January 2010

The respective merits of absolute-return and relative-return investing

Following the turbulent events in financial markets in recent years, the debate about whether investors should move from relative-return investing towards an 'absolute-return' approach has intensified. In this article, we consider the respective merits of absolute-return and relative-return approaches to investment.

Relative-return investing is, as its name suggests, the management of an investment portfolio relative to an industry-standard benchmark. Absolute return investing, by contrast, is the management of investments to achieve an attractive 'real' return without reference to a benchmark. At our investment briefing, we considered the respective investment approaches in relation to a number of key aspects of decision-making, including time, transparency, accountability and risk, and macro-environmental considerations.

Time horizons

Until the 1970s, investors were generally preoccupied with achieving absolute returns; only when inflation started to rise in the 1970s did investors start to adopt benchmarks in order to differentiate between the returns that came simply from the market in which they were invested and the value added to those returns by investment managers. The 20-year equity bull market which began in the early 1980s cemented the role of 'relative' investing as the central approach of the investment industry. However, the last decade has been a highly challenging time for investors and, following disappointing returns from equity markets, the debate about the movement from relative-return investing towards absolute-return investing has intensified.

In bond markets, yields have declined steadily since the mid-1980s as inflation has fallen. A relative-return investor would have made a return of 653% (in US dollar terms) by investing in U.S. government debt between June 1984 and December 2009[1]. Within the overall trend of declining yields, however, there have also been some significant periods of negative returns, during which yields have risen (principally amid concerns about rising economic growth and mounting inflation).

Government bond yields can not decline (or prices rise) indefinitely; indeed, as they fall closer to zero, there is a greater chance that they stop declining. During the 20 years before the 30-year 'bull' market in government bonds began, yields rose dramatically against a backdrop of rising inflation, strong growth and the authorities' loss of control of money supply. That period would have been a very good time to be an 'absolute-return' investor.

1 Source: Bloomberg, January 2010.

Time allows investors to take risks by affording them the opportunity to recoup the losses they may incur in a volatile portfolio. It may be that investors are simply not prepared to suffer such losses, either because the maturity of their scheme is such that funds are going to be required soon, or because their risk appetites are not sufficiently large. Trustees may also be concerned about their ability to adhere to their long-term strategy in the teeth of capital losses; if they feel unduly threatened in seeking to do so, it may be appropriate for them to pursue an absolute-return-orientated strategy.

Transparency

Investors who follow an absolute-return approach will have a very clear reference point for the kind of assets that are held in their portfolios. An index-based, relative-return strategy has the benefit of having a degree of clarity about both what the manager is seeking to achieve and how he or she is seeking to achieve it, and there is simplicity in measuring its returns as well.

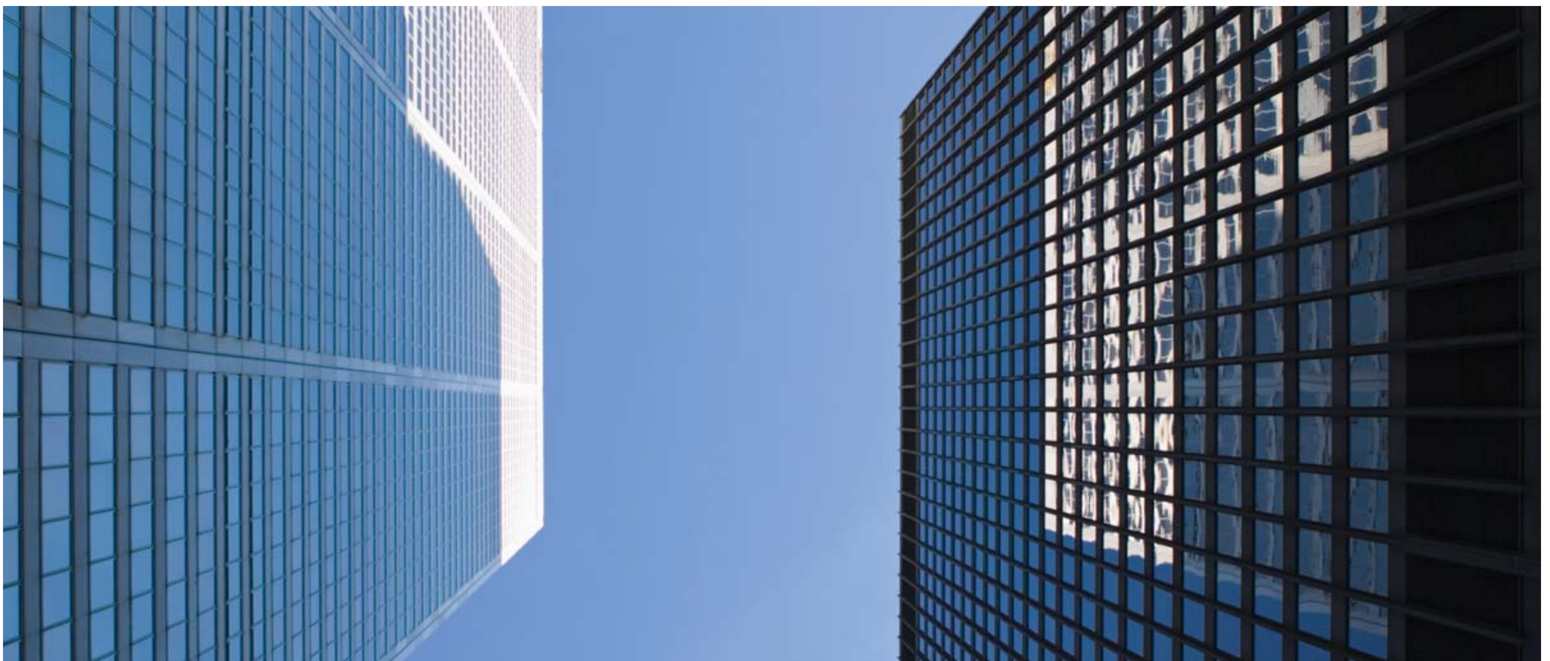
However, it is questionable whether investors should strive to achieve such clarity and simplicity when they set investment managers their objectives. Instead, investors might prefer to choose a benchmark that is more closely aligned with the objectives of their portfolio. If, for example, pension scheme trustees wish growth in the assets of their scheme to match or exceed the level of employment-cost inflation, they might choose to adopt a benchmark or target linked to that level.

