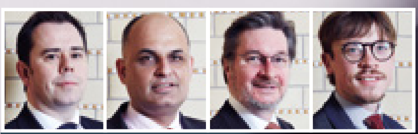
Absolute return

Assessing the promise of positive returns



In conversation:
Brendan Walsh | Himanshu Chaturvedi | Simon Hill | Sebastian Cheek

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Assessing the promise of positive returns

Absolute return has become hugely popular with institutional investors amid the volatility of recent years.

It's not hard to understand why: investors like its 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.

Unsurprisingly then, the space has grown massively since the crisis, both in terms of AUM and the range of products and strategies that are considered to fit under the absolute return moniker. Figures from Hedge Fund Research show assets have doubled since the financial crisis from $1.4trn in 2008 to $2.9trn at the end of the third quarter 2015. Fifteen years ago, in 2001, assets stood at $540bn – less than a fifth of today's value. In the mutual fund space, the quintupling of assets has been even more rapid. The IA Targeted Absolute Return Sector has grown from 25 funds with a total of £12bn five years ago to 60 funds with £54bn by the end of Q3 2015. The biggest winners have been the large multi-strategy funds: Standard Life's £26.7bn (as at 30 November 2015) Global Absolute Return Strategies fund, for example, accounts for over half the total £54bn assets in the sector.

The trend towards large multi- asset funds masks a growing problem for the absolute return sector, however: that of confusion and disappointment among investors.

Absolute return is the one fund sector defined by outcome rather than asset exposure, which makes it particularly sensitive to confusion and disappointment. Furthermore, there is no clear industry-wide definition of what absolute return means and, therefore, what investors should expect from it.

While there is some broad agreement on what absolute return means – positive returns are a given – the timeframe over which returns must be positive differs widely. They can range from 12 months to a full economic cycle, while others suggest performance should be positive in all or most market conditions.

This roundtable of industry experts discuss absolute returns' performance, how investors are positioning it in their portfolios, its use in DC and more.

Chris Panteli

editor, *portfolio institutional*

What's in a name?

Absolute return is massively popular, but confusion over what is promised can lead to disappointment, finds *Emma Cusworth.*

Absolute return has been one of the true buzz words of the last decade. As the term 'hedge fund' fell out of favour following poor performance during the financial crisis, absolute return became the common phrase for hedge fund strategies. The space has since grown massively, both in terms of AUM and the range of products and strategies that are considered to fit under the absolute return moniker. With a change in tide for markets underfoot however, the space deserves a closer look, not just because the potential for returns comes under threat, but also because its broad scope has created an environment of confusion and disappointment.

Figures from Hedge Fund Research show assets have doubled since the financial crisis from $1.4trn in 2008 to $2.9trn at the end of the third quarter 2015. Fifteen years ago, in 2001, assets stood at $540bn – less than a fifth of today's value. In the mutual fund space, the quintupling of assets has been even more rapid. The IA Targeted Absolute Return Sector has grown from 25 funds with a total of £12bn five years ago to 60 funds with £54bn by the end of Q3 2015.

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GROWTH MASKS CONFUSION

However, the trend towards large multi-asset funds masks a growing problem for the absolute return sector – that of confusion and disappointment among investors. As Dan Kemp, Morningstar's chief investment officer, EMEA says: "It is clear from the European market that the trend towards multi-strategy funds indicates people are faced with confusion – they chose a broader fund that gives exposure to a large number of areas. Paralysis by analysis is a symptom of confusion."

Absolute return is the one fund sector defined by outcome rather than asset exposure, which makes it particularly sensitive to confusion and disappointment. Furthermore, there is no clear industry-wide definition of what absolute return means and, therefore, what investors should expect from it.

Morningstar's Kemp says: "Defining what is meant by absolute return has been a real problem for the industry over the last seven years. If someone defines it in terms of limiting short-term losses, that is not compatible with delivering long-term cash-plus returns. The challenge with absolute return funds as a category is that it tries to serve too many masters, which creates confusion and ultimately disappointment as funds will do one thing rather than both."

DEFINING THE SECTOR

There is some broad agreement on what absolute return means – positive returns appears in almost all of them. The timeframe over which returns must be positive differs widely, however, from 12 months to a full economic cycle, while others suggest performance should be positive in all or most market conditions.

According to Caspar Rock, CIO at multi-manager solutions provider, Architas: "The majority of absolute return funds target positive performance in all market conditions, with low volatility and low sensitivity to traditional asset classes. While some may invest in income-producing assets, the strategies are not generally run to produce a regular income for investors. Downside protection is often a key feature, with the manager's ability to short various markets providing the tools to reduce the impact of volatility."

