

# PENSIONS *matters*

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## DIVERSIFICATION

### THE INVESTMENT WORLD'S FREE LUNCH



Pensions Matters 14 has been written by Alan Carey, Regional Director, Actuarial Services, at Alexander Forbes Financial Services.

Depressed stock markets, the continued effects of the “credit crunch” and a gloomy outlook for the economy is a dire combination for many investors. In times like this, we appreciate any morsel of good news and in Pensions Matters 14, we outline some positive news for the smaller investor (whether corporate or individual).

Until recently, there was no choice for smaller investors other than to rely on equities when aiming for longer term investment growth. This has now changed. Through diversification, you can embark on a far smoother journey without necessarily compromising overall returns – in effect, a free lunch and one that is open to all.

Pensions Matters 14 looks at why diversification is so important, the key benefits of spreading risk and the approach that many investors are already taking.

# Why is diversification so important?



**Firstly, it is important to remember that equity reliant strategies are sensible if you truly have a long term investment horizon, over which there is a high probability of equities providing additional returns. Recently though, the closure of defined benefit schemes and the move to accelerate the extinguishing of their liabilities, not to mention the pressures from the accountants and the Pensions Regulator, have all meant that sponsors' time horizons have shortened considerably.**

For individual investors, the short term pain from volatile equity markets is becoming increasingly uncomfortable and we are seeing greater appetite for more stable returns in excess of those from cash or bonds. Let's remember the UK stock market has never repeated its 2000 peak and eight years on, the FTSE 100 is still 20% below its all time high.

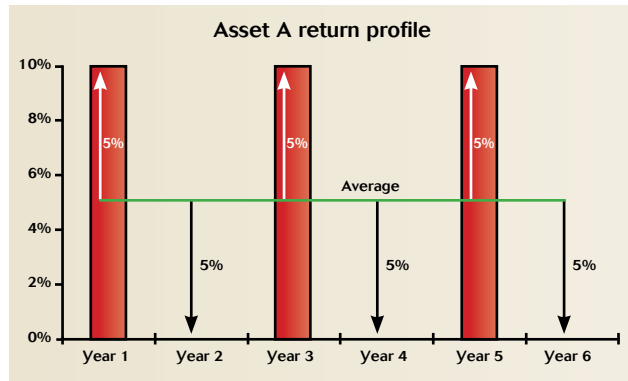
Many investors' attitude to risk has changed and they will no longer tolerate excessive volatility in their investment returns.

By investing in a wide range of asset classes that increase/decrease at different times to equities, it is possible to achieve a smoother investment journey. Our expectations are that a basket of several different growth assets will be expected to produce half the volatility of equities, i.e. analysis shows you would expect to lose only half as much money (in adverse markets) under a diversified approach compared to a pure equity strategy. The converse is of course also true and therefore, both the downside and upside are reduced, in the short term through diversified investing, but importantly the expected return over the long term remains similar.

*When attitudes to risk become more conservative, the extra certainty from diversification becomes invaluable.*

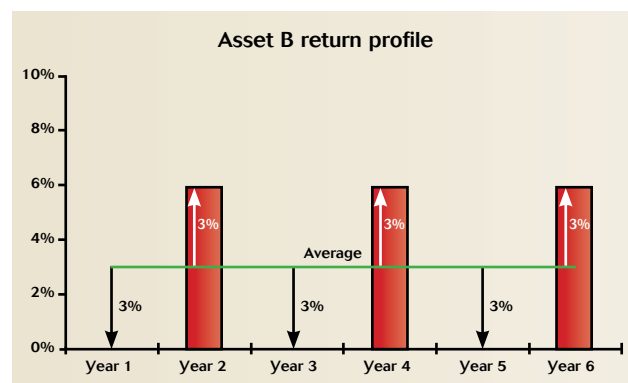
# How does diversification work?

Let's take an imaginary asset class, "A", which returns +10% in odd years and 0% in even years, as shown below.

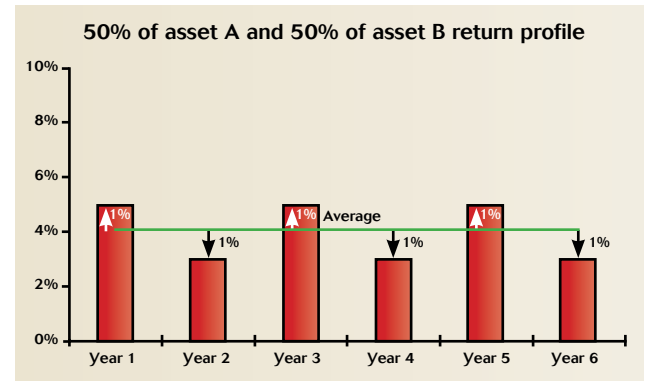


The average expected return is 5% pa, and the average deviation (what we refer to as investment risk or volatility) is 5% pa around the expected return.