Accountability and risk

In looking at the returns from an absolute-return portfolio, it is easy to assess the 'risks' that were taken to achieve those returns. In relation to absolute-return portfolios, the assessment of risk (certainly relative risk) may appear to be less straightforward. Risk might be defined simply as the risk of losing money. In order to conclude that risk relates instead to performance versus a benchmark, one needs to make the leap that the index or the benchmark itself is risk-free, or that it embodies risk that investors are happy to take (regardless of the composition or valuation of that index or benchmark). Investors might prefer, however, to charge their investment managers with the task of generating a 'real' return, which will encourage those managers to focus to a greater extent upon capital preservation.

Macro environment

In relation to absolute-return strategies, investors should be mindful of the risk of inflation; the risk may not be imminent, but it is salient to recognise its existence nonetheless. Higher inflation might also render cash-plus strategies less useful,



and employment-cost inflation, which historically has outstripped generalized inflation for long periods, may also be a major concern for pension scheme trustees.

The most powerful consideration, however, is the fact that markets have generated strong real returns in the long run. Following a decade of poor returns, it might seem like an attractive time to be investing in a relative-return, equity-biased portfolio. The difficulty with this conclusion, however, is that the backdrop to equity investment remains highly challenging.

We would argue that the fundamental attributes of many of the developed-world economies remain rather weak. Although financial markets do not seem too perturbed at present by the challenges that remain in those economies, we believe it remains imperative for investors to adopt strategies that take account of risks as well as the pursuit of returns (and particularly strategies that allow investment managers to harness value across a company's capital structure).

Summary

Investors' preference for a relative-return or absolute-return approach clearly depends on their time horizons, and it is also dependent on their objectives and risk appetites. Where investors have a long-term time horizon, it may well be advantageous for them not to restrict their investment manager(s) to a relative-return arrangement that is unnecessarily shackled by the imposition of an 'off-the-peg' benchmark.

In terms of transparency and accountability, using a market universe as a comparator is likely to lead to ease of analysis, but investors need to make sure that the comparator they use is relevant to them in the pursuit of their objectives.

We believe that relative-return and absolute-return approaches are complementary and that they can be managed by the same investment house (not least where both approaches harness the same investment process, as they do at Newton). In relation to the management of both approaches, we contend that achieving perspective through the use of long-term themes, and using judgment rather than historical models, can help investors navigate their way through challenging financial-market conditions.

At Newton, we manage both relative-return and absolute-return portfolios and, while we recognise the differences that exist between those portfolios, we contend that they should share some characteristics; most importantly, the investment manager of a relative-return portfolio should not be oblivious to the importance of capital preservation or to the generation of an attractive return (which may not derive simply by exceeding the return from a benchmark). We believe that the appropriate way to manage both strategies is to found the investment decisions within them upon theme-based investing and sound judgment.

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