Sonja Uys, portfolio manager, alternatives, at Insight Investment, says absolute return funds should aim to deliver positive returns over a set period of time. It should focus on not losing money in that period and display low volatility along with low correlation to other asset classes. "True absolute return funds therefore tend to prove their worth in times of market turmoil," she says.

Appropriate categorisation is an important factor of successful investment. UK equity funds, for example, are largely benchmarked against a big standard index and carry a similar level of risk to that index. Inherently they are fairly comparable, like horses racing around the same track.

"Absolute return is like letting all the animals in the zoo take part in the race," Morningstar's Kemp says. "The method and speed with which they get round will be very different."

Or, as Principal Global Investors' head of institutional business, Stephen Holt, puts it: "Absolute return strategies are highly reliant on manager skill, and the approaches taken will vary significantly between managers with no guarantee of success."

Accordingly, looking in great detail at the individual managers is more important in the absolute return space than anywhere else.

As Architas' Rock states: "Given the breadth of the universe and the varied interpretation of absolute returns, it's important for investors to conduct their research and gain a good understanding of the expected return and volatility profile of prospective investments."

SERVING TWO MASTERS

Being able to deliver positive returns in all (or most) market conditions means doing so when the market and other funds are down and when they are up. This requires significant skill and a small net exposure to markets.

Analysis of the Targeted Absolute Return sector by Barry Norris, CEO and manager of the Argonaut Absolute Return fund, shows only three absolute return funds are, in fact, delivering low correlation to traditional assets with negative correlation to the European stock market, and those funds tend to perform poorly. By contrast, over half of the funds in the sector have a correlation of over 0.5 with the European stock market, which suggests limited diversification benefits. Only two funds appear to combine an attractive return profile with a low correlation to the European stock market.

> The challenge with absolute return funds as a category is that it tries to serve too many masters, which creates confusion and ultimately disappointment as funds will do one thing rather than both.

Dan Kemp

The absolute return space as a whole typically exhibits a positive correlation to equity and bond markets, according to Morningstar's Kemp. "They have enjoyed a tailwind of rising equity and bond prices, but if we move to a scenario where real interest rates started to rise, then that would be a challenging environment for equities and bonds," he says.

On the other hand, if a fund were to serve the other master, as Kemp describes it, and provide long-term cash-plus returns, the low correlation and downside protection creates a significant drag on performance. This explains why many unlevered absolute return strategies tend to have relatively low return targets (such as cash plus 2-4%, for example). PGI's Holt says: "Over the credit cycle, absolute return strategies should lag an approach that is less constrained by the need for capital protection."

Analysis of 12-month returns for all share classes for EU domiciled UCITS funds in the Alt Morningstar Categories, however, shows that even these low return targets are difficult to achieve. Only 10.6% of share classes provided a yield greater than zero, with the rest posting zero yield. The average yield overall was a mere 0.2% and even among those that did achieve a positive return, the average yield was only 1.85%.

Meanwhile, the HFRI Fund Weighted Composite index posted a decline of -0.85 percent in December, giving it a full-year performance of -0.85%.

It appears the majority of absolute return funds have therefore failed to serve even one master in the recent past, and fewer still are serving both successfully by providing cash-plus returns and limiting short-term downside losses.

THERE MAY BE TROUBLE AHEAD

Demonstrating the ability to deliver on a promise is important for absolute return funds, however. Lack of a clear definition arguably means investors seek the comfort of a track record even more than they might for other sectors, but, as Richard Philbin, CIO of Wellian Investment Solutions points out, just because a fund has delivered an investor's desired outcome in the past doesn't mean it is going to do so in the future.

Capital markets have been driven by falling real yields over the last 25 years, which meant bonds didn't create too much of a drag when equities were doing well. Since the 1970s there has not been a sustained environment of falling equity and bond markets, which tends to happen in a tightening environment, although glimpses were seen during the Taper Tantrum in 2013 and also in 2004.

If markets move into a scenario of rising real yields, which the Federal Reserve expectations suggest will be the case, the market for equities and bonds will potentially be weaker and that could feed through into weaker returns from absolute return funds. Compared to prior interest rate cycles, this is also the weakest ever growth and inflation backdrop in which central banks have started raising rates.

Investors therefore need to be aware the environment for

absolute return funds may become more challenging. As Morningstar's Kemp warns: "We will really find out who has been swimming without their trunks on as the tide is lowering in terms of the investment opportunity set."

And then there is the question of fees, which, in the context of the low returns being targeted and the smaller opportunity set, will have a greater impact going forward. Argonaut's analysis across the Targeted Return sector, for example, suggests approximately one quarter of funds have an annual management charge of at least half their standard deviation.

