Preservation of capital is key in Asia

Risk mitigation, downside protection more important than achieving upside performance

By Paul Mackintosh

In a post-crisis world still racked by instability, where returns expectations have been revised sharply downwards as leverage levels fall, absolute returns investing appears to be enjoying something of a return to favour. Proponents of the approach would argue that it never went away, but it certainly had its relative merits reinforced recently. *Asia Asset Management* spoke to some of the leading absolute returns managers, locally and internationally, for their perspectives on the new climate for absolute returns.

Out of bond?

One fundamental question around absolute returns strategies obviously concerns asset mixes, or more specifically, how absolute returns platforms maintain their differentiation from pure bond portfolios. Here, there are a range of responses depending on the firm.

Malcolm Jones, investment director of the highly-regarded Standard Life Global Absolute Return Strategies Fund, notes that his platform is based upon a family of strategies, debt, equity and otherwise, consistent with certain key criteria, liquidity being one. This approach also includes considerable use of derivatives, an approach by no means universally shared. "We find it's better and more cost-effective to use derivatives to implement our ideas in the fund," Mr. Jones explains. "This comes back to the overriding basis of how we designed the fund in the first place: what's the most liquid and straightforward derivatives contract we can use in the marketplace."

"For bond strategies, we may buy physical bonds," he concedes. But the fund's range of other holdings includes "core vanilla interest swaps, exchange-traded futures, currency forwards in markets where those contracts are highly liquid; options, exchange-traded or OTC, but those that are highly traded."

Anthony Raza

> *"Market timing is not usually an approach associated with absolute returns investing, but according to some, it can be important at least at the portfolio construction stage"*

By contrast, Anthony Raza, senior director and head of asset allocation at UOB Asset Management, favours the fixed-income approach, though this depends very much on the client. "The main strategies we use are insurance portfolio techniques where we populate a portfolio with fixed-income instruments that on maturity will generate the principal," he says. "The average portfolio will usually start out at close to 90:10 in terms of asset allocation. It's only if risk capital grows that we can have more of an equity component."

Simon Flood, chief investment officer of Singapore's Lion Global Investors, which manages over US$20 billion for governments and government agencies, charitable organisations, insurance and endowment funds, as well as retail investors, also finds that client requirements are the arbiter of allocation. "Clients will come to us with an absolute return aspiration that is built round their need to generate income or the need to protect their capital," he notes. "How focused they are on either of those aspirations will determine our aspiration, in terms of the asset allocation for our clients."

As for the type of fixed-income holdings, "we use primarily corporate bonds, because those will give us a larger buffer," says Mr. Raza. However, "we're not using derivatives very significantly. The main instruments we're using is currency hedges." And, he adds: "We typically, in the mandate, only have three to five years. So we need to think in terms of opportunities that will grow significantly over the next year or two."

"Expecting to build portfolios that are better behaved through the investment cycle; that part of the argument has been accepted," concludes Mr. Jones. "How you do it: you'll get different answers from each manager, which will probably reflect the strengths that they have."

Macro cycles and asset choice

Market timing is not usually an approach associated with absolute returns investing, but according to some, it can be important at least at the portfolio construction stage, to provide an appropriate starting point for clients. Helen Lam, senior portfolio manager at RCM Asia-Pacific, a division of Allianz Global Investors, who co-manages the Absolute Return Fund with MD Stuart Winchester, states that: "We believe the key to success in an absolute returns fund is to identify where we are in terms of the economic cycle, such that we can structure the portfolio with favourable asset allocation to benefit most out from the economic condition with minimised risk." Obviously, this is more a focus on the longer-term macro perspective than short-term market fluctuations, though.

With this view on current macro trends, Ms. Lam is actually favouring a movement away from heavy weighting towards bonds. "Owing to the low interest rate environment, we do not anticipate fixed income from the developed markets will be able to generate the same kind of return as in previous years. While we think we may have more opportunities in local-currency bonds, and watch for opportunities to expand for the portfolio, we also believe that high-quality stocks with high-yield dividends may be able to outperform long-dated bonds, and should be regarded as another focus for the absolute return strategy." This squares with the perspective of many global institutional investors who aver, in the words of Mark Delaney, CIO of AustralianSuper, that bonds in the current environment are "expensive insurance."

Mr. Raza, though, sees strong performance and popularity for bonds through and after the crisis. "After the crisis, it really has been more a bond fund focus," he affirms. "As we've gone through this crisis, and typically in terms of our business, our bond funds had a great year last year. Our equity funds didn't see so many inflows."

"The important thing to understand is we're not running a hedge fund," remarks Mr. Flood. "We're not leveraging our positions; we're long-only." He styles this approach, "harvesting on the upside and mitigating on the downside." His colleague Gina Chan, head of absolute return strategies at Lion Global Investors, remarks that: "We tend to have more of the portfolio in credit. This leverages on the expertise of our fixed income team where a core strength is in credit selection."

And, Mr. Flood remarks: "Asia is very much a growth region, but saving for the future is something that Asian nations have done for centuries, and there is still a very strong element of conservatism in the way people, nations and governments organise their finances."

Helen Lam

> *"Risk mitigation and downside protection is arguably the primary skill of an absolute returns investor – far more so than achieving upside performance"*

Capabilities and risk management

Given the breadth of absolute returns strategies, as Mr. Jones points out, a firm's capabilities are key to how it goes about implementing them. And, as both he and Mr. Raza have alluded to, insurance company DNA can be very useful when applied to absolute returns, especially in regard to the critical question of risk management.

