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Investment intelligence

DGFs and capital preservation

M&G INVESTMENTS

May 2019

- DGFs remain a vital tool for investors to target both lower volatility and positive returns throughout market cycles
- After two challenging years for performance in much of the sector, many investors are seeking a new approach
- Our strategy is designed with the aim of preserving capital by managing volatility while being positioned to benefit from rising markets

Tristan Hanson, fund manager, M&G Global Target Return Fund

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance

A forward-looking view of correlation

Pension schemes have used diversified growth funds (DGFs) for years for the dual objectives of reducing volatility and generating positive returns in a range of market conditions. However, the past two years have proven challenging. In 2017, many investors who sought low equity beta lost out as stockmarkets rallied; in 2018, they found effective diversification scarce, as US interest rate dynamics and political uncertainty contributed to price declines across 90% of asset classes.

As market conditions change, we increasingly see the assumptions behind many diversification models being challenged. This is arguably to be expected, as simply holding a variety of asset classes or strategies does not guarantee diversification. Correlations between asset classes are not static and historical relationships change, as evidenced in today's equity and bond markets.

Instead, it is essential to take a forward-looking view on correlation. Asset valuations, the nature of near term price action and the prevailing economic regime can all provide information about how much genuine diversification is available today. We believe recognising this provides an advantage over traditional 'set-and-forget' approaches or multi-asset strategies that assume a blend of 'best ideas' will always, on average, deliver positive returns. Equally, it is important for investors to remember that short-term volatility cannot be completely avoided, and it is in fact crucial to beating returns on cash over the long term.

Understanding DGFs

DGFs are often viewed as complex and opaque; however, these are not intrinsic characteristics of such funds. A multi-asset strategy that can demonstrate a fundamental ability to both manage short-term volatility and deliver on long-term objectives, in our view, is an attractive option for pension schemes. We believe DGFs still have a greater ability to perform throughout market cycles than 'en-vogue' alternative strategies, which often sacrifice liquidity or constrain exposure to a single asset.

Nevertheless, the divergent behaviour among DGFs today reiterates the need for investors to gain a detailed understanding of how each is configured. This includes not only return and volatility objectives, but also strategic assumptions about diversification, portfolio construction methods and risk management processes.

In this paper, we outline our perspectives on each in relation to the M&G Global Target Return Fund, our DGF strategy with the strongest emphasis on protecting capital in volatile market conditions.

Diversification

DGFs benefited from strong returns from most major asset classes following the 2008 financial crisis, as an ongoing structural decline in interest rates enabled investors to achieve equity-like returns without the volatility that capital growth normally entails. The implied medium- to long-term direction of travel from today for central bank policies and asset valuations – particularly with low interest rates and bond yields – mean this outcome is unlikely to be repeated.

Investment strategies will therefore need to adapt. It is not always possible to achieve the same levels of diversification in different investment environments, as price changes in assets or asset classes can affect their relationships with others. The M&G Multi Asset team does not believe a multi-asset portfolio is inherently diversified, as this assumption overlooks the changing nature of correlations. The team also believes that, in some circumstances, short-term safety may require an excessive sacrifice of medium-term returns.

As such, we believe a directionally positioned portfolio, based on our assessment of the investment environment and asset valuations, combined with effective risk controls, should mitigate volatility more effectively than a 'blended' collection of best ideas, while also offering greater potential to generate positive returns in a variety of market conditions.

Strategic asset allocation (SAA)

A key factor in generating diversified returns and managing volatility is asset allocation. From an SAA perspective, this involves assessing whether assets are fundamentally over- or undervalued. The team believe that valuation provides information on both implied returns from, and expected correlations between, assets over longer time horizons.

