Volume 34 //

Acuity

The greatest wealth is **your peace of mind...**

Absolute return strategies are not what they seem

ABSOLUTE RETURNS

MASSIVE RETURNS

> **“Do not expect high returns without high risk. Do not expect safety without correspondingly low returns”**
>
> William Bernstein, “The Four Pillars of Investing” (2002)

The promise of generating stable returns in both up and down markets feels like an attractive strategy for investors to adopt, and ‘absolute return’ funds have certainly attracted large sums of cash since the credit crisis. Yet the reality of being able to deliver on this promise is far from convincing: strategies are varied, complex and hard to compare; fees are high, relative to sensible alternatives; and correlations to underlying assets – such as equities and bonds – are higher than might be expected. A surprising proportion of funds have delivered absolute losses to investors over horizons of one year and even over three years. At the end of the day, there are no risk-free returns above cash returns.

Absolute returns - a marketing man’s dream

The combination of short-term market uncertainty, human nature and an immediately attractive sounding moniker is a marketing man’s dream. The investment industry has been masterful at constructing and selling such products, not least ‘absolute return’ products.

We know that markets are always uncertain and that short-term market losses are a normal part of investing. We also know from behavioural finance research that human beings feel twice as much pain from losses than they feel pleasure from upside gains. In some older investors, this emotional asymmetry can be even more pronounced. This deep-seated behavioural trait has a tendency to result in investors over-paying for both downside protection, such as insurance, and gambling-like activities. It is perhaps worth remembering that a 35 year-old man who buys a lottery ticket on a Monday has more chance of dying during the week than winning the lottery![1] Products that put the two together – such as structured products and absolute return funds – tend to sell like (expensive) hot cakes.

It is always worth remembering that there are no risk-free returns to be conveniently collected above the so-called ‘risk-free rate of return’ delivered by cash (and even that bears inflation risk and the risk of the bank failing). Any such returns would be quickly pocketed by the vast number of extremely bright and hardworking professional investors and the relentless computer-driven trading algorithms employed by many.

So what are 'absolute return' strategies?

Absolute return funds employ active management strategies that seek to deliver positive (absolute) returns in any market conditions, i.e. up, down or sideways. Obviously the definition needs to define the horizon over which these positive returns are expected. Targeted returns are sometimes – but not always – stated relative to cash returns.

UK equities have delivered after-inflation absolute returns over every 30-year period from 1900 to 2015,[2] but investing in them is not classed as an absolute return strategy. The term is thus relative. The Investment Association (IA), which represents the fund management industry in the UK, sets this horizon at a maximum of three years in order to qualify for its absolute return badge. However, it is worth noting that the IA states that:

'[It] recognises that there is a wide expectation among consumers and advisers that funds in the Targeted Absolute Return sector will aim to produce positive returns after twelve month periods.'

Traditional, systematic approaches - such as the portfolios we offer our clients – tend to invest in a diversified portfolio of predominantly global bonds and equities, where assets are owned directly (e.g. shares and bonds) rather than via derivative positions, no leverage (borrowing) is used and only 'long' positions are held i.e. assets are owned and held. On the other hand, absolute return funds have the ability to go both long and short (i.e. where they sell assets they do not own with the hope of buying them back cheaper, if and when they fall in value), employ leverage, use derivatives and invest in non-traditional assets. This extra freedom gives them scope to position their portfolios in a more flexible manner to generate returns; it also provides more opportunity to get it wrong. The diversity and complexity of these strategies can be mind-boggling, thus making the comparison between funds with similar objectives particularly tricky.

Testing the promises using UK data

Let us take a quick look at the implied promises made by absolute return funds offered to retail investors in the UK. The high level analysis below uses the Investment Association's absolute return fund category, called the IA Targeted Absolute Return sector. By way of background, in June 2016 net inflow into these funds was £221 million, whereas equity funds suffered withdrawals of around £2.8 billion in the month, most likely due to concerns about Brexit and consequent portfolio repositioning. In eight out of the twelve months to July 2016, the sector had the highest monthly net retail inflows[3]. The astute reader will identify the dangers of such a return chasing/risk avoiding, buy-high-sell-low strategy. Given that a high proportion of retail assets are managed through advisers, it does beg the question of the quality of advice being given.

