

# WHY EQUITIES FOR ABSOLUTE RETURN?

May 2018

UNCORRELATED ANSWERS™

## Executive Summary

- As the outlook for market-beta returns deteriorates, investors are becoming increasingly focused on investment strategies with absolute return objectives based on alpha.
- Many commonly used absolute return strategies suffer from drawbacks such as liquidity, capacity, complexity and high fees.
- Large cap developed listed equities offer an abundant source of uncorrelated alpha that is highly transparent, extremely liquid and far cheaper to implement in absolute return strategies than many competing, popular approaches to absolute return.

**David Schofield**

President, International Division

## How did we get here?

*You can't eat relative returns.*

Absolute return strategies have come under the spotlight recently, but of course investors have always invested with an 'absolute return' objective. The purpose of investing, after all, should be to grow one's capital, so expecting a *positive* absolute return on one's investment over time, in exchange for the use of that capital, is nothing earth-shattering.

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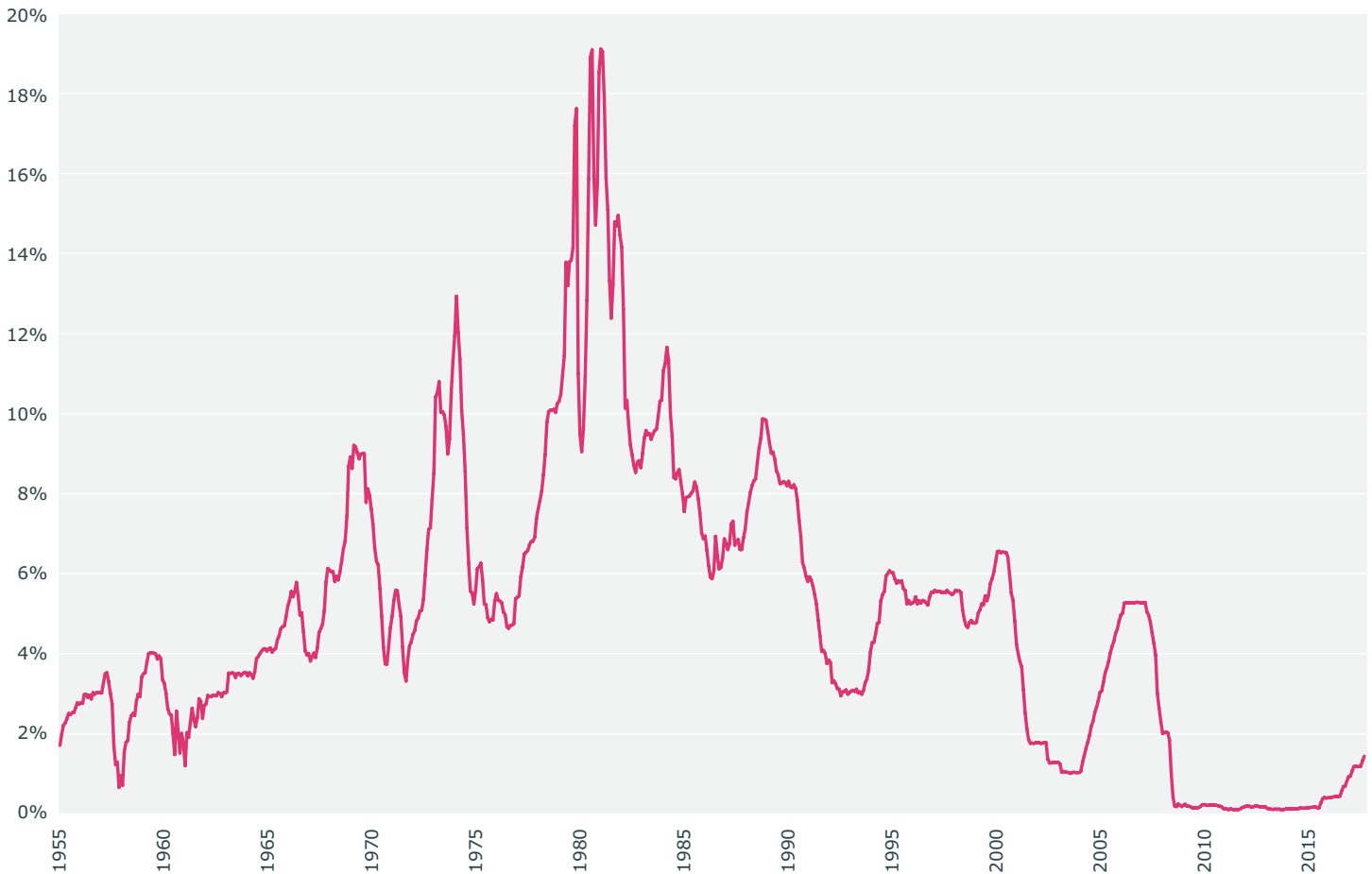
For example, pension funds have an estimated ‘actuarial’ absolute return target, typically 6-8%, deemed to be required in order to meet the fund’s own estimated future liabilities. An endowment fund may have an ongoing absolute-real-return target, say around 5%, that it needs to achieve to maintain its spending level and, at the same time, preserve or even grow the size of the endowment after inflation to support future spending. Even individual investors may have an absolute return in mind that they need to achieve in order to be able to satisfy personal goals, from a down-payment on their first property to their children’s university education.

