

Absolute Returns: What to Expect When Investing

What do these funds promise and what should investors really expect?



by
Nadia Papagiannis, CFA
Hedge Fund Analyst

Absolute Return Defined

Absolute return means the appreciation or depreciation of an asset over time, differing from the notion of relative return in that absolute returns are not comparable to a benchmark. Absolute return often describes investment vehicles, namely hedge funds, that employ investment techniques not used in traditional mutual funds to achieve these nonrelative returns.

In Morningstar's hedge fund database, there is no absolute return category, though there are 1,471 self-named "absolute return" funds that identify the term in the name or strategy description. These funds all define their absolute return strategies differently, but here is one very representative description: "The investment seeks to earn a consistent rate of return or 'Absolute Return' without relying on the direction of traditional stock and bond markets—an approach commonly referred to as

a noncorrelated investment strategy." Many funds go further to specify positive returns, but presumably no rational investor seeks consistently negative returns. The term over which these positive returns must be achieved varies, from monthly, to calendar year, to vague periods of time (over the medium term, for example). The magnitude of these positive returns and the standards by which they are measured vary, too, generally falling into two camps. The first is an absolute return goal, usually between 10% and 15%. The second is a relative return goal, relative to a risk-free proxy, on the order of between 4% and 6%. Besides positive returns, many of these absolute return hedge funds promise low volatility.

Essentially, absolute return funds appear to have three goals: high positive returns, returns that are not correlated with traditional stock and bond markets, and low standard deviation of returns. In this article, we examine all three of these goals, and see how hedge funds measure up. Then we look at the theory behind absolute return funds and find that, in fact, it is just that: a theory.

Claim 1: High Positive Returns

Absolute return hedge funds certainly have high hopes. Some, 119 of them, dare to quantify these hopes. Return targets range from 2% to 25% annualized, but the average minimum return goal (many funds state a range) of these

funds is 11% annualized, a difficult goal considering the history of stock and bond market returns. In reality, these absolute funds fared much worse than advertised. In fact, most funds failed to even preserve investors' capital.

Of the 870 funds reporting 2008 returns, only 133, or 15%, reported positive returns. The average return for all of the funds was negative 19.1%—slightly better than the overall Morningstar 1000 Hedge Fund Index, which lost 22.4%, and much better than the MSCI World, which lost 41%. It is true that the negative returns experienced by these funds in 2008 were atypical—in the previous nine years, less than 26% of the funds in any year reported negative returns. But this number is understated. Funds drop out of the database, typically due to liquidation or poor performance (which eventually leads to liquidation), and they rarely report the final dismal results. Of the 1,471 absolute return funds, 555 or 38% have dropped out, 196 of them in 2009 and 221 in 2008. Even without these funds' final results, we can see a stark difference in returns. The 196 funds that liquidated in 2009 reported average 2008 losses of 29.8%, while funds that stayed in the database reported average 2008 losses of 18.4%. The 221 funds that liquidated in 2008 reported 2007 returns of 11%, versus nonliquidated funds' returns of close to 16%.

Even ignoring database biases and factoring in prior years' positive results, these absolute return funds have still, on average, failed to live up to their self-created expectations. Over the last five calendar years, the average absolute return fund has outperformed stocks, but has only managed to match the 5% annualized returns of bonds, less than half that of the 11% return target. Any way you slice it, not only do absolute return funds fall short of their own return targets but they fail to deliver even positive returns when investors need them the most.

Convertible Arbitrage and Global Equity absolute return funds exhibited the highest stock correlations (greater than 0.5) of the single manager funds. The absolute return funds in the Hedge Fund of Funds Equity and Hedge Fund of Funds Debt categories exhibited the highest correlations to the stock indexes (greater than 0.55), while absolute return funds in the Hedge Fund of Fund Derivatives category showed the highest correlation to the bond indexes (greater than 0.29).

Claim 3: Low Standard Deviation

The final common claim of absolute return hedge funds, low volatility, also fails to pass muster. The average three-year standard deviation of 539 funds with 36 months of returns through March 31, 2009 is 14.4%. This is lower than the S&P 500's standard deviation of 17.7%, or the MSCI World's of 18.9%, but double that of the Barclays Capital Global Aggregate Bond Index of 7%. The high volatility of these funds could be caused either by more equity exposure than an absolute return mandate might suggest or by leverage. Neither option bodes well for investors seeking a low-volatility investment.

	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999
MSCI World NR USD	-40.71	9.04	20.07	9.49	14.72	33.11	-19.89	-16.82	-13.18	24.93
BarCap Global Aggregate TR USD	4.79	9.48	6.64	-4.49	9.27	12.51	16.52	1.57	3.17	-5.17
Absolute Return HF's	-19.07	14.69	15.94	7.04	10.76	22.38	8.31	15.63	15.46	37.11

Claim 2: Low Correlations to Stock and Bond Markets

We've established that absolute return hedge funds can't give investors consistent or high positive returns. But can they provide returns that are uncorrelated to traditional stock and bond markets? The short answer is no.