"This implies that even in a good year fees will eat away at least half of the implied return," according to Norris. "This begs the question as to whether low-volatility Targeted Absolute Return products offer value for money as their fees would seem to consume an unhealthy proportion of the targeted return."

A NEW DAY, A NEW MONIKER?

Interestingly, just as the term 'hedge fund' fell out of favour, so 'absolute return' appears to be going out of fashion. Many managers are keen to distance themselves from the moniker, especially given the widely-understood definition (and therefore expectation) of consistent positive returns.

Cardano's CIO, Keith Guthrie, believes this is because the term absolute return can be interpreted as "never being negative rather than an objective to target a certain level of return with risk that the returns could be negative". "People are trying to find the right words to encompass the concept," he says. "Many are using targeted returns."

Managers are also moving away from the notion of downside protection, focusing instead on the diversification benefits provided by the funds. As Michael Ho, a senior managing director of State Street Global Advisors says: "Post 2008, many hedge fund providers claimed to provide absolute returns, but that is not the case any more. They want to be seen more as diversifiers."

For an industry that generally hates talking in absolutes, it is perhaps unsurprising that so many managers are trying to move away from the absolute return moniker towards something that would naturally lower investors' expectations. With tough times ahead, the need to avoid confusion and disappointment becomes paramount. Importantly, the underlying strategies being employed remain the same, albeit they are adopting more appropriate titles that align better with the objectives they are likely to achieve. That said, Rock stresses the importance of assessing each investment individually, rather than getting caught up in "the classification lingo" as, he says: "managers will align themselves to whatever the classification du jour is."

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"As balance funds became DGFs became multi asset funds; a lot of those multi asset funds are now absolute return funds and are not doing anything particularly different from what a balanced fund used to do." *Brendan Walsh*

How have absolute return strategies performed given the current macro environment and market conditions? How should we be judging this performance?

Brendan Walsh: You have to be careful when talking about absolute return; I tend to think there are at least two different approaches. The first we call target return, where you are looking to deliver a cash (or inflation) plus target with low volatility, so trying to achieve that return with minimal risk. The other is the more classic hedge fund strategy looking to maximise return, given a risk budget you would expect the latter to be quite volatile particularly in this sort of environment.

Over the last two years some of the macro funds have struggled as co-ordinated central bank policy gives way to a somewhat multi speed world. Of course some of the target return funds have struggled as well – DGFs have been challenged as correlations have become more unstable. Having said that we have seen that its possible to deliver a cash plus return of over 6% thought this period if you pay attention to portfolio construction and take a longer term view.

Simon Hill: Judging absolute return means different things in growth assets as compared to bond type portfolios, and there are many different approaches. An absolute return fund should have generated a positive return last year. And though conditions were difficult, they weren't that unusual. I think they should be judged in terms of generating a positive return relative to cash. Of course, cash has been a peculiar benchmark for eight years now in itself.

We would not think about DGFs in the same way and would expect them to have done poorly in the circumstances we had in August/September last year or early this year, though we would expect them to fall less than 100% equity funds.

Himanshu Chaturvedi: There is no standard way of generating absolute return, so you should expect a wide dispersion between various funds. There have been only three or four occasions to really test the absolute return space in any meaningful way over the last few years. These periods serve as a good reminder of what these strategies do and – the clue is in the name – they should generate positive return to some extent across-market environments. As investors, we must continue to be discerning, understand these strategies because it is not an asset class for which you can easily say what you will get.

Walsh: In the same way that balance funds became DGFs became multi asset funds; a lot of those multi asset funds are now absolute return funds and are not doing anything particularly different from what a balanced fund used to do. Having a 60:40 equity/bond portfolio has delivered a reasonable absolute return over the last 15 years, but we think it will struggle to do so on a prospect basis over the next 15. One of the reasons is you are not getting that almost free protection from having a bond allocation. As an example, developed market bonds over the next five years in some cases price a negative expected capital return. A targeted absolute return fund though includes in it some concept of almost entirely eliminating the downside, but the critical issue is over what time period? A day, month, year? Five years? 10 years?

Hill: Funds defined as absolute return can get tempted away from that principle in conditions where growth assets are growing strongly. That would be concerning and it is no comfort to us to hear a manager of an absolute return product say they were caught long when equity markets go down – they shouldn't be there. It is key whether people are trying to do timing of risk, pursuing a highly diversified approach, or taking beta out entirely and using a really solid long-short strategy to get bits of alpha round the edges for a small return.