But how does one achieve this positive absolute return as consistently as possible?

## Single market betas are risky

Equity markets are generally thought to have the highest long-term return expectation of the major liquid asset classes. They’re averaging about 5%-6% per annum since 1900,<sup>1</sup> for a premium of around 3-3.5% above government bonds, but they also carry the highest level of risk. While it may be reasonable to expect markets in the major asset classes to generate positive absolute returns in the long run, they can also suffer substantial drawdowns and extended periods of negative returns along the way. Many of us will remember the ‘lost decade’ of equity market returns following the Tech Bubble burst in 2000. And most market participants are probably too young to remember a bear market in bonds given the 30-year decline in interest rates, but that trend may be coming to an end as can be seen in Figure 1.

FIGURE 1  
**EFFECTIVE FED FUNDS RATE**  
 January 1, 1955 to January 1, 2018



Source: Board of Governors of the Federal Reserve System/Federal Reserve Bank of St. Louis.

<sup>1</sup> Source: Credit Suisse “Global Investment Returns Yearbook 2017” and Elroy Dimson, Paul Marsh and Mike Staunton, “Triumph of the Optimists,” Princeton University Press, 2002, and subsequent research.

In order to mitigate this single market beta risk, most prudent investors take the approach of building a diversified asset allocation. They combine multiple asset classes, generally dominated by equities and bonds, in proportions based on their own capital-market return and risk assumptions. The objective is most definitely to deliver the target absolute return over time, but with less risk than would be incurred in any single asset class. In this way, the riskiness of individual market betas is mitigated, as long as the various asset classes are not highly correlated with each other.

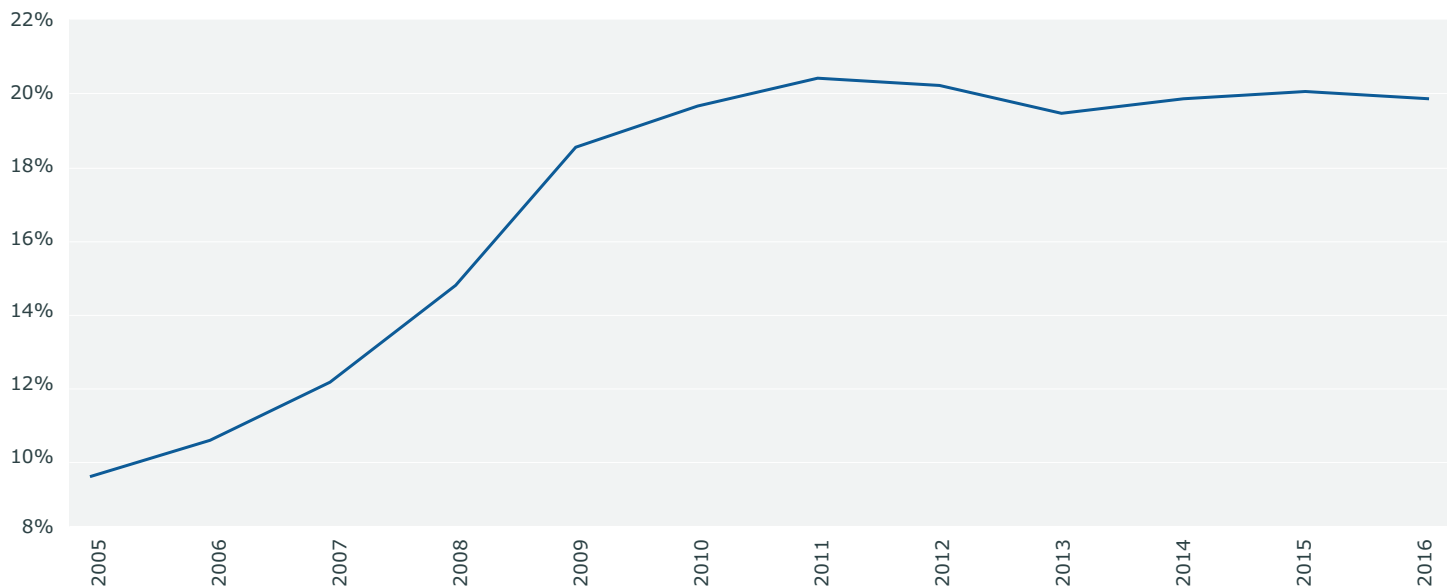
This approach led to the dominance for the last 30 years of 'relative-return mandates,' as specialist managers were increasingly hired by asset owners to each manage a portfolio in one of those distinct asset classes or sub-asset classes. Their objective is to beat the market benchmark associated with their respective, modest piece of the overall asset pie, and these managers are for the most part blind to the ultimate, absolute return objective of the client.

