Aon
Retirement and Investment

The Role of Diversified Growth Funds in DC Schemes

What are they good for?

Empower Results®

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Introduction

Diversified Growth Funds (DGFs) have received much criticism in recent years. Headlines in popular financial and pensions press have reported on high costs associated with DGFs (especially compared to passive equity funds); whether the performance of DGFs is overly reliant on equity market outcomes; and the fact that many DGFs have failed to meet their target performance objectives over the short term. This criticism has been exacerbated by the strong performance of equities over recent times and has led many investors to question the role of DGFs in their portfolios.

Much of the recent criticism has, quite rightly in many cases, focussed on the (under) performance of such funds compared to expectations, but were they the correct expectations in the first place? We believe that performance is just one of the many attributes to consider when evaluating DGFs.

In this paper, we argue that DGFs do fulfil an important role within a DC investment portfolio. However, it is important to consider which type of DGF is most appropriate as they, just like DC savers, are not a homogenous group so it is not helpful for us to treat them as such. We need to take our thinking back to first principles and ask “what are DGFs actually trying to achieve?”.

What are DGFs – Recap

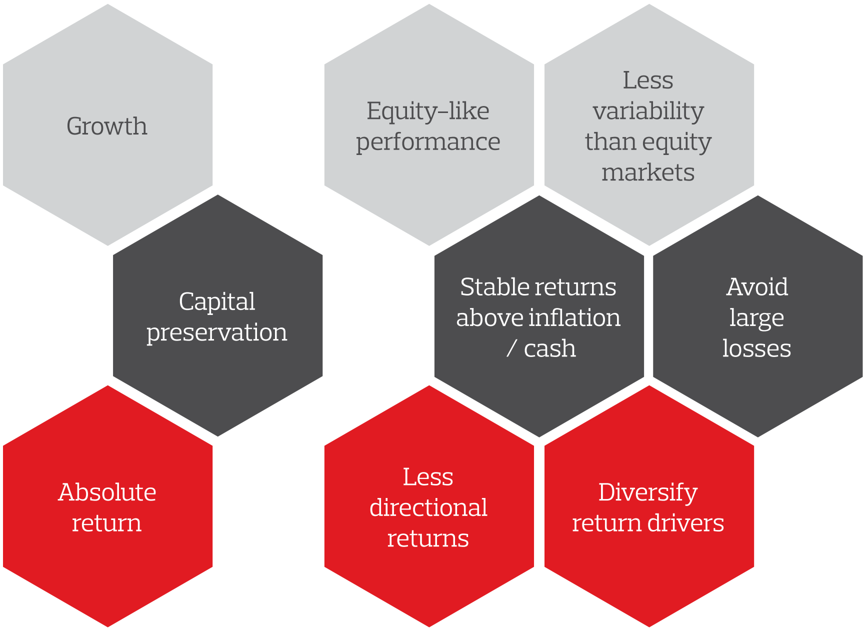
In general, DGFs invest across a wide array of asset classes, changing their asset allocation in anticipation of, or in response to, changing market conditions. Their broad aim being to produce stable returns above inflation or cash (over a period of three to five years) with lower volatility than equities. It is worth noting that we didn’t describe the performance objective as being to achieve ‘equity-like returns’ as this is not representative of all DGF mandates.

Many DC schemes utilise DGFs during the mid-career phase of a member’s working life, i.e. when the focus is typically on avoiding significant capital losses whilst retaining the ability to provide positive real returns. The perceived diversification benefits of DGFs when compared with equities, as well as, their capital preservation qualities in volatile market conditions can make them an effective choice in such circumstances.

DGF approaches

Each DGF differs markedly in how their portfolio is constructed and so DGFs do not fit neatly into a generic box. We think about the universe of DGFs as belonging to three broad sub types and each play a different role within a portfolio. It is important to consider which type of DGF is most appropriate for what you are trying to achieve for DC savers, before selecting a DGF manager.

