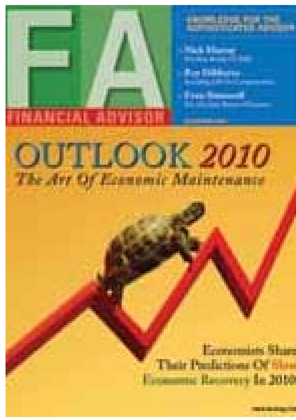


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## ABSOLUTE RETURN OBSESSION

*With the correlation landscape changing, this strategy is growing.*

By Evan Simonoff

At Morningstar's annual conference earlier this year, the firm's research director Don Phillips asked Vanguard Group founder John Bogle what he thought of the rising popularity of absolute return funds.

"Absolutely not," Bogle groused.

Purists recoil viscerally at the term "absolute return," voicing suspicion that it subliminally imparts a message to investors that they can earn equity market-like returns with little or no risk. Those who want to limit their risk should limit their positions to assets like equities and commodities, as well as long-term and low-grade bonds, they argue.

Confronted with razor-thin yields on risk-free instruments like short-term Treasurys, many advisors and their retired clients find those arguments impractical. So it's not surprising that a smorgasbord of strategies using the absolute return name, strategies that have been employed in the pension and hedge fund worlds for several decades, are sprouting up in the advisor space. Two 50% freefalls in equity prices in the last decade have conditioned investors of all stripes to look hard at vehicles claiming to offer some form of downside protection.

Investment companies like AQR, Putnam Investments and Rydex SGI all have introduced variants of the strategy for advisors and their clients. Some advisors like Legend Financial's Lou Stanasolovich, Financial Advantage's J. Michael Martin and Levitt Capital's Robert Levitt, have created their own alternative strategies.

What, exactly, does absolute return mean? Putnam CEO Robert Reynolds defines it as an "all-weather" strategy that is "totally uncorrelated to relative return products." Large institutions and wealthy institutions, he adds, have been investing 25% to 50% of their assets in such styles.

Reynolds believes these funds could capture 20% of all mutual fund assets, as aging baby boomers enter retirement. "You don't have to go to all bonds in retirement, which raises the risk of longevity, or outliving your money," he adds.

Implicit in the absolute return mantra is capital preservation, but that doesn't mean managers believe positive—or uncorrelated returns—are certain. In the stress-filled second half of 2008, many absolute return hedge funds saw their betas climb from their 0.2 targets to the 0.8 area. This included market-neutral funds, a subset of the absolute return universe, which aim for a zero beta. Few of these vehicles wound up in positive territory last year, though most limited their losses to less than 20%.

What the 2008 experience exposed was the pitfalls of the investment management industry's obsession with relative returns. Suddenly, beating the S&P 500 Index by 10% wasn't worth trumpeting.

AQR's CEO Cliff Asness describes absolute return as an attempt "to generate positive average return that is uncorrelated with the major traditional markets. It's not that you make money all the time. That type of investment never exists."

Asness continues to explain that absolute return is designed "to make you money on average and [act as] a very good diversifier." It's not risk-free, but it does reduce portfolio risk by "moving independently of the overall market."

Although the absolute return concept came out of the hedge fund world, advisors might be surprised that many of these vehicles set their performance bars relatively low and don't try to shoot the lights out. Single-digit return targets are common, and some funds claim they try to beat short-term Treasurys by a modest 100 or 300 basis points.

More than a few of these strategies emerged out of academic research. AQR's Diversified Arbitrage Fund is managed by Mark Mitchell and Todd Pulvino, two finance professors who have taught at the University of Chicago, Harvard Business School and Northwestern. They spent years in the 1990s building a merger and acquisition database that tracked every public deal going back to 1963, and they included deals that failed to be consummated. After completing the database in 2001, they hooked up with AQR to pursue merger arbitrage strategies in a joint venture called CNH. They also started building a convertible bond database.

