

Insights

'Absolute Return' promises –
easy to make,
hard to keep.



*“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 combination of short-term market uncertainty, human nature and an immediately attractive-sounding moniker is a marketing person’s dream.

Absolute returns – a marketing person’s dream

Over many years, the investment industry has been masterful at constructing and selling products which play to the most basic and powerful of human emotions, including fear and greed, as well as ‘loss aversion’, ‘regret avoidance’ and ‘social influence’ and a good recent example in this respect is so-called ‘Absolute Return’ funds / 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, with some variation person-to-person, are inherently pleasure-seeking, yet feel around twice as much pain from losses as they feel pleasure from gains. In some older investors, this emotional asymmetry can be even more pronounced and these deep-seated behavioural traits have a tendency to result in investors overpaying for / losing money on both gambling-like activities (such as speculating on investment opportunities) and downside protection (such as insurance).

It is perhaps unsurprising, therefore, that products that combine – or seem to combine – the potential for both significant gains and risk mitigation, such as ‘structured products’ and ‘absolute return funds’, tend to sell like (expensive) hot cakes. After all, given the willingness of people to speculate – or alarmingly, even base their entire financial future – on winning lotteries, even though the odds of them winning / losing their stake money are appalling (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), we probably shouldn’t be surprised at just how alluring these types of products can be.

1 Hale, T., (2006), Smarter Investing, 1e, FT Prentice Hall.

2 Barclays Equity Gilt Study, 2016

However, in an investment context, it is always worth remembering that there are no risk-free returns to be conveniently and reliably collected above the so-called ‘risk-free rate’ delivered by cash (and even that bears inflation risk and the risk of the bank failing), since any such returns would be quickly pocketed by the vast number of extremely bright and hardworking professional investors, as well as 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 and targeted returns are sometimes – but not always – stated relative to cash returns.

UK equities have delivered after-inflation positive returns over every rolling 30-year period from 1900 to 2015², 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 the time 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.’

“There are no risk-free returns to be conveniently and reliably collected above the ‘risk-free rate’”

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Traditional, systematic approaches, tend to invest in a diversified portfolio of predominantly global bonds and equities, where assets are owned directly rather than via derivative positions; no leverage (borrowing) is used and only 'long' positions are taken i.e. assets are owned and held. On the other hand, absolute return funds have the ability to go both long and short (where, for a fee, they borrow assets they do not own in order to sell them, with the hope of subsequently buying them back at a lower price and then pocketing the difference), employ leverage, use derivatives and invest in non-traditional assets. This extra freedom provides them scope to position their portfolios in a more flexible manner to generate returns – but 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 very 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 and context, in June 2016 net inflows 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. Indeed, in eight out of the twelve months to July 2016, the sector had the highest monthly net retail inflows of any category³.

The astute reader will identify the dangers of such a return-chasing, risk-avoiding, buy high / sell low strategy and given that a high proportion of retail assets are managed through advisers, it does also beg the question of the quality of advice being given.

“Absolute Return funds provide more opportunity to get it wrong”

³ Investment Association. www.theinvestmentassociation.org/fund-statistics/statistics-by-sector.html

Reviewing short-term outcomes

We do not normally review short-term performance data and reporting as it simply constitutes 'noise' rather than 'news', 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.

Looking back over the 12 month period to the end of 2016, the year 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. However, by March the headlines had changed; an example from USA Today on 6th March read:

'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:

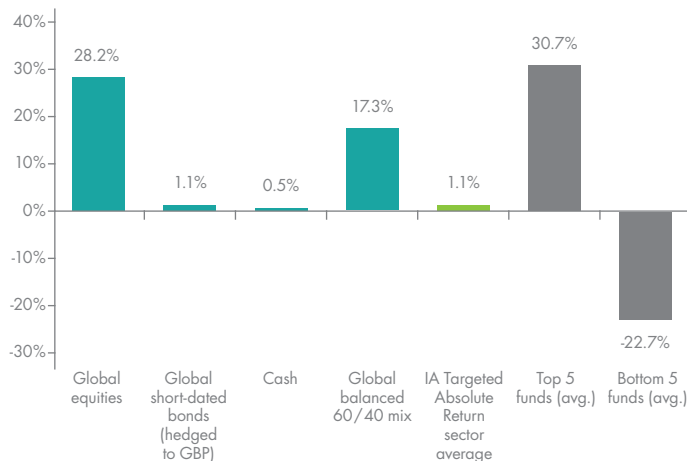
'US stock market closes at record high, rebounding from losses after Brexit vote'

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 and should be determined to stay the course and to simply remain invested, rebalancing his or her portfolio back to its original strategy when needed, thereby avoiding needless timing decisions and considerable transaction costs.

