



**ALLIANCEBERNSTEIN**

# Building Your DGF for the Journey Ahead

Four Ways to Achieve Your Diversified Growth Portfolio's Objectives



- + Too many Diversified Growth Funds (DGFs) have left UK investors disappointed with performance. We believe that lack of clarity about objectives, flawed design and bad luck have all been important factors.
- + In this paper, we show how a DGF can be designed with clear objectives, constructed using guidelines that are genuinely outcome-oriented, and then managed to achieve its objectives.
- + By identifying the key resources and attributes that are vital for success, we aim to help multi-asset investors build their own DGF portfolios or buy off-the-shelf funds.

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## Introduction

DGFs (also known as multi-asset funds) have typically been promoted as a way to achieve equity-like returns with less risk, through diversification and risk management. A second selling point is that they can offer a straightforward way to access a spread of assets and to delegate tactical asset allocation to the asset manager. In the UK, this attractive story has led to the use of DGFs proliferating in both retail and institutional markets. Investors have bought into DGFs for a variety of purposes—for instance, as an equity replacement strategy, as a convenient way to access alternatives, and/or as a mid-life growth vehicle for defined contribution (DC) default solutions.

In fact, the journey for many of these funds has been far from straightforward, and they have been unlucky to face an unusual market environment. Equities have performed better and for longer than normal, and diversification has failed to pay off in the way expected. Overall, DGF returns have been disappointing.

But things could have turned out so differently. With better attention to fundamental design principles by the asset managers, we believe that DGFs should have performed more in line with investors' expectations, and investors themselves could have had better information to guide their choices.

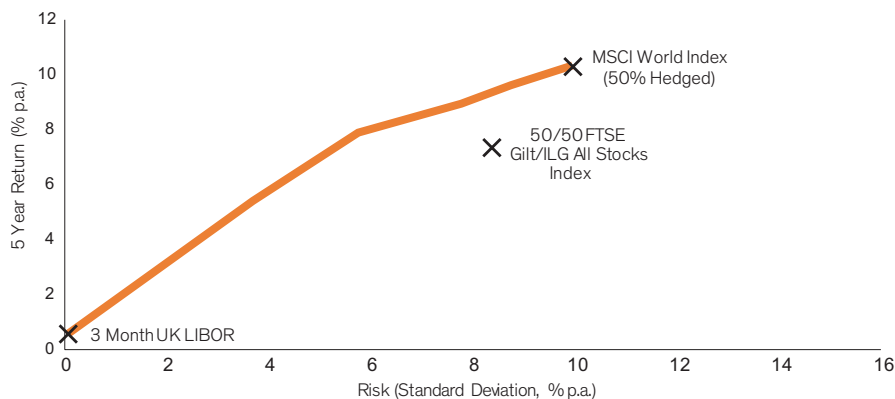
When properly resourced, designed and managed, we believe DGFs can provide attractive, differentiated returns that can't be easily replicated. In this paper, we highlight four ways to build a better DGF for the journey ahead.

## Defining Our Terms

Practical terms and clear comparisons are important for this analysis. We think a good cost-effective DGF should outperform a simple composite of passive market components that investors can buy cheaply. So we use simplified benchmarks comprising an efficient combination of passive equity and bond components to evaluate whether a DGF is really providing value for money (VFM) (Display, below).

## Our Value for Money Framework

AB UK DGF Sample Simplified Benchmark (Five Years to 30 June 2019)



### Historical analyses do not guarantee future results.

As of 30 June 2019. Performance is shown in GBP terms. Data shows the gross returns and standard deviation of the top 20 largest constituents of the eVestment Diversified Growth Fund and GTAA universe, excluding funds with no reported assets, performance for five years, or funds without GBP share classes. The AB simplified benchmark seeks to proxy the level of risk targeted (based on our long-term outlook) for each of our Target-Date Funds (as opposed to the asset allocation) using four widely used market indices.

