

Your guide to absolute return investing

Contents



Introduction	2
What is absolute return?	3
What are absolute return funds?	4
What strategies do absolute return funds use?	6
The future - how might the absolute return sector develop?	8
How might absolute funds be used in a portfolio?	9
What should I consider when choosing an absolute return fund?	10
Other frequently asked questions	11

Introduction



The volatile nature of investment markets in recent years, an increasing tendency for different asset classes to behave similarly and the very low savings rates offered by banks have proved an unsettling experience for many people, encouraging them to seek out other investment options. As such, absolute return investing has been a logical next step and absolute return funds have grown hugely in popularity.

This guide will discuss what absolute return investing is, weighing up its attractions alongside the associated risks before outlining the different strategies used by absolute return fund managers. It will discuss how absolute return funds might be used within a portfolio and address the various considerations investors and their financial advisers should bear in mind when choosing a particular absolute return product.

What is absolute return?

In seeking to assess the performance of a collective fund, such as an OEIC or unit trust, the traditional approach has been to measure it against an index of similar securities. For example, a fund that invests in large, 'blue-chip' UK stocks such as BP and Vodafone might be benchmarked against the FTSE 100 Index while a fund that invests in smaller UK companies might be benchmarked against the FTSE Small Cap Index. In this way, an investor can judge whether a fund manager is adding value through their selection of stocks.

However, this approach – focusing as it does on so-called relative returns – can have some unintended consequences. At times when markets are falling, a manager might technically be outperforming their benchmark but still be losing money for investors. Over the course of 2008, for example, the FTSE 100 Index fell 28% in value*. A manager might still be considered successful if their fund had fallen 25% in the same period – although, of course, their investors may not feel the same way. There is a saying in investment, "You can't eat relative returns." The absolute return approach to investing turns all this on its head. Long used for high net worth and institutional clients, the emphasis for an absolute return manager is on wealth preservation. Instead of a stockmarket index, the fund and its manager will usually be measured against cash or a cash-related benchmark such as LIBOR and will aim to generate consistent returns in all market conditions. The absolute return will not be guaranteed and the time period over which managers aim to generate it will vary from fund to fund.

Absolute return strategies use techniques that are now permitted within retail investment funds under European legislation known as UCITS III.

*Source: Datastream, total return in sterling at 31/12/08.

Useful terms

LIBOR: Short for 'London interbank offered rate', this is the interest rate at which banks borrow from each other and is widely used as a benchmark for short-term interest rates.

OEIC: Short for 'open-ended investment company'. An 'open-ended' investment such as an OEIC or unit trust is continually able to create new shares or units, usually to satisfy demand from buyers and sellers.

UCITS III: European legislation – short for 'Undertaking for collective investments in transferable securities' – which gives retail fund groups the power to use a broader range of investment strategies, products and techniques – including the ability to short stocks – than had previously been allowed.

What are absolute return funds?

Absolute return funds are collective investments that employ a number of different strategies with the aim of providing a positive return to investors in all market conditions – that is, whether the areas they invest in go up or down. Their performance will usually be measured against cash or a cash-related benchmark, but they may achieve absolute returns through investing in equity or fixed income markets or a blend of asset classes.

Most funds of this type sit within the Absolute Return sector, which is overseen by investment industry trade body the Investment Management Association (IMA). The sector is defined as containing funds “managed with the aim of delivering absolute – that is, more than zero – returns in any market conditions. Typically funds in this sector would normally expect to deliver absolute – more than zero – returns on a 12-month basis”.

The definition does come with a number of explanatory notes, including how “performance comparisons are inappropriate due to the diverse nature of the objectives of the funds” – for example, differing benchmarks, risk characteristics and timeframes – as well as a reminder that “funds listed in this sector do not guarantee returns”.