Unlike The Merger Fund, which focuses largely on investing in public mergers, AQR's Diversified Arbitrage Fund has the flexibility to go into other arenas besides M&A and convertible bonds. It can invest in SPACs (or Special Purpose Acquisition Companies), and also can arbitrage closed-end funds when their prices swing to a premium or discount to their net asset values. From time to time, it even engages in dual class stock arbitrage.

This flexibility allows the fund to move money around during when, say the M&A business or convertible bond business comes to a standstill, as both markets did late 2008. Since the fund was launched on January 15, it has garnered over $150 million in assets and returned 8% as of October 31. Its goal is to be 100% hedged to systematic equity and credit risk, which makes it both a market-neutral and an absolute return fund. It hedges both "equity and credit market risk out of the portfolio, since our investors are looking for uncorrelated returns," an AQR official says.

The fund has achieved a Sharpe ratio of 2.1, which appeals to advisors. Harold Evensky, CEO of Evensky & Katz in Coral Gables, Fla., says he has started using the fund because of its risk-adjusted return numbers and the fact that "it doesn't seem to be correlated to anything else we can find."

Since the financial crisis erupted into a full-blown meltdown in the summer of 2008, the correlation landscape changed radically, with liquidity serving as the driving external force from which most financial asset prices are taking their cues. Many classes of "debt traded like equities," notes Jeff Knight, who heads up two absolute return strategies at Putnam Investments and serves as chief investment officer for global asset allocation. Everything was trading together and the markets became all "one big call option on the liquidity cycle. This year it continued but it all went the other way."

Knight runs Putnam's 700 and 500 absolute return funds, which respectively attempt to give investors returns of 7% and 5% above inflation over a three-year period. Faced with compelling investment opportunities almost everywhere at the start of 2009, Knight tried to find the safest way to beat inflation by 7%.

That led to three opportunities early in the year, starting with the broken credit markets. "Any non-Treasury bond was very cheap and oversold, but many were creditworthy," Knight recalls. Suspecting the bond market would have to show signs of healing before the equity markets could mount a recovery, he targeted fixed-income securities first.

Knight also anticipated that the record level of volatility pervasive in the equity market in late 2008 and early 2009 was unsustainable. Betting that the roller coaster would ultimately slow down, Putnam's 700 absolute return fund sold a lot of call and put options "because implied volatility was too high."

Finally, Knight tried to position the fund to capitalize on the inevitable rebound in stocks. Although the 700 fund's equity allocation reached 18% in late March and has no explicit cap on stocks, Knight saw no reason to go a lot higher.

What's significant is that pure absolute return investors couldn't care less if they didn't keep up with the roaring bull market of the last six months. "We are 4% above our return targets," Knight observed in late October. "With a 12% equity allocation, we could hit our [2009] targets even if there was a 25% correction in stocks [in the fourth quarter]."

Few firms are as explicit as Putnam in terms of stating their target returns. Knight says there is nothing to stop the 700 fund from investing as much as 50% or 60% of its assets in equities; he just sees no reason to reach for return in the current environment.

It's hard to understate the willingness of absolute return practitioners to untie themselves from the relative performance trap.

"True diversification can't just be different flavors of equities," declares David Wright, manager of the Sierra Core Retirement Fund.

Wright, whose fund fell 3.3% in 2008, maintains every investment must satisfy one of two goals: Either it must protect shareholders when storm clouds hit, or it must help the fund deliver 8% to 10% annually. That's not always easy.

Correlations are converging. Commodities used to have almost zero correlation to the S&P 500; now it's close to 0.7.

This exacerbates the challenge facing advisors. "It's going to be hard to put together a traditional asset allocation pie-chart strategy that does better than 5% or 6%," Wright contends.

Wright's Sierra fund uses computer programs to monitor and update its stop losses daily. Other advisors in the absolute return space, like Legend's Stanasolovich and Don Schreiber in Red Bank, N.J., also employ them.

When investments have gains, absolute return managers want to protect them and don't mind booking a small profit, or a large one. Financial Advantage's Martin has clients invested in medical software manufacturer Cerner, which has soared from the $30-a-share range to more than $80 this year, so he's lightened up on it.

