GUIDE TO ABSOLUTE RETURN INVESTING

An Alternative Approach in the New Era of Investment

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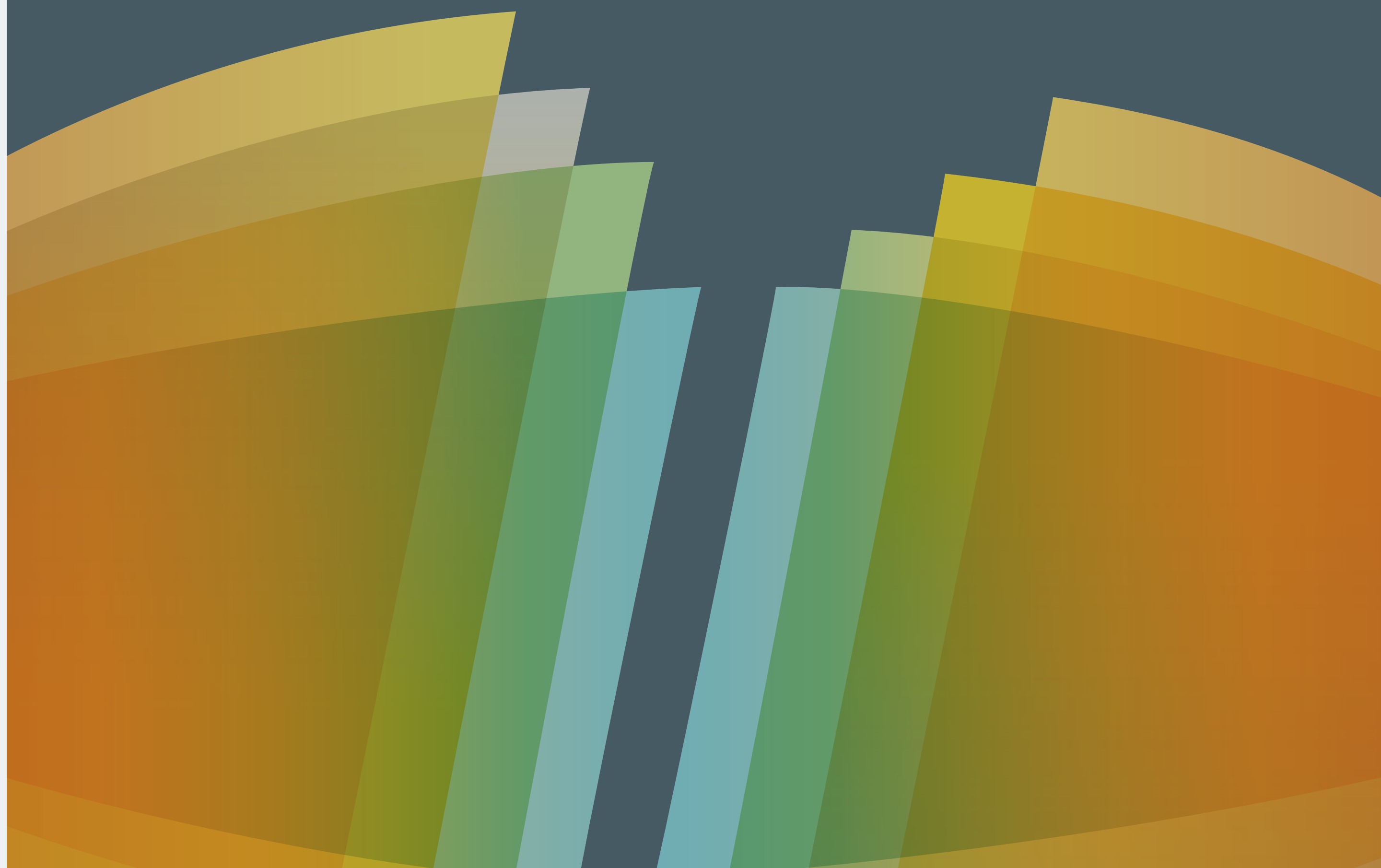


GUIDE TO ABSOLUTE RETURN INVESTING

Absolute return investing has long been popular with institutional investors such as the large superannuation funds. To date though, absolute return strategies have not necessarily been widely understood or used in Australia by investors who have favoured more traditional investments such as equities and bonds. However, absolute return investments can help greatly in boosting potential overall investment returns and reducing overall risk: this is particularly true at a time when returns from traditional investments appear to be lacklustre and volatile.