Himanshu Chaturvedi

The last 12 months was a key test because it ended up roughly flat in captal terms for most asset classes with no real help from interest rates or yields. You couldn't just get by with a cash return but you had quite a lot of volatility along the way in a number of asset classes that will have helped sort the sheep from the goats; and pursuing additional yield wasn't a good strategy last year because high yield blew out and so on and so forth.

Walsh: As a portfolio manager, I always want something in there that will do well when risk assets are doing badly. And if you take that as a starting point it is easier not to get swayed by becoming too directional; because you are always looking for offsets and asking the question what happens if I am wrong, what happens if nothing happens. So you are always conditioned to have something in the portfolio that performs when your central view is not really working, or is challenged by the market, and the key thing here is it should not cost very much money in your central view of the world. August and September last year and the start of this year are great examples of when this is useful. If you are trying to split the portfolio between longer term themes and tactically hedge, ie a strategic part and a short term piece, you are having to do tactical and strategic and I think in this sort of fast paced environment where the volatility is high, it is really easy to get sucked in to the tactical piece basically overwhelming your whole portfolio; and that is where you can sometimes see large drawdowns or unexpected volatility. It's one reason why we only concentrate on the three to five year horizon and don't try and exploit tactical oppurtunites.

Chaturvedi: If your portfolio construction was strong, the bits you got wrong should lose little amounts, but the other half should be making quite substantial returns. A traditional DGF – kind of akin to the old balanced fund; with some bonds, some equities and other asset classes – really has nowhere to hide. You are not going to make a higher return by being long various times. But even if expected returns are lower than normal, it is a very fertile ground for relative values. From an investor perspective, it is really attractive to add absolute return strategies to the portfolio. It is also fair to expect that the good managers who make strong returns in this environment are truly running absolute return strategies.

Hill: What we are looking for is for people to stay true to the process and the philosophy, even if things need to adjust with time. Last year, a lot of managers who did reasonably well did so because they got some currency positions right. One of the few things that didn't have a close to zero return was the dollar. We regard currency as being quite a specialist skill and not all multi-asset managers are blessed with the appropriate tools or expertise in those areas. The risk is that they suddenly think they know how to get currency right and many may not be so lucky in the future.

Walsh: In a traditional strategic multi-asset framework, you don't really have a currency view, or at least it's hard to ascribe a risk premium to a currency pair. If you are looking at allocating risk to a macro view then absolutely you should be using currencies, but you need to be comfortable with that and understand it from a macro point of view. Most of the volume that goes through currency markets is not speculation, but transactions, hedging, cross-border flows. So if you have got a very strong macro view, sometimes currencies are the cleanest way to express that and its also an extremely liquid market.

Chaturvedi: The managers we think are really strong they will have skills in currencies. If you are a global bond manager, I struggle to believe that you could have views on global rates and not have views on currencies. There is a subset of the absolute return space that does only bonds. These absolute return bond funds would have seen a lot of their bets of a short duration should have paid off in an asymmetric kind of trade, but a lot of them struggled as well. That might be due to currency.


Himanshu Chaturvedi

Going back to the manager's philosophy and process – you don't want to follow momentum, but you need that active side as well.

Walsh: They need to be able to adjust even if it is a long-term view. Suddenly you may get a whole load of information for example this summer in China so you have to stop, reassess, revalidate and then on that basis you may decide to step back or change your approach. I see it as different from being reactive based on price action, this is not always the best approach because you are reacting on what has happened in the past and it's not always easy to extrapolate that it the future but if you can integrate new information quickly, and use that to challenge your existing view, it definitely helps even if that view is longer term.

Hill: There are broadly two poles – those that take a very structured position in terms of how they manage the risk – or at least the downside risk – and deviate relatively little from that. The other pole is a kind


Brendan Walsh and Simon Hill

“Most of the volume in currency markets is not speculation, but transactions, hedging, cross-border flows. If you have a strong macro view, currencies are the cleanest way to express it. Its also an extremely liquid market.” Brendan Walsh

of strategic absolute return approach so (for example) you take duration out of a fixed income portfolio almost completely; or have long-short equity and deviate relatively little from that, getting some alpha here and there to give you the positive return. There are others who would be more tactical to start with by recognising that markets are more fluid and you need to be more dynamic.

How should DB schemes approach selecting an absolute return manager or fund?

Hill: There are two parts to the decision – is this the right sort of fund approach/strategy to have in an overall portfolio and then the manager selection follows from that, because you will have decided what you mean by absolute return and the characteristics you are expecting from it.

