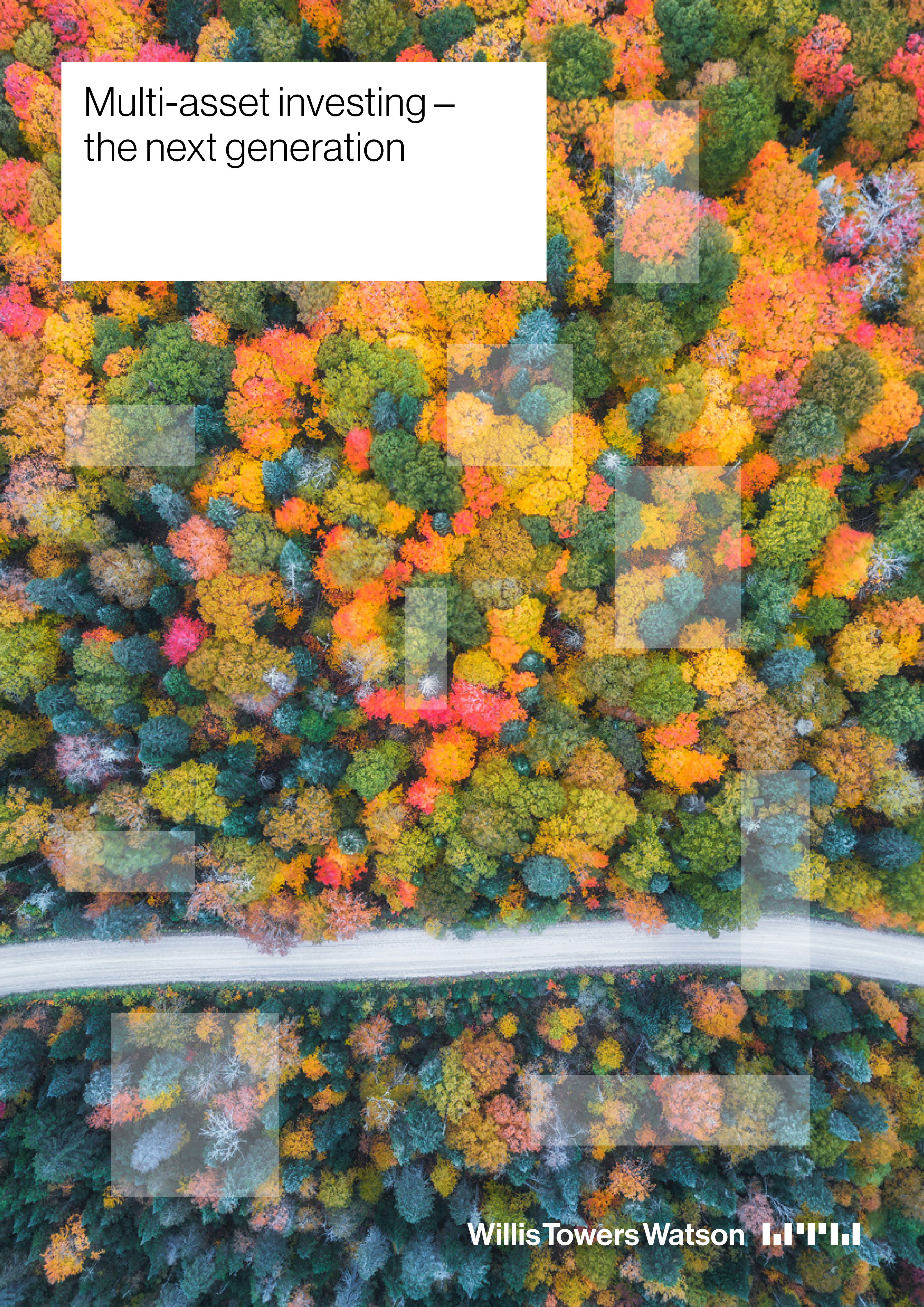
# Multi-asset investing – the next generation



Willis Towers Watson

# Multi-asset investing – the next generation

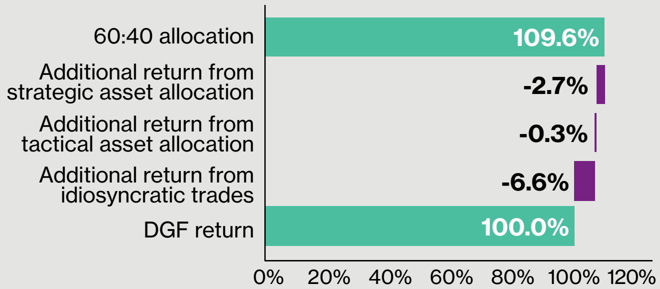
## Introduction

In our 2016 paper *Diversified Growth Fund investing: Is there a better way,* we highlighted that the Diversified Growth Fund (DGF) market was becoming saturated and wasn't delivering versus expectations. We urged investors to investigate a better way. At a time of high popularity for DGFs, our paper and its suggestions attracted mixed reviews.

