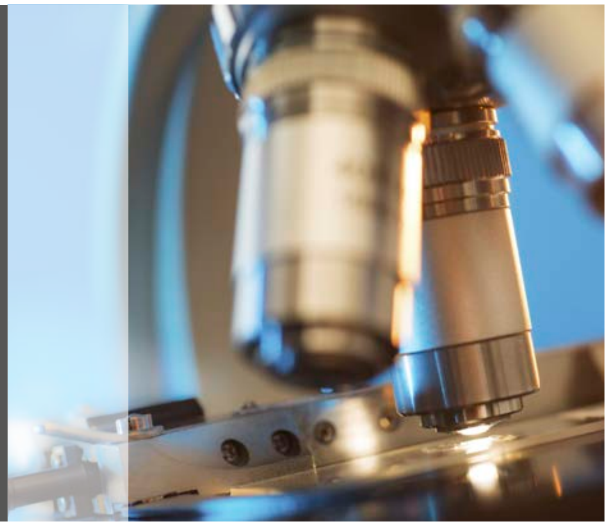
HAVING AN ABSOLUTE FOCUS



Andy Cawker
Head of specialist equities, Insight

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Investors need to choose their absolute return fund wisely as too often many are overly correlated to the equity market and long-only funds, providing little by way of diversification or bond-like volatility, according to Insight fund manager Andy Cawker. Here he discusses why today, in an environment of subdued economic and investment growth, limiting drawdowns has become ever more important.

Over the past 12 months, correlations have been unstable, with some periods of positive correlation between equities and bonds, and other periods where there have been episodes of 'risk-on/risk-off'. This has led to a wide variety of performance in absolute return funds; over the 12 months to 16 May, funds in the sector showing double-digit gains sit alongside those with double-digit falls. Andy Cawker, portfolio manager and head of specialist equities at Insight, notes: "In general absolute return and hedge funds have not been good at delivering positive returns that are uncorrelated to other asset prices and may instead be equity-like."

Cawker believes the attraction of absolute return funds should be their ability to add something different to a portfolio. "I do not believe absolute return funds returning 60% in a year that equities are up 30% is necessarily what investors are looking for; if you're looking for that kind of return then you might as well buy an equity fund," he contends.

Correlations are not just unstable among some absolute return products and equities but among assets themselves, making it increasingly difficult for portfolio construction overall. Cawker believes we are in a period of change and greater interconnectedness and so maintaining true diversification has become a challenge.

After decades of largely positive bond returns, last year marked a real change with not just low returns but double-digit negatives in some cases. Cawker says this has led investors to wonder what they should be doing with the low risk part of their portfolios. Meanwhile, he adds, equities have had a dramatic rise and re-rating, all without a corresponding increase in company profits or earnings.

According to Insight's head of product management for specialist equities, Matt McKelvey, while volatility looks relatively subdued so far this year, appearances may be deceiving. "It is a confusing market as there is becalmed

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volatility at the broad market level but beneath the surface stock risk has picked up." McKelvey points out that there have been big moves in individual stock prices on earnings announcements as well as increased M&A activity, he notes.

Calling the first quarter of 2014 a "choppy start", McKelvey notes the year started with a fall in equity markets, led by emerging markets, brought on by a combination of concerns on growth and currency weakness while fixed income rose. "Actions by some local central banks helped emerging market currencies and equity markets to stabilise in February, then from mid-March emerging markets equities sharply outperformed. This was in part on the back of anticipated Chinese stimulus but it also appears that some investors may have closed down their anti-emerging market bets. At this time there was almost perfect correlation between the upturn in emerging markets and a downturn in the US Nasdaq as well as a broader rotation in momentum across global markets – those previous winners underperformed and there was a move from growth to value."

McKelvey and Cawker believe earnings growth will be key to equity markets from here. "One issue for equity markets is that they have risen against a background of negative earnings revisions for an unusually long period. The equity market cycle had its valuation expansion phase and now we are moving into the earnings delivery phase. In order for the market to move meaningfully higher from here we have to see earnings come through to justify the expectations which are already built in. Interestingly, in Europe earnings expectations for the next 12 months are still being revised down, McKelvey says.

He adds the more subtle issue is that those individual companies which have been able to deliver positive surprises have generally been rewarded with outperformance momentum, supported by the market's willingness to pay more for that growth. However, he adds, this meant there has been a relatively narrow set of winning industries, particularly in the UK market, setting the stage for periodic reversals in performance momentum.

Cawker concurs, noting Insight's sense is that we are not in a normal cycle with respect to corporate profitability and economic recovery. "In the midst of the second quarter reporting season in Europe analyst forecasts for profit growth had fallen. If it is anything like it has been over the past couple of years, this will continue to fall. In the absence of quantitative easing (QE) in Europe, profits will need to start recovering to justify the move in markets." That said, Cawker believes QE in Europe is a real possibility as the European Central Bank may need to further stimulate inflation as the threat of deflation is mooted.

However, it is stimulus such as QE that has also created the unusual market climate of today. "We are in an artificial investment environment because of the actions of the central banks in pumping liquidity into the system," says the manager. "As a result markets are behaving almost like they are in the 'Truman Show' as Seth Klarman has famously described it. However, some participants are now starting to see the cameras and realise that the environment may not be real."
This uncertain environment has led to growth in absolute return products, which Cawker believes is likely to continue.