Reviewing short-term outcomes

We do not normally review short-term performance data as it constitutes noise, but in this case we wanted to do so to make a point: market timing is exceptionally difficult as markets move on the release of new information, which by definition is random. The year (2016) started badly with equity market falls driven by panic over the perceived slowdown of the Chinese economy. The Times, for example, had this scaremongering headline on 16th January:

'Markets suffer their worst start to the year since Great Depression'

From December 2015 to April 2016, Targeted Absolute Return funds were the best-selling funds of any IA sector. By March the headlines had changed; an example from USA Today read as follows, on 6th March:

'Stock storyline shifts from "worst start to year" to "not too bad"...'

Prior to the Brexit referendum in the UK, doom and gloom returned, and subsequent to the vote, according to The Guardian on 24th June:

'Brexit panic wipes $2 trillion off world markets'

It then changed its sentiment a month later with the headline on 11th July:

'US stock market closes at record high, rebounding from losses after Brexit'

The point to be made is that trying to respond to past market events or to second-guess the market's response to future events is extremely difficult and investors risk being whip-sawed by market noise and media hyperbole. An investor with a long investment horizon can afford to - and should be determined to - stay the course and simply remain invested, rebalancing his or her portfolio back to its original strategy when needed, thereby avoiding needless timing decisions and considerable transaction costs. With all the freedom of absolute return funds come the dangers of excess activity and emotionally-driven decisions.

Nearly all asset classes have delivered positive returns in the first half of 2016, as the figure below illustrates. We have also provided data for a simple 60% global equity, 40% global bond portfolio (i.e. a basic traditional portfolio) for comparison. As one can see, the IA Targeted Absolute Return sector hardly covered itself in glory, despite all its flexibility.

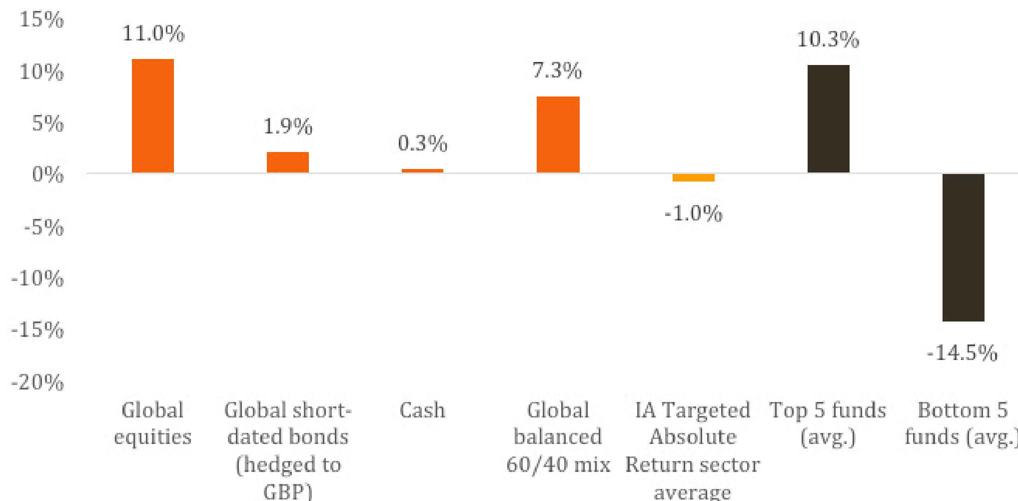

Figure 1: Year-to-date returns to June 2016.
Source: FE Analytics. See footnote for data details[4].

The wide dispersion of returns within this IA sector suggests that picking a successful fund is likely to be extremely challenging.

Taking a short- to medium-term view

The Investment Association tracks the performance of funds within the sector on a monthly basis by looking at rolling 12-month performance over the past 36 months, i.e. providing 24, 12-month periods that roll forward one month at a time . Only four out of 75 funds (~5%) with a track record of more than 36 months had no losses in any twelve month period in the three years to June 2016. At the other end of the spectrum, 15 funds had losses in more than half of the 12-month periods. Given this outcome, it is perhaps not surprising that the FCA – the UK industry's regulator – has recently confirmed that it will include absolute return funds in its wider review of the asset management industry and the value that it delivers to consumers.

