The benefits of diversification, dynamic asset allocation and downside protection

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For many years, LGPS funds have invested in a combination of equities, bonds and alternatives with the aim that these assets will provide the returns they need to match their long-term return expectations to meet liabilities. However, as many funds have experienced since 2000, the returns from asset classes such as equities are not only volatile but can significantly underperform for long periods of time. This has led to an increase in schemes looking for investment solutions that are likely to provide a smoother path of returns. One approach is diversified growth funds (DGFs).

Why adopt a diversified approach?

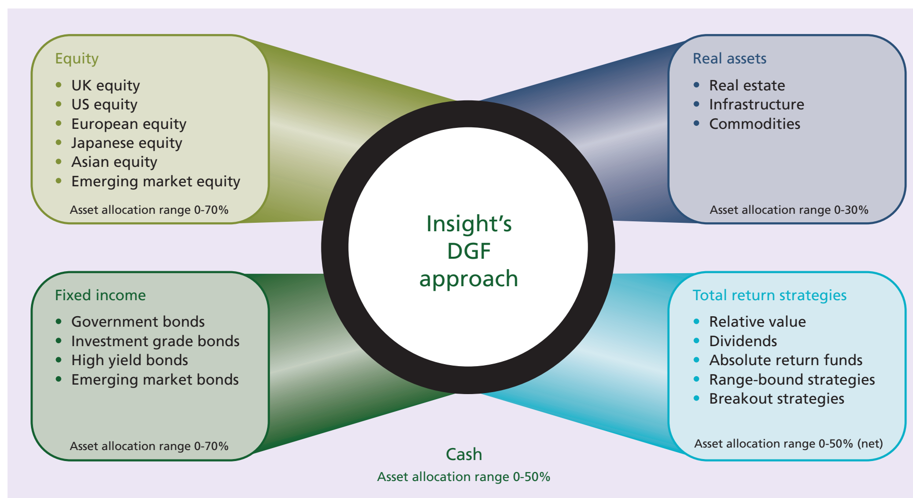
Diversification across investments is one tool that can be used to mitigate investment risk over the longer term. Investors can use diversification within particular asset classes and also across asset classes, blending them in a multi-asset approach such as a DGF (Figure 1). DGFs evolved from the "balanced mandate" mix of equities and bonds and have become increasingly sophisticated, with managers investing in an ever-wider array of asset classes using a more dynamic approach as they focus on aligning their investment strategies to meet the goals of their clients.

Many DGFs are managed in such a way as to potentially offer the best of both worlds: equity-like returns but with much lower levels of volatility. A more diversified and dynamic approach offers the potential to provide better capital protection, as at any one time some asset classes may be rising while others are falling.

Over time, the objectives of these funds have also evolved, from simply offering equity-like returns, to include absolute returns with a focus on capital preservation, or to outperform cash within certain volatility ranges. Today there are a wide variety of funds with different goals to suit different investor objectives.

"A more diversified and dynamic approach offers the potential to provide better capital protection"

Figure 1: Insight's DGF approach



Source: Insight Investment. For illustrative purposes only and subject to change.

Why is dynamic asset allocation important?

Traditional balanced funds tended to have relatively static asset splits with, for example, a 60% allocation to equities and a 40% allocation to bonds. This was based on the premise that such allocations would deliver relatively smooth returns over time. This static approach proved bruising during the extreme turbulence following the 2000 technology "bubble" and again in 2008 at the height of the credit crisis, when correlations rose and most financial assets fell in tandem.

At Insight, our multi-asset team formulates broad, macro-economic views to help build a highly dynamic approach to asset allocation that acknowledges that asset classes can behave in very different ways in both the short and long term as they progress through the different phases of the economic cycle. We are able to make substantial and swift asset allocation shifts as the broader investment landscape changes. In essence, our approach aims to identify the risks and opportunities across global financial markets in order to help construct a portfolio that fully reflects our views.

We only take exposure when we see opportunities. We are comfortable taking our weightings in specific asset classes down to zero when we expect them to deliver negative returns. For example, our exposure to equities has ranged from 0% to 70% in recent years. If we believe that the environment for equities is deteriorating, we can cut our exposures rapidly and rebuild once we think the worst is over, allowing our investors to participate in any subsequent rally. We believe this dynamic approach gives us the potential to capture most of the upside when markets are rising, but to avoid most of the downside when they are falling.

