Investments

Achieving better returns through true diversification

Our approach to delivering you a diversified growth fund

Achieving better returns through true diversification

Often diversification is judged through the lens of investing in different asset classes. Portfolios invested across equities, bonds and property appear well diversified. However, in stressed market conditions we often see that these asset classes sell off all at the same time, because they are all linked to economic activity.

We believe diversification is best achieved when considered through multiple lenses, such as:

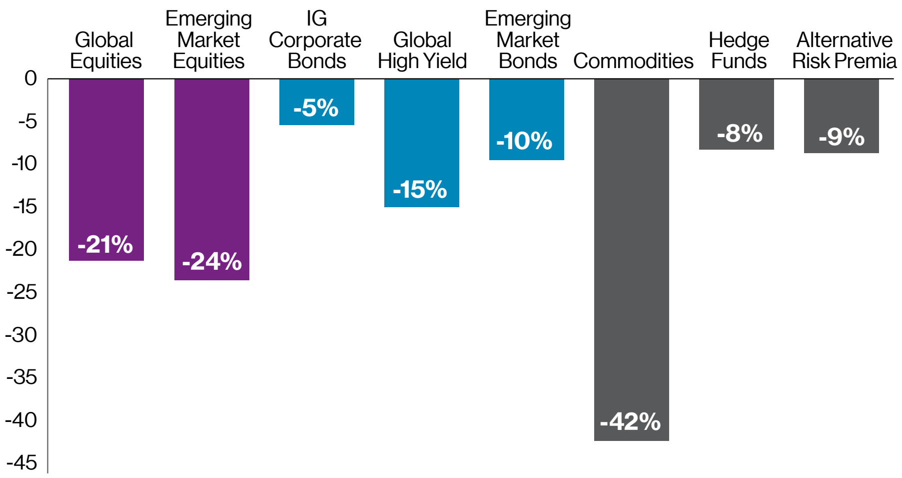
- Diversifying exposure away from corporate balance sheets to consumers and governments.
- Accessing more diversified sources of return such as illiquidity, skill and insurance alongside the more traditional equity and credit ones.
- Implementing through specialist managers that have deep expertise in their fields and are able to react nimbly to changing market conditions.

A sign of a truly well diversified portfolio is when each element is delivering returns at different times. *Figure 2* shows the returns of our 'best ideas' return seeking portfolio. You can see that in almost every year, the biggest contributor to returns has come from a different area.

For example, over the last ten years our diversifying strategies layer, which is predominantly exposed to hedge funds and similar strategies, has delivered returns far below equity and credit markets. We have from time to time been challenged by our clients as to why we continue to hold exposure to those types of investments.

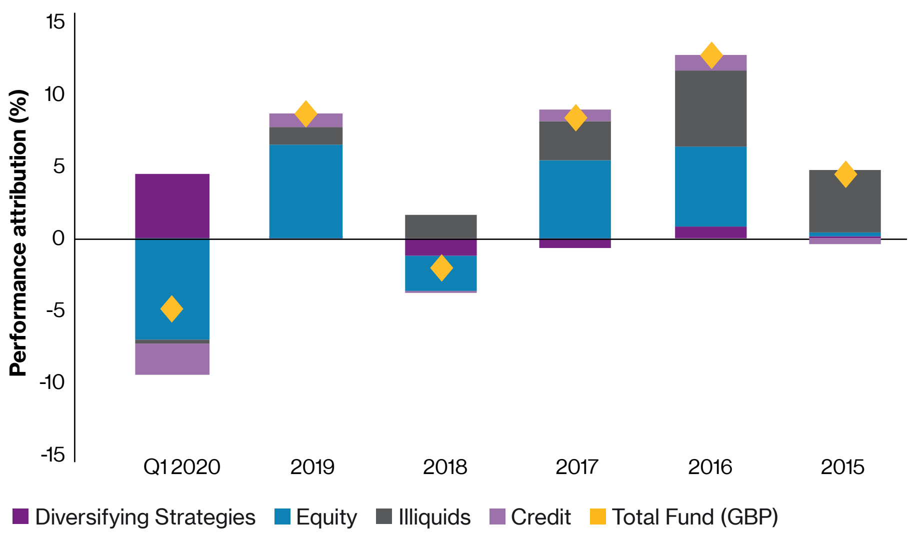
However, in Q1 2020 diversifying strategies really came into their own, delivering a return of 17%, which helped to provide a very resilient outcome for the portfolio as a whole.

Figure 1: **Q1 2020 performance for various asset classes**



Past performance is not a reliable indicator of future returns.
For detailed notes please see page 6.

Figure 2: **Performance attribution for our 'best ideas' return seeking portfolio**



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Is diversification still important?

As people come to terms with the impact that recent market volatility has had on their portfolios it is tempting to think that the case for diversification has diminished. However, it is worth noting that the S&P 500 is back at the level it was just 5 months ago and there is still a significant amount of economic uncertainty ahead of us.