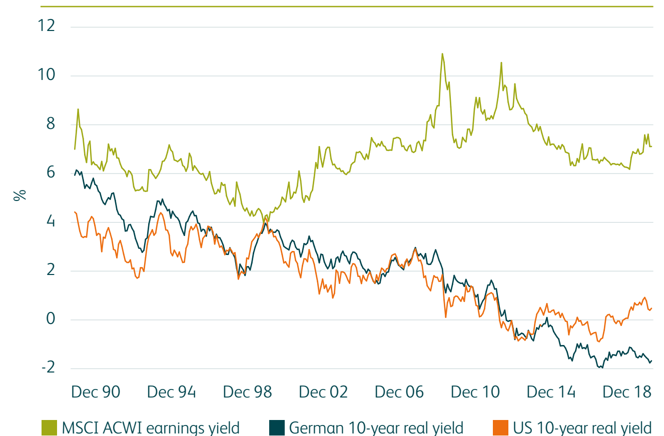
Importantly, these SAA considerations are not fixed, as is the case with traditional multi-asset funds that have set allocation ranges and fixed neutralities – which they are bound to in all environments, but are value-dependent. The M&G Global Target Return Fund can gain net long or net short exposure at an asset class level. As a result, its 'neutral' positioning is 100% cash.

One of the team's core observations, which it originally made in mid-2016, is that the negative correlation between equities and core government bonds of the past 20 years may no longer consistently hold true. Many core bonds' yields have limited scope to fall further, which has reduced their ability to protect against equity volatility. Today, the team believes short positions in low-yielding, core government bonds will periodically act as an effective, strategic diversifier against long equity positions.

It is important to note that the team's investment strategy avoids conventional economic forecasting. For example, we believe that it impossible to sustainably out-forecast the market on whether the US Federal Reserve will increase or decrease its number of planned interest rate rises, or whether the next round of earnings will come in above or below expectations. Moreover, even if one can successfully make these forecasts, this does not automatically lead to strong investment returns.

Our strategic views on prospective returns and correlations are therefore based on today's valuations and 'observable facts'.

Figure 1. The valuation gap between equities and bonds



Source: Thomson Reuters Datastream, 28 February 2019. Earnings yields are not inflation-adjusted. The chart shows the extent of this valuation gap by historical standards.

The M&G Global Target Return Fund has been strategically positioned net short of core government bonds and net long of global equities since its launch in 2016. This reflects the investment team's view that the valuation gap between these two asset classes is unsustainable in the medium term. In February 2018, we removed our short positions in US Treasuries, as we felt yields had moved close to fair value.

M&G Global Target Return Fund

A multi-asset DGF strategy that aims to deliver steady, positive returns while minimising downside risk.

Targeted outcomes:

- Gross return: 4% per annum above cash over three years
- Expected volatility: 3-7% per annum
- Drawdown thresholds: -3%[1]/-6%[2] over one month

Key characteristics:

- Performance drivers: dynamic asset allocation (DAA), top-down only
- Investment universe: equities, bonds and FX, withsome exposure to alternatives[3]
- Equity allocation: -35% to +35%
- Financial instruments: liquid (eg futures) and/or insurance-like (eg options, swaps)
- Stock picking? No[4]
- Multi-strategy/'blended' approach? No

Risks associated with this fund

- The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise.
- There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested. An 'absolute return' fund may not move in line with market trends or fully benefit from a positive market environment.
- Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund.
- The fund could lose money if a counterparty with which it does business becomes unwilling or unable to repay money owed to the fund.
- The fund may use derivatives to profit from an unexpected rise or fall in the value of an asset. Should the asset's value vary in an unexpected way, the fund will incur a loss.
- The fund's use of derivatives may be extensive and exceed the value of its assets (leverage). This has the effect of magnifying the size of losses and gains, resulting in greater fluctuations in the value of the fund.
- The fund can be exposed to different currencies. Movements in currency exchange rates may adversely affect the value of your investment.
- In exceptional circumstances where assets cannot be fairly valued, or have to be sold at a large discount to raise cash, we may temporarily suspend the fund in the best interest of all investors.

Further details

A more detailed description of the risk factors that apply to the fund can be found in the fund's Prospectus.

