For Professional Advisers Only

A Spotlight On:
IA Volatility Sector

April | 2019

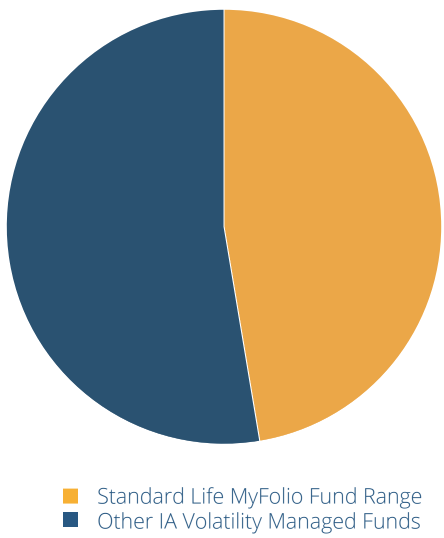
Introduction to Sector

Research undertaken by Invesco in September 2018 found that 56% of advisers use risk targeted funds, which compromises a third of their assets under management*. Given the large number of advisers who use risk targeted funds it is surprising that the IA Volatility Managed sector was only launched in April 2017. At launch the sector comprised of 83 funds with a combined AUM of £19.3 billion**, in the 17 month period since launch to the end of November 2018 the AUM has grown to £28.6 billion and now compromises 124 different funds (Source IA). However a large number of ranges managed by the likes of Architas, Premier and SEI remain outside of the sector, with most falling in to the IA Mixed Investment sector. So the actual AUM of risk targeted funds is much bigger than the sector number and we believe it is in excess of £50 billion.

Within the sector, the five Aberdeen Standard Investments MyFolio ranges (Managed, Manged Income, Market, Multi Manager and Multi Manager Income) which compromises 25 funds, represents nearly half of the total sector with circa £13.8 billion under management.

The sector consists of funds that, instead of having a specific return objective, look to target a specific volatility target or range over the long term. Therefore it is perfectly feasible for a fund to have performed poorly but will still be meeting its primary objective by remaining within its specified volatility parameters.

One of the major criticisms of the sector, is that it consists of different funds with differing volatility objectives. We acknowledge this fact, however we welcome the introduction of the sector, as even though the sectors median performance is meaningless, the sector is a good starting point for investors wishing to find funds that target volatility as their primary objective, instead of return.



Source: FE Analytics (28/01/19)

Fig 1: Breakdown of the IA Volatility Managed Sector

*https://www.invesco.co.uk/uk/news-and-insights/why-risk-targeted-funds?utm_campaign=summit-funds-launch&utm_medium=email-external&utm_content=sfes281118&utm_source=none

** https://www.theinvestmentassociation.org/media-centre/press-releases/2017/ia-launches-£19.3-billion-volatility-managed-sector.html

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Sector Nuance

One of the misconceptions of the sector is that, as all the funds have a volatility objective, they should all be able to protect investor's capital during market turbulence. The majority of the highest risk funds within each fund range target a volatility which is similar to global equities and we would therefore expect them to perform similar to global equities over the long term.

