

INVESTING IN DIVERSIFIED GROWTH & MULTI-ASSET FUNDS

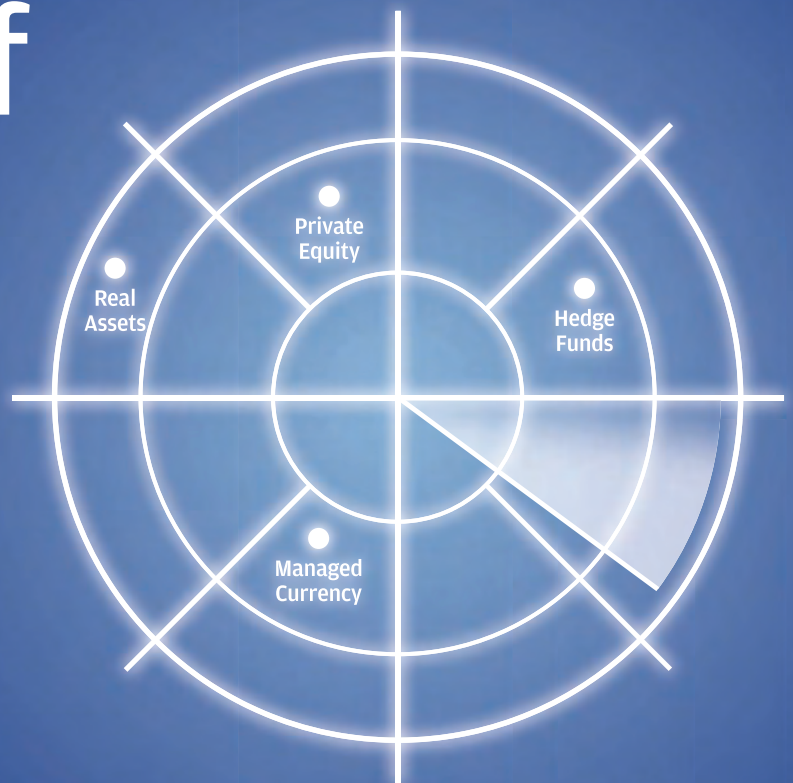


"THE SECOND ANNUAL ONLINE REPORT WHERE PENSION SPONSORS AND THEIR SCHEME REPRESENTATIVES ANALYSE THE ISSUES FACED IN UTILISING DIVERSIFIED GROWTH AND MULTI-ASSET FUNDS, INCLUDING THE CHALLENGES OF TRANSPARENCY, BENCHMARKING AND IDENTIFYING A FUND MANAGER'S SKILL BASE, EXPERIENCE AND RESOURCES"

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WHITE PAPER

The Evolution of Diversified Growth Funds; Learning from Experience



SIMON CHINNERY

Executive Director

UK Institutional Business

*J.P. Morgan Asset
Management*

Diversified growth funds have been gaining in popularity since they first emerged earlier this century, leading to a proliferation of diversified growth strategies and leaving many investors facing a difficult choice when it comes to selecting the right diversified growth manager.

This white paper will look to identify some of the main differences that have emerged between diversified growth fund strategies, and explain how these differences can affect the role that diversified growth funds can play in a portfolio, either as a standalone investment, or as part of a multi-strategy approach. With investors continually looking for new and innovative investment solutions, we will also speculate on what the future holds for these highly effective investment strategies.

THE BENEFITS OF DIVERSIFIED GROWTH INVESTING

DC plans can use diversified growth funds as a default investment option, as they provide plan members with exposure across a range of different asset classes within a single fund selection. Multi-asset strategies that aim to reduce volatility are likely to be better aligned to the objectives of more DC plan members than, for example, pure equity funds, which can be highly volatile and therefore unsuitable as a default option. Many DC plan members are likely to be fairly risk-averse and concerned with high levels of volatility – something that diversified growth funds aim to reduce.