In this model, the asset owner's primary task (often with the help of their investment consultant) lies in determining the appropriate asset allocation between the various asset classes and sub-asset classes, and selecting the managers.

It's worth pointing out here that the accuracy of the underlying market return and risk assumptions, used as the input to the asset allocation process, plays a crucial role in the overall success of such a strategy in achieving its target absolute return. The greater the uncertainty in the assumed return and risk characteristics for a particular asset class, the greater the likely misallocation, and the greater the impact on the outcome. This is particularly important as it is exceedingly difficult to forecast market returns simultaneously over a wide range of time horizons.

As the consensus return assumptions for the major asset classes have dwindled over time, investors' appetite for risk and new, diversifying, uncorrelated sources of return has had to grow in order to meet the absolute return requirements. As can be seen in Figure 2, there has been a doubling of the allocation by the 100 largest corporate defined benefit plans to alternative asset classes between 2005 and 2011 to about 20%, and it has remained at this level since. This has been funded by a reduction in average allocations to equities over the same period from about 62% to 36%, with the remainder contributing to increased fixed income allocations from around 9% in 2005 to about 20% in 2016.<sup>2</sup>

**FIGURE 2**  
**ALLOCATION TO ALTERNATIVE ASSET CLASSES BY TOP 100 U.S. DEFINED BENEFIT PENSION PLANS**



Source: Milliman Corporate Pension Funding Study 2017.

