UK INSTITUTIONAL GROUP

Diversified growth funds: Can one size ever fit all?

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One product can't solve all investing needs. That's why we believe fiduciary management is well worth considering.

For institutional investors only—this is a marketing communication.

This paper contains marketing material about our fiduciary management service. This webpage does not represent impartial advice on this service. In certain cases, you are required to conduct a competitive tender process prior to appointing a fiduciary manager. Guidance on running a tender process is available from the Pensions Regulator.

With no two defined benefit (DB) pension schemes identical, how suitable are one-size-fits-all investment products like diversified growth funds (DGFs)? Can they ever truly be considered a viable alternative to fiduciary management?

In this paper, we reflect on the rise of DGFs, and consider their pitfalls as one potential investment solution for DB pension schemes.

What are DGFs?

And why did they prove popular amongst DB pension schemes?

Before going any further, it's worth spelling out what we mean by a DGF. Although far from a homogeneous group, DGFs are essentially multi-asset strategies with an unconstrained mandate, meaning they are not trying to beat a specific index. Instead, these funds have a returns objective of cash or inflation plus a certain percentage per annum, typically over a five-to-seven-year time horizon. Amongst DB pension schemes, DGFs rose in popularity for a host of reasons. For one, the 2001 dot-com bust and 2008 housing market crash combined to produce two equity bear markets in the space of a decade. Accordingly, many DB schemes were left questioning whether shares could realistically deliver the growth necessary to close their funding gap.

And as equity markets stalled, DGFs were positioned as the perfect solution. Many claimed they were able to target 'equity-like performance', but without the volatility otherwise associated with equities investing. How? By diversifying across a number of asset classes to effectively manage downside risk. Clearly, for DB schemes looking to outsource their investment provision, DGFs presented something of a one-stop shop. It's only in hindsight that many observers have come to question whether DGFs really are as good as they once seemed.

What are some of the pitfalls associated with DGFs?

And how does our approach differ?

If success doesn't happen overnight, then neither does failure. Rather than imploding, several popular DGFs have fizzled out, fading over the course of a decade.

And whilst the rise and fall of such funds has all the hallmarks of a cautionary tale, we believe the decline speaks to the limitations of DGFs more generally.

Can any solution be all things to all people?

If DGFs demonstrate one thing, it's this: there is often a tension between a fund's objectives and its underlying investors.

Such funds can represent the likes of retail investors and charities, as well as defined contribution (DC) and DB pension schemes—all clients with slightly different objectives based on, well, circumstance. A DGF can't play to these differences: all underlying investors must adopt the same asset allocation. And for DB schemes—particularly those that are not fully hedged—the fact that DGFs tend to target cash or inflation plus a certain percentage is the most obvious example of this mismatch.

In contrast, at SEI®, we focus on a client's unique requirements. We consider the total portfolio benchmark relative to a scheme's liabilities, actively de-risking or re-risking the portfolio in response to certain triggers. We've been advocating such an approach since 1986, when SEI alum Gill Beebower co-authored a groundbreaking study showing asset allocation to be the primary determinant of portfolio performance.[1]

In short, rather than expecting a square peg to fit a round hole, we build solutions that start and end with our clients' objectives.

Too big to fail? Or too big to succeed?

Capacity is a constraint that most DGFs struggle to overcome. Funds that get too big become less agile and can have difficulty implementing investment ideas quickly.

This is not something that can be said of the solutions we build at SEI. As a multi-manager employing open architecture, we're able to diversify across a number of parameters, including style and asset class. We monitor manager diversification relative to the size of our funds and the capacity of the underlying managers, and as capital inflows increase, we're able to add new managers. This means we're not exposed to capacity risk in the same way a strategy implemented by a single manager would be.

We build solutions that start and end with our clients' objectives.

