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Inside an absolute return strategy

Written by: Iain Power, Chief Investment Officer at Truffle Asset Management

For investors, the idea of participating in market upside without suffering the down, is comforting.

Funds that target such an outcome are often said to be following an absolute return strategy. Understanding *how* investment managers deliver this asymmetric return profile is important in the context of financial planning. That knowledge allows for:

- deeper conversations between adviser and client;
- a better grasp of how such a strategy fits into overall portfolio construction; and
- improved ability to hold fund managers to account.

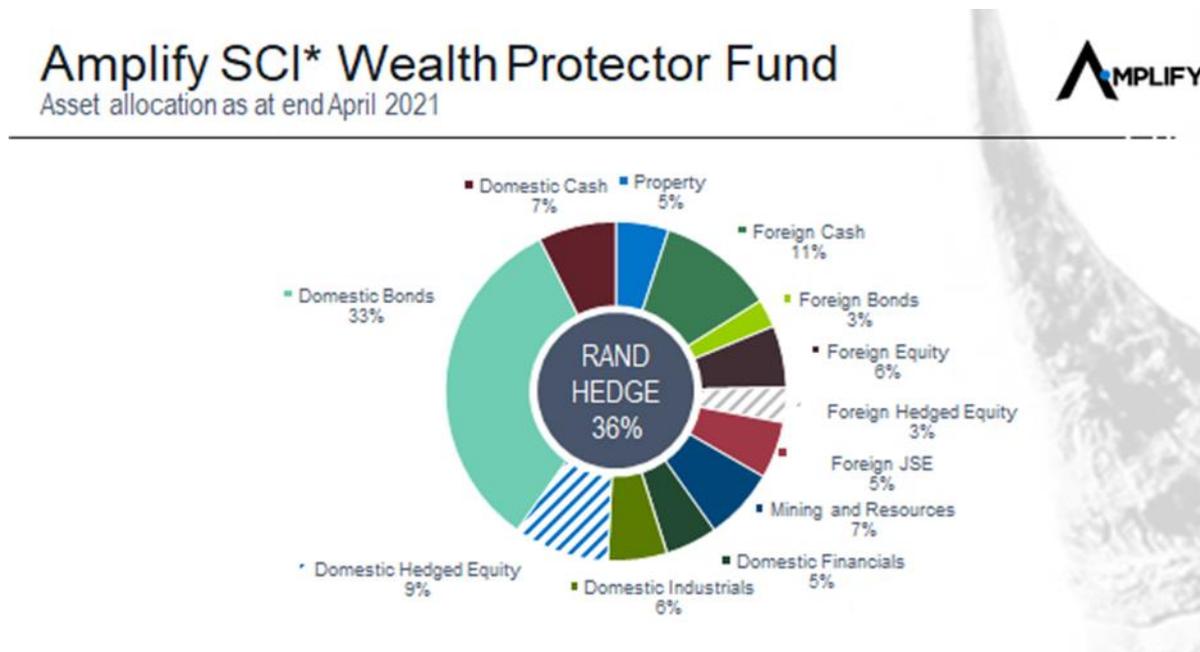
To those ends, this piece takes you inside the workings of an absolute return strategy.

Who can deliver absolute returns?

To be sure, all active fund managers want to earn asymmetric returns – if they move in lockstep with markets, passives will rightly eat their lunch. The extent to which asymmetric returns are possible is, however, often down to the mandate and limitations of the portfolio.

For example, it'd be a stretch to promise downside protection in a long-only equity fund because everything can go down at once a la Q1 2020. The obvious exception to this rule is long/short equity hedge funds; they have necessary tools to deliver absolute returns.

Outside of hedge funds, absolute return strategies tend to be multi-asset in nature because they need the benefits of diversification and active asset allocation to effect downside protection. We include the graphic below to illustrate what a multi-asset strategy with an absolute return focus might look like.



*Sanlam Collective Investments I Source: Truffle Asset Management

Still, the SA multi-asset fund universe is large, which leaves the door open for many to claim an absolute return investment focus. But there are subtleties central to an authentic absolute return strategy that can help you differentiate between the pretenders and the professionals.

Sacred principal

Where and how do I invest so that the return of the principal amount is all but guaranteed?

That's the starting point for genuine absolute return strategists. In building conviction that a potential investment has that defensive and desirable characteristic, fund managers will, broadly speaking, focus on two areas.