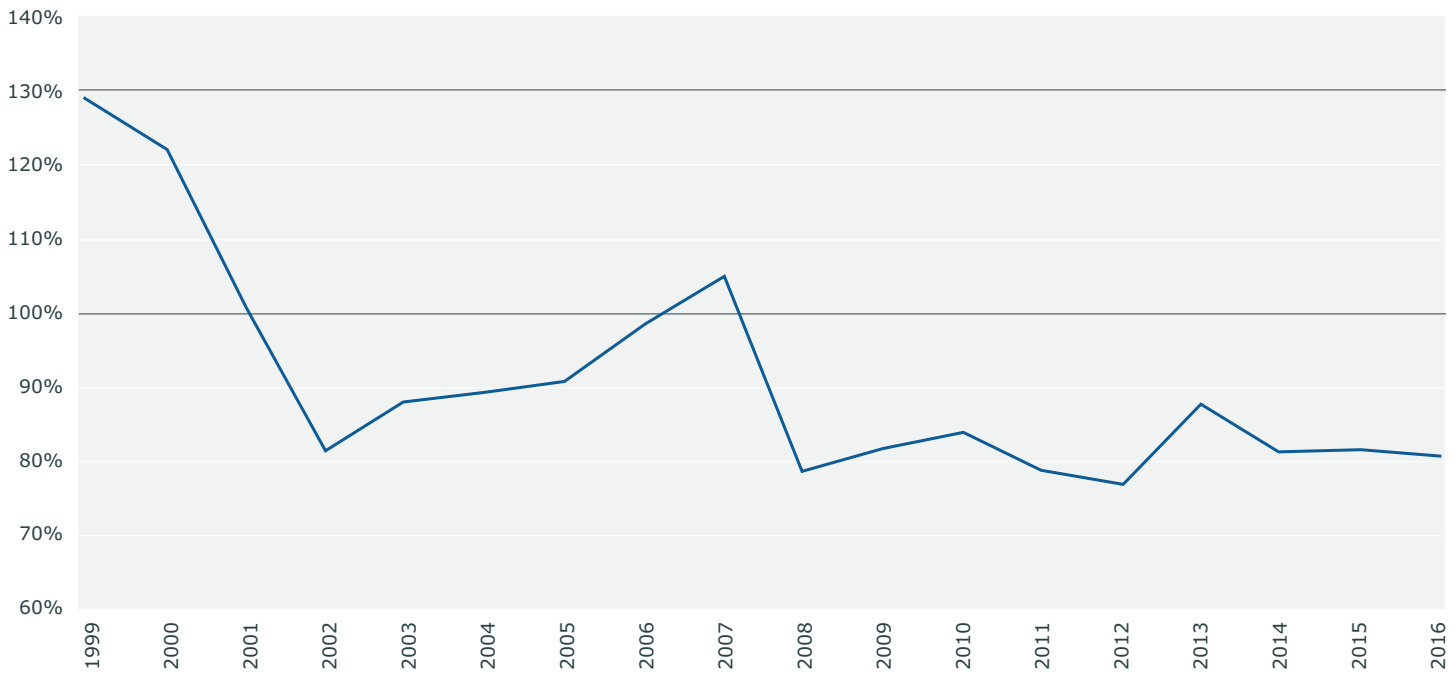
<sup>2</sup> Source: Milliman Corporate Pension Funding Study 2017.

And so the U.S. pension pie has become divided into ever more slices, and the number of managers employed by the largest investors has mushroomed. As of the end of 2017, the average number of managers employed by all pension plans in the U.S. with assets in excess of \$20bn is an eye-watering 84.<sup>3</sup>

Despite this increased allocation to highly specialised, more expensive alternative asset classes and an increase in both the diversity and complexity of the typical fund's investments, there has been no tangible improvement in the average funding status (see Figure 3). The average funding status of the top 100 corporate defined benefit plans over the last 8 years has been hindered by steadily falling interest rates, and ensuing lower corporate bond yields, which have offset the strong investment returns generated during this period.

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FIGURE 3  
FUNDED RATIO: ASSETS/PROJECTED BENEFIT OBLIGATION



Source: Milliman Corporate Pension Funding Study 2017.

<sup>3</sup>Source: Standard and Poor's MMD.

## Absolute return arrives

Absolute return strategies have emerged as an alternative to relative return strategies as the spotlight has returned to the ultimate overall investment objective of the investor, and these strategies now compete for a significant portion of institutional assets.

As market-beta return expectations decline, ever more emphasis is being placed on manager skill, or alpha, to provide an ever greater proportion of the fund's total return, rather than relying as much as in the past on the market returns themselves to deliver the bulk of the return.



In some cases, however, this has created other problems. As investors increase allocations to real assets and hedge funds or turn to increasingly complex structures in an attempt to meet their absolute return targets, they may very well encounter the following:

### Problem 1: Liquidity

In order to deliver attractive absolute return attributes, many strategies invest in illiquid securities or assets – this can include distressed debt, convertible bonds, private equity, commercial real estate, infrastructure and other such assets. Whilst these investments may well hold long-term value, it is not always possible to exit at will or without cost should the investor need to raise cash. Because of the illiquid nature of the underlying investments in some of these funds, there are often 'lock-up' or 'gating' requirements, limiting access to capital to certain pre-defined windows, and even then there may be a redemption fee as penalty for early or unscheduled withdrawal. Moreover, illiquidity tends to inflate the apparent long-term returns and depress the apparent short-term volatility of the assets, leading many researchers to question the very existence of the illiquidity premium.

