

## Absolute return is still alive

### An asset class under scrutiny

Fixed income absolute return funds have not had good press of late. Many of them are not achieving their Libor plus 2% or more targets, while some are actually in negative territory on the year. Given that these funds were marketed as being able to achieve a positive return irrespective of market movements, the question of whether the concept has failed seems justifiable.

However, the performance of these funds needs to be viewed in the light of the extreme market conditions of August and November. Here the problem was not that prices on credit instruments were going down, as many absolute return funds are structured to be able to profit from falling prices. Rather, the problem was the lack of liquidity, as investment managers were unable to sell paper that they no longer expected to perform well. To further aggravate the situation, credit indices based on derivatives (such as the Itraxx Crossover) performed independently of the underlying physical bonds that they would normally effectively hedge.

Performance of funds investing in corporate credit may also be artificially low due to the difficulty in obtaining realistic market prices for the securities in question. In the current environment, sellers of securities find that investment banks are marking prices downward aggressively to ensure that they do not have to take instruments onto their balance sheets ("bidding to miss"). Similarly, buyers who have an appetite for some of the opportunities being created in this environment are finding that securities are only available in token size. Funds are priced at the "mid" point of these two extremes, and the result is an unrealistic reflection of where value actually lies. As liquidity returns to the market, and the pricing becomes more efficient, absolute return funds will certainly benefit.

There is no doubt that 2007 was a poor year for the absolute return strategy, chiefly as a result of the issues discussed above. However, all strategies face difficult environments through time, but the experience in 2007 most certainly does not diminish the attractiveness of the absolute return proposition. In reality, most funds are only down in the region of Libor less 1 per cent. This is hardly a disaster and should be recoverable for most.

### The UCITS III opportunity

The introduction of the new UCITS III investment regulations strengthen the case for absolute return funds in that they provide greater flexibility to investment managers. Under UCITS III a sophisticated fund has the ability to go short via the use of derivatives. This is key to being able to generate positive returns in falling markets. UCITS III also allows leverage. Neither being short nor using leverage needs to be risky. The ability to implement a bearish market view/short view opens up the range of investment opportunities - particularly in credit markets where the risks are asymmetric as the potential loss on a corporate bond or emerging market bond is generally greater than the possible gain. The ability to go short these instruments reverses this asymmetry in favour of the investor. In addition, leverage allows micro relative value strategies, which are typically low risk in nature, to make a meaningful contribution to performance: if you are looking for the spread between 5 year British Telecom and 10 year British Telecom to move by three basis points, you need to invest a meaningful amount for the trade to make a material contribution. In fact, in this example, where you might be long a 5 year instrument in BT and short a 10 year instrument in BT, there is no actual default risk in the trade.

The key to managing derivatives and leverage sensibly is to have a rigorous risk management structure in place. This is what the UCITS III regulations have imposed with the requirement for daily VAR (Value at Risk) reporting on each instrument held in a fund.

### Some lessons

Clearly there are lessons to be learned from the market turmoil. Credit market indices based on derivatives have not acted as reliable hedging vehicles because they have not been subject to the same selling pressures as physical bonds. Therefore investors have had to look at other ways of reducing market risk: at the moment government bonds work well as a hedge for the corporate bond market as they tend to rally at times of risk aversion. It has also often been preferable to use derivatives on individual names (credit default swaps) on both sides of a relative value trade (for example positioning for one telecom issuer to perform better than another), to avoid the risk of an issuer's cash bond prices being distorted by non fundamental factors, such as forced sales.

### Future performance will tell

The last six months have been an exceptional period in markets and the impact on returns from the absolute return community should be seen in this context. Many can point to past periods of positive performance at times of market downturns. However, what recent history has shown is that it is difficult to uphold performance at times of market illiquidity. Nonetheless, the fact that most funds are still in positive territory points to their robust nature, given the extreme moves in ABS (Asset Backed Securities) and other parts of the credit market in which some players are invested. Indeed, thanks to UCITS III, managers who have experience in the use of short selling strategies and leverage have greater opportunity to generate higher potential absolute returns. I remain confident that the absolute return proposition is a strong one and that long term performance will be generated by those funds with robust structures and processes in place.

At Henderson, our approach is to seek out sources of uncorrelated alpha and to have a wide range of well diversified strategies within our fund. We aim to achieve performance via a combination of directional and relative value strategies across developed and emerging government bond markets, corporate credit and foreign exchange. The process incorporates a method of risk budgeting to ensure that all strategies can contribute equally and that no overriding macro theme dominates. While we cannot claim to have upheld performance at times of market illiquidity, we can point to many months of positive performance in negative market conditions – including July 2007 – that indicate the robust nature of this type of absolute return fund.

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*14 January 2008*

*This article first appeared in the Financial Times, Fund Management*