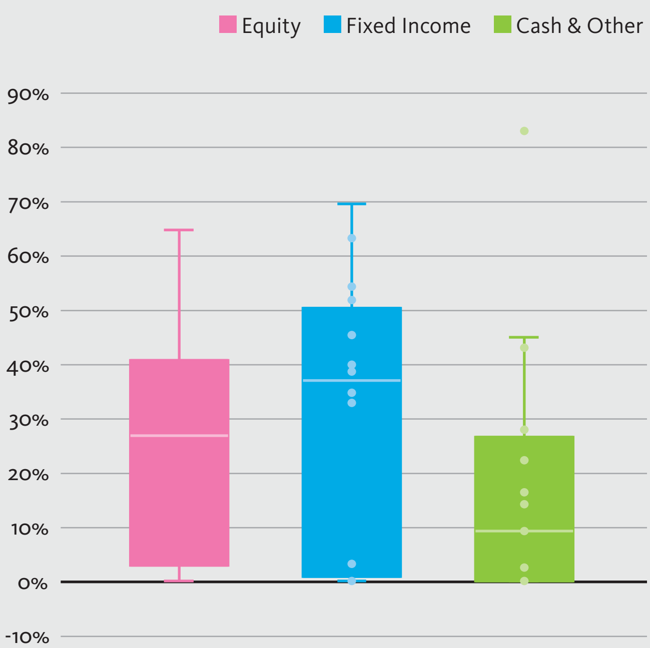
[1] Gary P. Brinson, L. Randolph Hood, Gilbert L. Beebower, 'Determinants of Portfolio Performance', *Financial Analysts Journal*, Vol. 42, No. 4, July – August, 1986, pp. 39-44

The challenge of serving both retail and institutional investors

Figure 1 illustrates what we've been talking about in this section—namely, that DGFs are far from a homogeneous group. Some hold a relatively high level of cash, which is an appropriate de-risking asset for retail investors, but is less suited to DB pension schemes, which tend to favour gilts for this purpose. DGFs also invest in mainly liquid assets—not ideal when you consider pension schemes are long-term investors, seeking a competitive advantage by holding long-dated assets that reflect the long nature of their liabilities. Add to this that DGFs are essentially a black box—wherein investors don't have oversight of what they're investing in—and you can see how such funds might create governance issues for a DB scheme.

Source: Bloomberg, SEI. As at 30 September 2023. Dispersion of asset allocation shown for 18 DGFs researched by SEI.

Figure 1. In the main, DGFs invest in liquid assets.



The 'cult of the star manager'

Of course, there's no way we can talk about the performance objectives of DGFs without mentioning what's sometimes referred to as the 'cult of the star manager'. When a fund's early success centres on the capabilities of a few talented individuals, then a decline in performance often follows the departure of these key players. Why? Well, when a product is built around one or two stars, nothing can solve for those individuals leaving and taking their bright ideas with them.

At SEI, we take a different approach. Rather than being overly reliant on a lead manager, we place a greater emphasis on alpha sources—areas of the market that have been empirically proven to outperform over the long term. This allows us to identify and exploit persistent opportunities across different market cycles and geographies.[2]

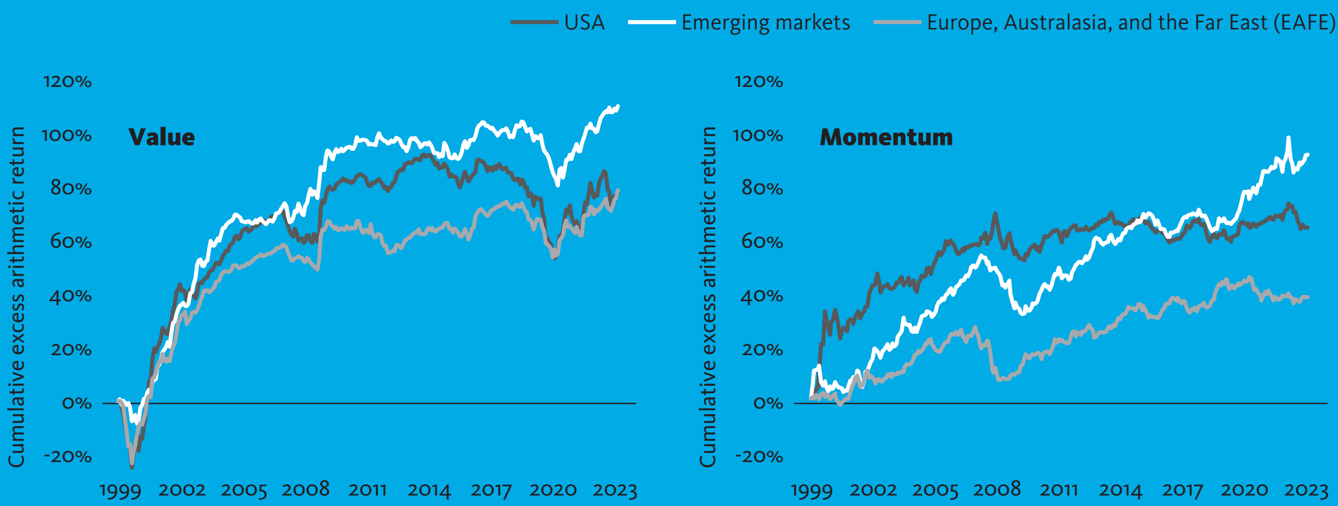
[2] A client portfolio run by SEI would typically use these factors in combination to aid diversification.

