



24 November 2023
Volume 1208

Absolute Return Funds

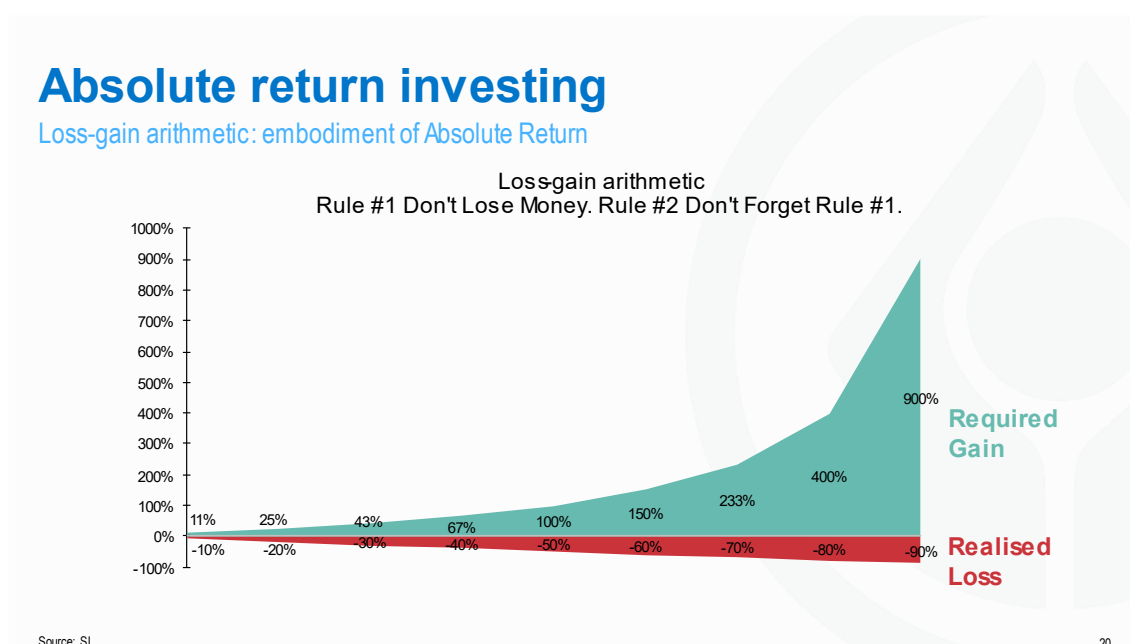
Author: Fernando Durrell, Portfolio Manager, Sanlam Investments

“Asset classes are volatile, and depending on when one buys or sells these, your experience could be very different. Absolute Return Funds are risk-managed funds with one of their aims being to mitigate this entry point risk.” – SIM Absolute Return

The Absolute value is a concept taught in high school and is closely related to how Absolute Return funds were named. The aim of these funds was to generate returns equal to their absolute value; the only returns (or values) equal to their absolute value are positive returns. Thus, the aim of these funds was to generate only positive (or non-negative) returns. Alfred Winslow Jones (an Australian investor) is credited with creating the first Absolute Return (AR) fund in 1949.¹

The importance of not experiencing negative returns is depicted in Figure 1 below. For every percentage loss, an investor needs to generate a corresponding order-of-magnitude greater positive return just to recoup what was lost, let alone the growth missed out on. So, if one's portfolio loses, say 10%, then one has to make +11% to break even; lose 30% and one has to make 43%, and lose 50%, and one has to make 100% to get back to one's original value.

Figure 1: Importance of minimising drawdowns (or negative returns).