For defined benefit plans, investing in a diversified growth fund allows asset allocation and stock selection decisions to be outsourced to experienced investment professionals. This not only means that asset allocation decisions are taken by experts, but also that the decisions are made quickly to reflect constantly changing market conditions. Diversified growth funds also provide DB plans with liquid access to often illiquid alternative assets. Alternatives provide excellent diversification benefits but some pension plans are put off by the long lock-up periods inherent with some alternative structures. Furthermore, given the high minimum deal size for many alternative strategies, DB plans with relatively small amounts of capital to dedicate to alternatives may struggle to construct diversified portfolios. Diversified growth strategies can help these DB plans overcome such challenges.

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Finally, the ability of diversified growth funds to dampen volatility provides greater predictability for a DB plan's regular actuarial valuation.

DIFFERENT APPROACHES TO DIVERSIFIED GROWTH

Although diversified growth funds have evolved around similar objectives, fund providers use different investment methodologies and measure themselves against different benchmarks. However, the common factor is an aim to reduce volatility and provide diversification in difficult markets.

Ostensibly there are three different drivers of return within diversified growth portfolios: strategic asset allocation, tactical asset allocation, and investment approach/security selection. Diversified growth managers not only manage each of these return drivers differently but they also apportion varying amounts of risk to each of them.

A diversified growth fund's strategic asset allocation is usually determined by sophisticated proprietary modelling techniques. The strategic allocation may be designed to outperform equities, inflation or cash depending on the objective of the fund and the manager's investment approach. The typical strategic allocation therefore varies across the diversified growth spectrum, with some funds biased towards bonds or equities, some maintaining a more balanced approach, and some funds utilising more esoteric assets such as hedge funds and commodities, or even derivative trading strategies.

Many diversified growth funds also use tactical asset allocation to allow them to dynamically increase short-term exposure to the most attractive asset classes while reducing exposure to asset classes that appear overvalued or where the investment case looks less compelling. This tactical asset allocation, often implemented using derivatives, can vary widely in terms of the allocations to different asset classes and the concentration achieved, as well as the process used. Tactical asset allocation can of course introduce additional risk if the manager gets their tactical decisions wrong.

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The Evolution of Diversified Growth Funds; Learning from Experience

Once asset class weightings are determined, diversified growth managers can employ a different investment approach for fund/stock selection across each asset class. For example, some funds use passive management, while others are highly active. Some use an internal fund of funds approach, while others use external funds.

The result of these differences in approach has been the evolution of a complex diversified growth sector, which provides a range of opportunities for pension plans. However, this complexity also means that investors need to ensure that they fully appreciate a fund's risk profile and style of management when selecting a diversified growth strategy.

STRATEGY CONSIDERATIONS – SELECTING THE RIGHT DIVERSIFIED GROWTH FUND

Before selecting a diversified growth manager, pension plans need to think carefully about the balance they want to achieve between volatility reduction and the ability to continue to grow their assets over the long term. A clear understanding of the investment approach taken by different diversified growth managers is therefore crucial, so pension plans should ensure they undertake rigorous due diligence of investment processes and philosophies..

For example, many diversified growth funds measure themselves against cash, but this doesn't necessarily mean that they are low risk. Investors looking for low risk funds should look for strategies that emphasise downside protection and aim for conservative annual returns. Some funds with a cash or inflation benchmark are actually able to take considerable equity risk and offer only limited downside protection. This is particularly important in the current volatility market conditions.

However, investors should recognise that diversified growth funds with a greater bias towards growth assets also have a strong role to play in pension planning. More aggressively positioned funds can participate more fully when global equity markets and other riskier asset classes rally, as they are likely to have higher exposure to risk assets. These funds can therefore be used by pension plans to complement or even replace their portfolio's existing equity exposure.

