MULTI-ASSET REVIEW

Q1 2018

Calculated risks

ONE YEAR AFTER IT CAME INTO BEING, THE IA'S VOLATILITY MANAGED SECTOR NOW BOASTS MORE THAN 100 FUNDS WITH OVER £25BN IN ASSETS. **ALEX FARLOW** TAKES A CLOSER LOOK AT WHAT IT OFFERS – AND WHY

It was around this time last year – on 3 April 2017 to be precise – that the Investment Association (IA) launched its new Volatility Managed fund grouping. A response to the growing number of risk-focused products available to investors, the sector is set up to contain funds that have the objective of managing returns within specified volatility parameters.

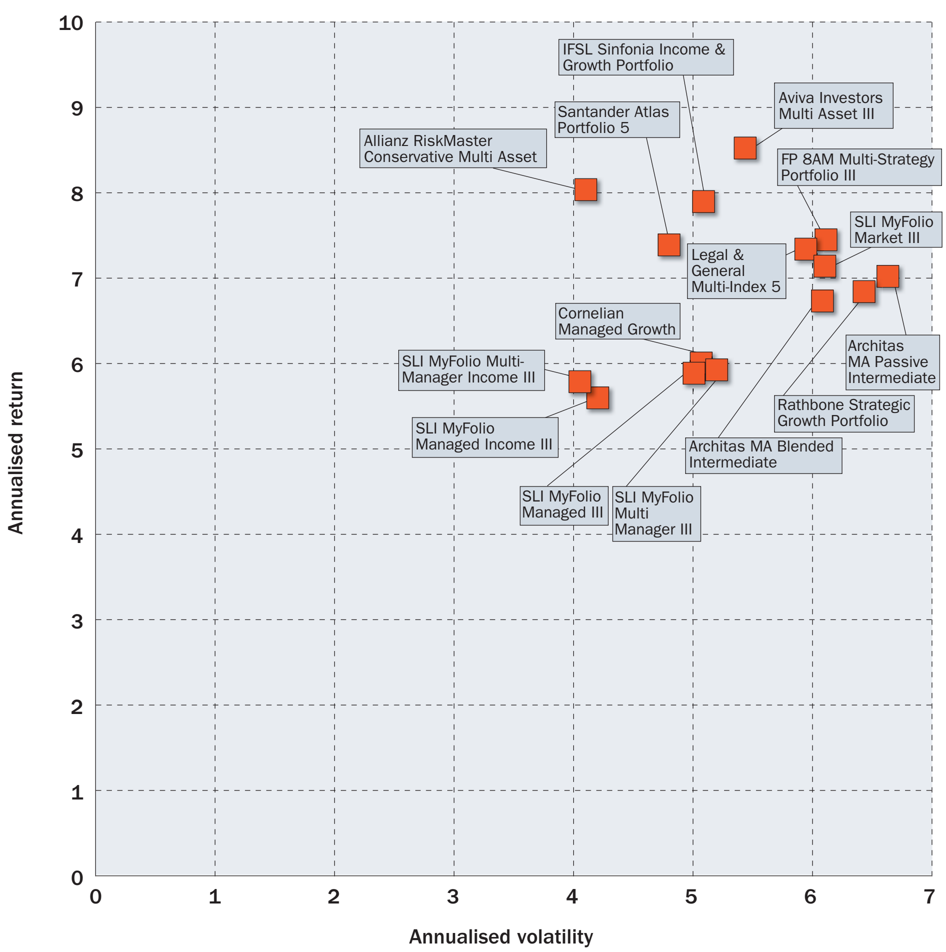
Like other IA sectors, there are broad guidelines that govern which funds can be categorised within it. One of the key stipulations is that groups managing funds in this sector are expected to disclose publicly that the fund is managed with the intention of delivering a volatility/risk outcome. The IA defines public disclosure as being made in the 'KIID' key investor information document or prospectus.

To ensure the sector continues to work in the best interests of consumers and their advisers, the IA Sectors Committee is due to carry out a 12-month review looking at disclosure levels and whether it is possible to develop or subcategorise the sector in a way that better serves investors. This work remains ongoing and we look forward to reading the IA's findings once they are published.

When the Volatility Managed sector was launched, it contained 83 funds with combined assets of £19.3bn – and today it contains 103 funds with combined assets of £25.1bn. Data for the sector over its first ten months – to the end of January 2018 – illustrate net flows were positive in each calendar month over this period.

The consistency of flows has also been reasonably steady, which should not come as a big surprise as risk targeted funds are frequently used as a core part of an advisory firm's centralised investment proposition and are therefore less susceptible to investor asset allocation changes that impact the flows of single-sector strategies.

Three-year annualised risk and return data for a cross section of funds that sit in the IA Volatility Managed sector and are designed to have a balanced risk



21 Mar 2015 to 16 Mar 2018
__Return Period__ Weekly, __Benchmark__ Funds own sector average __Risk-free Rate__ 3.5% __Annualised Ratios__ Yes __Currency__ Pounds Sterling

Arguably of more interest, the sector is in the top quartile of flows, based on the average monthly flows since launch. Compared with other sectors that predominantly comprise multi-asset funds, the Volatility Managed sector has generally seen lower flows than the Mixed Investment 20-60% Shares and the Mixed Investment 40-85% Shares groupings but higher flows than the Mixed Investment 0-35% Shares and Flexible Investment ones.