These approaches are distinguished by their differing focus on generating returns and risk profile:



Given the stated objectives above, in the following sections we consider each DGF sub-type through three lenses:

1. Performance / Returns;
2. Diversification and volatility; and
3. Capital loss

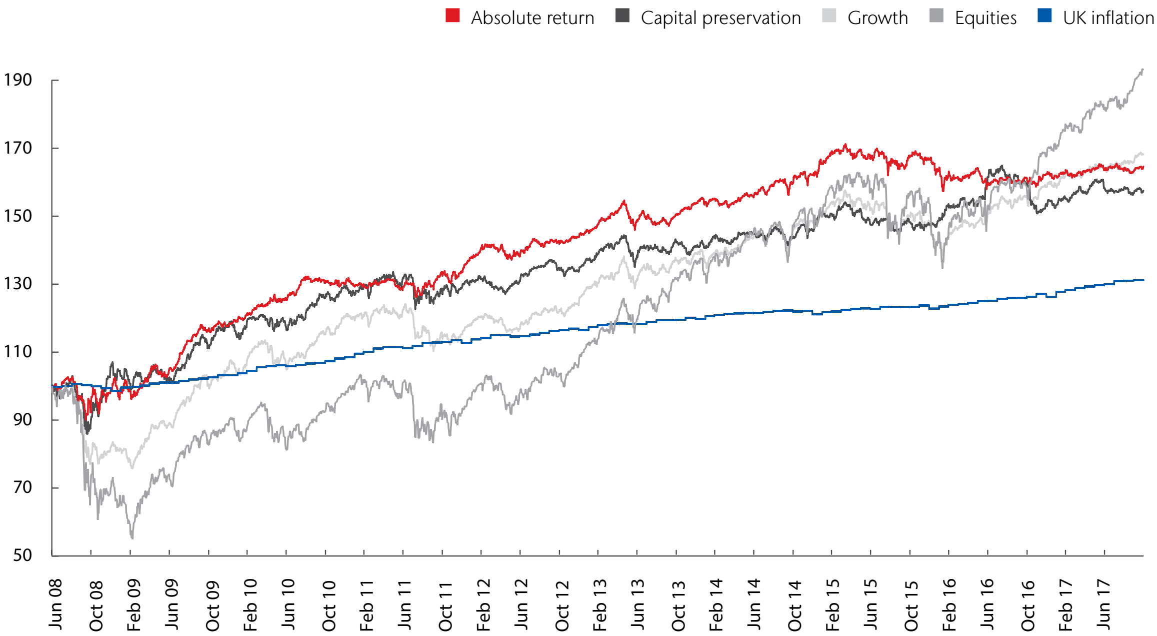
to test, historically, their respective abilities to achieve these objectives.

Performance / Returns

In the following charts we analyse the cumulative returns of each DGF approach (using a representative manager to illustrate) beginning in 2008 until June 2017 and net of fees. We use this period for two reasons:

1. It was the start of increased interest and investment in the UK for DGFs.
2. It was just before the peak of the Global Financial Crisis and so provides a real-life example of a severe shock to markets.

Growth in investment



Source: Aon, Datastream

From the chart above we note:

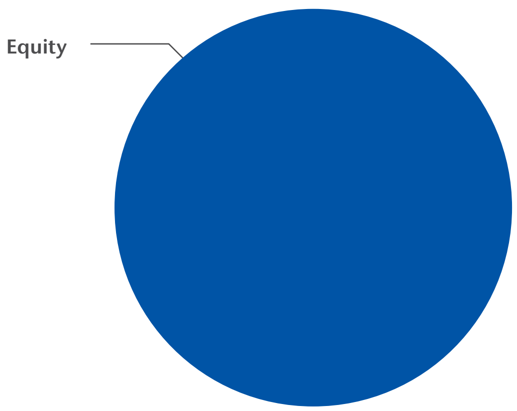
- The Growth approach has done a good job matching the performance of equities in most periods coupled with fewer ups and downs.
- The Capital Preservation approach has achieved stable returns that have been consistently above inflation (as well as cash) and has achieved its return objective.
- The Absolute Return approach has produced positive returns over the period shown.

Over an extended period of time therefore, the three DGF approaches have generally achieved their respective return objectives.

Diversification and volatility

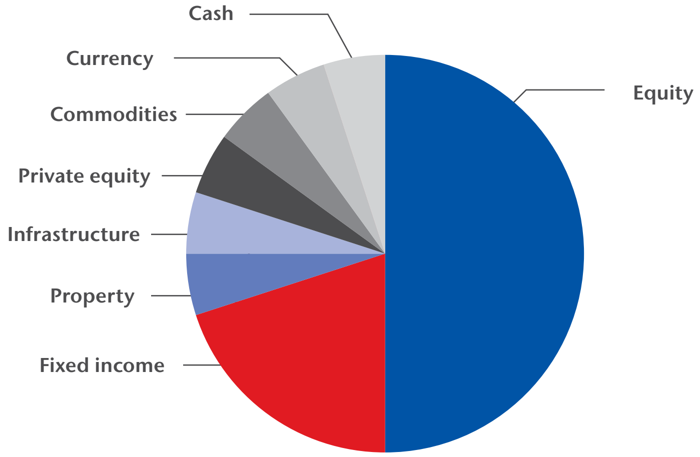
Each of the charts below shows a representative asset allocation for each DGF approach with annualised volatility since 2008 shown below.