Given the different strategies available and the different risk/return profiles that exist across the diversified growth sector there is an increasing demand for transparency and simplicity. For their part, pension plans, trustees and advisers need to be comfortable with the investment objectives of their chosen diversified growth funds, carrying out rigorous due diligence on their diversified growth managers and regularly monitoring fund holdings and derivative strategies as well as fees and charges. However, the selection process is perhaps helped by the fact that many funds have been able to prove their credentials during the unprecedented volatility of the Global Financial Crisis of 2007-2009.

LOOKING INTO THE CRYSTAL BALL – THE FUTURE FOR DIVERSIFIED GROWTH

Because of the different strategies used by different diversified growth funds, we are likely to see pension plans begin to diversify their diversified growth exposure. Some DB pension plans are already beginning to consider taking a multi-manager approach, maintaining exposure to a range of diversified growth managers depending on the growth and liability profile of the plan. Such an approach would also require a macro/tactical asset allocation overlay to ensure there is no unintended bias towards a particular return profile within the overall diversified growth portfolio.

DC plans are increasingly emulating the DB sector by employing two or more diversified growth strategies within a blended default option. As the sophistication of DC plans increases, some may also think about designing age-related defaults based on blended diversified growth strategies.

Meanwhile, diversified growth managers are continually looking to innovate. Given the potential inflationary consequences of today's ultra-easy monetary policy, pension plans could face a challenge in the future protecting their investments from inflation given the low yield, low return environment. Currently, diversified growth strategies tend to maintain a bias to equities and equity-linked securities to target long-term returns in excess of inflation. However, such strategies can carry greater risks, particularly in times of severe market stress when correlations across asset classes tend to rise.

Therefore we'd expect to see a move to diversify away from equities into assets that can give adequate inflation protection while also providing some protection during periods of stock market volatility. This would include widening the investment scope to include a greater exposure to real assets and other inflation hedging assets, including greater use of alternatives. Such inflation sensitive investments may include index linked bonds, CPI swaps, real estate investment trusts, commodities, natural resources and infrastructure. Also, unconstrained bond strategies (for example strategic bond funds) can provide a higher yield and cushion returns against inflation while also providing significant diversification benefits.

At the moment a broad move into these securities may be out of the scope of many DC schemes, where there is a demand for daily dealing and high levels of liquidity. However, there is no reason to believe that these issues cannot be overcome in the future as DC plans accept the need for wider investment flexibility to hunt for yield. Also, many DB schemes are already allocating to forestry, infrastructure, commodities, real estate and a host of other alternative strategies (including hedge funds and private equity), so diversified growth strategies aimed at inflation-plus returns and invested increasingly in real assets and alternatives would seem like a natural progression from here for DC plans too.

ROUNDTABLE DEBATE

What is Driving Growth in Diversified Growth Funds and is this Sustainable?

MODERATOR:



DAVID ROWLEY
Editor
*Pensions Week at
Financial Times*

PANELLISTS:



ANDREW CHESELDINE
Principal
Lane Clark & Peacock



DAVID MCCOURT
Investment Specialist
*National Association of
Pension Schemes*



**JUSTIN URQUHART
STEWART**
Director and Co-founder
*Seven Investment
Management*



DONNY HAY
Pension Trustee
LawDeb Pension Trustees

DAVID ROWLEY: Thank you everyone for joining us. I'd like to begin by examining what factors are driving growth in diversified growth and multi-asset funds and then pose the question of whether this is sustainable. The second part of this question relates to the concern in the market that beyond a certain asset size, diversified growth funds cannot be nimble with all that they entail. Donny, would you like to start us off by sharing your views on this?

DONNY HAY: There are five aspects driving the growth and demand - poor equity returns over the past ten years being one in particular. The diversification benefits coming from the vehicles used as well as the fees which are much lower than hedge funds are other diversifiers that people are attracted to. DGFs are replacing equities as funds de-risk and for a number of schemes we are seeing it as a simple investment governance solution. There is a £300m scheme that we look after that is predominantly made up of two diversified growth and multi-asset funds.

