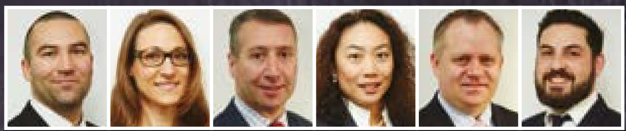
Absolute return

Transparency is the key to understanding performance



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Transparency is the key to understanding performance

Absolute return funds and other investment strategies designed to deliver a promised level of return or income in all but the most extreme market conditions have proven popular with institutional investors amid the volatility of recent years.

It's not hard to understand: investors like their ability to generate relatively stable returns that are uncorrelated to other asset prices. It is often said investors would rather lag just behind a rising market than underperform in a weak one, preferring to be in control of their portfolio's volatility as opposed to being exposed to the wide performance swings of risky assets in fluctuating market conditions.

Absolute return investing attempts to achieve this control by producing a positive return regardless of the prevailing market conditions. Even when markets take a tumble, an absolute return fund will still be making money, or so the theory goes. And so, in these times of uncertainty and continued volatility, these strategies have proven a popular choice for institutional investors hungry for stability alongside growth.

As with their more illiquid older sibling the hedge fund, many absolute return funds seek consistently positive results through the ability to short, thereby profiting from both the ups and downs in markets and stock prices. The types of strategies available are legion, however, and the term can include anything from multi-asset diversified growth funds through to single asset class funds like long/short equity, fixed income, as well as hedge funds.

In addition, the plethora of options available can make choosing the right approach difficult for investors, and it is therefore vital that they do their research and ask exactly how the fund in question sets about achieving its desired goals. As ever, transparency is key to understanding performance.

This roundtable looks at how investors should approach absolute return investing, from equities to fixed income and beyond. It also considers how these strategies have coped in the risk-on/risk-off environment and the key concerns around gauging performance and liquidity.

Chris Panteli
editor, *portfolio institutional*


Chris Panteli

Ian Pizer

“If the client gives you greater investment freedom, you have to be able to demonstrate you are actually going to use that freedom within a responsible, risk-informed approach.” *Ian Pizer*

With so many options available in the absolute return space, how can investors be sure they’re investing in a genuine alpha-generating fund, rather than paying over the odds for beta?

Ian Pizer: A lot is down to transparency. If the client gives you greater investment freedom, you have to be able to demonstrate you are actually going to use that freedom within a responsible, risk-informed approach. You have to be able to provide transparency, so clients can see you are doing what you actually set out to do, rather than a black box approach where they can’t be sure.

Florence Barjou: It’s very important for clients to be able to understand what they’re purchasing. It’s not a problem if you purchase beta exposure, as long as it’s cheap. It’s very important to be transparent; full access to the investment strategy of the alpha vehicle and transparency on the positions, as well. Clients have to understand where performance comes from; be able to explain performance.

Celene Lee: Transparency is very important. The first thing I look at in any absolute return fund is the asset allocation, how dynamic it is and whether that aligns with what the investor is looking for. Equities have given us very good double-digit returns in the last few years. Trustees are looking for absolute return funds to do something a little bit different – not just diversify, but strategies they may not be able to implement themselves, like relative value trade. Value for money is also very important.

Michael Adam: If evaluating a long-only diversified growth fund (DGF) or dynamic asset allocation (DAA)-type manager, one of the first things we do is look at their track record compared with an index-tracking, 60/40, global equities/global bond mandate, to see whether there has been relative outperformance.

Robert Howie: We don’t see pure alpha very often in any sort of investment vehicle where the returns are driven purely from skill. Even in hedge funds, you tend to find there are alternative risk premiums that are mixed in with returns. That's not necessarily a bad thing, but you need to understand it. If you're getting unsophisticated beta-like equities or credits, then the costs of the funds should reflect that. That's one reason some multi-asset funds are able to be a lot cheaper than hedge funds – they are mixing beta and alpha and the cost is reflected in the fund. You're getting some cheap beta and some expensive alpha.

Lee: Because the equity markets have done very well, it makes it a bit harder to really test whether these absolute return funds are really achieving the fund objective as intended. This is particularly difficult when passive index equity returns have been going up significantly. This masks the task of what an absolute return fund is meant to do, which is to protect you. If things were to go wrong now, it would really put those funds to the real test as to whether they do what they say on the tin.

