INTRODUCTION

DIPPING A TOE IN THE WATER OR MAKING A SPLASH?

The post-Ucits III environment has opened a door to a new investment vehicle in the form of alpha-generating absolute return strategies. But, as these are unchartered waters, which pioneers are willing to take the plunge? Elizabeth Cripps provides the answers

When equity markets collapsed, European investors "got the hangover but didn't have time to enjoy the party". They had, recalls Jon Baillie, of Russell Investment Group, come later than their US counterparts to the technology boom – too late for the highs to have matched the lows.

No wonder then, that mass affluent and high-net-worth Europeans are still running shy of equity. But interest rates are low and hedge funds, to many, retain connotations of very risky strategies. So what is a risk-shy, return-hungry investor to do?

Enter absolute return strategies – the "next big thing", according to Tony Stenning, director of product and client strategies at Merrill Lynch Investment Managers; something that big name UK distributor Abbey is "very excited about, and the industry ought to be", says its head of client investment, John Kelly, and, for Attilio Ferrari, managing director of Arca SGR in Milan, they are "the most interesting part of the panorama of products in the Italian market".

The European Ucits III directive has paved the way, extending the range of products permitted in unit trusts to include money market instruments, cash deposits, other funds and financial derivatives, as well as transferable securities. Products are being launched right, left and centre.

One of the latest comes from Italian retail group Arca, with investment expertise courtesy of Russell Investment Group and a target of €200m-€300m under management by the end of the year.

According to Mr Baillie, Russell's, managing director of partnerships and distribution alliances, the Arca Rendimento Assoluto t3 and t5 products involve "a collection of very diverse strategies from a diverse range of managers, trying to provide consistency in all market conditions". Up to 20 per cent will be in hedge funds, Arca's Mr Ferrari explains, with the remainder in closed end funds and non-directional products.

Baillie: assembling absolute reurn products

Russell sees this as the first of many similar ventures. "We are in discussions with people in a number of different countries about products of this ilk," says Mr Baillie. "We are assembling these Russell products in some combination to offer absolute returns."

At the other end of the scale, a huge pan-European house, Crédit Agricole Asset Management has added three absolute return sub funds to its international flagship umbrella fund: the volatility-focused CA Funds Dynarbitrage Volatility, CA Funds Dynarbitrage Forex, which focuses exclusively on currency, and an actively managed inflation-linked bonds portfolio, CA Funds Arbitrage Inflation.

Until U III, says Merrill's Mr Stenning, it was "pretty much impossible" for traditional fund managers to provide genuine absolute return products. "Some did by bending the rules, but it was very much frowned upon. In essence, we found in the fund management industry that we had one hand tied behind our back. For unit holders we could offer relative returns only, long only products. Most were bull market fund ranges."

The problem, of course, is that bull market fund ranges lose their charm in bear markets. Since the turn of the century, individual investors, always naturally inclined to be absolute return-orientated, have abandoned their 1990s fling with relative returns and become obsessed, all over again, with risk. "The investor's benchmark is always cash," says Tristan Mawdsley, head of UK retail sales at UBS. "That's where they start from mentally."

Mr Ferrari adds the Italian perspective: "Italian families have been in a lot of pain subscribing to funds with benchmarks, without proper consulting for the risks they took in starting a portfolio. Now, people are very concerned about risk. They want to have better consultancy, or products with the consultancy process embedded in them."

Private investors, from the mass affluent up to the ultra-wealthy, vary in sophistication. But they have one thing in common: a desire to hold onto their money. The individual clients of specialist house GAM, which runs $12.5m (€10.5m) in its absolute return strategy, "have taken a lot of risk to generate their wealth and want a conservative approach as they approach retirement", according to portfolio director and team head James Fairbairn.

These, says Mr Mawdsley at UBS, are individuals who have acquired, or inherited, large sums of money and want to protect it. Accordingly, he says, they tend to be risk averse but with perhaps some risk "around the edges".

It is easy to see how attractive absolute return strategies would be to this type of investor. "This is potentially a very big game indeed," says Abbey's Mr Kelly. "Who is our affluent customer? They are typically middle-aged, with generational-transfer achieved wealth. That money can't be capital at risk. Because they are at the stage where they are past peak earnings, the change of their replacing the money is very small.

"This is why there is a mismatch between the products on offer and uptake by the public. The traditional response is that the public doesn't understand the products, but you can just as well such that they do. They understand only too well what an equity income fund is, and they don't want it."

Absolute return strategies, on the other hand, provide investors with "capital guarantees and returns based on something they understand – cash". They are, Mr Kelly says, "becoming the products of choice for large sections of the market".

LEARNING THE ROPES

But with the newness of the market comes the need for greater clarity – and some careful navigation. "A number of issues still need to fall into place," warns Mr Stenning at MLIM. "Taxation issues, for example. In certain areas, things are still a bit up in the air. We will need to look at things on a case-by-case basis. Pioneers can end up with arrows in their backs so a number of people are sitting and watching before dipping their toes into the water."