JUSTIN URQUHART STEWART: One key issue here is the move away from the traditional dominance of equity markets. Some of this is down to the way that certain firms are moving away from equity providers, equity sales and equity dominated firms as well as starting to take a more responsible attitude to running money on a broad base of asset classes. For

many years the industry has been stuck on a sort of 'equity drug.' Hence why going back to probable failure of managing volatility through a broad asset allocation set-up and through elements of predictability meant that we've seen a significant growth in diversified growth funds. Over the past eight years they have been able to prove themselves whilst markets have been going up and down like yo-yos.

"For many years the industry has been stuck on a sort of 'equity drug'"

DAVID R: What is the difference, David or Andy, between these types of funds and balanced funds? I often hear it said that diversified growth funds are just like the old balanced funds, but they are a bit more dynamic aren't they?

ANDREW CHESELDINE: Justin is right. There is a focus around volatility and risk rather than a focus on return. Many investors always look for that extra bit of outperformance which is frankly ephemeral, but if you look at volatility, it is a much more sensible way to manage your targets. The difference between diversified growth - which can mean lots of different things - and a balanced fund is that a balanced fund was typically focused on the return it was going to give whereas diversified growth

funds are more focused on managing the risk.

JUSTIN: The term 'balanced fund' was misleading. When you looked at the IMA measures and the Atkins measures, they had 60-80% equities leading to a higher level of volatility. With diversified growth funds, we're seeing a significant change in that you often see a balanced equity portfolio with a broad range of equities in the region of 40-45%.

DAVID R: For the last part of your question: 'is this sustainable', surely the answer is yes. You can have every sort of fund manager who creates their own DGFs, but are the most popular ones becoming oversubscribed?

DONNY: The question of sustainability of DGF growth raises the question of whether it is just a trend that we are going to move on from once equities start to perform more consistently again, or whether it is here to stay.

ANDREW: That is a very good point. One aspect you have to note is that NEST and its investment philosophy is basically one giant DGF. There isn't an awful lot of difference between what they're doing in 'target date land' and diversified growth. They are looking for largely passive equity and safer asset classes. If you see that it is going to add between £8-10 billion in a year of contributions, yes the growth is sustainable.

ROUNDTABLE DEBATE

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It's going to accelerate if anything, but it will reach a natural end. Someone asked the question 'what happens if equities become more sustainable?'. I believe one of the good things about the move to DGFs is that it's basically been proven right and it's worked. The analysis that has been produced shows that DGFs have reduced risk and in many cases have outperformed pure equity funds. The problem will come when there has been a sustainable bull market, by which I mean 3-5 years consistency, and when people start saying, 'why aren't I getting the 10%-15% returns that I would get in equities'. We need to manage the message to them that says it's about managing risk not return.

JUSTIN: To add to that, we now have a broader range of assets that are possible to invest in than we had before. Whether you are talking about commodities in terms of timber, property, infrastructure or currencies, you've actually got many more legs that weren't there before. Therefore you don't need the elements just to be weighted on how equities perform. It is all about that issue of risk management and it's absolutely right that as soon as you do find a bull-run in equities, people always want to try and demand a top bid. If you are running an investment program you are not running it on a three month basis, you are running it on a 3-5 year basis at least. Therefore you are showing people the management of that volatility and risk over that period of time ignoring short term shocks.

DAVID R: Moving on to the second question, do diversified growth funds fill space between return seeking and 'safe' investment strategies?

JUSTIN: Does this refer to funds that are kept in a safe!? I find this interesting because this is where it comes down to the measurement of risk which of course is always very controversial. You are carrying out an active allocation model which is allowing you to adjust according to circumstances so that if you perceive greater risk, you are able to adjust as necessary. It's not just a matter of the diversified growth funds themselves, it's the fact that they are alive and able to adjust within given bounds.

DONNY: It's part of the investment

governance move by trustees to delegate more authority to specialists. Trustees may decide that they are not necessarily in the best position to judge whether they should be in return seeking assets or matching assets.