Barjou: What you're saying is interesting, because when I started working in the hedge fund business, clients expected hedge funds to just deliver performance. It was not a problem if you were buying an emerging market fund which was leveraged three times. People tended to have in mind that hedge funds were meant to beat the S&P. Today, things are completely different. Sophisticated clients – pension funds in particular – don't want to purchase hedge funds for return, but want to diversify their portfolio. They want downside protection and the focus is on risk and drawdown control, so the mindset has really shifted.

Adam: Dynamic asset allocation products have delivered effectively for us in the last few years, but as part of an asset allocation review, we are asking ourselves how might those funds perform in future and are there other products which could complement that strategy? We are beginning to look at asset classes which should be less correlated to global equities and global bond markets. The absolute return philosophy is there but we might execute that strategy with some different tools.

Barjou: If you take a 60/40 portfolio and you look at the expected high equity yield and the bond yield, you're not going to achieve 5% in real terms, which is the objective most people have. Pure buy-and-hold is not going to generate any performance.

Lee: Consultants have a job to do, to look through to the underlying allocation. There have been occasions where trustees have gone through an exercise looking at absolute return managers and instead of investing in the fund, they decide to go and invest in specific, defined asset classes within those funds, such as infrastructure debt or emerging market debt rather than a mixture of multi-asset credit for example. That's an interesting exercise to go through, to sense-check the investors' attitudes when faced with options and look through the underlying strategy.


Michael Adam

Pizer: We say 'absolute return funds', but is your start point a target return sort of strategy, in which case it's essentially a vol minimisation process, or is it a risk-budgeted maximum return fund? Both are perfectly valid processes, but if you aim to maximise return for a given risk budget, you're probably not going to get as much downside protection. By contrast, when things go well, you're going to get a lot more upside.

Howie: There's a lot out there and it's hard for investors to get their heads around individual products and how they might fit. It's not always obvious, particularly for a DB plan, where that fits in your portfolio. Many core multi-asset products are designed as one-stop shops for growth assets. As a pension fund trustee, if you use that product, you lose control over the asset allocation. The fund manager may not be quite as good at asset allocation as you thought. Particularly if the asset allocation is very dynamic, you get exposures that shift quite a lot. That is hard to monitor, and what you invest in at the start may be quite different a year later. It's hard, but the fact that equity markets have rallied, credit markets have rallied: investors really do need to look for things like active return to generate returns because the main markets are not expected to continue to rally like they have done.


Florence Barjou

"Managing the beta is how we create the alpha, basically. So, we don't try to be market-neutral. We're happy to have exposure to the market, if it's rewarding. It's about being flexible and reacting to changing markets." Florence Barjou

Is it hard to remain market-neutral and how do you avoid that correlation?

Barjou: We don't try to be market-neutral. We think it's fine to have some beta if you're correlated to something which is going up, but you don't want correlation to something which is going down. Managing the beta is how we create the alpha, basically. So, we don't try to be market-neutral. We're very happy to have exposure to the market, if it's rewarding. It's not about not having exposure but being able to be flexible and reacting to changing markets.

Pizer: In terms of beta, an appropriately-priced market doesn't give you a zero return, but rather a return that is commensurate with the associated level of risk. However, the challenge from an asset allocation perspective is that you don't have enough moving pieces. This means it's important to be able to drill down to specific sub-sections of asset classes – the next level of granularity. You may not want to invest in a global government bond index, but it's not to say you can't find pockets of value within that sort of universe. Having the flexibility to focus means you don't have to take the broad benchmark beta, but take beta at very specific points.

Howie: I find the term 'market-neutral' being used less and it is hard to find a fund that is completely market-neutral. I think the term that's probably more honest is 'low beta'. If you want to be market-neutral, and you want to hedge all your exposure to sector risks, you end up with nothing.

Adam: With the risk-on/risk-off periods of the last few years, these funds have been quite attractive to

Robert Howie

"It is hard to find a fund that is completely market-neutral. The term that's more honest is 'low beta'. If you want to be market-neutral, and hedge all your exposure to sector risks, you end up with nothing." Robert Howie

us. They have that degree of tactical flexibility to shift assets into cash, or to ramp up and ramp down the equities element of the portfolio: that has actually been quite well-suited to the macro environment.