This guide seeks to introduce and demystify the concept of absolute return investing and to explain the key benefits that these strategies seek to provide.

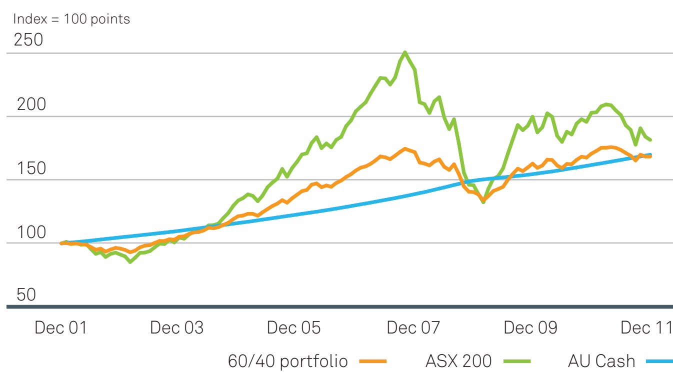
THE CHALLENGE WITH TRADITIONAL PORTFOLIOS

Commonsense and investment theory say that a prudent investor should not put all their 'eggs in one basket'. It makes sense to diversify an investment portfolio across a number of different asset classes, which behave in different ways at different times.

In Australia, this has traditionally meant that many people who save for the long-term, whether for retirement through superannuation or for other purposes, have invested in so-called 'balanced portfolios', which typically hold around 60% of their portfolio investments in growth assets (such as equities) and the remaining 40% in income assets (such as bonds or cash).

This makes sense intuitively and it may have worked well at particular times in the past. However, over the last 10 years, a traditional 60/40 balanced portfolio has performed poorly. The absolute returns have only been around 4.6% per annum (before any fees and taxes). In spite of holding a broad mix of equities, bonds and cash, the traditional 60/40 portfolio has moved virtually in line with the S&P/ASX200 Accumulation Index. The returns earned have basically not been sufficient to compensate for the risks that have been taken. Put another way, an investor could have done just as well simply by leaving their money in a term deposit account. This is illustrated in *Figure 1.*

FIGURE 1: PERFORMANCE OF A 60/40 PORTFOLIO VERSUS CASH AND ASX200 OVER THE LAST 10 YEARS



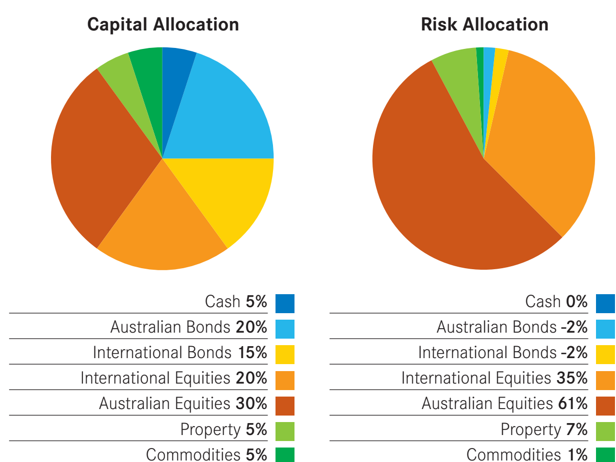
For illustrative purposes only. The 60/40 portfolio comprises a 40% allocation to income assets represented by an equal weight investment in the UBS Composite Index, the Barclays Global Aggregate Bond Index Hedged to $A, and the UBS Bank Bill Index. The 60% allocation to growth assets is represented by a 20% allocation to the MSCI World Ex Australia Hedged to $A and a 40% allocation to Australian Equities. Source: BlackRock, Datastream.

