For Investment Professionals only

What can investors learn from DGF performance in 2016?

March 2017

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'Diversified Growth Funds' (DGFs) are a core part of many pension scheme strategies, used specifically with the aim of generating returns comparable to equities with less risk. Since they came to prominence in 2008, the market environment has supported reasonable performance with low levels of risk, even those with more traditional, static allocations.

However, 2016 saw a challenge to this environment, resulting in a wide dispersion of DGF returns. This highlights the need for skill and an effective, dynamic investment process that can deliver institutional objectives in all environments, not just those that are supportive for traditional "safe havens".

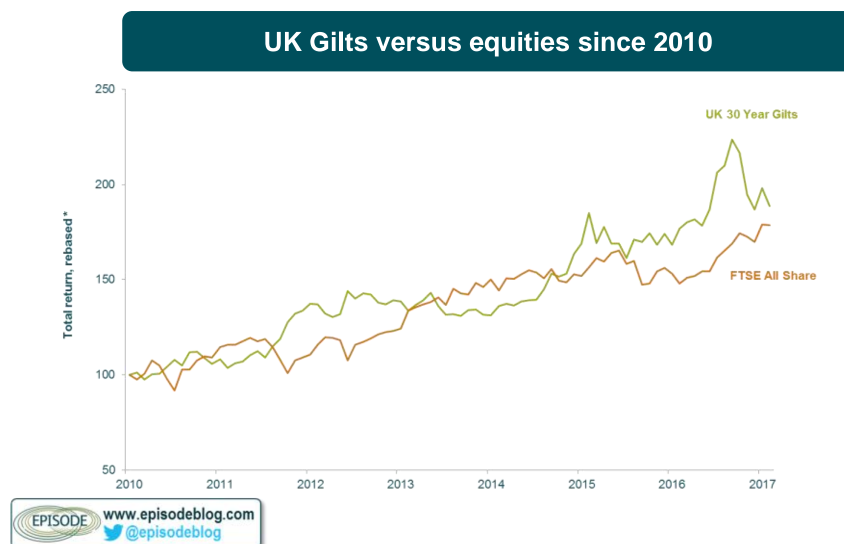
Diversified growth is not an asset class like equity or fixed income – it is more a label for strategies that seek to deliver growth with a focus on diversifying risk and lowering volatility. Diversified Growth funds have been successful at raising assets in a world where many institutional investors have been 'de-risking' and the return of capital has been emphasised relative to the return on capital.

The environment has been supportive for DGF-style outcomes

Institutional demand for DGFs is not just the result of the changing needs of institutional investors. It also reflects the fact that these funds have come to prominence against the background of a supportive market environment. As we mentioned in a previous note[1], many strategies have been able to deliver equity-like returns with lower risk simply by holding a static mix of bonds and equity.

Adding exposure to traditional 'safe haven' asset classes has in many cases actually enhanced returns. This can be seen in the chart below, which shows that long dated gilts have kept pace with the FTSE All Share since 2010, while also being negatively correlated in periods of stress.

UK Gilts versus equities since 2010



30-year UK Gilts versus FTSE All Share total returns, rebased. Source: Datastream, 1 February 2017. *Rebased as at 31 December 2009

[1] See: 4 Reasons why asset allocators will need to be more dynamic (February 2017), M&G

