Absolute Return, the new industry mantra.

by

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In recent years a transformation has occurred in the investment industry. Following the nineties bull market, when long equity only portfolios would have enjoyed average annual returns of 17%, the worst bear market, in both U.S and European terms since 1929, was to follow. Three years of pain later and investors have found themselves desperately seeking the relative safe-haven of the last best performing asset, which until recently, was property. However, with property values seemingly peaking and bond yields leaving little scope for an “inflation shock”, where do we go from here?

For the foreseeable future, we expect the equity market to revert to the 100-year long-term average of around 5 to 6% per annum return, but accompanied by the high levels of volatility experienced recently. This is not so attractive a proposition and it would seem that realistic expectations are important going forward.

As the key determinant for long-term performance of a portfolio remains asset allocation, our investment managers propose a sensible spread of assets. They concentrate on the challenge of enhancing portfolio returns whilst moderating risk. Accordingly, this includes an allocation to absolute return strategies, or, as they are commonly referred to, “hedge funds”.

Hedging in financial terms means protecting the value of an asset holding by taking an offsetting market position to protect against adverse price movements. The principal distinguishing feature of many hedge funds is the application of specific investment and risk management skills to seek positive returns, regardless of market direction.

Broadly speaking, there are four main hedge fund strategies:

- **Relative Value** funds seek to capitalise on pricing inefficiencies among individual securities, focussing on the value of one security relative to another. They are market neutral, basically seeking to hold the undervalued security, whilst selling short the overvalued.

- **Event Driven** funds invest based on the anticipated outcomes of company-specific or transaction-specific situations such as a merger, acquisition or emergence from bankruptcy.

- **Long/Short** equity funds take both long and short positions in equities with the balance between longs and shorts depending on the manager’s views of potential opportunities.

- **Global Macro** funds seek to benefit from macro-economic opportunities in the global equity, fixed income, currency and commodity markets. These are the best known categories of hedge funds, made famous by the likes of George Soros' Quantum Fund, which memorably attacked the pound sterling on "Black Wednesday". Such funds seemingly attract a disproportionate amount of press coverage, often negative, but these strategies only account for a small proportion of the broader absolute return pool.

Hedge funds are undoubtedly attracting investors at the moment, although any sign of a sustained equity market rally would result in hedge funds losing some of their lustre, but, with their low correlation to traditional asset classes, they are still vital components in a diversified portfolio. It is therefore important to consider an investment house with a strong capability across all asset classes in formulating a consolidated investment strategy.

Absolute return can also be achieved, by definition, from capital guaranteed structured products. The capital may be guaranteed from pre-specified levels of, say, 90% to 103%.

In general, these principal protected notes are constructed using Zero Coupon Bonds and Call Options. The capital guarantee is obtained by investing the required amount in a Zero (which will grow to 100 at maturity) and the excess is used to purchase call options over the underlying index or basket. Lowering the level of capital protection to say 95% allows for greater investment in options and therefore greater participation in the underlying index/basket. Hence the inverse relationship between capital protection and investment participation.

The three main categories are Foreign Exchange-linked, Equity-linked, and Yield-Enhanced.

An example of what can be constructed is as follows: perhaps you have Australian dollars on deposit, but feel bearish on oil. By purchasing a linked structured product, in this case, an AUD-Oil linked deposit, then instead of earning just 4.50% on the AUD deposit you may earn up to 10 % if your pessimistic view of the direction of the oil price comes to fruition, but still earn 2% if it doesn't.

There has been increasing interest in these structured products, particularly from those investors seeking to dip a toe in the markets, but at the same time desiring protection of all, or part, of their principal.

Investment styles come and go. Like "Growth investing" in the late 1990's, the new industry mantra is "absolute returns".

We have been using such vehicles, where appropriate, to increase portfolio diversification and reduce risk for many years. Deutsche Bank has one of the leading capabilities in this field and currently manages in excess of US$6 billion of hedge fund assets. However, we do feel that there is no single "investment solution."

Hedge funds have already emerged as a major asset class in their own right and should no longer be considered peripheral investments. In order to enhance return and control risk we encourage all investors to consider introducing an allocation to alternative investments to compliment their traditional bond and equity investments.