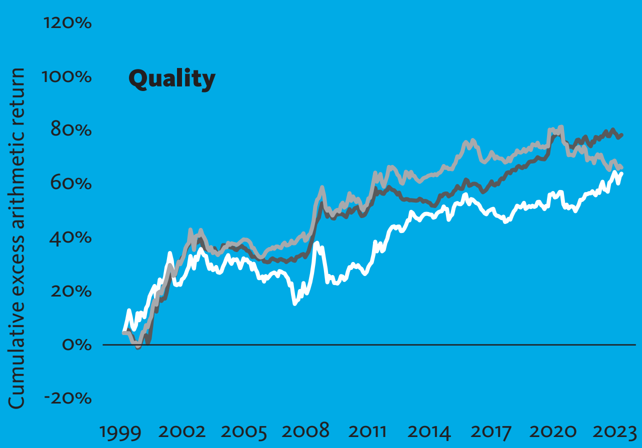
CASE STUDY

Factors as an enduring source of equity alpha

Figure 2 demonstrates what we've been talking about in this section. Taking our approach to equities as an example, we have used back-testing to demonstrate the enduring nature of our preferred factors (i.e., our alpha sources). Whereas the performance of a star manager might be extremely volatile, factors such as **value, momentum,** and **quality** tend towards steady, long-term outperformance. This is the case irrespective of region.

Figure 2. Factor investing tends to emphasise long-term performance.





Source: SEI, based on data from MSCI, Axioma and Factset. Regional equities are represented by Russell 1000 Index, MSCI Europe Index, MSCI Emerging Markets Index. Returns are quoted in USD. The metrics are composites of underlying ratios that SEI has determined an appropriate measures of each factor. Data refers to past performance of liquidity-weighted, top-tercile portfolios vs. the capitalisation-weighted benchmark, and is rebalanced quarterly. Past performance is not a reliable indicator of future performance. Data for the period from 30 June 1999 through 31 October 2023.

What's more, the client determines our approach to asset allocation, not the other way around. The extent to which we'd take advantage of a short-term market dislocation, for example, depends on the client's predetermined risk budget and investment strategy. Where some DGFs employ a passive or thematic approach to certain asset classes, we're fully active, meaning we're able to make tactical calls in response macroeconomic events as they unfold. Whether we do or not depends on how appropriate we deem such calls to be relative to the underlying client.