Five-year returns provide greater perspective, but only when viewed in the context of what other investment opportunities have delivered. Again, the performance of the sector as a whole has been somewhat underwhelming, delivering returns similar to those from short-dated bonds and far below those of a simple 60/40 global balanced strategy.

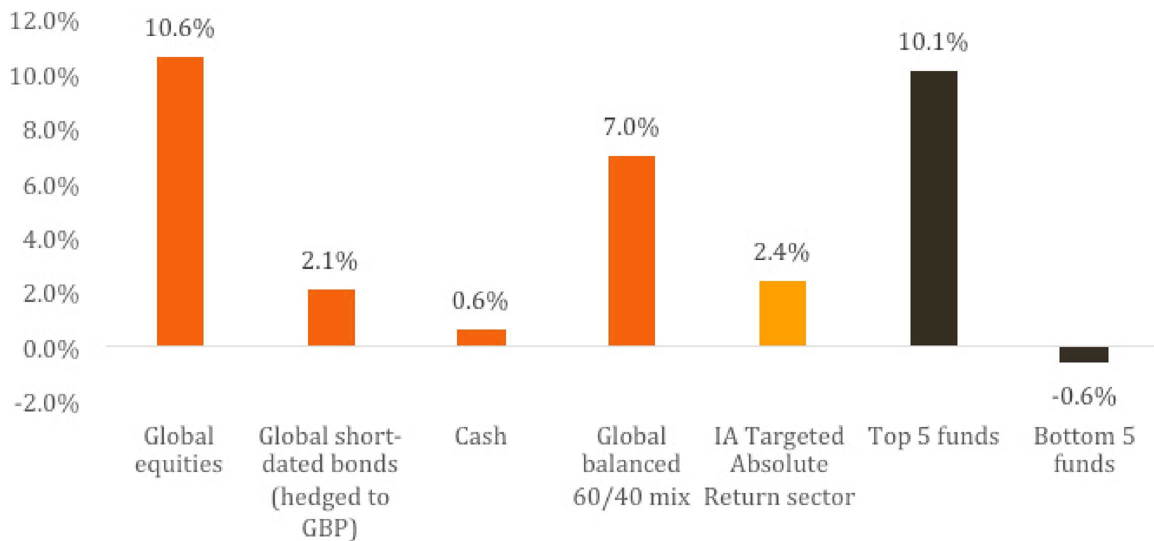

Figure 2: Five-year annualised returns to June 2016

Source: FE Analytics. See footnote for data details.[5]

The figure overleaf illustrates the maximum peak-to-trough falls plotted against the cumulative returns of each fund for the three years to June 2016. The 60/40 global balanced portfolio is also included. To the left of the vertical line are funds that failed to deliver a positive return over the three years. The majority of funds delivered a paltry return of less than 10% in total over the three years. Many had material peak-to-trough falls during the period. The 60/40 balanced portfolio delivered strong returns with relatively low interim falls. We know where we would rather be invested.

