Diversified Growth Funds – Adding value during turbulence?

	2018	5 yrs to end 2018
Global Equities (hedged to £)	-7.4%	6.5% p.a.
FTSA - All Share	-9.5%	4.1% p.a.
Corporate Bonds	-1.5%	5.1% p.a.
Cash + 3.5% (Typical DGF Target)	+ 4.1%	4.0% p.a.
Average* Diversified Growth Fund (DGF)	-4.9%	3.0% p.a.
Range - Best DGF vs Worst DGF*	*10.1%*	*5.5% p.a.*

* PiRho's 'core' DGF universe performance is net of fees (institutional share class)

Source: PiRho, Thomson Reuters Datastream

After a very poor final three months (down 12%), global equities rounded off the year with the worst annual return since the global financial crisis in 2008. There were few, if any, hiding places in 2018 as all major equity regions and asset classes lost value over the year. Against this backdrop, DGFs also struggled to achieve their investment objectives of giving positive returns. The average DGF in the PiRho 'core' universe returned -4.9% in the twelve month period, but as has been the case in recent years there was a large range of returns from the best to the worst performer.

The following examines the 22 DGFs in the current PiRho universe in more detail. We have for many years, classified DGFs into four categories based on a qualitative assessment of the various approaches to risk management. The categorisation is *not* a simple 'cautious/ balanced/ growth' approach, placing funds from low to high risk. Rather, our classification considers how the managers attempt to target positive returns using the very wide asset allocation parameters to which they work within. A full explanation of our categorisations can be found on our website, but at a high level:

'Hedge Fund Lite' Funds Control risk by reducing market exposure via derivatives and focus more on manager skill as a source of returns

'Capital Preservation' Funds Believe that the best way to make money is not to lose it in the first place, and will potentially hold large amounts of cash

'Sharpe' Funds Carefully calibrate the various positions in their portfolios to maximise the overall return for a given quantum of risk.

'Growth' Funds Typically rely on holding a wide range of growth assets (equities, high yield bonds, etc) to add diversification to the portfolio and hence lower risk

The chart overleaf shows the range of returns (grey bar) of PiRho's core DGF universe for each calendar year since 2013, as well the average return of funds in each of the four PiRho DGF categories.

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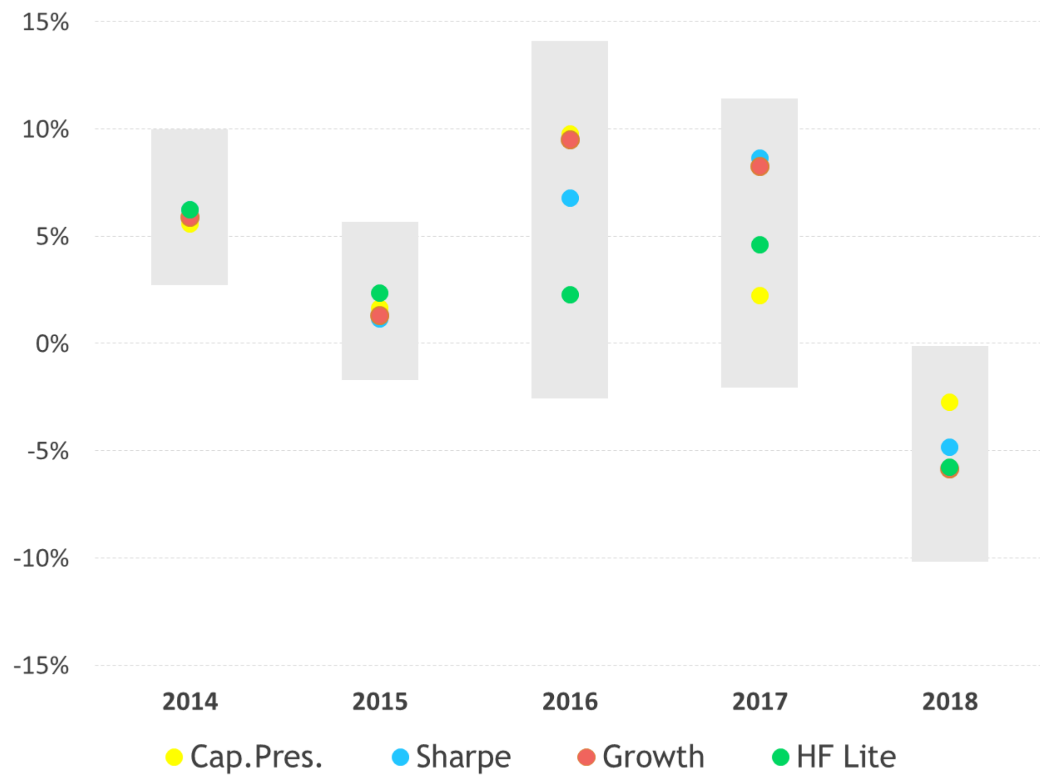

Source: PiRho, Thomson Reuters Datastream

Observations

- Generally, funds in the ‘Hedge Fund Lite’ category (green dot) disappointed in 2018. These funds typically have low equity betas and rely materially on long/short ‘relative value’ strategies, so might have outperformed in a tough year like 2018. This was not the case, albeit the dispersion of returns within this category is generally the widest – so manager selection is especially important.

- Unsurprisingly, ‘Capital Preservation’ funds, which on average disappointed in 2017, were the best performers in 2018. However, a capital preservation mind-set is not a guarantee of relative out-performance in tough times. Managers still have to decide on the most appropriate method of protecting portfolios and 2018 showed that it was entirely possible to lose money in the “wrong type” of crisis.

- Over 2018 and longer term periods, ‘Sharpe’ and ‘Growth’ funds have had on average similar returns. However on a risk adjusted basis (looking at annualised returns relative to annualised volatility) the ‘Sharpe’ funds have delivered their returns in a far more stable manner than the average ‘Growth’ fund.

- Over the past five years, DGFs have on average given relatively lacklustre returns compared to mainstream asset classes but have been far better at controlling volatility. 2018 saw some relative catch-up. However, our main conclusion is that investors need to understand the manager’s individual approach to controlling risk before investing.

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January 2019

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