think tank

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Are absolute return funds aiming too high?

Prasheen Singh, Consultant

Historically, equities have been the only asset class to significantly outperform inflation. However their high real return (returns above inflation) expectations are accompanied by an increased exposure to risk and potential capital loss. Studies have shown that a positive realisation of an equity risk premium is only a certainty for investment periods of around 20 years and that returns over shorter time periods can be highly volatile.

The increased volatility of equity funds over the last 5 years has resulted in the growing popularity of absolute funds. The goal of an absolute fund is to outperform inflation by a set percentage over a defined period, without exposing investors to high levels of volatility. Managers of absolute funds use either CPI or CPIX as inflationary measures and the funds aim to outperform these measures by up to 8% (most averaging inflation + 5%). The funds aim to meet these targets over a rolling 3-5 year period, without losing capital over any 12-month period. While these funds may seem very attractive investments, investors must question whether these funds can realistically fulfil their set return goals.

RisCura good thinking

“Investors have become so disillusioned with equities, particularly given the high real returns of cash and bonds.”

Managers of the funds attempt to achieve performance targets by using a wide range of investment strategies including:-

- derivatives and inflation-linked bonds to reduce downside loss;
- tactical asset allocation (switching between asset classes) to maximise returns and manage risk;
- careful stock selection.

It should be noted that the probability of a fund achieving a target of inflation +8% p.a. over a 3-year period is low, and generally only achieved at high risk levels. An inflation-linked bond currently yields between 3.5%-4% above CPI with very little risk (before tax).

Simplistically, if one adds one unit of return for every two units of risk, the consequence of increasing a return by 4.5%, is generally a higher risk level, giving rise to more unstable returns and therefore possibly not the capital protection an investor might have expected.

Historical lessons can be helpful in determining a reasonable targeted return, however, they cannot be used to predict future performance. The table below indicates that real returns from an equity investment in South Africa over 101 years would have outperformed inflation by a geometric average of 6.8%. For the period between 1990 and 2000, this outperformance was down to 3.5%. This provides some explanation as to why investors have become so disillusioned with equities, particularly given the high real returns of cash and bonds over this period! The effect of tax however has not been considered here and may change this scenario somewhat.

	1900 - 2000	1960 - 2000	1980 - 2000	1990 - 2000
Real Equity Returns	6.8%	7.7%	6.1%	3.5%
Real Bond Returns	1.4%	0.8%	2.4%	7.95%
Real Cash Returns	0.8%	1.7%	3.2%	6.1%
Inflation	4.8%	9.0%	11.7%	9.1%

As a crude long-term return approximation, RisCura used the average domestic balanced portfolio (65% equities, 25% bonds, 10% cash) from 1960-2000 to simulate a simplistic absolute fund portfolio. Over the period 1960–2000, the return for this type of portfolio would have outperformed inflation by 5.9% per annum. If we look at 3-year rolling performance periods, it would have beaten inflation 82% of the time while achieving inflation +5% for 59% of these periods. We can therefore conclude that a real return target of more than 5% p.a. might be difficult to achieve consistently without added risk, and significant value-add from a fund manager.

Over the long term, equities have delivered real returns of about 7%, illustrating the importance of equities for investors wanting to outperform inflation. It is however questionable whether a real return target of more than 5% can consistently be achieved over any 3-year period. To achieve higher real returns, a manager would have to display unfailingly good management skills or increase the fund’s risk profile by including more equity in the portfolio. Although this may result in higher returns, it also exposes investors to capital loss should equity markets underperform. When expected returns above inflation are increased, a fund will be forced to invest in riskier markets and instruments to achieve this return. This is the portfolio construction problem that faces absolute funds, particularly those with high real return expectations.

Investors must be aware of the implications of fund managers’ investment calls being wrong. Most managers make incorrect calls at some stage and investors need to understand the potential impact of these decisions on a fund’s returns. As a manager takes riskier positions so as to fulfill possibly unrealistic return expectations, the negative affect on performance can be extreme if the calls are incorrect. This is particularly important if, as in the case of absolute funds, investors are expecting a high level of capital protection.

“...a real return target of more than 5% p.a. might be difficult to achieve consistently without added risk.”

Kevin Ewer, Director

Hedge funds and their risks

Risky Business

Despite their growing popularity with pension funds, hedge funds are still considered by many to be risky investments. Below, we outline some of the key risks that should be considered by pension funds prior to investing in a hedge fund.

The main difference between a hedge fund and a "long-only" investment is the use of "leverage", "shorts" and "derivatives". Both these strategies have their associated risks. For example, with a short position, it is possible for a fund to lose more than it has invested.

