

Skillful diversification across asset classes can enable DC members to achieve equity-like levels of growth at lower levels of risk, says **Simon Chinnery**, senior client adviser at **JPMorgan Asset Management**

# Time to spread out

It is often pointed out that the most important difference between a defined benefit and a defined contribution pension scheme is that the investment and funding risks transfer from the employer to the employee. After a year in which the FTSE100 has rollercoasted month by month to fall a total of 1000 points, DC scheme members are receiving a sharp lesson in exactly what that transfer of risk entails.

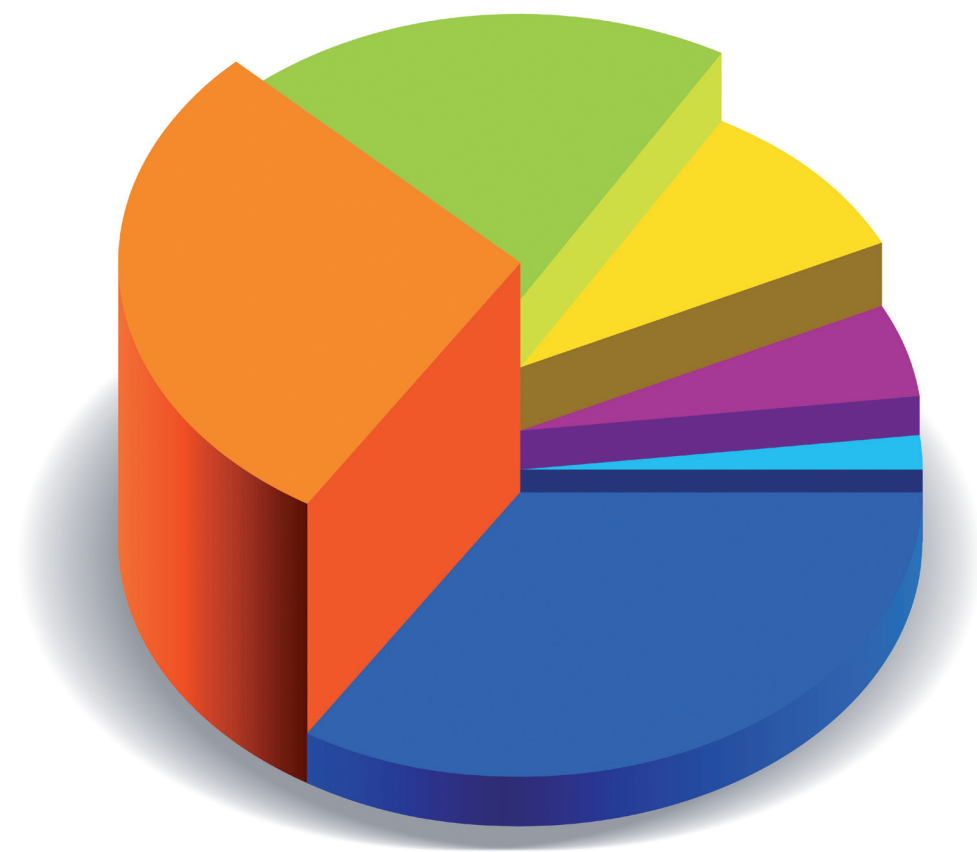
Market turbulence is heating up the debate as to how much responsibility employers and trustees have in helping DC members to manage investment risk.

Should members be given an array of investment choices, have the relevant risks explained to them and then be left to make the most appropriate choices themselves? Should members only be offered investment choices within a limited risk spectrum to protect them from market losses? And what is more reprehensible: exposing members to the risk of capital loss or limiting their downside risks and therefore reducing their long-term growth potential?

These are all difficult issues but they boil down to one thorny problem: how can a DC scheme enable each member to achieve the investment growth they require to fund their later years without also exposing them to unacceptable capital risks?