"ABSOLUTE RETURN STRATEGIES PROVIDE INVESTORS WITH CAPITAL GUARANTEES AND RETURNS BASED ON SOMETHING THEY UNDERSTAND – CASH"
JOHN KELLY, ABBEY

Abbey's Mr Kelly says: "There is tension across the industry with innovation and getting a precise understanding of what some of these words mean. We will have to see the regulatory progress stepping forward as people understand that they can structure products to equal out a lot of the apparent risks. This is something regulators and a lot of the distributors have to understand."

From the distributor's point of view, the newness of the market makes for challenging selection and marketing processes. "How do you present these?" Mr Kelly asks. "How do you market them?" The industry, he says, has tended to rely on past performance, with the inference being that managers will repeat themselves. But these products are new.

"We have to think of new ways to describe these products and different ways to distinguish ours from the rest. This is difficult as the concepts behind them are quite simple. There are quite interesting dynamics on the economics of distribution which are not yet understood."

The selection of the products is no easier. Abbey plans to launch in the new market later in the year, but is aware of the pitfalls. "It is very important to design it right," says Mr Kelly. "We are looking at lots of products, from lots of

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TONY STENNING, MLIM

potential suppliers, singly and in combination. They are not all as tested as we would like them to be.”

NEWER, BETTER, SAFER

There is no doubt that these are the products of the moment. But what makes them so much better than the other routes open to investors wanting absolute returns? Investing directly, for example, in hedge funds.

Hedge funds are still, especially to nervous investors, associated with extreme risk, and are hard to get hold of even when you are prepared to take the gamble. Absolute return products, according to Mr Kelly, are “more easily sold, more easily understood”.

Mr Baillie agrees, adding: “In a number of European countries it is difficult, if not impossible, for an individual investor to access hedge funds directly, and a lot of people don’t necessarily feel comfortable investing a lot of their money in hedge funds.”

Moreover, an absolute return fund is more than a hedge fund, or any other single-stranded product. In its more sophisticated incarnations, it will often hedge funds, but it will have the flexibility to move in and out of various asset classes and use each as is most appropriate.

“We take a dynamic approach to asset allocation,” says Mr Fairbairn, of GAM. “We know what to expect from the different managers in the different market conditions. We are very happy moving between them depending on what the market requires.”

And there lies the crux of the matter. These “embedded consultancy” products, as Mr Ferrari dubs them, offer risk budgeting and allocation decisions that individual investors too-rarely have the know-how to make.

Catering for varying degrees of sophistication

What exactly is meant by an “absolute return strategy”? It seems that this term on everyone’s lips can cover anything from a bond fund to a basket of different strategies mixed and matched to each client’s needs.

The key differentiator, says Tristan Mawdsley, head of UK retail sales at UBS, is that the investments are no longer benchmarked to an index, as such. “The benchmark becomes cash or inflation and the strategy is to outperform a cash-based return,” he adds.

Within that, are a huge range of alternatives, for investors with different levels of sophistication. UBS, for example, offers a £3.2bn (€4.7bn) absolute return bond fund at one end of the scale; the £3.6bn offshore-based Dynamic Alpha, at the other. Managed by the UBS asset allocation team, this draws on strategies from across the firm’s asset management capabilities.

Merrill Lynch Investment Managers runs the Nationwide Target Return Fund, at one end, focused on equities, bonds and cash, with no derivative overlay, and its own Absolute Alpha product at the other.

GAM, according to portfolio director and team head James Fairbairn, uses “a combination of traditional asset classes – cash, bonds, equity” and also incorporates equity long/short and equity hedge funds, and non-equity correlated alternatives.

“Since the 1980s, we have employed hedge fund managers trading currencies, commodities and bonds,” he says. “Some strategies do use derivatives but we keep a close eye on the level of gearing undertaken because effectively we are employing these managers not to lose our clients’ money.”

An investment committee meets “at least weekly” to position the portfolio, and has full flexibility to put 0-100 per cent in any of the asset classes. “We move in and out depending on how we see markets,” Mr Fairbairn explains. “In 2002, at our most bearish, we had 15 per cent in equities, and of that we were very focused on bottom-up value-driven managers. Last year we increased equity exposure to 35 per cent and our long/short managers also had a net long bias.”

But, he stresses, GAM does not advocate aggressive market timing. “The graveyard is littered with market timers. More often than not you will destroy rather than add value. We tend to move at the margin, although last year we did increase long only exposure.”

Like everything else, this is a balancing act. “We are very conscious that the only way to generate the compound is to get the call on equity markets right,” says Mr Fairbairn. “But the way to destroy capital very quickly is to get that call wrong.”