In simplistic terms there are three broad plausible economic scenarios from here, which help us understand the range of possible impacts of COVID-19 on economic, business and financial market conditions in 2020/21. These are:

1. A global economic recovery in Q3.
2. An extended global recession.
3. A wide-scale credit squeeze and defaults.

Unless you put 100% probability on the first scenario (and believe that this will lead to a very sharp V-shaped recovery that has not been seen in other such bear markets) and 0% probably on the second two scenarios, it makes sense to increase diversity from here.

Indeed, it is worth remembering that a diversified portfolio would also likely do well in the first scenario, and it may well be asset classes outside of equities that do the best.

Does volatility matter?

Managing volatility, whilst still generating returns is an increasingly important objective for funds.

- **Firstly**, volatility does matter. Many funds are regularly selling assets to meet benefit outgoings and avoiding having to crystallise significant losses is highly desirable.
- **Secondly**, it's one less thing for trustees to have to worry about; this latest crisis is not just a financial one and we are all having to deal with many challenges, both personal and professional. Many funds will be focussed on making sure their administration systems and processes still work and understanding the impact of COVID-19 on their sponsor. Having a resilient investment portfolio helps them to focus on these important issues.
- **Thirdly**, having strong downside protection really changes the way the trustee boards and fund managers approach decision making. If you have experienced a 15% fall in your assets, there's a danger that you would feel the pressure to re-risk significantly or make big tactical calls to try to recover lost ground. By protecting capital much more effectively it allows you to take a more measured approach to decision making and gives you the ability to take advantage of opportunities to buy assets that look cheap.

> **Diversity is key. With so much uncertainty, nobody can be confident about return forecasts for any asset class. Heightened volatility means path dependency (the pattern of returns) is as important as long-term average expected returns, so risk reduction is key for all investors, particularly cash-flow negative ones.**
>
> Craig Baker, Global CIO, Willis Towers Watson

Have DGFs delivered what was promised?

Many funds use DGFs as a way to access a diversified portfolio. Splitting the DGF universe broadly into two helps make sense of recent market performance.

The yellow bars show the “absolute return” style of DGFs that hold very little market exposure, instead preferring relative value opportunities, similar to the hedge fund industry. These types of funds have been resilient over Q1, perhaps unsurprisingly. The more traditional DGFs that have more market directional exposure across equity, fixed income and real estate markets have suffered falls of between one half to two thirds of equity market sell offs, again this is not surprising as many of the markets in which they invest have sold off at the same time.