Shorts.
a financial structure whereby you sell shares you don't own in the anticipation that the price will go down.

There are numerous hedge fund strategies, ranging from the easily understood long-short strategies (underlying the bulk of hedge funds locally) to the more complex global macro, market neutral, managed futures and distressed securities strategies. Because of this wide range, the "riskiness" of hedge funds should be considered on a fund-by-fund basis.

Common risks to be considered

Leverage/Gearing

Due to a hedge fund's ability to use derivatives, gearing and shorts, a fund can have exposure greater than its total fund value. Excessive leverage combined with illiquid positions can lead to undue risk. However, many hedge funds depend on leverage so as to extract sufficient return to profit from their strategies. Leverage in itself is therefore not negative, but should be closely monitored. Leverage limits should be set according to the style of the fund. For example, fixed income arbitrage funds typically require more leverage than equity long-short funds.

Most of the hedge fund and banking catastrophes have been as a result of the misuse of gearing. A 5% adverse movement in an investment geared 2000% (or 20 times) could wipe out the entire capital of a fund!

Leverage.
creating market exposure greater than the net asset value of the fund.

Style Drift

It's important to monitor whether a manager is managing the hedge fund in line with the style set by its mandate. Particularly in bull markets, a manager may be tempted to become more directional so as to keep pace with the market's performance.

Directional.
more correlated to the market by, for example, increasing long positions in the market.

Derivatives

Understanding the impact these may have on a portfolio is key to monitoring risk. This entails analysing the fund on a look-through effective exposure basis and where options are used, understanding the potential losses that may arise from the complexity of these positions.

Look through.
analyzing exposure right down to the underlying shares

Effective exposure.
analyzing exposure down to the underlying asset class

Currency

For funds that invest internationally, special attention should be paid to the potential impact of their exposure to various currencies. This is particularly important if a fund is not intending to have currency exposure, but wants to exploit opportunities in other countries. The impact of volatile and difficult to forecast currency exposure must also be quantified and understood.

Liquidity

The liquidity of short positions in hedge funds needs to be very closely monitored as positions in the market may take time to unwind. This is a primary investment risk for hedge funds with more exotic or obscure investment transactions.

From an investor's perspective, liquidity refers to the ability of the investor to invest in or withdraw from an investment. The risk of an investor not being able to liquidate their investment in a hedge fund may be heightened due to its short positions.

Some hedge funds also impose "lock in" periods preventing investors from withdrawing money or penalising any withdrawals within a set period with an exit fee. Other hedge funds restrict the timing of entry and exit to a monthly or quarterly period.

Transparency

Because of the sensitive nature of short positions and other strategies, many hedge fund managers are reluctant to reveal too much information about their positions. While some investors regard this negatively, correct analysis of leverage, liquidity, return and volatility as well as good compliance, can ensure sufficient risk transparency without requiring strategy disclosure.

Daily rather than monthly net asset value (NAV) calculations should also contribute to investor comfort. Intra-month volatility, which is important for analysing the consistency of a fund's risk return relationship, cannot be calculated if the fund only provides a monthly NAV. This can easily be done without prejudicing a fund.

> **"Due diligences of hedge funds are becoming increasingly important."**

Administration

Checks such as independent audits, valuations and confirmations of deals and holdings need to be performed by credible parties. Due diligences of hedge funds are becoming increasingly important as the scope for fraud in these investments is unlimited.

what's NEW?

Joint Venture with NBC

About 2 years ago, RisCura entered into a joint venture with NBC's investment consulting business (NBC Investment Insight) to provide risk management reporting infrastructure. Our involvement was subsequently expanded to include skills transfer in the areas of investment consulting and research. Our involvement has since been significantly reduced due to the upskilling of NBC's staff which has allowed them to move forward independently without our assistance.

New Clients

Since RisCura's inception in 2000, we have focused primarily on large pension fund clients. However, in 2004, we decided to expand our focus to include smaller pension fund clients. This is possible due to the scaleability of our services and the belief that research done over the last 4 years for our large pension fund clients would be of significant benefit for the smaller pension funds as well.

We are very proud to announce that the following pension fund clients recently came on board:-

- University of Witwatersrand Retirement Fund
- Aviation Union Retirement Fund
- Smollan Group Retirement Fund

The Right

Selecting Asset Managers

Mxolisi Mbekwa, Director

The risk of a fund failing to meet its liabilities or return targets is the central point around which a pension fund strategy is set. The fund strategy determines the composite "risk budget" for the fund, which then drives the recommended asset allocation.