Margin of safety

The mean reversion of asset valuations is one of the most powerful forces in the world of investing. Unlike the workings of traditional gravity, the pull towards the mean gets stronger as the asset drifts further from its long-term average. An asset whose valuation has fallen well below its mean is, therefore, a natural bedfellow for an absolute return investor; the probability that it falls further, eroding the principal, is low.

Here it's important to highlight why *relative* valuation methodologies don't offer the same level of downside protection. By definition, relative valuation is established by comparing the valuations of two assets against each other, and then – we're oversimplifying here – picking the one that looks the cheapest. However, if both assets were expensive against their own averages to start with, then either one of them has the potential to incur large principal losses as it falls first to its mean and possibly beyond.

However, it's critical to understand that even an attractive absolute valuation is not enough to secure the principal; long-term average valuations of any asset will be overlooked by the market if the fundamentals of the investment are deteriorating.

Fundamental support

Attractive price-to-earnings (PE) or dividend yield (DY) ratios of an equity or property counter only matter if the underlying earnings of those businesses are sustainable. Similarly, the yield on a bond must be looked at in conjunction with the creditworthiness of the corporate or government that has issued the paper.

Establishing conviction that these fundamentals are strong enough to uphold the gravitational pull of the mean is, arguably, the most challenging piece of the puzzle. Forecasting earnings is an order of magnitude harder than calculating a PE ratio. It would not be unusual, therefore, for managers following an absolute return strategy to be drawn to businesses and borrowers that have a track record of producing steady cashflows.

As is the case for every style of investing, pushing the 'buy' button is just the beginning. To deliver consistent asymmetric returns, absolute return style investors must manage their positions carefully.

Taking profits and using protection

Capital protection is obviously not the only goal of an absolute return strategy. Turning to the Amplify SCI* Wealth Protector Fund as an example, capital protection is indeed targeted over any rolling 12-month period. However, the Fund also has a CPI+3% benchmark that it aims to deliver on over any rolling three-year interval, while simultaneously producing income in the medium term.

Broadly speaking, a fund manager following an absolute return strategy strives to acquire assets with valuation support (to limit downside potential) where the potential exists for the underlying fundamentals (earnings growth, creditworthiness) to then improve. Such an outcome is, arguably, one of the most effective ways to generate powerful investment returns.

However, even if that exciting scenario unfolds, the portfolio manager presiding over the absolute return strategy is likely to be circumspect.

They know that as an asset gets closer to, or exceeds its historical average valuation metrics, the risk of the trend reversing increases proportionately. So, many will take profits on their winning positions as they approach or move beyond their mean valuations, recycling the proceeds into other assets with greater upside potential and more downside protection.

Of course, if their research leads them to believe that the fundamentals of the investment in question are improving, thereby justifying a higher valuation than the mean might suggest, they have the flexibility to maintain the holding rather than selling it outright.

Absolute return strategies will often make use of derivatives to reduce risk when an asset class as a whole becomes expensive. For example, instead of selling a percentage of all the shares they own because they believe the JSE All Share Index has run too hard, they can deploy a single instrument that will profit from a fall in the market, providing the necessary downside protection. The same can be achieved in other asset classes like fixed income.

Benefits and suitability

With the above in mind, what are the benefits of an absolute return strategy and who is it best suited to?

Implementing a strategy like the one we've discussed above should give investors access to a return stream that exhibits low volatility and has enough upside potential to generate real returns. In our minds, that makes it appropriate for the retail investor who has an investment horizon that warrants downside protection, but who also needs to be shielded from the corrosive effects of inflation.

Even more specifically, clients who gravitate towards the practice of mental accounting, where they prefer to ringfence certain portions of their wealth to achieve specific goals – like paying for education or saving up for a deposit on a house – would find it particularly useful.

Glacier Research would like to thank Iain Power for his contribution to this week's Funds on Friday.



Iain Power
Truffle Asset Management

Iain Power manages the Amplify SCI* Wealth Protector fund and has been part of the Truffle team since 2010. He began his career at RMB Asset Management in 1993. In his 16 years with the company, Iain has held various positions including serving as a member of the Board of Directors and the Management Board. He also fulfilled the role of a senior investment professional in the equity team. Iain's move to Truffle was part of his decision to move from a corporate environment into a smaller asset management business where he could be part of building a larger an owner-managed business.