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Diversified growth funds – are they the complete DC solution?

Tim Banks of AllianceBernstein considers the role of diversified growth funds in DC strategies

We sense a change in market thinking about defined contribution (DC) investment design. The introduction of diversified growth funds (DGFs) is encouraging trustees and plan sponsors to embrace default approaches, rather than alternatives where the success of the plan depends on fostering member understanding and engagement.

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Are DGFs really the best solution for DC, or can we do better?

A relatively recent innovation, DGFs are multi-asset funds encompassing a broad selection of approaches. They typically invest in a diversified range of asset classes, looking to generate equity-like returns with lower volatility, often with performance benchmarks linked to inflation. Some DGFs incorporate the expertise of a number of different fund managers and some make use of complex derivative strategies.

These features have encouraged a change in DC plans' default approaches. Over the last few years, many have moved from offering passive global equity funds as the sole component of their default strategy to the more diversified approach that using a DGF can bring.

Certainly, if I put myself in the member's shoes, I would want a fund manager actively managing the asset allocation of my fund. I would want them to be taking account of prevailing market conditions, rather than blindly following a pre-determined strategy. And, indeed, a number of these funds have performed very well through the recent difficult markets.

So are there any drawbacks to DGFs?

We can see that DGFs are a definite improvement on a simple passive-equity strategy. But they also come with problems. The typical DGF is more expensive than a traditional strategy, which can present challenges in a DC world needing to keep fees below 1%.

Then, as the fiduciary, a plan sponsor or trustee using a single DGF can mean them taking on single-manager risk. But the same manager may not always be the best one for all the asset classes used by DGFs.

We believe that DGFs, while a great innovation, are not the whole solution for DC plans. The fund/asset allocation manager may be able to react to the prevailing market environment, but they remain blind to the individual member's risk capacity.

We know that an individual's risk capacity diminishes over time. So how can we combine within the default fund design the best features of a DGF, while taking account of changes in an individual's risk capacity? Happily there is now a way of solving this, and it's called a flexible target date fund, or age-appropriate diversified growth fund.

How does an age-appropriate diversified growth fund work?

To tailor the structure to the individual, we create a range of funds for the default option, with each fund based on the expected retirement date of a group of members of similar age (or 'vintage'). These flexible target date funds are typically created in one, three or five-year vintages.

This approach has considerable advantages. The investment design can be made robust for a wide range of retirement dates. It is not as end-point sensitive as lifestyle strategies, and can therefore seamlessly adapt to people's changing retirement patterns through time (see chart right).

There is still a portfolio/asset allocation manager responsible for the target date fund range, with similar decision making powers to those of a DGF manager. But, because they have more information, they are able to combine the market environment with a view of the member's risk capacity. This allows the asset allocation decisions to be applied appropriately – and often differently – across the range of default funds.

In applying dynamic management to the range, the manager can choose how to apply the tactical overlay. Are they looking to add return or manage risk? For our part, we believe that dampening volatility without harming returns is an attractive feature.

In our view, it's better if the choice of underlying components for the target date funds can be made from the whole of the market. Open architecture solutions lead to greater diversification, taking account of the best investment ideas at any particular time, and remove single manager risk.

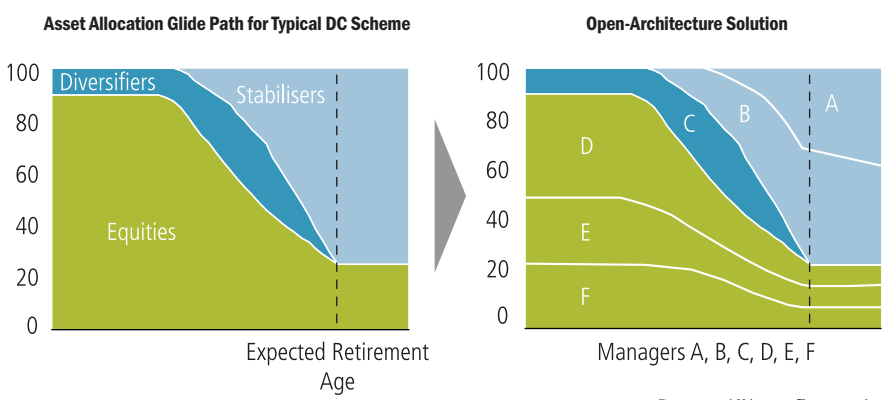
A huge advantage of using this approach is the ability to seamlessly change the default fund range for members at any point. Irrespective of whether the trustees or plan sponsors want to change an individual underlying fund component or the strategic investment 'glidepath', this can be done quickly, at reduced cost, and with no disruption to members.

In conclusion

We believe DGFs have an important role to play in the overall DC strategy, but should not be the whole strategy. Rather, they should be an intelligent component of an approach dynamically managed to assist members in getting better outcomes from their savings.

We see the adoption of diversified growth funds as a natural progression towards age-appropriate DGFs or flexible target date funds for those plans that wish to improve the investment approach, sophistication and governance for members.

Age-appropriate Diversified Growth Fund/Flexible Target Date Fund



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