Desperately seeking diversification

Why and how should you diversify your growth assets?

Summary

Suitably diversified growth asset portfolios have better risk-return profiles than narrow portfolios but, in practice, formulating and implementing a diversified strategy is not always straightforward. Investors can delegate investment decisions to overcome this. There is a wide variety of solutions available for diversifying growth asset portfolios, and different solutions are appropriate for different investors.

Diversified growth funds (‘DGFs’) offer diversification within a single fund, providing actively managed exposure to a range of asset classes. However, whilst the fund itself may be diversified, it may not offer diversification benefits if held alongside an investor’s other assets given its correlation with traditional asset classes.

Appointing a manager of managers (‘MoM’) in a single asset class can ease the governance burden of spreading risk across a number of managers. However, care needs to be taken to ensure that the value added by an active MoM outweighs the cost of a double layer of fees.

Pension schemes are increasingly delegating the implementation of their investment strategies in order to diversify within a low-governance, cost-effective framework. Delegated solutions should be considered alongside other options for diversifying a growth asset portfolio.

What is diversification?

Investors who hold all their growth assets in a single asset class, such as equities, are exposed to the risk that the single asset class delivers poor returns.

Diversification involves investing in a range of asset classes to provide protection as, at any one time, it is likely that some asset classes will be rising, even if others are falling. As an 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 growth asset classes tend to fall in value, but some fall by less than others (see chart below).

Source: Thomson Reuters Datastream, Aon Hewitt and IPD.

By having exposure to asset classes that fall less in a crisis, diversified portfolios can give smoother returns than investing in a single asset class, without reducing the expected level of returns.

Hence, diversification improves the risk and return profile of a portfolio over an economic cycle, giving investors a theoretical ‘free lunch’.
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How to diversify?
Most pension schemes’ growth assets have a high equity allocation. In order to diversify, they could switch some holdings into other growth asset classes such as property, high yield debt, emerging market debt, hedge funds, infrastructure and private equity.

However, care needs to be taken. It is important to combine a range of different asset classes to improve risk-adjusted returns, rather than to diversify for its own sake. Some more niche asset classes can experience heightened volatility and become difficult and/or expensive to sell in times of market stress.

The governance hurdle
In practice, formulating and implementing an investment strategy with a large range of asset classes can be time consuming and expensive.

It takes time to learn about new asset classes and decide whether they offer reasonable value. To implement a new asset class, investors need to choose an appropriate fund manager, negotiate fees, review the fund documentation and finally transition the assets. Investors also need to continually monitor the holding and manager in any new asset classes.

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

The costs of formulating and implementing a strategy tend to be fixed; it takes the same amount of time for investors to learn about an asset class irrespective of the size of the investment. Equally, the cost of legal reviews of fund documentation do not depend on the amount of assets to be invested.

On the other hand, the benefits of diversification are proportional to the portfolio size. Therefore, larger investors often find that the benefits of diversification outweigh the governance costs. Conversely, it is often not worthwhile for smaller investors to employ a large range of fund managers in different asset classes.

Diversified Growth Funds (‘DGFs’)
As a way to overcome the governance hurdle, DGFs have gained popularity over recent years. These invest in a range of asset classes to achieve diversification in a single fund, similar to traditional balanced funds. DGFs typically aim to outperform cash or inflation by 3-5% p.a. with lower volatility than equities.

DGFs tend to invest in a larger range of asset classes than balanced funds. Some provide access to more esoteric asset classes such as bank loans, insurance linked securities and timber, whose returns can dampen the volatility of traditional asset classes over a market cycle.

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

As a result, DGFs are a heterogeneous group, with a range of risk and return profiles, as illustrated below.

Source: Aon Hewitt, managers and Thomson Reuters Datastream.

The actively managed exposure to different asset classes and dynamic asset allocation in response to market opportunities has meant that DGFs have demonstrated better risk-return profiles over the long term than a cash and equity portfolio.
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Managers of Managers (‘MoMs’)

DGF investors delegate portfolio implementation to the manager. This includes choosing individual securities across several asset classes, using exchange traded funds or single asset class funds (which can be internally or externally managed), and choosing between active and passive funds. Utilising manager expertise to deliver intelligent implementation is a key attraction.

However, where a DGF manager selects and invests in single asset class funds, there may be a double layer of fees charged. As no manager is likely to have ‘best in class’ offerings across all asset classes, DGF managers have conflicts of interest when deciding whether to use internal or external funds. This is likely to mean that investors in some DGFs are not accessing the best managers.

Do DGFs really diversify?

An investor who replaces a growth portfolio consisting largely of equities with a single DGF is likely to benefit from diversification with a low governance burden.