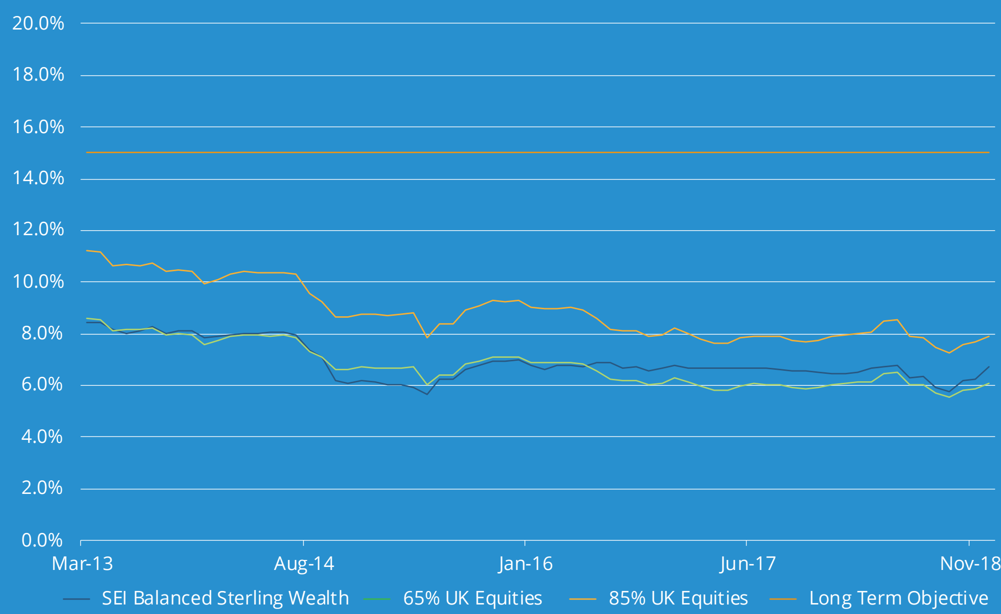
The sector consists primarily of ranges of funds, which is effectively when an asset manager manages a number of different funds, generally ranging from low risk to high risk, but with a similar investment approach. One of the problems with this is that each range will determine risk differently depending on the long term market assumptions that drive the respective asset allocation. Therefore two funds may have similar absolute volatility targets but Fund A's view on what a volatility of 10% means maybe totally different to Fund B's view. A perfect example is when comparing the HSBC Global Strategy Balanced Portfolio against the Cornelian Managed Growth fund (which is also expected to be a balanced portfolio). The HSBC fund has a long term volatility target of 9.5% p.a., while the Cornelian fund targets a volatility of between 8.4%-10.5% p.a. You would expect both funds to have a broadly similar asset allocation and short term volatility. Interestingly the HSBC fund, over the last 5 years to 31st December 2018 provided a volatility of 7.2% p.a. while the Cornelian funds volatility over the same period was 5.9% p.a. (Source FE Analytics) In addition, the HSBC fund has a larger allocation to riskier assets with 65% of the fund in equities while only circa 50% of the Cornelian fund is invested in equities. Overall investors should be aware that just because two funds have similar volatility targets, over the short and medium term their volatilities may not be the same.

Recent Sector Performance

The IA Volatility Managed sector consists of many funds with very different objectives and generally the only similarity between funds is that they manage returns within a specified volatility parameter. Some funds will look to preserve investor's capital, while other funds will try to target a similar volatility, and hence return, to global equities. Therefore looking at the sector's return and determining a fund's quartile ranking is pretty futile and would be more of an assessment of market conditions than the fund's performance.

Even though in the last six months volatility has increased, since the global financial crisis, volatility in markets has generally been subdued. Over the last five years to 31st December 2018, the MSCI World had a volatility of 9.8% p.a. in GBP terms. Compare this to the 15 years prior (31st December 1998 – 31st December 2013), where the volatility of the index was 15.3% p.a. (Source FE Analytics). Due to the subdued volatility in markets more recently, the majority of funds in the sector have not provided volatility close to their long term target. We are there not disappointed in the performance of these funds, and actually believe that most have been investing in a prudent way. As discussed previously, the HSBC Global Strategy Balanced Portfolio has a long term volatility target of 9.5%, if it was to achieve this over the last five years then it would have to have been fully invested in global equities, which is not what investors would expect from a balanced portfolio.

Most funds in the sector have long term volatility targets, that is 10-15 years, and occasionally longer, to take account of periods of above average or below average volatility. Therefore assessing whether a fund has hit its volatility target over a five year period is not that useful. Over shorter term periods, comparing a funds volatility relative to the volatility of equity markets, over the same period, is a much more useful exercise. For this reason, for every risk targeted fund recommended by Square Mile, not only do we state the fund's long term volatility objective, but we also estimate the expected volatility relative to UK equities, which we believe is a more understandable measure for UK retail investors. For example the SEI Balanced Sterling Wealth fund will target an expected annualised volatility close to 15% over the long term, however in practice we believe that it is expected to deliver a level of volatility similar to 65% to 85% of UK equities. The graph below highlights that, even though the fund's volatility has been considerably below its long term target of 15%, it has remained broadly within its UK equity bands and therefore has been delivering a volatility in line with our expectations.