Risk mitigation and downside protection is arguably the primary skill of an absolute returns investor – far more so than achieving upside performance. The 2008 crisis was a graphic demonstration of what can go wrong when even the most well-worn strategies have insufficient diligence performed on their real risks. Mr. Jones's explanation of the behaviour of many portfolios during the crisis is straightforward: "Many of the strategies that looked like providing diversification in pro-growth conditions were ultimately linked to growth. When you went into a low-growth environment, they started behaving like each other. We saw that across the credit markets. You've got so many different types of credit market; high yield, asset-backed, bank debt, but at the end of the day they're all linked to credit. And when credit went down, so did all of them. And so, the benefit that people looked for hadn't materialised."

RCM's absolute returns product did experience some downside in 2008, but this was very effectively mitigated and soon recovered, according to Ms. Lam. "Although it was the first time that the absolute return funds did not manage to deliver a positive return for the year, it was able to fare much better compared to pure equity portfolios, due to the prudent risk control. The absolute return fund was able to recoup all the loss from the previous year in 2009 whereas the performance for pure equity portfolios was still in the red for the combined years of 2008 and 2009. We believe its characteristics of high consistency with low volatility allowed the absolute return product to demonstrate its defensiveness under a down market like 2008."

Post the crisis, Mr. Raza remarks, his team, after achieving a pretty good result, were also able to profit by improving the platform. "We've been able to analyse where our weakest links are," he says, though this is more a question of areas of vulnerability than actual poor performance. "We need the fixed income team to make sure we are picking good credits. If we lost some of the capability there, that would hurt us. We have this risk capital buffer that we're using to generate returns, and that's driven by the equity team."

Mr. Flood also highlights the use of financial technology to manage risks and secure returns. "We are using derivative instruments to protect and mitigate the potential for losses. That is about staying on top of the returns." But he also sees more basic, traditional stock-picking skills as vital. "As soon as you have an exposure to equities you have an exposure to downside," he says. "What we are thinking of is the quantum and type of equities we have. You would find in our portfolios a lot of stable equities with strong revenue flows and high dividend yields."

"We were quite pleased with how these strategies have held up through the crisis," adds Mr. Raza. "This is a true battle test of the strategy." And in the case of UOB, some of the portfolios are actually guaranteed, meaning that the bank itself is taking on the risk of their performance. "We've never had to implement our guarantee in any case," he affirms. "Every portfolio has at least returned the principal and in some cases with very solid returns." But, understandably, "it's internally highly scrutinised what our views are on the credits." And UOB leans heavily on its "fairly large Asian credit fixed income team" to counter risks to its clients, and itself.

Mr. Jones sees constant future-proofing of the fund by hypothetical projections and internal back-checking as integral to its outcomes. "There's a whole load of standard tests we need to fulfil anyway. We've built a lot around qualitative work that we do, thinking of logically coherent scenarios that could damage the fund. They're not impossible, but highly improbable. For example, if everyone goes on a US Treasury strike tomorrow, interest rates would rocket."

Risk tolerance may also be a question of the underlying investor, in Mr. Flood's view. "The first thing we need to get right for understanding our clients is to understand what profile they have," he opines. "That will dictate our exposure to the higher end of the risk curve, which is equities ... It's putting yourself in your client's shoes and understanding what they want to achieve."

For Ms. Lam, the absolute returns focus in itself, not tied to benchmarks, is part of the key to its performance. "The benefit of investment flexibility to adjust the weighting on different asset classes, and country allocation purely based on the market outlook, without being subject to any benchmark constraints, allows the portfolio to have better control of the downside risk."

Gina Chan

"In Asia as well as elsewhere, there is a stratum of institutional investors who are more than content with the security and predictability of absolute returns strategies"

"You need to have a wide diversification of risks and not have any systemic risks in the fund," affirms Jones. "You can be well diversified across many credit markets, but effectively you are long credit. If you are long credit and credit blows out, you need to have a strategy that will make money for us, which would normally be a holding strategy that would make money as interest rates fall, which logically makes sense."

Absolute returns in Asia

Belying the region's reputation for gung-ho entrepreneurialism and high risk tolerance, the absolute returns managers polled find that their discipline actually is very favoured in Asia. "It's difficult to make generalisations about an entire region, but if you have a look at the top ten savings nations in the world, the top five are all Asian," points out Mr. Flood . "The absolute return fund has a proven track record for its consistency with minimal risk," asserts Ms. Lam.

Of course, much of this is a function of the type of client. But in Asia as well as elsewhere, there is a stratum of institutional investors who are more than content with the security and predictability of absolute returns strategies, even if these fall below equity markets performance benchmarks. "Our main client demand is largely institutional safe money, just like councils in Singapore," avers Mr. Raza. Mr. Flood agrees that "what you'll typically find in this space is institutions where capital preservation is important. You often find quasi-government entities in this space."

Mr. Jones notes, conversely, that because of some slightly curious perceptions in Asia over his platform's use of derivatives, "it's put in the hedge fund bucket, which is not where it finds itself in the UK." Rather than try to modify these perceptions, he says, "one of the things we're looking at in the offshore strategy is a leveraged share class," to meet the expectations of Asian investors. "They've put money into alternatives because they want some spice," he adds. "That's a challenge for us in terms of positioning what is a very good product."

"There are a large number of investors in Asia and Singapore where preservation of capital is a very important aspect of their investment thesis," Mr. Flood confirms. "This is something we are developing in terms of developing a product that aligns the risk profile with the risk appetite." Mr. Raza reports that, "our absolute returns mandates are doing quite strongly in terms of return business."

"There is definitely an appetite for absolute return products in Asia; there is definitely a desire for people to protect capital," concludes Mr. Flood. "It is that discipline which has created a buffer that has seen Asia through the recent Global Financial crisis." ■