With DB pension schemes, the attraction of absolute return is not immediately obvious because it is not linked to liabilities. Its usefulness is subsidiary because absolute return in itself in most circumstances for DB schemes is not particularly helpful. Absolute return in itself for a DB pension scheme has limited value just because it is not linked to the liabilities; not linked to the underlying problem.

Chaturvedi: The majority of my clients are DB pension schemes and I think it misguided that your investment objective is either to hedge liabilities or to earn the highest possible return. There is a middle ground. If you pick a good absolute return fund that is able to make cash plus four, that is better than buying a bond that is guaranteed to lose you money on a real basis. So from a portfolio construction perspective, we take a different view here. DB pension schemes should construct portfolio on a more holistic basis. While it is desirable to reduce interest rate risk, ultimately you need to get to your buyout level, fund in x amount of time whatever objective is set. From a philosophical perspective we stand on opposite ends.

Hill: I don't think we do. Oddly, I agree with 90% of what you said. We take a very similar view that simply hedging your liabilities is not the way to solve pension schemes' problems. We also take a holistic view about how you allocate capital. The bit where we part company with you is that if an absolute return fund aims to deliver say a cash +4% over a long period of time; if we could be certain of that, we would solve a lot of problems at very low volatility.

Chaturvedi: It is about setting really high standards when picking managers and understanding the strategies. You can't just go buying a bond or buying equities and hope for a 5%, 6%, 7%, 8% per annum

analysed over long periods of time. Absolute return is actually pretty critical.

Hill: But last year, how many absolute return funds – how many funds at all – delivered cash plus four or five? There weren't many, not even among the hedge funds, though there have been hedge funds that have delivered very good rates of return over quite long periods of time – including your own. But where does absolute return really work for a DB fund?

Chaturvedi: You say absolute return doesn't fit naturally into the DB world because we don't know whether they will consistently deliver those cash plus four returns. I would say depending on what your definition of consistent is, equities are certainly not going to do that. So if you are willing to put equities in

"You can't just go buying a bond or buying equities and hope for a 5%, 6%, 7%, 8% per annum analysed over long periods of time. Absolute return is actually pretty critical." Himanshu Chaturvedi


Himanshu Chaturvedi

"If you are willing to put equities in a DB portfolio, putting an absolute return fund in a DB portfolio is an equally valid approach. The key thing to note here is they should bring something different to the portfolio." Himanshu Chaturvedi

a DB portfolio I think putting an absolute return fund in a DB portfolio is an equally valid approach. The key thing to note here is they should bring something different to the portfolio.

There are also two kinds of risk – short term, motivated by the trustees having to revisit their DB scheme evaluation every three years and long-term of a scheme failing. Trustees have to balance both of those. The more you focus on reducing short term risk almost by definition because you are not earning excess return the more the risk that ultimately the scheme fails or needs external support from a sponsor.

Hill: Yes, but return relative to cash doesn't matter as much as return relative to liabilities. That is our caveat around absolute return; whether it actually does the job. There probably are strategies out there which could fulfil what you are talking about, but we are just a bit sceptical about whether they will do that in a consistent enough way to play the role that you suggest.

Walsh: Within a liability matching approach a cash plus strategy is ideal; the value of your liabilities will rise if long term interest rates move higher if this is triggered by a rise in cash rates (which seems possible) your cash plus return will also rise. But even more broadly the whole concept of earning an equity risk premium to match liabilities is pretty well known which is why most DB schemes have a large equity allocation. The problem is that this introduces volatility and may at times swing the fund into deficit. I think we all agree the ideal outcome for DB schemes is a steady cash plus growth over a rolling period with low volatility it is just there is perhaps some disagreements of whether that is an achievable outcome. I think we are demonstrating with the AIMS TR fund that it is.

Chaturvedi: It is an important point because a lot of trustees would be unfamiliar with these strategies. There's great comfort to be hand in a long run and being able to demonstrate these things work over a more appropriate, longer time period.

Where is the money come from? Is it coming out of equities, for example?

Chaturvedi: Absolute returns have been a core portion of portfolios for a long time. So even if you are relatively static about the asset allocation over a period of time you would have rebalanced typically more. Because the last seven years have been very strong for equities and not so strong for absolute returns, you would have been taking money from equities and investing into absolute returns just from a re-balancing perspective. Newer portfolios undergoing a review are thinking from first principles about how to get their funding objectives. Absolute return is being increased at the cost of bonds and equities, but in particular at the cost of credit, as liquid credit is overvalued.

How does absolute return compare to, say, a DGF?