Source: Bloomberg and AB. Risk is volatility – not how we measure and manage risk, but a simple market definition. Return is annualized five years. Equities 8% p.a. with 9% volatility. Bonds 7% p.a. 8% volatility. Cash 0.5% p.a.

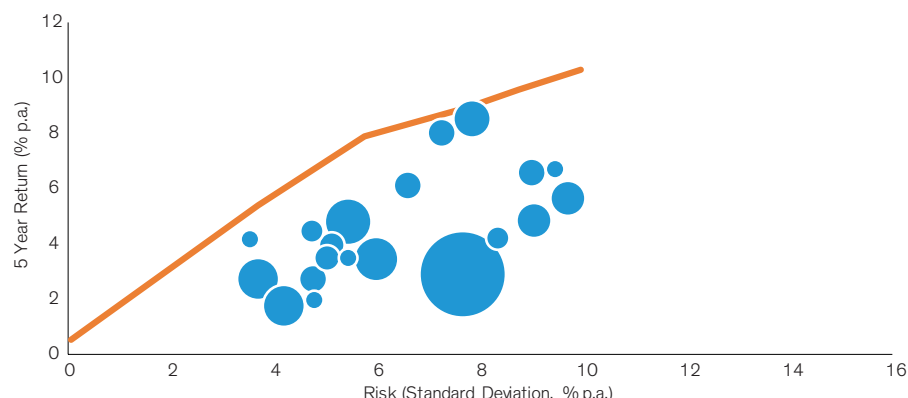
DGFs need to be built for the journey ahead

We start with a simple yardstick to determine value for money performance

By this yardstick, the largest global DGFs available to UK investors have delivered poor value for money over the last five years (Display, below).

## DGFs Have Disappointed

20 Largest Funds in DGF and GTAA UK Universe (Gross of Fees)  
versus AB Simplified Benchmark (Five Years to 30 June 2019)



DGFs' performance has disappointed

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So what were the reasons? We believe four factors explain much of the poor past returns—and point the way to better performance for the future.

## #1 The Investment Objective – Setting a Clear Direction of Travel

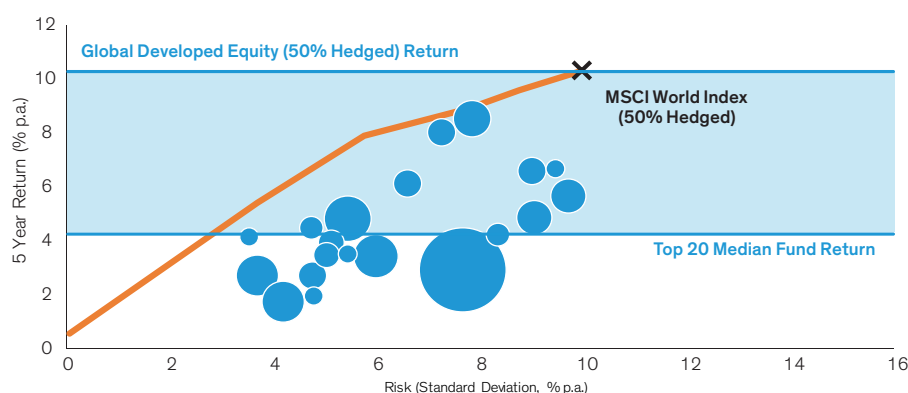
Investment objectives need to be specific, measurable, achievable and aligned with investors' needs over a defined timescale. Against these criteria, many DGFs were designed with poorly stated and misaligned objectives, in our view. Consequently, they were constructed with inappropriate guidelines—and managed with sub-optimal results.

Many DGF managers defined “equity-like returns” as cash + 5% annualized (or some broadly equivalent measure). In the display below, we show the return experience over the last five years for the 20 largest DGFs and Global Tactical Asset Allocation (GTAA) funds in the UK market.