The limitations of this sector for comparative performance and risk assessment purposes have been well documented – and indeed the IA states this in its guidance notes. The sector contains funds that have very different outcomes, making comparisons challenging, to say the least.

Funds that are managed to volatility targets can span a very broad range of risk and return profiles. The sector contains funds that invest to a limited extent in high-risk assets, such as equities, as well as those that invest most of their portfolio in equities.

As such, no meaningful comparison of funds within the sector can be made and no quartile rankings are published. To illustrate this, over the three years to 31 January 2018, the volatility range of the funds in the sector has been between 1.65% and 11.49%. Over this period, the MSCI World index had volatility of 9.48% and the Bloomberg Barclays Global Aggregate index had volatility of 2.59%.

Even funds that, on the surface, have similar associated risk targets could behave very differently as they may use different benchmarks or be managed to different timeframes.

There are many different ways to structure a portfolio to target a specified risk level and so funds that are perceived to have a similar risk profile are likely to have a range of asset allocations. This will be due to funds using different asset allocation providers that model a different set of asset classes as well as having different rules around permitted diversification and maximum limits for each asset class.

The extent to which funds are permitted to make short-term adjustments to longer-term allocations and the breadth of the risk bands means it is unlikely any two funds will look exactly alike. The chart on the preceding page illustrates the three-year annualised volatility and return figures for a cross-section of funds in the sector that are designed to have a balanced risk profile.

For most funds within this sector, the starting point for asset allocation is based around an optimisation process that aims to construct a portfolio that can deliver the highest potential return for a given level of risk. The assumptions that largely drive this process are often determined by third-party providers of strategic asset allocation and capital market assumptions – though some asset managers do this in house.

These assumptions are usually long-term – that is, ten years plus – and are a best estimate of what the expected return and risk of a range of asset classes might be. For most funds, this asset allocation is only used as a guide although, for some, it is the fund's benchmark and is rigidly adhered to. For the large majority of funds, however, adjustments are made to the long-term asset allocation to take account of short-term valuation anomalies or market opportunities not factored into the long-term expectations.

Flexibility to adjust

Most risk-targeted funds target a range of risk outcomes as opposed to a single risk target. This is because targeting a risk range allows a manager flexibility to adjust the asset allocation without having to worry whether this change has taken the fund away from the single target risk level. Additionally, a target risk range also allows a manager the ability to increase or decrease the overall portfolio risk based on their outlook for investment markets.

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The popularity of the Volatility Managed sector – and indeed multi-asset funds more generally – has been driven by a number of factors, including a greater focus on investment suitability and investors' increased awareness of risk, following the global financial crisis of 2008/09.

This has in some part been regulatory-driven and has led to an increase in advisers outsourcing their investment propositions and reducing their business risk. The efficiencies have left many advisers with more time to focus on the provision of advice and financial and tax planning activities, which clients tend to confirm they value most.

While the sector is relatively new, three-quarters (77%) of funds have three or more years of history and two-thirds (64%) have at least five years of history, illustrating there are a number of relatively established funds within it. Standard Life Investments' MyFolio Growth and Income fund ranges dominate the sector and account for around 50% of total assets. Unsurprisingly then, at £3.5bn, the largest fund is Standard Life Investments MyFolio Managed III (see below).

The risk-targeted sector look set only to grow over the next few years as new players enter the market. It is also likely other funds that are managed to risk targets, but which currently reside elsewhere, will move to the Volatility Managed sector in time – both as asset managers work towards fulfilling the IA requirements for inclusion and in the wake of the conclusion of the IA's planned review to sub-divide the sector.

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Fund profiles

❖ **Standard Life Investments MyFolio Managed III** is the middle in a range of five funds that invest primarily in Standard Life's own range of active investment strategies. The fund targets a volatility that is expected to fall between 45% and 75% of the MSCI World index volatility over the long term – defined as 10 years or greater. The fund is managed by the well-resourced fund solutions team, supported by the large multi-asset team who provide tactical input to the investment process. This is a 'Recommended' fund within the Square Mile Academy of Funds.

❖ **Legal & General Multi-Index III** aims to provide capital accumulation from a combination of income and growth over the longer term while seeking to maintain a level of risk consistent with Distribution Technology risk profile 3. This equates to a risk level broadly similar to 35% to 55% of equity volatility. The fund offers investors access to a portfolio that is low-cost, actively managed and which is diversified by asset class. Investors should remember the underlying funds will predominantly be passively managed. Both this fund and Legal & General's Multi-Index range have a 'Recommended' rating within the Square Mile Academy of Funds.

❖ **SVS Cornelian Growth** aims to provide capital accumulation over the long term from investment in a broad range of assets, including equities, bonds, alternatives and cash. The manager targets a real return and one that is in excess of the UK Retail Prices Index plus 2.5% a year over a market cycle, while limiting the associated forecast volatility to below 12.6% a year, which is broadly around two-thirds that of equity volatility. In our view, this is a robust proposition for investors who require a real return on their capital along with some certainty around the level of risk the portfolio can take on in order to achieve this.