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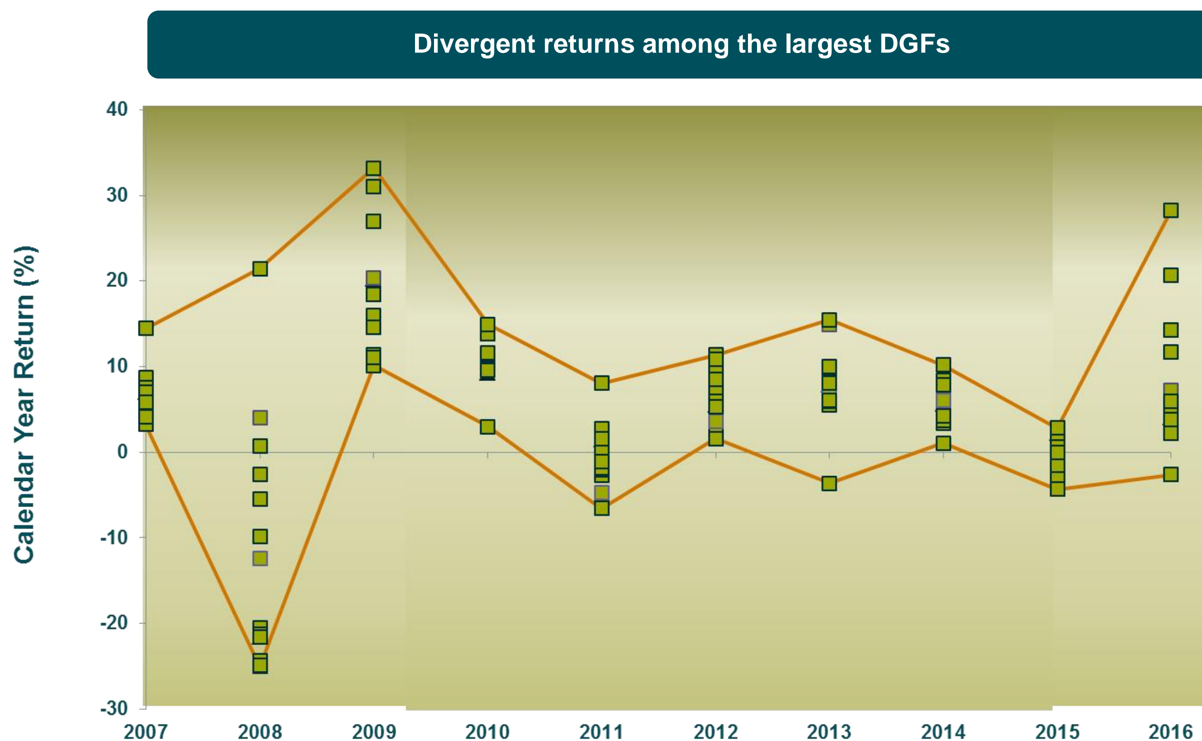
2016 was a test for this environment

The chart on the previous page shows how there was a sharp change in asset behaviour in the middle of 2016. This was symptomatic of a broader challenge to the environment that has prevailed for much of the last five to ten years. The result was that the 15 largest DGFs, represented by green squares in the chart below, delivered their most divergent returns since 2008.



Source: M&G, Morningstar, January 2017. 15 Largest DGFs by end of year AUM (only 10 funds in 2007, 14 in 2008).

The unpredictability and volatility of 2016 stress-tested DGF funds in three key ways.

1. Bond behaviour changed, relative to both historic performance and equities

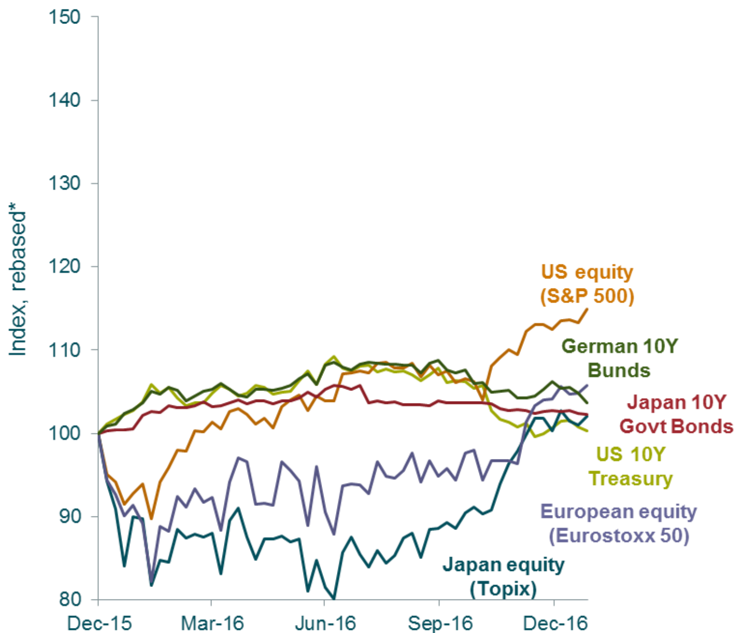
2016 marked a challenge to the monetary policy consensus that has characterised much of the last three decades. Investors reacted badly to the introduction of negative rates in Japan, politicians across the world began to question the role of central banks and fiscal reflationary policies gained more attention.

