

What does the future hold for Diversified Growth Funds?

Many so called 'diversified growth funds' (DGFs) have seen significant outflows over the past couple of years, driven by Defined Benefit (DB) pension schemes re-aligning their investment strategies or pursuing bulk annuity transactions.

With many DGFs now a fraction of their previous size, this paper considers whether funds can survive without the scale and might of the DB market which helped fuel their early commercial success. We also consider whether the sharp increase in outflows since 2022 could have acted as a drag on fund returns.

Key Takeaways

- ▶ A number of DGFs have seen large outflows; across a peer group of 13 DGF funds analysed, net outflows exceed £10bn over the last 3 years, with 2022 being a significant turning point.
- ▶ For those DGFs that have bucked the outflows trend, a key theme has been a well-diversified investor base and/or having explicit sustainable/ESG objectives.
- ▶ We found no evidence that negative flows have affected past returns. However, smaller funds tend to have higher costs, although the complexity and sophistication of the strategy is a more prominent driver of costs.
- ▶ Falling fund sizes may lead to some funds becoming commercially unviable. We expect some fund consolidation over the next few years, where managers may streamline the number of fund variations available. This could prove important in keeping funds at a size and scale where they can continue to offer value to investors.
- ▶ With expected ongoing variation of fund performance and potential fund consolidation, manager and fund selection is now arguably more important than ever.

A brief history of diversified growth funds

A multi-asset fund is a broad umbrella term for a type of fund that invests in more than one asset class. Multi-asset funds of one sort or another have been around for decades. While 'balanced' and 'managed' funds grew popular in the 80s and 90s, their significant bias to the UK saw them replaced in the mid -00s with a new wave of funds launched termed 'diversified growth funds'. DGFs were often marketed at UK DB pension schemes where trustees sought a holy grail of equity-like returns but with a smoother returns path.

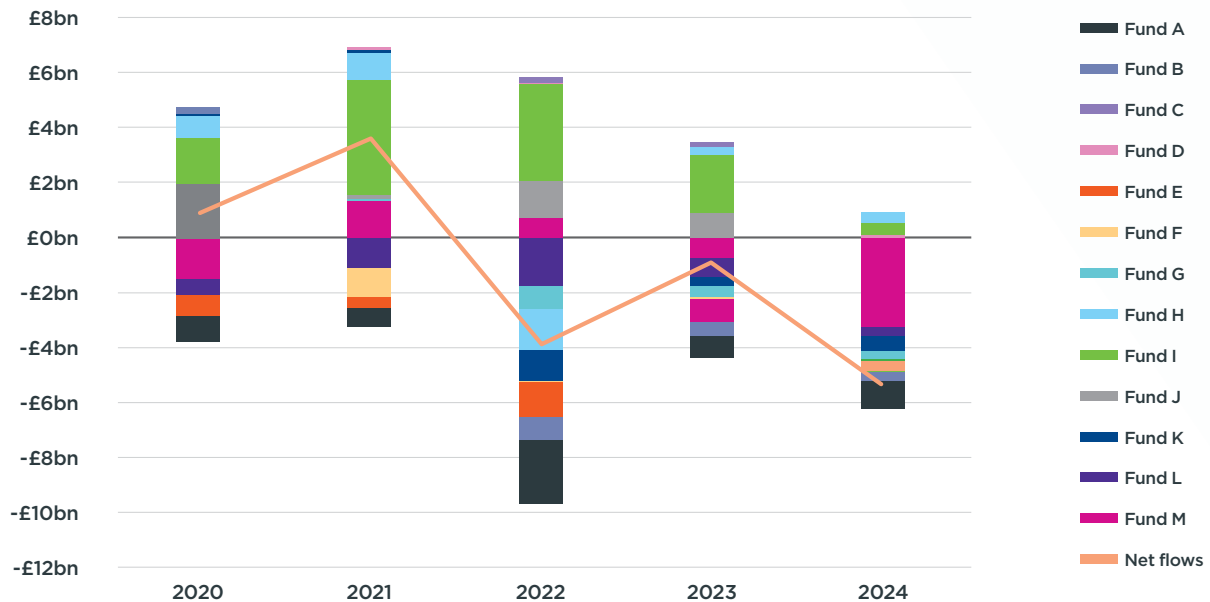
Compared to their balanced and managed predecessors, DGFs typically sought to achieve their objectives through a more dynamic and global approach to allocation. With a greater focus on downside protection, and access to a broader set of asset classes such as alternatives and real assets, in some cases, DGFs looked and felt more like hedge funds than traditional asset allocators.