### Problem 2: Fees

The costs associated with certain absolute return strategies are still too high. Hedge funds and private equity have typically commanded the highest fees, demanded for the claimed skill of the managers in question and their systems and algorithms. The 'standard' hedge fund fee of '2 and 20', that is to say a 2% 'base' fee plus 20% of the alpha above a certain return level, still exists (as do even higher fee structures), but it is by no means the norm any more. Still, fees of 1% plus 10% of the alpha are fairly common, and this continues to represent a high bar for managers to achieve before beginning to deliver a positive net return for their clients. Furthermore it is often the case that hedge fund equity beta exposure is often above 0.5, meaning that investors are often paying high fees in rising markets for returns that may be largely driven by market beta.

### Problem 3: Transparency

Many absolute return strategies offered by hedge funds and others are proprietary in nature and the managers are keen to protect their intellectual capital. As such, it can be difficult for investors and their advisors to get timely access to portfolio holdings information in order to appraise the current state of their investment, provide attribution for its performance and assess the outlook for the near future. In addition, this shielding of holdings can make it difficult for investors to perform proper risk assessments of their overall portfolio at the plan level, and the possible interactions of securities held in the absolute return strategy with securities held elsewhere in the plan's holdings.

### Problem 4: Complexity

In the search for attractive levels of absolute return at acceptable apparent levels of risk, the investment-management community has devised even more complex and exotic means to deliver on such heady promises. We have mentioned already that this often involves the use of illiquid securities which can in themselves be unusually complex to understand and to value. Also, there is often widespread use of complex combinations of derivatives which would prove challenging for an experienced investment consultant to appraise and value, let alone a lay trustee board. Even multi-asset approaches to absolute return, such as the diversified growth funds that have been popular in the UK market, suffered from the same difficulties as pension funds themselves. They too need to determine the appropriate asset allocation based on a whole raft of capital market assumptions that may be wrong and market timing decisions that are notoriously difficult. All this complexity can result in fragile investment products that may well perform as planned in the short term, but can be prone to crumble under market stress at the most inopportune times.

## Problem 5: Capacity

The most skilled hedge fund investors are in great demand, as it is a rare skill to be able to deliver consistently high, positive absolute returns with controlled levels of risk. The strategies underlying the most successful funds tend to be fairly complex, as discussed, and often involve the use of illiquid securities. Both of these common elements lead to the reality that most such funds can only handle a relatively modest amount of assets under management by institutional standards. They are generally forced to close to new investors at quite low levels of assets in order to preserve the alpha-generating capability of their strategy, and so gaining access to such strategies can be problematic for investors. For large institutions, it can also mean that it is difficult to allocate a meaningful amount to an individual fund so as to make a material impact on the overall plan's total return. To make such a meaningful, worthwhile allocation to this sort of strategy would require identifying, accessing and then monitoring a large number of funds, which is often beyond the governance budget of even the largest investors, who may deem it not worth the trouble.

## What about equities for absolute return?

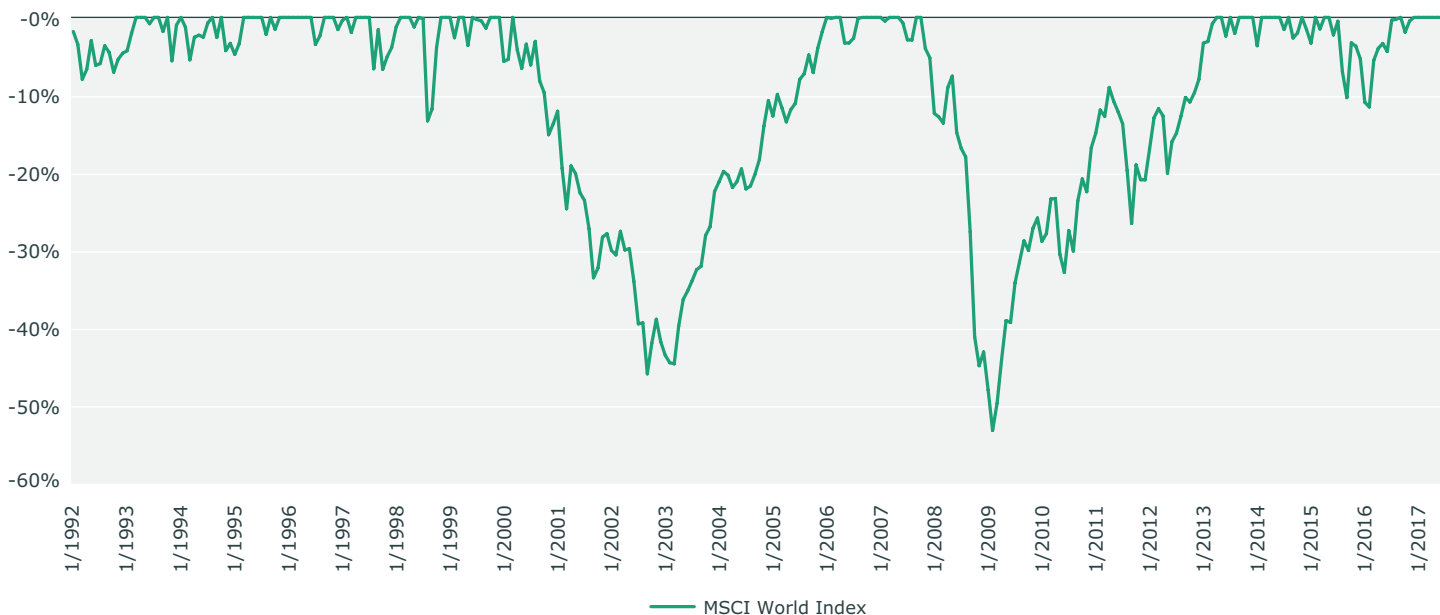
As we have seen above, many providers of absolute return strategies have turned to complexity, illiquidity and high cost in an attempt to generate attractive absolute returns. However, there are other strategies that successfully attempt to deliver meaningful, positive absolute returns based on a single, liquid, transparent asset class.