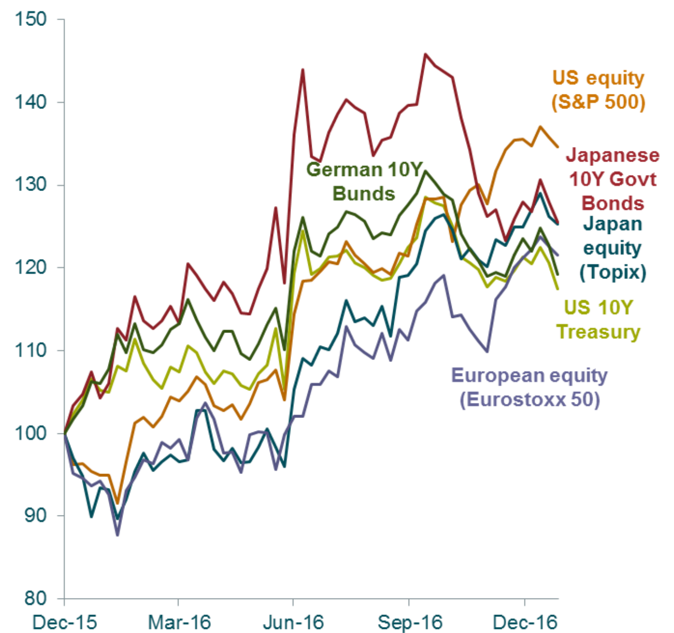
These changes had important implications for bond yields. As the pessimism of the first half of the year unwound, government bonds in developed nations saw greater volatility than equity markets and more unstable correlation patterns.[1] Such moves are a challenge to any portfolio that relies on large bond or bond proxy weightings to mitigate volatility.

2. Currency hedging decisions had profound impact on returns

In the UK, the Brexit vote resulted in the sharpest declines in sterling since 2008. This meant that choosing whether or not to hedge overseas assets had a far greater impact on portfolio returns than would normally be the case. The charts below shows how not hedging (right hand chart) resulted in higher returns, and higher correlation, on a range of overseas assets.

Hedging decisions have been critical for UK investors





Source: Total returns, in local currency and Sterling terms. Source: DataStream, end January 2017. *Rebased as at 31 December 2015

These violent currency moves served to amplify small differences in overseas versus domestic exposures. Moreover, funds which do not actively manage currency exposures may have seen return and risk characteristics in their portfolios that they had not anticipated, with many funds delivering higher returns than one might expect from a DGF.

3. Unexpected events and price responses highlighted the pitfalls of forecasting

Events like the Brexit vote and Donald Trump's US election victory meant that 2016 felt much more volatile than it actually was. However, these events did illustrate the weaknesses of forecast-led approaches. Not only were the events themselves surprising, but market responses were very different from what many would have expected even if they had correctly predicted those events ahead of time.

Unexpected equity market responses to significant geopolitical events in 2016

X% Weight in equities

Source: MSCI AC World and M&G Episode Allocation Fund responses. Source: M&G, Datastream, 4 January 2017. *Source: http://www.telegraph.co.uk/business/2016/02/11/rbs-cries-sell-everything-as-deflationary-crisis-nears/. Trump image source: By Michael Vadon - →This file has been extracted from another file: Donald Trump August 19, 2015.jpg, CC BY-SA 2.0, https://commons.wikimedia.org/w/index.php?curid=42609338

Investors who panicked amidst the recession fears of January and February 2016 or fell into the trap of forecasting in response to the Brexit vote or Trump's victory would likely have struggled over the year. However, approaches with a longer term view, robust investment framework, and the freedom to respond dynamically to the volatility would have found plenty of opportunities in this environment.

What can investors learn from this?

The short lifespan of DGFs as a label means that few have been tested outside of what has been a relatively supportive investment environment. 2016 provided such a test and the wide range of outcomes delivered illustrates the need for careful due diligence and rigorous manager selection.

It remains to be seen whether the developments in 2016 mark a more sustained shift toward a different market environment in the years ahead. However, they do serve as a reminder that investors looking for 'growth' will need to ensure their chosen managers possess the following attributes going forward:

a. **An experienced and stable multi-asset team** that combines a depth of expertise and investment experience across asset classes,
b. **A proven and repeatable investment process** that blends an unwavering focus on asset fundamentals with an assessment of the drivers of prevailing price action,
c. **A benchmark-unconstrained approach** that can access a broad investable universe from which to select genuinely diverse investment themes,
d. **The flexibility to respond dynamically** to the opportunities that volatility can create, and
e. **Robust risk management processes**, including the discipline to constantly question how the market is pricing risk and to avoid underestimating how asset risk profiles can change

For more information contact:

Andrew Swan	+44 (0)20 7548 2375	andrew.swan@mandg.co.uk
John Atkin	+44 (0)20 7548 3466	john.atkin@mandg.co.uk
Henry Barstow	+44 (0)20 7548 3469	henry.barstow@mandg.co.uk
Sunita Dey	+44 (0)20 7548 3393	sunita.dey@mandg.co.uk
www.mandg.co.uk/institutions		**institutional.clients@mandg.co.uk**

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