Many DGFs were designed with poorly stated and misaligned objectives

## What Did Equity-Like Returns Mean? Cash +5%?

Equities have Delivered Cash +9%, Versus Cash +3% for Median DGF  
(Five Years to 30 June 2019)



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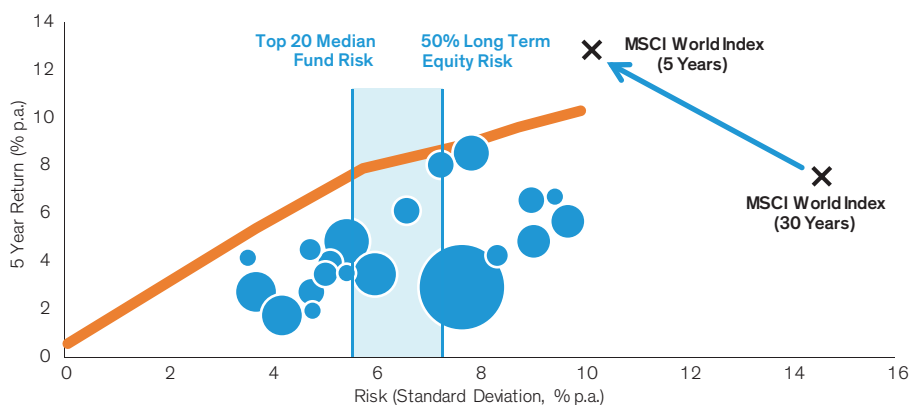
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In fact, over the five years under review, global equities (50% hedged back to GBP) returned the equivalent of cash + 9% annualized, while the average DGF in our sample returned cash + 3%. While the cash + 9% outcome might be qualified as supernormal, that cannot excuse a DGF return that was so clearly below expectations. The DGFs' performance looks even worse in the light of UK gilt returns over this period of cash + 6%. How could things go so wrong? We believe a central feature was lack of clarity about the drivers of risk and return, and about the way these related to the investment objective.

A typical DGF over the last five years aimed to take half to two-thirds equity risk. However, it was seldom clear at the outset whether this risk objective was an ex-ante number based on historical norms, or an ex-post guideline to follow prevailing market risk levels. The cash + 5% definition was typically based on a sample of historic annualized equity returns. Logically, repeating these historical returns into the future should also involve risk-taking related to historical levels. Moreover, investors would normally expect to express their own risk preferences relative to long-term investment characteristics (or to a maximum drawdown percentage). However, DGF asset managers' risk targets appeared to be unanchored from historical experience. Over this five-year period, equity risk levels were very subdued, around two-thirds normal levels (Display, below). At the same time, in this low-risk environment DGF managers chose to pass up the opportunity to increase their equity exposure as absolute risk fell. Instead, they cut back their equity weightings and kept overall portfolio risk levels very low—in fact, so low that they were equivalent to only one-third of long-run equity risk.

### What Did Half Equity Risk Mean?

Equities Have Delivered 67% of "Normal" Equity Risk: DGFs 33%!  
(Five Years to 30 June 2019)



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So one immediate reason for the performance shortfall stands out. DGFs generally were too inflexible to add equity exposure in a market that rose in a very low-risk manner. They also failed to allow for prevailing equity market risk being way below historical norms. As a result, DGFs generally were running with risk levels below those usually necessary to come close to an equity return. In a nutshell, they didn't take enough risk—either in equities, or in their other investments. Unsurprisingly, the DGFs' risk-averse positioning led to sub-par returns.

From a design perspective, the lessons are clear.

Investment objectives should be much more than just an assertion. Rather, asset managers need a robust framework to demonstrate how they will achieve their objectives under different scenarios. In particular:

- + Sources of risk and return need to be clearly defined and set out, with parameters that are directly related to the investment objective
- + The role of each asset class/strategy in achieving target performance needs to be clearly explained
- + Investors need sufficient information to be clear about the route for the journey ahead

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We believe a central feature was lack of clarity about the drivers of risk and return, and about the way these related to the investment objective

Half equity volatility is not = 5%! To match the long-run equity premium, asset managers need to take long-run levels of risk

We believe it is axiomatic that DGF managers should ensure a clear link between the investment objective, expected asset class returns, and proposed asset class weightings. Rigorous risk-monitoring and adherence to clearly stated guidelines should also be central.

