Absolute Return Investing

A three-part guide

Standard Life Investments

January 2015

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Introduction

In the face of economic uncertainty and market volatility, investors are increasingly adopting an absolute return approach to help meet their long-term investment objectives within acceptable risk parameters. In response to growing interest and demand for education on the products available, we have written this three-part guide. It aims to highlight the role played by absolute return investing as well as the opportunities on offer, and to show how a multi-asset, multi-strategy approach can deliver both genuine diversification and portfolio flexibility.

The first article in the series examines the evolution of absolute return investing, from the traditional balanced approach through diversified growth portfolios and, finally, on to the multi-asset, multi-strategy approach. We then show how absolute return investing can result in a portfolio with resilient performance in many circumstances, using our own multi-asset portfolio as an example. Finally, we consider how the overriding absolute return objective - to provide positive returns whether markets are rising or falling - results in increased flexibility for portfolio management. We hope you find the guide informative and useful.

A Guide to Absolute Return Investing: Part One

The evolution of genuine diversification

By Mark Foster

"It is not the strongest or the most intelligent who will survive but those who can best manage change." - **Charles Darwin**

Traditionally, investors have sought to mitigate the impact of market uncertainty and economic crises through diversification. To help them achieve this, investment companies have delivered products that seek returns from multiple sources. While these have generally met with limited success, the most recent evolutionary step is absolute return portfolios that invest on a multi-asset, multi-strategy basis. These finally offer investors genuine diversification and the potential to withstand periods of instability while also delivering positive long-term returns.

Taking a balanced approach

For many years, investors seeking simple diversification were only offered traditional balanced portfolios. These generally consisted of a relatively static mix of equities, bonds and real estate, aiming to provide an acceptable level of return while spreading risk. As markets generally maintained an upward trend for much of the 1980s and 1990s, these portfolios appeared effective. However, when the tech bubble burst at the start of this century, their flaws were exposed.

Balanced portfolios are managed on a relative return basis, i.e. performance is compared to an index or peer group, and the assets they hold therefore tend to congregate around the benchmark median. This meant that most held a relatively high proportion of equities. As stock markets fell, outperforming a peer group benchmark was no real comfort for investors who were still receiving negative returns overall. Furthermore, the diversification that had been apparent in the good times proved transitory as the overall correlation of assets rose; their diversified portfolio was not durably diversified.

The hedge fund alternative

For institutional investors, hedge funds offer a way to extend the mix within their balanced portfolios. Hedge funds share a similar objective with absolute return portfolios – to achieve a positive return whether markets are rising or falling – and can also invest in a diverse range of assets and employ a variety of investment strategies. However, while hedge funds offer a number of benefits, they also present a number of issues. For example, in many countries they are not available to retail investors. Because they are not sold to the public, hedge funds have not historically been subject to as stringent restrictions as other types of investment and are therefore accused of a lack of transparency and liquidity. They also employ leverage, e.g. borrowing money or trading on margin, which can increase returns but can also increase the severity of losses. Their fees have also been very high in comparison with more mainstream portfolios.

Understandably, investors have therefore used hedge funds sparingly and they have constituted only a minor allocation of most portfolios. This has limited their ability to make a meaningful difference overall, even when they have been successful.

Seeking more diversified growth

A more viable alternative for many investors was the development of diversified growth portfolios. These invest in a more diverse range of asset classes than balanced portfolios, such as high-yield bonds, emerging markets, private equity, commodities and infrastructure. As a result, they seek a greater spread of investment risk alongside more opportunities to achieve positive returns. However, these too have limitations that were highlighted in 2008 when the global economy tipped into recession. Many asset classes used within diversified growth portfolios were unsurprisingly linked by a single factor – economic growth. Therefore, when the global economy retreated, so did nearly every asset class. These portfolios consequently failed to provide sufficient diversification in these extreme circumstances.