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As the figure below illustrates, nearly all asset classes delivered positive returns in 2016 and data for a simple 60% global equity, 40% global bond portfolio (i.e. a fairly traditional portfolio) is also provided for comparison. As one can see, the IA Targeted Absolute Return sector hardly covered itself in glory, despite all its flexibility and exaggerated claims of all-weather ability.

Figure 1: Returns to December 2016.



Source: FE Analytics. See footnote for data details⁴.

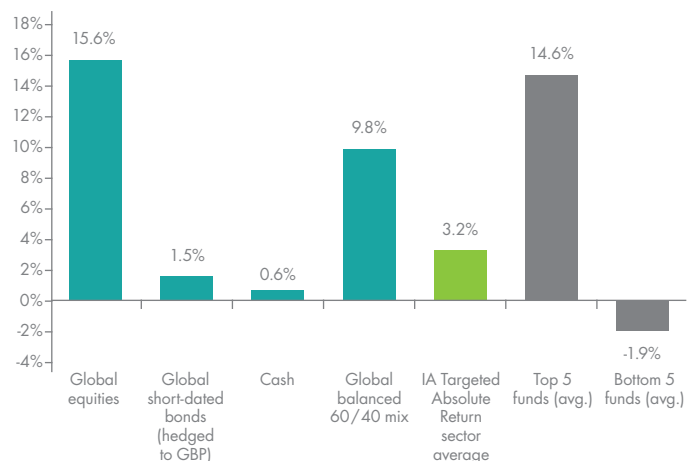
The wide dispersion of returns within this IA sector suggests that picking a successful fund is likely to be extremely challenging and indeed, it is worth reflecting on the 'risk-adjusted' returns shown by the sector as a whole (the returns achieved for the risk taken) and accordingly, it is quite alarming to note that for all of the risk investors in these funds were exposed to, not only did they fail to capture the simple market rate of return delivered by global equities, but they also achieved the same return as global short-dated bonds, which, by definition (and purposefully, in a broad portfolio context) have a low expected risk and return profile.

Taking a short- to medium-term view

The Investment Association tracks the performance of funds within the sector by looking at monthly rolling 12-month performance windows over the past 36 months i.e. providing 24, 12 month periods that roll forward one month at a time⁵. Only four of 75 funds (around 5%) with a track record of greater 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 windows. Given this outcome, it is perhaps not surprising that the Financial Conduct Authority – the UK's financial 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 alternative investment opportunities have delivered. Again, the performance of the sector as a whole has been somewhat underwhelming, delivering returns closer 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 December 2016



Source: FE Analytics. See footnote for data details⁴.

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

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Looking at the latest academic research

The brief review above of the UK absolute return fund sector, whilst (hopefully) 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 does⁶.

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 (remember, these funds and strategies prey on human emotional traits and behavioural biases and accordingly, really are marketing gold).

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 both short and long positions. Likewise, bond-related strategies exhibited – perhaps not surprisingly – exposure to interest rate and credit spread risks and as such, losses, rather than returns, should be expected from these portfolios when markets get tough.

Fees were high, too, with expense ratios (which don't include the cost of trading within the funds, which commonly adds c0.50% pa in unseen costs, but can add much more) ranging from 1% to 2% pa, depending on the strategy.

The long and short of the research is that the absolute return fund industry has not really lived up to its claims. That said, there may be a small number of funds managed with truly exceptional skill, but as ever, the trouble lies in identifying them in advance, which requires long track records and the ability to distinguish, with some rigour, between skill and luck.

In conclusion

As always, the siren songs of the investment industry can draw the naïve and unwary onto the rocks. 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 money 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.

At the end of the day, there are no risk-free returns above the rate which can be achieved from cash and this truism is always worth keeping in mind, particularly where hefty marketing budgets and cynical manipulation of our basic human tendencies would try to lead us to believe otherwise.

Best regards

Michael

“Losses, rather than returns, should be expected from these portfolios when markets get tough”

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Michael Smith *CEO*

In addition to being a Chartered Wealth Manager, Michael is a Chartered Financial Planner and holds the globally recognised Certified Financial Planner qualification. He is also a Fellow of both the Personal Finance Society and the Chartered Institute for Securities & Investment and as such, is one of the most highly qualified financial planning professionals in the UK. Michael also sits on Chamberlyns' Investment Committee and helps to produce the firm's regular series of in-depth 'Insights' articles, which explore, explain and demystify often complex wealth planning issues.

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