At Intech® we believe that the large cap developed equity markets offer one of the most productive hunting grounds in which to deliver significant levels of absolute return with controlled risk and, perhaps most importantly, at significant enough scale for many large investors to be able to make meaningful allocations without concern over transparency, complexity or liquidity.

### High returns, high risk

We previously discussed earlier the fact that equities as an asset class appear to offer the highest long-term return among the liquid, listed asset classes in the public markets. The problem is, of course, that they also carry the highest risk. Losing around half your money in a relatively short period, though not common, is not impossible. For the MSCI World Index (Figure 4), it's happened twice since the turn of the century.<sup>4</sup>

FIGURE 4  
**GLOBAL EQUITY MARKET DRAWDOWNS**  
Monthly data for 26 years ended December 31, 2017



Source: MSCI.

<sup>4</sup> 'Tech Wreck' (3/2000-9/2002) max drawdown -46.31%; 'Global Financial Crisis' (10/2007-2/2009) max drawdown -53.65%.

For any investor, this is a catastrophic event, whatever your time horizon. It's going to take a long time to dig yourself out of that hole – about 10 years at 7% a year. So how to mitigate that risk?

### Treating beta as a burden

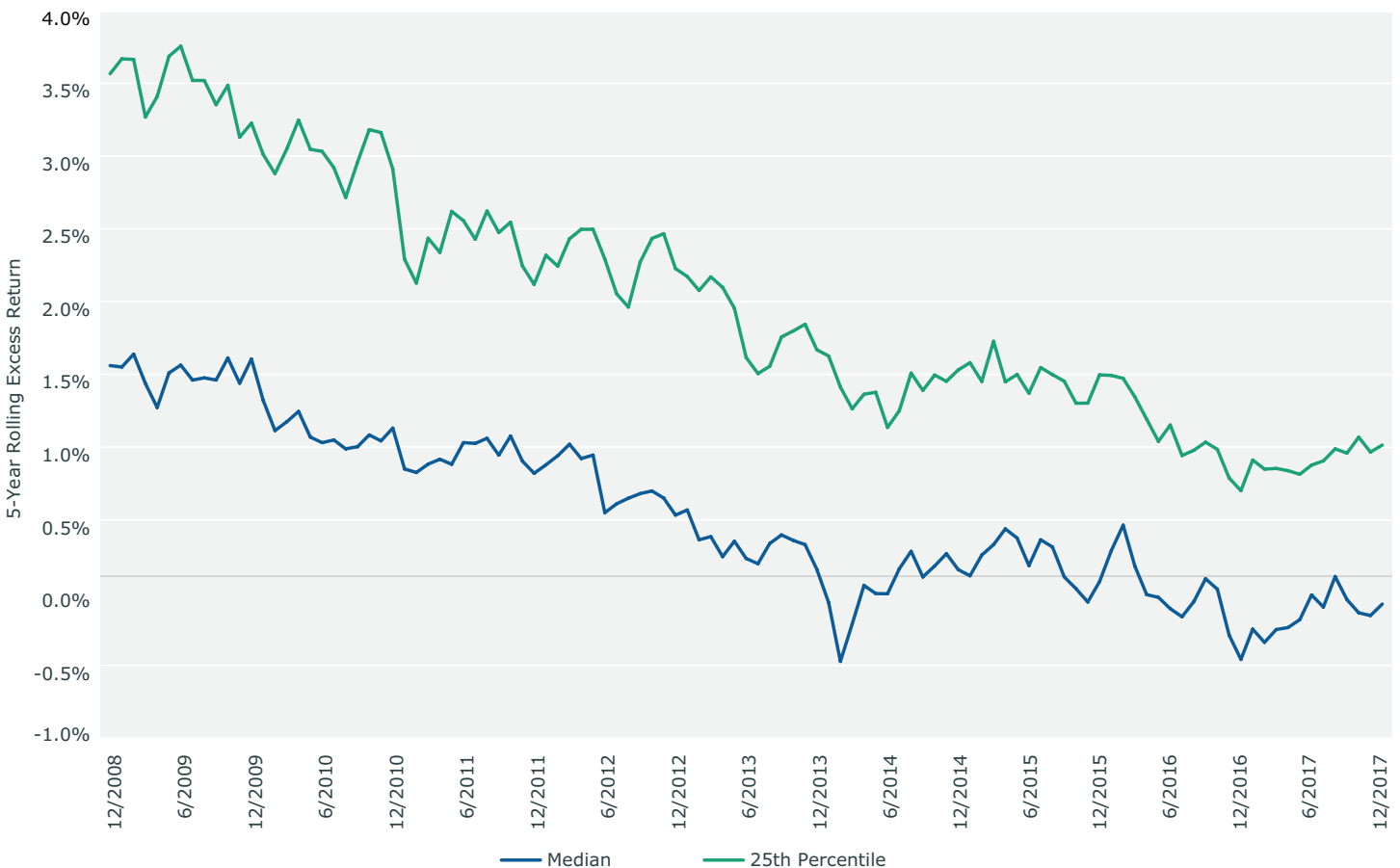
The traditional, long-only approach is to combine equity beta with other, diversifying asset classes and adopt a long-term horizon. There are, however, equity absolute return funds in the marketplace that attempt to *completely* hedge the risk of an equity market decline by entirely removing the impact of market beta.

Hedging is typically achieved by selling short individual securities or equity futures or swaps in a suitable proportion in order to arrive at an overall beta exposure in the portfolio of zero. Such funds are known as 'market-neutral', and they rely on the active,

