MyFiduciary
Governance & Investment Support

Objective-based Funds: Analysis and Investor Considerations

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Summary

Objective-based asset allocation (OBAA) funds were born in the ashes of the GFC and target an absolute return. Their appeal is that they offer investors a one-stop solution and better potential management of downside risks through dynamic asset allocation and risk protection overlays. However, our analysis shows most have under-performed conventional balanced funds since inception, and they have not, in general, meaningfully used the asset allocation ranges permitted by their investment policies. They are also yet to be truly tested in a bearish market environment. For retail investors such as retirees the evidence to date suggests they may be better off investing in a conventional fund or KiwiSaver product in line with their risk tolerance and objectives.

For Advisers and wholesale investors OBAA funds do not remove the need for comprehensive due diligence. Analysis in this paper shows that while these products have similar performance and risk objectives, they differ markedly in the actual investments made. We also caution that while an OBAA manager will make asset allocation and fund selection decisions, they are still the responsibility of the Adviser or investor – they cannot be delegated away.

Introduction

Objective-based funds came into prominence in response to GFC, where many investors suffered larger losses than they were able to stomach, or bear given their distributional requirements and cash-flow needs. In turn, leading up to and during the GFC most fund managers were operating mandates that severely constrained their ability to adjust asset allocations and risk levels to shelter investors as markets tumbled. These experiences have influenced the design of OBAA funds. Their aim is to deliver an absolute return that meets the investor's growth and income needs through all market environments, including times of stress.

Fund managers have been rolling out objective-based products and fund flow numbers show they have been getting strong interest. But are they really a suitable replacement for a traditional balanced fund? Let's take a closer look.

Table 1 below summarises six OBAA funds domiciled in New Zealand and Table 2 shows their broad asset allocation ranges. They either have an income or return target (or both), and to achieve this a very flexible asset allocation policy. In contrast traditional multi-sector balanced funds have a long-term strategic allocation to various asset classes, with less ability to tactically move away from this.

Most of the return-seeking funds have return targets of CPI inflation or the Official Cash Rate plus a hurdle of 3-5%. With inflation and interest rates currently running at around 1.75%, and a median fee is 1%[1], this equates to a total return target of around 6 – 8%. This is no easy feat in a low return environment.

Table 1: New Zealand based OBAA funds

Name	Objective	Type
AMP Capital Global Multi Asset	CPI plus 5% over 5 Years	Return targeting
AMP Capital Income Generator	Regular & stable income & long-term capital growth	Income targeting
Castle Point 5 Oceans	OCR plus 3% over medium-term	Return targeting
Harbour Income	OCR plus 3.5% over 3 years	Return targeting
Milford Diversified Income	Capital growth over 3 years with quarterly income	Return targeting
Mint Diversified Income	CPI plus 5% over 5 Years	Return targeting

Table 2: Broad Target Asset Allocation Ranges

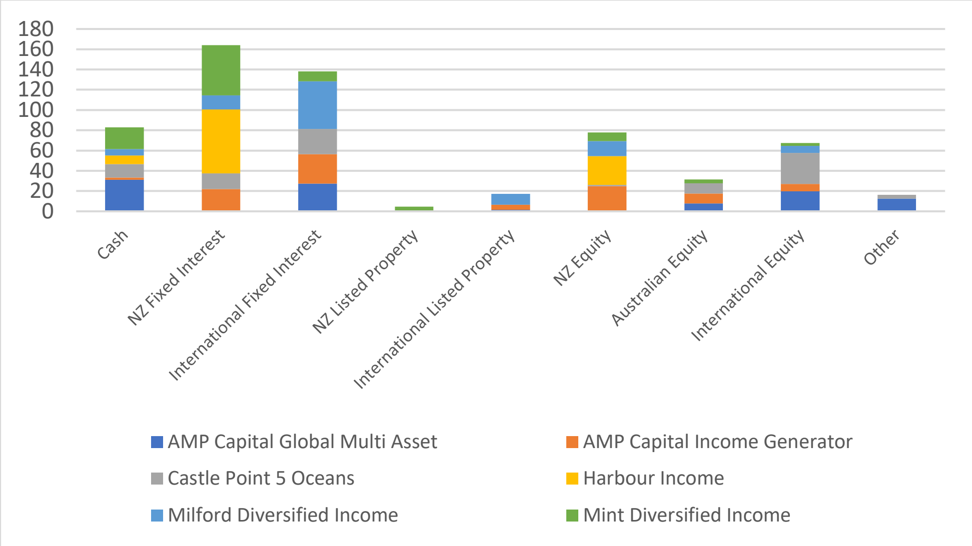
Name	Fixed Income	Equities
AMP Capital Global Multi Asset	0 – 100%	0 – 75%
AMP Capital Income Generator	60	40
Castle Point 5 Oceans	0 – 100%	30 – 70%
Harbour Income	20 – 90%	0 – 60%
Milford Diversified Income	0 – 70%	5 – 50%
Mint Diversified Income	TBC	TBC

