Fureyous: Absolute return investing... a nice goal

Michael Furey | Delta Research & Advisory | 29 April 2014

Absolute return investing, according to many definitions, is about getting positive returns irrespective of the overlying "market" return of whatever asset class the investor is being exposed to. This essentially means that any "absolute" returning investment needs to employ strategies that are independent of market direction. For example, if the market (and it can be any market) is declining in value, the absolute return investment will need to have long exposures that still may move up (they may include put options), or perhaps be trading in the direction of the down market by short selling that market, whether at a security level or market level (e.g. futures, CFDs, ETFs, or options).

OK... So, that said, absolute return strategies must demonstrate skill in market timing, so they can profit in up and down markets. Much more easily said than done.

Like these first two paragraphs, most discussion on absolute return investing focuses solely on achieving a positive return. There is no mention of how much and what timeframe. Let's face it, achieving a positive return is very, very easy - just place your funds in a bank deposit, choose your term and, voila! You have a government guaranteed "absolute return" for your chosen term!

So, what defines an absolute return fund in terms of required size of return and desirable timeframe?

My personal belief based on discussions with advisers and investors suggests the required return is "equity-like" and the measured timeframe is one year. So, each year, investors expect and want to see a positive return that is in the ballpark of cash plus 3% to 4% or, perhaps, a minimum of 10% per annum. Today, that means an annual return of around 7% to 10% each year - again, much more easily said than done and I would suggest that the risk required to achieve this return goal is quite significant.

So I thought I'd have a look at the hedge funds available in Australia (and reported to Morningstar) to see how they've actually performed in recent years. I thought I'd give them a helping hand by only looking at the last five years (i.e. since very close to the bottom of the sharemarket). There were only 51 strategies that had a five-year track record (surely there'd be more, but no). I chose hedge funds specifically because all other investment categories are "long only" meaning they can't employ the above-mentioned strategies to profit in down markets.

Of the 51 hedge fund strategies, only 19 did not have a negative return over any 12-month rolling period in the last five years. To be honest, I thought it would be lower - so not a bad result. Of those 19 funds, only three failed to have an average return above 7% per annum.

So my positively biased analysis has yielded 16 different hedge funds available in Australia that may meet the investor's and adviser's definition of an absolute return fund - and that's out of many, many more than 3,000 funds available in Australia. (As a side note, I also wonder how they'll go when global government stimulus is no longer the norm and interest rates are much higher?...But I digress.)

When you consider that a very high proportion of investors (and advisers) has an "absolute return" investment objective, you have to wonder why there are so few investments designed to achieve it. The bottom line is that absolute return investing is incredibly difficult and achieved by very few.

My personal thoughts and conclusion on absolute return investing? It's fine to have positive returns year-in, year-out as an objective or goal. But, absolute returns should never be presented as an expectation, as disappointment is inevitable. When aiming for "equity like" returns be prepared for the occasional negative year or two or three.

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