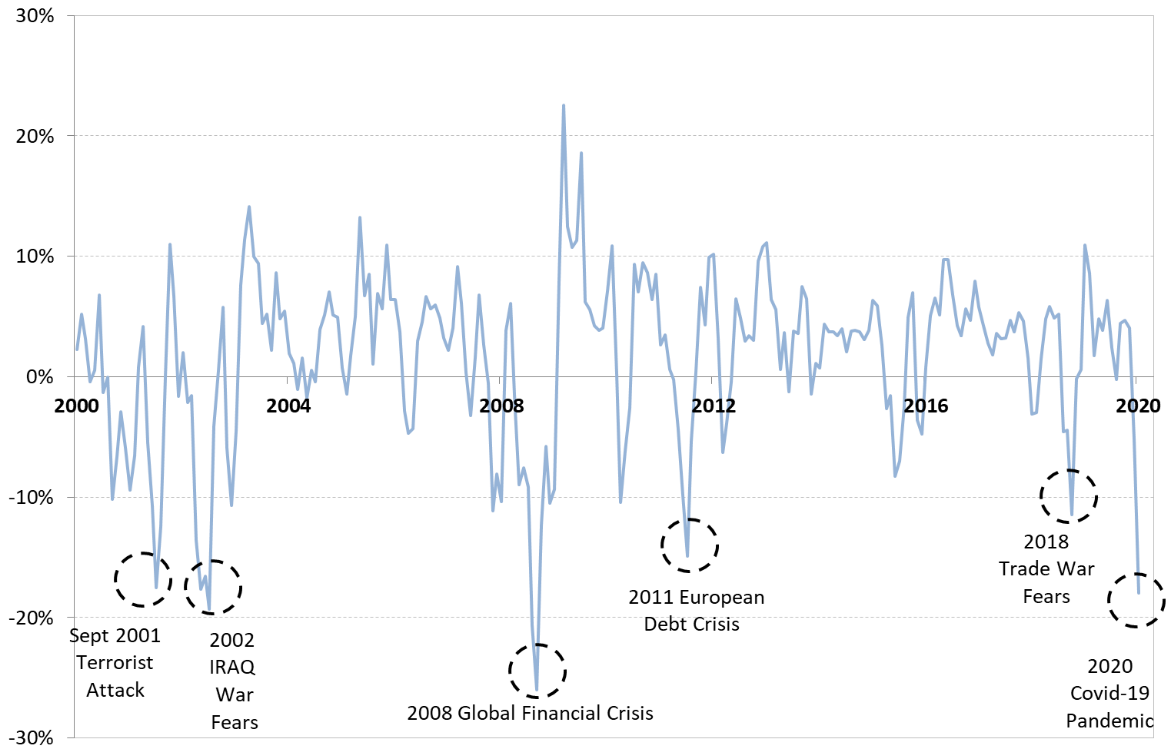
April 2020

Diversified Growth Funds – Surviving Coronavirus?

Introduction

Over the 3 month period to end March 2020, global equities have lost nearly 20% of their value. The chart below looks at rolling three month periods since 1999 to put that loss into a historical perspective. Apart from the 2008 Global Financial Crisis, the 2020 fall is as bad as any over the twenty year period and at the time of writing the outlook continues to be for a long and uncertain period of economic upheaval.

Fig 1a – Rolling 3 month returns of global equities* since 1999



Source: Refinitiv, PiRho

* Index – 50% Currency hedged FTSE All World (Total Return) rolling 3 month returns based on end calendar month data

One could argue that the popularity of Diversified Growth Funds (DGFs) was a result of their performance during 2008. A number of these multi-asset class, dynamically-managed funds dramatically outperformed a traditional ‘60:40’ Equity bond balanced fund during this market crisis.

Since then, the number of DGFs has grown substantially, although the popularity of individual funds have waxed and waned, typically on the back of relative performance. Whilst over the past decade, DGFs often failed to match the returns of simple fixed benchmark funds, this note examines the more recent performance of DGFs.

How PiRho defines the DGF universe

There is no single agreed definition of what constitutes a DGF. We define a DGF as an open-ended fund with the following characteristics:

- Absolute return objective. The fund has to have an objective of positive returns (Libor plus, Inflation plus, etc) rather than an asset based benchmark.
- Exposed to more than a small set of asset classes. Otherwise it is not diversified!
- Flexibility. If it is not tied to a fixed asset based benchmark, then there should be the capacity to dramatically alter asset class weightings.
- Not a hedge fund. All the above could describe the typical hedge fund. Whilst we include funds in our DGF universe which use certain hedge fund strategies (such as relative value trades), we exclude funds that use excessive leverage combined with performance fees.

There are more than 50 sterling denominated funds that could be classified as DGFs but the following analysis covers 16 large institutional funds (which each have assets under management above £1bn and a multi-year track record) that make up part of our core research universe.

Official fund objectives for DGFs: how significant are they?