Pizer: Market timing is the hardest piece for anybody, and there's so much of the industry that's really focused on trying to get that short-term tactical timing right. We've adopted an approach that entails taking a view on the long-term direction of markets. The challenge is to construct a portfolio that can cope with the ebb and flow of the market. By having longer term, more strategic positions, you can spend more time analysing whether any given position is an appropriate strategy before you make that call. Being able to watch a portfolio live and breathe as it slowly evolves means you can see how all these different pieces are interacting. In this context, risk is much more than just a compliance function. It is a key tool we use in terms of trying to build a portfolio, in which we combine quantitative risk metrics with a qualitative assessment of what the model tells us.

Barjou: Understanding the correlation between what you trade is very important information to manage your risk. You see it in multi-asset portfolios, and not if you manage the asset classes separately.

Is there a preference for long-only return funds?

Howie: Yes. In terms of a long-only absolute return product, it's obviously got less flexibility, fewer levers, to use. If it's the default option in a defined contribution (DC) plan, it could be very sensible to keep that simple, and long-only, and cheap. But in other places, clients are interested in long-only products, for example an equity mandate which has more of an absolute return orientation. Those products – though I hesitate to put them in the absolute return category – may have some traction for some investors.

Michael, you are doing research into a long-only fund. Is that your preference?

Adam: Historically, we have only invested into long-only products. That is not a firm policy but probably reflects our view of our own sophistication and the perception that short positions could add to risk in the fund. But saying that, I don't deny that long-only has its own challenges. Over the past five years, the fund has generated average annual growth in excess of 10%, but we are re-examining all of our asset allocation because markets have moved on and we are in a different place ourselves. We are looking at credit, infrastructure and some event-driven and special situation type ideas which could diversify risk and return.

Lee: Markets are now quite driven by government policy. Rates are the centre of attention, which then impacts on currency and volatility. Being able to long/short and play currency is quite an important play within a strategy because the fluctuation is massive.

Barjou: It makes a lot of sense to have a core allocation to long-only and then something a bit different. It's your long risk premium on equities, bonds, and credits. Commodities are a bit different, but as long as the multi-asset manager you delegate your investment to is able to manage the volatility and move to cash to protect the portfolio, that's fine. Implementing a short position at a time when market volatility is high is an active bet which can be quite risky. Often, you have the option to move to cash, which is a very robust way of protecting performance.

It makes sense to mix the long-only multi-asset bracket with something a bit different, which is going to have very different performance drivers.


Michael Adam and Florence Barjou

Lee: I do wonder, with pretty much every asset class that's gone up, and supposedly 'expensive', whether potentially managers are forced to park a lot of money in cash.

Barjou: If you look at bonds or equities, we can agree they are expensive. But if you do screenings on sectorial, regional or a country basis, you will find opportunities.

Pizer: There are pockets of value, but the biggest challenge is finding your defensive asset class. That's where having a bit more flexibility is important. For example, peripheral government bonds in Europe do continue to look attractive. Given the size of the asset purchase programme, the ECB is fully in control of the market. The problem is, if something goes wrong around the group negotiations, you stand to lose a lot more than you might gain. With cash rates where they are, I expect equity will give you a positive return,

as will some global government bonds. While they're expensive relative to their own valuation metrics, they are not given cash rates of zero, or indeed negative rates, as you now find in parts of the world.

What is the effect of the high-profile exits we've seen from the hedge fund space?

Howie: Fees have been a top issue for many years, and you can't get away from the fact that they're expensive. Hopefully they will get cheaper, but I don't think they're going to become cheap relative to other asset classes. If you're paying for skill, you need to attract the right people; that is not cheap.

Pizer: I'd be interested to know your view on performance fees. They are appropriate for a maximum return strategy that's given a certain amount of risk budget flexibility. But for something that aims to be a core portfolio allocation they may be less appropriate, as they incentivise managers to take the maximum amount of risk budget the mandate allows. A better alignment of interest is achieved when the firm has a significant amount of its own money invested in the product.

Howie: A performance fee without a hurdle rate, and where performance is crystallised in the shorter term isn't necessarily the best way of alignment. A structure which has hurdle rates, which incentivises long-term generation of performance is much better than a structure that incentivises short-term performance.

