Can Absolute Return Protect Against the Comeback of Volatility?

Key Ideas

- Institutional investors face a dilemma: Given the multi-year strong rally in equity markets, the challenge today is to preserve those gains should volatility make a comeback.
- Absolute return strategies hold the potential for improving portfolio efficiency and protecting on the downside, but the heterogeneity of this group of investments requires careful evaluation and application.
- We show that by focusing on absolute return outcomes instead of categorizations you can glean practical insight into their use: how to fund them, how to identify true sources of diversification and how to set your own return expectations.

UNCORRELATED ANSWERS®

Richard Yasenchak, CFA
Senior Managing Director,
Head of Client Portfolio Management

Valerie Azuelos
Managing Director, Product Specialist

Kevin Armstrong, CFA
Managing Director,
Consultant Relations

Intech®

Introduction

Since the global financial crisis nearly a decade ago, institutional investors have looked at absolute return strategies to increase diversification and reduce portfolio volatility to improve risk-adjusted returns.[1] Today, global equity markets have risen substantially while volatility has reached historical lows. How much longer can this continue? The dilemma for investors is preserving those gains in equities should volatility return to historically normal levels.

But are absolute return strategies the answer? We'll attempt to answer this question through the lenses of correlation, volatility and return.

Absolute Return to the Rescue?

We believe absolute return strategies can help protect the strong gains equity markets offered over the past nine years. After all, they tend to offer low correlation to traditional asset classes which can help reduce overall portfolio volatility and drawdowns. It's a nice promise, but the flexible nature of absolute return strategies make it difficult to understand how any one strategy might impact your portfolio.

Strategies of similar names or classifications can have a myriad of different attributes (e.g., benchmarks, beta exposures, investment horizons, timing decisions, etc.) that will drive a variety of results. To understand their impact on your portfolio, you need to see the forest through the trees. You need to ignore categorization; instead, focus on outcomes of correlation, volatilities and return given the common expectations for absolute return strategies (Table 1).

TABLE 1
COMMON EXPECTATIONS FOR ABSOLUTE RETURN STRATEGIES

Common expectations	Attributes
Positive return regardless of market direction	Lower correlation
Focus on alpha with less beta risk	Volatility reduction
Reference point is cash plus	Higher risk-adjusted returns

Absolute Return Correlations – Diversifying or Growth-Oriented Strategies?

You can generally think of absolute return as either *growth oriented strategies* (e.g., directional equity, event driven, relative value) that are geared to have higher correlations to equity markets or *diversifying strategies* (e.g., market neutral, global macro, multi-strategy) that should have lower correlations to equity markets. Overall, the correlations to equity will vary based on underlying objectives, but you should expect substantially lower correlations to equity from diversifying strategies given their lower return expectations and risk targets. The lower correlation characteristics of the diversifying strategies could justify a larger allocation than growth oriented strategies in the overall multiple asset portfolio.

[1] We broadly use the term of absolute return but recognize that not all hedge fund strategies have absolute return as their return objective.

Correlation

Correlation measures the tendency of two assets to move in tandem. It's the foundation of prudent portfolio construction. Investors recognize the benefit of reducing the average portfolio volatility by combining uncorrelated assets. Therefore, when considering absolute return strategies for your portfolio, it's critical to find options that have a low correlation with traditional asset classes.