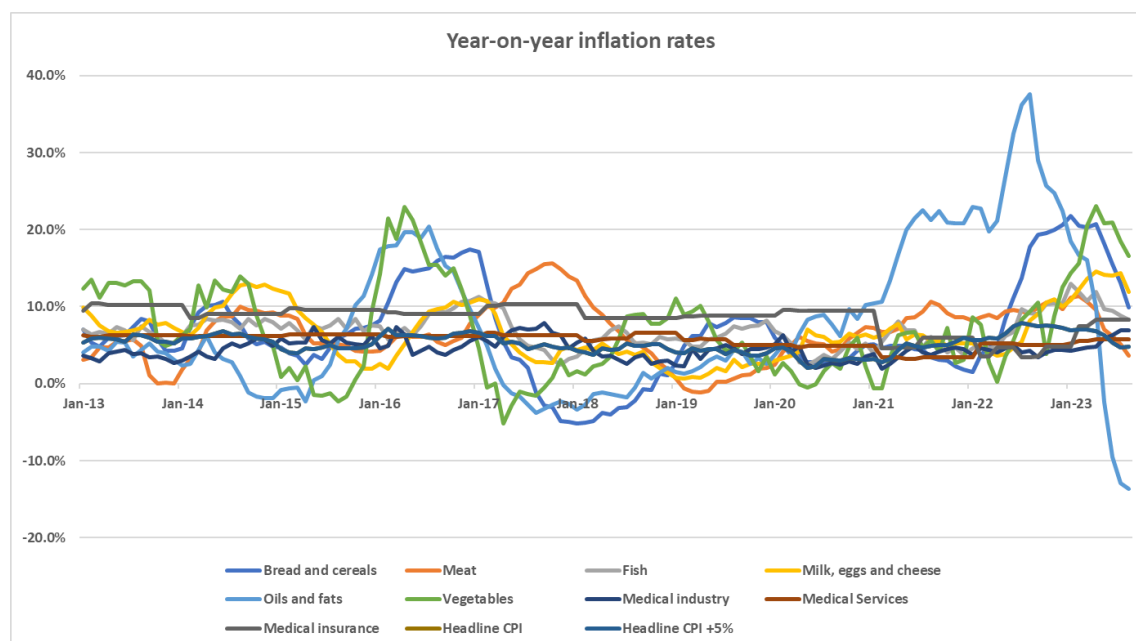


Cost of living adjustments

One could argue that the primary purpose of investments is to create wealth for their owners over a desired period. When we consider increases in the cost of living (inflation), we deduce that investors actually desire investment returns that can keep up or outpace inflation, i.e. positive real returns. Below (Figure 2) we depict South African inflation (SA CPI) for various categories, and we notice that most of the categories reside within the SA CPI+0% to SA CPI+15% range. This is why most mandates awarded by SA clients specify these return thresholds between 0% real and 7% real, depending on the client's specific cost of living adjustment and risk appetite.

¹ Investopedia (<https://www.investopedia.com/terms/a/absolutereturn.asp>)

Figure 2: Various SA CPI categories, SA headline CPI and SA headline CPI+7%.



Absolute Return and portfolio construction

Now, most Absolute Return targets, refer to as Inflation + x% or Cash + x%; the point is that these benchmarks being referred to, are not investable, i.e. there are no groups of securities one could buy, to exactly replicate the performance of these benchmarks. As an aside, most equity-only or fixed income-only benchmarks are investable, i.e. one can buy all instruments in the benchmark and be guaranteed to replicate the benchmark's performance exactly (before costs). Moreover, the value of an investable benchmark is that the manager knows, at any point in time, the required instrument exposures to be able to create a neutral positioning, i.e. be able to create a portfolio guaranteed to deliver the performance of the benchmark (before costs). In many multi-asset portfolios, of which Absolute Return funds is a subset, the benchmarks are not investable. So the Absolute Return manager does not have a natural neutral portfolio to invest in (in the absence of strong views). The Absolute Return manager needs to create this neutral portfolio, which is referred to as a Strategic Asset Allocation (SAA), from scratch; the SAA is the best buy-and-hold portfolio over time to achieve the client's target. Creating an SAA requires skill; portfolio construction skill. It also requires the skill of generating expected returns for all asset classes in the client's investment universe, let alone appropriately deciding on the most appropriate investment universe. The human mind can generally cope with a two-asset investment universe. Still, as more and more assets are added, the multidimensionality of the problem overwhelms the mind, and we need computers to be able to solve those sorts of complex problems.

An SAA is not always the most appropriate allocation to employ, as it frequently has a relatively higher exposure to risky assets, and this is why Tactical Asset Allocation (TAA) is so critical to multi-asset portfolio management. Market participants frequently over- and under-react to market events, and TAA in the presence of these market participant reactions, provides an Absolute Return manager with the opportunity to mitigate risk and add alpha. Again, generating an appropriate TAA requires distinct portfolio construction skills.

Now, asset classes are market directional instruments, in the sense that if you hold these and their values go up (down), then that component of your portfolio value goes up (down). In steps derivative securities, some of which have the characteristic of asymmetry, where, even if the underlying instrument's value on which the derivative is based falls by a lot, the derivative's losses can be notably contained. Incorporation of derivatives in a client's portfolio requires experience, skill and tactical ability in being able to manage the derivative exposures.

