INVESTMENT STRATEGY

Absolutely the right thing for clients

Put simply, many clients are absolute return investors, and they will increasingly seek out the houses that demonstrate the absolute capability that enables them to achieve their goals, writes David Tiller

Across the investment industry we are seeing an increased focus on absolute return investing. So is this the latest fad or is there something more fundamental behind this change?

In most instances, investors seeking a discretionary investment management service do so in the expectation of receiving an absolute return. To believe otherwise would suggest that they wish to passively bear the market risks associated with their portfolio, rather than have these risks actively managed by their selected manager.

THAT UNCOMFORTABLE FEELING

Few in the industry would claim presenting a negative performance to clients is a comfortable experience. If a manager presents with a net loss of, say, 5 per cent as an outperformance because the market is down 7 per cent how will they feel - let down, disappointed, even angry?

Why is this? Quite simply they are absolute return investors.

It is sometimes said that investors want relative returns when the market is on its way up and absolute returns when it is falling. In our experience this does not really hold true.

When the risk/return trade-off is explained to clients clearly they are much more realistic in their expectations. The prevalence of relative return portfolios reflects constraints on the solutions that have been available.

"TO TRULY SATISFY CLIENTS IT IS ESSENTIAL THAT WE UNDERSTAND THEM AND BUILD PORTFOLIOS THAT ARE DRIVEN BY THEIR GOALS AND PRIORITIES"

Until recently there has been a dearth in genuine accessible absolute return capability so clients have been presented with the best solution available. As an industry, however, we have to accept some responsibility for perhaps not emphasising the potential limitations of traditional relative return portfolios.

It has suited all portfolio managers to run relative return portfolios. After all they are much easier to construct and traditional asset classes are readily available. And, while markets have been rising, clients have by and large achieved returns in line or even ahead of expectations.

Unfortunately, less attention has been paid to the risk exposure the client is carrying – the sting in the tail when markets fall.

GOAL BASED AND ABSOLUTE RETURN

To truly satisfy clients it is essential that we understand them and build portfolios that are driven by their goals and priorities. It is too simplistic to treat a client as an entity with a single attitude to risk, evidenced through a single questionnaire.

It is far better to recognise, for example, that the investment requirements for a reserve for tax liabilities are very different from the investment solutions proposed for long term savings problems.

Portfolio managers need to focus on the client, to create a client defined list of financial goals, each one of which is treated with the client's priorities in mind.

For short to medium term goals riding the ups and downs of the stock market is clearly far too risky. However, even for longer term goals, clients want increased certainty and in the risk assessment this is clearly indicated by the losses they are comfortable to tolerate, typically less that 10 per cent of portfolio value. A significant downward adjustment makes for a very disappointed client.

Just as clients seek to manage the economic cycle within their own businesses, they have a right to expect their fund managers to do the same with their investments. That is why a sensible core proposition could be described as "goal-based, absolute return investing."

"A SUCCESSFUL ABSOLUTE RETURN STRATEGY RESTS UPON A SOUND AND REPEATABLE INVESTMENT PROCESS "

It is rare that the client can afford to or is comfortable funding their goals by only investing in cash/gilts. Also, from a discretionary investment management point of view merely offering cash-like portfolios would also be tantamount to admitting defeat.

Generating higher levels of absolute return is challenging, requiring a higher degree of skill and also access to more sophisticated investment techniques and instruments. While these techniques can be found in the institutional world they are rarely deployed in private client portfolios.

ABSOLUTE RETURN STRATEGIES PHILOSOPHY

Traditionally, investors have been offered balanced managed portfolios to achieve their goals. The big drawbacks of this approach have been the relatively static asset allocation structure and the narrow opportunities set employed.

For instance, if a long-term strategic benchmark has been set, the portfolio manager rarely has the scope to move substantially away from this split of assets, even if they strongly believe one asset class will outperform the other significantly over a given time period.

This inflexibility is reinforced by traditional portfolio constraints such as dealing costs and Capital Gains Tax. The net effect is to transfer the risk of a severe market downturn on to the client, failing to deliver the absolute return ideal.