Barjou: Clients have become much more pragmatic. Before 2008, they came to us just to build a hedge fund portfolio. Now, they're coming to us to buy portfolios which combine everything – ETFs, mutual funds, and absolute return or hedge funds. The overall fee of the portfolio is going to come down quite dramatically because the whole beta share is going to be very cheap. It's a different way to offer a solution to clients, but you still pay for the talent. But clients won't pay for just being exposed to an equity index.

Adam: I'd say there are really three questions: are you willing to pay these kind of fees at all? Does the fee structure align the interests of the manager and the investors? And most importantly, are you getting alpha or beta returns?

Pizer: The problem with fees, historically, wasn't necessarily the level, but there wasn't necessarily a correlation between what clients were getting and what they were paying, so were paying far too much

"There are really three questions: are you willing to pay these fees? Does the fee structure align the interests of the manager and the investors? And most importantly, are you getting alpha or beta returns?" Michael Adam

for just a pure beta play. Products that had a justifiably high fee are being taken out of the investment universe for the end investor. So you risk getting a two-tier system, where some of the better products are no longer on offer to core investors, only higher-wealth individuals or slightly more sophisticated clients. That's a very blunt tool to be using, and no-one has explained just what a justifiable fee is.

Adam: Government is looking hard at fund manager fees paid by local authorities. But it's wrong to point at higher fees without considering value for money. We need to justify why making room for alternatives in our growth asset allocation is good value for money compared with leaving the money in active or passive equity mandates or a DGF fund.

Lee: We've had to take some DGFs and absolute returns out of DC default funds to meet the charge cap, which is unfortunate. They're still available under self-select, but I agree it is a blunt instrument. It doesn't think about the value-add and access in terms of alternatives that we can offer to retail customers; individuals can access these things that they weren't able to before.

It's a shame, but I can also see many people who go into DC funds may potentially never understand alternatives.

Does the rate cap leave a place for these strategies, or are they just completely priced out?

Howie: The industry is innovating and we are seeing providers coming to market with products that are within the price cap, that do the best they possibly can within those fees.

But price-capped DC investors are going to miss out on some of the most skilled investment managers out there, because of that cap. That's just a fact of life.

Do absolute return bond funds differ in how they are run?

Pizer: There's a vast array of absolute return bond funds and the lack of commonality between many of them illustrates the diversity on offer. A lot of them are mainly short-duration credit, which is essentially low-beta equity. However, there are some very aggressive absolute return bond funds. But those with a relatively low hurdle – say 3% over cash – should be quite defensive.

Lee: I think there is a role to play, but the transparency issue bothers me, personally. For example, many funds have double-digit asset class exposure.

Barjou: Most bond funds are typically carry strategies. They have high tail risk; especially as the yields are very low. You really have to dig into the details because if you just buy carry, then that is very, very risky. You should really go for something a bit different – long/short credit, for instance – or at least a very robust duration management.

Adam: We have quite a defensive absolute return bond manager. Recently we looked at some funds which have generated higher returns and we were not totally comfortable with the levels of sub-investment grade and emerging market debt because this is meant to be the low risk end of our portfolio.

Pizer: The challenges associated with the complexity of the different asset classes that constitute the bond market are just as evident – in fact, more so – if you look into multi-asset. What you really want to be looking for is a firm that can genuinely leverage off the strengths of a broad range of asset classes and subsectors managed in-house.

Adam: Do you think there could be liquidity issues given the quantum of money which has been invested into these funds in the belief of finding a safe haven?

Pizer: I don't think they are all safe haven funds although liquidity, to me, isn't so much of a concern in itself. Some absolute return funds have been rebadged strategic bond funds, but the investment style has not really changed; the money is still in high yield - it's just that it's now got a different badge on the front of it.

Ian Pizer

Barjou: Liquidity is being driven only by central banks, so you have a massive policy risk. You see so many inflows in credit funds because people are chasing yield, and this is also why they're moving down the ratings curve. What happens if liquidity starts to dry up? You are depending on one or two big actors to drive the market's liquidity, and that's a risk in itself.

Pizer: Bonds have got a reputation for liquidity because of sovereign yields and the fact that when there is a bit of a stress event and investors turn defensive people will want to own them. If you need liquidity, you can sell them in that crisis because they're in demand.