All too often, DC pension schemes have responded to market turbulence by encouraging members into low-risk asset classes. Bonds and cash both have their place in a pension portfolio, particularly in the run-up to retirement. But a premature wholesale move into these low-risk/low-growth assets can leave younger members recklessly out of pocket when they finally reach retirement, unless they can afford to contribute a very high proportion of salary into the pension.

But gradually, DC pension schemes are coming around to a new means of managing risk while preserving real returns: diversified growth investing.



Diversified growth investing aims to deliver the long-term return potential of a global equity strategy but at far lower volatility. It looks to achieve this by combining multiple asset classes, selected for their low correlation to one another.

Each asset class may, individually, have a relatively high risk-reward profile. However, careful blending enables these individual risks to be offset against one another. The result is a portfolio whose overall risk profile may be lower than its individual constituents but that still retains very strong return potential.

## A spectrum of sources of return

Diversified growth investing is a well-established approach among leading North American institutional investors such as the Yale Endowment Fund and

the Ontario Teachers' Pension Plan. These funds have built a formidable reputation for maintaining a risk-reward profile that even enabled them to weather the dark days of 2000-2002 with minimal losses.

The success of these strategies draws heavily on the principle that it is asset allocation, not simply stock selection, that contributes the bulk of portfolio returns.

Until recently, asset allocation for most UK pension funds has meant switching tactically between equities, bonds and cash. Diversified growth investing takes this principle much, much further.

Instead of standard core equities and bonds, diversified growth investing brings together a far broader array of asset classes with a strong focus on alternative assets. Typically,

these asset classes may include:

- Global equities – to achieve diversified equity exposure including exposure to the world's fastest-growing emerging markets;
- High-yield bonds – to provide higher return potential than investment-grade bonds while still retaining low correlation to equity markets;
- Commodities – to provide a hedge against inflation and return potential that is strongly linked to emerging market growth;
- Real estate – to provide further inflation-hedging protection plus reliable yields and good capital growth potential;
- Private equity – to provide long-term growth potential that's superior to public equity markets;
- Absolute return strategies – to provide long-short exposure to hedge-fund strategies that can deliver returns in both falling and rising markets.

As this list makes clear, diversified growth investing has a very strong focus on "interest-rate sensitive" real assets such as property, commodities and, increasingly, infrastructure – all of which can provide pension scheme members with an effective hedge against the eroding effects of inflation.

The correlation diagram (table 1 below) illustrates the potential benefits of blending these asset classes together. Over the five years analysed, most of these asset classes demonstrated a correlation coefficient of less than 0.5, indicating that there is very low linkage between their performance.

By combining high-growth asset classes with low correlation to one another, then actively managing allocation between them, it should be possible to retain high-return potential at reduced levels of overall risk.

### 1. CORRELATION OF DIVERSIFIED ASSET CLASSES JUNE 2001 – MAY 2006

	Global equities	Private equities	Property	Absolute returns	High yield	Commodities
Global equities	1.00					
Private equities	0.82	1.00				
Property	0.57	0.50	1.00			
Absolute returns	0.40	0.31	0.41	1.00		
High yield	0.75	0.57	0.40	0.31	1.00	
Commodities	0.04	0.06	0.10	-0.11	0.06	1.00