As equities went into freefall during the Global Financial Crisis of 2008/09, most of the early wave of DGFs displayed much more resolute characteristics, enabling them to post highly attractive initial performance track records relative to equities. This appealed to pension scheme trustees and their advisors with DGFs successfully gathering billions in assets under management. Arguably the most commercially successful DGF was the behemoth Standard Life Global Absolute Returns Strategies (GARS), which at its peak size in 2016 amassed total assets of £53bn.

What goes up (in AuM) often comes down

Despite its huge early success, in late-2023 GARS weekly folded with less than £1bn in assets under management (AuM). Whilst this is undoubtedly one of the most high-profile falls, asset outflows have affected many other DGFs. To quantify this, the chart below shows fund flows data from 13 different DGFs that we actively research covering the 5-year period over 2020-2024:

Chart 1: flows by year across a selection of 13 DGFs



Source: Fund net flow data sourced directly from each respective manager

The chart shows 2022 being a key turning point with net cashflows turning negative to the tune of £3.9bn with 8 out of 13 funds registering net outflows in that year. In 2023, 8 funds (-£0.9bn net) saw outflows, rising to 10 out of 13 funds (-£5.3bn net) in 2024.

The 2022 experience - and the after effects through 2023 and 2024 - can be attributed to three primary factors:

- 1 The gilts crisis in the Autumn of 2022 caused a large number of DB pension schemes to seek liquidity to shore up LDI collateral levels. With DGFs offering both high liquidity and a relatively stable capital values they became an obvious source of liquidity for schemes.
- 2 Despite the turbulence of the gilts crisis, many DB schemes found themselves in an improved funding position that enabled the general de-risking of investment strategies. With many schemes 'locked in' to illiquid assets, de-risking was often focused on multi-asset allocations including DGFs.
- 3 While there is a wide dispersion in fund returns, generally DGF returns have underwhelmed over recent years - particularly when stacked against a strong equity bull market. It has undoubtedly been a challenging market for DGF managers when almost all assets used to diversify portfolios have dragged on returns - especially bonds.

However, there are positives to take from this data. 5 of the 13 funds saw positive net flows over the most recent 5-year period totalling £17.7bn, albeit this total is heavily skewed by the fund with the highest inflows responsible for £11.9bn of this total. There are two key themes that stand out amongst these 'winners':

- 1 The three funds that saw the largest positive inflows all have an investor base with a large Defined Contribution (DC) presence, with DC inflows more than offsetting outflows from DB investors.
- 2 Three of the five funds that saw positive inflows had an explicit sustainability/ESG objective.

What's next for fund flows?

Our view - and one supported through our ongoing dialogue with DGF managers - is that it's likely the large-scale DB investor shakeout post-gilts crisis is over. However, structural trends in the DB market are not going away and we still expect DB schemes to be net sellers of DGFs over the coming years, albeit it at a much slower pace.

Naturally, managers are exploring ways they can broaden their investor base, focusing on DC schemes, wealth managers, endowments and foundations. Evidence so far suggests that many managers are struggling to gain significant traction with new types of investors, albeit one fund we research with a sustainable focus has secured inclusion in a large UK wealth manager's 'off the shelf' fund portfolio which is an encouraging sign for future AuM growth.

Have outflows affected returns?

The assessment of whether large scale outflows negatively affected fund performance is hard to quantify, given any observed relationship could be explained through fund performance causing investors to decide to take their money elsewhere. However, based on the below chart - which plots the returns of our peer group of funds over a 5-year time period against net fund flows - there is no clear trend that the direction of fund flows and performance have any link.

Chart 2: 5-year annualised return to 31 December 2024 compared to 5-year net flows to 31 December 2024



Source: Fund net flow data sourced directly from each respective manager. Performance data sourced from Refinitiv. 2 funds out of our 13-fund peer group have been omitted as they have track records less than 5 years.