Absolute return funds:

- Their objective is to generate a specific actual return
- Managers will invest only in assets believed to offer genuine potential to increase return
- Managers are concerned with the potential for losing money and will take measures to deal with this risk

For private investors, the opportunity to invest for absolute returns really began with the launch of fixed income-based funds in 2004 but from there the sector has evolved into a more diversified grouping that includes equity long/short and multi-asset funds. Now the sector increasingly appears to be moving beyond the UK and has seen the launch of European, Japanese and North American long/short funds.

Absolute return funds are often built out of fund groups’ existing hedge fund strategies that were previously unavailable to private investors. Often these hedge funds will have lengthy track records and be run by managers with extensive experience of the techniques involved. As we will see later, risk control is a vital component of absolute return investing and so hedging experience is arguably one of the first things investors should look for in a fund manager.

Relative return funds:

- No specific target beyond a benchmark so they could lose money yet still achieve their objective
- Managers may have to hold stocks just because they are included in the fund’s benchmark
- Managers measure risk relative to a benchmark and not to how much money could potentially be lost

What are absolute return funds?

Absolute return funds - some myths exploded

Absolute return funds are NOT guaranteed to deliver positive returns each month BUT they do have the potential to record fewer negative months

Absolute return funds are NOT immune from market risk BUT investors can expect volatility to be lower than traditional funds

Absolute return funds are NOT a new way of investing BUT the UCITS III legislation means they are now available to private investors

Absolute return funds are NOT hedge funds BUT they do borrow techniques from them and they are regulated funds

Useful terms

Long investing: Where a fund manager invests in a stock in the belief it will go up in value and thus make money. A portfolio's 'long exposure' is therefore the percentage of its net asset value represented by purchased assets and the portfolio will benefit from any price rise in these assets.

Shorting: Investment technique where a manager will 'borrow' a stock they do not own in order to sell it, on the understanding they will buy it back at a specified point in the future. If that purchase price is lower than the earlier sale price, the manager will make money. A portfolio's 'short exposure' is therefore the percentage of its net asset value represented by assets borrowed from a third party and sold.

What strategies do absolute return funds use?

Absolute return funds have grown hugely in popularity as investors look for ways to deal with the growing volatility in global markets and also the increasing correlation between different asset classes. One of the features of the market rises from 2003 was how assets such as equities, property and even bonds grew more correlated on the way up and then, as markets crashed in 2008, how correlated they were on the way down.

These uncertain market conditions have led fund groups to develop more innovative products that look to reassure investors by offering specific investment goals, such as cash or 'cash-plus' targets, while at the same time aiming to offer asset diversification and to preserve capital. Strategies used by absolute return funds fall into three main categories – equity, fixed income and multi-asset.

Equity strategies

Equity absolute return strategies aim to make money in all market conditions through the stock-picking skill of the fund's manager. Absolute return funds maximise the deployment of the manager's skill by enabling them to go 'short' certain stocks or certain areas of the market and thereby profit from falling share prices*. This is in addition to the more widespread practice of 'long' investing, where the manager looks to profit by purchasing stocks that go up in value.

* The wider investment powers permitted under UCITS III regulations allow funds to execute 'synthetic' shorting using Contracts for Difference (CFDs). These are cash settlement derivatives that enable the manager to participate in a share price movement without establishing a physical short position, hence the term 'synthetic' shorting.

Among the most common techniques for equity-oriented absolute return fund managers are:

Market neutral: Some equity absolute return managers structure their portfolios to be entirely market neutral, which means they will have no sensitivity to market risk – technically they have a beta of 0 (see useful terms opposite). If the market rises very strongly, this may mean the fund will lag, but it also means the fund may deliver a positive return even when markets are falling.

Market directional: In contrast, market directional funds will take a view on the likely direction of markets, which may mean a stronger return when markets rise or fall, but can create greater volatility in a portfolio.

Pairs trading: In pairs trading, a manager will go long in one stock and short in another within the same sector. In this way, he is making a call on the direction of the stocks relative to each other rather than on the direction of a stock in absolute terms. This ensures it is only the superior qualities of one stock over another, rather than market sentiment towards the sector as a whole, that deliver returns.

