Absolute Return Portfolio

Introducing the EQ Absolute Return Portfolio

eQ investors

Dynamic investment strategies for an uncertain environment

Our Absolute Return Portfolio seeks to generate positive returns from falling as well as rising market conditions and mitigate risk through a variety of dynamic investment strategies.

Its goal is to provide investment returns over the medium to long term in excess of those available from cash deposits without incurring a high level of investment risk.

What is an Absolute Return investment approach?

Most investment funds select assets that will fall in value when markets decline as they inevitably do from time to time. An Absolute Return approach differs in that it employs a set of investment management techniques with the aim of obtaining a positive return (or at least limiting losses) from investments irrespective of whether markets are rising or falling.

Absolute Return does not offer any form of guarantee of positive returns. It is a flexible alternative investment strategy that may be suitable in uncertain markets.

How does an Absolute Return investment approach work?

Most investment funds focus on a set of investments, such as UK equities, and try to outperform the market, such as the FTSE 100 Index of UK companies, but few are able to do so.

The good ones are a select number of active fund managers who will buy investments based on independent, fundamental research and outperform the market as a result. However, they will still lose money when the market falls.

Absolute Return managers are active managers who have a greater number of tools at their disposal. Not only can they buy investments they believe will rise in value, but they can also use investments which make money when markets fall in value. In addition they can add “insurance” to their portfolios to protect against unwanted risks, such as the general risk that the market will fall. These and other specialist tools allow them greater degrees of flexibility to potentially generate positive returns irrespective of whether the general market is rising or falling.

Managing risk

One of the potential benefits of a fund manager being able to use absolute return strategies is that their prices tend to be less variable, due to the additional tools available to them. However, they cannot remove all the risk of holding stock market assets. The consequence of reducing this variability is they may not capture as much growth when stock markets grow.

The chart below illustrates the variability of Absolute Return strategies as measured by the DJ CS Hedge Fund Index (in blue) alongside the variability of the global stock market as measured by the Morgan Stanley World Index (in red). Absolute Return as a strategy will typically generate good returns when markets are rising, but the gains will be less pronounced. This is mainly caused by the cost of the "insurance" strategies they use. Conversely, when markets are falling, Absolute Return strategies will occasionally rise in value, but mainly they do not lose as much as the market. Overall, the 'journey' is therefore a smoother one.

Total Return Bid-Bid line chart from 1 Jan 2004 to 30 Dec 2015, showing the MSCI World Index and DJ CS Hedge Fund Index (both rebased in US dollars). Data provided by Financial Express. Care has been taken to ensure that the information is correct but it neither warrants, represents nor guarantees the contents of the information, nor does it accept any responsibility for errors, inaccuracies, omissions or any inconsistencies herein. Website: www.financialexpress.net

Absolute Return strategies

Within Absolute Return strategies, individual fund managers will employ their own methods for executing that strategy. The key strategies are:

Directional trading

This strategy tends to be applied at sector level and involves long and short positions in asset classes based on expectations of likely future movements. For example, a fund manager may have a positive view on the future value of the US Dollar and a negative view on certain Asian stocks. This could translate into a long position in the US Dollar versus a basket of other currencies (aiming to profit from a rise in value) and a short position on an equity index future on the Hong Kong stock exchange, expecting it to fall.

Long/ Short

Using the same principle, long and short positions can be taken at a stock level on individual securities issued by companies, buying when it is thought that prices will rise and selling short when it is thought prices will fall. A fund manager may hold a positive view on the value of shares in Vodafone while separately holding a negative view on the value of shares in IBM, therefore taking a long position in Vodafone and a short position in IBM within the portfolio.

Event driven

Long and short positions can be taken on individual securities, which are specifically expected to be involved in corporate transactions (such as mergers, acquisitions, restructuring, financial distress and leveraged buy outs) or such 'other' events, the announcement of which may cause significant differences between their market and fundamental values. For example, a fund manager may have expected the merger between two businesses to fail and so post-announcement, they will buy shares in one of the companies and simultaneously sell shares in the other with the expectation that a profit can be made.

Relative value

This is a combination of long and short positions in securities, at both sector and individual stock level, aiming to exploit any perceived discrepancy between the value of individual stocks and the wider sector of which they are part. For example, a fund manager may hold different views on two supermarket chains, such as a positive view on Sainsbury's but a negative view on Tesco. He would enter a long position in Sainsbury's and a short position in Tesco, which would be 'neutral' to the overall direction of the market and would generate a profit from the 'relative value' of these two equities as the market recognises the higher value of Sainsbury's versus Tesco.