Howie: Liquidity is something that should probably be more in the minds of investors; not just fees, returns, and the volatile returns which can be negative. It should also be about the fact you could be locked up in an investment that is currently liquid. To come back to the absolute return bond funds, investors need to understand the liquidity terms and conditions in the documentation; understand what could happen if the bond market becomes illiquid; if there's a run on the fund, and realise in the worst case scenario they will be stuck in the fund.

How is this sector going to develop?

Howie: There's going to be even more choice. We see lots of products labelling themselves absolute return and in some cases, mislabelling themselves as absolute return. There's a lot of due diligence for consulting firms and investors to do to pick the winners. There's a lot of noise and jargon in trying to cut through that, and just look at good, high-quality products that deliver high quality returns net of fees; that's the key goal.

Celene Lee

"Rates are the centre of attention, which impacts on currency and volatility. Being able to long/short and play currency is quite an important play within a strategy because the fluctuation is massive." Celene Lee

Barjou: Transparency is the key. Clients need advice and to understand what they're buying. What's frustrating for clients – and that's very much the case in the market-neutral segment – is that you buy something which you think is market neutral, then you have a massive sector rotation and you lose a large amount of money. Transparency is important so the client can understand how performance is generated.

Pizer: I'd expect the absolute return universe to fragment a little as investors get more clarity about funds and what they are actually trying to achieve. In general, it will be the funds that are transparent about their philosophy, objectives and processes, and can then deliver on these, that will be successful.

Adam: We are a mature DB scheme with a funding deficit, so an absolute return approach makes sense for us. We need to regularly evaluate whether products we hold in the belief that they are going to generate absolute return are still appropriate in changing market conditions and we need to be open-minded with respect to alternative asset classes which could deliver similar levels of risk-adjusted return.

Lee: Investors should really think about the economic environment we're in, or are going to be in, rather than always looking back. If the style of the fund is no longer suitable, they need to review it and adopt a slightly different strategy. Finally, warn pension funds and investors they could be fooled by labelling, whether absolute return, unconstrained, or whatever. They must do their homework and really understand the differences. If institutional investors fare well in the next few years, then they should congratulate themselves, because it's not easy, to see what may happen. These are interesting times.

Resting easy with multi strategy

By Ian Pizer, head of strategy, Aviva Investors

Well-constructed multi-strategy portfolios can provide the funding and investment returns pension schemes need, however volatile markets become. Investment strategies designed to deliver specific returns or levels of income in all but the most extreme market environments have proven attractive to a wide array of institutional investors in recent years. Their popularity lies in their ability to generate relatively stable returns that are uncorrelated to other asset prices. That in turn has made them an attractive option for pension schemes as they look to reduce deficits and fund the costs of hedging out their liabilities.

Aggressive monetary policy has meant most asset classes have done extremely well in recent years. However, this will not persist indefinitely. While US interest rates may not rise for a while longer yet, they will have to go up eventually. Investors could be in for a bumpy ride when the Federal Reserve does reverse course, particularly if asset prices remain highly correlated, as seems likely. As such, demand for multi-strategy investments looks like it could be set to grow as investors begin to anticipate higher US rates.

Approach

By combining a diverse range of strategies with different drivers of performance, multi-strategy funds can provide specific returns or levels of income with limited volatility. Such funds' performance tends to be relatively uncorrelated to equities, bonds and other traditional asset classes. As such, investing in these kind of funds can help improve the risk-adjusted performance of a traditional multi-asset portfolio.

The correlations between asset classes have increased dramatically since the financial crisis of 2008, in large part due to the unprecedented policy responses of central banks. Correlations between equities, bonds and other assets are much higher than their long-term norms. So the typical diversification benefits of investing in a mix of assets are far lower than they once were. Investing in multi-strategy funds with little correlation to traditional asset classes and based on forward-looking assessments of the markets rather than past performance, is one way to attempt to generate smoother long-term returns.

Markets are quick to embed information but not always the correct information, potentially leading to large swings in sentiment. So, in our funds for example we ignore short-term market events and focus on spotting mispriced investments with attractive risk-adjusted returns over a three-year investment period. By ensuring they have exposure to many different types of investment opportunities, multi-strategy portfolios can aim for specific results – such as the level of return or regular monthly cash flows – with greater confidence than traditional forms of investment.

