absolute return:
the great diversifier?

May 2009

Difficult market conditions have led many investors to seek alternative ways to preserve capital or generate positive returns – and 'absolute return' funds have been major beneficiaries of this trend.

Over the next four pages we introduce two new absolute return vehicles to the Skandia fund ranges from Threadneedle and BlackRock focusing on bonds and European equities. Each group offers a reminder of absolute return fund strategies and why picking the right manager is so important.

threadneedle.

Quentin Fitzsimmons, Head of Government Bonds and co-manager, Threadneedle Absolute Return Bond Fund, explains how an understanding of absolute return funds can aid portfolio diversification.

Recent times will have reminded investors of the need to control risk in their portfolios. The most basic way to do this is to diversify your investments into a range of assets that react differently to changes in market conditions.

The classic diversification play is between equities and gilts. Equities typically do well when the economy is growing nicely, there is a bit of inflation in the system and risk appetite is healthy. Gilts, on the other hand, normally benefit from economic downturns, falling inflation and poor risk appetite. When one is going up, the other is often going down - they are 'negatively correlated'. This helps to make the portfolio less volatile on average.

But what we are really looking for in a portfolio diversifier is something with a low correlation with existing holdings, rather than an outright negative correlation. Something that doesn't just move in the opposite direction but whose performance is unrelated to the other investments in the portfolio. The new breed of absolute return funds is increasingly being seen as a possible answer.

what is absolute return?

Absolute return can mean any product seeking to deliver positive total returns over the medium term irrespective of market conditions. The returns are likely to be modest, and will be unlikely to keep up with traditional relative return funds in bull markets, but the appeal is their aim of being relatively reliable. As such, they are equally useful investments at any stage of the market cycle, even though their profile is automatically raised in periods of risk aversion.

There are a number of different approaches to absolute return investing but each one ultimately relies on fund manager skill to generate the returns. The investments made could theoretically be in any asset class from equities to bonds and beyond. It is important to remember that whatever the asset class, reflecting

BlackRock

Mark Elliott, Head of Strategic Alliances at BlackRock, looks under the bonnet of absolute return investing and introduces the BlackRock European Absolute Alpha Fund.

The concept of absolute return investing is actually very simple: an 'absolute return' strategy aims to generate positive returns irrespective of financial market conditions by deploying techniques that are able to profit from both the ups and downs in markets and stock prices.

Absolute return investing provides access to an investment toolbox with much more choice than that of typical relative return investing, resulting in an ability to make profits by purchasing shares that are expected to rise, and 'going short' on stocks that are expected to fall.

Simplistically, 'going short' is industry jargon for a strategy in which a fund manager either agrees or has the option to sell a stock they do not own. The sale is made on the assumption that they will be able to buy the stock at a lower amount than the price at which they 'went short'. The key point is that the manager does not own the stock at the time they 'went short', which means they are forecasting that the stock will have fallen to a lower price than when the deal was struck – thereby making a profit on the transaction.

an enlarged toolbox

Managers were granted a much-enlarged toolbox some time ago in terms of the investments they were able to utilise within the management of Authorised Unit Trusts. Critically, this included the ability to create 'synthetic-short investments' through the use of cash-settled derivatives.

Such positions are mainly achieved by investing in Contracts for Difference (CFDs). CFDs are an efficient way of securing the effect of a short investment, as they allow investors to participate in the price movement of a stock without having to take full ownership. The addition of these investment powers means absolute return managers now have a number of traditional and derivative-based investment techniques available to them.

the fund manager's views in the portfolio involves taking investment risk. As such, none of these approaches are risk-free and there is no day-to-day capital guarantee.

do the underlying asset classes matter?

There has been a good deal of debate about how absolute return funds should be classified. For example, where should an absolute return fund driven by views on equity markets fit in an asset allocation model? It could be expected to display some correlation with equity markets, but this correlation may be limited. And its objectives and returns are likely to be completely different to those of a relative return equity fund.

The performance objective is likely to be more similar to an absolute return fund powered by views on interest rate and currency markets. In this case, however, the performance is likely to be somewhat correlated with bond markets rather than equities.