ANDREW: Back to Justin's point, I believe he is right. The safest place from an investment risk point of view is in a safe, not invested anywhere. If you go back to 2009, in very broad terms there was a trillion pounds of deposits in the banking system but the Financial Services Compensation Scheme (FSCS) had to pay out £20 billion in compensation. So 2% of cash investments disappeared! Therefore, there was a 2% loss on something that most people considered to be a zero risk investment – particularly important as direct investments in deposits by trustees are not covered by the FSCS.

DAVID R: Moving to the third question, 'are diversified growth funds proving themselves in volatile periods'? I spoke to an investment consultant who said he is following 6 DGFs from Newton, Ballie Gifford, Blackrock, Standard Life Investments, Barings and Schroders. He said over July and August they varied between 0 and -4% with the FTSE being down about 9% and the S&P a bit more over that period. That would seem to say, as some of you have said already, they are proving themselves in volatile periods.

JUSTIN: If you go back to 2008 where we saw 30% drops in equities, you'll find that well managed diversified funds actually came through that period quite cleanly. Yes there were reductions, but nowhere near the volatility that you had with equities.

ANDREW: That is right. There are also different types of diversified growth funds. You mentioned Schroders which is fairly equity biased. Barings and Baillie Gifford are much less so, Standard are quite derivative based. There is almost an infinite variety of them there but overall, yes, they have done pretty well.

DONNY: One thing worth pointing out is that the DGF benchmark i.e. a return over cash has been relatively easy to beat. It's not a particularly high hurdle, albeit, you do have to make sure that you don't lose

money. Unlike equities, it's less of a zero sum game when you think about it. The problem that equity managers have is that there will be winners and losers and they need to balance up. That is not necessarily the case in DGFs

ANDREW: You've got to look at it in terms of net returns, net of charges and costs.

DAVID R: I know, Andy, that in their default fund one of your clients at LCP has 50% in passive global equities and 50% in Standard Life's GARS fund? How common is this and is it cheaper overall?

ANDREW: Yes, rather than going into pure diversified growth with, for instance, Standard Life's GARS fund (a DGF), we tend to set the long-term portfolio in our default lifestyle as 50% passive global equities and 50% split between two diversified growth funds. We are looking for some complementary aspects between the DGFs, so perhaps doing slightly different things in different ways we find the best balance. What you don't want to do is chop and change too often because then you are incurring additional costs. One of the key aspects we like to tell trustees is that we don't take commission so we are completely independent. But there could still be a kind of a bias here if you are going to pay us fees each time we change a manager. So we need to make sure, when we say sack A and replace them with B, that there is a significant net benefit in doing so because the cost of transition can be quite steep. In addition to fees, there are market risks and transition costs.

JUSTIN: One of the interesting developments with some of the passives is that you can now run portfolios which are 100% passive but still have active allocation. Of course the transaction costs of those are very much lower indeed so you can reduce that cost and still have the flexibility and the discipline of tactical as well as strategic asset allocation. We are now even getting to the stage where once you have sufficient volume in there, you can actually bypass the ETFs and effectively buy the stock yourself and sit on that as part of your core and focus on the asset allocation, not necessarily the more expensive active manager.

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ANDREW: I would issue a couple of words of caution: it's easy to look at a passive global equity fund and say fund A is much cheaper than fund B which seems similar, but two key questions you have to ask yourself are, how much stock lending is going on and who is getting the benefit of it, and what effect does that have on the price? Secondly, is the currency risk hedged or not and if it is, how hedged is it and what is the cost?

JUSTIN: Absolutely. This is where the stock lending work has to be done very carefully indeed. If you did without the stock lending, it would still enable you to have a significantly reduced cost, certainly compared with a lot of the active managers - which I find can't even get near their benchmark.

DAVID R: So is stock lending something that adds value for the fund? Is it through the fees for lending the stock?