A move towards risk parity

In other markets, such as the US, a parallel development took place that seemed to tackle this flaw. The risk parity approach attempts to avoid over-exposure to any individual market risk factor and seeks to perform in all economic environments. At its most basic, historical risk and correlation data and modest leverage are used to structure broadly equivalent risk/reward contributions from across the investment universe. While this is a good first step towards risk-adjusted returns with durable diversification, the difficulty is that this largely quantitative approach is essentially backward looking. By drawing on history for the critical variables used in portfolio construction, it fails to capture how correlations and risk change over time. In addition, it may be better to hold unequal risk allocations to protect against extreme events, as not all are equally likely.

The results have shown that risk parity can offer some more durable diversification characteristics but investors have still seen variable results across the economic cycle. In practice, successful managers have also gradually become more forward looking in their approach.

Developing multi-asset, multi-strategy solutions

As all of these approaches tried but ultimately failed to provide genuine diversification, a different approach is required that draws on the positive aspects of these advances but also overcomes their weaknesses. We now consider absolute return portfolios that take a multi-asset, multi-strategy approach.

Investing in this manner provides the potential for positive returns irrespective of global economic conditions. This is because it widens the universe in which managers can invest even further, to include asset classes such as inflation, volatility and currencies. While investing passively in these assets for long periods is unlikely to produce a positive return, investing in them over shorter periods, say three years, can exploit established market inefficiencies. As well as traditional asset classes, absolute return managers can utilise additional strategies. These include relative value strategies that allow them to express a view on the performance of one market compared to another. By doing so, they can achieve positive returns even if markets are falling as long as their preferred market outperforms.

The real proof for multi-asset, multi-strategy absolute return portfolios is in their performance both during and since the Global Financial Crisis, one of the most difficult periods for investors in living memory. In these challenging market conditions, they have proven adept at stabilising investment portfolios and enhancing investor wealth. As a result, they can truly be considered as a very significant step in the evolutionary process towards genuine diversification.

Mark Foster
Investment Director

About the author

Mark Foster is a senior member of the global investment specialist team at Standard Life Investments. Mark began his career at Aegon and was involved in advising pension schemes on a range of investment and actuarial issues. He then moved to Mercer in Edinburgh where he was a senior investment consultant.

A Guide to Absolute Return Investing: Part Two

Taking an absolute return approach

By Malcolm Jones

"Uncertainty is the only certainty there is, and knowing how to live with insecurity is the only security." - **John Allen Paulos, Professor of Mathematics at Temple University and author of Innumeracy: Mathematical Illiteracy and its Consequences**

Absolute return portfolios offer the potential for consistent, positive returns as they give investment managers more scope to diversify and deliver returns from a variety of strategies. They normally use cash as a benchmark with a target return over and above this. This means the manager has the freedom to invest in different geographies and markets, investing wherever they see the best prospects.

At Standard Life Investments, our Global Absolute Return Strategies (GARS) portfolio takes a multi-asset, multi-strategy approach. It has a target return of cash +5% per annum (gross of fees) over rolling three-year periods, which many consider to be commensurate with expectations of the long-term return on equities. However, we expect GARS to display less than half of the investment risk associated with equity markets. To achieve this, we dynamically allocate to our highest conviction views, typically employing a diverse array of 20-35 liquid strategies at any given time. This results in a durably diverse portfolio that has the potential to perform in multiple environments.

Investing in an uncertain world

In building a genuinely resilient portfolio that can provide stable and positive returns, the investment strategies we choose may have to reflect, at any given time:

- a fragile global economic recovery
- continuing levels of high market volatility
- a surge or a collapse in commodity prices
- inflation becoming a major problem
- deflation fears growing
- emerging markets growing ever faster
- the emerging markets bubble popping

... and many more.

These are just some of the extreme futures we think about when deciding on the balance of investment risks within GARS. As you can imagine, building a portfolio to provide stable performance for this potential range of eventualities is no easy task. We also have the extra challenge of ensuring that all our investment strategies are highly liquid. To achieve this, we combine physical investments in large equity and bond markets with conventional derivative contracts. This allows us to implement our investment themes as efficiently and with as much liquidity as possible.

