

Absolute return strategies: let's dive in

Anthos Fund & Asset Management



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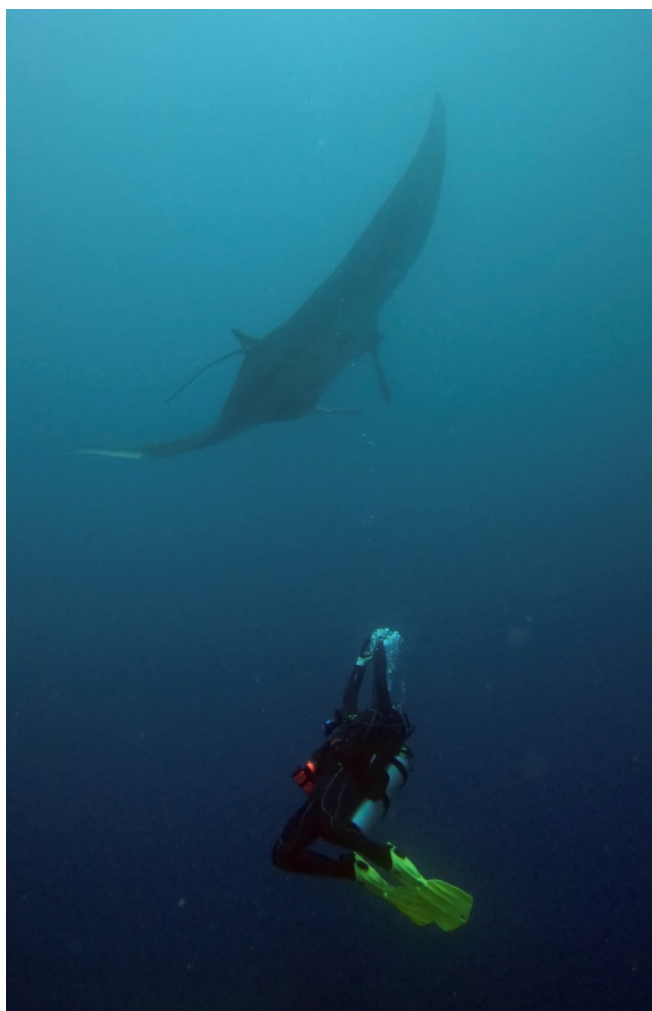
Foreword – by Matthew David Kaplan

Raja Ampat, Indonesia is the global epicentre of marine biodiversity. If you have explored Raja's vast and diverse coral reefs, you have seen first-hand how a healthy marine ecosystem requires a plethora of animals working together in equilibrium in order to thrive. As a portfolio manager who is passionate about scuba diving and capturing the underwater world on film, the ocean serves as my favourite analogy to describe the merits of a well-diversified investment portfolio and explain the important role that absolute return strategies play within it.

Like a healthy coral reef, a well-structured portfolio must comprise a variety of asset classes and investment strategies, each of which serves a specific purpose and contributes to the overall performance and stability of the portfolio. A biodiverse reef features a multitude of fish species (equities), steady and consistent currents bringing in nutrients to the system (fixed income), the coral reef structures themselves (real estate and hard assets), and larger animals including turtles and manta rays (private equity).

However, for the reef to be able to continue to thrive, it must include many other unique species, each playing an important role and serving a specific purpose: polyps, anemone, cephalopods, cleaner shrimp, nudibranchs, and many more (absolute return strategies).

Absolute return strategies are especially important when you consider the current market environment where investors are looking for greater stability and strength beyond traditional asset class diversification. Just as it is imperative that we



"Matthew & Manta" – Raja Ampat, Indonesia.
Photo credit: Justin Gilston
Diver: @matthewunderwater

protect our coral reefs (and portfolios) from adverse influences to maintain biodiversity, absolute return strategies are able to integrate responsible investing and environmental, social and governance (ESG) considerations, which make them a viable option for values-based investors.

What are absolute return strategies?

Absolute return strategies are those which are expected to deliver positive returns regardless of the direction of equity markets. They often feature specialist investment managers that allocate capital to lesser-known sectors of the market. The universe of absolute return strategies includes, but is not limited to, global macro, trend following, equity market neutral, insurance-linked securities, specialty finance, convertible arbitrage, litigation finance, digital assets, and even climate-related strategies that use ESG expertise as an alpha driver.

Investors have long built their portfolios with equities and bonds. Over time, most forward-looking investors realised that the environment of high valuations and low yields was not a sustainable environment for such asset classes alone. This was the case in 2022, when equities and bonds both declined in tandem and it became painfully obvious for investors that they needed to expand their portfolios beyond the asset classes on which they traditionally focused. That is why investing in absolute return strategies is increasingly being used to diversify portfolios, making them more resilient to various economic environments and increasing the likelihood of achieving strong risk-adjusted returns for a total portfolio.