ANDREW: Typically yes. A normal fee for a very big pension fund on a passive equity fund might be getting 6-8 bps and if there is significant stock lending going on it could be down to 1 or 2 bps, certainly in the U.S. The question is, is it a fair division of the spoils between the investment manager and you as the client and how much extra risk is going on in there?

JUSTIN: The investment manager should be paid for one thing only, the investment management and nothing else. Everything else should be going back into the fund.

ANDREW: And there are ways of dealing with it but it is one of the important questions that you have to ask the manager, how do you do this and where does the money go?

DAVID R: We did a good news story story in our magazine two weeks ago about how the GARs and the Barings asset allocation funds had done quite well over July and August. So schemes that were invested - and I know some schemes were invested 100% in these funds - they were thinking 'we've done OK'. David, in your view is this a good news story for pension funds?

DAVID MCCOURT: Well if it is managing the volatility, then it would have to be a good news story. It's whether they're able to consistently deliver over time that would be the issue. Certainly given the horror story headlines that we've seen on the likes of the Daily Mail, that millions have been wiped off pension pots, we reacted to this ourselves. These sorts of approaches have got to have serious consideration as to whether they can prove themselves in such difficult market conditions.

"DGFs have reduced risk and in many cases have outperformed pure equity funds"

DONNY: DGFs have had a very favourable wind over the past few years in terms of non-equity type investments - corporate bonds, commodities, the emerging markets and currency have generally all worked in their favour. They seem to have done well in July and August. The MCI World was down around 11% in July and August. 0% to -4% from DGFs is quite attractive in relationship to that!

ANDREW: Ignoring the efficiency of investments, it seems we should also be looking at what the members believe is happening to their money. It is almost a truism that the average DC member thinks that the trustees are managing their asset allocation. No matter how many times they are told 'you are making this decision', and 'it's all up to you', they still think that the trustees are managing it. One of the great aspects of DGFs is that somebody is actually doing some of that management.

JUSTIN: One of the important steps that we can now take is to allow people more access to their investments so they can see them and have a better understanding of what it is invested in rather than, 'trust me, I'm an investment manager' because quite frankly an awful lot of them don't.

DAVID R: On that point Justin, can I move onto the last question. With DGFs accumulating so many assets, is there a danger of innovation going too far?

JUSTIN: I love that phrase, 'a danger of innovation going too far'. On that basis, if we just stuck with the flint it would be much easier. There should be more development to come and a reduction in cost. We've been able to find ways of reducing or managing risk and volatility. The next stage of innovation is going to be in terms of effective communication so that people not only understand what they've got inside their box, but also what it's doing and how applicable it is to them. In a period of nervousness over the next few years, people need much more assurance.

DONNY: From a trustees perspective, transparency is really important and there has generally been pretty good transparency within DGF funds. Innovation can often mean higher cost, and that needs to be controlled. Regarding capacity, history tells us to beware.

JUSTIN: Innovation should be driving down costs not putting up costs. If we are putting up costs, then it's not very good innovation. Our industry has had a torrid history of not adhering to the phrase, 'it's a privilege to look after people's money, not a right'. We're still not totally clear with people what all the costs and charges are and in my view that is not right.

ANDREW: The fundamental question which stems from all of this is 'who benefits'? If innovation is designed to make some investment banker his million pound bonus, it probably isn't going to be that useful. The crucial aspect is who is going to get the benefit out of this and what kind of benefit it is i.e. risk reduction, high return, lower charges or some kind of combination of all of these.

DAVID R: On that final point, I'd like to conclude and thank the panel for joining me.

Multi-Asset Investing in DC is here to Stay, However...



STEPHEN BUDGE
DC Investment Lead
KPMG LLP

We take a look at how and why diversified growth and multi-asset absolute return funds have made significant inroads into DC scheme default design and what the future holds for their continued use in an increasingly risk-aware pension industry. At KPMG we see a bright future for these products and believe the days of 100% equity in the growth phase of a default lifestyle strategy are numbered!