Market capitalisation: As with 'traditional' equity funds, managers will have a preference for certain types of stock – indeed, an equity absolute return strategy will often be built on the existing investment process of a manager. If they have previously favoured smaller companies and that is where their knowledge and expertise lies, they will use the same process in their absolute return fund. Smaller companies may offer more scope for outperformance while larger stocks may offer less volatility.

What strategies do absolute return funds use?

Fixed income strategies

Fixed income strategies were among the first absolute return funds onto the market. These funds aim to generate alpha by going long and short in instruments such as interest rate swaps, currencies and government bonds, but will generally hold a portfolio of short-dated bonds to preserve capital. These funds tend to have lower volatility than other types of absolute return fund. They will usually be benchmarked to LIBOR, so returns can look anaemic when LIBOR rates are low.

Multi-asset strategies

Multi-asset strategies blend a number of different lowly or non-correlated asset classes with the aim of delivering absolute returns. A typical multi-asset fund may incorporate equities, fixed income, commodities, currencies or derivatives strategies. Most are unconstrained and will move to different areas of the market where they find the most compelling valuations. They will generally use index replication or synthetic instruments rather than investing directly in securities, though some will use a multi-manager approach.

Multi-manager funds could, for example, make use of investment trusts or exchange-traded funds to access more esoteric asset classes, such as commodities, and tend to be offered by larger groups that can call upon a broad range of expertise. The IMA Absolute Return Sector now also contains some 'funds of funds' that look to blend together a number of portfolios that are all trying to achieve absolute returns but in different ways.

Useful Terms

Alpha: The return over and above a market or an index. At a very simple level, it may be seen as outperformance.

Beta: The sensitivity of an investment to changes in the level of the wider market. An index-tracking fund will therefore have a beta of 1.

Capitalisation: Total monetary worth of a company or stock market. The market capitalisation of a company is assessed by multiplying its share price by the number of shares in issue.

Correlation: The extent to which different types of investment – for example equities and bonds – react similarly to different economic and market conditions.

Diversification: Investing across a range of different asset classes rather than, as it were, 'putting all your eggs in one basket'.

Volatility: The uncertainty inherent in returns from an investment and indicative of the extent to which that investment's returns have deviated around their average.

The future - how might the absolute return sector develop?

The sector is becoming increasingly diverse following a raft of new launches in recent years. These launches have been predominantly UK and international equity long/short funds but there have also been a small number of launches in the fixed income sector – though these have generally been from existing providers.

At present there are two main schools of thought on investing in absolute return funds. The first is to see these funds as part of a wider ‘alternatives’ portfolio, sitting alongside private equity or hedge funds and separate from the long-only part of an investor’s portfolio that will tend to be confined to assets such as corporate bonds or equities.

The second is to see absolute return investing as simply another way of running money. In this case, an investor would have some of their portfolio in the US, in Europe, in the emerging markets and so on – just as they would with a long-only portfolio. In this case, investors would hold several absolute return funds.

The latter approach may sound some way off yet, but a similar shift has been seen in the perception of the fixed income market over the past decade or so. At the turn of this century, private investors would not generally have held a portfolio of bond funds but now this practice is commonplace. As more companies launch more international funds, the scope for investors to go down this route will grow.

To date, the majority of fund groups launching new funds have existing expertise in running absolute return strategies either offshore or for private clients. As such, most have an identifiable track record and robust process in place although history suggests less experienced managers may enter the fray as the sector’s popularity grows.

Useful terms

Core/satellite investing: This investment approach involves dividing an investor’s portfolio into a lower-risk ‘core’ component, such as a cautious or absolute return fund, and one or more higher-risk investments – the ‘satellites’.

How might absolute funds be used in a portfolio?

Absolute returns may offer a different slant on investing but that does not mean you can ignore the basics of good financial planning. If you are thinking about putting money into an absolute return fund, you still need to ask yourself what you are trying to achieve – just as you would with any other investment.

