

CONJECTURE

This week's Conjecture panel discusses some of the issues affecting the poorly understood and diverse IMA Absolute Returns sector

Defining and expounding absolute returns

By Alex Beveridge

Absolute return strategies are gaining traction within the retail investment space. Yet one of the major criticisms levelled at the sector is investors often do not understand the strategies they are buying into, an issue exacerbated by the plethora of strategies on offer. Our panel of experts consisted of Iain Stewart, investment leader of global funds at Newton Investment Management; Ajay Dayal, investment director at Legg Mason Global Asset Management; Reza Vishkai, head of specialist investments at Insight Investment and Kate Hollis of Standard & Poor's.

What are absolute return funds? And how easy are they to define

Kate Hollis (KH): We put a definition of absolute return funds in place about three or four years ago. We decided to classify them as onshore regulated funds that can have positive or negative market beta, whether that is duration or credit beta, or equity market beta. By definition they are long/short and have return targets that are likely to be linked to Libor.

Recently we have seen a number of Ucits hedge fund clones being launched, which we would not define as absolute return because they are low beta funds, not funds that can have negative beta, but a lot of people are putting them in the absolute returns space.

The IMA's absolute return definition is rather different from ours and includes funds we would consider pure long only.

Ajay Dayal (AD): There are many definitions of absolute return, but very simply are you going to be able to deliver a positive return on a consistent basis to your client base and give them better clarity on what that return is likely to be over the long term?

AR funds have to be an all-weather strategy that works in both up and down markets. You can get to that through a variety of strategies, but the objective should be to deliver consistent



Kate Hollis, S&P

positive returns to your client base.

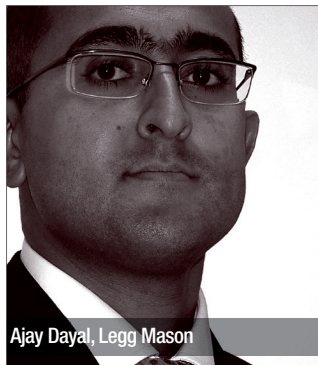
Reza Vishkai (RV): Absolute return investing is not an asset class it is a investment philosophy focused on delivering returns across all market environments. It does this using a range of strategies that are generally a lot more flexible than traditional ones. They have a bias towards preservation of capital.

Iain Stewart (IS): Keeping it simple is important. I think of it as having a target that is upward only, which is the same as trying to produce a decent return with lower volatility than one might expect from relative-type investing. I guess it is a return to what investing should be about – we are trying to make money for people one way or another.

Kate, what are the difficulties you find in trying to compare the various strategies?

KH: It is very much a case of comparing apples to pears. I would agree anybody's definition of a group of absolute return funds is going to be a bucket or a sector rather than a peer group. If you can achieve the same result in many different ways, whether you want to run long/short equity or multi-asset, you can achieve Libor plus returns.

But at various times, those strategies will be subject to different crosswinds from the market. Some of them therefore will outperform others in the market, just as we have seen over the years in the hedge fund sector.



Ajay Dayal, Legg Mason

Iain, you manage a lot of money in this space, is there a lot more explanation to do to the client?

IS: To some extent there is. But, on the other hand, we are trying to focus on building a low-risk portfolio, so there is an emphasis on capital preservation. Investors are becoming more relaxed about some of these approaches.

What is intriguing about the debate over absolute returns is perhaps it should be reversed. Why were people so focused on relative returns? That seems to be the key question. The answer is because markets broadly went up over a long period of time.

We do not necessarily think that is the case now, and then you get into the question of how do you do it? It is quite difficult to compare these approaches, but I guess the numbers will tell in the long run.

AD: If you are talking about the absolute returns sector as a whole, there is a bit of confusion. It is a real mongrel peer group when you think about it – a mixed bag. You have pure Indonesian funds, equity funds, currency funds. You have absolute return funds that are targeting certain levels of volatility and others that are targeting a certain level of Libor plus returns.

The way we cut through this swathe of uncertainty for many investors was by launching a fund called Legg Mason Permal Global Absolute fund. We came up with two clear objectives that we wanted to give people.

One was an investment return objective, and we are trying to achieve 8% to 10% returns per annum over a three- to five-year



Reza Vishkai, Insight Investment

rolling period. So that is clear and people know it is not based on Libor. It is clarity in what they should be expecting over a period of time.

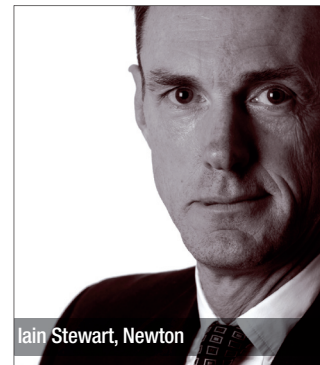
Having a low volatility fund is also very important and we are targeting between 6% to 8% per annum on that same basis. That gives investors a real clarity in the risk profile of the fund.

If you look at this concept in terms of the Sharpe ratio – of anything between 1 and 1.5 – if you deliver that you are doing as well as the best providers in those asset classes. That is something that is consistent, deliverable and attainable. This is what the mark of an absolute return fund should be.

RV: I believe there are two key points with absolute return strategies with respect to investors. Firstly, generating absolute returns is fairly complex. That raises the education requirements on us as an industry in conveying an investment message. The other point about absolute return strategies is they tend to be more skills based compared to relative return or more traditional strategies.

For absolute returns strategies, your benchmark tends to be cash, you only make money when you take a view. The market does not carry you. Whereas traditional strategies, typically over most periods, 90%, to 95% of your risk and return can be explained the market direction.

With absolute returns it is how you use the flexibility afforded by Ucits III and how you use the range of strategies



Iain Stewart, Newton

and instruments to generate return. That can make it more difficult for investors because identifying skill in fund managers is very difficult, and separating skill from luck in particular is difficult.

The strategies people deploy, whether it is going long and short or using derivatives, are genuinely more complex. By definition a traditional long only equity fund, tends to be more straightforward.

Is it important to have a truly international aspect when it comes to constructing an absolute return portfolio?

KH: No, I do not think it is. It depends what kind of strategy you are trying to run. If you are trying to run a global macro strategy, then obviously it is essential. But if you are running a UK market neutral strategy you do not need a global aspect.

And you have to play to your strengths. If a manager is very good at bottom-up stockpicking in the UK market, but you give him a mandate where he can go into the US, he may make money on the UK section of his portfolio but give it all away and more on the non-UK section. So he would be much better off running a pure UK portfolio.

THE NEXT DEBATE

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