From a transaction cost perspective, all the DGF pooled funds surveyed have some form of pricing mechanism (such as bid/offer spreads or anti-dilution levies) that serve to protect existing investors from the impact of transaction costs from other investors redeeming units. Beyond transaction costs we considered whether managers having to place regular sell orders on the underlying assets could cause market pricing for those assets to move, which *would* impact exiting investors. Our conclusion here was that, as the vast majority of DGF portfolios are invested in highly liquid assets, it's unlikely that outflows will have caused any discernible pricing impact.

The managers we have spoken to about this topic have dismissed the notion that negative flows have affected returns. We therefore conclude that, providing trading costs are appropriately captured in pricing, and that funds are predominantly invested in highly liquid markets, then no reason large scale redemptions should impact fund performance. Whilst not an approach adopted by the funds that we research, investors in funds that operate a single priced model where costs are shared across all fund investors would likely be disadvantaged in an environment of greater fund trading.

Do smaller AuMs affect the investment case for DGFs?

Because DGFs invest in liquid markets, there is a reasonably strong argument that reduced fund sizes are not compromising the ability to access and build highly diversified portfolios. However, looking at the performance of DGFs over the last 3 years versus their current size, does demonstrate that smaller funds have tended to differ more significantly in returns. Some managers we have spoken to have discussed the positive outcomes from smaller AuM, particularly those investing in more niche assets such as small cap stocks, listed infrastructure or REITs where previously the fund's scale would have caused liquidity issues. Employing more niche strategies may be considered desirable but the scope for a wider range of outcomes needs considered when selecting a fund.

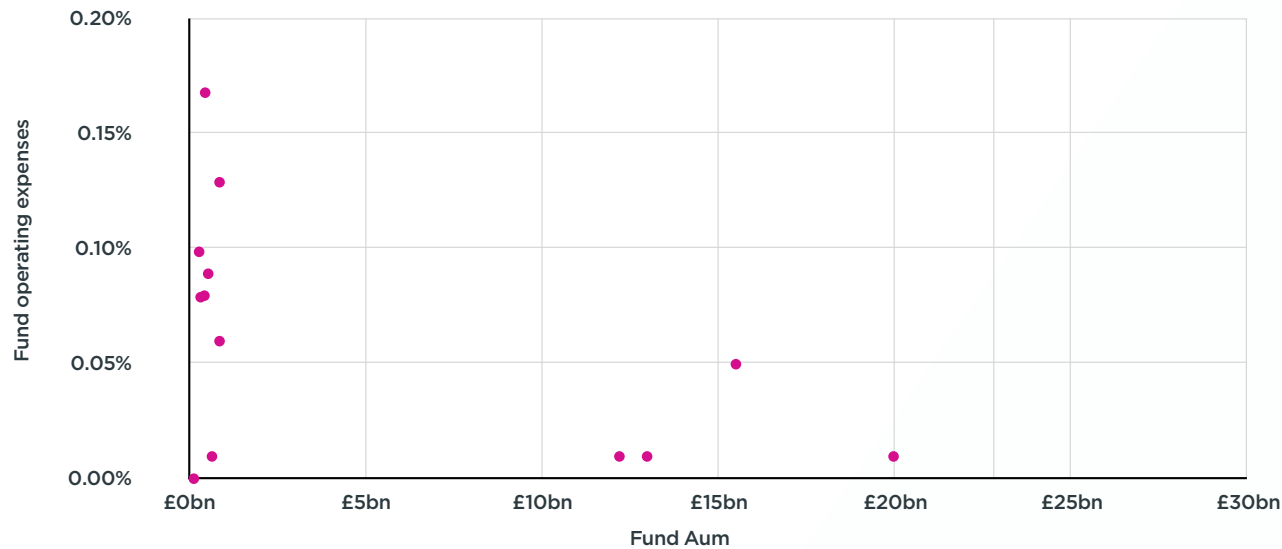
Chart 3: 3-year annualised return to 31 December 2024 compared to fund AuM at 31 December 2024



A potential downside of a smaller fund AuM is the impact of ongoing fund operating expenses such as custody, legal and administration. These operating expenses are usually fixed in nature meaning they represent an increasing drag on returns as the fund size shrinks. While this is a valid consideration, usually this only becomes of real significance when a fund size drops into the £10s of millions. Some managers may cap operating expenses to limit the impact on investors.