Fundamental questions to address would therefore include:

- What are your investment objectives? Are you looking to generate capital growth, income or both?
- How much risk do you feel comfortable taking on? Do you want to protect your money or can you stand to lose some of it in the hope of ultimately making a greater return?
- What sort of timeframe are you looking at? Are you in a position to leave your investment alone for the long-term – at the very least five and preferably 10 years – or might you need access to it at short notice?

The volatile nature of investment markets in recent years means weighing up your thoughts to questions such as these has arguably never been more important. The rollercoaster ride offered by even supposedly less risky assets such as bonds, twinned with the very low savings rates available from bank accounts, will have encouraged many people to seek out other investment options – especially if they have a lower correlation with other asset classes.

Absolute return funds now offer a wide range of choice with regard to investment strategy, portfolio composition, risk-reward profile and even time horizon. As a result, they offer potential solutions to a number of different investment needs.

At its most basic, an absolute return fund's objective of generating a tangible return, usually in excess of cash, allows investors to tap into the power of compounding. Compounding comes about when an investment generates a return, which is then reinvested to help generate further returns and so on.

It is perhaps easiest to see how this would work within a savings account – and, in that context, you will probably have come across the term 'compound interest' – but, less obviously, compounding is also at the heart of equity and bond investing (and, for that matter, house price rises). Absolute return funds therefore allow investors to access the power of compounding for a set risk profile.

As such, they could suit investors looking to achieve equity-like returns but with lower risk levels than equities over a market cycle. They could also be appropriate for equity investors willing to sacrifice some return to achieve steadier performance, investors wanting to protect existing gains by reducing downside risk or simply those looking for a core holding for their portfolio, ISA or self-invested personal pension.

Thus an absolute return fund could form the 'core' part of a core-satellite investment approach – the solid middle around which investors and their advisers would then be able to build some more risk, for example, through a smaller companies or emerging markets investment.

On the other hand, absolute return funds can also be helpful in diversifying a portfolio. In addition to the risk profile and potential annual return, a fund's correlation with other investments, the sector or asset class in which it invests and the investment strategy itself can be diversifying factors. The lower correlation of absolute return funds to equity and bond markets is therefore an important consideration for investors and their advisers.

Another way investors and their advisers can use absolute return within their portfolios comes through different funds having different investment timescales. So while a more cautious fund may have a shorter time horizon, a riskier fund may have a higher return target and a longer-term time horizon. This means investors should be able to track down a fund that suits their attitude to risk at a particular stage in their life.

The fact absolute return funds will tend to look to beat savings accounts returns may even make them of interest to more conservative investors. Nevertheless, those investing with this in mind should note they will have to remain in an absolute return fund for a longer period than would be the case with traditional savings options and that, if they were to take their money out sooner, they risk losing some. While absolute return funds may be used as an alternative to cash funds, investors should remember they are in no way the same.

What should I consider when choosing an absolute return fund?

The extra techniques allowed by the UCITS III legislation mean absolute return funds are more flexible and their managers can move between different asset classes and markets – both with a view to looking to capture returns and aiming to limit exposure to market falls. However, while absolute return funds offer a bigger toolbox, in the hands of the wrong manager or company those tools can be dangerous.

Risk management is key and investors should therefore ensure they are buying into a fund and a company with a good infrastructure and very clear compliance and risk controls. Many absolute return funds aim to limit their risk profiles and keep them within tightly controlled parameters through a method known as value at risk or 'VaR', which measures the worst loss scenario that could be expected under normal market conditions and over a given period of time.

Furthermore, since short investing adds an extra layer of complexity to the management of a portfolio, it is important that a fund is underpinned by strong systems and risk management techniques. A fund manager who does not have the necessary systems or processes in place may be unable to execute trades effectively or could be taking risks of which they are not fully aware.

Historically absolute return funds have been seen as an 'alternative' asset class because they had lower correlation with other investments but better risk management. Risk management is vital in the absolute return space because, if a manager is not careful, they can take on far more risk than with a long-only fund. The ability to leverage bets aggressively in absolute return funds means the investment risk is magnified.

