ABSOLUTELY FABULOUS!

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A maturing bull market makes it harder to identify good relative value or discounted assets against long-term trends. Strong momentum in equity markets remains undiminished, supported by strong fundamentals in terms of cheap capital and consumer and corporate confidence powered by China's industrial revolution.

With 2-3 fold increases in small and mid-sized company valuations becoming not uncommon across the world, professional opinion on future duration from economists and fund managers is becoming ever more divided. This is nowhere more so than in the hedge fund industry where purist fund strategies aiming to deliver returns above the risk-free rate (cash) become ever more polarised in their approach. In the alternative market the strategies can be broadly grouped into two areas: first, the long/short and market neutral funds that tend to be set apart from the remainder given that they are more likely to hedge out market risk using a short book enabling clients to achieve diversification and consistency in outperforming cash on a regular basis.
The second group comprises hedge fund managers who tend to focus on having a much higher net long position. These will include funds operating strategies such as event driven and market arbitrage (to mention just two).

Absolute return funds that do not rely on beta (market directionality) normally achieve diversification by delivering returns from both sides of the balance sheet (ie both their long and short positions) independent of equity market conditions. These types of absolute return managers that have achieved consistent risk-adjusted returns with market neutrality tend to offer protection from traditional equity market corrections.

Bull markets have a tendency to distract and tempt experienced investors (fund managers) to increase their net market exposure thus increasing the correlation to equity returns - this is often referred to as 'tactically exploiting beta'. However, the more entrenched a bull market becomes the higher the structural exposure that tends to creep into the funds. So what's wrong with that? After all, global markets are consistently achieving double digit returns often ahead of core indices. The answer lies within the history of UK life companies that for generations offered the 'with profits' principle by advertising smooth returns allegedly independent of market risk. Many of these funds fell foul of indirect equity exposure that ultimately came to light after the dot.com bubble burst in 2000. Had investors been provided with full transparency regarding the underlying investments then demand for this type of product may well have been tempered by some investors looking to achieve diversification elsewhere.

This principle of removing risk and achieving returns above cash is not too dissimilar in the majority of core hedge fund strategies. Cash return, after all, is a given and free of risk so excess returns are considered real alpha, assuming this is achieved with risk well below the equity markets. If the risk is similar to markets then there is a good chance that your investment with a hedge fund manager remains exposed or vulnerable to the corrections or losses that you may incur in a normal long-only OEIC or unit trust.

This lack of clarity in understanding fund strategy is often a key reason as to why investors become so disillusioned, head for the exit and don't come back. Seeking out fund managers able to deliver excess returns above cash with low volatility is fundamentally important if investors are looking for

consistency throughout different market cycles without incurring many marginal losses. Always be prepared to challenge an absolute return strategy that employs as much risk as the market.

This is a good time to reflect on the recent marketing hype surrounding the 130/30 funds that will shortly be arriving in the UK market utilising the additional powers of UCITS III. The 130/30 approach is, in concept, the same as a long-only fund as it has 100% net long exposure to the market. The concept offers more exposure in a rising market assuming the fund manager has achieved good stock selection. Conversely, in a falling market, successful short exposure achieved through various Contracts for Difference (CFDs) or derivatives protects the downside only to the extent that it falls in line with the market. Once again, conceptually, this sounds like all part of efficient portfolio management in a traditional long-only fund with the manager generating real return from badly performing stocks. However, it is worth pointing out that if a fund manager has read the market incorrectly and achieves poor performance in their long book there is every chance that they may compound further losses by sustaining similar disappointments on the short side thus exhibiting higher risk and losses within the portfolio. The jury currently is out and the key consensus of offering such a vehicle to the UK market is that in addition to being a qualifying fund (CGT friendly) this type of equity model will attract managers to think about utilising short positions to reduce volatility and improve alpha.

Despite the superb performance of global beta, demand for absolute return continues to grow in a number of different product classes. These include the cautious managed sector where non-UCIT retail schemes (NURS) are utilising the 20% allocation to hedge funds. The arrival of the 130/30 product also adds to this developing product range as will the widely anticipated principles of engagement from the FSA on funds of alternative investments (FAIFs) expected by Q4 2007. The general availability of absolute return funds will help investors particularly bearing in mind the growing requirement to take more ownership of personal welfare consideration. Absolute returns will be required to help grow and maintain wealth management at the latter stage of welfare provision.

Thus, absolute return strategies will become more integrated across a variety of product lines proving that their arrival represents a new core consideration as opposed to a passing trend.

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