ABSOLUTE RETURN PRODUCTS

Building a more efficient portfolio

As managers are forced to put together a high performing portfolio while avoiding exposure to risk, they are seeking different investment strategies. One solution that offers diversification, potential to generate alpha and a high degree of flexibility is absolute return products. Credit Suisse Asset Management outlines the benefits

A variety of sophisticated investment strategies are available to investors looking for possible solutions to the twin challenges of building a portfolio capable of improving investment returns, while minimising exposure to risk.

One strategy that has been growing in popularity is to include an absolute return product in order to generate more consistent positive returns and further improve diversification. This asset class encompasses a broad range of alpha-generating products that make efficient use of available risk, with various strategies available to suit the needs of different risk budgets.

To meet the needs of all investors, a wide variety of absolute return products exist, with different investment strategies and return expectations. Despite their differences, absolute return products typically offer investors the following benefits:

- They can exhibit a low correlation with traditional asset classes, providing additional opportunities to generate alpha whilst further improving diversification;
- They have the potential to generate diversified forms of alpha and can potentially create positive returns, irrespective of market conditions;
- They provide a high degree of flexibility, with investment strategies not bound to benchmarks and with some strategies offering a low volatility solution that can be beneficial to an investor's portfolio
- They incorporate dedicated risk management systems to ensure risk is controlled.

THE SEARCH FOR ALPHA

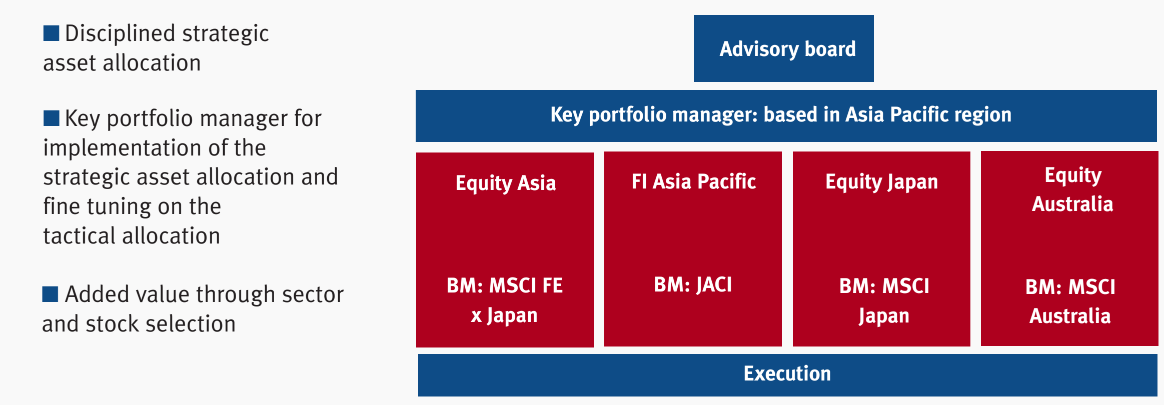
The rapid growth of this particular fund group raises the question of what key features investors should take into account when considering an investment into absolute return products. With the need for positive returns balanced against the need for a degree of limited downside risk, there are two key features that come to the fore.

These are risk control measures in order to minimise any downside potential, and the capability and structure of investment management teams so as to deliver the returns.

Dealing with the issue of manager capability is a particularly important issue, given that absolute return strategies commonly seek to exploit thematic or regional opportunities, as well as invest in a diverse range of asset classes. Furthermore, timing is a key issue in running multi-asset class strategies and, as such, local knowledge of the markets the product invests can be decisive.