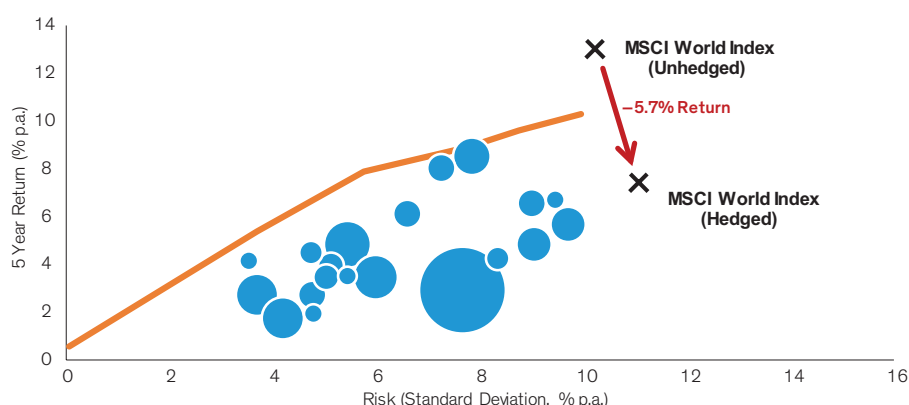
To build a better DGF, asset managers need a wide range of tools to evaluate short- and medium-term asset allocation choices. An effective toolkit of market indicators might include, for instance, option market indicators, credit conditions, realized volatility and momentum signals over different time periods.

## #2 Hedging – Taking the Right Currency Risks for Your Journey

Currency is an important source of risk and potentially return and needs to be carefully managed in line with the investment objective.

### Currency an Important Source of Risk and Potentially Return

Most DGFs Built as “Global” Solutions Fully Hedge Currency Risk: Is This Really Aligned with Investors? (Five Years to 30 June 2019)



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Most UK DGFs bought by UK investors have been designed to be 100% hedged back to the currency of the end investor it was originally intended for – be that US dollars, Pounds Sterling or Euros. Commercially, this approach is easy both to implement and to market uniformly to investors in different countries – with a simple overlay programme making the product easy to transport from one currency to another. And on the face of it, risk reduction through hedging out currency risk appears aligned with investors’ circumstances.

However, this complete hedging approach is almost certainly suboptimal for investors in many countries. Our research demonstrates that the benefits of hedging overseas currency exposure vary according to investors’ domicile. For instance, because the US dollar tends to rise during crisis periods, the value of US investors’ overseas investments in US dollar-terms can be vulnerable to large falls. Consequently, for US investors, the risk of leaving overseas investments unhedged is relatively high – and hence the current policy of many DGFs of full hedging is potentially optimal for US investors. By contrast, the UK pound can be vulnerable to sharp falls during periods of dislocation. So for UK investors, retaining exposure to overseas currency, the US Dollar in particular, can be a highly effective risk management tool. Indeed our research shows that, in a typical DGF, retaining an exposure of 40% of the overall assets to overseas currencies is likely to be optimal for UK-domiciled investors. That is, some hedging needs to take place, but many DGFs contain a fatal design flaw which leads them to inefficiently over-hedge currency risk. By contrast, some low-cost DGFs (in an attempt to keep costs down) are almost equally suboptimal by hedging none of the risk.