Equities



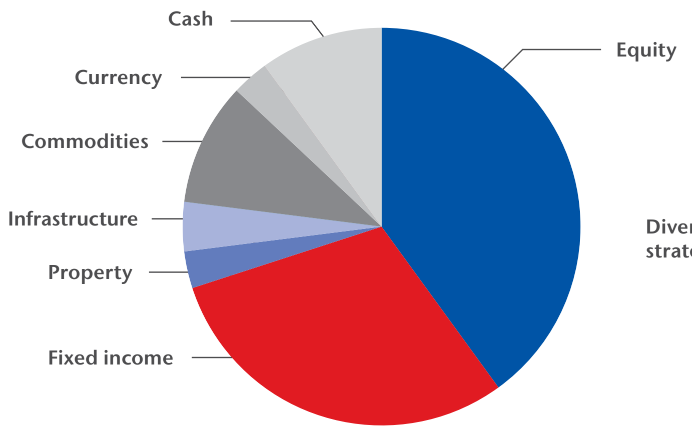
14.3%

Growth



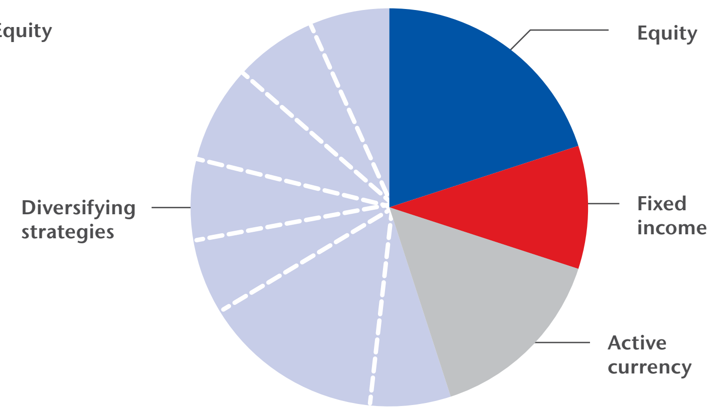
8.8%

Capital preservation



7.7%

Absolute return



5.3%

Moving from top left to bottom right we see that each DGF approach provides increasing diversification through the reduction of equities and increased focus on other asset classes, with Absolute Return having a large allocation to diversifying, or hedge fund like, strategies.

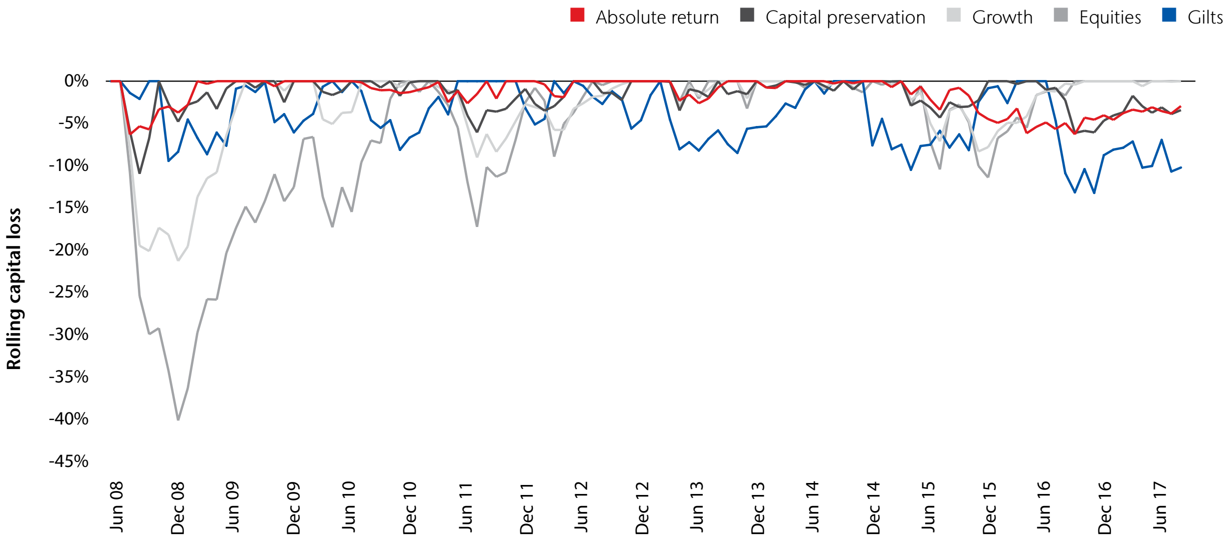
The numbers below each chart represent the annual volatility for each of the asset allocations. It is unsurprising to note that as the allocation to equities falls so does the volatility. While volatility can both benefit and detract value from investments, each DGF approach has successfully reduced the variation, or risk, in outcomes for investors.