To illustrate this point, figure 1 shows the historic correlation of Threadneedle's Absolute Return Bond Fund with various asset classes. This is an absolute return fund based on interest rate and currency markets and therefore displays some correlation with government bonds. Its correlation with equities and with high yield and emerging market bonds has been negative, and it is reasonable to assume that the correlation with absolute return products based on these assets would be very limited. These are historic correlations. The point about this sort of fund is that if the manager thinks that high yield bonds will do better than traditional government bonds, for example, the structure provides the flexibility for the fund to be tilted in favour of those other asset classes, giving the potential to be correlated with the best performing markets as they come and go through the cycle.

diversification within absolute return

There are further diversification opportunities within the absolute return bucket. For example, an adviser might choose to combine three absolute return products: one based on government bonds and currencies, one on equities and one on corporate bonds. These asset classes have limited correlation with one another and each of the respective funds is likely to have limited correlation with its underlying market. As a result, the three funds are likely to be very lowly correlated, yet (if chosen carefully and managed successfully) provide ultimately similar returns. Thus, combining several absolute return funds with distinct approaches that draw alpha from different underlying markets could potentially further lower the volatility of the absolute return exposure, and hence the portfolio as a whole.

figure 1 historic correlations of the Threadneedle Absolute Return Bond Fund

	Absolute Return Bond Fund	Uk Government	UK Corp Debt	UK High Yield Debt	Global Emerging Markets Sovereign & Corp	FTSE 100 Equity Index
Absolute Return Bond Fund		0.61	0.08	-0.43	-0.09	-0.25
Uk Government	0.61		0.54	-0.36	0.18	0.04
UK Corp Debt	0.08	0.54		0.27	0.55	0.59
UK High Yield Debt	-0.43	-0.36	0.27		0.70	0.63
Global Emerging Markets Sovereign & Corp	-0.09	0.18	0.55	0.70		0.59
FTSE 100 Equity Index	-0.25	0.04	0.59	0.63	0.59	

Source: Threadneedle, Merrill Lynch and Bloomberg, as at 31 March 2009. Based on monthly returns since launch (November 2005). All data calculated in fund currency. Fund data is quoted on a bid-bid basis with income reinvested at bid. Fund data is gross of tax and TER to facilitate compensation with the indices.

Past performance is not a guide to future performance.

informer TV skandia H2H HEAD TO HEAD

Quentin Fitzsimmons appeared in Skandia's 'Head to Head' on informer TV offering his views on the global economic situation.

Visit **www.informerlive.co.uk/node/739** for more details

The Threadneedle Absolute Return Bond Fund is available through Skandia's Life and Pensions fund ranges and Selestia Investment Solutions platform.

DNA of a successful absolute return manager

How do you know a good absolute return manager when you see one? Because of the wide variety of approaches undertaken and the immense instrument flexibility afforded by UCITS III, understanding the strengths and weaknesses of managers is hugely important for advisers.

Ultimately, absolute return funds are still vehicles for converting fund manager expertise into investment performance, so it is important for advisers to have confidence in the fund manager and the resources at his disposal. However, UCITS III flexibility means that there are also other considerations, including experience of derivative investing, strong broker relationships and a thorough understanding and control of risk.

At Threadneedle, we believe we are one of very few managers that display all of these characteristics. Moreover, because of the benefits of low correlation outlined above, and its strong track record since launch, we see our Absolute Return Bond Fund as an important new portfolio diversification tool for advisers and their clients.

The Skandia fund will not mirror the performance of the underlying fund because of Skandia fund charges, taxation adjustments (if appropriate) and the Skandia investment process.

The Threadneedle Absolute Return Bond Fund may hold up to 100% in cash or money market securities. Therefore, investors should be aware that the Fund may not participate fully in a market rise. The Fund's exposure involves short sales of securities and leverage which increases the risk of the Fund. Short selling is designed to make a profit from falling prices. However, if the value of the underlying investment increases, the short position will negatively affect the Fund's value.

effective strategies

The BlackRock European Absolute Alpha Fund includes traditional long holdings in European shares, synthetic long and short investments in European shares, and pair trades (see example). Notably, the latter is regarded as a very effective strategy for eliminating a high degree of market risk, inherent with equity investing and therefore enhancing the effect of a fund manager's stock picking skills in generating performance.