Hill: Diversified growth funds have had a particularly difficult period, because the diversification hasn't been enormously beneficial. Growth disappeared and this affected a lot of asset classes at the same time, so diversification hasn't given you any benefit. Many DGF managers have in fact been more concerned about not losing money and have ended up being better risk-reducers than growth fund managers – some through diversification, others through being permanently hedged.

Walsh: I tend to think both diversified growth funds and risk parity suffer from some of the same problems. How do you put together such a portfolio? Generally you are quite reliant on some sort of model – historic data and historic correlations. Where a lot of diversified growth funds have suffered is that in the current environment correlations are very unstable and quite different from the last five years. EM index-linked debt from 2009/2010 through to 2013 and commodities was a popular strategy in DGFs because the model said it was diversifying or offered a great risk adjusted return. This was because we had a commodities supercycle at the same time and quite probably driven by a global wave of liquidity that found its way into EM assets. So you have this illusion of diversification. When correlations break down the diversified growth funds can really struggle. It's a similar problem for risk parity funds they rely on leveraging up what looks like low risk parts of the portfolio to achieve essentially the same return as higher risk parts to the portfolio. Suddenly, if you get a shift of behaviour of those low risk assets into a higher risk environment, that can be very painful. The two really suffer from that hindsight bias, whereas absolute return in the hedge fund and multi strategy senses don't necessarily because you think hard, on a prospective basis, your macro view and in our case look to leverage that view to achieve a target return while making sure you have positions that preserve capital if you are wrong. We use risk models as well, but we try to use them as an explanatory aid and a challange, not use it as the driver for portfolio construction.


Simon Hill

Hill: Brendan's quite right about the role risk models play and the role historic data plays in the two approaches. This is one of the great problems with engineered risk management although it has its place. It is important to use that framework to think about what you are doing and how much return you are going to get for the risk you take. Many of the problems for multi asset managers in general is they are often judged over quite short time periods and everything is unstable on a short time period, though I have never known a period when correlations were stable.

Chaturvedi: There is a lot more homogeneity between risk parity funds than you might find between absolute return funds. There is a lot more heterogeneity in absolute return and hopefully if you have done the work and picked the right managers, they have that asymmetric profile that protect the downside.

Traditional diversified growth funds have a similar problem and will suffer when both equities and bonds are going down. Where they will differ from risk parity is leverage. Having said that, there is a lot of discretionary market timing element to it as well and it is just as likely that you are on the wrong side as the right. They might compound their troubles by cutting equities at the bottom or adding to equities at the top.

What role does absolute return play in DC and how has the landscape changed?

Hill: I can see absolute approaches having more of a role to play in DC than DGFs. DGFs have modernised the traditional balanced fund with a few more bells and whistles. As long as it has been able to fit inside the charge cap it has been a reasonable solution because it is also something that a DC member might find reasonably easy to understand. The balanced fund has had a bad press, but it did a reasonably good job in this context. I can see a role – particularly with the pension flexibilities – to have an absolute return sort of fund in the mix, playing a role in default funds as well. What a default fund should be is not yet fully developed. We have had this mantra for a long time that communication is the main thing that matters. I don't think that is the point at all. It has to be something that individuals can understand and in our experience, even quite sophisticated trustees have problems understanding the concept of how a bond works and the fact that the price and the yield move in opposite directions.


Simon Hill

Walsh: Absolute return helps in some sense in that while the man in the street doesn't understand a bond derivative, he probably understands even less the concept of relative return, or perhaps it better to say the utility of relative return given their objective which is to save for retirement. If you say to people you want to grow their capital year on year with low volatility and that we are targeting x, that is our absolute return target for you and we will do our best to hit that whatever the enviroment, they may understand better or at least they have an understanding of their outcome should we achieve our target. Contrast that with an approach which can outperform a benchmark but still deliver a large negative return, the fund has achieved its target but this is not the outcome the client was hoping for or needs.

Hill: Target date funds have become popular in DC schemes, particularly in the US. It is an attractive concept to members and by the same token, therefore, it is attractive to trustees because it is something the members can understand. Trustees have recognised they do have to do something about DC schemes now, whereas 10 years ago, many took the view that it was the member's problem. The legal advice has shifted and many sponsors of DC schemes have recognised that if the outcomes are poor, that is bad


Brendan Walsh

"The concept of absolute income is a post-retirement solution that pays regular distributions that is not guaranteed but has a clear target which moves with interest rates and you take cash out whenever you want." Brendan Walsh

news from an HR perspective. The big employers with DC schemes have been taking a lead in getting concerned about this, but it does mean that trustees will be much more proactive.