Source: Fund Manager Statement of Investment Policy & Objective

The flexibility in the mandate design of these funds results in very different portfolios across the providers, as Chart 1 illustrates. Cash allocations vary from 31% (AMP Capital Global Multi Asset Fund) to around 2% (the AMP Capital Income Generator). Harbour Income has 63% allocated to New Zealand fixed income, yet AMP Capital Global Multi Asset has zero. Castle Point 5 Oceans fund has 31% allocated to international equities, while the Mint Diversified Income has just under 3%. The key point this illustrates are that these products are not homogenous - the broad ranges give the fund managers a large amount of discretion in how they target risk, and potentially shift allocations around.

[1] The management expense ratio of the 6 funds ranges from 0.88% to 1.71% with a median of 1.09%

Chart 1: Current sector allocations across OBAA funds



Source: Morningstar Direct

As a result, these funds should not be treated as a 'set and forget' investment decision. While they have similar absolute return objectives, their quite different approaches imply it is imperative that you do your research before considering investing. Each of these funds also invest into their own inhouse products, which means they are also limited by their internal product range and inhouse speciality. If they don't offer an international fixed income strategy, then it's probably not going to be included in the mix. And, if they have a growth bias, that style will flow through too. It's why you see such a large divergence in the asset classes in the chart above, and in the different return profiles of the funds. The potential wide discretion to shift allocations around also argues that due diligence should examine the investment processes that the manager has in place to make well-informed dynamic asset allocation (DAA) decisions.

Regarding DAA, a feature that stands out from the historical record is that while these funds have a very broad mandate, and managers may claim that they will actively shift the portfolio around according to the reward for taking risk, the evidence isn't there that they are using this discretion. When examining the portfolios through time, the allocations between cash and fixed income and equities doesn't change a great deal. This isn't perhaps surprising given it's notoriously difficult to time markets, but it does beg the question of whether they will really protect capital in a downturn over and above conventional funds that have similar, *on average*, risk profile as these funds have been running.

A second key feature of the data is that these funds have tended to be run relatively conservatively. None of them currently have more than 50% allocated to growth assets, and as discussed this is not unusual in their history. The question this begs is how well do these funds achieve their return targets? With such high allocations to cash and fixed income it's arguably very hard to deliver after-fee returns of CPI plus 3-5%.[2] Chart 2 below illustrates this point. Milford Diversified Income (which within fixed income has tended to allocate more to high yield compared to other managers) is the only fund to achieve a return broadly in line with its mandate. In addition, most of these funds have under-performed the average NZ balanced fund (Table 3 and the navy-blue shaded area in Chart 2).

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[2] Unless within fixed income they go down the capital structure into high yield (which some do)

