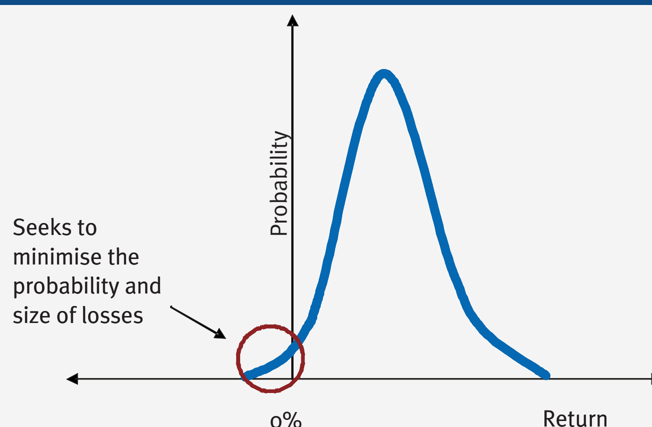
TARGETING HIGHER RETURNS

The power to maximise performance absolutely

Given the expectations for a prevailing low-return environment and the increased fear of capital losses, investors' attention is increasingly turning away from relative performance and moving towards absolute returns. But what are the merits of absolute return strategies and how can long-only investment houses structure their products with the aim of providing both long-term positive returns and shortfall protection?

Targeting positive returns with shortfall protection



Generic return profile for an absolute return strategy. For illustrative purposes only.
Source: Pioneer Investments

Real returns have been exceptionally high over the last 20 years. The strong performance of equity and fixed income markets has, in part, been driven by a clear dis-inflationary trend, a decade of strong economic growth and a general downward re-rating of the risk premium. Looking ahead, various factors suggest strong market performance seems unlikely to be repeated and we are most probably facing a period of below-average asset returns.

An absolute return strategy is a mandate that seeks to achieve targeted positive returns over a certain time horizon, while minimising the probability and size of losses. The principle idea behind an absolute return approach is to achieve a target by extracting alpha from any source independent of beta considerations. As total return portfolios are generally managed against a target return, and not versus a benchmark, the investment approach eliminates the constraints associated with traditional relative-return portfolios and breaks away from trying to extract alpha solely from market risk.

The Building Blocks of Traditional Investment Process used to Construct Absolute Return Portfolios

The need to generate alpha to meet absolute return targets reinforces the need for a robust investment process. To successfully manage absolute return portfolios, it is necessary to be able to produce alpha consistently at a firm level across a wide range of asset classes. The building blocks of a strong, established investment process – proprietary fundamental research, strong quantitative capabilities and active management – are the foundations on which an investment manager must rely in order to effectively generate opportunity sets or 'alpha pools'. In absolute return portfolios, value-added strategies derived from 'alpha pools' represent a key component of overall returns – they underpin the portfolio manager's ability to achieve return targets.

EXTENDING ESTABLISHED CAPABILITIES

The leading European fund groups' absolute return capabilities are founded on the building blocks of an established investment process. Through independent fundamental research, proprietary quantitative research and active management, fund houses aim to consistently build 'alpha pools' and effectively manage total return portfolios. The key reasons why these building blocks promote value creation are outlined below:

Fundamental research

A commitment to extensive and intensive proprietary research enables managers of equity and fixed income asset classes to make informed judgements about companies, industries and economies.

Quantitative research

A focus on quantitative research adds further insight and discipline to an investment process, supporting the process of idea generation by challenging fundamental assumptions and encouraging debate.

Active portfolio management

Active portfolio management needs to span all dimensions of the investment process. This means that managers can respond promptly to market movements

and implement timely strategies that have the highest probability of achieving the target absolute return in a risk-efficient way.

Generating absolute returns

The level of alpha that can be generated in any one particular total return portfolio is a function of its risk propensity, time horizon, breadth of the investment universe and the number of independent active positions, as well as the skill of the investment management team.

Generally speaking, there are three sources of value in total return portfolios:

- Return from core holdings;
- Return from alpha strategies;
- Risk management overlay.

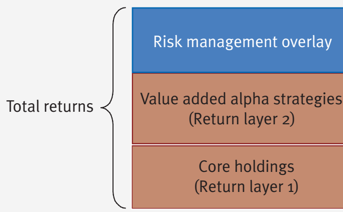
Absolute returns are generated through the two independent layers of return, while the risk management overlay enables the portfolio manager to target a total return more efficiently.

The first layer of returns is characterised by beta exposure or core holdings, which are designed to lock in a certain minimum return. The second layer of returns is achieved through the implementation of value-added or alpha strategies.

The portfolio management team exploits opportunities across a broad investment universe to put in place a range of diversified alpha strategies. Absolute return portfolios aim to achieve their target return in all market environments through dynamic asset allocation between core and value added strategies, and among the alpha positions themselves.

The third source of value in absolute return funds is a risk management overlay, which aims to make the most of the risk available to the portfolio and minimise the probability and size of any losses. Investment risks can be managed in absolute return strategies in a number of key ways, for example through risk budgeting and risk measures including value at risk (VaR). Later we expand on the role of alpha strategies and risk budgeting in achieving absolute returns.