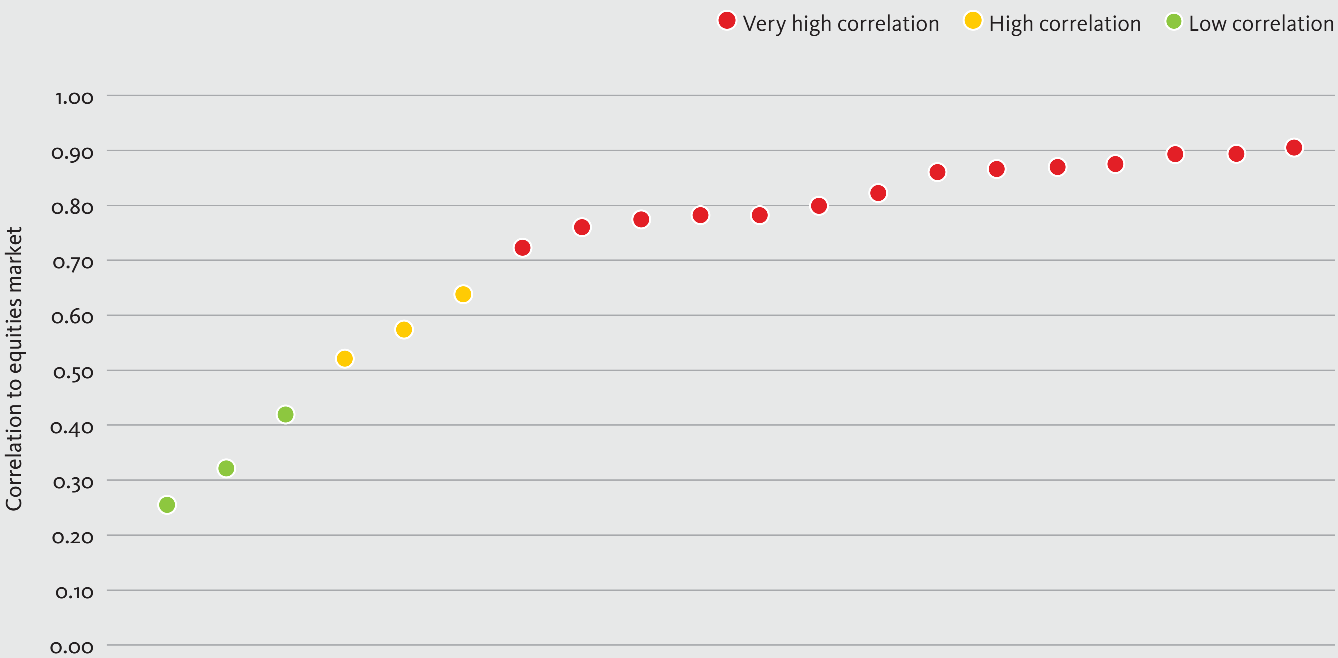
Do you really get what you pay for?

Finally, manager skill—and particularly 'star manager skill'—comes at a cost. Critics have long questioned whether the high fees associated with DGFs are justifiable.

A costly way to gain equities exposure

Figure 3 shows a strong positive correlation between the returns generated by some of the market's most popular DGFs and the returns generated by the global equity markets. Not only does our analysis suggest DGFs are not offering investors diversification—remember, DGFs are supposed to do well when equity markets are falling—they're in fact charging a premium for equities exposure. It would be far more cost effective to invest in equities directly.

Figure 3. Most of the DGFs we analysed were strongly correlated to equity returns.