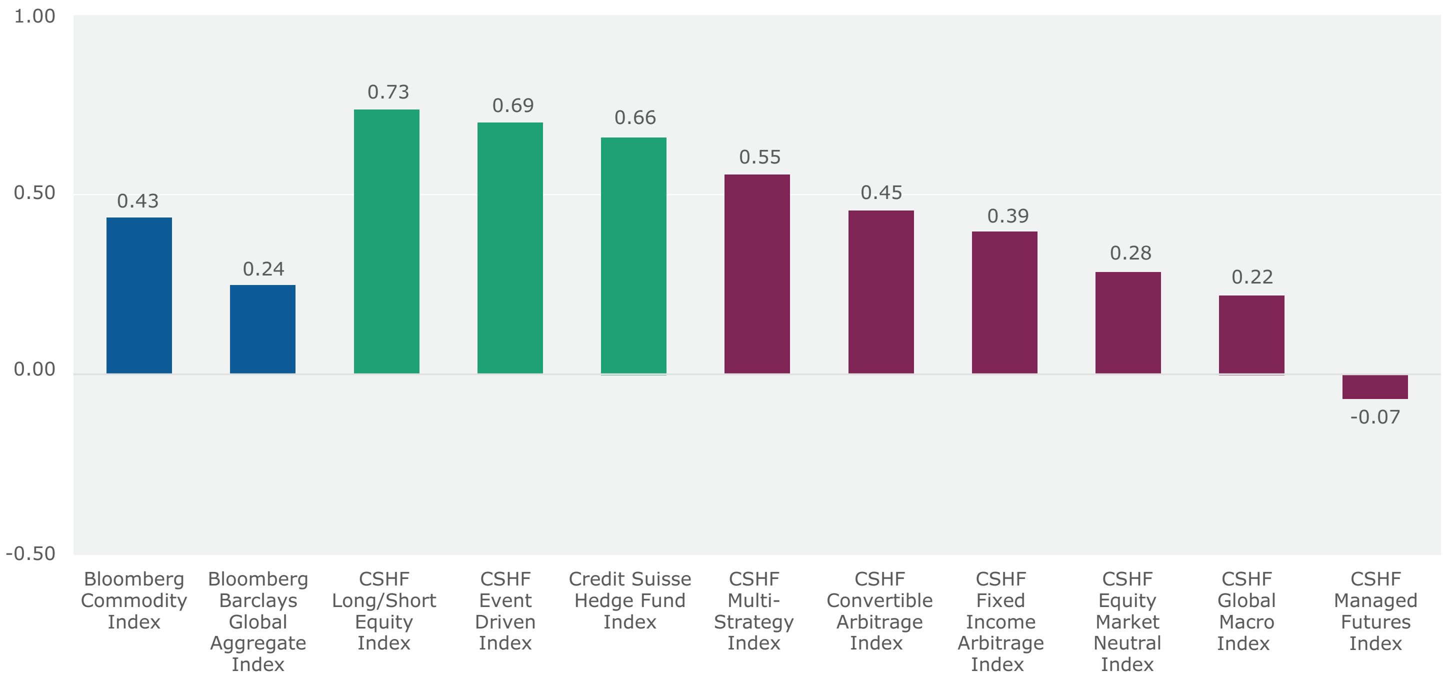
In Figure 1, we highlight the correlation of various asset classes and absolute return strategies to global equity risk – the predominant risk in a multiple asset class portfolio.[2] The absolute return strategies have a wide range of correlations relative to the global equity market index. While market neutral strategies have lower correlations to global equities since these strategies seek to offset most of the market risk, the correlation to the MSCI All Country World Index is still relatively high at 0.35 for a strategy that seeks to hedge out beta risk. Conversely, directional and event driven strategies tend to have the highest correlations given their net long bias. Overall, as a group, the absolute return categories exhibit higher correlations to global equities than what might be expected. The challenge is to find those individual absolute return strategies that show a tendency to provide lower correlations over time.

Many Absolute Return Strategies Exhibit High Correlations to Equities

FIGURE 1

CORRELATIONS OF ABSOLUTE RETURN STRATEGIES TO MSCI ALL COUNTRY WORLD INDEX

January 1, 1998 to December 31, 2017



Source: FactSet. Credit Suisse Hedge Fund (CSHF) Index information is shown net of fees. Indexes are unmanaged and investors cannot invest directly in an index. Results reflect monthly data. Past performance does not predict future returns.

[2] We examine the returns of absolute return strategies that have exposure to equities and/or offset equity risk in some manner. Returns of the funds that composed HFRI indexes are net of fees.