The relative return aspect of these absolute return managers can easily be seen by simple regressions on traditional stock and bond market indexes, such as the S&P 500 TR and MSCI World USD Indexes. Of the 539 absolute return funds with 36 months of returns ended March 2009, a large percentage exhibited significant positive betas to the S&P 500 TR and MSCI World USD stock indexes, while a smaller percentage exhibited significant betas to the Barclays Capital US Aggregate Bond TR and Barclays Capital Global Bond indexes.

Furthermore, average correlations of these funds were relatively high. More than 50% of these funds exhibited correlations north of 0.75 to the stock indexes, and 23% of funds showed correlations higher than 0.75 to the Barclays Capital Global Bond index.

The numbers reveal a strong relative return relationship to the most basic of asset classes, stocks and bonds, in both single-manager and fund-of-hedge funds structures. This makes the case for measuring performance against a cash benchmark or no benchmark weak. Only two of 119 funds that explicitly stated return goals named a benchmark other than a cash proxy, such as the 90-day T-bill or LIBOR rates. Investors should beware of any fund that claims it cannot be compared with a benchmark other than cash, and they should run simple beta and correlation calculations to see if, in fact, these absolute return funds are taking on traditional market risks. This way, an investor is less likely to mistake the fund's relative market returns for actual manager skill.

The Case for Absolute Return Hedge Funds

The data show that absolute return funds on average do not deliver what they intend: high positive returns, low correlation to stocks and bonds, and low standard deviation. Is such a strategy, therefore, even possible?

Well-accepted portfolio theory asserts that any portfolio delivers the return on the market, or beta, plus a nonmarket return, or alpha, derived from market timing and security selection. All returns, then, are relative to the market risks taken, whether or not those market risks can be represented by standard benchmarks. Accepting this premise, the only way for an absolute return fund to produce positive returns with no correlation to the market and low volatility is for a skilled (positive alpha) manager to follow a market neutral-strategy, where all relative market risk is fully and dynamically hedged out, through offsetting short positions. After all, what remains is a risk-free return plus any alpha the manager may deliver. Alpha is typically not high—lbbotson and Chen (2006) approximated this post-fee hedge fund annual alpha at 3% (prior to the market crash). A return equal to the risk-free rate plus a reasonable alpha will also result in low volatility over time.

539 Funds with 36 months of returns through 3-31-09		
	% Funds with Sig Beta	Avg Beta
S&P 500 TR	0.76	0.49
MSCI World USD	0.81	0.51
BarCap US Agg Bond TR	0.28	1.84
BarCap Global Agg TR	0.35	1.47

But an absolute return fund is unlikely to have it all—high positive returns that are uncorrelated to the market with low volatility. Indeed, of the 265 funds with positive three-year returns (ended March 31, 2009), those generating returns of less than 8% averaged a 3.5% annualized standard deviation, while funds generating annualized returns in excess of 8% averaged 15.3% volatility. Returns higher than the risk-free rate plus an alpha of 3% could indicate the manager is using leverage, or that the measure of beta is simply incorrect.

Assuming a fund exhibits positive alpha and the strategy is not highly levered, a market-neutral strategy theoretically delivers most of what absolute return funds promise. Only 87 absolute return hedge funds in Morningstar's database claim to follow market-neutral strategies. In fact, the investment strategies of these funds are very diverse. The most common categorization of these funds is multistrategy. Other common categories are directional in nature—emerging markets equity (6%) U.S. equity (7%), and Europe equity (7%). So it's clear that most absolute hedge funds aren't investing in to the only strategy that, theoretically, might produce what hedge funds deem absolute returns.

Market neutrality, however, is easier said than done. Market risk, unfortunately, is not easily identified or hedged. Hedge funds take on both standard equity and bond risks, which can be easily identified through regression against common stock and bond benchmarks. But they also take on more esoteric risks, such as selling insurance and providing liquidity.

Hidden Betas

Two large sources of hedge fund or alternative strategy returns are insurance selling, or taking on bets with blowup risk, and liquidity providing, capturing a premium from holding a less liquid instrument. Take, for example, merger arbitrage. Mitchell and Pulvino (2001) find that the return profile of this strategy is similar to selling uncovered index put options.

The arbitrage is selling insurance on a deal closing, receiving small premiums while the deal closing becomes more certain and the spread between the target and acquirer stock narrows. If the deal fails, and spreads blow out, as occurred for a record number of deals in the fall of 2008, the arbitrage or insurance seller experiences large losses. These short-put strategies have low or no traditional market beta in good times and positive betas in bad times—something investors don't see until the bad times occur. Unfortunately in bad times, lack of liquidity is also an issue.

