INTRODUCTION

ABSOLUTE RETURN SLOWLY COMES INTO FOCUS

The concept of absolute return is gaining popularity even as its precise definition remains elusive. Elisa Trovato speaks to industry experts to clarify what it is and how to use it

Having grown in popularity during the equity downturn at the beginning of the decade, absolute return products have since earned their pivotal position in investors' portfolios because they stabilise volatility, as well as offering diversification.

But investors tend to mistake them for the panacea for all market risks, as if managers, finally free to operate outside benchmark constraints, can offer a sure guarantee against capital losses.

The truth is that the concept of absolute return is still vague, and has come to embrace anything from a bond-type product to a hedge fund. This can lead to some misunderstanding and concern, say industry experts.

"If you ask 10 different professional managers what an absolute return product is, you will receive 10 different answers," says Marco Pirondini, global chief investment officer at Pioneer Investments in Milan. "Absolute return products represent one of the most interesting trends of these past years, but what I see in the market is quite scary. The term absolute return is abused. It can include everything."

Periods of negative markets will expose those funds, which are aligned to the absolute concept in no more than just their labelling, believes Mr Pirondini. "Many funds will not be able to keep their promise and will suffer heavy losses. And this could spoil the name of absolute return," he warns.

Pioneer Investments adopts a multi-strategy approach in its suite of absolute return products, worth €10bn out of the group's €220bn total in assets under management. Aiming to deliver up to 200/250 basis points more than bonds in the medium term, depending on the risk profile, these products represent an evolution of the traditional concept of balanced products, including 50 per cent equities and 50 per cent bonds, says Mr Pirondini.

Pirondini: opinions vary among professional managers on what constitutes an absolute return product

"They aim to deliver similar returns [to those of balanced products], but with a volatility decisively lower. And this is possible only by employing a high number of different strategies, uncorrelated between them."

Combining 15 to 20 uncorrelated strategies and asset classes in a single portfolio enables the manager to deliver more stable returns and address "the biggest problem" that investors have: volatility. This concept is very appealing especially for European clients, who are still newcomers to the equity world, reluctant to abandon the traditional fixed income safety, says Mr Pirondini. "These products can help clients to bridge the gap between the two worlds in a simpler and less volatile way," he says.

The extraordinary acceleration and development of markets has opened up new investment opportunities. "Large asset managers can now invest significant amount of money into new sophisticated strategies, which was not even conceivable five years ago," says Mr Pirondini.

Under the competitive pressure of hedge funds and private equity, the traditional long-only world has started exploring less liquid asset classes, thus benefiting from the extra return given by the lower liquidity.

"This is one of the aspects of convergence between the hedge and long-only space," says Mr Pirondini. "Strategies such as arbitrage on convertibles, trading strategies on currency or volatility, real estate, distressed assets, exposure to credit risk in all its forms are all included in these absolute return products."

The impressive growth of derivatives, in addition to that of new asset classes, enables a level of flexibility in managers' strategies that it was not possible before, continues Mr Pirondini. The new opportunities offered by Ucits III legislation have further contributed to this flexibility. But these new technical instruments can also represent risks for those who cannot manage them, he says.

"Only those asset managers able to manage multiple strategies and asset classes can implement this approach to absolute return," he says. "It's not something that the small boutique, specialised in one thing and very good at that, can offer."

Mr Pirondini has no problems in admitting that in its three Italian absolute return funds of funds "Evolution" launched in mid-2006, Pioneer employs external managers, when the group can identify a particularly good manager, excelling in a strategy or in asset class not available internally.

The products, with three different risk profiles, make the most of the new opportunities offered by Ucits III and employ new asset classes such as private equity and hedge funds. The company also has

Views on new instruments in the fixed income armoury

The possibility to short, given by Ucits III legislation – to sell a security that is not owned when the price is expected to fall, with the view to buy it back at that time to make a profit – has offered managers interesting new instruments to implement their ideas even in fixed income, which is traditionally seen as the rather safe part of an investor's portfolio. Companies such as ABN Amro Asset Management have focused principally on the fixed income space to provide absolute return products.

Pure absolute return bond funds represent the logical next step from managing enhanced cash funds, explains Anne-Sophie Girault, global product specialist for absolute return at the Dutch house.

The company has enjoyed much success with its Ucits III absolute return bond fund, which, since its launch in 2005, has topped €2.5bn, of which €2bn was gathered in 2006, explains Ms Girault. The fund benefits from the combined input of five different teams: interest rate, credit, high yield, emerging and foreign exchange.

"The tools that managers can use to implement their ideas represent the very big difference between traditional long-only funds and absolute return funds", she says. "If you are convinced that that the outlook is negative for a corporate bond, in an absolute return environment you can go short, so that you can perform positively even when that bond is going down."