Source: FE Analytics (28/01/19)

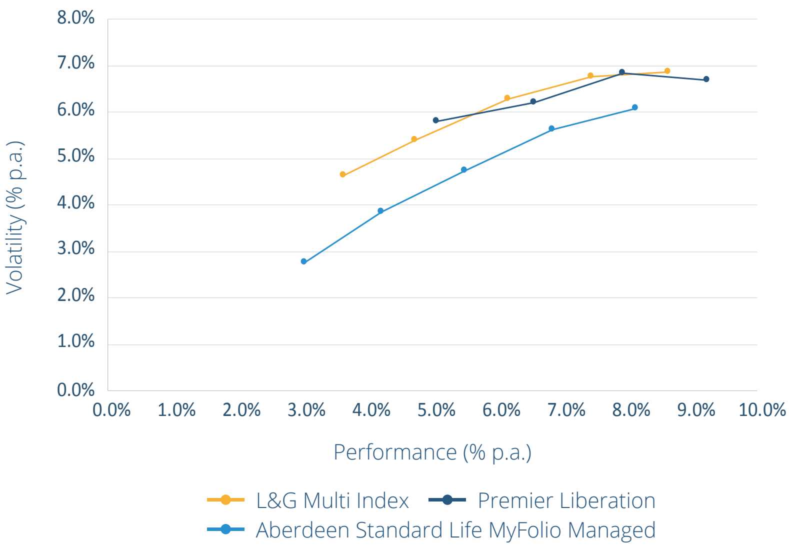
Fig 2: SEI Balanced v UK Equity Targets, rolling 3yr monthly volatility

Funds in Focus

Fund ranges within the IA Volatility Managed sector can generally be classified under three broad headings; passive funds, fettered fund of funds (invested in internally managed active funds) and unfettered fund of funds (invested in externally managed active funds).

Passive Funds

The L&G Multi Index range will predominantly invest in passive funds managed by the wider group, but even though it invests in passive funds, it is not purely passive in nature. All five funds within the range benefit from L&G's proprietary tools and assumptions and these help build the long term asset allocation which is used as a starting point for portfolio construction. The lead fund manager, Justin Onuekwusi, and the Asset Allocation team then make tactical short term (1-5 years) adjustments to the long term asset allocation in order to build the final five portfolios. Therefore even though the funds may invest in passive funds, the final portfolio is certainly not passively managed.



Source: FE Analytics 28/01/2019)