Multi-strategy

This is a combination of each of the above strategies in a single fund, with an investment manager taking several positions in stocks or asset classes on a global basis.

Building the EQ Absolute Return portfolio

In building our Absolute Return portfolio we have selected a diversified set of funds and specialist fund managers that have the ability to extract value from a range of different market conditions. We have chosen those that we believe can apply their strategies both rapidly and thoughtfully to capitalise on movements in value at individual company level, within investment sectors and across high level market indices, whether prices are rising or falling.

The importance of a dynamic approach

We live in a fast moving and often unpredictable financial environment. As a result we have to be more active in our asset allocation and increasingly seek fund managers with a more dynamic approach to allocating capital. This dynamic approach allows a fund manager to buy and sell assets and securities in anticipation of, and in response to, market movements more flexibly than some traditional fund managers. Such flexibility mitigates the risk of losses when capital markets fall but enables participation in gains when a rally occurs.

Our investment process

At EQ Investors our investment process is entirely proprietary, independent, risk conscious and seeks diversification so we are not dependent on any one type of investment strategy. It consists of three distinct stages:

Strategic Asset Allocation Committee

Determines the types of asset we invest in

- Macro-economic research
- Economic data analysis
- Capital markets analysis
- Future expectations
- Portfolio asset allocation
- Risk/reward optimisation

Fund Selection Committee

Recommends the funds we invest in

- Initial research
- Sourcing/idea generation
- Fit with strategic asset allocation
- Risk/reward objectives
- Qualitative analysis
- Market opportunity
- Investment strategy & process
- Portfolio management
- Risk management
- Organisational stability
- Investment/executive team
- Reference checks
- Quantitative analysis
- Return characteristics
- Peer analysis

Investment Management Committee

Reviews both asset allocation and fund recommendations

- Review recommendations of:
  - Strategic Asset Allocation Committee
  - Fund Selection Committee
- Approval/dismissal of portfolio allocation changes
- Fiduciary duties
- Stakeholder interaction
- Business strategy

Strategic asset allocation

Determining the proportions of the portfolio allocated to different types of assets is the first stage and this is assessed by the Strategic Asset Allocation Committee. Information is gathered from various sources to inform our understanding of the current and expected future state of the world and how this will impact different types of assets such as equities and bonds.

We then interpret which absolute return strategies should be best able to capitalise on the expected future state of the world and build what we believe is the best mix within the portfolio.

Fund selection

We operate a detailed, proprietary filtering and sorting process in order to identify the universe of potential funds that could provide the strategies we require. Starting with a broad sweep across our data sources, we look for indicators of suitable fund strategies and sectors.

Within each strategy universe, we rank funds based on a proprietary analysis of historical returns where we seek to identify managers with stable and repeatable investment processes. Analysts on the investment team will then interview fund managers, allowing us to form a qualitative opinion on their strengths and weaknesses, which are documented through internal research reports for presentation to the Fund Selection Committee.

Investment management

A separate Investment Management Committee is responsible for applying all the necessary checks and balances to ensure the investment team and the portfolio achieve their objectives.

The results from all three stages of the process are subject to regular review so that we can adjust and rebalance the portfolio as economic trends and fund performance changes.

Key characteristics of the portfolio

The Absolute Return Portfolio aims to:

- Invest in liquid funds only
- Operate an active allocation process
- Be uncorrelated to traditional asset classes
- Deliver lower price variability and risk than a 'long-only' equity portfolio
- Offer an effective strategy alongside traditional portfolios
- Be a stand-alone portfolio for investors concerned about market uncertainty
- Provide the reassurance that only regulated funds will be considered

Risk rating

The Absolute Return Portfolio is not a "no risk" option for investors. It should not be compared to putting capital in cash deposit accounts which offer effectively no risk. However, it should be remembered that such accounts generally offer very modest returns which may not keep pace with inflation.

This portfolio provides an alternative strategy, aimed at generating returns in uncertain markets, when a more flexible approach and speed of action may help realise value. To achieve this objective, significant investment in equity markets is required. This gives rise to a degree of risk, although the nature of the Absolute Return strategies employed within the portfolio may, to some degree, mitigate the level of risk relative to a 'long only' investment strategy in similar types of assets.

As always, when constructing a portfolio we look at the overall effect of the investments and the risk of the portfolio as a whole. Within the Absolute Return portfolio it is likely there are individual funds and investments that may not individually employ Absolute Return strategies (if they are held in isolation from the rest of the portfolio). By combining these funds the objective of the overall portfolio will be to achieve an Absolute Return.

Further Information

To discuss the Absolute Return Portfolio, please contact us on: **020 7488 7110**
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