Investment Insight:
Jargon busting the latest ‘hot’ investment strategies

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Panacea or pandemic?

Pension fund trustees are, more than ever, faced with a plethora of investment strategies on offer from asset managers. This mounting number of investment choices has ballooned post the financial crisis. During times of market distress, accepted wisdom is often questioned which can lead to innovation and an acceptance that new tools are needed. Coupled with this, a number of investment themes have gained traction in the last few years, notably capital preservation, greater emphasis on liability matching and the need for more diversification.

From the perspective of pension fund trustees faced with low government bond yields, worsening pension deficits and the prospect of lacklustre future investment returns, there is also a growing need to bring down the cost of running pension schemes. This environment has led to the development of new strategies to meet investor needs. In this research piece, I have outlined the key characteristics of a few of the latest ‘hot’ strategies: smart beta, diversified growth funds (DGFs) and absolute return funds.

But before we begin, a health warning: these strategies can vary hugely in their objectives and make-up, so a detailed understanding of each particular strategy is needed before investing.

1. Smart beta/alternative-weighted indices

One of the many consequences of the financial crisis of 2007-2009 was the growing belief amongst investors that traditional market capitalised-based indices had not served the end investor very well. Some believe that cap-weighted indices (such as FTSE100, MSCI) encourage asset bubbles and lead to an over-concentration of risk; a fund manager tracking an equity index is forced to buy more and more of the equity that is going up as it becomes a larger part of the index. In the world of fixed income, this effect is even clearer as traditional market cap indices weight indebted borrowers more heavily thereby forcing passive managers to buy more bonds when a government or corporate entity becomes more indebted. So, for example, if Italy needs to borrow more in the bond market then it issues more bonds, Italy's weighting in the market cap sovereign index goes up, thereby forcing a passive manager to buy more Italian bonds to match the new index weighting.

Investors were also understandably shaken by the volatility of returns during the financial crisis. This led to the increase use of passive management aimed at reducing the level of portfolio risk in order to achieve more control over investment performance and to bring down the costs. Smart beta one could argue is an extension of passive management as the asset manager passively manages the portfolio against a chosen index that is not cap weighted.

Alpha? Beta? What's Smart about it?

Smart beta is an elusive term. Sometimes called alternative beta, smart beta lacks a strict definition.

In a nutshell, if alpha strategies aim to outperform markets through active management and beta strategies aim to deliver returns based on an index…. then a smart beta strategy is a passive strategy that adopts a non-market cap-weighted index that is expected to outperform the cap-weighted index.

So smart beta is passive investing using a non-conventional index or benchmark.

What are these non-conventional or alternative indices and what about cost?

Among the best known and most widely used smart beta indices in equities are: low volatility, equal weighted, low correlation and indices based on fundamentals (eg book value or dividends). In the fixed income space, alternative weighted indices include indices that are based on the fiscal strength of a country or on its Gross Domestic Product (GDP). In terms of cost, smart beta strategies are generally more expensive than traditional passively managed funds but less expensive than actively managed funds.

Does it have legs?

The Economist[1] recently noted that £88 bn of assets are currently invested in smart beta funds and this number is growing quickly. Among the NAPF's membership, there is a movement towards adopting a more thematic approach such as that embodied in smart beta. The overriding driver of pension funds' investment decisions, however, remains the need to squeeze as much return from the pension assets as possible for the least amount of cost. Beyond the UK, investors in Holland and in Benelux in general are increasingly adopting smart beta.

Smart beta is passive investing whilst tilting the portfolio towards a theme such as low volatility. The proof of the pudding therefore is down to the 'smart' choice of the theme or the alternative index and how well the 'smart' manager performs against this. The manager still needs to be given risk control parameters regarding how the mandate is run and the choice of strategy/alternative benchmark has to suit the scheme's overall investment objective.

2. Diversified Growth Funds (DGFs)

There are many different 'flavours' of DGFs but, in general, a DGF is an active fund run by one asset manager that invests in a wide variety of asset classes. DGFs typically target equity-like returns but with lower volatility than an actively managed equity fund. The benchmark or target return is based on achieving a positive return of x% amount over, for example, inflation or the base rate.

Tasked with achieving equity-like returns but with lower volatility, the DGF manager is expected to bring together a 'best of breed' portfolio of assets and use his/her skill to switch between assets to maximise returns. In an ideal world a DGF fund aims to take advantage of sweet spots for different asset classes during the course of an economic cycle (for example, overweighting equities as the economy picks up).