If we introduce another imaginary asset class, "B", which returns 0% in odd years and 6% in even years, as shown below, the average expected return is 3% pa with an average deviation of 3% pa around the expected return.



Now, if we construct a portfolio that consists of 50% in asset class "A" and 50% in asset class "B", we would expect the following returns each year.



The average expected return is now 4% pa, but importantly the average deviation is now reduced to 1% pa through diversification, i.e. we have greater certainty. This is a better return than B on its own and with a lower average deviation!

**Although this is a simplified example, exactly the same principle applies to real life investments. If we can invest in different types of growth-seeking assets that are uncorrelated we can significantly reduce the average deviation and hence the investment risk or volatility.**



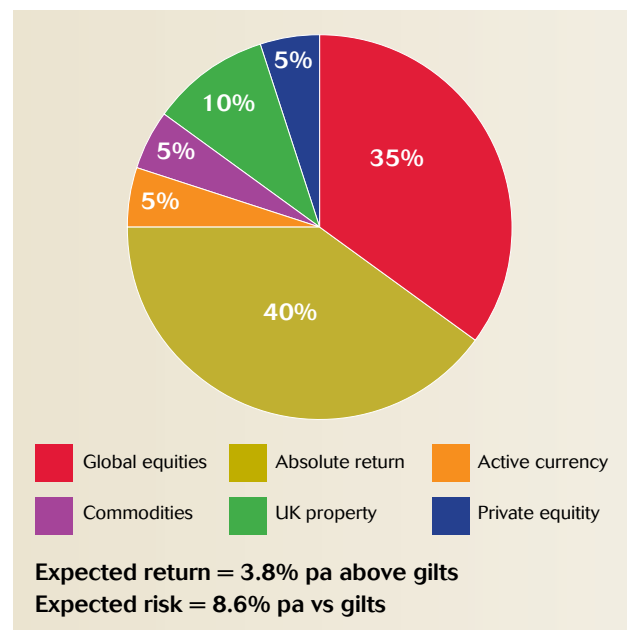
# The benefits of spreading risk

If diversification presents an opportunity for a free lunch, then it makes sense to enjoy as many of those lunches as we can. The principle is fairly intuitive, in that we don't want to rely on one source of return, for example UK equities, to generate investment growth, as historically this has proved to be something of a rocky ride.

The theory also backs up the intuition. At Alexander Forbes Financial Services, we meet regularly to agree a set of house assumptions on the expected return and volatility for each asset class, and the correlation of returns between asset classes. These assumptions

are based on past experience with some sensible adjustments made to reflect future expectations. We can use these assumptions to calculate the expected risk saving benefits of diversification. The two charts below show the expected return and volatility for an equity only portfolio and those from a diversified basket of assets.

The market refers to the method of investing shown in the right hand pie chart as a "Diversified Growth" approach (see below) and the significant reduction in volatility from this approach is especially attractive when attitudes to investment risk have become more conservative.



## A PRACTICAL APPROACH TO IMPLEMENTATION

The theory backing the arguments for diversification is sound but historically we have faced the challenge of implementing diversification for smaller investors. The very large investors have for several years now been taking advantage of their large research budgets and buying power to gain access to certain niche asset classes, such as

- *derivatives (including swaps and options)*
- *absolute return bond funds*
- *commodities*
- *foreign currencies*
- *specialist private equity funds*
- *infrastructure stocks*
- *hedge funds*

Diversification has become common practice within the wider investment industry and is backed up by economic theory. About three years ago, the marketplace saw a significant increase in the number of pooled fund products in these alternative asset classes tailored towards pension schemes. Unfortunately, access continued to be limited to only the very biggest players due to the fees.

More recently, there has been a further development, with the arrival of what the market refers to as "Diversified Growth Funds". These funds package together several different diversifying asset classes with an overall aim of equity-like growth at a lower level of volatility. These funds have changed the landscape for diversifying assets. It is now much easier for the small investor to access alternative asset classes and, for the first time, there is a real opportunity to invest in a truly diversified way.

We believe that all of our clients should make an allocation to these funds for the risk reduction benefits that they provide. This allocation should come mostly out of the current UK equity allocation.

## FURTHER BENEFITS OF THE DIVERSIFIED GROWTH FUND APPROACH

We have already explained the need for investors to diversify and how diversified growth funds can deliver this in a ready packaged way that is accessible to small investors. There are other significant benefits from using these funds.