Walsh: You mentioned pension freedoms. The concept of absolute income is just starting off. This will be a post-retirement solution that pays regular distributions that is not guaranteed but has a clear target which moves with interest rates and you can take the cash out whenever you want. Clearly, we are one of the first people in that area taking that absolute return multi strategy solution and all the good things around risk reduction and protecting the downside and utilising this to deliver a natural absolute income. We will see more of that because it seems to fit perfectly as the post retirement version if you like of absolute return in a world where fewer people are choosing not to put all of their money into annuity, but still require a smooth monthly income.

Hill: That makes a lot of sense to me and of course asset managers linked to wholesale organisations like insurance companies are particularly well placed to develop that.

Brendan, how might your fund be used for DC?

Walsh: I think in the asset accumulation phase the target return fund is ideal for all the reasons we dis-

Simon Hill

"Another major issue is not just scalability, but liquidity. Lots of approaches that make a lot of sense as part of a DC portfolio will tend to be ruled out by this predilection for daily liquidity and I don't think DC members need it." Simon Hill

cussed around DB schemes, a steady return compounding your assets at cash plus 5% over a rolling three year period works extremely well in the DC space. As a post retirement solution the target income fund targets paying out an income of cash plus 4% a year which we have identified as being sustainable in all market environment's and seems to fit well with the needs of clients we have spoken to. The fund has been running since December 2015 and we paid out roughly 5% last year. So its is doing what it said it should in a really tough environment for income strategies, a lot of interest is coming from retail advisory clients, though we do have some institutional investors who see it as almost a liability matching solution. To expand on this they struggle to find a debt instrument with a coupon of 4-5% with low duration or credit risk. It is basically a new absolute return strategy which is why we like to talk about absolute income. At the moment we don't believe there are any other multi strategy income funds out there but I think we see huge potential growth for it. So I don't expect we will be alone for long.

Chaturvedi: It is important for the DC market that strategies be scalable. Sometimes return potential is negatively impacted because the sides and highly liquid markets are well followed and inefficiencies are more ruthlessly priced out. From a behavioural perspective a lot of these clients are pension investors who can call up their DC pots in terms of how they are invested in many ways. If they see losses in the portfolio early on that is going to be a big deterrent to taking risk; never mind that they have a 20-year runway. Absolute return strategies have slightly lower behavioural risk, as a component of a portfolio. They certainly shouldn't be the entire portfolio, especially for those with longer horizons to retirement.

Hill: Another major issue is not just scalability, but liquidity. Lots of approaches that make a lot of sense as part of a DC portfolio will tend to be ruled out by this predilection for daily liquidity and I don't think DC members need it. People who are thinking about retirement don't suddenly need the money tomorrow and even people who might be sufficiently engaged to want to switch funds simply don't need to do it tomorrow. That is ruling out a lot of approaches and assets that you might be invested in, such as real estate, which certainly has a role to play.

Walsh: We don't have an issue with the liquidity. The very philosophy around the fund means there absolutely should be daily liquidity because it has to be scalable. But I do agree that if you are investing for 20 years plus there are strategies out there that are not liquid but probably offer you a great return potential for that horizon, and these can definitely form a part of a DC allocation in the pre retirement phase alongside a target return approach.

Chaturvedi: This whole generational shift from DB to DC has probably done society a disservice because it has shortened time horizons for capital and it has made it more difficult. It is a big challenge for the DC industry to figure out how investors, pensions, future pensions can access that premium for long-term investing. It is one of the biggest holes that we haven't filled.

Hill: It is a problem that we are only really beginning to think about as the shift happens. Most people retiring in the next five years will have relatively small proportions of DC in their total retirement provision and most will be quite dependent on the state. Even DB schemes aren't quite as long-term in their thinking as they would like to think.

Himanshu Chaturvedi

From multi-asset to multi-strategy

By Brendan Walsh, co-fund manager AIMS Target Return and Target Income Funds, Aviva Investors

Absolute return multi-strategy and multi-asset funds invest across a diverse range of asset classes, including equities, fixed income, property and alternatives such as commodities. By spreading their risk, both types of fund seek to offer investors more attractive risk-adjusted returns than are available by investing in single asset classes alone. Although they differ in important respects, we believe they should be seen as complementary strategies with both having a role to play in meeting investors' needs.

The managers of both multi-asset and multi-strategy funds take a view on how financial markets are likely to perform and allocate investors' money accordingly. Multi-asset funds achieve this goal by varying the mix of asset classes in which they invest, raising exposure to one asset class, such as US equities, at the expense of another, for example, US treasuries. Multi-strategy funds are a natural evolution from multi-asset funds. However, while the managers of these funds also take a view on where the world is going, they focus on identifying the investment ideas that will benefit best from their forecasts. They are inevitably more complex than multi-asset funds but they also offer important advantages.