Dynamic management of currency exposures can be an important source of returns to support the investment objective

In the five-year period under review, currency fluctuations resulting from the Brexit vote highlighted the importance of this research and the merits of effective currency positioning for UK investors in DGFs. Before the vote, the pound's valuation discounted a remain outcome and reflected close to a zero probability of a leave victory. This valuation asymmetry meant there was no downside to leaving overseas investments unhedged, because a remain vote would not cause the pound to rise. By contrast, a leave vote would—and did—make it plunge. Most DGFs missed out on the potential gains from leaving sterling unhedged at this pivotal time. This was an expensive oversight when their chosen return drivers were not performing strongly and so failing to hit the investment objective.

Interestingly, a similar design flaw can also be shown to exist with the approach a typical DGF takes to bond investing. The failure to build the bond investments around the domicile of the investor leads to a mismatch between the management of the strategy and the potential needs of the investor. Brexit again demonstrated this, with DGFs built for a global audience not picking up the outsized returns that could be earned on Gilts necessary to compensate UK investors for the likelihood of poor long term economic growth in their home market.

This all goes to show that currency hedging—and bond allocations—of DGFs should be constructed to be appropriate to the specific investors' domiciles, circumstances and desired outcomes.

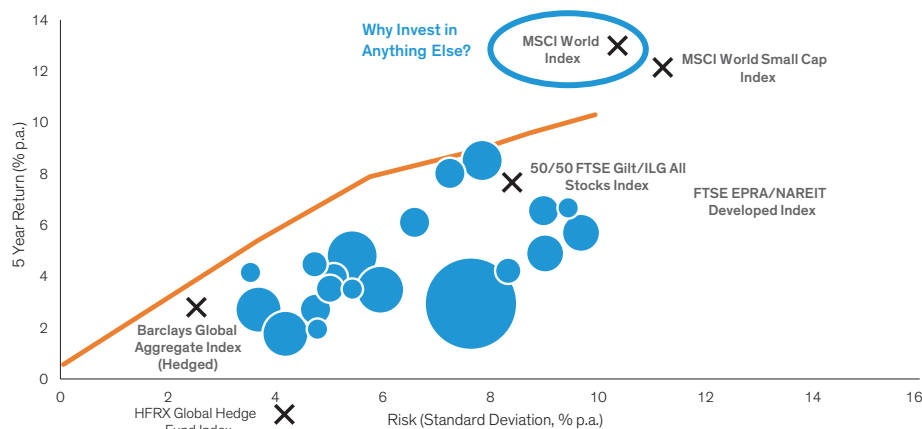
### #3 Diversification – Packing the Right Assets for Your Route

Over our five-year review period equities were the best-performing asset class (Display, below).

This made it a tough time for DGF asset managers, whose task was both to diversify away from equities and still match their returns.

### Diversification Has Not Been a Free Lunch

Diversification in These Markets Has Cost Returns and Potentially Raised Risk  
(Five Years to 30 June 2019)



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Arguably it was bad luck that many DGFs were caught out both by a big downward move in sterling and unexpectedly strong equity performance. Even so, we believe that a clearer focus on the investment objective and the investor domicile would have helped address this problem. As we have seen above, most asset managers incurred an opportunity cost from flawed investment design regarding their currency and bond allocations.

Hedging guidelines for DGFs should be constructed to be appropriate to the specific investors' domiciles, circumstances and desired outcomes

Many asset managers suffered from diversifying into assets that did not support the investment objective and/or were too complex for them to understand

However, poor currency and bond alignment—and bad luck regarding diversification—were not the only areas where DGFs failed. Many DGFs also over-relied on active stock selection and/or complex trading strategies to meet their objectives, and these approaches subsequently failed to deliver. For example the two most common systematic approaches used to make tactical asset allocation decisions, relative value and volatility management, disappointed over the period. Indeed only those managers who were able to recognise the dangers of these models and intervene to mitigate their effects were able to protect their investors from losing money.

