

# Diversified Growth Funds

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## Background

This short report is designed to introduce Diversified Growth Funds (DGFs) in terms of what are they, what do they invest in, why would an investor invest in such a fund and common issues that arise when selecting a DGF manager.

Of note is that the terms DGF, total return and absolute return are often used interchangeably to describe the same thing. The information provided below relates equally to DGF, total return funds and absolute return funds. These terms cover an extremely broad range of funds and Trustees should take particular care to become familiar with the characteristics of whatever fund they are considering, regardless of which of these terms is used.

## Diversified Growth Funds – What are they?

DGFs are funds that invest in a wide variety of asset classes in order to deliver a real return over the medium to long-term. Such funds are typically used as a replacement for a portion of the global equity allocation as a diversified means of looking for growth. There is quite a wide range of DGFs in the market place but typically these funds aim for a certain level of positive return or a certain level of return over inflation or over cash.

The long-term aim is typically to produce a similar level of return to equities, but with about two-thirds the level of volatility of equities.

## Diversified Growth Funds – What do they invest in?

The investment manager of a pooled DGF is generally given a good deal of freedom in terms of what the fund can invest in. The underlying asset classes that a DGF invests in varies greatly from manager to manager but typical asset classes included are as set out below. This is not an exhaustive list by any means.

Global equities

- Emerging markets (equity / debt)
- Private equity
- Investment grade corporate bonds
- High yield bonds
- Cash
- Property
- Commodities
- Infrastructure
- Hedge funds

There are a wide range of DGFs available. Funds vary significantly from manager to manager, in terms of asset allocation, the underlying asset classes that the fund invests in, in terms of the use of active versus passive management and in terms of whether the underlying asset classes are internally managed by the DGF manager or are managed by an external manager.

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Some funds make use of leverage i.e. borrow capital, although such funds are typically considered closer to hedge funds than to DGFs. There is often some use of derivatives in most DGFs to hedge risk (currency risk for example) or to implement certain profit seeking strategies.

## Diversified Growth Funds – Why invest in them?

Diversification (and DGFs) reduce reliance on equities as the main source of return i.e. they offer exposure to a variety of return sources and this is the main reason to invest in such a fund. The theory is that if equities were to fall significantly that a DGF would not fall by as much (or would recover more quickly) because of the variety of asset classes (return sources) within the fund. DGF returns should be less volatile than equity returns but DGFs still aim to provide equity-like returns over the long-term.

DGFs, being pooled funds, allow even small investors and members of DC pension schemes access to a broad range of asset classes within one fund and this is often difficult for small investors to achieve if investing directly in each underlying asset class.

## DGFs - common issues that arise when looking at diversification or when selecting a DGF manager are as follows:

- Increased governance – while diversifying by investing in a DGF requires less time and resources on the part of Trustees than investing in a broad range of asset classes directly, additional governance is required from Trustees to assess a fund of this nature in terms of whether it would be appropriate and to select and monitor the DGF manager
- Higher management fees – typically DGFs have higher management fees than passive funds and can have some 'hidden fees' which is why it is important to focus on the Total Expense Ratio (TER) rather than just on the management fee
- Measuring performance is only meaningful over the long-term and over a variety of equity market cycles, yet most DGFs were launched in the last few years.