Diversifying risk

Investors may think they have a diversified portfolio because they hold a mix of assets. However, they may be taking more risk than they appreciate. For instance, a portfolio that holds 60% of its assets in equities and 40% in bonds, is actually placing 90% of its risk in equities due to the relatively risky nature of that asset class.

The way strategies are expected to interact with each other across a range of market conditions is crucial to managing a portfolio's risk exposure and delivering the performance investors expect. For instance, AIMS portfolios consist of three types of strategies: market, opportunistic and risk-reducing. The first looks to generate returns when markets perform as we expect, the second looks to exploit market dislocations and generate positive performance irrespective of market performance, and the last looks to support performance when markets behave unexpectedly. The aim is to combine these strategies in such a way that we can deliver equity-like returns for less than half the risk.

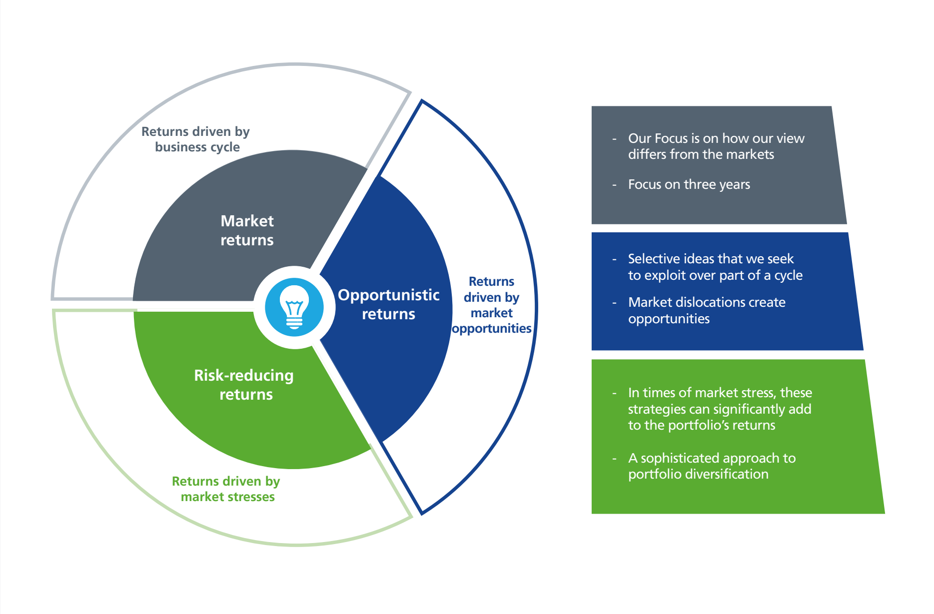
An example of a risk-reducing strategy could be one looking to gain exposure to the volatility of the South Korean equity market, which is heavily exposed to economically sensitive stocks, versus a typically less volatile market like the US. This strategy could be profitable if markets become more volatile as an unprecedented period of experimental monetary policy comes to an end. By contrast, an opportunistic strategy may involve being 'long' the Indian rupee and 'short' the euro. This strategy should be profitable if structural reforms in the Indian economy boost growth more than the market expects or if eurozone monetary policy is easier than the market expects for longer. Indeed, the euro has weakened in recent weeks with the European Central Bank (ECB) embarking on outright 'quantitative easing' in January. But if our House View on QE was wrong and the ECB surprised markets by not embarking on it, other strategies in the portfolio (such as a risk-reducing one based on European equities being more volatile than US equities) could benefit from investors' subsequent reaction.

Built for the long term

By combining a mix of strategies from the above three categories, multi-strategy portfolios can generate lower overall portfolio risk than the sum of the risks of each individual strategy. Indeed, when constructing portfolios we assess how much each individual strategy will add to the overall portfolio's return and its impact on overall risk. We also assess the ease with which we anticipate we can exit the position and whether it will work when the fund grows substantially in size. Derivatives are often employed in order to be able to alter asset exposures quickly, especially in illiquid markets, and manage risk efficiently. They also allow managers to get more exposure to an underlying asset than by investing directly in the asset itself.

Strategies can be quickly added or removed from the portfolio to refine risk exposures and ensure the portfolio is appropriately positioned as the outlook for economies and markets changes.