alpha-generating process of the fund to provide **all** of the return. The contribution of the market return itself has been nullified, both on the downside and on the upside.

The difficulty with such an approach is that equity alpha alone is rarely enough to make up the total return of a satisfactory long-term investment. Whilst it is of course the case that certain equity strategies may occasionally deliver a **relative** return of 5%, 6%, or even 7% in any given year, which for most investors would be an adequate **total** return, this is rarely sustainable in the long run. In fact, the median annualised excess return level in global equities is only 0.24% for the last 10 years as of 12/2017, and even the top-quartile manager on average has delivered 1.23%.<sup>5</sup> The chart below shows the rolling 5-year excess return for the median and top-quartile manager in global equities. Both are far from being enough to meet most institutional long-term absolute return requirements.

FIGURE 5  
**FIVE-YEAR ROLLING EXCESS RETURNS: GLOBAL EQUITY MANAGER PEER GROUP VS. MSCI WORLD INDEX**



<sup>5</sup> Source: eVestment Alliance. Peer Universe eA Global Large Cap Core Equity as of 12/31/2017. Data reflects past performance which is not indicative of future results.



## How to solve this conundrum?

A number of different absolute return equity strategies are available that attempt to boost the total return beyond the alpha derived from the long portfolio's stock picks.

A skilled stock-picker, for example, may be able to do this if they are as good at picking losers as they are at picking winners - they may even be able to double their alpha by successfully shorting losers. However, there is little evidence to suggest that short-side alpha is sustainable for long periods, and even if such a skilled manager were to exist, doubling the alpha may not be enough in light of the top quartile long-only alpha levels of 1.23% seen above.