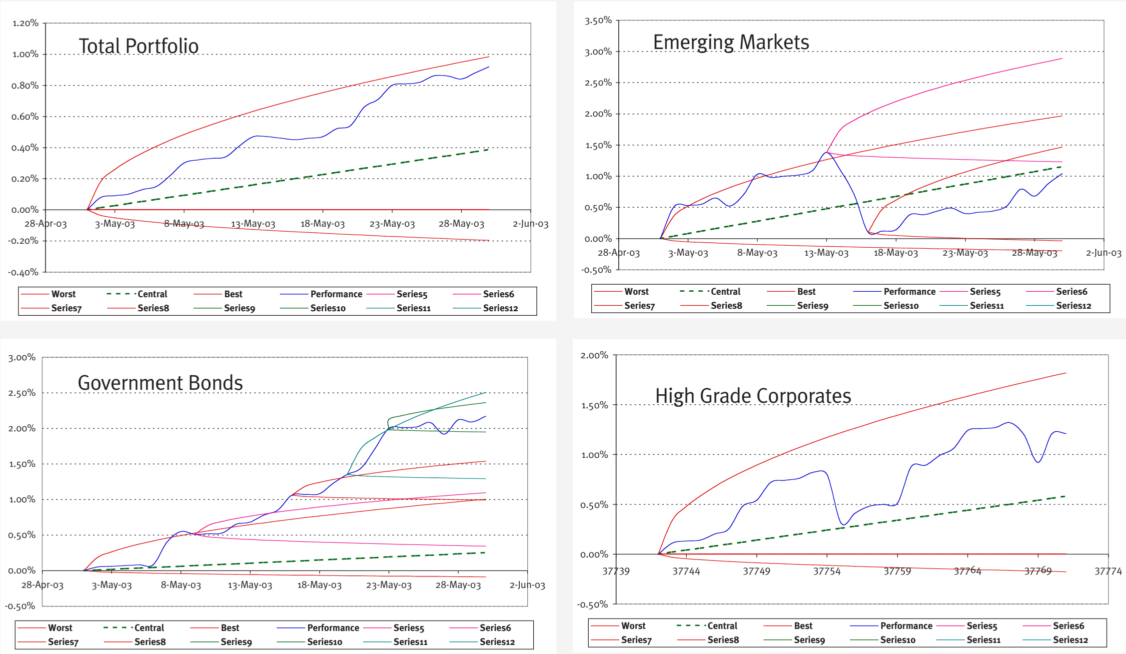
Experience has taught us that the effectiveness of these strategies is closely linked to a manager's ability to consistently add value across a range of market conditions. Therefore, the depth of resources available will play a critical role in

Chart one: taking an innovative structural approach to the asset allocation process



Source: CSAM

Chart two: An overarching risk management tool helps to ensure portfolios maintain their optimal asset allocation



Source: CSAM

generating positive returns.

Another often overlooked feature that investors should consider is the way that information is leveraged within the investment management team. Innovative total return products, such as those investing in the Asia Pacific region, for example, can provide a useful example of how team structure can provide an information advantage.

Investing across equity, fixed income and cash markets within Asia Pacific, a forward-thinking absolute return strategy can provide an opportunity for tactical allocations within the region's markets. Central to the success of the product is the innovative structural approach used within the asset allocation process that leverages an advisory board composed of investment professionals with long-standing experience of advising and investing in Asia-Pacific markets.

Its role is to monitor the various markets, therefore to developing macroeconomic views and providing the core thematic investment ideas that will then be translated into optimal asset allocation decisions. Leveraging the proprietary research teams at the local level should also enhance the identification and selection of valued enhancing stocks. This structure ensures a consistent information flow down to the product areas and enhances the investment management teams' capability to identify value added investment opportunities.

RISK CONTROL

The introduction of an expanding range of more complex instruments, each with their own individual risk characteristics, requires robust risk management systems capable of capturing the risk profile of both traditional and enhanced securities contained within the portfolio.

