update

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Total Return/Absolute Return Investing - fad or future?

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Can this new approach to investment deliver what investors want, or is it another investment fad, preying on investor's misfortunes in recent times and ultimately doomed to disappoint? Ruffer has been using this strategy for nearly 15 years now.

What do savers actually want?

Firstly, they don't want to lose their money. Secondly, they want to make a decent return, ahead of cash and inflation.

"Clients love making money, but not as much as they hate losing it".

After two equity bear markets in less than ten years, investors are looking for an alternative and absolute return looks very attractive.

What is absolute return?

Absolute return funds come in all kinds of shapes and sizes, with names such as total return, asset allocation and hedge funds. Some have been successful in preserving capital in the bad times and others have not done so well.

The aim for absolute return is protection of capital in falling equity and bond markets. Then it should deliver cash plus/inflation plus returns with low volatility. Ruffer believes that this can only be achieved by a multi asset or perhaps long/short fund.

Ruffer's investment philosophy and approach

There are two objectives. Firstly, capital preservation, the fund managers try not to lose money on a twelve month basis. They then try to make consistent real returns. Aim to beat cash and inflation with a decent return of around 10% per annum.

The funds are "long only" in their approach. This means no shorting, leverage, derivatives or structured products. Investment is undertaken within conventional asset classes such as global equities, bonds and currencies.

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We, at Ruffer, provide active asset allocation and focused stock selection. We should not be regarded as a hedge fund, we certainly don't believe in performance fees.

The CF Ruffer Total Return fund is a microcosm of the wider Ruffer strategy. The fund value as at 31 October 2009 was £592m. The fund performance since launch (29 September 2000) has been +177% compared with the FTSE All-Share Total Return which has returned +15%.

Fear and greed

The key to the strategy is in producing stable, consistent returns, irrespective of market conditions. Not losing money in the bad times, so that investors can benefit from compounding.

It is a broadly agnostic strategy in terms of market direction. The fund is constructed so that at all times there is a combination of investments for the difficult times (referred to as "investments of fear"), providing a positive return when the markets are difficult and always holding some investments for the good times (referred to as "investments of greed") which are normally equities.

Active asset allocation

The skill lies in the juxtaposition of the "greed" and "fear" aspects of the portfolio, according to our top down view of the world. Not surprisingly our top down view of the world is constantly changing.

Two years ago, we viewed the world to be full of risk and were scared about the level of leverage in the global economy. Now, we are a little more optimistic, while remaining cautious overall. In 2007 we had 30-35% in equities, in contrast to a present level of 40-50% in equities.

On average since the launch of the fund, we have had more "fear investments" than "greed investments". Our greatest current fear is that of inflation. This is not just an issue when the recovery comes, but a potential problem much sooner and shockingly quickly.

The government is printing money via quantitative easing and we believe that this could quickly lead to a loss of confidence in currencies, making index linked gilts the right investment for protecting money. Gold is a good inflationary investment too, but is much more volatile.

At the same time, we think that the rally could continue. The fund holds some cyclicals and we have been buying into some high yielding stocks. There could be a "nifty 50" bubble, because when interest rates are this low, investors need to seek out income sources.

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Outlook and strategy

Our outlook is fairly cautious at present. Quantitative Easing gave a massive boost to markets and will continue to do so in the short term. Corporate earnings are rebounding strongly.

At some point, the government will need to build an exit strategy. If they wait too long with this strategy, it will lead to inflation. If it is removed too early, it could be deflationary. The government will favour an "inflationary error" over "deflationary mistake". Therefore, we think the likely outcome will be inflationary.

There is a risk that even if they switch off the quantitative easing too early, tipping towards deflation, they will re-start the stimulus very quickly again and people will then begin to worry about the extent of easing. In this event, inflation could come back into the market at a shocking speed.

Performance of equity markets over the past couple of years has an uncanny resemblance to the pattern that happened during the Great Crash. In the Great Crash there was a 50% recovery in markets followed by a further collapse in equities. We do not think this will be repeated, as government has reacted quickly in this crisis and will stop the debt deflationary trap at all costs. This again, supports our belief that the economy will inevitably tip into an inflationary trap.

Total return/absolute return investing - fad or future?

Total return /absolute return strategies appear to be what clients want, but it is not easy to deliver. Many firms are trying this strategy for the first time. Ruffer has had nearly 15 years experience in the type of investing.

It should be noted that this strategy may not succeed in the future, as times are extraordinary within the investment markets and may continue to surprise.

We do not have a crystal ball. At Ruffer we do not know what will happen next but have enough positions in different investments, in order to protect the portfolio going forward and deliver performance in the future.