Fig3: Risk Targeted Risk v Return, 31/08/2013 - 31/12/2018

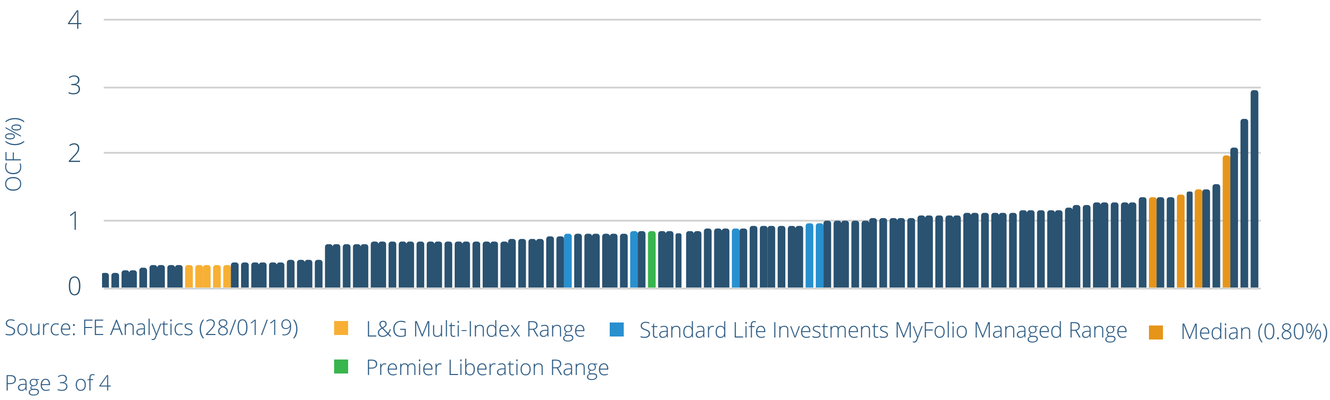
Fettered Fund of Funds

One of the fettered fund of funds ranges we have a high regard for is the Aberdeen Standard Investments MyFolio Managed range, which consists of five funds all managed by the experienced investor Bambos Hambi and his team. This is the largest fund range in the sector by AUM. The funds in the range will predominantly invest in Aberdeen Standard Investment funds which limits the investible universe available to Mr Hambi. However, we believe that the breadth of funds currently available is large enough to build suitably diverse portfolios. Given the use of internal funds, this fund range will typically be 40/50bps cheaper than a fund range that uses external active funds. One of the reasons why we like this range is the breadth of funds that Mr Hambi can invest in made possible by the size and scale of the Aberdeen Standard Investment business. This type of fund structure may not be suitable if it is managed by a smaller asset manager who has a limited number of funds.

Unfettered Fund of Funds

The final type of fund range available to investors, is one that predominantly invests in active funds. The Premier Liberation range follow this approach and consists of four risk targeted funds. The starting point for each fund is the long term asset allocation determined by Distribution Technology. The team responsible for the funds, led by the experienced David Hambidge, will then look to add value through both tactical asset allocation as well as fund selection. They look to add value through fund selection by investing across a broad range of asset classes and investment vehicles, including both open-ended and closed-ended investment companies. This gives the team the widest universe of funds to invest in and therefore provides them with the greatest alpha opportunities compared to other funds in the sector. However, this type of approach is the most expensive in the sector, which means the team have to generate more alpha in order to provide the same net returns as peers.

Over the long term, theoretically, we would expect the Premier Liberation range to outperform the Aberdeen Standard Investment MyFolio Managed range that would outperform the L&G Multi Index range, due to the greater alpha opportunities available to each manager. However since the L&G Multi Index range was launched in August 2013, this has not been the case. The L&G and Premier ranges have broadly provided similar risk and return outcomes, and this trend has generally been reflected across the sector. The reason for this is, even though alpha has been generated through fund selection in international equities within the unfettered approach, passive funds have generally outperformed active funds in UK equities, as the mid cap bias active funds generally have has been hurt by the Brexit fall out. Additionally, the majority of fixed income managers have underperformed their benchmarks as they have been surprised by the prolonged low yield environment. One of the reasons why the Aberdeen Standard Investments MyFolio Managed range has a lower risk and return profile than its peers is due to the structure of the funds. All five funds within the range have a 10%-20% allocation to absolute return strategies. Returns from many absolute return funds have been disappointing over the recent period particularly when compared to equities.



Source: FE Analytics (28/01/19)

Sector Outlook

The IA Volatility Managed sector was only launched in April 2017 and there are still adjustments needed in order to make it more useful for investors. As mentioned previously, we believe that the sector is a good starting point for investors looking for risk targeted funds. However, the sheer range of volatility objectives in the sector does lead to limitations. In the future we would like to see sub sectors created within the sector (we understand this is something the IA are looking into), so a better comparison can be made for lower risk, medium risk and higher risk funds. The difficulty is, how to form a sub sector. Unfortunately there is no perfect solution, however, it is feasible that sub sectors could be based on the funds historic volatility, its risk rating from an external provider, or from a fund's long term volatility expectations relative to UK or global equities. We accept that none of these suggestions may provide the perfect solution for every fund range or every investor, but it would provide some progress from the current arrangement.

One of the observed trends within this, and other sectors, is how fund groups are under pressure to reduce their fees. Over the last 12-18 months we have seen both Aberdeen Standard Life Investments and Architas reduce their fees by 20bps or more. This will have an impact on revenue but it also means they should still remain competitive. Additionally, BMO have recently launched three risk targeted funds that utilise internal active funds and all have an OCF under 30bps. These moves have meant that all funds within the sector, and especially active funds with high OCF's, are under increasing pressure to justify their fees. The reality is, if they can't justify their fees, then they will either have to reduce them or face the prospect of investors going elsewhere.

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