Three sources of value in absolute return strategies



ALPHA STRATEGIES

The second layer of returns – alpha strategies – in total return portfolios can be derived through active management across all asset classes. A wide breadth of value-added strategies helps to maximise a portfolio's alpha potential and affords a better risk profile due to diversification benefits.

Diverse value-added strategies are implemented through investment in straight bonds and equities, and increasingly through derivative instruments. Within the fixed income asset class, alpha strategies may include duration bets, including negative duration via short futures positions to add real returns in an environment of rising yields.

Within the credit universe, an absolute return portfolio can typically follow two strategies; a carry strategy or a tightening of spreads strategy. Value-added equity exposure can be implemented via bottom-up stock selection in undervalued companies which offer upside potential and/or via equity index futures in order to capture absolute returns from both upward and downward market movements.

Active currency positioning is also a good source of alpha in total return funds. Currency strategies can help to improve the risk profile of such portfolios due to the low correlation of currency market movements with those of other asset classes.

Derivative instruments are increasingly being used by managers of long-only absolute return strategies in order to capture alpha opportunities. Derivatives are cost-effective instruments that allow for more efficient portfolio management and specifically they can be used to implement alpha strategies or to hedge away unwanted risks within a portfolio. Their use is particularly relevant in long-only absolute return funds, as they allow the portfolio access to previously inaccessible niche strategies or those that are becoming increasingly crowded. Derivatives allow more flexible and efficient position-taking as market conditions change.

A portfolio's absolute performance target, its investment time horizon and underlying market conditions are key factors in determining the portfolio's asset allocation and its overall level of risk. An absolute return portfolio manager will be careful not to expose him/herself to potential losses that cannot be recouped over the time horizon of the portfolio. Typically, every value-added position within an absolute return portfolio is a trade-off between expected return and the contribution to overall portfolio risk. The process of risk budgeting greatly enhances the ability of the portfolio manager to handle multiple alpha strategies, while actively managing their underlying risk.

RISK BUDGETING

Effective risk budgeting should provide the portfolio manager with a detailed view of the contribution to risk of each alpha strategy (standalone risk) and the correlation between strategies (diversification risk). An absolute return investment approach requires a structured process of risk management in order to increase the probability that the given return target will be reached. The use of alpha pools in absolute return funds can mean there are often multiple sources of risk. Risk budgeting allows the portfolio manager to actively allocate risk according to the expected return of each alpha strategy, with a view

Advantages and disadvantages of absolute return strategies

ADVANTAGES	DISADVANTAGES
• Focus on absolute return and risk of loss	• Return not guaranteed – could be negative
• Flexibility to employ optimal investment strategies	• Limit to upside potential
• Active management of downside risk	• May miss upward trends
• Stable return profile	
• Low correlation with other assets	

to optimising the benefits from portfolio diversification.

VaR helps to define risk in absolute return portfolios
Given that a key feature of absolute return portfolios is minimising shortfall risk, a key consideration in the risk budgeting process is to quantify the shortfall risk of the portfolio. VaR is the most common approach for measuring shortfall risk. It indicates how much the portfolio could potentially lose in absolute terms over a given time horizon at a given probability level. In addition, VaR can also be a powerful tool for modelling how portfolio risk could be affected by the introduction of alternative alpha strategies that may be under consideration.

ABSOLUTE RETURNS AND TRADITIONAL ACTIVE MANAGEMENT

The positioning of absolute return products in the context of an overall portfolio depends on the investment objectives of the investor but it is also influenced by the characteristics of the products themselves.

Correlations between total return strategies and other asset classes tend to be low, which facilitates the diversification of risk. However, it should be borne in mind that the active management of downside risks in total return strategies can limit the degree to which portfolios participate in upward asset price trends if the underlying asset itself is deemed too risky.

The central role of traditional portfolio management is not threatened by the emergence of total return products, as traditional fully active portfolios will typically not face the same constraints on performance. Rather, total return strategies can be employed as a satellite strategy to traditional investments by providing an additional source of alpha in an overall diversified portfolio. Our view is that total return investing complements and extends, rather than replaces traditional, long-only, active investing.

HERE TO STAY?

The key test for absolute return strategies is how well investor demand for such products would withstand a possible sustained period of positive returns for equity markets. Given that demand for such products has actually grown in the last two years despite the attractive returns generated by global equity markets in the same time, we believe this growth reflects not only the soundness of total return investing as a concept but also the fundamental shift that has occurred in the approach of institutional investors to investment planning.

Investor demand for total return products is growing and regulatory change is enabling traditional long-only investment managers to better meet this growing demand. A key component of successful absolute return portfolio management is the depth and variety of the alpha pools at the portfolio manager's disposal.

We believe an absolute return investment process should be underpinned by proprietary fundamental research and strong quantitative capabilities working in concert with active portfolio management. These are the building blocks of a successful investment process and, in our view, these capabilities underpin an ability to generate alpha and meet absolute return targets.

Total return portfolios offer advantages to the investor as satellite strategies to traditional relative return products, as they can look beyond potentially low market returns and target alpha. The clear and growing demand from investors for absolute return products brings some challenges, but overall represents a growth opportunity for the asset management industry.

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