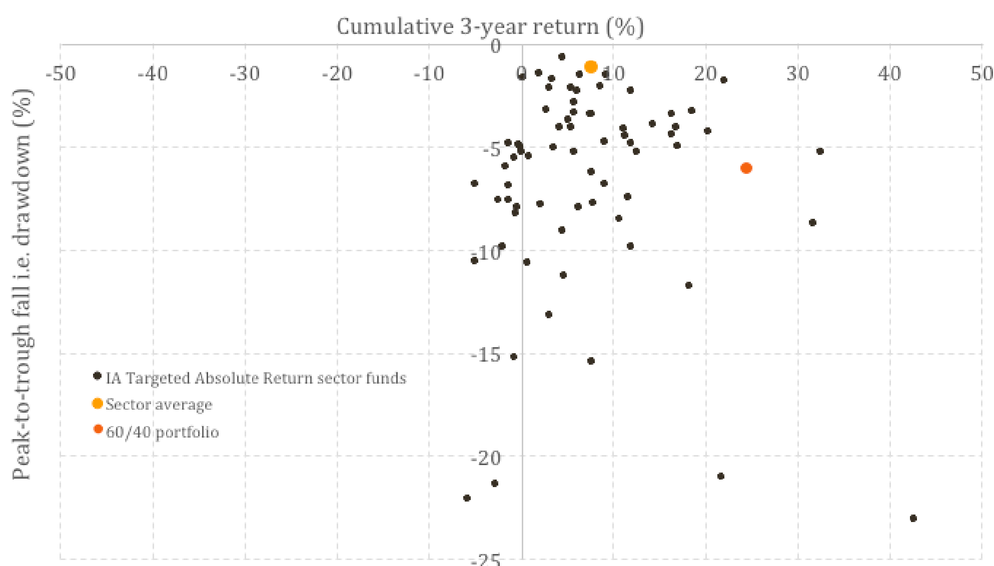

Figure 3: 3-year cumulative returns vs. maximum peak-to-trough losses to June 2016
Source: FE Analytics. See endnote for data details.[6]

Where are the economies of scale?

A quick analysis of the funds in the IA sector reveals that the average Ongoing Charges Figure (OCF) of these funds is around 1.2% p.a. One of the major constituents of the sector has assets of over £26 billion. Its lowest cost share class has an OCF of 0.72%, and on this basis the fund management company extracts around £190 million of investors' money for itself each year. At this size of fund, some of the economies of scale should be passed to investors. They are not. As we know in investing, you get what you don't pay for.

Looking at the latest academic research

The brief review above of the UK absolute return fund sector, whilst informative, does not apply the academic rigour that is required in order to draw any more definitive insights or conclusions. Fortunately, a recent piece of research from the US does[7]. The author of the paper looked at 15 different absolute return strategies covering 1,140 funds managing $464bn for the period 1994 to 2014. The first interesting point to note is that only around one quarter of the funds existed before the credit crisis in 2008.

In the study, the author regressed the monthly returns of the funds against four common risk factors (the equity risk premium, value, size and momentum) and found that these factors explained much of the return variation of the funds. The skill-based performance contribution from managers (known as 'alpha') was in fact negative, on average, across all 15 categories. The research also showed that equity-related strategies exhibit significant exposure to the equity markets, despite being able to hold short and long positions. Bond-related strategies exhibited – perhaps not surprisingly – exposure to interest rates and credit spreads. As such, losses should be expected from these portfolios when markets get tough. Fees were high, too, with expense ratios ranging from 1% to 2% depending on the strategy.

The long and short of the research is that the absolute return fund industry has not really covered itself in glory. That said there may be a small number of funds managed with truly exceptional skill. The trouble lies in identifying them, which requires long track records and the ability to distinguish between skill and luck.

In conclusion

As ever, the siren songs of the investment industry can draw the naïve onto the rocks. There is little evidence at the sector level that suggests that absolute return funds really do add something different to traditional portfolios. With exposure to market risks - and thus potential losses - high fees, and esoteric and complex strategies, most longer-term investors are better off sticking with their traditional, systematically managed portfolios. Short-term market losses are part and parcel of investing and are not uncommon. Those with the fortitude to stay invested and stay the course, should be well rewarded. Patience, discipline and fortitude are the values that lead to success in this game. Absolutely!

End notes

1. Hale, T., (2006), Smarter Investing, 1e, FT Prentice Hall.
2. Barclays Equity Gilt Study, 2016
3. Investment Association. www.theinvestmentassociation.org/fund-statistics/statistics-by-sector.html
4. Global equities – MSCI World Index (net div.); Global short-dated bonds – Citigroup World Government Bond index (1 to 5 years) hedged GBP; cash – UK 1-month T-Bills; Global balanced 60/40 – 60% global equities, 40% Global bonds less 0.25% estimated OCF; Top/bottom 5 funds – cumulative over the period and equally weighted.
5. Investment Association Targeted Absolute Return sector monitoring information. Month end: June 2016. www.theinvestmentassociation.org
6. The average of the share classes monitored by the Investment Association.
7. Klement, J., (2016), The Cross-Section of Liquid Absolute Return Funds, The Journal of Index Investing, Winter 2015, Vol. 6, No. 3: pp. 21-32.

Other notes and risk warnings

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