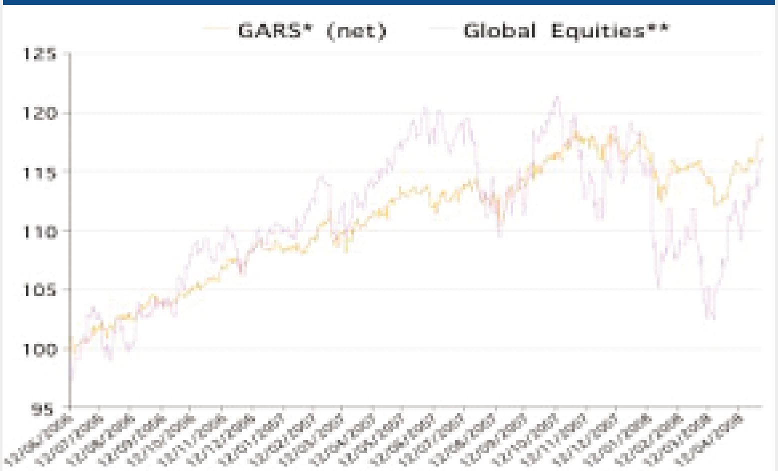
A sensible answer is to offer a truly active approach to diversified asset allocation. This can greatly enhance an investors risk/reward profile. Client portfolios can have a more diverse array of asset class exposures and avoid the issues associated with long-term market based benchmarking by setting an absolute return target.

This type of approach liberates the portfolio manager to implement the best ideas to the full extent of their conviction. It results in client portfolios that maintain a highly diversified, actively managed asset allocation profile with the possibility of positive performance regardless of conditions in individual markets.

A successful absolute return strategy rests upon a sound and repeatable investment process which combines dynamic allocations to traditional assets such as equities, bonds, property and treasuries, alongside the possibility of allocations to more advanced sources of market returns.

The best portfolio managers have the freedom to select freely

Figure 1: Comparing GARS to Global Equities



Source: Internal Standard Life. Past performance is not a guide to future performance. The value of investments may go down as well as up and cannot be guaranteed.

Key facts

■ **9.5% annualised return (from inception to 29/02/08)**

■ **Maximum Drawdown:**
- **GARS - 5.4%**
- **Global Equities -15.7%**

■ **Volatility:**
- **GARS 5.1%**
- **Global Equities 14.9**

(using weekly data, to 10/03/08)

■ **VaR (95%, weekly):**
- **GARS -1.5%**
- **Global Equities -3.4%%**

(annualised. using weekly data, to 10/03/08)

across geographies and markets, investing in the best prospects but with robust risk constraints that hard-wire a requirement to search for diversifying opportunities.

They are looking for positive expected rewards that also contribute to limiting the overall amount of risk taken within the portfolio.

INVESTMENT STRATEGY

The total return in each client portfolio can be achieved by a combination of:

•Exploiting a diverse range of stock selection expertise

The Portfolio Manager must seek out alpha managers they believe offer the potential to outperform market benchmarks. Direct investments can be selected, where there is a clear information advantage arising from access to propriety research capabilities.

•Multiple and diverse sources of market returns that are managed dynamically over time to create enduring diversity and value

Through the prudent use of derivative instruments the managers can access advanced sources of return such as duration, volatility and relative value trades.

THE STRATEGY IN ACTION

Figure 1 shows Standard Life Investments' Global Absolute Return Strategies Fund (GARS) compared to Global Equities. This fund is available to professional clients only. A retail version of this fund was opened to investors on 7th May 2008.

This diagram clearly demonstrates how the strategy has enabled the fund to produce equity-like performance for bond-like volatility.

SO HOW DOES THIS APPROACH DIFFER FROM A TRADITIONAL BALANCED APPROACH?

The pie charts in Figure 3 show how we diversify market risks within investment portfolios through allocating to cash and derivatives. Large exposures to equity markets are reduced and replaced by a diverse range of alternative ideas.

With the traditional approach the universe of opportunities for stock selection is defined by the portfolio's strategic asset allocation.

"MARKET RETURN STRATEGIES ARE NOT JUST ABOUT ALLOCATING BETWEEN BONDS AND EQUITIES OVER THE ECONOMIC CYCLE"

Unfortunately, not all markets/assets are equal when it comes to finding alpha and asset allocation decisions can greatly reduce the opportunities to find outperformance.

We recognise that the best stock selection activity may come bundled with market risks for which we do not expect to get rewarded. By way (solely) of an example, a Pacific Basin equity fund may exhibit good stock selection, but an impending global recession means that Pacific Basin equities are likely to go down.

There needs to be reconciliation between the best stock selection allocation, and the best market risk allocation.

This is done with a derivatives overlay.

THE ALLOCATION OF MARKET RISKS

Another clear difference between the traditional balanced approach and the absolute return approach is found in the range of rewarding investment opportunities which can be engaged on the client's behalf. Market return strategies are not just about allocating between bonds and equities over the economic cycle.

Forward-thinking portfolio managers need to look for strategies globally and apply advanced techniques, often using derivatives, so being able to combine those that offer the best return prospects and risk diversification to the portfolio.