The chart below illustrates the operating expenses (taken as the difference between the ongoing charges figure (OCF) and the annual management charge (AMC)) of our peer group of DGFs. There is evidence that smaller funds have higher additional costs, albeit this is a narrow view and generally the complexity of the investment strategy has a much stronger link to additional expenses.

Chart 4: Fund operating expenses compared to fund AuM

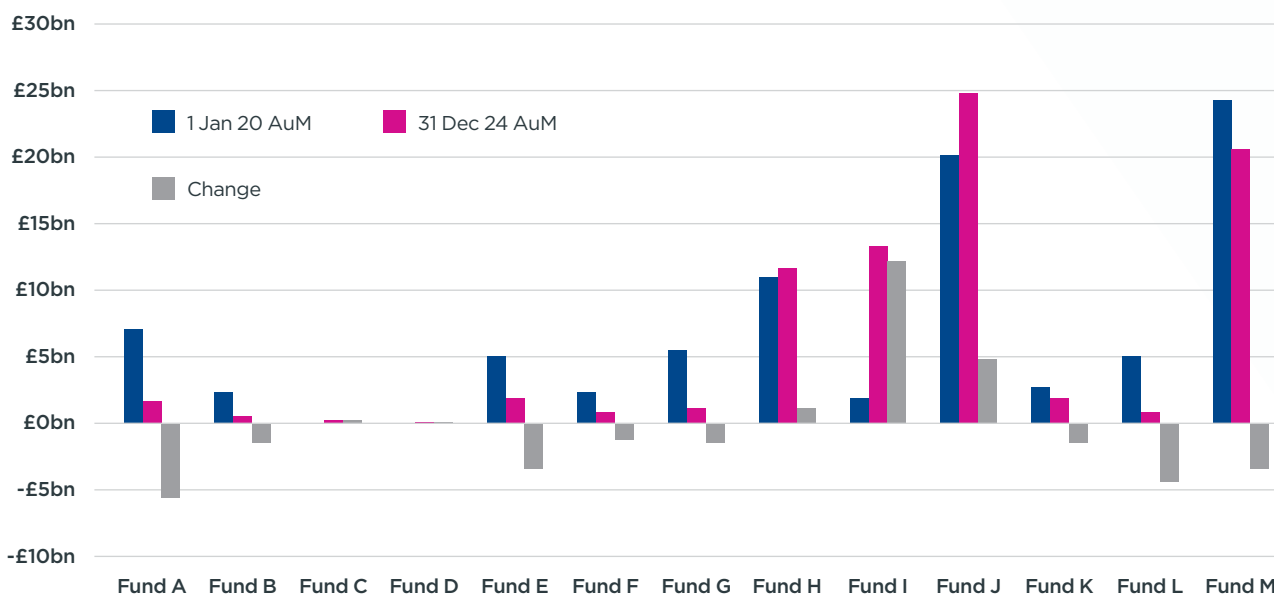


Another potential downside to smaller fund sizes is the impact on people and resourcing. Outflows reduce future fund management revenues, and as a result we have seen some investment managers reducing headcount within multi-asset teams. Cutting resources or losing key members of portfolio management teams could ultimately weigh on longer-term performance. Therefore it is important that investors consider this aspect as part of their ongoing governance.

Will continued outflows cause funds to close?

As discussed above, we don't believe falling fund sizes has a meaningful bearing on the returns funds deliver. However, the commercial aspects are more nuanced. With fixed resourcing and operational costs combined with a lack of pricing power (the ability to increase DGF annual management charges is largely non-existent) continued outflows could lead managers to consider their DGF commercially unviable. While managers are unlikely to publicly disclose the threshold level of assets where a fund could be considered commercially unviable, most managers we meet with acknowledge that a continuation of large-scale outflows would at some point prompt these discussions.