Figure 3: **Diversified Growth Funds Universe Q1 2020 performance**

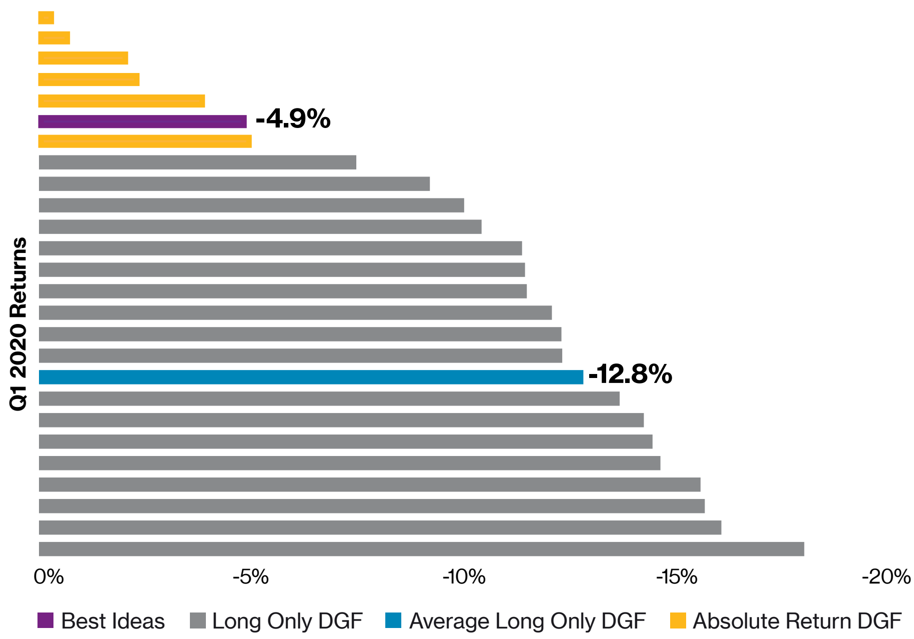

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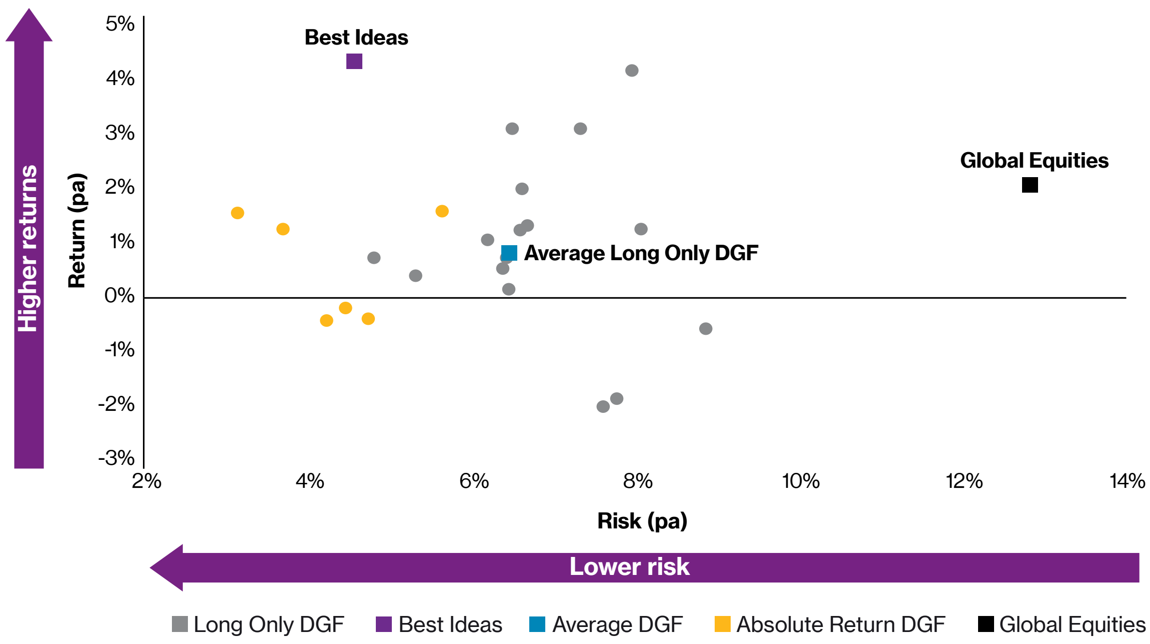
Figure 4: **Delivering superior risk-adjusted returns vs peer group – 5 year risk and returns to end March 2020**



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Taking a longer-term view however, we can see that those same absolute return DGFs, whilst delivering low risk, have delivered poor returns over the last 5 years. Despite their resilience over Q1, these funds have struggled to deliver significant upside when equity markets have rallied over the last few years. The converse is true of the long-only DGF managers, many of them delivered decent returns over the last few years, participating in some of the equity market rally, only to have those outcomes wiped out by their results in Q1.

Our best ideas portfolio, which exploits a much broader opportunity set than the DGF market has delivered resilient returns in the face of both market turbulence and rallies.

These results are not that surprising, in our paper "Multi-asset growth investing: the next generation" we noted some structural disadvantages with DGFs that we believe challenge their ability to generate the outcomes investors expect. These are:

- **A constrained opportunity set:** most DGFs offer daily liquidity, thereby limiting the amount of proper diversity they can achieve in their portfolios.
- **Limited use of specialist skill:** most DGF managers use their in-house capabilities, which further restricts the opportunity set and doesn't make use of as broad a range of skills as could be possible.
- **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. The long-term results have shown that most DGF managers have detracted value through this activity.

A different approach?

What should you 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.

Notes

Figure 1:
Notes: MSCI ACWI = Global Equities, MSCI Emerging Markets = Emerging Market Equities, Bloomberg Barclays Global Aggregate Corporate Index = IG Corporate Bonds, Bloomberg Barclays Global High Yield Index = Global High Yield, Bloomberg Barclays Index EM Hard Currency = Emerging Market Bonds, Standard & Poors Goldman Sachs Commodity Index = Commodities, HFRI Fund Weighted Index = Hedge Funds, HFRI Asset Managers Risk Premia Index = Alternative Risk PremiaData as at March 2020

Figure 2
Notes: Performance data sourced from BNY Mellon Fund Services (Ireland) Limited, 31 March 2020.
'Best ideas' return seeking portfolio refers to the Towers Watson Partners Fund. The Towers Watson Partners Fund (an Irish Qualifying Investor Alternative Investments Fund) was created by way of a Scheme of Amalgamation with the Towers Watson Partners LP (a Limited Partnership) on 1 January 2015. Performance shown is for GBP A Shares of the Towers Watson Partners Fund, net of an annual management charge of 0.5% pa and performance related fees for an investor in the GBP A Shares; sourced from BNY Mellon Fund Services (Ireland) Limited, 31 March 2020. Individual client performance will vary depending on when they invested and the level of their high-water mark.

Figure 3:
Source: eVestment, MSCI and Willis Towers Watson, 31 March 2020. Performance is in GBP. Accurate as of 27 April 2020. Performance is shown for GBP A Shares of the Towers Watson Partners Fund, net of fees. Sourced from BNY Mellon Fund Services (Ireland) Limited. The external Diversified Growth Funds are included if they are part of the eVestment Diversified Growth Fund universe, have more than 3 years of performance available (in GBP) and have assets more than £1 billion.

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Source: eVestment, MSCI and Willis Towers Watson, 31 March 2020. Performance is in GBP. Accurate as of 27 April 2020. Performance is shown for GBP A Shares of the Towers Watson Partners Fund, net of fees. Sourced from BNY Mellon Fund Services (Ireland) Limited. The external Diversified Growth Funds are included if they are part of the eVestment Diversified Growth Fund universe, have more than 3 years of performance available (in GBP) and have assets more than £1 billion.

For more information

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