DEFAULT STRATEGIES

Not so long ago, the default investment design for the average defined contribution ('DC') scheme was almost as straight forward as investing 100% in equity and then moving to a mix of bonds and cash as retirement approached – well, almost. Over the last couple of years we have witnessed a great deal more focus on improving the design, with guidance from government, pressure groups and views from a wealth of other industry figures. With the onset of auto-enrolment, schemes should review their default design to make sure it is appropriate for members who may not even be aware that they are in a pension scheme.

The Investment Governance Group ('IGG')—established as a joint industry and government forum—produced a set of best practice Principles (<http://www.thepensionsregulator.gov.uk/about-us/investment-governance-group.aspx>) intended to encourage greater focus on better governance in DC schemes. The Principles indicate that the design of an appropriate default strategy should consider the needs of the broad membership, taking account of the scheme members' attitude to risk and what an appropriate outcome for members should be. The Department for Work and Pensions ('DWP') published its own guidance in a response to consultation (<http://www.dwp.gov.uk/consultations/2010/dc-default-option-consult.shtml>) that supported the work of the IGG and reinforced the focus on appropriate default design.

DGFS & ARFS

The limitations in accessing DC investments which, in the main, required daily dealing and daily valuations meant only the more traditional asset classes were typically available to scheme members; inclusion of a multi-asset fund was typically limited to a fixed-weight allocation or a peer group of funds. This and the long-term expectation of equity returns provided the rationale for members to be invested in equities for the majority of their working life.

However, with the introduction of diversified growth funds ('DGFS') and multi-asset absolute return funds ('ARFS'), we have seen a significant improvement in the opportunity for members to access more interesting asset classes and investment techniques previously only available to defined benefit ('DB') schemes. Multi-asset funds provide access to these more complex asset classes and techniques in a controlled and managed manner. One could just imagine a member investing their savings in a 'super risky' fund not understanding the need for diversification.

Some of the newer DC-related investment terms used in default strategies:

Risk-graded – the categorization of a fund or strategy associated with a particular level of investment risk.

Super accumulation phase – a small allocation to more exotic growth investments during the period where members still have a long-term investment horizon but have accumulated some savings worthy of the additional risk. Not quite the opposite of NEST's 'foundation phase' used in their target date fund series, but close.

Target risk – funds or strategies which manage risk on an active basis reducing the allocation to risky assets if the risk measure approaches or exceeds a pre-defined level.

Target replacement ratio – targeting a pension income relative to salary at retirement.

Targeted return – A managed default working to a target replacement ratio. The member's asset allocation is dynamically managed between 'growth' and 'protection' funds.

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Multi-Asset Investing in DC is here to Stay, However...

These funds, which are still relatively new in the main, purport objectives such as delivering equity-like returns with lower volatility, a return exceeding cash or some inflation-linked return (before fees). Although similar in concept, the DGFs tend to opt for inflation-linked targets and focus on accessing a wide range of asset classes directly, whereas the ARFs tend to perform against a cash-plus benchmark and make greater use of hedge fund techniques, but approaches vary widely. These performance objectives tend to suggest monitoring performance over a market cycle. In the market cycle we are currently experiencing, the majority of these funds have met the objective of reducing the market impact on members – some better than others.

These diversified funds have made significant inroads into the default space of DC schemes, although the fee for the funds tends to prohibit their sole use over long periods of time. Schemes are tending to use them as part of their growth portfolio, typically blending with a lower fee investment fund such as global equities or moving members' savings into these funds ahead of the pre-retirement phase to reduce the volatility risk of returns when members have their highest level of savings, typically between 15 to 5 years from their target retirement date. The chart shown highlights the risk and return impact of eleven portfolios invested in a global equity fund and a multi-asset fund, with varying allocations over two example three-year periods. The risk metric highlights the variation in monthly returns.