The proliferation of absolute return vehicles for advisors is striking a chord. In addition to AQR's $150 million in assets in less than nine months, Putnam's four strategies captured a total of $700 million so far

this year.

Still, a handful of advisors are taking it upon themselves to devise their variants on the strategy. Few are more ambitious than Robert Levitt, chief investment officer of Levitt Capital Management in Boca Raton, Fla. Several years ago, he concluded that the best investment opportunities were abroad and moved to the French Riviera, which he uses as a base to scour the globe for the $450 million in client assets he manages.

We caught up with Levitt in Kuala Lumpur, Malaysia, where he was on a research trip as he pursues a thematic, global absolute return strategy. These themes include growing affluence in the developing world, an aging population, growing agricultural needs, technology and urbanization. Levitt's return goals are somewhat more ambitious, as he targets a three-year average return in the low teens.

In late October, Levitt says a typical client portfolio was up 25% after a 16% decline in 2008, when returns in foreign investments were hurt by a flight to the greenback. U.S. equities accounted for only 10.5% of the portfolio, while South America (mostly Brazil) represented 6.8%. European stocks were 8.5% and Chinese equities were 15%. However, his clients have investments in Israel, Iraq, India, Canada, Russia, Qatar and Pakistan, among other places.

Levitt says he is quick to lighten his exposure to stocks if the markets go against him. "If my clients want to get out, we'll get out," he explains. "If the markets look scary, we'll get out, even if we are wrong."

Solutions in the absolute return space are all over the map. Sanjay Yodh, managing director of alternative strategies at Rydex SGI, says his firm is broadening the suite of products to allow advisors and their clients the ability to manage risk more effectively.

Each of Rydex SGI's products—managed futures, commodity long-short and multi-hedge fund of funds—have different risk/return profiles. "It's very important for investors to focus on risk management, and we believe many alternative products can help mitigate loss," Yodh says. "These strategies need to be flexible enough to capture returns in any type of market by utilizing all the levers available, which include being able to go long, short, hedging, etc."

## Caveats Galore

Advisors relying on absolute return strategies for the lion's share of clients' portfolios acknowledge that, while clients were delighted in 2008 to suffer losses in the low teens, they've started to voice discontent since many major indexes have soared 50% or more since mid-March. Some observers think they've seen it all before.

"A lot of what people were wearing for a philosophy was merely an outlook," declares Nick Murray, editor of the electronic newsletter Nick Murray Interactive. "This is precisely why you find advisors significantly altering their approach, through 'tactical asset allocation' (the world's smelliest euphemism for market timing), shorting, option writing and various other return-reducing devices: What they thought was a philosophy was merely a mistaken notion of how the world works, and/or the absence of a sufficiently adult memory. Now those advisors are going to punish their clients for what they (the advisors) still haven't learned.

"As with the other two major episodes of a decade of no equity returns in the last hundred years (the ones that ended in 1935 and 1974), I suspect you will now see a protracted period of above-average returns, with trailing ten-year returns cycling back up toward 20%, as happened in both other instances," Murray continues. "Marty Zweig famously said that the market will always figure out a way to disappoint the largest possible number of people, and my hunch is that the most bitterly disappointed advisors and investors over the next block of time will be those who are just now shrilly excoriating the 'outdated' notion of buy-and-hold."

Leading practitioners of absolute return investing understand where Murray is coming from, even if they are somewhat more agnostic in their outlook. Putnam's Knight views absolute return as "a complement," to other holdings in an investor's portfolio, not a substitute for them.

And AQR's Asness sees the danger of reading too much into the events of 2008. "Investors of all types tend to overreact to the relatively recent past, particularly to what's happened over, say, the last three to five years," he says. "If over this time frame, long-only strategies outperformed absolute return, investors would probably favor them more than usual. Sadly it would probably be the precise time to do the opposite."

In the interest of disclosure, many of the sources quoted in this article, including Nick Murray, Michael Martin, Cliff Asness and Lou Stanasolovich, do write or have written for *Financial Advisor* magazine.

http://www.fa-mag.com/component/content/article/1-features/4793-absolute-return-obsession.html