Liquidity is another ubiquitous risk factor. Pastor and Stambaugh (2003) defined a liquidity factor, also termed market impact, and found that it is, in fact, a priced factor for stocks. Chen and Ibbotson's 2009 research found similar results. Other academics have found priced liquidity factors in many markets. Liquidity premium can be captured by buying securities that most investors do not want to own, such as one involved in a corporate event, a security in or near distress, or very small issues. Arbitraders profit from this liquidity premium by shorting a related, more liquid security. For example, convertible arbitrage takes a long position in an illiquid convertible bond and shorts a more liquid stock.

When liquidity premium is coupled with leverage and leveraged hedge funds dominate the market, the results can be catastrophic (hence the convertible arbitrage meltdowns of 2005 and 2008). Some large, highly levered hedge funds even sell insurance against illiquidity (for example, write credit default swaps and buy subprime mortgages). Margin calls in these funds can lead to large losses in seemingly unrelated liquid assets such as equities, as was seen in the quantitative funds meltdown of August 2007.

To Invest, or Not to Invest?

Investors should be skeptical of investments touting themselves as absolute return

and should do their homework to identify the risks of such a fund. If a fund's strategy description implies that it typically maintains a long-only or net long market exposure (whatever market this may be) as opposed to a market-neutral exposure, it's not rational to believe that this manager is generating absolute returns. Investors should expect that such a fund will suffer along with the market exposure it takes. From our simple examinations, more than 75% of absolute return funds took on stock market exposure, so it's not surprising that 85% of funds saw negative returns in 2008.

If a fund claims to invest according to a market-neutral strategy, investors should analyze returns of the fund against various market indexes to see if, in fact, the fund is taking on basic market risks. Furthermore, if this market-neutral fund promises to deliver high returns, greater than the risk-free rate plus a couple percent, investors should delve deeper into the fund, looking for leverage or hidden risks. Often, investors can find a similar strategy in a more transparent mutual fund format (Highbridge Statistical Market Neutral HSKAX, for example). This makes the process of identifying risk a lot easier than in hedge fund format. Furthermore, mutual fund regulations restrict illiquid investments and leverage, mitigating the risk of blowups. ■■■

References

- Ibbotson, Roger and Peng Chen, "The A,B,Cs of Hedge Funds: Alphas, Betas, and Costs," Yale ICF Working Paper No. 06–10.
- Chen and Ibbotson, "Liquidity Investing," *Ibbotson S&P 500 Classic Yearbook*. Chicago: Morningstar Inc, 2009.
- Mitchell, Mark and Todd Pulvino, "Characteristics of Risk and Return in Risk Arbitrage," *The Journal of Finance* Vol. LVI, No. 6, December 2001.
- Pastor, Lubos & Stambaugh, Robert F., 2003. "Liquidity Risk and Expected Stock Returns," *Journal of Political Economy*, University of Chicago Press, Vol. 111(3), pages 642–685, June.

Alternative Investments Observer

Editor

Nadia Papagiannis, CFA

Contributors

Bradley Kay, Ben Alpert, CFA

Copy Editor

Jennifer Ferone Gierat, Janice Frankel

Design

Adam Middleton

Data Team

Dade Dang, Dan Aliaga

Publisher

Scott Burns

Vice President of Research

John Rekenenthaler, CFA

Managing Director

Don Phillips

©2009 Morningstar, Inc. All rights reserved. Reproduction by any means is prohibited. While data contained in this report are gathered from reliable sources, accuracy and completeness cannot be guaranteed. The publisher does not give investment advice or act as an investment advisor. All data, information, and opinions are subject to change without notice.

The information contained in this Report: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Morningstar depends on each individual hedge fund to provide it with accurate and complete data. To the extent that one or more hedge funds do not provide Morningstar with data or these data are deficient in any way, the statistics provided by Morningstar may be compromised, including, but not limited to, failing to accurately reflect the hypothetical performance of the Portfolio as a whole. In addition, because these data are primarily backward looking (i.e., they're comprised of historical performance statistics), neither the data nor Morningstar's analysis of them can be relied upon to predict or assess the future performance of a particular hedge fund or the hedge fund industry. Unless otherwise specified, the data set out in this Report represent summary data for those reporting hedge funds comprising the database, and not for an individual hedge fund. Please note that, as a general matter, any return or related statistics that are based upon a limited number of data points are considered statistically suspect and, therefore, may be of limited value. The publisher does not give investment advice or act as an investment advisor. All data, information, and opinions are subject to change without notice. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of the content of this newsletter or any information contained in or derived from it. "Morningstar" and the Morningstar logo are registered marks of Morningstar, Inc. All other marks are the property of their respective owners.

For inquiries contact: newslettersupport@morningstar.com.