Ultimately many DGFs provided, in the eyes of their investors, generally poor after-fees returns over this period. What's more, too few of the investors in these DGFs were really equipped by the DGF manager or their adviser to understand the more complex underlying strategies and the conditions under which they would do well or badly. And in fact many DGF managers terminated these strategies abruptly, even when their performance, while disappointing, sat well within the statistical range that they should have expected given the manner in which the strategies had been designed. This behaviour suggests a lack of understanding of the underlying investment proposition, in our view. Also, in the field of alternative risk premia, DGF asset managers typically were insufficiently resourced to access the full opportunity set, and so experienced a wider range of outcomes than expected.

So whilst a combination of design flaws, market conditions and poor investor understanding may explain much of the recent disenchantment with DGFs, we think that the experience of the last five years highlights a broader concern regarding DGFs. Substantial resources, expertise, skill and experience are required to understand a wide array of investment strategies across multiple asset classes, and to anticipate their interaction over different timescales and investment regimes. We think asset managers and investors with modest in-house resources would likely have done better to stick to a more limited range of strategies and asset classes, implemented passively, rather than add complexity and/or cost in search of benefits that proved elusive.

In our view, the asset managers best placed to really make diversification work in support of the investment objective are those with deep and wide resources, and long experience across multiple markets globally.

#### #4 Transparency – Supporting Better Governance from the Start

Clients need to understand what they are buying, and to be aware of the range of possible outcomes that can result from their choices. We believe there is no substitute for analysing both the drivers of investment return and the opportunities and risks these open up for a client's portfolio. By considering these drivers, clients are better equipped to make appropriate choices and to specify custom DGF solutions appropriately if they need them.

We think a matrix decision framework (Display below) can help identify key risk and return drivers when evaluating DGFs, and can provide a more complete way of assessing the relevant issues. It creates a basis for discussing the key levers at investors' disposal: beta (both "smart" and "dumb"), asset allocation, timing and stockpicking.


#### A Matrix for Assessing DGF Return Drivers

Managing Investor Expectations

Core Asset Allocation Management	Strategic	Dynamic	Currency
Advanced Risk/Return Management	Leverage	Options Strategies	Integration
Markets Accessed	Developed	Emerging	Private
Asset Classes Utilized	Equities	Bonds	Liquid Alternatives
Stock Selection Approach	Active	Systematic/Factor	Index
Responsible Investment Qualities	Active Engagement	ESG Integration	Screening



The asset managers best placed to make diversification really work in support of the investment objective are those with deep and wide resources, and long experience across multiple markets globally



Clients need to understand what they are buying, and to be aware of the range of possible outcomes that can result from their choices

This type of analysis has major advantages for clients:

- + **Better understanding of key risk and return drivers.** This equips investors to choose the most appropriate strategies for achieving their investment objective. For instance, a client using this matrix would be unlikely to choose a manager using purely a long/short relative value approach to substitute for a large part of their equity allocation.
- + **Improved management of expectations**/reduced probability of making a change at the wrong time/for the wrong reasons
- + **Keener awareness for bespoke portfolios** – does a product provider have the tools to design and manage a solution specifically for the client's individual requirements?

Naturally, this analysis needs to be supplemented by ongoing transparency from the DGF managers into the underlying portfolio holdings and the associated investment thinking. Such transparent reporting further improves clients' understanding and helps set expectations appropriately.

## Conclusions

Despite disappointing performance over the last five years, we think DGFs still offer an attractive and effective solution for investors. But it's important to learn lessons from recent experience that can help guide best practices in constructing a DGF or choosing a provider.

Given the challenges, we think DGF providers with deep resources, a wide skill-set and a repeatable investment process are best positioned to take advantage of the broad flexibility offered by the multi-asset universe.

Investors should also ascertain whether a proposed solution or provider is genuinely focused on the specific outcome that they seek. DGF managers must demonstrate that they manage currency risk and return appropriately for the client's mandate, and that they can harness a diversified mix of assets in a way that supports their investment objective.

Lastly, transparency into the investment process and ongoing insights into how the desired objectives will be achieved are essential components of a DGF that is clearly focused on the client's best interests.



A matrix analysis helps identify drivers of risk and return and results in better choices with fewer mistakes

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