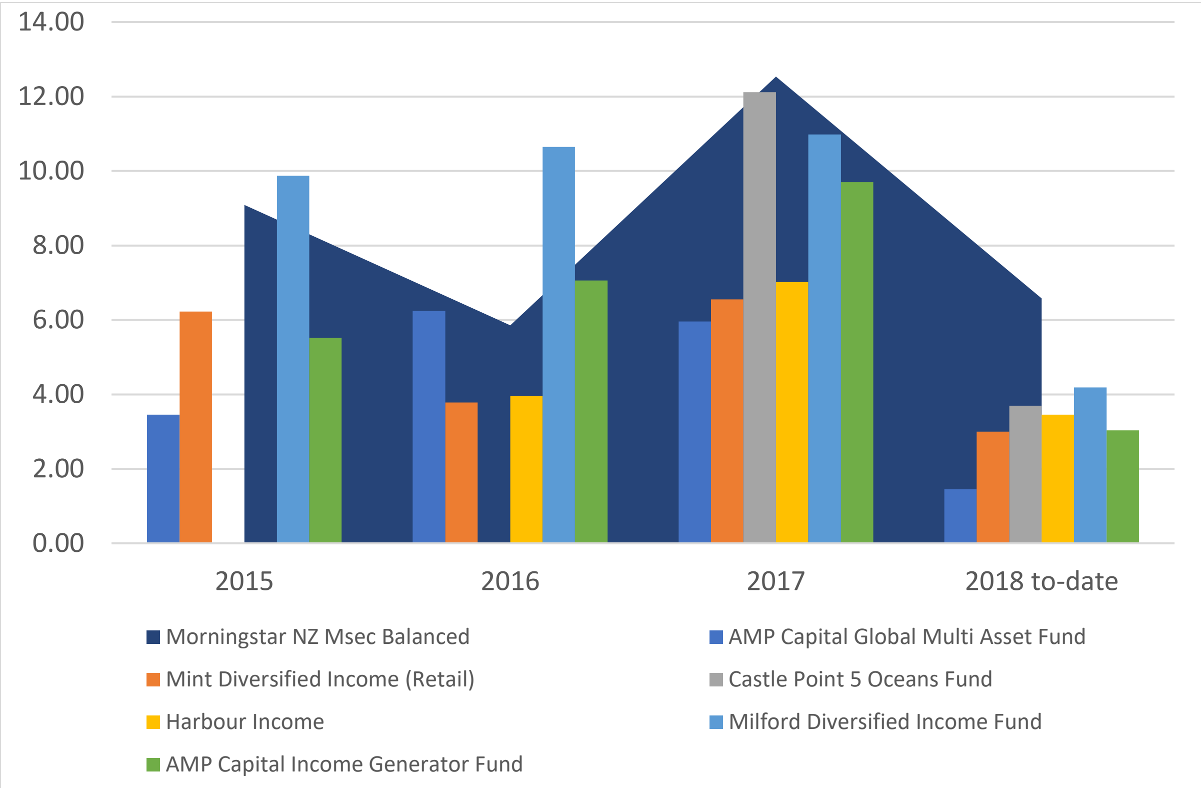
Based on the record to date, investors would have been better served in a more conventionally managed portfolio.

Table 3: Performance of New Zealand Domiciled Objective-based Funds

Name	Inception Date	3 Months	1 Year	3 Years	5 Years
AMP Capital Global Multi Asset Fund	Dec-13	1.11	3.95	5.21	
AMP Capital Income Generator Fund	Jun-14	1.41	5.36	7.79	
Castle Point 5 Oceans Fund	Oct-16	2.77	8.06		
Harbour Income	Oct-15	2.56	5.69		
Milford Diversified Income Fund	Apr-10	2.36	7.82	10.30	11.18
Mint Diversified Income (Retail)	Sep-14	1.77	5.21	5.39	
Morningstar Multisector - Balanced Peer Group		**3.29**	**8.99**	**7.45**	**8.30**

Source: Morningstar Direct as of 31 August 2018

Chart 2: Performance of OBAA funds versus the average multisector balanced outcome



Source: Morningstar Direct as of 31 August 2018

In summary, like all investments, with OBAA funds it's critical to do your homework. This includes a detailed understanding of the asset allocation decision-making and portfolio construction processes; understanding key fund manager biases and whether they invest only into in-house products or invest more broadly; and understanding all fees and costs (make sure you check to confirm the return target is after fees). As always, all answers should be backed up by evidence of data, don't just take a manager's word for it!

Financial advisers and Trustees have a fiduciary responsibility for all asset allocation and fund manager decisions they make on behalf of their clients or members or beneficiaries. A word of caution is that by investing into these funds you pass this decision – but not obligation - to a fund manager. For this reason, if anything, we suggest that due diligence and monitoring process needs to be heightened in order understand and have confidence in the processes run by an OBAA manager. The approach should also be compared against your investment philosophy and beliefs. OBAA implies for example a belief that managers can add value through taking tactical or dynamic asset allocation decisions. Is it worth this extra effort? The evidence to date suggests not really.

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