The combination of long and short investments in absolute return funds means that market risk is normally less than in traditional long-only funds. Therefore, you will often find that absolute return funds demonstrate a risk profile similar to the more cautious areas of the market, as seen with bond funds or cautious managed funds. However, the good news for investors is that despite a reduced level of risk, returns can still be competitive with levels associated with punchier areas of the market, as populated by equity funds.

The BlackRock European Absolute Alpha Fund will be available through Skandia's fund ranges shortly.

what to look for
in an absolute return fund manager

Key in choosing your absolute return fund is picking the right fund manager, as this form of investing relies heavily on stock selection for performance success. A number of questions therefore need to be asked ahead of investment, including:

- What is the fund manager's experience in investing for both long and short strategies?
- What is the manager's long-term record in stock picking?
- What sort of risk management culture exists within the fund manager's firm?

While the BlackRock European Absolute Alpha Fund may be a new proposition, BlackRock has a proven track record in absolute return investing, evidenced by the performance of the pioneering BlackRock UK Absolute Alpha Fund.

The BlackRock European Absolute Alpha Fund is managed by Citywire A-rated Vincent Devlin. Prior to launch, the Fund was paper-traded and stress tested, resulting in a strong absolute return despite some of the most challenging market conditions on record. Between 12 June 2008 and 31 March 2009, the paper portfolio delivered an impressive 8% (net) gain, compared to a fall of over 30% from the MSCI Europe*. (Please note that the Fund will not be measured against an index and the MSCI Europe index has been used for reference only.)

Vincent, a Director and senior member of BlackRock's European Equity Style Diversified Team, has vast experience of managing European equity funds, including the BlackRock Continental European Fund.

In transferring his 15 years' experience of long-only investing to the BlackRock European Absolute Alpha Fund, Vincent uses the same process that identifies strong investment opportunities in highlighting companies that do not meet the correct criteria as stocks that he believes will substantially underperform. These candidates can then be utilised in the 'short' portfolio, via synthetic-short holdings and/or pair trades.

Furthermore, Vincent has a wide and diverse universe of stocks to choose from for either the long or short side of the portfolio as the European marketplace provides a hunting ground of approximately 2,000 stocks listed in 20 countries.

Finally, in terms of risk management culture, understanding risk is at the heart of BlackRock's investment management process. With a business and reputation built on expert risk analysis, BlackRock has developed sophisticated technology to ensure portfolio managers like Vincent can perform their duties to the best of their ability irrespective of market conditions.

example – pair trades

If we decide that Oil Company A is a very good investment, but think the reverse of Oil Company B, we can agree to buy shares (go long) in Company A and sell shares (go short) in Company B. As both are in the same industry, by buying stocks in one oil company and selling another, we are removing a large degree of industry exposure.

Instead, we are exploiting the expected differential of performance between the two investments. The perfect result would see Company A rising in value and Company B declining, resulting in a good profit. However, the money making opportunity for this strategy is not limited to this outcome. To make money, Company A simply needs to outperform Company B either in a rising or a falling market. It is possible, therefore, for the manager of this type of fund to make profits from their stock picking skills, whatever the prevailing market conditions.

*Source: BlackRock, performance based on paper-trading from 12 June 2008 to 31 March 2009 in Sterling. The paper portfolio is intended to demonstrate the potential of the investment strategy to be employed and the stock picking capabilities of the manager. Performance figures do not take into consideration actual trading conditions. The results are disclosed for illustrative purposes only.

Past performance is not a guide to future performance.

The strategies utilised by the Fund involve the use of derivatives to facilitate certain investment management techniques including the establishment of both 'long' and 'synthetic short' positions and creation of leverage for the purposes of increasing the economic exposure of a Fund beyond the value of its net assets. The Skandia fund will not mirror the performance of the underlying fund because of Skandia fund charges, taxation adjustments (if appropriate) and the Skandia investment process.