Naturally, protecting investors' capital is a key objective for absolute return funds but, ultimately, their managers need to be going long on stocks that go up in value and shorting stocks that go down in value. As such, investors and their advisers also need to be convinced their manager has the ability and track record to do that – ideally, this would be someone who has experience of running both long-only and absolute return portfolios.

Put simply, proven stock-picking expertise is essential. Investors and their advisers should be aware the increased flexibility of any portfolio using the wider investment strategies allowed by UCITS III will not cover up any shortcomings in this area and may even exacerbate them. In the end, the overriding consideration when choosing an absolute return fund is to find a manager, who has the experience, skill and access to resources to maximise potential returns.

Questions investors and their advisers should ask about an absolute return fund and its manager:

- What is the fund's volatility compared to the market?
- What is the fund's VaR?
- Has the fund manager used a rising market to achieve performance?
- What is the fund's beta?
- How many negative months has the manager had compared to the associated market?
- Where have the fund's returns come from?
- What is the manager's experience?

Other frequently asked questions

Can I lose money in an absolute return fund?

Investors should never lose sight of the fact that an absolute return is an objective not a promise. There is a danger absolute return funds may be sold as investments that cannot lose money but this is by no means the case. Most absolute return funds have the strategies and tools to enable them to deliver positive returns in all market conditions, but these are only as good as the manager using them.

Are absolute return funds guaranteed?

Absolute return funds are neither guaranteed by the provider nor do they come with any guarantees attached. As such, they are not appropriate for those who have no appetite for risk at all.

Do absolute return funds beat inflation?

Absolute return funds should be in a position to beat inflation and, depending on the level of inflation, may have an investment target that is inflation-beating. That said, absolute return funds are unlikely to be specifically set up to beat inflation.

Do absolute return funds have lock-in periods for investors?

No. Funds in the IMA Absolute Return sector are structured as OEICs or unit trusts and must therefore offer daily liquidity and the same access requirements for investors as any other open-ended fund.

Is there a difference between absolute return, total return and target return funds?

While these terms are often used as if they are interchangeable, there are actually subtle distinctions between them. As discussed earlier, absolute return funds aim to preserve capital and achieve consistent and positive returns and are measured against an absolute benchmark such as cash. The forerunners – and now essentially a subset – of absolute return funds, target return portfolios tend to be fixed income-based and set a target of LIBOR, typically aiming to beat this by two or three percentage points. For their part, total return funds invest so their return comes from a combination of income and capital growth and will often have an index or peer group benchmark. Absolute return, target return and total return funds can all fall in value.

Are absolute return funds a type of hedge fund?

The converse is more accurate. Many hedge funds use an absolute return process with the aim of preserving capital and generating positive returns. Both types of fund may use the same investment tools and strategies, such as shorting, to achieve these objectives.

Should I ignore long-only funds in favour of absolute return funds?

With their ability to go both long and short on stocks, absolute return funds operate very different strategies to long-only funds and so returns are likely to vary considerably. Investors and their advisers should bear in mind that, while a fund that takes both long and short positions should not see the same level of decline as a long-only fund in a falling stock market, equally it is unlikely to achieve the same degree of capital growth in a fast-rising market.

Important information



This document is issued by Cazenove Capital Management which is the name under which Cazenove Capital Management Limited and Cazenove Investment Fund Management Limited both authorised and regulated by the Financial Services Authority provide investment products and services.

The contents of this document are based upon sources of information believed to be reliable. However, save to the extent required by applicable law or regulations, no guarantee, warranty or representation (express or implied) is given as to its accuracy or completeness and Cazenove Capital Management, its directors, officers and employees do not accept any liability or responsibility in respect of the information or any recommendations expressed herein, which, moreover, are subject to change without notice.

Nothing in this document should be deemed to constitute the provision of financial, investment or other professional advice in any way.

Head office address:

Cazenove Capital Management Limited
12 Moorgate, London EC2R 6DA

For more information please contact your financial adviser.

If you do not have a financial adviser please visit:
www.unbiased.co.uk
