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Real Return funds…lacking reality?

Michael Furey | Delta Research & Advisory | 01 September 2015

What a fascinating investment world its been over the past few months. We've had concerns about Greece exiting the Euro, commodity price crashes, a Chinese sharemarket crash and now some of the biggest developed economy sharemarket declines since the dark days of the Global Financial Crisis. Volatility has been somewhat benign for a long time, thanks to QE3 and the money printing out of Japan and Europe - but it's back with a vengeance.

One of the more recent trends in the product landscape resulting from the GFC has been objective based investing - most notably, real return funds. The story goes that investors are looking for a decent return above inflation and don't really want exposure to nasty sharemarket volatility, as market exposure didn't appear to be too aligned with their true investment goals. These objective-based investments appeared (or at least, most of them did) following the GFC and have been quite popular.

Today - and pretty much for most of recent times - these products have a bit of a problem. They have dug a hole for themselves from which they'll probably struggle to get out. The problem is they are real return plus "too much" - and, it has turned them into investments that will not only struggle to meet their objectives, but which have landed investors back where they came from - that is, with exposures that carried too much risk.

The most popular objective (at least, as I've noticed) of real return funds is CPI+5%. A few years ago, this wasn't perceived as too big an issue. Cash rates during 2011 and 2012 were mid 4%, term deposits were paying attractive premiums (150bps+) over government bond yields, as were investment grade bonds (BBB-rated bonds were 200 to 300 bps over government bonds). So, given an expected CPI at the Reserve Bank of Australia target mid-point of 2.5%, scrambling for a few extra basis points didn't require massive risk taking and a diversified portfolio of defensive and risky investments could do the trick.

Fast forward to today and its a completely different story:

- RBA cash rates are at 2%, below expected inflation, and priced to go lower;
- Government bond yields are between 1.8% (short term) and 3.2% (15+ year terms); and,
- BBB-rated bonds have premiums of less than 2% over government bonds with total yields for three to five year securities at less than 4%.

Meaning, traditional defensive securities are quite debilitating to any portfolio looking to achieve CPI+5%. This can only mean that to achieve the desired objective the portfolio must

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load up on risk, and a fair bit of it. Risk from sharemarkets, junk bonds and, almost by default, illiquidity.

None of this should come as too big a surprise when you consider the last 50 years. Equity returns in Australia and globally have equated to real returns of only a little more than 5% per annum, pretty much equaling the real return fund objectives. Meanwhile, bonds and cash have understandably fallen well short. So, portfolios containing not much other than equities (and other risky assets) should have been expected.

Today, we are clearly in a position where real return funds (or at least those with a +5% real return target) must adopt a significant levels of risky assets to achieve objectives... and, waddayaknow, we have badly behaving sharemarkets. Hopefully, this bad behaviour is short-lived but either way, I have to wonder how these objective-focused, real-return investors will react when they discover (once again) that their objectives are struggling to be met and/or they are carrying uncomfortable levels of risky assets. Unfortunately, the main problem is that real return investors have failed to grasp that there aren't too many asset classes that actually provide real returns of a +5% magnitude. Sure, they might outperform inflation by 5% over long periods of time – but the returns are typically not highly correlated to inflation, so "real returns" is quite the misnomer. Oh yeah, and inflation-linked bonds don't provide anything like CPI+5%.

The bottom line: real return investing isn't too real at all, with big targets like CPI+5%. It is an objective that is not strongly linked to the reality of investment markets – so prepare for another investment approach aligned with disappointment.

Fire away!

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