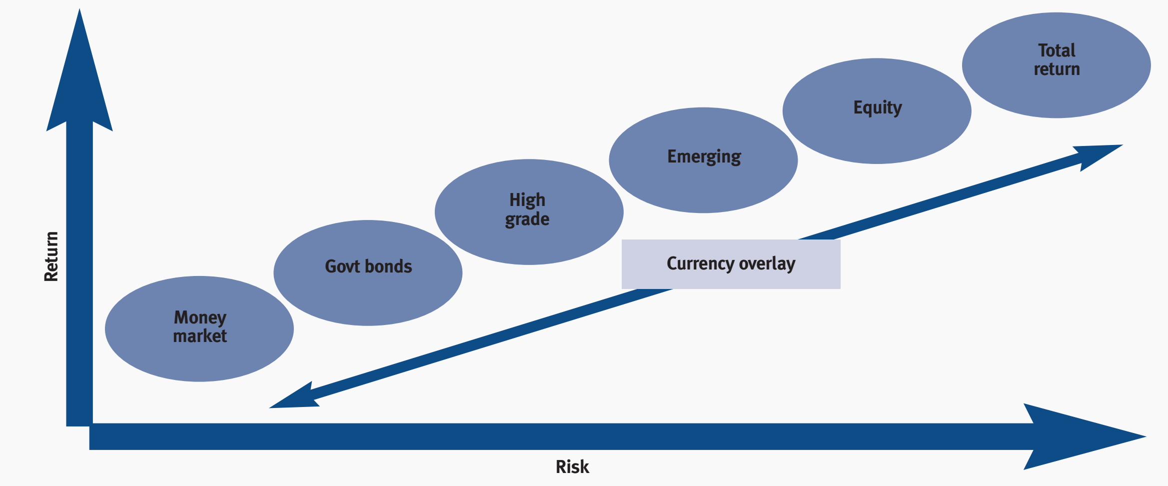
"CENTRAL TO THE SUCCESS OF THE PRODUCT IS THE INNOVATIVE STRUCTURAL APPROACH USED WITHIN THE ASSET ALLOCATION PROCESS"

At CSAM, the development of absolute return strategies has focused on ensuring there is in-depth knowledge of these new instruments as well as the expertise to understand and control the risks therein. By incorporating dedicated risk management systems, different asset classes can be incorporated into a single portfolio not only for their potential risk premium, but also their ability to offset downside risk in the portfolio as a whole. Investors can benefit from maximising potential positive alpha generation within strict risk parameters.

This approach is adopted within CSAM's Target Return concept that invests across a wide range of fixed income asset classes, whilst focusing on capital preservation. Risk analysts within the portfolio management team identify the fundamental and structural differences between the various asset classes.

As one would expect, capturing all the risk embodied in a complex portfolio is impossible using only one volatility parameter, such as Gaussian VaR. For an optimal risk/return profile the downside risks of non-government asset classes need to be captured accurately and

Chart three: alpha from inefficent markets



Source: CSAM

the Cornish Fisher VaR model addresses this issue by including other risk metrics such as skewness and kurtosis, as well as volatility, in its methodology. This allows asset allocation strategies to select asset classes not only for their risk premium, but also their ability to offset downside risk in the portfolio as a whole, thereby maximising potential positive alpha generation.

This encompassing risk management tool also uses sensitive triggers to ensure both upside and downside events are constantly measured. Termed an asset class 'envelope', both upside and downside scenarios are measured against the actual performance of the relevant asset class on a daily basis. Triggers are set should the upside envelope limit be breached where profit taking may occur. Similarly, if the downside envelope limit is broken, the position is re-evaluated and re-allocation may occur (see chart two).

Irrespective of how financial markets behave in the coming years, growing numbers of investors are likely to add absolute return products to their portfolio to generate more consistent positive returns and further improve diversification. Asset manager capability to deliver the products and returns, together with the necessary risk management systems to ensure risk is controlled, are the two key criteria by which investors are likely to evaluate these products.

INNOVATIVE PRODUCTS

Their importance is particularly relevant given the many innovative absolute return strategies that are now on the market, providing investors with alternative forms of alpha generation. For example, one area that has seen a growth in interest has been active currency management. This type of strategy has the potential to deliver gains from foreign exchange exposures whilst also having the ability to hedge losses. Since many absolute return strategies have holdings denominated in foreign currency, the potential is created to gain from uncorrelated returns from the underlying investments using overlay strategies. As currency values move in long, uneven cycles, active management is both an opportunity and an increasing necessity.

Innovative absolute return strategies such as these contribute to the overriding aim that is to ensure investor's portfolios make the most efficient use of their available risk budget. Whereas the trend has been to incorporate just one strategy into a portfolio, strategies such as these suggest that holding a broad range of alpha generating products can contribute to achieving an optimal portfolio structure, enhancing diversification and making efficient use of available risk.

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