It is quite easy to identify reasons why the last 10 years have been different from the decades that preceded them. A glance at headlines from this period would, for instance, show:

- The slump in the prices of technology, media and telecommunications stocks from 2000–01.
- The rise in the real prices of oil and other natural commodities, thanks mainly to the economic growth in China and other emerging markets.
- The global financial crisis reaching a critical phase in the third quarter of 2008, following the bursting of the housing bubble in the United States.
- The sovereign debt crisis across much of the euro area since 2009.
- A spate of natural disasters, political upheaval in the Middle East and heightened terrorist activity, creating uncertainty and causing havoc with world financial markets.

The fundamental problem though is this: at times of crisis, different asset classes tend to move together to a much greater extent than at normal times. In a traditional 60/40 portfolio, equities may make up about 60% of the total assets, but can generate 96% of the expected risk of the portfolio. This is illustrated in *Figure 2* below.

FIGURE 2: TRADITIONAL 60/40 PORTFOLIO



Source: BlackRock.

In the current era of low and unstable economic growth, returns from equity markets may continue to be lacklustre and volatile. Portfolios, which rely heavily on equity returns to achieve their growth objectives may continue to disappoint. Investors need to rethink how their portfolios will achieve their return targets – as well as provide diversification away from risks for which they are not being compensated. Absolute return strategies could be the answer, as they aim to deliver positive returns, irrespective of whether equity markets are rising or falling. As a result, absolute return strategies also tend to have low correlation to equity markets so can aid in diversifying investor portfolios.

WHAT IS ABSOLUTE RETURN INVESTING?

Absolute return investing aims to produce a positive return over time, regardless of the prevailing market conditions. Even when markets are falling, an absolute return fund still has the potential to make money.

Producing consistent positive returns is the key objective for an absolute return fund. All investment funds aim to beat the long-term returns from cash. However, unlike a traditional long-only equity fund where investors accept the risk that equity markets can fall dramatically from time to time, an absolute return – by not being tied to any particular equity benchmark – aims to produce more consistent positive returns over a given investment horizon. Investment gains can never be guaranteed but, by using a range of techniques not available to traditional investment portfolios, absolute return funds have the capability to generate smoother returns throughout the market cycle.

Although they vary widely, absolute return strategies usually have most of the following characteristics[1]:

- Generally, they utilise sophisticated investment manager skills and systems to generate active returns.
- The strategies are typically less constrained, allowing managers to take opportunities in a wide range of market environments (e.g. use of short-selling, derivatives etc).
- The strategies tend to be more complex than those that are typical in traditional 60/40 portfolios.
- Manager remuneration is more aligned with fund performance.
- Liquidity is sometimes conceded in return for the likelihood of higher risk-adjusted returns as these investments seek different risk premia not readily available to retail investors.

1. Lonsec Managed Funds Research, Alternatives Sector Review 2011, August 2011, p5.

WHAT ARE SOME EXAMPLES OF ABSOLUTE RETURN STRATEGIES?

As outlined above, absolute return strategies vary widely. However, some common examples are as follows[2]:

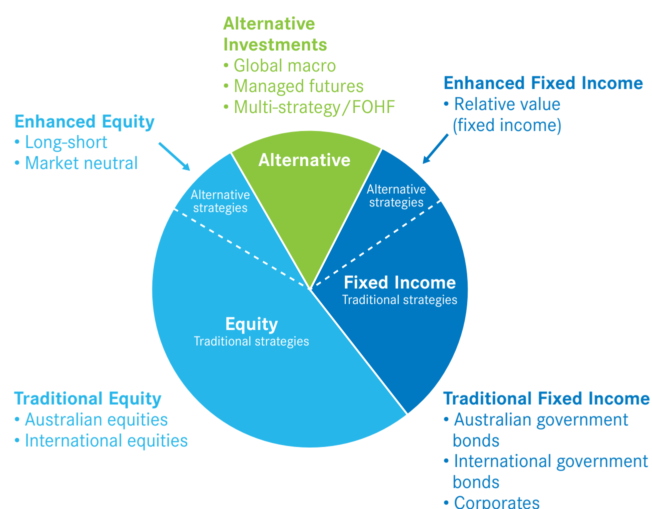
- **Long-short equity strategies**
  These are strategies that involve a combination of 'long' and 'short' positions and are generally highly liquid. Examples include long-bias equity, portfolios of paired trades, market neutral equity and short-bias equity.
- **Relative value strategies**
  These are strategies that seek to exploit apparent pricing/valuation anomalies between particular securities. Typically, the manager will take a 'long' position in the security, which appears to be undervalued and a 'short' position in the security, which appears to be overvalued. Examples include equity market neutral and fixed interest relative value strategies.
- **Event-driven strategies**
  These strategies involve an assessment by the manager of how company specific events, such as mergers, bankruptcies and restructurings, are likely to evolve. Depending on the exact circumstances, the manager often takes a 'long' position in the securities of one of the companies involved, and a 'short' position in another. Examples include merger arbitrage and distressed debt.
- **Global macro strategies**
  These strategies involve an assessment by the manager of developments in global economies and financial markets. Sometimes they are driven by the qualitative judgments of the manager. In other cases, the strategies are driven mainly by the use of quantitative models.
- **Managed futures funds**
  These strategies typically use algorithmic[3] and technical models that focus on the trends exhibited by futures and other very liquid securities. These include most commodities funds.
- **Multi-strategy funds**
  These strategies use a number of the strategies noted above. As they are diversified across a wide range of different absolute return strategies and asset classes, they aim to deliver consistent returns with low levels of volatility. They are generally managed by one manager, providing a single, cost-effective access point to absolute return strategies.
- **Funds of hedge funds (FOHF)**
  These strategies often invest in 30 to 70 different underlying alternative strategies. What sets them apart from multi-strategy funds is that each of the underlying alternative strategies is typically handled by a different manager.

In Australia, long-short equity, managed futures, global macro and FOHF strategies are most commonly used by investors. There has recently been a movement away from FOHF to a single strategy or single manager/multi-strategy approach.

WHERE DO ABSOLUTE RETURN STRATEGIES FIT WITHIN INVESTOR PORTFOLIOS?

At BlackRock, we suggest that absolute return strategies deserve a core allocation in investor portfolios, along with other forms of alternative investments. *Figure 3* below provides an illustration of how a traditional 60/40 portfolio can be enhanced with a core allocation to absolute return strategies and other alternative assets. Some of the money that was previously allocated to equity strategies tied to an equity benchmark is moved to equity-related absolute return strategies. Some of the money that was previously allocated to traditional fixed income is moved to absolute return focused fixed income strategies.

FIGURE 3: ALTERNATIVES ARE TAKING A BROADER ROLE IN INVESTOR PORTFOLIOS



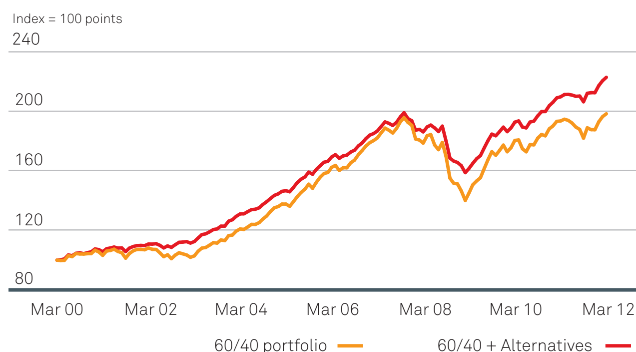
Source: BlackRock.

