LATEST BRITISH INVASION – DIVERSIFIED GROWTH FUND

The UK's influence on music reaches beyond its borders. The Beatles and the Rolling Stones were among the first British groups to make it big in North America, leading to the term, "the British Invasion".

The pension investment world has witnessed a "British Invasion" of its own with the export of "the Diversified Growth Fund"(DGF) which delivers a different approach to multi-asset class (balanced) management.

So far DGFs have made reasonable in roads into the US, but have yet to break through into Canada in any meaningful way. This article reviews the genesis of the DGF and what their broader acceptance north of the border could mean for Canadian investors.

ATTRACTING ASSETS

By attracting strong asset inflows in the UK and US, DGFs are proving to be one of the more successful investment innovations in recent years.

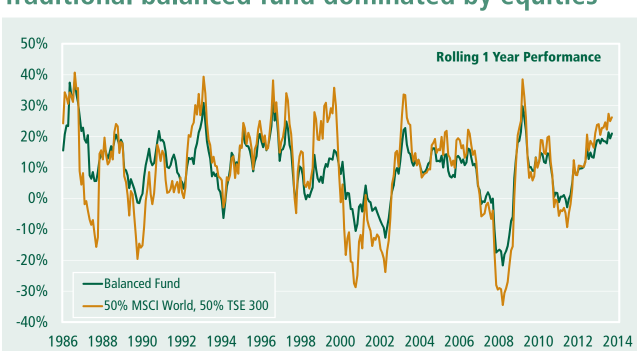
DGFs are multi-asset class funds, or balanced funds, that adopt a more dynamic asset allocation compared to the asset mix of traditionally managed balanced funds. This dynamism enabled DGFs to better adapt to the challenging markets during the global financial crisis of 2008-2009, resulting in superior returns compared to balanced funds utilizing a traditional asset mix approach.

So what's the problem with traditional balanced funds?

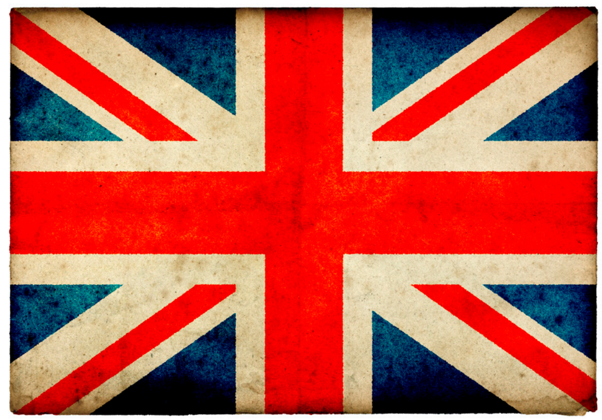
Globally, traditional balanced funds have predominantly invested in equities, with the remaining allocation to fixed income.

For Illustrative purposes, the chart below shows the rolling one-year returns of a traditional Canadian balanced fund[1]. Plotted alongside the balanced fund returns is the rolling one-year return for a simulated equity portfolio passively invested 50% in global equities and 50% in Canadian equities.

Traditional balanced fund dominated by equities



Source: CC&L Financial Group, CC&L Investment Management & Thomson Reuters Datastream



The similarity in returns of the two portfolios, generally rising and declining in step, underlines how the risk profile of balanced funds have been at the mercy of equity markets.

CHALLENGES OF DIVERSIFICATION

To remedy this situation, large investors typically moved away from a traditional balanced fund approach and adopted a plan-specific asset mix, often introducing additional asset classes to enhance diversification and implemented through specialist investment managers.

Over time this approach has created governance challenges for some investors due to the increased complexity associated with a larger stable of investment funds and managers.

These governance challenges have led to the revival of balanced funds in the UK and US, but with a more dynamic and diversified approach to asset mix and relabeled, Diversified Growth Funds. The greater dynamism allowed the DGF to invest in hedge funds, real estate, infrastructure and commodities, asset classes not generally invested in by traditional balanced funds.

DGFs' roots date back to 2006 when the University Superannuation Scheme (USS) of the UK asked their consultants to produce a report on its approach to asset allocation and to compare how other investors in their global industry tackled asset mix.

The review observed that the USS's global peers typically had a more diversified asset mix, which helped them better weather the challenges of 2000-2003 compared to the USS.

DIVERSE RANGE OF APPROACHES

While the nomenclature suggests a high degree of commonality between different DGFs, there exists a diverse range of approaches adopted by investment managers offering these funds. For example, UK investors must carefully look under the hood to discover the exact composition of each fund, as there can be significant variation in the allocation between the different DGFs to hedge funds, real estate, infrastructure and commodities.

It is estimated that 23% of UK defined benefit (DB) plans are invested in a DGF, with almost C$ 200 billion invested in these funds and an expectation for significant growth in the short to medium term[2].

DB plans are not the only investors interested in DGFs. There has also been significant interest by defined contribution (DC) plans. Some DC plans are introducing DGFs as a default option in preference over target date funds, which have historically been a popular default choice by many plan sponsors.

Simplicity is the reason cited by UK plan sponsors for preferring the DGF over target date funds due to the reduced complexity of the DC plan offering a single default fund rather than a range of funds under the target date approach.

WHAT DOES THE FUTURE HOLD?

DGFs have made decent in roads into the U.S. with approximately US$ 35 billion in assets based on the US DGFs in the eVestment database (at September 30, 2014).

It's still early days in Canada, but DGFs could follow the lead of the UK and the US by creating a revival for balanced funds for several reasons:

Better equipped	Many investment firms are much better equipped to offer a diverse range of solutions under a single firm, including a number of Canadian-based firms
Better governance	Investors recognize the merits of alternatives, but are conflicted by the complexity and governance challenges that alternatives imply. A DGF approach can provide allocations to alternatives without the burden of a large roster of managers and associated governance complications
Outsource alternative	A DGF approach can provide plan sponsors an alternative to a full outsource model (e.g., a fiduciary manager, or outsource Chief Investment Officer).

With respect to the last point, instead of fully outsourcing the responsibility for asset mix and investment manager selection, the plan sponsor is able to delegate to the DGF investment manager the more challenging governance tasks, such as managing and determining alternative investments allocations.

FRUSTRATING, BUT DELIVERING

Based on the UK experience, DGFs are a frustratingly loose investment category with a range of constituents requiring scrutiny to understand the exact composition of each fund. However, to date, they have passed the key test for any successful investment innovation by delivering on what they promised - equity-like returns with lower volatility.

The volatility, governance and related challenges that DGFs have helped investors manage in the UK and US are the same as those faced by Canadian investors. Therefore, perhaps it is only a matter of time before DGFs invade Canada in a more meaningful way.

[1] The sample balanced fund is the CC&L Genesis Fund.

[2] Spence Johnson, Deeper Perspectives, May 2014

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