However, an investor who has already diversified their growth assets, for example by including property, hedge funds and corporate bonds, will gain little in the way of diversification by adding DGFs, given their correlation with traditional asset classes. Such investors may still benefit from the additional skill set that a DGF can provide, but they would be relying on the DGF manager to invest in the right areas at the right times. These investors should look for other ways of achieving asset class diversification whilst limiting the governance cost.

Investors typically 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 diversification that these funds achieve. For full diversification, a manager needs to invest in illiquid assets, such as property and infrastructure, as well as liquid assets. To provide daily dealing, managers tend to either have low allocations to illiquid assets or access them using listed vehicles. Being listed on stock exchanges makes these vehicles more sensitive to movements in equity markets, so either way there will be a reduction in diversification.

Managers of Managers (‘MoMs’) can access a single asset class by appointing a MoM which then allocates money to a range of underlying external managers. For example, there are managers of hedge fund managers, managers of property fund managers, and managers of infrastructure fund managers. This diversifies manager risk, which is particularly important in asset classes where performance can be very dependent on the manager employed, or their particular investment style. MoMs aim to allocate to managers with complementary styles to enhance diversification benefits. As MoMs pool investments, they may overcome minimum investment sizes for underlying managers and hence provide access that smaller investors could not attain on their own. They may also be able to negotiate fee discounts with underlying managers.

MoMs tend to charge a flat fee and, sometimes, a performance related fee, both on top of the underlying managers’ fees. Investors need to ensure that fees do not dilute performance enough to erode the benefit to the portfolio of diversifying into a new asset class. Where the MoM does not select top performing funds, it can be difficult to justify the double layer of fees.

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

Many MoMs have delivered disappointing performance over recent years.

Where possible, we prefer directly appointing strong individual managers where there is high conviction in their skill. This avoids the double layer of fees diluting returns.
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Delegated Solutions

For a variety of reasons, pension schemes are increasingly delegating the implementation of their investment strategies therefore allocating their governance resources more efficiently (see chart to the right for more details).

We offer fully delegated growth and liability matching portfolios. Such portfolios are tailored to investors and allow 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 wish to access asset classes that have a high governance burden are looking to delegate in these areas only. For example, we offer delegated alternatives mandates, such as a combination of hedge funds, property debt funds, infrastructure and areas of debt markets such as bank loans. These typically have lower fees than their MoM equivalents, and are more tailored to pension schemes’ needs.

Source: Aon Hewitt Delegated Investment Survey 2013
## Contacts

<table>
<thead>
<tr>
<th>Location</th>
<th>Name</th>
<th>Phone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>Birmingham</td>
<td>Gary Mallon</td>
<td>0121 230 6833</td>
<td><a href="mailto:gary.mallon@aonhewitt.com">gary.mallon@aonhewitt.com</a></td>
</tr>
<tr>
<td>Bristol</td>
<td>Hannah Coleman</td>
<td>0117 900 4415</td>
<td><a href="mailto:hannah.coleman@aonhewitt.com">hannah.coleman@aonhewitt.com</a></td>
</tr>
<tr>
<td>Edinburgh</td>
<td>Kenneth Ettles</td>
<td>0131 456 6426</td>
<td><a href="mailto:kenneth.ettles@aonhewitt.com">kenneth.ettles@aonhewitt.com</a></td>
</tr>
<tr>
<td>Farnborough</td>
<td>Peter Jackson</td>
<td>01252 768 035</td>
<td><a href="mailto:peter.jackson@aonhewitt.com">peter.jackson@aonhewitt.com</a></td>
</tr>
<tr>
<td>Leeds</td>
<td>Tim Manuel</td>
<td>0113 291 5038</td>
<td><a href="mailto:timothy.manuel@aonhewitt.com">timothy.manuel@aonhewitt.com</a></td>
</tr>
<tr>
<td>London</td>
<td>Sophie Moore</td>
<td>020 7086 9209</td>
<td><a href="mailto:sophie.moore.3@aonhewitt.com">sophie.moore.3@aonhewitt.com</a></td>
</tr>
<tr>
<td>St Albans</td>
<td>Darren Kidd</td>
<td>01727 888 670</td>
<td><a href="mailto:darren.kidd@aonhewitt.com">darren.kidd@aonhewitt.com</a></td>
</tr>
</tbody>
</table>

### Asset Allocation
- Lucinda Downing
  - Phone: 020 7086 9440
  - Email: lucinda.downing@aonhewitt.com

### Delegated Consulting
- Doug Steevens
  - Phone: 020 7086 9312
  - Email: douglas.steevens@aonhewitt.com

### Manager Research
- Ian Smart
  - Phone: 020 7086 9250
  - Email: ian.smart@aonhewitt.com

### Risk & Modelling
- Yves Josseaume
  - Phone: 020 7086 9157
  - Email: yves.josseaume@aonhewitt.com

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