It would seem reasonable to expect that those DGFs that have higher return objectives would consistently take on more risk and hence do relatively well in the good times and suffer more when markets fall. However, it can be difficult even to determine return objectives, as DGFs variously reference return targets over cash, inflation (either RPI or CPI), or do not state any specific return target at all. In addition, some stated targets are gross of fees and others net.

To allow a comparison we make the following assumptions (see table below) and then, based on each DGF's official objective, calculate the gross nominal return objective for the fund.

Fig 1b- PiRho Return Assumptions

Benchmark	PiRho Benchmark Return Assumption	Example Target Return Objective	PiRho Assumed Gross Nominal Return Objective
Cash	1% p.a.	'Cash + 3.5% p.a.' gross return	**4.5% p.a.**
CPI	2% p.a.	'CPI + 3% p.a.' gross return	**5.0% p.a.**
RPI	3% p.a.	'RPI + 2% p.a.' net return (fees are 0.5%)	**5.5% p.a.**
Unstated			**4.0% p.a.**

Fig 2a overleaf ranks the selected DGFs in the PiRho universe from the highest nominal return objective to the lowest. For example, based on our return assumptions, the Schroder Diversified Growth Fund targets a nominal return before fees of 7.8% p.a. (i.e. CPI + 5% net return).

Those funds that do not state an official return objective often give looser descriptions of their targets. For example one fund states "*The fund seeks to provide a stable stream of real total returns over the long-term with low absolute volatility and significant downside protection.*" Typically these funds have defensive characteristics and we have assume that a nominal return objective of 4.0% p.a. (i.e. RPI + 1% p.a. gross of fee).

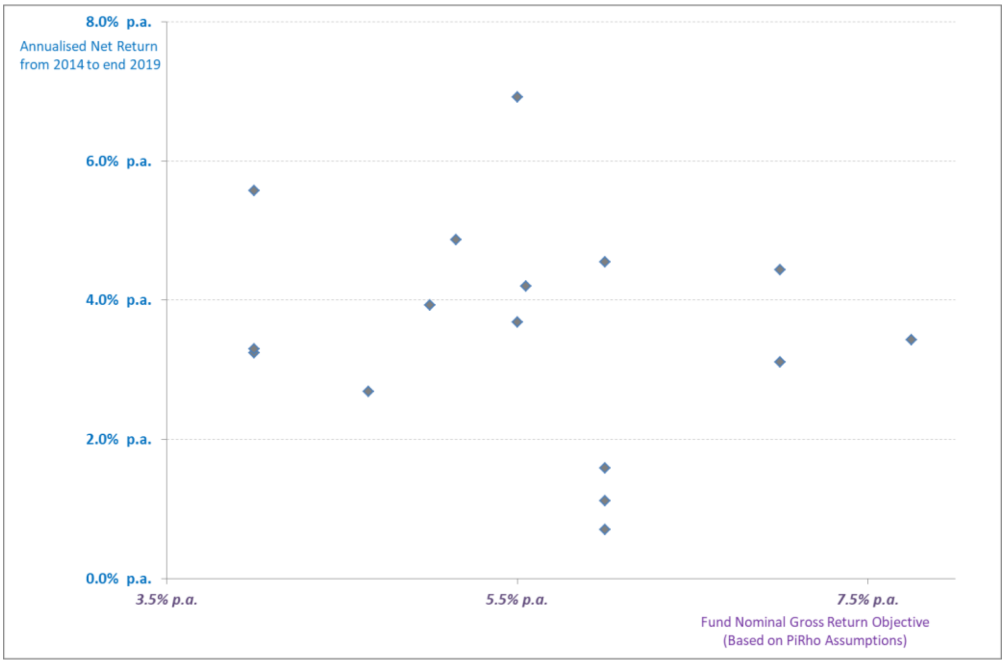
Fig 2b compares the actual return of DGFs over a 5 year period to end 2019 with their actual or assumed return objectives. ***Our conclusion is that there is little to no correlation between a fund's official objective and the fund's actual return***.

Fig 2a - DGF Return Objectives (funds ordered from highest to lowest return objective)