A risk budget indicates the degree to which returns could deviate from the benchmark without compromising the fund's objectives. Once the risk budget has been set, the fund's assets are split into the various asset classes. Thereafter managers will be selected to manage the assets around these allocations in line with either a specialist or balanced mandate.

Our research shows that for pension funds, asset allocation drives 90% of total fund return while manager selection only contributes about 10%. Manager selection is therefore only considered once the optimal asset allocation structure for the fund has been determined. This approach is well accepted both internationally and locally, and has proven to be highly successful.

Selecting the appropriate group of investment managers for a pension fund should be based on four cornerstones – appropriate level of risk, optimisation of return, cost management and fund specific issues.

Appropriate Level of Risk

The selection of a fund's investment managers should be done in line with the overall risk budget. Tracking errors and information ratios for the whole universe of investment managers should be analysed before any selections are made. Once managers have been selected, their mandates must specify an appropriate risk budget and performance targets.

These are some of the risks we consider when selecting investment managers:-

- volatility/risk budget
- liquidity of assets
- credit risk
- sensitivity to the market (beta and duration)
- style bias
- industry and stock specific risk

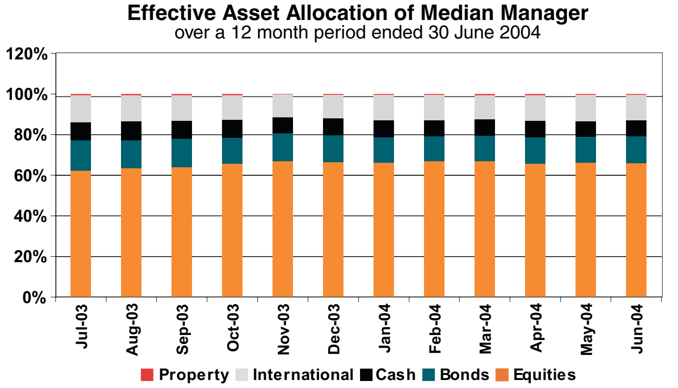
Optimisation of Return

Specialist vs Balanced Mandates

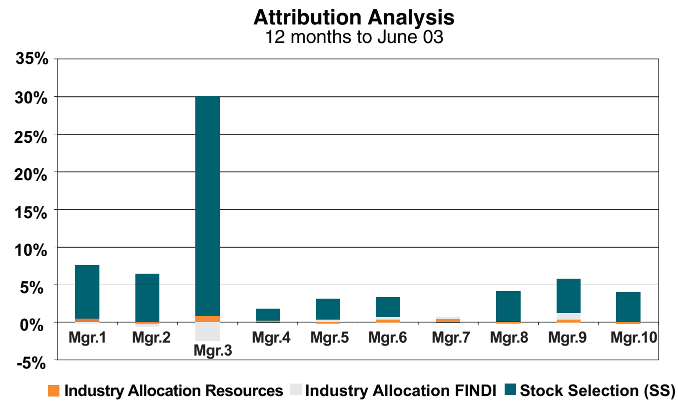
There is a strong argument favouring specialist mandates in South Africa. Our research shows that very few investment managers are proficient in managing balanced portfolios, which require numerous bets around specific stocks, assets and asset combinations. Most managers focus and therefore excel in a particular area. For example, they may have above average equity skills but below average bond skills, which when combined lead to average overall performance.

Our research also shows that the benefits from good stock selection outweigh that of asset allocation.

Most managers are also not that active with asset allocation as indicated in the graph below. This graph shows the changes in asset allocation bets of the median manager over a 1-year period.



The graph below illustrates the return from stock selection and sector allocation for the 12 months to December 2003. The graph indicates that returns gained from stock selection are much larger than those gained from allocating between sectors. Appointing managers with good stock selection skills in a particular sector is therefore important.



Combining specialist mandates using a building block approach, and appointing managers according to their strengths in managing specific types of investment mandates is key to optimising returns. The track records of RisCura's client portfolios substantiate this.

It's also beneficial to combine investment managers with different investment styles to reduce overlap in the portfolio (i.e. managers holding or buying/selling the same stocks to each other), improve diversification and increase returns.

Passive versus Active

Comprehensive quantitative research conducted by RisCura suggests that there are adequate opportunities for investment managers to add alpha (outperformance) above local benchmarks and after fees. We therefore believe it's important to include active managers in a portfolio to optimise returns.