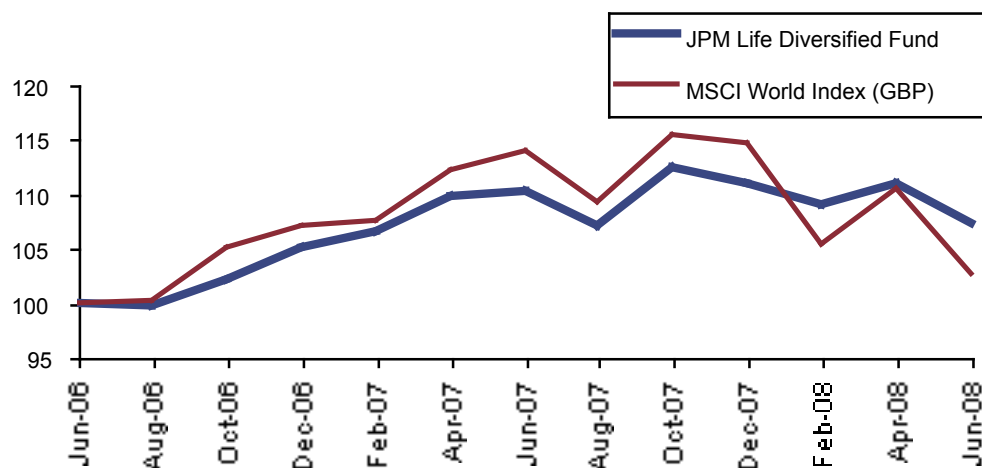
Source: JPMAM. Correlations calculated on a static mix of products and strategies over the relevant historic time period. Where strategies have limited or no history backfilling has not been used.

### 2. PERFORMANCE OF DIVERSIFIED GROWTH AGAINST KEY BENCHMARKS

	6 Months	1 year	Since Inception*
JPM Life Diversified Growth	-3.5	-3.2	3.5
MSCI World Index	-10.2	-9.5	1.8
1 Month GBP LIBOR	2.8	6.1	5.7
JPM Global Bond Index	4.8	17.7	5.6
Lehman Brothers UK Non-Gilts 10+	-6.1	-1.6	-1.7

Source: JPMAM. All performance in GBP, gross of fees; based on performance 30/06/06 - 30/06/08, performance is annualised

## Diversified growth reduces global equity volatility



Source: JPMAM

## But does it work?

Diversified growth strategies have a stated aim to deliver equity-like returns at reduced levels of risk. So in the short period of time that diversified growth funds have been available to DC pension schemes in the UK, has this objective been achieved?

As there is no specific life sector for diversified growth strategies, we can only cite the example of our own fund – the JPM Life Diversified Growth Fund – with the caveat that performance data is only available over a two-year period since its launch in June 2006.

Since launch, the JPM Life Diversified Growth Fund has achieved an annualised return of 3.5pc per annum compared to 1.8pc from global equities as represented by the MSCI World Index (see table 2, below left).

Compared to core DC pension fund choices, diversified growth investing also appears to hold up very well. For example, over the year to end-June 2008, the median return from the CAPS Balanced Fund was -7.5pc with the upper quartile averaging -5.9pc. In the CAPS Global Equity sector, the median return was -9.9pc, with an upper quartile average of -6.4pc. In other words, the Diversified Growth fund has outperformed both these sectors by around 11pc-13.4pc.

For the sake of balance, it should be pointed out that both the JPM Life Diversified Growth Fund and the MSCI World Index have underperformed returns from global bonds and cash over this period, as the table shows.

However, the outperformance of bonds and cash is, in our view, unlikely to be sustainable over the medium to long term. We will be interested to see

how the fund performs against these benchmarks over a period of five years or more.

What is perhaps more interesting at this point is how the Diversified Growth strategy has managed to dampen down market volatility over its first two years of life.

While the MSCI World Index has experienced volatility levels of more than 13pc, JPM Life Diversified Growth Fund has experienced volatility of just 8.5pc. The biggest drawdown (fall from a peak to a trough) for the MSCI World Index was 9.6pc. For the JPM Life Diversified Growth Fund, it was less than 6.5pc.

It is perhaps too early to draw too much from this performance. But these are very promising signs that a diversified growth strategy can achieve strong returns at reduced levels of risk, even in the extraordinary market conditions we are currently experiencing.

## Creating a default option

There are many applications for the diversified growth investment approach. But we believe it should be of particular interest to DC schemes looking to structure their default investment option.

More than 90pc of new contributions continue flow into the default options offered by DC pension schemes. It is therefore essential that this investment option is engineered to be as robust as possible in any market conditions.

For DC scheme trustees and sponsors looking to help their members to balance capital risks against capital gains, diversified growth investing is a promising place to start.