Fast forward to 2019 and the conclusions from our 2016 paper remain valid, indeed the results of the updated analysis look worse. While some clear exceptions exist in this market, the average DGF is trailing performance expectations and failing to add value. Also, in the vast majority of DGF portfolios we continue to observe low levels of portfolio breadth and thus limited scope to outperform a 60:40 equity:bond portfolio going forward. And while Willis Towers Watson is now far from alone in outlining the challenges facing DGFs, we believe the case for change is stronger.

*While there are some clear advantages to DGFs and they remain a key building block in portfolio construction for certain types of asset owners, we believe the majority of investors should review their perspective on multi-asset investing.*

Figure 1. **Deconstructing the mean gross DGF return streams**




Source: DGF Manager Universe Analysis (see Notes).
**Past performance is not a reliable indicator of future performance.**

## Should we have expected anything else from DGFs?

DGFs started gaining prominence in the early to mid-2000s evolving from traditional "balanced" equity:bond funds.

DGFs invest across a range of asset classes, with the typical goal of achieving equity-like returns with lower volatility, over the medium to long term. Managers typically have broad discretion, with the flexibility to implement through a combination of passive, active, internal and external manager funds, while overlaying asset class views directly.

In *Figure 1* we have updated the results of our 2016 analysis. This shows that the average DGF has not managed to outperform a simple 60:40 equity:bond portfolio over almost a 10 year period, even on a gross-of-fees basis. Meanwhile, the fees charged for DGFs are typically much higher than that of a 60:40 fund (the average standard fee for a DGF is 0.62%[1]). Although this time period has been marked by rather unusual equity and bond bull markets, we view these results from DGFs as disappointing. Our analysis suggests that approximately 70% of leading UK multi-asset funds have failed to meet their return target.[2]

Unfortunately, this disappointment in DGF outcomes extends even to the risk dimension. The average DGF has achieved no lower volatility than a simple portfolio comprised of 60% equity, 40% bonds (see Notes).

While the DGF market segment is by no means unique among active investment strategies in its average underperformance, we believe that as a category it could do much better targeting a **wider breadth of opportunity set** and exploiting **greater specialism in security selection** in order to address the mediocre returns achieved historically.

We will address these potential sources of return throughout this paper.

[1] This sample includes all managers classified as a Diversified Growth Fund on eVestment as at Dec 31 2018 which provide gross and net returns.

[2] This sample includes all managers classified as a Diversified Growth Fund on eVestment denominated in GBP with a 5 year track record and AuM larger than £1bn.

## DGF investing: the challenges:

***Constrained opportunity set***

During a recent survey of the manager universe, the average DGF had around 17.5% invested in alternative asset classes.[3,4] We view this as low in the context of the return and risk goals of an average DGF and the discretion afforded.

The allocation to alternatives can be viewed as a crude bellwether for the degree of diversity and stock selection return potential in a DGF; the scope for differentiated insights is greater in less efficient and less followed "alternative" strategies. Furthermore, our analysis reveals that a larger allocation to alternatives within DGFs is typically indicative of higher long-term returns.

In practice, it can be difficult to implement a larger allocation in the DGF market given how current product design typically seeks to comply with (some) regulatory restrictions. The low allocation to alternatives is heavily influenced by regulatory constraints imposed on liquidity and fee requirements for certain client types. Given the popularity of DGFs in defined contribution (DC) pension schemes, unit-linked life funds[5] are a common vehicle for them. In the UK, this vehicle structure is governed by the FCA's Permitted Links rules[6] which cover capital limits on relatively illiquid strategies. Current discussions around the relaxation of these rules are encouraging, as an ease of these constraints could effectively broaden the opportunity set available to long term asset owners who may be sacrificing the illiquidity premium, and therefore additional return.[7]

Additionally, in the UK fee sensitivity arising from the imposition of the charge cap in the default investment of a DC scheme can incentivise managers to constrain themselves to a cheaper opportunity set. Managers will typically exclude more expensive and illiquid alternative assets, which could improve investment outcomes if introduced. The regulatory focus on value for members can also be misconstrued to be a preference for cheap solutions as fees are easier to assess and control versus future net returns.

*For those investors that don't face such constraints, we believe the time is ripe to exploit a broader universe of investments. There are some approaches that have been doing this successfully by investing in both public and private markets.*

***Limited use of specialist skill***

We have also found that DGFs are not exploiting the permitted discretion to exploit specialist skill across different asset classes and the associated diversification benefits of different investment styles. In our analysis, only 26% of DGF managers had allocated to externally managed investments (what we refer to as the "open architecture"[8] approach ) and of those, the average allocation size was only 11%.[9]

*A typical DGF manager will be reluctant to allocate to other managers to achieve a more diversified outcome as this will likely lower their product revenue; paying fees to a third-party manager typically means less fees to the DGF manager.*

Asset managers are also likely to have a bias to their own opportunity set versus another. This is partially a result of self-confidence bias (where portfolio managers place a higher weight on their own remit versus peers), and availability bias (where portfolio managers assign a greater value to areas where they have more information). We also believe that identifying skilled asset managers requires a different skill and knowledge to that of identifying attractive assets. Most traditional DGF managers are experienced and well-resourced in the latter, but not the former.

