

generating lift

With stock market performance remaining uncertain, funds with the potential to offer equity market exposure while reducing downside risk could provide an ideal solution. **Ryan Hughes** explains.



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Investors in UK equities have undoubtedly endured an extremely testing time over the past 18 months. Nonetheless, the asset class is, for most, still an essential component of a balanced long-term investment portfolio and typically represents the single biggest element. Skandia's asset allocation tool, developed with leading investment consultancy Watson Wyatt, suggests that investors in all risk levels from 2 to 10 should have some exposure to UK equities in order to

achieve the highest mathematically expected returns for each level. Ensuring your clients have the most appropriate investments within the asset class is paramount and with the IMA UK All Companies sector alone currently comprising more than 340 funds, this is no easy task.

With the outlook for the UK – and global – economy uncertain, stock market volatility is likely to persist for some time.

In such an environment, traditional long-only funds, which constitute the vast majority of the UK equity fund universe, are likely to continue to struggle. But what are the alternatives?

reducing volatility

The magnitude of the equity market falls over the past few years has led to a dramatic erosion in appetite for risk and many investors are seeking to reduce volatility within their portfolios. Those

with a particularly bearish view may be considering moving part of their traditional equity exposure into an absolute return fund. A precise definition of 'absolute return' funds remains elusive but typically they aim to provide positive long-term returns in excess of cash, a potentially attractive proposition for the risk-averse. Nonetheless, caution is required since strategies, risk profiles and types of assets held vary widely across the sector and their degree of success has been mixed to date.

One type of absolute return fund that may be particularly appealing in the current environment is equity market neutral. By combining a broadly equal number of long and short positions, equity market neutral funds aim to remove – as far as is possible – all exposure to the underlying stock market. The result is that performance is driven solely by the manager's stock-picking capabilities, regardless of whether the market is rising or falling. However, to achieve consistent performance through stock selection alone clearly requires great skill, which not all market neutral managers will be able to boast. Furthermore, by fully hedging market exposure, market neutral funds are likely to lag their traditional counterparts during bull markets.

capturing alpha and beta

Another option would be to switch some long-only UK equity exposure into a lower beta fund such as Skandia's UK Strategic Best Ideas, which invests in a portfolio of highly regarded managers from around the world, who in turn invest in their ten best stock ideas. Like market neutral funds, Skandia UK Strategic Best Ideas is able to generate alpha from both long and short positions, an invaluable feature during market downturns. A key advantage of the latter over market neutral funds, however, is that the underlying managers have the flexibility to adjust their net market exposure (from 0-100%) depending on market conditions, typically moving it lower when the market is falling and increasing it when share prices are expected to rise. This can provide some downside protection in weak markets and, crucially, help to ensure that the fund does not miss out on all the upside during a market rally (although it may underperform during rapidly rising markets as any short positions may act as a drag on returns).

a top performer

Skandia UK Strategic Best Ideas is the top-performing fund in the IMA UK All Companies sector since launch on

19 September 2007 and ranks in the first quartile over the past 6 and 12 months (to 16 March 2009). Since launch, the Fund has outperformed the sector by more than 20% and, importantly, has achieved its returns with the third-lowest volatility in the sector.*

This excellent performance has been driven by the Fund's ability to take short positions (to a maximum of five per manager) as well as the outstanding stock-picking skills of its underlying managers, who have been carefully selected, blended and monitored by Skandia Investment Group's investment team to form a well diversified, high conviction portfolio. Stock selection has made a positive contribution to returns on both the long and short side, with short positions delivering the majority of the outperformance since launch. In particular, stock selection within financials has been a key driver of returns. The Fund has held a very low average exposure to the sector, with a variety of shorts adding value. Short positions in a number of consumer services stocks have been another source of gains, together with good stock selection within the basic materials sector. ●

*Source: Financial Express, bid to bid, with net income reinvested, in Sterling, to 16 March 2009. Past performance is not a guide to future performance.

Skandia UK Strategic Best Ideas versus market neutral and long-only funds

	UK Strategic Best Ideas	Equity market-neutral funds	Traditional long-only funds
Longs	50 - 100%	50%	100%
Shorts	0 - 50%	50%	Zero
Market exposure (longs minus shorts)	Flexible 0 - 100%	Zero	100%
Fund type	MultiManager	Single manager	Single manager or MultiManager
IMA sector*	UK All Companies	Absolute Return	UK All Companies
Likely behaviour during bear markets compared with UK equities	Strong outperformance	Very strong outperformance	Dependent on the skill of the manager
Likely behaviour during bull markets compared with UK equities	Slight underperformance**	Underperformance	Dependent on the skill of the manager

*Typical IMA sectors only.

**May underperform in rapidly rising markets as any shorts held may act as a drag on returns.

Skandia UK Strategic Best Ideas – top 5 contributors to performance

	Fund %	Benchmark %	Relative contribution %
HSBC	+0.52	+7.14	+3.41
Barclays	+0.23	+1.51	+2.31
Royal Bank of Scotland	+0.38	+1.78	+1.77
Rio Tinto	+0.78	+2.74	+1.71
Consumer services company – Short	-0.32	+0.06	+1.68

Source: Factset, 30/11/2007 – 28/02/2009, based on average holding over the period. Past performance is not a guide to future performance.

For further information on the Skandia UK Strategic Best Ideas Fund visit www.skandiainvestmentmanagement.com/fa/bi

www.skandia.co.uk

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