RISK GRADED FUNDS

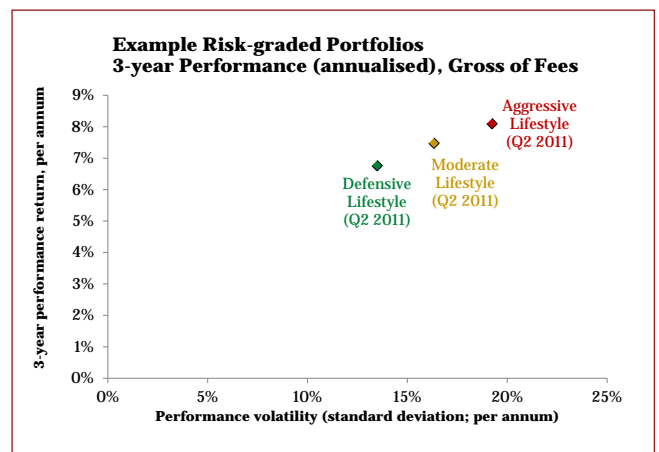
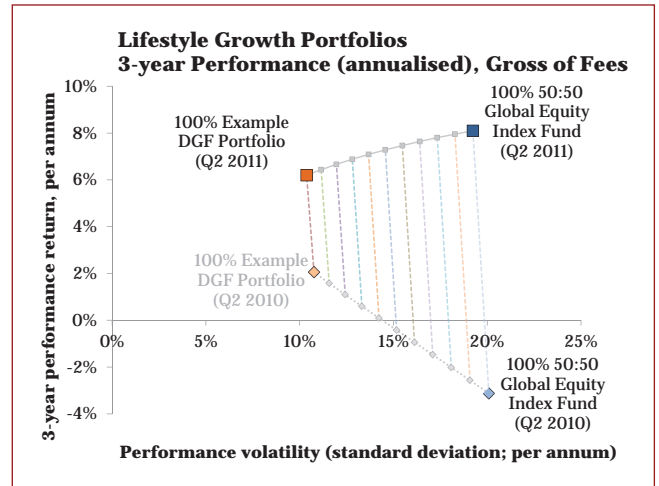
More recently, there has been a great deal of focus on appropriate levels of risk and allowing a member to actively choose their investment strategy based purely on their tolerance for volatility. This is typically defined through the use of a risk questionnaire rather than forcing a member to choose between a lifestyle strategy and single asset funds. This approach results in the provision of multiple lifestyle strategies or risk-graded fund choices.

The rationale for allowing members to make a choice based purely on their attitude to risk is one of engagement. Active decision making increases engagement and therefore improves the value of the sponsors' benefit spend. We have moved beyond the notion that a default is the wrong investment choice for members, it may well be the best – but members need to engage and make that choice. We strongly believe that there should be greater use of managed strategies and that these approaches can increase member engagement.

At KPMG we are working with clients to offer this approach to members and typically a scheme going down this risk-graded route will offer two to three strategies, designed to cater for different risk tolerances. Strategies can vary their risk signatures by affecting the length of the pre-retirement phase and/or modifying the growth portfolio to take on more or less risk. There may be choices in active or passive management as well as different designs for funds used in the pre-retirement phase, but on the whole it is the growth portfolio which is the focus for risk categorisation. The chart shows performance of an example set of client portfolios of three risk-graded growth fund options.

Linked to NEST's approach of defining its performance objective for the Growth Phase of their Target Date Fund series, we believe performance targets linked to objectives relative to the member's requirement i.e. to return performance ahead of inflation over the long-term, are likely to become the norm. NEST has already opted for 3% above CPI and multi-asset funds have already moved DC schemes in this direction with their inflation-linked or cash-linked targets. However, default and strategies are yet to monitor performance at a total portfolio level against longer-term benchmarks as the focus still remains on individual fund performance.

The future for DGFs and ARFs in DC scheme design, and in particular, structured portfolios and strategies is bright. We have no doubt that we will see increasing use of these types of funds and the newer 'passive' versions called Diversified Beta Funds ('DBFs') over time. The days of 100% equity in the growth phase of a default lifestyle strategy are numbered!





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