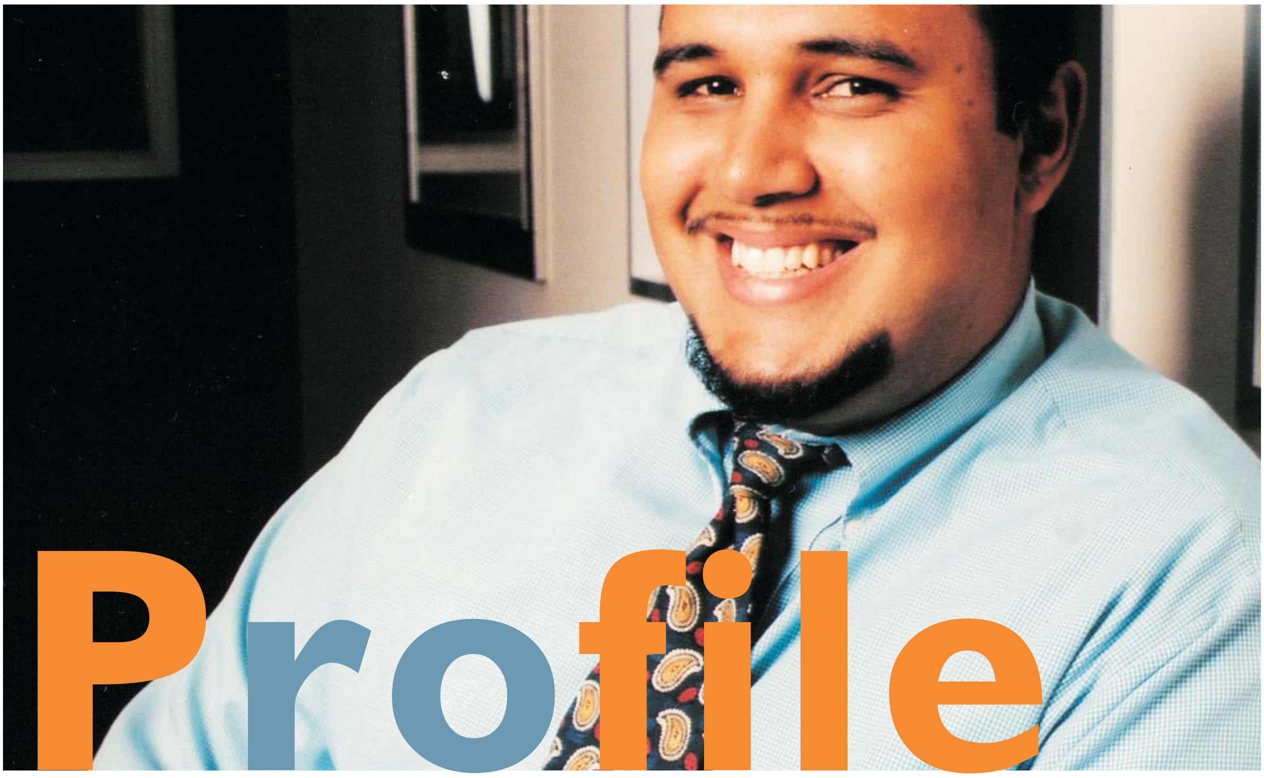
Cost Management

We believe that the fees charged by asset managers are an important consideration in manager selection. Fees should fairly remunerate managers for work well done, and provide added incentive for outperformance. Incentive fees however become problematic if the managers charge different clients different fees for managing money using a "best view" approach. Random outperformance and luck also make paying incentive fees tricky. We believe fees charged on cash mandates, where the opportunity for flair and value add is minimised, are very important to control.

Fund Specific Issues

A key fund specific issue is black economic empowerment (BEE). An asset manager's BEE credentials should be balanced against the pension fund's quest for optimal returns. Many pension funds have different views on this issue. Questions around what constitutes adequate BEE, the value of established versus emerging managers and allocations to both, need to be considered. Other fund specific issues include trustee training and administration.

"Fees should fairly remunerate managers for work well done."



Waheeb Karriem

Risk Analyst

Job description: Part of the reporting team that provides risk and performance analysis to our clients.

Experience: Worked at Standard Trust Ltd (unit trust department) as a trust officer for 2 years.

Passionate about: My family and my religion, Islam.

Dislike: That so many innocent children are being oppressed and killed as a result of crime and war.

Spend my spare time: Fishing and... fishing.

Favourite books: The Holy Quraan (Muslim bible)

Best thing about living in South Africa: The freedom to live life the way we want to - an opportunity that millions of people all over the world have never experienced.

What motivates you: People who have a positive outlook on life and.....food!

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RisCura
good thinking