INTRODUCTION

FUNDS THAT REALLY DO WHAT IT SAYS ON THE TIN

With investors looking for less risk than the market offers, and disappointed by hedge funds that aren't really 'hedged', absolute return products are starting to come into their own. And the Ucits III regulations have meant they now have a much broader audience, writes Yuri Bender

Insight Investments, the funds arm of the HBOS group, whose distribution outlets include Halifax and Royal Bank of Scotland, is beginning to enjoy some success in selling its absolute return range of products in Europe.

The London-based group, which oversees client assets worth £110bn (€138bn) is only now seeing appetite for these type of alpha-seeking, non-benchmark funds really starting to develop, as investors take stock of uncertain markets, says Andy Cawker, Insight's head of UK equities. Assets in Insight's absolute return products, including its Dublin-registered Ucits III fund, which targets a return of cash plus 4 per cent, have just overtaken the £150m mark.

HEDGE FUNDS THAT DON'T HEDGE

Mr Cawker believes that in a world of misnomers, there is at least one key, overarching attribute which must be present for a product to be classified as 'absolute return.' The fact that in conversation, he freely swaps the term with the label 'hedge fund,' gives us a big clue to his viewpoint. "In theory, hedge funds are supposed to go up when the market goes down, but in reality, many have posted bad returns," comments Mr Cawker. "The problem is that they were not actually hedged. What is important for us, is that a hedge fund does what it says on the tin. For every 'buy' position, there must also be a 'sell'.

"Investors have been telling us that there have been a lot of funds promising 15 or 20 per cent returns. So when we have been offering cash plus 4, which amounts to 9 per cent, they say 'thanks very much, but there's the door'."

But now that investors are seeing the high leverage and exposure that goes with the promised blockbuster performances, they are being forced to look at volatility, which means comparing risk-adjusted return profiles of a fund with those of the market in general. This allows them to pick a fund which is less risky than the market, yet uses stockpicking to perform just as well in the long-run.

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Insight uses its own fundamental research as part of its investment process. An example would be Dana Petroleum, on which its oil analyst issued a favourable note back in January, highlighting earnings per share potential, and up and coming newsflow expected over the next six months. After looking at such recommendations, says Mr Cawker, most funds would provide a list of long favourites and a list of stocks they want to short. "You end up with a load of risks, which you then need clever computer programmes to hedge out," he says.

But with the fundamentalist, 'puritanical' approach espoused by Mr Cawker, the idea is to separately hedge out risk for every particular stock. One option was to buy Dana and then sell the FTSE 100 or FTSE 250 indices, to strip out the move in the Dana price attributable to the market. But in reality, decided Mr Cawker, the Dana share price was more exposed to the oil price than the stockmarket. So the decision was to buy Dana and take a short position on the oil sector in general.

Currently, the fund is also long on the FTSE 100 and short on British Land, as part of its bearish position on commercial property. "We are shorting the stocks we see least value in; that does not mean we are saying they are bad companies. It's just the sector and the fact that we don't like property."

These types of products have only really taken off since the introduction of the European Ucits III regulations, which have meant strategies previously only available as Cayman-based offshore hedge funds, have been able to be repackaged as 'absolute return' funds for a much broader, onshore European audience. "In terms of opening the market, Ucits III has made a huge difference,"says Mr Cawker.

CONTRACTS FOR DIFFERENCE

Another way that Insight might hedge a position is by matching two stocks, or pair trading.

Groups such as Sarasin, the Swiss private bank, do this through purchasing derivatives known as contracts for difference (CFDs).

"We can have the short experience through a CFD, essentially trading two similar shares, one with superior prospects to the other," reveals Rupert Tate, head of the IIID fund range, launched by the Swiss group in 2006, specifically to take advantage of new investment powers granted in the Ucits III legislation."You have a short exposure to the one you expect to underperform, through a CFD. This allows you to achieve absolute return without market risk, only stock risk."

This use of derivatives to generate alpha, rather than purely for efficient portfolio management, may be utilised in further launches, though plans for a new emerging markets fund appear to have been shelved for the time being. "We will be taking a similar approach, saying you may like an asset class, but you may want to invest with lower volatility, downside protection and active management of net market exposure through cash allocations," says Mr Tate.

Through this approach, Sarasin can now cater for private clients looking to add 3.5 or 4 per cent on top of a cash or inflation benchmark, something that was not possible before, unless a client went into a long-term lock-up hedge fund. Sarasin is sticking with its long-term big-picture investment themes of corporate restructuring, global convergence, pricing power, intellectual property and security of supply. But it is following these themes by limiting equity exposure and giving investors extra protection.

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RUPERT TATE, SARASIN

The policy of using derivatives to reduce volatility has also been taken on board by Henderson, among others, where hedge funds are now very much integrated into the European distribution machine. Henderson is using its experienced hedge fund managers to run funds in the retail space.

"We wouldn't let a fund manager use derivatives in a retail fund unless they had demonstrable experience in doing so," says a Henderson spokesperson. "The best hedge funds give you the opportunity to make money in up and down markets. In theory, it is the same in the retail world, but only in the hands of a talented manager. Derivatives for many years have been seen as the baddies, but in the right hands they can enhance performance and lower costs."

Managers such as Threadneedle have indeed avoided this area of absolute return in equity management, while choosing to remain in traditional hedge funds, and adopting an absolute return approach in fixed income.

"In the equity space, the absolute return long-short product is really a 'hedge fund lite' product, as they are not leveraged as much as proper hedge funds," says Celeste Dias, investment specialist at Threadneedle. "We have not done it at Threadneedle, as it is not necessarily the space we want to play in." There may be a worry that at Threadneedle, as in other groups with a similar dilemma, that if they are to dabble in the new area, it could compromise the success of long only and hedge fund businesses with a healthy track record.