The time horizon for each of our strategies is important too. We have a long legacy of multi-asset investment management and managing large amounts of money. Therefore, we have expertise in understanding longer-term macroeconomic changes and each of our strategies is assessed with the aim of delivering a positive return on a three-year timeframe. While we constantly monitor markets, our value comes from having placed monies prudently, rather than through the highly competitive world of high frequency trading.

Building a multi-asset, multi-strategy portfolio

Taking these factors into account, we first add market returns from traditional asset classes, including equities, bonds and listed property. These are expected to provide long-term returns superior to cash and we actively manage weightings among these asset classes depending on our macroeconomic outlook. We also, on occasion, seek to enhance returns from these asset allocations through our in-house security selection capabilities – also known as seeking alpha.

Taken together, traditional exposures combined with security selection give us a traditional multi-asset portfolio. These two sources could potentially produce positive returns in a number of economic scenarios. However, as seen in the case of balanced and diversified growth portfolios, this is insufficient in isolation.

Therefore, to achieve true diversification and the potential for positive returns in all economic conditions, we add more advanced strategies, which we term ‘directional’ and ‘relative value’.

Directional strategies are based on cyclical market opportunities relating to our views on asset classes such as foreign exchange, interest rates and inflation. For example, we are currently positioned against the euro, which we believe will weaken as the European economy continues to struggle with the fiscal strains of numerous Euro-zone members. We therefore hold a short position in the euro versus the US dollar. This type of strategy is often unavailable to traditional portfolios as these asset classes do not offer a long-term reward for being held continuously. However, we expect this strategy to deliver a profit over our three-year time horizon, and to provide diversification against other strategies we are running.

Relative value strategies allow us to take advantage of the differences in behaviour between two normally similar markets. For example, we currently hold a position preferring German companies to their French counterparts. A core driver for this position is the differing performance dynamics of their respective economies which we believe is not reflected in stock market valuations. The strategy will be profitable as long as the German equity market outperforms the French market regardless of whether stocks are going up or down. Consequently, such relative value strategies can provide further levels of diversification as they are not directly exposed to the overall direction of the underlying market.

Achieving genuine diversification

The breadth of strategies available to absolute return investors ensures that diversification can be achieved even in the most demanding investment conditions. In addition, constructing a portfolio of liquid, diversified investment opportunities allows us to aim to deliver positive returns for relatively low risk in all investment conditions. This is because if one strategy fails to perform at any given time, it should be offset by positive performance from other strategies held.

It is this stability that makes absolute return investing an attractive proposition for many investors. If you were offered a deal now where in three years time you would potentially have annualised returns of cash +5% for less than half the volatility of equity markets, would you take it? In the uncertain world we currently live in, an absolute return portfolio that potentially offers more certainty on future return outcomes, while aiming to achieve long-term investment objectives, seems like a very good prospect.

Malcolm Jones
Investment Director

About the author

Malcolm Jones is an investment director at Standard Life Investments. He is an asset class specialist responsible for multi-asset and absolute return investing. Malcolm joined the company in 2003 after 15 years with AEGON Asset Management as an investment manager.

A Guide to Absolute Return Investing: Part Three

Allocating absolute return strategies within investment portfolios

By Chris Nichols

As we have shown in the previous article, a multi-asset, multi-strategy approach can provide investors with a positive outcome irrespective of market and economic conditions. While a positive outcome is a desirable feature in its own right, it also provides flexibility in the ways in which an absolute return investment can be used within portfolio asset allocation models. In this article, we examine some of the different uses investors have found for absolute return investing.

