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AR funds struggling but not at the point of no return

Holding out the possibility of delivering returns in all markets, absolute return funds have enjoyed a surge in popularity in recent years –and a fair amount of bad press. Absolute return and target return funds have distinct definitions, yet have become synonymous in the Irish market.

These AR funds – as we may call them – have proved attractive to investors in search of less volatile returns. They have attracted adverse comment due to high charges and disappointing performance.

Of the AR funds available from Irish life companies, nine have a five-year track record and their average return to the end of March was 1.6% per annum net of charges. Of the seven that have a specific performance target, the average return was 1.7% per annum; or 1.8% per annum below the average gross target (before charges).

Even allowing for relatively high charges, the gross returns of all seven have come up short over the five years.

Over shorter terms, returns have been even more disappointing with the average three-year net return being slightly negative. While this has bred growing disillusionment, a fair assessment should look at periods of at least five years.

In the broader universe of absolute return funds, the HFRI Fund Weighted Composite Hedge EUR index shows net annualised five, seven and 10-year returns in euro of 3.3%, 2.6% and 3.0% respectively. The index includes a greater proportion of what would be considered "true" AR funds – funds which can take short positions, for example, rather than long only funds.

Many of the funds in that HFRI index bear quite high charges and would generally have come closer to hitting gross targets of cash plus 5%. Of course, it is the net return that matters, and the longer term numbers are underwhelming.

The other significant statistic revealed within the index is that, over the past 10 years, the degree of correlation with the leading global equity indices, at 0.7, is higher than one would like, or indeed expect. The peak to trough decline, or maximum drawdown of 22% experienced by the HFRI index between 2007 and 2009 is very much related to the strong correlation with equity markets.

The correlation with equities shown by a number of the "Irish" AR funds is also quite high, casting some doubt on the true value of these investments as portfolio diversifiers.

All the evidence from markets suggests that true manager skill is a scarce commodity. However, as most of the time these funds run a blend of net long positions in risk assets, we would expect them over the longer term to harvest at least some of the market risk premium – the "beta" – that accrues to those assets. And that is why it is reasonable to expect them to produce a small positive return in the longer term.

An obvious conclusion then is that most, if not all of the stated performance targets are simply too ambitious. In our view, the range of targets, which are typically pitched at cash plus 3% to cash plus 5% (depending on the fund's strategies and volatility level), should see the plus bit trimmed by 1%, and in some cases more.

Of course as the expected return diminishes, so does the excess over the charges, raising the question of whether these funds are value for money. Is it worth paying a known additional charge for an uncertain net return of perhaps 2%-3%? A financial analyst would ask for the probabilities around expected return and standard deviation from the mean and might well conclude that the trade-off was not particularly attractive, especially in the case of individual funds with relatively high charges. The ratio of charges to risk-adjusted prospective return may not be very palatable, but in these times, this is equally true of many other asset classes.

It is emphatically the case

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for fixed income, where quantitative easing has driven bond yields to historic lows from where it is almost impossible to envisage the lump sum investor making a positive real return. Bonds have been the traditional "anchor" asset class used to populate the lower-risk part of a cautious or balanced portfolio. Current valuations call that into question. We recommend a blend of AR funds to supplant at least part of what would have been otherwise allocated to bonds.

Those AR funds may be unlikely to achieve their own grandiose targets, but if they earn even a modest net margin over cash they will have delivered what we need. And that will almost certainly be better than what bonds can produce.

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