The assets held in a DGF portfolio can range from equities and bonds to currencies, property and commodities. This brings with it the benefits of diversification.

Are DGFs that new?

Some commentators have suggested that DGFs are simply a rehash of the balanced funds of old. Balanced funds were run by one manager, invested across a range of assets, but were generally benchmarked against a peer group benchmark (such as Lipper) and bundled into a relatively cheap product.

Balanced funds are similar to DGFs in certain respects but a key difference is that DGFs have a more direct link to the pension fund's objectives and liabilities. Balanced funds were benchmarked to the peer group. However, many have since argued that comparing investment returns to those of other asset managers has little to do with meeting the scheme's objectives.

As a result of growing pension fund deficits and greater regulatory scrutiny, short term valuations have become increasingly important. The Minimum Funding Requirement (MFR), FRS17, IAS19 and measures introduced by The Pensions Regulator (TPR) have led to greater scrutiny and the need for deficit recovery plans. Scheme-specific asset allocation that takes into account the fund's liability profile and investment objectives have become de rigueur. A key consideration for pension schemes today is how much risk to hold in order to avoid short-term shocks whilst at the same time achieving long-term investment returns.

What are the pros and cons?

Pros

- A single asset manager can be more nimble and easier to monitor than having multiple managers managing different assets
- The target return is more aligned to the pension fund's funding target
- Greater access to a range of assets provides diversification benefits not usually available to smaller schemes in particular

Cons

- Reliance on one manager to get it right
- May be more costly than conventional active mandates as premium charged for manager skill
- Scheme's overall level of volatility depends on what else is happening in the fund

1 The Economist, The rise of smart beta, July 6, 2013.

What have we seen?

Our DC and DB members are increasingly using DGFs to manage their investments. For DB funds, they are often used in conjunction with Liability Driven Investments (LDI). In DC, DGFs are regularly deployed as the default fund, as they provide members with exposure to a broad range of assets within a single fund. DC scheme members can also benefit from the stock selection and asset allocation decisions outsourced to experienced fund managers.

3. Absolute Return Funds

Absolute return encompasses any investment strategy which aims to achieve a given level of long-term positive return. Often absolute return funds will have a cash plus return target rather than a return linked to a specific benchmark or inflation measure. **Ultimately, absolute return funds aim to deliver positive returns over the long-term, regardless of prevailing market conditions.**

What, a free lunch?

Absolute return funds have grown in popularity following the EU's UCITS 3 Directive, which came into force in 2004. This Directive enabled the wider use of derivatives in a highly regulated manner. **The key objective of an absolute return fund is to preserve capital when markets are going down. A key feature of these funds is the use of derivatives to short (sell or go underweight) an asset that is expected to fall in price and have exposure (long position) in assets that are likely to go up in price.**

Absolute return funds can be invested in equity, fixed income or multi-asset. Equity strategies typically involve taking long (ie buying) exposure to equities that are likely to go up in price and taking a short (ie selling derivatives) exposure to equities that are likely to go down in price (and making money out of the equity price going down!). Similar strategies are employed in fixed income absolute return funds using fixed income derivatives to buy and sell bonds. In multi-asset absolute return strategies the key aim would be to combine a number of asset classes that are poorly correlated (assets whose prices do not move together) with the aim of generating an overall absolute positive return. Generally speaking, absolute return funds have a low correlation to other funds, which can improve the diversification within a scheme's overall portfolio.

Another feature of absolute return funds is the existence of performance-related fees. Some absolute return funds charge a performance fee on top of the annual management fee.

Then there is the question of complexity. NAPF members are increasingly using derivatives within portfolios where allowed, but some of the jargon employed by absolute return fund managers can discourage investors. We often hear the comment from our members "If we can't explain what a strategy is to our members then we won't have it in the portfolio".

Conclusion

We welcome the high level of innovation aimed at providing suitable solutions to the evolving needs of pension schemes. A number of strategies based on diversification, capital preservation and the need for maximising investment returns resonate strongly with our members' needs. However, there are no free lunches and strategies do not always deliver what is written on the tin. Each strategy has to be considered carefully in terms of its suitability and reward-cost profile.

If you have feedback on this edition of Investment Insight, or would like to speak to us about forthcoming editions, please contact our investment specialist: **Helen.Roberts@napf.co.uk**.