Relative Returns vs. Absolute Returns

Relative Returns

The term "relative returns" refers to a money manager’s performance compared to a benchmark index. The vast majority of money managers aim to produce returns that beat a benchmark such as the S&P 500 stock index or the Barclays Capital bond index.

For example, suppose that the S&P 500 is down 35 percent in a year and the money manager produces returns that are down 25 percent. He can boast a superior performance and claim, rightly so, that he has beaten the benchmark index. But the financial reality is that you lost 25% of your hard earned money.

Relative Returns are important to larger pools of investment assets like pension funds and endowments. Since these large investors usually hire a consultant to guide asset allocation, managers are hired to out-perform a small sub-section of the overall market. Since over the long term, stocks have returned about 10% and bonds about 5% a year, it usually pays an investor to stay fully-invested. The idea is that the right allocation and selection of managers that out-perform their benchmarks will help the pension plan meet its long term goals.

For the individual investor, relative returns are less meaningful as few retail investors have large enough portfolios to hire an institutional style investment consultant or have the assets to attain a robust and multi-faceted asset allocation. The individual investor is emotional and tends to react to losses and gains differently without the guidance and support of a committee or outside experts. The individual investor may actually be more oriented to absolute returns as their goals will tend to be shorter term than the long term liabilities of pension plans or the infinite horizons of endowments.

Absolute Returns

As the name suggests "absolute returns" refers to the money manager’s performance of an asset class or strategy, without comparing it to any benchmark. Absolute return managers aim to generate positive returns year after year no matter what happens to the S&P 500 or any other benchmark index. Their goal is to beat zero.

Most absolute return money managers have traditionally not been available to individual investors. They have been reserved for high net worth individuals only through hedge funds, partnerships and investment boutiques. Hedge funds are stringently regulated by the SEC to the degree that they can't even be marketed to the general public... let alone sold. That's because
Absolute Return Strategies

hedge fund investors have to meet very stringent income and net worth criteria. However, in a period of sideways markets like we have experienced, the popularity of new funds and managers that aim for positive absolute returns has blossomed into an industry trend.

The S&P 500 has not produced ANY capital appreciation over the past 11 years. The S&P 500 was at 1000 in 1998. In the summer of 2009 it was at 1000 again! Given this dismal performance, more stock investors are moving toward an absolute return strategy in hopes of better results. In the bond market, fears persist of the heavy deficits and spending patterns of governments around the world that will result in inflation. The resulting rise in interest rates would reduce bond prices and deteriorate the principal that investors initially invested. More bond investors are increasingly fearful of such a possibility but do not know about managers who can increase principal values even when rates are increasing and bonds prices are falling.

Market Trends

Most relative return managers will rely on long-lasting positive market up trends to make their strategies work. What happens when stock markets and bond prices do not trend up? Relative return, long-only strategies may not produce positive results. Absolute return strategies are focused on shorter term movements in prices and especially in moves that will impair principal values. This style of investing attempts to profit regardless of market direction. Alternatively, when the market direction is unclear, many absolute return managers move to cash to protect principal. This is something that relative return, long-only managers only rarely will do. Their mandate is to beat the index they are measured against, if only by a small amount to justify their hiring.

Downside Returns

This strategy may allow managers two ways to generate returns, when prices are both rising and falling. Some absolute return managers have the ability to make money when the market goes down by using unique funds and ETF's that are inversely correlated to a market index. These funds go up when the market goes down both with and without using leverage. By using these investments, absolute return managers can create alpha from both bear and bull markets or from volatile environments where the overall market direction is unclear.

What are Absolute Return Strategies?

There are many different types of absolute return strategies. In the past these strategies were closely associated with hedge fund long-short and tactical market timing strategies. However, lately some major fund companies have presented funds with absolute returns as their benchmark. Eaton Vance, Putnam and Goldman Sachs among others have all developed funds named “absolute return”. Many of these funds are invested mostly in bonds to provide stability and the prospect of consistently positive returns. Morningstar or Lipper still do not have a separate category for absolute return strategies although the funds in this sector currently total over $10 billion. An investor must separate out more conservative funds from a long-short list or
Absolute Return Strategies

from multi-sector and broad based funds. Many ETF’s have been created but most are one
directional, they are constructed to only profit from either rising or falling prices, not both. An
investor today must do their homework to determine that the underlying investments in the
absolute return strategy are suitable for their investment plan and evaluate the skill of the money
manager that they are hiring in selecting profitable long and short positions.

Where do Absolute Return Strategies fit?

Most individual investors do not have an asset allocation that includes absolute return strategies.
Most large institutional funds do. One of the largest pension plans in the country, the California
Public Employees Retirement System has recently adopted an asset allocation plan for the next
three years that includes a separate asset class entitled “absolute return strategies”.¹ CALPERS is
the largest public pension fund in the US and is a leading force in the investment community. As
recently as 2008 in its own plan, Yale University has targeted 21% of its total $22 billion
endowment to absolute return investments which is a guide for the educational endowment
marketplace.² The classification would fall under the non-traditional or alternative investment
category.

Solid Risk Management

Probably the cornerstone of any successful absolute return strategy is a robust risk management
system. Absolute return strategies will set up risk management methodologies could include
portfolio construction, stop losses, profit preservation and most importantly capital preservation
techniques. The best of these are dynamic in nature learning and adapting from evolving
economic conditions in this rapidly changing world. Finally, absolute return money managers
should be backed by at least 5-10 years of vigorously back-tested results. These back-tested
results would probe the soundness of the system as well as risk management across various
market cycles, trends and shocks.

Can you Invest in Absolute Return Strategies?

Yes! A total portfolio will include traditional investments combined with alternative strategies.
Watching the total portfolio is the key as there will always be performance differences in the
component pieces of your overall strategy. As the large pension and endowment plans move to
diversify into absolute return investment, retail investors should take note. It is a new world and
information flow is rapidly accelerating. It is important for investors of all types to understand
how the world is changing and adapt.

¹ Hedgefundintelligence.com
² Yale University Endowment, June 2008