Chart 5: DGF flows compared to start and end AuM over a 5-year period



One trend that we expect to gain momentum is fund consolidation within a manager's offering, where they currently offer a range of similar DGFs. Often this arises because a manager has in the past launched variants of a flagship fund, e.g. funds with broader investment remit or "sustainable" versions of existing DGFs. Typically, the size of these fund variants is relatively small and therefore managers may seek to merge funds together. Providing the consolidation is between funds that have broadly similar approaches and there is commonality across the portfolio management team, then we do not necessarily see fund mergers as a negative. In fact, consolidation may prove important in keeping funds at a size and scale where they can continue to have the level of resources needed to deliver successful returns with reasonable ongoing running costs.

Given the heterogeneous nature of the DGF universe it is important that investors consider the risk of a fund becoming commercial unviable on a fund-specific basis. While some DGFs may be commercially viable sub-£100m, others may have significantly greater lower asset limits. The key point is there are no blanket rules, and a manager may also not consider their DGF AuM in isolation. For example, many DB pension schemes hold a DGF with the same manager as their LDI allocation; closing the DGF could lead investors to pull money from other asset classes.

Conclusion

DGFs have faced multiple headwinds over recent years causing several funds to suffer significant outflows. Whilst this trend is likely to continue for funds that retain a large DB investor base, managers that are successful in marketing their fund to a broader investor base are likely to see better fund flow outcomes.

We still believe there is a positive investment case for DGFs as an approach for a wide range of investors seeking long-term positive real returns with relatively low levels of volatility and lower governance. However, with some large shifts in the DGF landscape, and a range of observed performance, getting the fund selection right is arguably more important than ever.

About us

XPS Group is a leading UK consulting and administration business specialising in the pensions and insurance sectors. A FTSE 250 company, XPS combines expertise and insight with advanced technology and analytics to address the needs of over 1,400 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over one million members and provide advisory services to schemes and corporate sponsors in respect of schemes of all sizes, including 86 with assets over £1bn. We also provide wider ranging support to insurance companies in the life and bulk annuities sector.

Our investment team advises over 350 clients with assets of over £100bn.

Award winning

Pensions advisory



Investment consulting



Administration



Culture and Sustainability



Find out more

To discuss any of the issues covered in this edition, please get in touch with **Josh Pilley** or **James Kidd**. Alternatively, please speak to your usual XPS contact.



Important information: Please note the information and opinions expressed herein do not take into account the circumstances of individual pension funds and accordingly may not be representative of the circumstances affecting your fund. This note, and the work undertaken to produce it, is compliant with TAS 100, set by the Financial Reporting Council. No other TASs apply. The note has been written on the basis that decisions will not be based on its contents. Appropriate advice should be obtained before any decisions are made. The information expressed is provided in good faith and has been prepared using sources considered to be reasonable and appropriate. While information from third parties is believed to be reliable, no representations, guarantees or warranties are made as to the accuracy of information presented, and no responsibility or liability can be accepted for any error, omission or inaccuracy in respect of this. This document may also include our views and expectations, which cannot be taken as fact. The value of investments and the income from them can go down as well as up as a result of market and currency fluctuations and investors may not get back the amount invested. Past performance is not necessarily a guide to future returns. The views set out in this document are intentionally broad market views and are not intended to constitute investment advice as they do not take into account any client's particular circumstances.

Please note that all material produced by XPS Investment is directed at, and intended solely for the consideration of, professional clients within the meaning of the Financial Services and Markets Act 2000 (FSMA). Retail or other clients must not place any reliance upon the contents.

This document should not be distributed to any third parties and is not intended to, and must not be, relied upon by them. Unauthorised copying of this document is prohibited.

© XPS Group. XPS Pensions Consulting Limited, Registered No. 2459442. XPS Investment Limited, Registered No. 6242672. XPS Pensions Limited, Registered No. 3842603. XPS Administration Limited, Registered No. 9428346. XPS Pensions (RL) Limited, Registered No. 5817049. XPS Pensions (Trigon) Limited, Registered No. 12085392. Penfida Limited Registered No. 8020393. Polaris Actuaries and Consultants Ltd, Registered No. 9640309. All registered at: Phoenix House, 1 Station Hill, Reading, RG1 1NB. XPS Investment Limited is authorised and regulated by the Financial Conduct Authority for investment and general insurance business (FCA Register No. 528774).