Capital loss

In the chart below we look at the size of the capital losses incurred by investors in each DGF type compared with an investment in equities and gilts / UK government bonds, and the time taken to regain them. These factors are particularly important for DC savers for two reasons:

1. DGFs are often used in a glidepath or lifestyle strategy, where members' savings are automatically transitioned to less risky assets as a member approaches retirement. The larger and longer the losses are experienced by DC savers, the more it can impact their overall retirement outcomes.
2. Many glidepaths hold DGFs and equities right up to retirement which is the period that it is most critical to avoid significant and sustained losses.

Capital loss



Source: Aon, Datastream

The Global Financial Crisis during 2008 is shown on the left hand side of the chart, and highlights a real and severe test of each DGF approach. During this period we find:

- All the DGF approaches suffered lower losses than equities, albeit the Growth approach, which aims for equity-like returns, still had significant losses in absolute terms.
- All DGF approaches regained their losses more quickly than equities.
- The Capital Preservation and Absolute Return DGFs both suffered losses, these were much less significant than both equities and Growth DGFs, and were regained quickly.

Other periods of market stress have seen a similar pattern of results, which suggests that we can conclude that DGFs have generally achieved their objective for reducing capital losses.

It is also interesting to note that while markets over the past year cannot really be described as 'stressed' we have seen significant falls in the value of fixed income driven by an improving economic outlook and heightened valuation levels. This is an important point given the number of default strategies that still invest heavily in fixed income as a member nears retirement. In the new world of freedom and choice, fixed income can be a risky investment! A point we will cover in a future research paper.

In general we therefore believe that DGFs have met their respective objectives. However, it is clear that the differing approaches offer particular characteristics that will potentially suit members at different stages of their savings journey.

Understanding the member journey to retirement and beyond

Members face evolving risks and objectives as they negotiate the path to retirement and beyond. It is therefore important that Trustees utilise the right tools to mitigate these risks and tailor DC strategies, particularly in the lead-up to retirement. Having access to appropriate DGFs can help with this..

In our paper, *Putting DC members front and centre*, we constructed a member focused framework to help Trustees understand the evolving risks DC savers face and how we can help mitigate these. As discssed in our paper, we can summarise the main investment risks into three broad areas that differ in significance based on where on the savings journey a member is. Key risks include:

- **Opportunity cost** – not generating enough investment return resulting in a lower/ insufficient level of retirement savings is a significant risk faced by all savers.
- **Inflation risk** – protecting the real value of savings is important during the mid-career phase of a member's savings journey and in the run up to retirement. Investments that do not sufficiently exceed price inflation will therefore cause savings to lose purchasing power.
- **Capital risk** – significant capital losses can be disastrous for members, particularly in the period directly in the run up to retirement, as there may not be sufficient time for significant falls in savings to be regained.

The analysis in this paper shows that DGFs, to a differing degree based on their objectives, can help to mitigate each of these three risks. That said, it is crucial that you fully understand the investment objectives of your members, as well as the different types of DGFs, in order to mitigate these risks efficiently.

Summary

We believe that DGFs still have a valuable role to play for DC savers despite the recent criticism. However, it is important to be aware of the different types of strategies pursued and how these are expected to perform in different market environments.

Taking the process back to first principles to better align DGFs with member risks and objectives is critical in the construction of tailored investment strategies. By using DGFs in a more considered and targeted manner we believe DC schemes can expect to achieve better outcomes for members, net of fees.

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