Shorting therefore represents another source of value, as opposed to not getting any detraction from not owning that bond in a long-only traditional fund, says Ms Girault.

But not all managers agree. Theodora Zemek, head of fixed interest at New Star, says: "I don't think that absolute return, in the sense of going long and short, makes a huge amount of sense for bonds. It makes more sense for equities, although I don't think that equity fund managers are necessarily better at it than bond fund managers."

Ms Zemek, who is rated AAA manager by mutual fund

Girault: do not treat absolute return like long-only

tracker Citywire, points out that 80 per cent of managers in the market consistently make bad judgements and lose investors' money. "My view is that if people are so bad at getting their performance right on a long-only fund, giving them greater powers is not necessarily going to mean that their performance improves, it probably means that is going to deteriorate."

In other words the wonders of Ucits III, as far as bond funds are concerned, have been "over-glorified", according to Ms Zemek. "Bond products are fairly simple, retail investors want a reliable income stream. Being able to short bonds makes the fund probably more volatile, because you can lose a lot if you get you bet wrong. And of course, if you sell something and it does not go down, you still have to pay out your borrowing at a very high rate, when you are shorting it."

a range of total return funds in Luxembourg, investing in securities only.

As to whether distributors appreciate the increasing level of complexity used in these products, Mr Pirondini says: "European distribution channels are becoming more and more sophisticated. The process of institutionalisation of retail sales is growing. More and more, investment professionals are not just interested in past returns but how managers get to those returns."

Past performance is the worst indicator in fund selection, accounting for just 30 per cent weight in Pioneer's third-party selection process, says Mr Pirondini. Analysis shows that selecting the top 100 funds for past performance or the worst 100 makes no difference in the portfolio, he says.

DIVERSIFICATION THROUGH ALTERNATIVES

Strategic diversification as a way of producing absolute return can mean substantial allocation to alternative investments, says Jeremy Beckwith, chief investment officer at Kleinwort Benson private bank, a wealth management company which comes under the Allianz umbrella. Mr Beckwith explains that extensive work with Morningstar consultant Ibbotson Associates has generated allocation models with "weighting of well over 40 per cent in alternatives, most of them in hedge funds but also in property and commodities, and some in private equity".

Tactical asset allocation is an effective way to add return, "for example by using options that gives protection in the downside and exposure to the upside in certain markets". The UK-based bank offers its customers absolute return funds, targeting 2 per cent above libor (London Interbank offered rate) with a volatility of five-year government bond and balanced return funds, targeting libor+4. The latter have the approximate volatility of 15-year government bonds.

"We are seeking to deliver cash+4, which is the long-term return for equity markets, but with much less risk. Less than half of the portfolio would be in equities," says Mr Beckwith.

ABSOLUTE RETURNS IN EMERGING MARKETS

An increasing number of companies have made absolute return the only focus of their investment strategy. Standard Asset Management (SAM), for example, manages the totality of its assets, $1.1bn (€826m), in fixed income absolute return products. Within that, it specialises only in global emerging markets and high yield.

The decision to focus its asset management operation in this area has been a natural consequence of being part of the Standard bank group, one of the largest banking operations on the African continent and large player in emerging markets, says Kevin Colglazier, chief investment manager at SAM.

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"Also, emerging markets have traditionally been the best-performing asset class within fixed income," he says. "We have blended high yield in our products as it is a great diversifier; it is relatively low correlated to emerging markets and has very good income characteristics."

Mr Colglazier explains that they have a bias towards corporate investing. "In emerging markets, we like the shorter-dated higher income characteristics of corporate securities versus a longer date sovereign debt."

Corporates in emerging markets represent a lower risk from a price volatility point of view, says Mr Colglazier. "There is more volatility in sovereign debt that in corporate debt now."

FROM INSTITUTIONAL TO RETAIL

Growing demand for absolute return products has led Pictet Asset Management to launch its first retail fund in this space. Leveraging its experience in managing four absolute return funds targeting institutional or high net worth clients, the company launched its absolute return global diversified, a Ucits III Luxembourg fund, in March 2006.

Gianluca Oderda, fund manager, explains that two main strategies are employed in this fund. The first strategy, alpha, involves selecting the best managers within Pictet Asset Management.

"We combine them and how much they manage, like an orchestra director, in a way to respect the risk parameters of the fund," he says. "We can give a segregated mandate to the best manager or buy funds from them, if they manage one. What we buy are pools, entities replicating the fund portfolio. The advantage is that this way we do not pay any type of commission."

The second strategy is the beta strategy, or risk premium strategy, which enables the product to have exposure to equity or bond markets through futures. "The objective is to save all the capital of the fund for the high added value or alpha strategies."

This strategy, portable alpha, has been increasingly used by asset managers in the absolute return space.