Spreading investment risk

Why and how should I diversify my assets?
Summary

Portfolios which contain a suitable spread of investments are much less risky than those which invest in a narrow range of assets. However, creating and putting into practice a broad spread of investments is not always straightforward. Investors can pass on their investment decisions to overcome this. There is a wide variety of solutions available for creating a mix of investments, and different solutions are appropriate for different investors.

Diversified growth funds (‘DGFs’) offer a range of investments within a single fund, which are actively managed. However, while the fund itself may be ‘diversified’, it may not offer the related benefits if held alongside an investor’s other assets given its link to traditional asset classes.

Appointing a manager of managers (‘MoM’) in a single asset class can help by spreading risk across a number of managers. However, you need to be careful that the value added by a MoM outweighs the cost of a double layer of fees.

Pension schemes are increasingly passing on the job of putting their investment strategies with an appropriate spread of assets into practice to specialists. This helps to achieve a framework which is easy to manage and cost effective.
**What is diversification?**

Investors who hold all their assets in a single type (or class) of asset, such as shares, are exposed to the risk that the single type of asset will deliver poor returns.

Diversification involves investing in a range of assets to provide protection. This is because, at any one time, it is likely that some types of asset will be rising, even if others are falling. For example, umbrella manufacturers do well in winter periods, whereas sunscreen manufacturers do well when it is sunny. Combining the two in a portfolio can reduce risk without sacrificing returns.

In times of market crisis, all types of asset tend to fall in value, but some fall less than others (see chart below).

By being invested in assets that fall less in a crisis, and spreading the investments, you can achieve smoother returns than investing in just one type of asset, without reducing the expected level of returns.

As a result, diversification improves the risk and return profile of a portfolio over an economic cycle.

**How to diversify**

Most pension schemes invest a lot in shares. To diversify, you could switch some holdings into other types of assets such as property, high-yield debt, hedge funds, infrastructure (such as transport and communication) and private equity.

However, you need to be careful. It is important to combine a range of different types of asset to improve returns for a given level of risk, rather than to spread out investments just for the sake of it. Some more specialist types of assets can be more risky, with more ups and downs, and become difficult or expensive to sell in times of market stress.

**The hurdle**

Creating and putting into practice an investment strategy with a large range of assets can be time-consuming and expensive.

It takes time to learn about new types of asset and decide whether they offer reasonable value. To choose a new type of asset, you need to choose an appropriate fund manager, negotiate fees, review the fund documents and finally buy the assets. You also need to continually monitor the holding and manager for any new type of asset.

In combination, these factors can be a burden. The extra costs of adding new types of asset to a portfolio have to be balanced against the expected improvement in the assets’ risk and return profile.

The costs of a strategy tend to be fixed. It takes the same amount of time for you to learn about an asset class no matter how much will be invested in it. Equally, the cost of legal reviews of fund documents does not depend on the amount that will be invested in those assets.

On the other hand, the benefits of diversification are proportional to the size of the portfolio. Because of this, larger investors often find that the benefits of diversification outweigh the costs. At the other end of the scale, it is often not worthwhile for smaller investors to employ a large range of fund managers in different types of asset classes.
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Diversified Growth Funds (‘DGFs’)

As a way to overcome this problem, DGFs have gained popularity over recent years. These invest in a range of assets to achieve diversification in a single fund, similar to traditional balanced funds. DGFs usually aim to outperform cash or inflation by 3% to 5% a year, with lower ups and downs than shares.

DGFs tend to invest in a larger range of assets than balanced funds. Some provide access to more specialist types of assets such as bank loans, insurance-linked securities and timber, whose returns can smooth the ups and downs of traditional asset classes over a market cycle.

Compared to balanced funds, some DGFs take a more active approach to choosing how much to invest in different types of asset, and how much to invest in the underlying securities in each asset class. They aim to invest in areas of the market that they believe will perform best.

As a result, DGFs are a wide-ranging group, with a range of risk and return profiles, as you can see below.

Aon Hewitt Buy-Rated DGF Managers

Return versus Risk 5 years (p.a.) to 30 September 2013

Because DGFs are actively managed and invest in a range of assets, they provide better risk-return profiles over the long term than investments in shares and cash.