[1] Normal-to-stressed market conditions.
[2] Highly stressed market conditions (global equities decline more than 10%).
[3] Includes ABS, infrastructure and private loans.
[4] The team expresses its macro views primarily by allocating to equity and credit indices, government bonds and currencies. If the team wishes to allocate to a sub-section of the market, for example, the finance sector, it will draw on the stock-picking expertise of M&G's equity and fixed interest teams to build a basket of securities that best reflect its macro views.

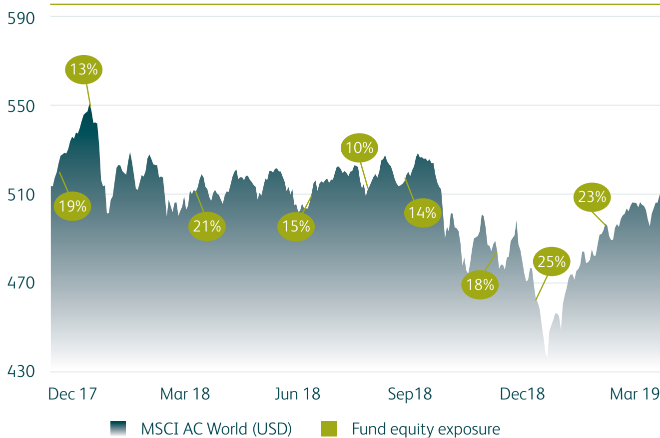
Dynamic asset allocation (DAA) and position scaling

While valuation signals provide important signals around the prospects for long-term returns through SAA, we believe this must be supplemented by DAA to deliver DGF-style objectives through market cycles. This is because valuations and correlation patterns can shift materially in the short term – sometimes frequently – which provides opportunities to both capture potential upside and mitigate downside risk.

DAA can be primarily achieved by investing in liquid asset classes such as equities, bonds and currencies to enable quick responses to changing market conditions. Position sizing and scaling can be an effective means of providing downside protection. For example, our overall equity exposure is scaled significantly up and down over time, as shown in Figure 2.

The M&G Global Target Return Fund can also take short positions in individual assets or asset classes with a view to protecting against falling prices. Short positions will be based on valuation-led observations, in other words, an asset class or market appears fundamentally overvalued and therefore vulnerable to surprises to the downside. They can be used to either reflect the team's base case view or to hedge against the portfolio's overall directional positioning, which is described further in the 'hedging' section overleaf.

Figure 2. Actively scaling equities as market conditions change



Source: M&G, Thomson Reuters Datastream, 18 March 2019. *Delta adjusted notional value. Please note: the chart shows a sample of the fund's equity positioning at different points in time. It does not show each individual change.

The team has been highly active in scaling overall equity exposure. At the end of January 2018, the team felt the extended bull run in global equities represented signs of 'euphoria', which could leave stockmarkets vulnerable to the downside. While the timing of the next market decline was unknowable, it in fact materialised in February 2018. The team looked to rebuild equity exposure by capitalising on lower prices in the following period; however, further bouts of volatility (notably in August 2018) required the team to de-risk to keep the fund within its intended volatility and drawdown ranges, which was successfully achieved. At the end of 2018, the fund's delta-adjusted equity exposure was its highest since launch, which enabled the fund to capitalise on subsequent stockmarket recoveries driven by more Dovish policy rhetoric from the Fed[5].

Investment universe and position sizing

M&G's Multi Asset team expresses its top-down allocation views through a broad range of assets in both developed and emerging markets. This primarily involves assessing equity, government bond, credit and currency markets, as well as some exposure to alternative assets such as ABS, convertibles or private loans. In DGF strategies that rely on DAA, liquid asset classes are highly preferable, as they allow investment ideas to be implemented quickly. The team typically looks to implement asset allocation views through multiple positions, as reducing portfolio concentration should mitigate short-term volatility.

We believe multi-asset DGF approaches offer greater potential diversification than strategies that invest purely in a single asset class. A narrower investment universe provides less scope for diversification over the course of a market cycle. For example, credit can be highly correlated to equities in periods of market stress.

[5] Source: Bloomberg, as at 28 February 2019. Fund GBP I Acc share class versus MSCI World Index.

