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A Spotlight On:
IA Targeted Absolute Return

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Introduction to Sector

The performance of a fund is measured and judged against a benchmark. The benchmarks for most funds which invest in equities and bonds are the most appropriate stock and bond market indices (or combinations of them for mixed asset funds), and the managers of those funds seek to deliver relative returns to those indices. In the first quarter of 2020, broad measures of UK equity performance were down by about 25%. The manager of a UK equity fund which has that benchmark, and which was down by 'only' 20% over the same period therefore achieved very good performance, even though investors in that fund lost a lot of money. Managers of absolute return funds have no such place to hide. Their benchmark is cash which, unless you are in the eurozone or Switzerland but not so far in the UK, cannot deliver a negative return. Managers of absolute return funds are therefore aim to deliver positive returns in absolute terms over reasonable timeframes, irrespective of what is happening in stock or bond markets.

Sector Nuance

The premise of absolute return funds is that investors are willing to accept returns that may appear dull when markets are soaring, but the flipside is that they expect to see their capital protected and preserved when markets tumble. Sadly, the absolute return sector as a whole has consistently failed to deliver the latter. The first quarter of 2020 provided a perfect opportunity for absolute return funds to shine. However, just 23 out of the 119 funds in the IA's Targeted Absolute Return did not lose money. With global stock markets plunging by 20%, perhaps it is unreasonable to have expected total preservation of capital. However, setting a drawdown limit of 3% adds only another 17 funds to the list which means that two thirds of the funds in the sector lost more than 3%. Most shockingly of all, 28 funds in the sector lost 10% or more and 2 lost more than 30%.

Maybe it is unfair to judge these funds over such a short timeframe, which also saw the sharpest slump in stock markets since 2008's financial crisis. Over the whole of 2018, global stock markets fell by just over 7%. However, only 16 of the 105 funds in the sector at that time did not lose money and more than half lost more than 3%. The ability to preserve capital, not just once but consistently, is also surely important. The FP Argonaut Absolute Return fund delivered an eye-catching return of 23% in the first quarter of 2020 but was down by 12% in 2018 and by 26% in 2016. The Natixis H2O Multi-Returns fund was one of the best performing funds in 2018 with a gain of 10% but lost 31% in the first quarter of 2020. Just a handful of funds in the sector delivered gains in both the first quarter of 2020 and over the whole of 2018. The investment objective of many absolute return funds is to provide those returns over 3-year rolling periods. Over the three years to 31st March 2020, which include the buoyant years for risk assets in 2017 and 2019, almost two thirds of absolute return funds lost money.

Not surprisingly and deservedly, disillusionment with the sector is rife and investors have been voting with their feet. Assets in the sector peaked at £144bn in July 2018 but have since fallen to £54bn. The share price of the once-mighty ASI Global Absolute Return Strategies ("GARS") fund is below where is was five years ago and assets have dwindled from £26bn to just £4bn. The size of Merian Global Equity Absolute Return ("GEAR") fund, another erstwhile legend in the sector, has plummeted from £12bn to less than £2bn as the price of the fund has fallen more than 20% from its March 2018 peak.

Another criticism often levelled at the sector is the complexity of some of its constituent funds. Certainly, the sector is far from homogeneous. We have identified long/short equity, unconstrained bond, global macro and long-bias multi-asset as the main sub-strategies, but the sector also contains a number of specialist strategies including merger arbitrage, short-dated bonds, emerging market debt and Commodity Trading Advisors (CTAs).

Funds in Focus

Whilst many of the funds in the sector are, in our opinion, unfit for purpose, there are a few gems. Not least because of their relative simplicity and our confidence in the structural liquidity of the underlying asset class, we are attracted to equity long/short funds and our favourite fund in the sector is the **Blackrock European Absolute Alpha** fund. Class D shares of the fund have delivered an annualised return of 4.3% per annum since launch in April 2009 to the end of April 2020. The fund has been profitable in every calendar year except 2016, which led to one of the co-managers being replaced. The fund made money for investors in 2018 (+5.0%) and again in the first quarter of 2020 (+4.3%). It is managed with low net exposure and this, together with a demonstrable record of alpha generation on both long and short investments, has resulted in the fund's monthly returns exhibiting virtually no correlation (in fact, slightly negative correlation) with the MSCI Europe Index. This, in our opinion, is what the return profile of a good absolute return fund should look like.

Some funds in the absolute return sector charge performance fees. This is a contentious issue and some investors will, on principle, never buy funds which levy performance fees. The Blackrock European Absolute Alpha fund charges a performance fee of 20% of gains in excess of 3-month cash deposits and the fund's high-water mark. The fund's published returns are, of course, net of performance and all other fees.

Sector Outlook

Given its lack of homogeneity and full spectrum of asset classes, it is impossible to write about the outlook for the sector in general. As always, funds in the sector will continue to deliver a very wide range of returns and, perhaps more than in any other sector, fund selection is critical. Unsurprisingly, the brutal falls in stock and corporate bond markets in recent months have prompted many investment management firms to state that they are now making development of product in this sector a priority. Easier said than done though. We would like it to be deeper, of course, but the evidence so far is that the existing talent pool of managers with the requisite skillsets to deliver consistent absolute returns is very shallow.

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