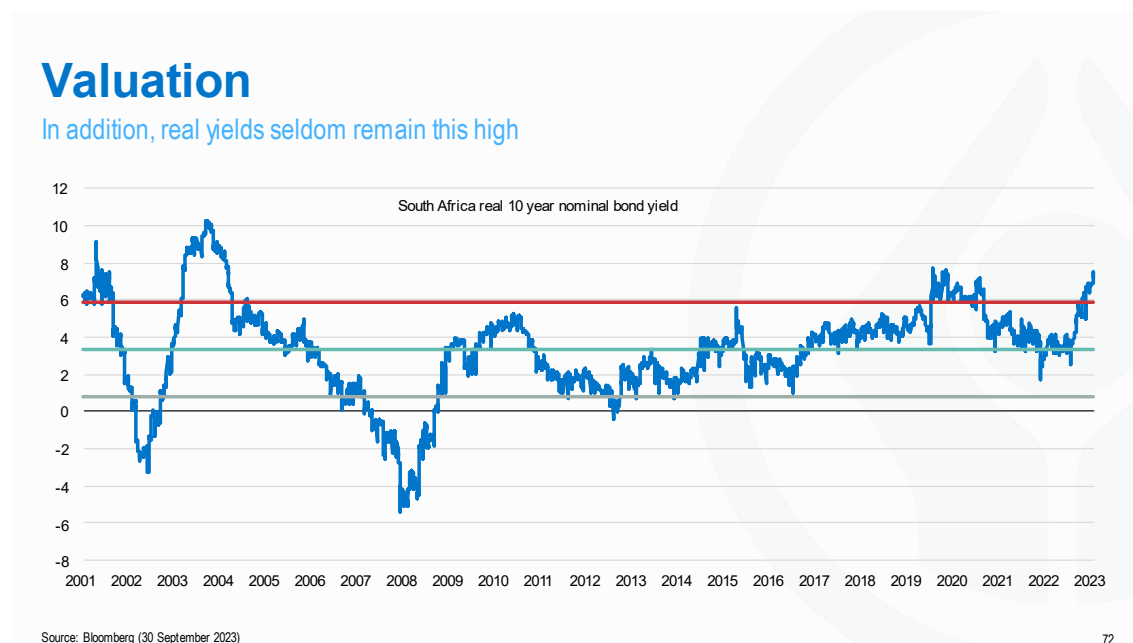
Current environment

Given the surge in inflation, global interest rates have also increased notably, making the real returns from interest bearing asset classes very attractive. This current environment of high SA real yields, historically, hasn't lasted long, however (see Figure 3), and it is the exception and not the rule that fixed income assets are providing such solid returns. These interest-bearing assets currently provide a fertile hunting ground for Absolute Return managers in the achievement of clients' real return targets.

On equities and property, through the cycle, one can expect higher real returns from these assets, but with greater risk. The current environment of higher rates for longer, geopolitics, recessionary risks and slowing earnings, provides significant headwinds to equities and property, however.

Global (i.e. local plus foreign) cash and bonds yields are now quite attractive in both absolute and real terms, at generally lower risk.

Figure 3: South Africa real 10-year nominal bond yield



In closing, risky assets do provide solid real returns over the long term, but they come with significantly more risk. Absolute Return funds, at a minimum, aim to mitigate entry point risks due mainly to the higher volatility of growth assets, permitting investors to better plan for the future. Well managed Absolute Return funds provide investors with a full complement of investments, which can be combined towards the achievement of the client's target, by actively managing risk.

Glacier Research would like to thank Fernando Durrell for contributing to this week's *Funds on Friday*.

Fernando Durrell
Portfolio Manager
Sanlam Investments

In May 2018, Fernando became an Absolute Return Portfolio Manager at Sanlam Investments. Before this role, he served as the Head of Multi-Asset at Vunani Fund Managers, accumulating extensive experience in researching and implementing strategic and tactical asset allocation in multi-asset funds. Fernando also has a background as a Senior Quantitative Analyst and Portfolio Manager.

Before venturing into the financial services industry, Fernando lectured on Numerical Modelling and tutored Financial Mathematics to Master's students at the University of Cape Town. His academic achievements include a Doctorate of Philosophy in Mathematics, a Master's of Science in Financial Mathematics, and a Bachelor of Science in Mathematics and Applied Mathematics, with honors in Applied Mathematics. Additionally, he holds the Chartered Financial Analyst charter and has successfully completed level one of the Chartered Alternative Investment Analyst Association exam.