Typically the portfolio should include a variety of traditional and advanced market return seeking strategies, as is shown in Figure 2.

These positions may be delivered through trading in physical assets or by generally using highly liquid derivative instruments on major global markets. This adaptable approach enables us to extract maximum value efficiently from all the opportunities we identify.

THE INNOVATION CHALLENGE

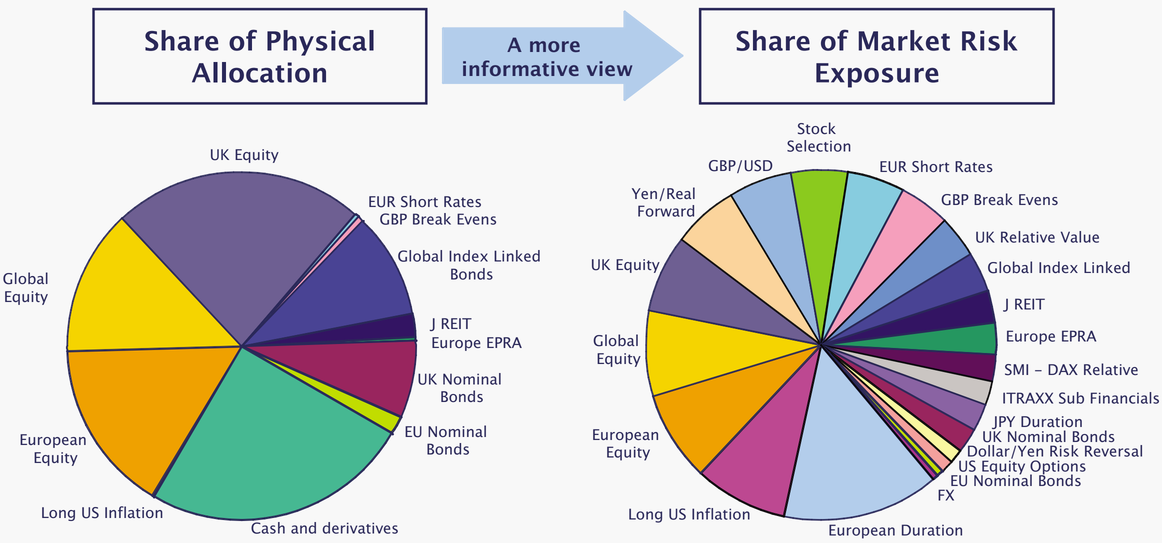
Wealthy clients rarely arrive without a substantial (and often CGT constrained) portfolio of legacy assets. They also lead complex lives and may have a range of different investment goals.

The challenge, therefore, is 'how to create a **bespoke** absolute return?'

Figure 2: Market return seeking strategies:

Traditional Techniques	Advanced Techniques
■Equity	■Duration (Interest Rate View)
■Bonds	■Credit (Default Protection)
■Property	■Inflation
■Foreign Exchange	■Volatility (view and downside protection)
	■Relative Value (within and between asset classes)

Figure 3: Diversifying market risks



Source: Internal Standard Life, 31st March 2008

The preferred solution would enable the portfolio manager to actively manage market exposure while selecting the best alpha sources from the whole of the market, but this requires the use of sophisticated instruments.

Often portfolios are not large enough to be able to secure the required positions and these instruments are difficult for clients to truly understand - purchasing units in a fully regulated fund is far more acceptable.

This is why Standard Life Wealth uses a unique Unit Trust, the Strategic Investment Allocation Fund to deliver a derivative overlay to client portfolios. Unlike typical funds of hedge funds, for example, this fund does not look to generate an absolute return in its own right.

Instead is looks to do so alongside the other assets held in a private client portfolio. This is key, as it allows the incorporation of individual targets and client legacy assets while reducing enforced trading and hence CGT.

"TYPICALLY THE PORTFOLIO SHOULD INCLUDE A VARIETY OF TRADITIONAL AND ADVANCED MARKET RETURN SEEKING STRATEGIES"

The challenge for the industry is that it takes the resources and intellect of an institutional investment house to successfully execute the advanced techniques needed to generate an absolute return. Derivatives should be bought by the dedicated market facing teams that would be expected in a major fund management house. Private investors are reassured by the familiar and fully regulated authorised unit trust structure.

The present move towards absolute return investing is much more than just a fad and innovation has become an imperative for success in the business of private client investment.

Clients will no longer meekly accept the portfolios we want to manage. They will increasingly seek out the houses that demonstrate the absolute capability that enables them to achieve their goals.

David Tiller, marketing and strategy director, Standard Life Wealth