

## Absolute Returns

“Absolute return investing” is the latest buzz phrase in the investment industry. We are seeing new funds launched with this theme every month. So what is it and how does it differ from the more traditional approach adopted by other funds investors may currently hold?

### What is Absolute Return Investing?

The idea is simple in that such funds aim to make a positive return in all market conditions. To achieve this they deploy techniques that are able to profit from both the ups and downs in markets and stock prices.

### How are they different to the funds investors already hold?

A traditional UK Equity growth fund aims to generate good long term returns, and outperform the UK stock market. However, an investor in such a fund should expect it to broadly follow the fortunes of the UK stock market. If the stock market falls, they should expect their investment to fall as well.

A long term investor in a traditional investment fund accepts these periods of short-term pain for the potential long-term gain. And this is where absolute return funds differ, as an absolute return investor is looking for less volatility, and returns that do not necessarily mirror stock markets.

### How are they able to profit from both the ups and downs in markets and stock prices?

Absolute return funds use a variety of different techniques. One of the most popular is the multi-asset strategy which blends traditional asset classes like equities and bonds with alternative asset classes such as hedge funds, gold or private equity. In times like now, when the mainstream asset classes are volatile or losing money, these managers at least have the opportunity to invest in assets delivering positive returns

Traditional funds invest in equities, bonds or property. Such funds are known as “long only” funds, they buy a share with the expectation that the asset will rise in value and can then be sold for a profit. Absolute return funds are able to make money from share prices falling as well as rising.

The fund manager is able to “short a stock” or “go short” where they believe the price of the asset will fall.

Here is a simple illustration of the way a 'short investment' works:

A fund manager identifies a share which they think is overpriced and expect it to fall.

An agreement is made to sell 10,000 shares at £5 each = £50,000.

At this time, the shares are not physically owned, but the manager is required to provide financial cover that they will be able to pay for them.

Six months later the same shares can be bought at £2.50 each. So the fund manager buys them for a total of £25,000, making a profit of £25,000.

If the reverse had happen, and the cost of the shares had increased by £25,000 over the period, the fund manager would have lost £25,000.

Not all funds are allowed to sell shares they do not own so they use a process known as "synthetic shorting" which allows them to benefit in the same way. This is a process using financial derivative instruments to create the exposure to the price of a stock rather than physically holding it.

Another strategy used is "pair trading". This seeks to benefit from the fund managers ability in stock picking. In the same industry sector, the manager thinks company A is a very good investment and that company B is overpriced. The manager therefore buys shares in company A and goes short in company B.

The manager is looking to exploit the difference in performance of the two companies. The ideal result being company A goes up in value and company B falls, resulting in a good profit. This strategy is not just limited to this. To make money company A simply needs to outperform company B. Therefore the fund manager can make profits using their stock picking skills in all market conditions.

Absolute return investing is therefore based on the combination of long and short investments.

## What are the advantages and disadvantages of this approach?

*The main advantages of an absolute return fund are:*

- Aim to provide a consistent return in all market conditions
- Lower risk than some traditional funds
- More consistent returns as not reliant on the market direction
- Highly regulated unlike hedge funds
- Daily dealing, allowing greater liquidity

*The main disadvantages of an absolute return fund are:*

- Highly dependant on the ability of the manager and supporting team
- Performance may lag or be restricted in a rising market, although it should still give a positive return.
- There is no guarantee that the fund will achieve its objective and therefore, could deliver negative returns.
- Different funds have different definitions of when they will deliver the absolute return. There are a significant number who would normally expect to deliver absolute (more than zero) returns on a 12 monthly basis. There are, however, managers who look to achieve their returns over three or five years, or more vaguely 'a complete market cycle'. This is important as it should be noted that a significant number of this style of fund have lost money over the 12 month period to 31 May 2009.
- Performance fees. A particular difference to traditional funds is that some managers charge a performance fee in addition to the annual management charge, subject to achieving a specified level of performance. The fee is a percentage of the growth above a performance target.

Whilst Absolute Returns could be the ideal core part of a portfolio, if not thoroughly researched investors could expose themselves to risks and returns that they were not expecting. We therefore believe it is essential that investors seek professional independent financial advice before making any decision to invest.