If successful short-side alpha is not enough to boost the portfolio's total return to a desirable level, then leverage may be employed. In this case, leverage means borrowing money or shorting more stock in order to invest more than 100% of your capital in the portfolio, thereby magnifying the alpha by the amount of leverage (minus the borrowing costs). However the use of leverage, or borrowing to invest, has its drawbacks and is not suitable or even permissible for all, especially if the similarly magnified risks are not properly understood.

Finally, some fundamental managers may attempt to increase the total return of the long-short equity portfolio by not fully hedging the equity beta exposure and attempting to make market-timing decisions. This is notoriously difficult to do reliably, and many such funds have been exposed in previous market crises, caught with uncomfortably high beta exposures when markets suddenly turned.

## A different way to use equities for absolute return

Our core expertise is in exploiting the natural price-volatility of stocks, and understanding the impact of stocks' volatility characteristics on the overall behaviour of stock portfolios, in order to build strategies with desirable risk-return characteristics.

In order to address the problem of generating enough absolute return alpha from an all-equity portfolio, Intech® took the approach of making use of its long-established, long-only Adaptive Volatility portfolio in an attempt to boost the overall returns of the absolute return portfolio by allowing modest exposure to market beta when it is most advantageous to do so.

This long-only portfolio has a variable beta depending upon the level of absolute volatility in the market. When stock volatility is high, typically at times of market stress, the Adaptive Volatility portfolio tends to have lower beta and protects on the downside; when market volatility is low, typically during benign market conditions, the beta tends to rise in order to participate in a rising market. Unlike fundamental approaches to varying equity beta exposure based on questionable attempts to time the market, this methodology requires no such ability.

Combining the asymmetric return profile of this all-long portfolio with a variable short index-futures position, based on both the beta of the underlying long portfolio and the absolute risk of the portfolio itself, is enough to supplement the alpha-generating capacity of the long portfolio with a modest amount of market return. This has the potential effect of boosting the absolute return of the overall long-short portfolio to about cash +5% in the long run, around 2% in excess of the pure alpha expectation of the underlying equity portfolio.





## Conclusion

The goal of investing has always been to generate positive absolute returns in order to grow capital. The means used to achieve this have evolved somewhat over time, all recognizing the need to avoid the risks associated with single market beta exposure.

Today, our ever-inventive investment industry has devised numerous alternative ways of building portfolios with an absolute return objective. Unfortunately, many of these products use combinations of instruments that are often complex, illiquid, expensive and lacking transparency. And these problems often result in capacity limits that prevent institutions from making meaningful investments.

Using equities for absolute return can overcome these shortfalls, but beta exposure can have a catastrophic impact on your portfolio and efforts to eliminate it leave little return. As an equity specialist for over 30 years, Intech® has found another way. By combining an existing alpha-generating engine with a systematic – not tactical – adjustment to beta exposure, investors can access an absolute return strategy with the benefits of equity investing: daily liquidity, cost-efficiency and full transparency.

## Our approach: Evolution, not revolution

The Intech® Absolute Return Platform is just the latest iteration of the investment platforms that preceded it. Like the others, our Absolute Return Platform seeks to reap the benefits of equities while mitigating the risk associated with them.

- Traditional Intech® strategies seek to minimize tracking error.
- Newer Intech® strategies seek to minimize portfolio standard deviation.
- Intech® absolute return strategies seek the highest risk-adjusted return while curbing correlation.

### EVOLUTION OF REAPING EQUITY BENEFITS WHILE MITIGATING RISKS

Platform	Enhanced Equity	▶ Active Core Equity	▶ Low Volatility Equity	▶ Adaptive Volatility Equity	▶ Absolute Return
Year	1987	1993	2012	2013	2017
Target	Excess Return Over Benchmark	Higher Excess Return Over Benchmark	Benchmark-like Returns	Excess Return Over Benchmark	Cash + Return
	Minimize Tracking Error	Minimize Tracking Error	Minimize Standard Deviation	Minimize Standard Deviation	Low Correlation High Volatility Reduction

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Past performance is no guarantee of future results. Investing involves risk, including possible loss of principal and fluctuation of value. There is no guarantee that any absolute return strategy will be able to achieve its

long-term objective or achieve positive absolute returns during up or down markets. While these strategies target a specific risk objective, actual or realized results for longer or shorter periods may be materially higher or lower than the stated objective depending on market conditions.

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