the 'Capital Preservation' and most of the 'Hedge Fund Lite' funds therefore have a lot to prove in the next market downturn in terms of catching up lost performance. Though, we would also caution new investors not to select 'Growth' and 'Sharpe' funds without understanding the reasons for their past outperformance.

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