Fund Name	Target	PiRho Assumed Return Objective (Gross of fees)
Schroder Life Diversified Growth Fund	UK CPI + 5% p.a. (Net of fees)	7.8% p.a.
Russell Multi-Asset Growth Strategy Fund	UK RPI + 4% p.a. (Gross of fees)	7.0% p.a.
Investec Diversified Growth Fund	UK CPI + 5% p.a. (Gross of fees)	7.0% p.a.
Invesco Global Targeted Fund	3M LIBOR + 5% p.a. (Gross of fees)	6.0% p.a.
Standard Life GARS Fund	6M LIBOR + 5% p.a. (Gross of fees)	6.0% p.a.
Aviva Investors Multi-Strategy Target Return	BoE Base Rate + 5% p.a. (Gross of fees)	6.0% p.a.
Threadneedle Dynamic Real Return Fund	UK CPI + 4% (Gross of fees)	6.0% p.a.
Barings Dynamic Asset Allocation Fund	3M LIBOR + 4% p.a. (Net of fees)	5.6% p.a.
LGIM Dynamic Diversified Fund	BoE Base Rate + 4.5% p.a. (Gross of fees)	5.5% p.a.
Insight Broad Opportunities Fund	3M LIBID + 4.5% p.a. (Gross of fees)	5.5% p.a.
Diversified Growth Fund	BoE Base Rate + 3.5% p.a. (Net of fees)	5.2% p.a.
Newton Real Return	1M LIBOR + 4% p.a. (Gross of fees)	5.0% p.a.
BlackRock Dynamic Diversified Growth Fund	3M LIBOR + 3% p.a. (Net of fees)	4.7% p.a.
Pyrford Global Total Return (Sterling) Fund	UK Inflation	4.0% p.a.
CF Ruffer Absolute Return Fund	Deliver returns over cash	4.0% p.a.
Trojan Fund	UK RPI (Net of fees)	4.0% p.a.

Note: 'PiRho Assumed Return Objective (gross of fees)' has been estimated based on institutional share class fees for funds with 'Net of fees' targets. PiRho cannot guarantee access to such share classes or fees, which are used for information purposes only.

Fig 2b - DGF Return Objectives vs 5 Years Net Realised Returns



Source: Refinitiv, Managers, PiRho

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Categorising DGFs by their official fund objectives

This section examines whether we gain better predictive results from understanding a DGF's investment approach rather than simply relying on the fund's official objectives.

PiRho breaks the DGF universe into three broad categories.

- Capital Preservation DGFs: The approach can be described as 'The best way to make money is not to lose it in the first place'. It is notable that three of the four DGFs in this category do not have official return objectives.
- Growth Biased DGFs: Typically a long only approach where either dynamic asset allocation or the range of the diversification within asset classes enables the fund managers to target absolute returns.
- Hedge Fund Lite: These funds typically employ a number of hedge fund strategies (e.g. relative value approaches going 'long' an asset expected to appreciate and 'shorting' an asset expected to fall) that enable the manager to target positive returns.

Fig 3 below shows the performance of the 16 DGFs since end 2018, split into two periods: calendar year 2019 (where equity returns were strong) and Q1 2020 (the period of an equity bear market).

Fig 3 – DGF net returns since end 2018
(funds ranked from highest to lowest return for the fifteen months to 31st March 2020)

Fund Name	Return in 2019	Return in Q1 2020	Total Return from end 2018
Capital Preservation	**11.0%**	**-1.7%**	**9.1%**
Capital Preservation	8.7%	**-2.2%**	**6.2%**
Hedge Fund Lite	10.1%	**-3.8%**	**5.9%**
Hedge Fund Lite	7.1%	**-2.0%**	**5.0%**
Hedge Fund Lite	3.3%	**-0.6%**	**2.7%**
Capital Preservation	**12.5%**	**-9.3%**	**2.0%**
Growth Biased	10.1%	**-7.4%**	**2.0%**
Growth Biased	**14.4%**	-12.0%	**0.7%**
Growth Biased	**11.9%**	-10.3%	0.3%
Capital Preservation	5.3%	**-4.8%**	0.3%
Growth Biased	10.6%	-9.9%	-0.4%
Hedge Fund Lite	**12.6%**	-12.4%	-1.4%
Growth Biased	10.7%	-11.3%	-1.9%
Growth Biased	**12.4%**	-13.9%	-3.2%
Hedge Fund Lite	**12.8%**	-15.9%	-5.1%
Growth Biased	**12.0%**	-18.0%	-8.1%
Median	**10.8%**	**-9.6%**	**0.5%**

Source: Refinitiv, Managers, PiRho

Note - Performance above median is highlighted and in bold.

Given an understanding of the underlying investment approach, then patterns of returns within DGFs are more easily explained.

Funds that have a **'Capital Preservation'** bias have not surprisingly under-performed in 2019 and out-performed in 2020.

'Growth Biased' funds have for the most part had the opposite experience of the funds we have categorised as 'Capital Preservation'.

'Hedge Fund Lite' DGFs are the least dependant on the direction of markets which explains why this category has outperformed the median DGF in Q1 2020. However as these types of funds have the ability to take long and short views on many different markets, then we would expect a great deal of dispersion in their returns, and this is exactly what we see.

Lastly it is important to understand that the PiRho categories are broad classifications and within each of these categories individual funds have a variety of different strategies. In addition, some funds don't fit easily within our classification framework and may share attributes of two categories.

So, will DGFs survive Coronavirus? DGFs set out to smooth some of the ups and downs of investing by managing volatility and target absolute return rather than simply outperforming an asset class benchmark. As at the end of Q1 2020, almost two thirds the 16 DGFs with assets over £1bn have eked out a positive return since the start of 2019. It is still early days, but some of the more growth oriented funds and some of those we term "Hedge Fund Lite" are currently struggling to demonstrate superiority over more traditional benchmarked approaches.

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