People who invest in DGFs pass on to their portfolio manager the responsibility to pick investments. This includes choosing individual securities across several types of asset, using exchange-traded funds or single asset-class funds (which can be internally or externally managed), and choosing between active and passive funds. Using manager expertise to deliver an effective strategy is an important attraction.

However, if a DGF manager chooses and invests in single asset-class funds, there may be a double layer of fees. Because no manager is likely to have ‘best in class’ offerings across all types of asset, DGF managers have conflicts of interest when deciding whether to use internal or external funds. This is likely to mean that those who invest in some DGFs will not be using the best managers.

Do DGFs really diversify?

If you replace a growth portfolio consisting largely of shares with one DGF, you are likely to benefit from a spread of investments with a low level of administration.

However, if you have already spread out your growth assets, for example by including property, hedge funds and corporate bonds, you will gain little in the way of diversification by adding DGFs. However, you may still benefit from the extra skill set that a DGF can provide, but you would be relying on the DGF manager to invest in the right areas at the right times. You should look for other ways of achieving a spread of assets while limiting the costs involved.

Investors usually prefer to be able to sell some of their holdings at short notice, so DGFs tend to deal daily or weekly. However, this feature can limit the amount of spread of investments that these funds achieve. For full diversification, a manager needs to invest in assets such as property and infrastructure which are not easy to convert to cash (illiquid) as well as those which are (liquid). To provide daily dealing, managers tend to either have low levels of illiquid assets or invest in them using listed vehicles — effectively through shares. Being listed on stock exchanges makes these vehicles more sensitive to movements in share markets, so either way there will be a reduced level of diversification.
Managers of Managers (‘MoMs’)  

Investors can invest in one type of asset by appointing a MoM which then allocates money to a range of external managers. For example, there are managers of hedge-fund managers, managers of property-fund managers, and managers of infrastructure-fund managers.  

This spreads the manager risk, which is particularly important for assets where performance can depend on the manager used, or their particular investment style. MoMs aim to allocate to managers with complementary styles. As MoMs pool investments, they may overcome minimum investment sizes for managers and so provide access that smaller investors could not achieve on their own. They may also be able to negotiate fee discounts with managers.  

MoMs tend to charge a flat fee and, sometimes, a performance-related fee, both on top of the underlying managers’ fees. You need to make sure that fees do not eat away at the benefit to the portfolio of investing in a new type of asset. If the MoM does not pick top-performing funds, it can be difficult to justify the double layer of fees.  

Over-diversification can also be an issue with some funds. Using too many managers can mean that strong performance from the top managers is reduced by weaker performers, resulting in industry-average returns.  

Many MoMs have delivered disappointing performance over recent years.  

Where possible, we prefer to appoint strong individual managers where we have faith in their skill. This avoids the double layer of fees diluting returns.
Delegated Solutions

For a variety of reasons, pension schemes are increasingly passing on the responsibility for their investment strategies to specialists. (See the chart below for more details.) We offer fully delegated growth and liability matching portfolios. These portfolios are tailored to you to allow you access to illiquid assets such as property, private equity and infrastructure as they are not held within a pooled fund that deals daily or weekly.

Some pension schemes who want to invest in asset classes that involve a lot of administration are looking to delegate in these areas only. For example, we offer a combination of hedge funds, property debt funds, infrastructure and areas of debt markets such as bank loans. These normally have lower fees than their MoM equivalents, and are more tailored to the needs of pension schemes.

Reasons for delegating

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<th>Reason</th>
<th>Percentage</th>
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<tr>
<td>Add expertise to decision making</td>
<td>57%</td>
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<tr>
<td>Implement asset allocation decision quickly</td>
<td>46%</td>
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<tr>
<td>Manage flight plan and de-risking challenges</td>
<td>40%</td>
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<tr>
<td>Reduce funding level volatility</td>
<td>32%</td>
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<tr>
<td>Reduce Trustee governance time</td>
<td>22%</td>
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<tr>
<td>Implement manager changes more quickly</td>
<td>19%</td>
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<tr>
<td>Better risk/return trade-off</td>
<td>19%</td>
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<tr>
<td>Achieve discounts through bulk buying</td>
<td>12%</td>
</tr>
<tr>
<td>Do not know</td>
<td>5%</td>
</tr>
<tr>
<td>Other</td>
<td>5%</td>
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Source: Aon Hewitt Delegated Investment Survey 2013
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