Capturing investment performance



Fitting in

Institutional investors and consultants are showing increasing interest in outcome-oriented funds. There are a large variety of such funds offering different risk and return objectives. While consultants generally recommend outcome-oriented funds to larger schemes, we believe there are good reasons why smaller-sized schemes might want to consider them too. Not least, the fact they offer access to a well-diversified range of investments that may be hard to replicate in-house. For instance, the Aviva Investors Multi-Strategy funds draw on investment ideas from across our business. They are then implemented and monitored by fund management and risk specialists experienced in running these kinds of portfolios.

AVIVA INVESTORS

Changing the absolute return game

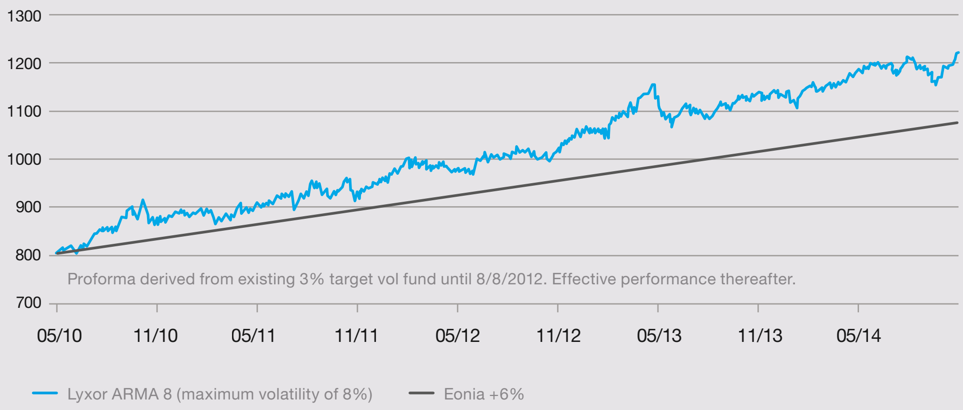
By Florence Barjou, deputy head absolute return and solutions, Lyxor Asset Management

Not many funds have been able to record performance in two years with as different characteristics as 2013 and 2014. However, based on an innovative Active Risk Parity approach, Lyxor's ARMA 8 absolute return fund – a highly diversified and reactive strategy – has been able to deliver absolute returns within a long only framework and an annualised rate of return close to 10%.

The rules of the game are changing. After more than six years of a significant compression in risk premiums, investors will probably have to adapt to a lower return environment. The combined rally in equities and bonds has left yields across asset classes trading at historically low levels, a challenge for traditional investment techniques. Buy and hold for instance, which has been a winning strategy since March 2009 could face compressed returns going forward. By comparison, active and diversified strategies, like Lyxor's ARMA 8 fund (Absolute Return Multi Asset) should be well fitted. This innovative fund implements an Active Risk Parity approach, a strategy which has recently aroused strong investor interest.

Figure 1: ARMA 8 track record

Source: Bloomberg



Traditional risk budgeting techniques – a strategy where Lyxor is recognised as a pioneer – are a very robust way of diversifying a portfolio and to answer the asset allocation challenge. An advantage of this technique is that risk-based portfolios do not make any assumptions on future expected returns. Risk-based portfolios are agnostic. They diversify positions by equalising the risk contributions of the asset classes they invest in. This is the purest expression of the traditional wisdom which recommends "not to put all the eggs in the same basket". Indeed, the "eggs" should be best seen as the risks that an investor is ready to take.

The traditional 60/40 equity bond portfolio for instance, is certainly not diversified in terms of risk, as close to 90% of the portfolio's volatility is going to be driven by equities. On the contrary, a risk parity portfolio is going to allocate an equal amount of risk to all the asset classes that make up the fund's investment universe.

Thanks to their solid diversification properties, portfolios based on risk budgeting techniques tend to generate very robust performances over the long term. However, two set-backs are worth mentioning.

First, in a risk parity portfolio, the lower the risk of an asset class, the higher the end exposure in the fund. As a consequence, effective positions in bonds, which have a lower volatility than equities, tend to be significant. This can lead to losses when interest rates increase. The topic was heatedly debated in 2013, a year where traditional risk parity funds recorded disappointing performances owing to the negative behaviour of sovereign bonds. In 2015, the question could arise again. In Europe, the ECB's large scale purchases should keep interest rates in check, but in the US, the probability that rates will move upwards, even though modestly, is high. The recent strength in the labour market is clearly pushing the Fed towards a first rate hike in 2015. The adaptability of traditional risk parity funds could thus again be questioned.