### • Outsourcing investment decisions to experts

There are numerous asset classes in the investment world, and within each asset class, there are several possible products.

Past performance is a very dangerous predictor for the future especially in the more unfamiliar asset classes and therefore it is prudent to outsource the decision making aspects of diversification to investment experts. This can be particularly important for trustees of defined benefit schemes wishing to demonstrate they have carried out their fiduciary and legal duties in the most appropriate manner.

### • Time and cost savings

Obtaining advice on the appropriate managers for alternative asset classes can be a very expensive exercise. For example, the typical cost charged by larger consultancies to pension schemes for manager selection has been £15-30k per asset class.

In addition, there is significant time and cost required to monitor these managers. The review and monitoring process is even more important for the alternative asset classes as the element of returns related to manager skill tends to be higher than that for equities, and as a result, a more expert level of scrutiny is required.

The diversified growth approach allows investors to outsource the decision-making to investment experts, saving both time and expense.

# CONSIDERATIONS

There are several areas to note when investing in these types of funds.

- **Relative performance**

Diversified growth funds aim to outperform cash by 2-4% pa, over a 3-5 year period, after all manager fees. However, the performance will be volatile relative to this benchmark on a quarterly basis, far more so than active equity and bond managers (with whom investors are more familiar) will be against their respective benchmarks.

Investing in a diversified growth fund requires patience, and while we have full confidence that these funds will outperform cash over time, there could be periods of underperformance against benchmark that should not automatically trigger a replacement of manager.

- **Manager fees**

The diversified growth fund manager will charge a fee for investment management services, just as the manager of an equity or bond fund would.

However, the manager will then invest in a series of products, each of which also has an underlying fund management charge. Some of these fees can be higher than the levels investors are used to paying for equity and bond funds and there will typically be a performance related fee payable in addition. Such fees will be collected from the underlying assets and are not charged explicitly.

The pie chart analysis shown earlier takes into account the impact of fees on expected returns (i.e. expected returns are calculated after the deduction of expected fees) and despite the additional fees payable, the expected benefits of diversification remain compelling.

- **Beware the make up of some funds**

These funds invest in many asset classes, each managed by a specific fund manager. However, some diversified growth fund managers will use several in-house funds managed by the same company, which are not necessarily of the highest quality. There is an obvious element of self interest for these managers to use their own funds and we would advise against using these managers, as an investment manager is unlikely to have skill in all asset classes.

We favour those funds where the products in each asset class are selected on a best of breed basis using external managers.

- **Minimum allocations**

The diversified growth managers tend to have minimum investment and ongoing deal flow sizes. The minimum entry sizes could be an issue for some investors. For this reason, operationally it makes sense to make one-off allocations to these funds rather than drip feed small amounts of money on a regular basis.

- **These funds can go down in value**

While the intention of most of these funds is to preserve capital, investors should note that there will be periods of negative returns (as will happen for equity and bond funds). This is to be expected as investment markets always surprise us, but such time periods should be short-lived. Although we are enthusiastic about these funds, investors should not mistake this enthusiasm as a guarantee that these funds will provide a magical investment that could never lose money. Unfortunately, funds which allow investors to target returns in excess of cash over the longer term and without risk do not exist.

Similarly, these funds will experience periods when equities have better relative returns. However, these funds provide greater certainty and that is the clear rationale for using them; it is important to remember this in times of strong equity performance as emotions can sometimes make us forget why we make sensible investment decisions in the first place.

Over the last eight years, we have endured two periods of steep stock market falls that have seriously tested our appetite for risk.



## SUMMARY

We believe that investors can no longer ignore the risks attached to over concentrating their investments in one or two major asset classes. The pain that results from adverse markets for equity biased strategies is too great for many of us now. Over the last eight years, we have endured two periods of steep stock market falls that have seriously tested our appetite for risk.

If investors can truly say that they will stick with equities through thick and thin, and ignore the impact on their emotions when markets go down, then equity investment with a long term time horizon remains a sensible, if higher risk, approach.

The present circumstances surrounding UK pension schemes mean that the case for diversification is strong:

- *For defined benefit schemes, Trustees arguably have a legal duty to diversify, and diversifying together with*

*the use of synthetic bonds, (highlighted in Pensions Matters 13) delivers risk savings greater than the sum of the individual parts.*

- *For defined contribution schemes, Trustees need to think about whether diversified growth investing should become the default investment.*

Pensions Matters 14 has been prepared to outline a practical way to diversify portfolios. We advise all investors to think carefully about increasing diversification levels within their investments.

Alexander Forbes Financial Services would be delighted to talk through any questions you may have on diversification and practical approaches for implementing diversification in investments, including how much to allocate to such strategies.



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