[3] Source: DGF Manager Universe Analysis (see Notes).

[4] Total allocation to the following alternative asset classes: high yield bonds, loans, ABS, listed property, unlisted property, infrastructure, commodities, alternative betas, hedge fund strategies (including relative value).

[5] This vehicle structure is used by UK DC platforms.

[6] https://www.handbook.fca.org.uk/handbook/COBS/21.pdf

[7] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/776181/consultation-investment-innovation-and-future-consolidation.pdf

[8] "Open architecture" is the concept of a system or structure built and maintained without constraints, selecting amongst all the available components.

[9] Analysis is based on 21 responses from a Willis Towers Watson survey as at Q218.

*Ineffective security selection*

In our experience, it is atypical for one asset manager to have high quality security selection skill across a broad range of asset classes. Even for those larger asset managers providing investment management services across the entire spectrum, it is unlikely that all teams within the business are highly skilled. We note that many niche strategies demand different skill sets and different cultures to be highly effective – housed within a larger business, greater bureaucracy and operational requirements may limit these opportunities. For example, the skills required for identifying opportunities in public and private markets are often different, with a greater emphasis required to effectively source the best private assets.

In summary, there are certainly advantages to the traditional DGF model, notably simplicity, easy portfolio oversight and the avoidance of any double layer of fees associated with hiring third-party specialists for part of the portfolio.

*There are skilled DGF managers and this still represents a valid implementation option for some investors. However, we believe that compromised security selection, limited use of specialist skill and a constrained opportunity set outweigh the benefits typically cited for DGFs.*

## A different approach?

What should investors look for in a multi-asset solution? The delivery of attractive risk-adjusted returns through genuine diversity including **a broad opportunity set, specialist skill** and **high quality security selection**. This may require a change in approach in order to achieve greater access to alternative asset classes and the illiquidity risk premia. We encourage investors to rethink how they invest in DGFs, looking for those strategies that embrace an open architecture mentality.

In the context of DGF investing, an open architecture approach is unbiased in its access and use of internal and/or external specialised asset managers, thoughtfully combined to create a well-diversified portfolio. It is better placed to exploit a full range of asset classes, including those with an embedded illiquidity premium, providing a valuable source of additional returns. This approach requires fund vehicles that are not constrained by daily liquidity, avoiding a mis-alignment of the liquidity of assets, client redemption terms and the associated risks.

An open architecture approach is agnostic to the source of the manager skill, with a simple goal of exploiting the very best investment returns and no dis-incentives around allocating to specialists and more costly-to-access areas. A particular attraction is the scope for accessing those niche opportunities that offer outsized return potential through security selection, typically priced out of traditional DGFs due to tight cost constraints.

## Conclusions:

The average traditional DGF has failed to deliver against performance objectives. And while there are clearly some skilled managers in this segment, we believe this is increasingly **a structural design issue of failing to provide the desired breadth, access specialist skill and achieve effective security selection** across the board, which is minimising the probability of success for an average traditionally designed DGF. Furthermore, with the active risk taking often dominated by the tactical asset allocation views of the (single) manager, we believe investors should be mindful of concentration when seeking to invest a significant proportion of growth assets in one or two DGFs.

**We call on investors to rethink the role of DGFs in their portfolio**. Particularly where less constrained by any over-arching regulatory requirements around liquidity, we believe there is scope for improvement in the approach to multi-asset investing. **One possible solution is the adoption of an open architecture approach and mentality**. Embracing open architecture provides access to greater breadth, unfettered access to specialist skill, greater diversity of active management styles and more effective security selection, although clearly this requires the successful appointment of skilled active managers. We believe a revised approach should help to increase the probability of better outcomes.

## Further information

For more information please contact your Willis Towers Watson contact or:

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**Notes**

Unless specified differently, all analysis uses the performance of a wide range of managers, from Q1 2009 to Q3 2018. We were limited to this period as the track records of many of the products began post-2008 when most DGFs were launched. We highlight therefore that the results of the quantitative analysis could be sensitive to experience given the limited data. Given the demands of the analysis, we were limited to funds that had a track record of greater than 18 months and that provided historical asset allocation data and gross returns in eVestment.

Past performance is not a reliable indicator of future performance. Data is presented in GBP.

The 60:40 fund allocation is a static portfolio of 60% MSCI World (GBP hedged) and 40% Bloomberg Barclays Global Aggregate Index. Over the calculation period, the standard deviation of the 60:40 portfolio is 7.68%. The volatility of the average DGF is 7.92% over this same period. The standard deviations of the 60:40 portfolio and the average DGF aren't statistically different (F-test value of 225), implying that this analysis doesn't need to be risk adjusted.

Sources: MSCI, FTSE, DGF Manager Universe, Bloomberg Barclays, Hedge Fund Research, S&P, Office for National Statistics, Bank of America Merrill Lynch, eVestment.

## About Willis Towers Watson

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