Second, risk parity strategies are by nature dynamic. Indeed, they react to changes in market volatilities and in correlations between asset classes. However they are not dynamic enough to rapidly adapt to rapidly changing market conditions. Since diversification is in their very nature, they will remain exposed to an asset class, even if this is a losing bet. When the market environment evolves and asset classes re-correlate – sometimes aggressively, as was the case in May 2013 – the short term market impact can outweigh the long term benefits of risk based diversification. In other words, risk parity in itself is not an absolute return strategy.

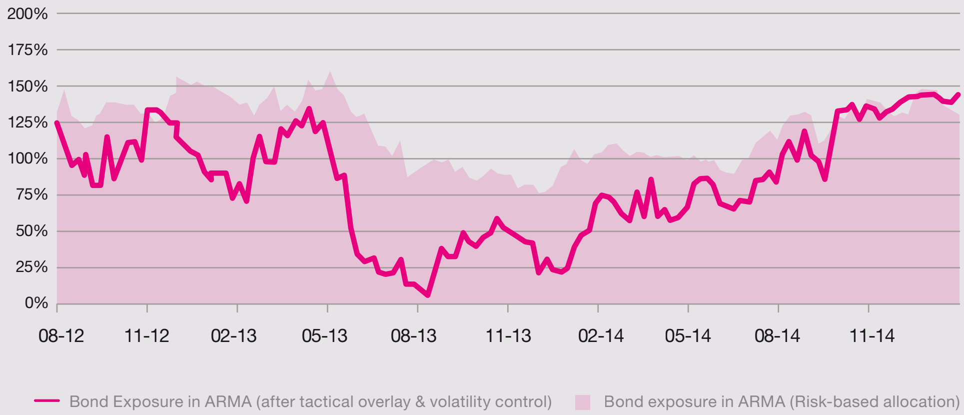
Risk parity should only be viewed as a starting point, a robust solution to generate diversified allocations over the longer term. In order to be able to achieve an absolute return like profile, traditional risk parity approaches have to be enhanced. In particular, it is important to take a more active approach.

The Lyxor ARMA 8 Fund (Absolute Return Multi Asset) is a new generation Active Risk Parity fund. It focuses on two additional performance drivers: (1) a significant tactical overlay and (2) a daily volatility control, as the fund targets a maximum volatility budget of 8%.

The tactical overlay itself rests on two distinct pillars. It combines a purely systematic trend following bucket and a judgemental, discretionary global macro portfolio. The tactical overlay helps incorporate performance expectations for each asset traded in the fund. In this way, the strategy can rapidly adapt to market conditions, cutting exposure on assets with potential downside and increasing exposure to assets which have the highest upside. The tactical overlay significantly increases the reactivity of a purely risk-based investment process. Combined with wide investment boundaries (0% to 100% on equities, 0% to 200% on bonds for instance), this reactivity makes ARMA a truly flexible strategy.

Figure 2: ARMA 8 bond exposure

Source: Bloomberg



As for the volatility control, it is extremely effective in preventing severe losses.
The combination of decorrelated performance drivers enable ARMA 8 to boast a solid 9.6% annualised rate of return and a 1.55 Sharpe ratio (as of December 2014). In 2013, a difficult year for many multi-asset managers, the fund recorded a solid 9.4% performance. Key to this result was the active exposure management during the Taper Tantrum market shock. In just two weeks, the fund's exposure to bonds dropped from 125% to just 7%, effectively preserving performance. As shown in the above chart, a purely risk based allocation would have trimmed exposure to bonds too, but would have kept a close to 75% exposure on a losing asset class. The tactical overly clearly helped the fund, which was able to rapidly adjust to a changing world. In 2014, however, a year where most market participants had expected interest rates to continue to increase, the fund was able to re-allocate back to bonds, while remaining exposed on equities.

Lyxor's ARMA 8 thus managed to generate performance in two strikingly different years, effectively living up to its absolute return objective and outperforming most of its peers.

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