2. Lonsec Managed Funds Research, Alternatives Sector Review 2011, August 2011, p19.
3. Computerised models that seek to exploit statistical anomalies between asset prices.

Enhancing a traditional 60/40 portfolio by allocating to absolute return strategies in this way can substantially improve a portfolio's risk/return profile, as the table below shows. Based on historic returns for the last 12 years to March 2012, including a 30% allocation to a representative absolute return strategy, improved the overall portfolio return from 5.9% to 6.9%. Meanwhile, the overall volatility dropped from 7% to 5%. The portfolio's sharpe ratio – a measure of the returns gained relative to the risks taken – rose from 0.1 to 0.3. Perhaps most importantly in this new era of investment, the maximum drawdown (i.e. the maximum peak to trough loss over any given period) reduced from 28% to 20%.

FIGURE 4: INCLUDING ALTERNATIVES AS A CORE ALLOCATION

Return Analysis (Apr 2000 – Mar 2012)	Traditional 60/40 Portfolio	60/40 Portfolio + Alternatives
Return	5.9%	6.9%
Risk	7.0%	5.0%
Sharpe Ratio	0.1	0.3
Max Drawdown	28%	20%
Correlation to ASX	0.96	0.93



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WHAT FACTORS SHOULD BE CONSIDERED WHEN CHOOSING AN ABSOLUTE RETURN STRATEGY?

Absolute return investing covers a wide range of investment styles, asset classes and levels of risk. Some funds will take positions (mainly) in equities, while others may only invest in lower-risk bonds and cash investments.

Some funds will have a policy of eliminating market risk from the portfolio (a 'market neutral' strategy), while others may choose to make a call on the direction of one or more markets (a 'directional' approach). Most funds will have set limits on their long and short exposures.

In general terms, the three issues that we think are most important for an investor to understand prior to investing in absolute return strategies are:

1. The manager's skill as evidenced by a long and consistent track record of delivering strong risk controlled returns.
2. The manager's experience in executing both long and short strategies.
3. Existence of institutional quality risk management controls and procedures.

Greater detail is provided in *Figure 5* below.

FIGURE 5: INVESTOR CHECKLIST

Important criteria for absolute return investors	What institutional investment partners should offer
Organisational issues	
Fiduciary responsibility	Never trade against or ahead of clients
Manager experience	A robust platform that allows them to attract, hire and retain top industry talent
Alignment of interests	Significant principal, firm and employee investments alongside clients
Operational issues	
Risk management and continuous oversight	Globally integrated analytical systems capable of 24-hour monitoring; a culture of risk management, an environment where risk is deliberate, diversified and appropriately scaled
Independent risk monitoring	Clear separation of risk management and investment responsibilities
Counterparty risk management	Experience negotiating, managing and diversifying counterparty risk
Operational framework	Robust infrastructure and valuation procedures within a strong culture of compliance
Investment issues	
Investment strategy	Diverse set of strategies with unique opportunities to generate alpha Ability to deliver solutions rather than products
Performance/track record	Strong risk-adjusted returns and avoidance of negative compounding
Liquidity, gates and side pockets	Liquidity matched to investment strategies and adherence to withdrawal requests
Leverage	Ability to properly mitigate risk with leverage (shorting) and proper leverage monitoring
Transparency	Full position level transparency
Fees	Profit for performance

CONCLUSION

Absolute return investing has many potential advantages, including the potential to deliver stable returns in both strong and weak markets.

Absolute return funds can meet a range of investor needs and goals. Depending on a fund's individual objective and approach, it could be considered by an investor who is looking for:

- A core holding as the basis for a diversified portfolio.
- Extra diversification to complement traditional equity funds.
- Growth with less volatility – smoothing out of stock market highs and lows.
- Higher returns than those that are available from cash accounts.

With continued uncertainty over the prospects for domestic and global equity markets, the increased versatility of an absolute return strategy, and its potential for sustainable performance irrespective of wider economic conditions, make this approach a highly compelling alternative to the traditional approach for investors.

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