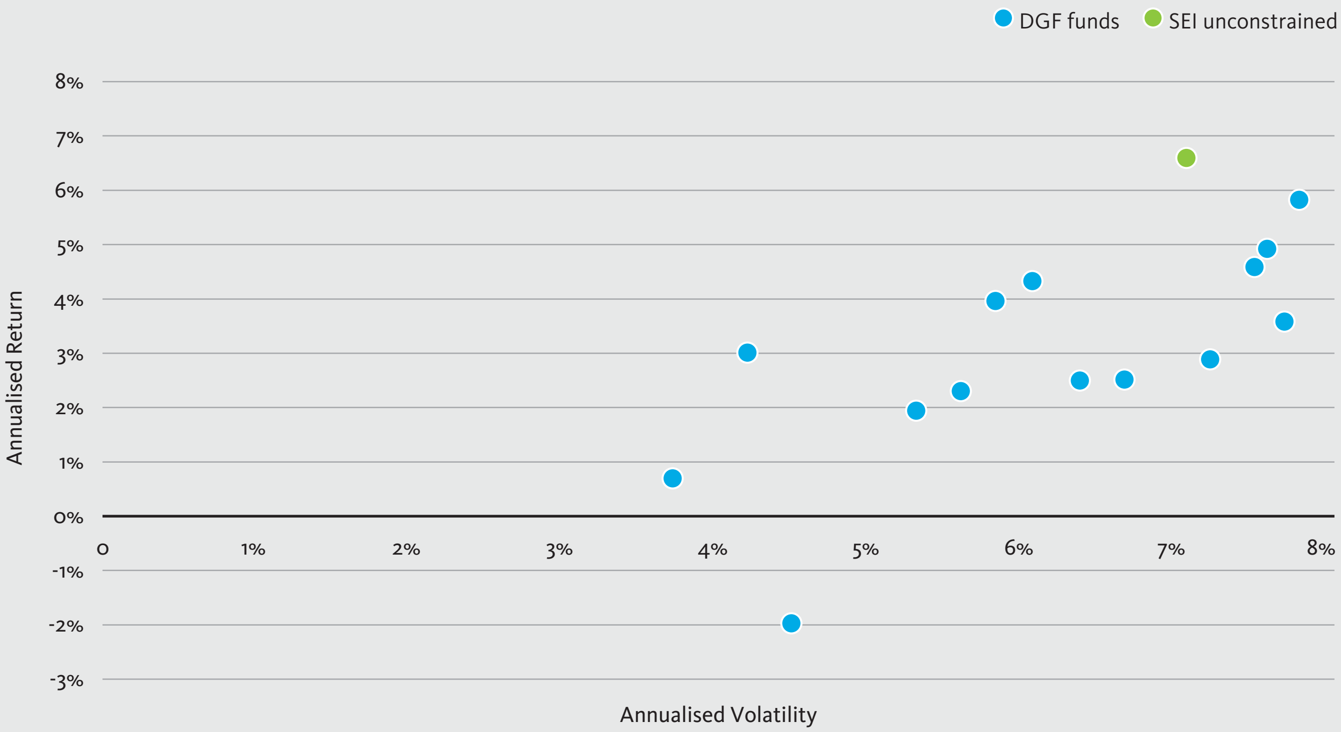


Source: Bloomberg, SEI. From 31 December 2015 – 30 September 2023 (this date range has been chosen to capture as many live DGFs as possible). Equity returns have been calculated using the MSCI World Net GBP Index. DGF performance has been calculated gross of fee. Each dot represents a DGF.

Winners and losers stand a world apart

Figure 4 demonstrates that, over the last eight years, the difference between the best and the worst performing DGFs. A pension scheme investing £50m in a DGF in 2015 could have seen their investment grow to £82m by September 2023 (if they had invested in the best performing strategy) or instead shrink to £43m (if they had been investing in the worst performing strategy).

Figure 4. Annualised returns for individual DGFs (Sept. 2015 – Dec. 2023)



Source: Bloomberg, SEI. Absolute returns are calculated gross of fees, on an annualised basis, from 31 December 2015 – 30 September 2023 (this date range has been chosen to capture as many live DGFs as possible). The 'SEI Unconstrained' model portfolio has been shown for comparative purposes, as the return target is similar. For illustrative purposes only—past performance is no indicator of future success.

Why should DB schemes consider fiduciary management?

Success is sometimes just a case of being in the right place at the right time. Several DGFs rose to fame as investors grappled with the equity bear markets that characterised the early 2000s. Like all products that are a runaway success, these funds capitalised on a problem and positioned themselves as the solution.

The fact that some darling DGFs have petered out suggests, amongst other things, that the investment landscape has changed. DGFs are no longer seen as the panacea to all investor woes—and for DB schemes, there are arguably better options available.

In this context, we believe fiduciary management is well worth considering. Rather than taking a 'one-size-fits-all' approach—the only approach available to a DGF—a fiduciary manager can build a bespoke investment portfolio that answers to a scheme's specific needs. This is perhaps the most important difference of all. With fiduciary management, a scheme is not investing in a fund, it is investing in a partnership.

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Discover SEI®.

SEI delivers technology and investment solutions that connect the financial services industry. With capabilities across investment processing, operations, and asset management, SEI works with corporations, financial institutions and professionals, and ultra-high-net-worth families to solve problems, manage change, and help protect assets—for growth today and in the future.

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