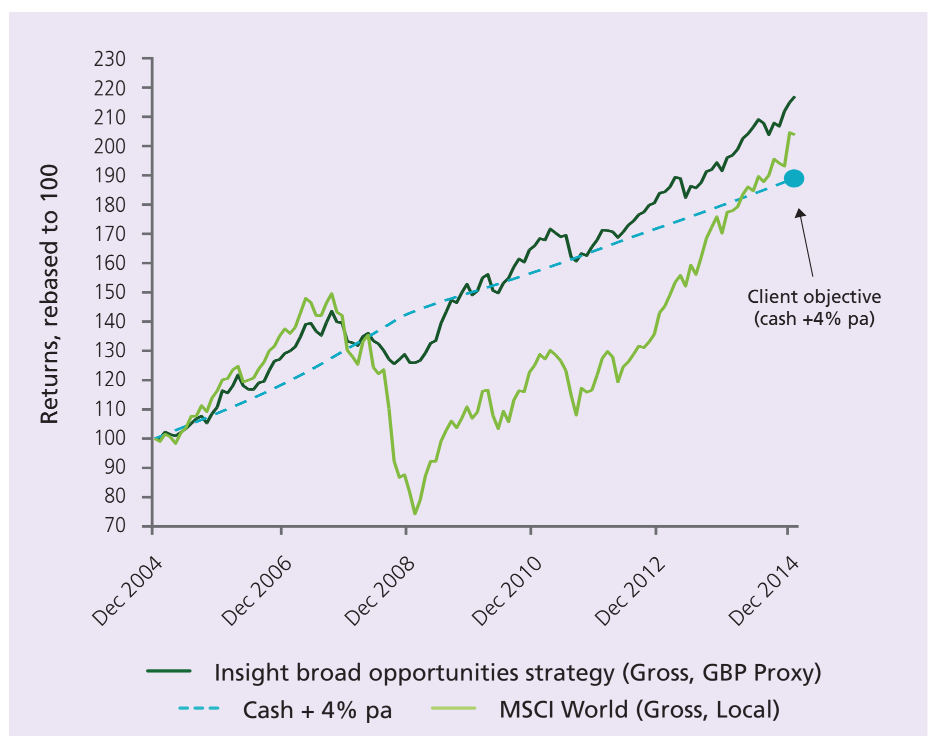
Is limiting downside worth striving for?

History shows that equity markets can enjoy strong periods of outperformance, which, unfortunately, may then be followed by long episodes of extreme turbulence. The end result may be a return path that is simply too volatile for many investors to tolerate, especially at the time of a valuation when contribution rates are being set. DGFs seek to address this challenge by targeting returns that are broadly equivalent to long-term investment in equities, but with materially lower volatility. In Figures 2 and 3 we show the return and volatility profile of Insight's flagship DGF offering, the Broad Opportunities Fund.

This fund has a target return of cash plus 4% to 6% pa. gross of fees over a market cycle.[1] Our goal with this fund is to achieve an attractive distribution of returns in the form of a steady and smooth return profile.

While there are wide differences in the structure and focus of individual DGFs, they share common features. They often have no pre-defined asset class benchmark, have scope to invest in many