Likewise, the investment team believes it is important to distinguish between assets that are genuinely less volatile and those that are simply illiquid. Overvalued illiquid assets will likely deliver negative capital growth over the medium term, even if they give the illusion of reducing short-term volatility by being less frequently marked to market. In the case of private debt, the move towards 'cov-lite' loans has also increased the chances of permanent capital losses for creditors, which the team believes should always be considered a more important measure of risk than short-term volatility.

Hedging

DGF strategies that combine 'best ideas' typically implement positions designed solely to deliver positive returns. However, in directionally positioned DGFs such as the M&G Global Target Return Fund, hedging against the investment team's base case scenario may be the most effective way to reduce short-term downside risk. When used selectively, a hedged position should offer protection at a price the team believes is worth paying rather than deliver positive returns.

Tactical long positions in US Treasuries in May and October 2018 are examples of trades we implemented to hedge against the portfolio's overall pro-growth positioning, with negative market sentiment around the global economy during these periods leading US Treasuries to protect against equity volatility.

Financial instruments (liquidity and insurance)

Financial instruments can play a significant role in influencing portfolio volatility. The investment team will always look to use the most liquid instruments, such as equity and bond futures, which allow the team to respond quickly to changing market conditions.

In periods of heightened market volatility, insurance-like instruments may be preferable to participate in potential upside, albeit to a lesser extent than other instruments, because they limit losses. However, the investment team believes such instruments should be used selectively, as the 'insurance' costs of these positions can drag materially on portfolio returns over the medium term.

In late 2018, we decided to use call options instead of futures to capitalise on sharp price falls in US equities, given the prevailing level of market volatility. We have also used buy protection on emerging market sovereign credit default swaps (CDS) as a cheap and liquid way of hedging against global equity volatility, although these positions did not fully offset drawdowns from our equity positions in 2018.

Portfolio review process

The M&G Global Target Return Fund applies an additional portfolio review process to supplement M&G Multi Asset's existing risk management framework, reflecting its more defensive approach. This is designed to keep the portfolio within its intended risk thresholds of 3-7% per annum volatility and one-month drawdowns below 3%. Breaching these thresholds or interim levels observed by the investment team will trigger a formal portfolio review with senior M&G Multi Asset fund managers and M&G's independent risk team.

In August 2018, a sharp fall in the Turkish lira led to contagion across emerging market assets and European banks due to their exposure to Turkish debt. A one-month drawdown exceeding 1.5% triggered formal reviews, which led the investment team to reduce overall equity exposure from around 19% to 11%. This included reducing emerging market equity exposure from 4% to 2% and European banks from just under 3% to 1%. Emerging market bond and currency positions were also reduced. This enabled the fund to stay below its 3% drawdown threshold.

It should be noted the investment team retains full discretion over such decisions. For example, in 2017, the fund's volatility fell below 3%. The investment team felt market volatility was unusually low and that this did not represent the true level of forward-looking risk in the portfolio – as indicated by stress tests replicating historical scenarios and theoretical asset class shocks. This put the portfolio in advantageous position heading into 2018, when market volatility increased sharply.

Outlook

Just over one year ago, the consensus economic view was one of 'synchronised global growth'. Today, it is easier to articulate risks to the global economy stemming from China, trade wars, interest rates and problems in Europe. The realisation that consensus views are repeatedly and profoundly surprised in this way is the reason the investment team seeks to avoid forecasting and exploit market overconfidence in either direction.

Global equity valuations began 2019 at more attractive levels they reached in the first quarter of 2016 – the last time such pessimism over global growth was evident, and from which global equities provided strong returns over the subsequent two years. Indeed, today's opportunity set appears highly compelling.

A DGF that is positioned to take advantage of today's valuations in global equities and emerging market assets should therefore be well-placed to deliver positive returns over the medium term. For investors who wish to minimise the associated downside risks, a DGF can provide the flexibility to adjust short-term asset allocation, which can offer greater potential to help pension schemes protect capital and meet liabilities throughout the market cycle.

For more information, please visit www.mandg.co.uk/multiasset

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