By definition, absolute return multi-strategy funds deploy multiple interactive investment strategies across and within asset classes, and in order to do this they often use financial instruments that are inaccessible to managers of multi-asset funds. The ability to hold both long and short positions means multi-strategy funds can perform well in all kinds of market conditions. Furthermore, returns tend to be relatively uncorrelated to equities, bonds and other traditional asset classes. This is an important factor given that in recent years swings in asset prices have been far more correlated than was previously the case. Historically, rising equity prices, for example, were associated with falling bond prices and vice versa. Stronger economic growth would boost corporate earnings and hence share prices, whilst causing interest rates to rise, undermining the appeal of bonds. Thus, the risk of investing in equities could be offset to some degree by allocating part of the fund to bonds.

A new world order?

However, the aggressive monetary policy adopted by central banks around the world in response to the global financial crisis of 2008 has boosted asset prices simultaneously in recent years. Equity and bond prices have soared in tandem, while commercial property has also risen strongly in many markets. Thus, investing in a mix of assets will reduce a fund's risk by less than previously. Consequently, the traditional approach of targeting equities for capital growth, bonds for income and as a safe haven in times of trouble, and alternatives for extra diversification, no longer appears as valid. Furthermore, it is difficult to rely on equities for long-term capital growth given that valuations look expensive on most long-term measures. Meanwhile, the income generated by bonds is very low. There are also doubts as to the amount of protection bonds will afford in the event of an equity market downturn given that prices are already so high.

A fresh approach

Absolute return multi-strategy funds offer a solution to investors concerned about the growing correlation of asset classes. They also offer hope to those wanting to grow their capital or generate income in a world of low yields.

These funds look to achieve their targets by combining a diverse range of strategies with different drivers of performance. The Aviva Investors Multi-Strategy range of funds is very flexible. They are not constrained by a benchmark, are not wholly dependent on ideas that are linked to the economic cycle and they can deploy tools that exploit falling and volatile markets to generate positive returns for investors. All of these factors underpin our confidence that our multi-strategy funds can meet their objectives.

When constructing funds we assess how much we expect each individual strategy will add to the total return and its impact on overall risk. We also assess the anticipated ease of exiting the position and whether it will be of benefit should the fund grow substantially. Derivatives are often employed in order to be able to alter asset exposures quickly, especially in illiquid markets, and manage risk efficiently. Due to the fact they usually employ leverage, they can also allow managers to get more exposure to the underlying asset than is available by investing directly in the asset itself.

The nuts and bolts of multi-strategy funds

Markets react quickly to events, often in an illogical manner. The fear that the market herd will thunder away into the distance leads many investors to panic. Sentiment can thus shift suddenly and sharply. However, this creates opportunities for patient investors who are willing to take a longer-term view.

In our multi-strategy funds, we ignore short-term, headline-grabbing developments and focus instead on spotting mispriced investments with attractive risk-adjusted prospective returns over a three-year investment horizon. For example, one strategy is to go long of the Indian rupee against the euro. We expected this strategy to be profitable should structural reforms boost the Indian economy by more than the market anticipated, or were euro zone monetary policy to be looser than the market expected. In January 2015, the European Central Bank did indeed ease monetary policy by more than expected and the euro fell sharply as a result.

The way the strategies in a multi-strategy fund are expected to interact across a range of market conditions is crucial to managing a fund's risk exposure and delivering the performance investors expect. Our multi-strategy funds consist of three types of strategies: we call them 'market', 'opportunistic' and 'risk-reducing'.

The first looks to generate returns when markets perform as we expect. This group of strategies essentially performs the role that equities have traditionally played in multi-asset funds. The second seeks to exploit opportunities where one asset appears mispriced relative to another. We look for these strategies to generate positive returns irrespective of how markets perform. This group can be thought of as playing the role of alternatives within a multi-asset fund. Their returns have in the past been relatively uncorrelated with those of equities and fixed income. The last group is designed to cushion performance when markets behave unexpectedly. It can be thought of as playing a similar role to fixed income in a multi-asset fund, providing protection against market turbulence.

We aim to combine these strategies in such a way that we can deliver equity-like returns for less than half the risk of equities. Strategies can be added or removed from the funds to refine risk exposures and ensure the fund is appropriately positioned as the outlook for economies and markets changes.

All of these factors – diverse and interactive strategies, flexibility and the use of strategies that benefit from falling markets – give us confidence that our multi-strategy funds can be successful in their pursuit of specific targets – whether it be capital appreciation or consistent, sustainable income – for today's investor.

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