Seven ways absolute return strategies can help investors

1. **Portfolio diversification:** absolute return strategies employ a wide range of investment instruments and focus on non-correlated assets. They offer the opportunity to diversify a portfolio and reduce exposure to directional market risk. As a result, returns generated from these strategies are less likely to be impacted by market selloffs and can provide investors with more stable and predictable returns.
2. **Potential for superior risk-adjusted returns:** skill-based investment strategies are expected to deliver higher returns than traditional passive investing approaches at a given level of risk. They are designed to take advantage of market inefficiencies and exploit opportunities through the use of advanced investment techniques.
3. **Flexible and asymmetric:** absolute return portfolio managers can adjust their investments quickly to changing market conditions. Using a wide variety of financial instruments, portfolio managers can structure funds to exhibit a return profile with a large expected payoff should a trade be successful, while exposing the strategy to relatively low downside risk should they be wrong.
4. **Access to talent:** absolute return strategies should be managed by teams of experienced and knowledgeable portfolio managers who have a deep understanding of their markets and investment techniques. They will be among the first to identify undervalued assets as well as investments offering superior growth. Moreover, they will have the skill to structure trades to create a favourable asymmetric ratio between upside potential and downside risk.

5. **Access to niche assets:** by investing in niche assets and smaller sectors, investors have the opportunity to gain exposure to untapped or underrepresented markets. Such markets offer higher levels of expected risk-adjusted returns in part because they tend to be less researched and less widely followed than larger, more established markets.
6. **Risk management:** one of the key benefits of absolute return strategies is the focus on risk management. Portfolio managers use a range of techniques to manage and mitigate downside risk, including the use of financial derivatives. This can help to ensure that portfolios are protected from downside volatility and generate returns consistently and predictably over time.
7. **ESG integration and values-based investing:** it is increasingly important to integrate responsible investing and sustainability into portfolios, just as it is critical to do so in the ocean. Portfolio managers are increasingly incorporating ESG considerations as both risks and opportunities within their portfolios. There are many examples where managers use ESG factors as an investment edge, including strategies that go long (buy) the most resource-efficient companies and short (sell) the most resource-intensive companies.

How do absolute return strategies work in practice?

As one example, consider convertible bonds for a moment. To bond investors, they may be less attractive because they may offer a lower coupon. However, their embedded option to exchange the convertible bond into common equity becomes valuable when the company does well and its stock price rises. Are convertible bonds therefore compelling instruments for equity portfolios? Well, not always because the company's share price needs to appreciate in order for the option to become relevant. It is for these reasons that many investors own few convertible bonds in their overall portfolios.

Some absolute return strategies bring exposure to convertible bonds through 'convertible bond arbitrage.' The arbitrage typically involves going long a convertible bond hedged with a short position in the same company's common equity. The goal is to harvest a steady return from pricing discrepancies that may exist between convertibles and the associated equity. Interestingly, expected returns from such strategies increase at times of uncertainty when equity markets' moves up and down are likely to be greater.

Just as convertible bonds do not fit neatly into an allocation to equities nor bonds, there is a large variety of investments that are difficult to 'box' while still providing a compelling expected return. In absolute return portfolios, one can find strategies whose returns are linked to the outcomes of court cases (litigation finance), the weather (insurance-linked securities), servicing of mortgages (mortgage servicing rights), credit card payments (structured credit), the success of corporate acquisitions (event driven), and many others. In addition, the range of investment opportunities constantly expands to new markets. For example, with the advent of digital assets (including crypto tokens), price discrepancies between different digital trading venues creates arbitrage potential. This emerging sector also provides the opportunity for venture capital to be invested into new businesses built on blockchain technology.

How to invest in absolute return strategies

As the current investment landscape continues to add complexity and uncertainty to an ever-growing list of concerns, investors would do well to incorporate absolute return strategies into their portfolios. We are encouraged to see that many investors now allocate 10-25% to absolute return.

It is important to note that investing in absolute strategies comes with its own unique set of risks and challenges. Such investment strategies are typically more complex in terms of their structure and use of derivatives. Portfolio managers of absolute return strategies are often less transparent about their positions in part to protect against the risks associated with enabling others to use such information to trade against them. In addition, some managers may be less focused on integrating environmental and social considerations into their portfolios.

A well-constructed portfolio comprising a number of absolute return strategies investing across a variety of sectors offers clients a solution to deal with the challenges of the asset class whilst preserving its benefits. It is critical to leverage an experienced team of investment professionals that have the expertise to perform extensive due diligence to select funds and to construct and maintain a well-structured portfolio. The team responsible for the selection of absolute return funds also actively monitors each fund, decides when to lean into tactical opportunities, allocates to co-investments, and divests from certain sectors or funds when appropriate.

By pooling together capital from various investors, one is able to reach scale, enabling significant negotiation of fees and terms which may be more important in this asset class where fees are higher and funds are less liquid than traditional equity and fixed income strategies. Liquidity differs significantly across funds. By maintaining a portfolio comprising a variety of funds, an overall absolute return portfolio is typically able to offer investors monthly or quarterly liquidity.

Having invested in absolute return strategies on behalf of our clients since 2004, we have seen first-hand the advantages of approaching the asset class in this way. This was especially true for us in 2022 when our absolute return strategy was able to generate positive returns despite the challenging market environment, helping to buoy our clients' portfolios. With investing, as in the ocean, it is variety and balance that sustains positive results over the long-term.