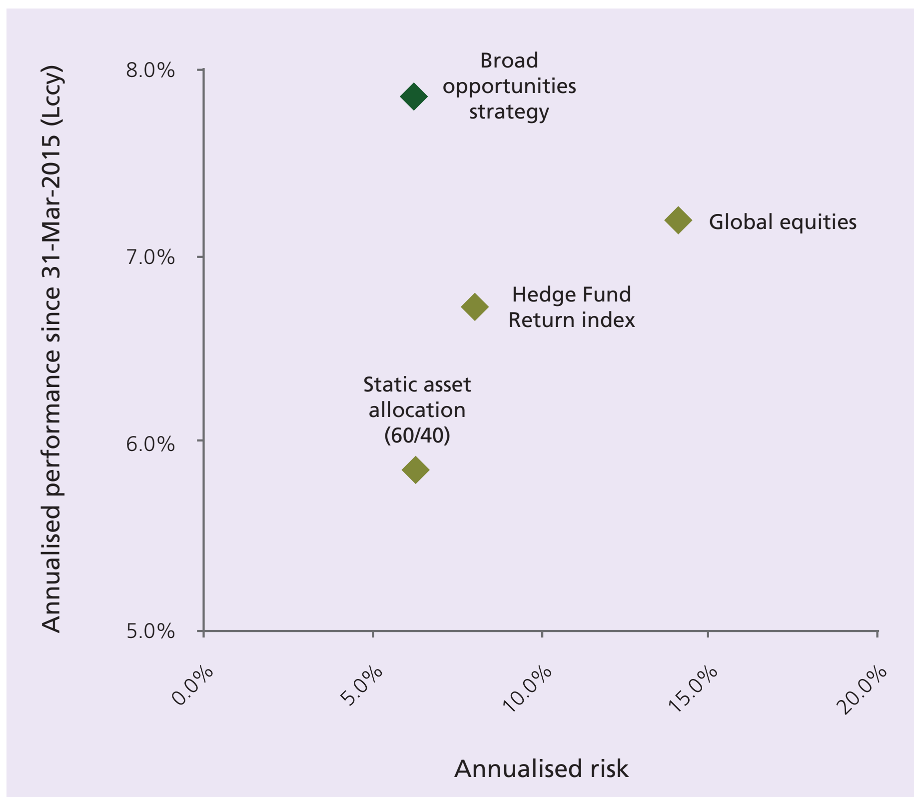
Figure 2: A smoother path to long-term returns



Source: Insight Investment

Past performance is not a guide to future performance. Data as at 31 March 2015. Gross returns, rebased to 31 December 2004, when strategy was initiated. The long-term track record of the Insight broad opportunities strategy has a base currency of USD. This performance record has been adjusted by interest rate differentials to derive a GBP proxy. No currency adjustments have been made to the underlying investments. Cash represents 3 Month GBP Libid. Static asset allocation is based on a 60% equities (MSCI World TR index in local currency terms) and 40% bonds (J.P. Morgan GBI index hedged into USD) allocation. Global equity is based on the MSCI World TR index in local currency terms. Indices shown as Total Return in local currency. The global equities index is shown to illustrate the strategy's volatility against equities. This investment strategy shown is used to illustrate Insight's skills and experience.

Figure 3: Reducing volatility without compromising long-term returns – Strategy risk/return since inception



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different asset classes and strategies, and share an absolute return focus expressed over a multi-year time horizon.

In our view, a genuinely well-diversified and highly dynamic approach that incorporates short-, medium- and long-term considerations may be able to deliver highly attractive risk-adjusted returns over the course of a market cycle. We also believe that an outcome-oriented mindset can help to ensure close alignment with our investors' key goals: the pursuit of capital preservation, stable growth and predictable returns.

What are the benefits of Insight's approach to DGF?

Insight's Multi-Asset Team runs a number of DGFs, including the Broad Opportunities Fund. This fund has four return-seeking components: equities, fixed income, real assets (such as commodities and infrastructure), and total return strategies that aim to add value regardless of market direction.

Our investment process involves deciding overall allocation to asset classes and sectors, selecting the most efficient instrument to gain that exposure and managing risk. To decide the fund's asset allocation we use long-term valuations of various asset classes and an assessment of the economic environment, and short-term analysis informed by a range of indicators. The fund is structured to allow substantial changes to asset allocation if deemed necessary: it can hold zero in an asset class if we expect it to lose money.

To manage risk we use sophisticated controls to help our investment strategy perform in line with expectations. We follow two principles with regard to the fund: first, we scale any initial investment according to our conviction and tolerance for risk; second, we dynamically manage the size of the investment over time as our conviction and tolerance for risk change. In this way we seek to participate in positive performance while limiting losses.

We believe our approach offers a way to target equity-like returns with significantly lower volatility. The team has the freedom to select where to invest at any given time, depending on the prevailing economic outlook. This means the fund can aim to generate positive returns in a range of market conditions.

DGF selection criteria at a glance: does your DGF offer?

- Compliance with LGPS guidelines
- A strong track record
- An established, stable investment team
- The ability to replace a scheme's exposure to equities or form part of the 'alternatives' allocation
- Genuine diversification across asset classes
- Dynamic asset allocation
- Attractive, risk-adjusted returns
- Transparency

Source: Insight Investment

1. The Fund has a performance aim of cash (3-month sterling Libid, which Insight defines as 3-month Libor minus 0.125%) plus at least 4-6% (gross) p.a. over a market cycle (typically 3 to 5 years). This is not a guarantee, may not be achieved and a capital loss may occur. Funds which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

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