Equity replacement

Many investors hold equities in their portfolios as they expect good returns over the long term. However, equities can display high levels of price volatility and offer highly variable and unpredictable returns even over the longer term. In contrast, GARS seeks to deliver returns in line with investors' long-term expectation from equities (or the equity risk premium) over much shorter timeframes, i.e. three years, with considerably less volatility than just investing in equities. In the UK, many mature pension plans have faced the twin challenges of investing to clear deficits yet de-risking as more of their members receive benefits. They have found a re-allocation from equities to absolute return to be a very rewarding approach.

Falling markets have also forced investors who can tolerate higher volatility, such as endowments and public funds, into making investment choices they would not otherwise make. For these investors, an allocation to a highly liquid and accessible absolute return investment gives more flexibility to protect their downside risks, while also providing a potential source of funding for less liquid investment opportunities.

Further asset diversification - palatable 'hedge fund'

The term 'hedge fund' covers a wide array of investment strategies, including global macro, multi-strategy, event driven and fund-of-hedge-funds. For investment portfolios, these strategies offer a return profile that further diversifies traditional allocations to equities, fixed income and real estate. However, their drawbacks typically include a lack of transparency and/or liquidity, as well as very high fees. In addition, many hedge funds have materially failed in their ability to deliver the required risk and return characteristics. As a result, portfolio allocations to hedge funds are usually limited.

In contrast, investors have been able to make sizeable allocations to absolute return strategies. This is because they deliver additional diversification while also offering daily liquidity, full transparency and much lower fees. In addition, GARS has delivered competitive returns and risk comparisons against the various strategies on offer within the hedge fund universe. It therefore offers extra diversification delivered at an acceptable cost.

An essential component of a 'lifestyle' defined contribution plan

Defined contribution (DC) plans need to offer investments that allow their members to build up a sizeable amount during their working lifetime (the accumulation phase) and then go as far as possible to support them during their retirement (the drawdown phase). These investments need to be robust in the face of changing market conditions during both phases in order to ensure that different generations get similar benefit outcomes.

The inclusion of absolute return strategies within a pre- and post-retirement portfolio can offer demonstrable and effective solutions.

a) Absolute return strategies can maintain investment performance throughout the member's entire lifetime. Currently, investment portfolios in the accumulation phase tend to have large equity allocations where the end result is highly uncertain and unlikely to be consistent from generation to generation.

b) They can also enhance the ability to absorb market shocks, giving a degree of protection for members during potentially the most vulnerable period of their investment lifetime (late accumulation and early drawdown).

c) Absolute return strategies can mitigate the requirement to switch investment strategies. Currently, investing in the drawdown phase requires heavy allocation to expensive 'safe' bond assets whose value will be materially impacted in an era of rising interest rates. Absolute return bond strategies have the potential to offer low risk positive returns irrespective of the interest rate cycle.

Given these benefits, we believe the use of absolute return strategies should merit serious consideration by all DC investment plans that seek to both maximise income and protect capital for members.

Indeed, an allocation to absolute return strategies should be part of any portfolio looking to improve its risk/return characteristics. In this article, we have highlighted just three of the main ways investors currently utilise the asset class. As absolute return investing continues to prove its worth and increases in popularity, we believe that it will become an increasingly important portfolio component for investors around the globe.

Chris Nichols
Investment Director

About the author

Chris Nichols is an investment director at Standard Life Investments. He is responsible for the development and management of multi-asset investment strategies for institutional clients. Chris worked for Standard Life from 1991 to 2004 in various actuarial roles before moving to Standard Life Investments.

Conclusion

Our research shows the investment industry has taken significant steps in recent years, moving on from the traditional balanced approach to absolute return strategies that finally offer the potential for genuine diversification.

At Standard Life Investments, we believe that a multi-asset, multi-strategy approach provides investors with an opportunity to achieve positive returns in all market conditions and achieve their long-term investment goals. This approach also has multiple uses within an investment portfolio and gives investors extensive flexibility. These benefits make absolute return investing an increasingly attractive proposition and one that we believe will continue to stand the test of time.

If you would like to find out more GARS, please visit www.standardlifeinvestments.com where you will find contact details for your location.

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