Application

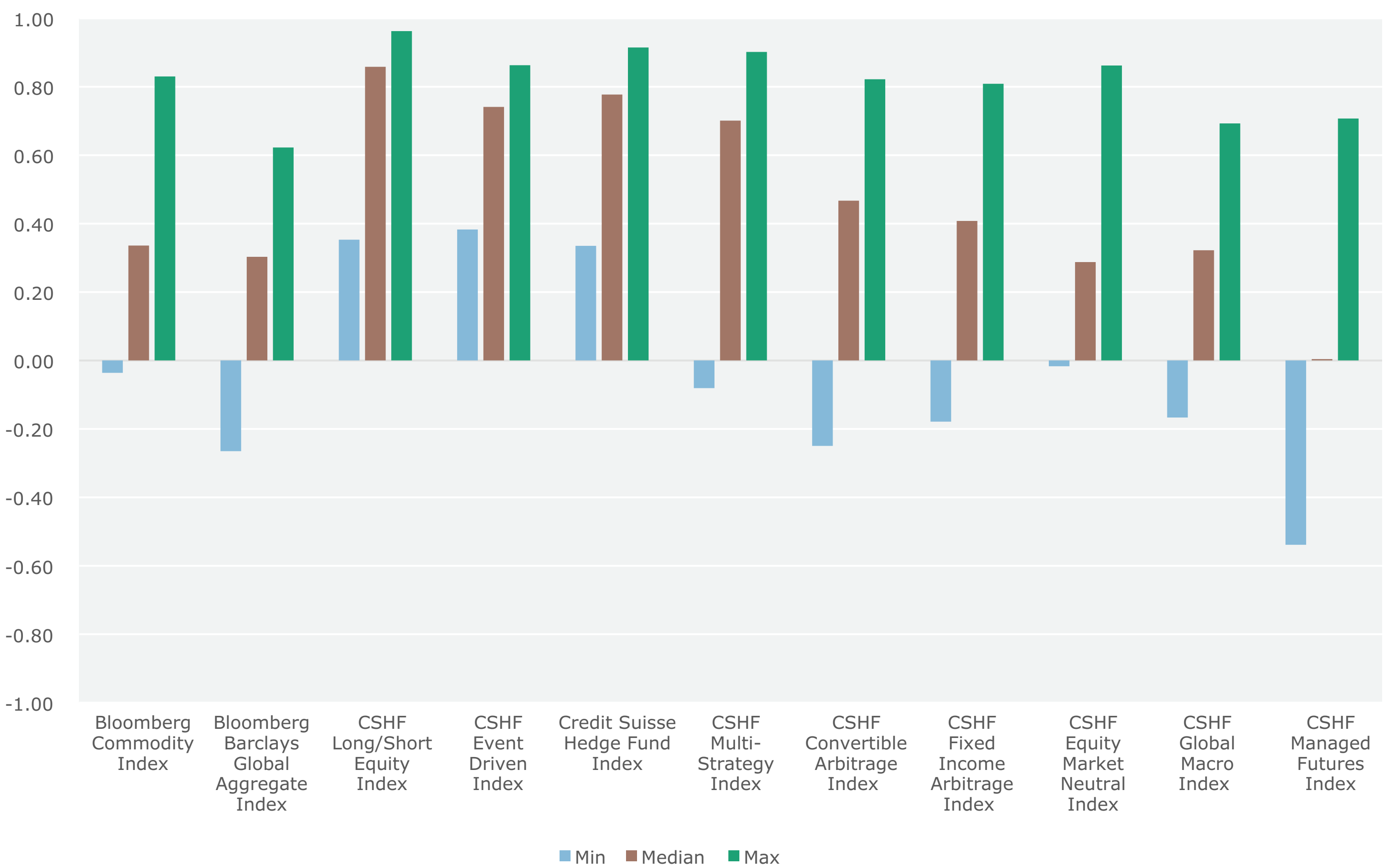
All absolute return strategies attempt to help you dampen portfolio volatility but their correlations to risk assets can tell a great deal about how to use them. The replacement for some portion of the entire multiple asset portfolio is from a strategy that demonstrates diversification over various time periods and ideally preserves upside potential.

As shown in Figure 2, it's important to note that correlations can and will vary over time given certain market environments. Overall market volatility is a key driver impacting those variations. For instance, during periods of acute market stress, systematic risk overwhelms asset-specific risk as investors rush to quality; consequently, there's a tendency for risky assets to become increasingly correlated. What's more, the fact that assets move in the same direction is only part of the problem. The magnitude of those movements matter too. That's why absolute return investors also need to examine return volatility.

FIGURE 2

ROLLING 36-MONTH CORRELATION RANGES OF VARIOUS ASSET CLASSES TO MSCI ALL COUNTRY WORLD EQUITY INDEX

January 1, 1998 to December 31, 2017



Source: FactSet. Credit Suisse Hedge Fund (CSHF) Index information is shown net of fees. Indexes are unmanaged and investors cannot invest directly in an index. Results reflect monthly data. Past performance does not predict future returns.

Volatility

Diversification is not only about correlation. Standard deviation, as a straight-forward measure of volatility, is also an important factor in evaluating absolute return strategies. Like correlations, the volatility differences between absolute return strategies vary greatly over time. A beneficial absolute return strategy should offer not only the potential for significant volatility reduction, but also downside protection (relative to global equities) through a variety of risk regimes.

Figure 3 provides the range of rolling 36-month volatility of traditional asset classes and absolute return strategies.[3] It's not surprising to see that global equity and commodities have the largest range of volatility as they tend to have more pronounced volatility regimes. The absolute return strategies generally provide a narrower range of returns relative to global equities, yet the range of returns across absolute return strategies is wide.

> "Diversification is not only about correlation. Standard deviation, as a straight-forward measure of volatility, is also an important factor in evaluating absolute return strategies."

The Magnitude of Returns Can Vary Greatly

FIGURE 3

ROLLING 36-MONTH STANDARD DEVIATION RANGES OF VARIOUS ASSET CLASSES

January 1, 1998 to December 31, 2017

Source: FactSet. Credit Suisse Hedge Fund (CSHF) Index information is shown net of fees. Indexes are unmanaged and investors cannot invest directly in an index. Results reflect monthly data. Past performance does not predict future returns.

[3] For purposes of this paper, we use standard deviation rather than beta because beta is a measure of both correlation and relative volatility, which are both covered in the paper to give better insight on what's driving the beta.

Application

These illustrations make it clear that any assessment of the diversification potential of absolute return strategies must look beyond just correlations. The range of returns matters too. Strategies with low correlation are good diversifiers, but lower variability in returns helps diversification as well.

As a simple example, consider the benefits of bonds as a diversifier for equities. Low correlation is not the only factor helping bonds dampen portfolio volatility; indeed, there are periods when bonds are more correlated to equities as observed in Figure 2. It's their lower total volatility that also helps bonds reduce average portfolio volatility.

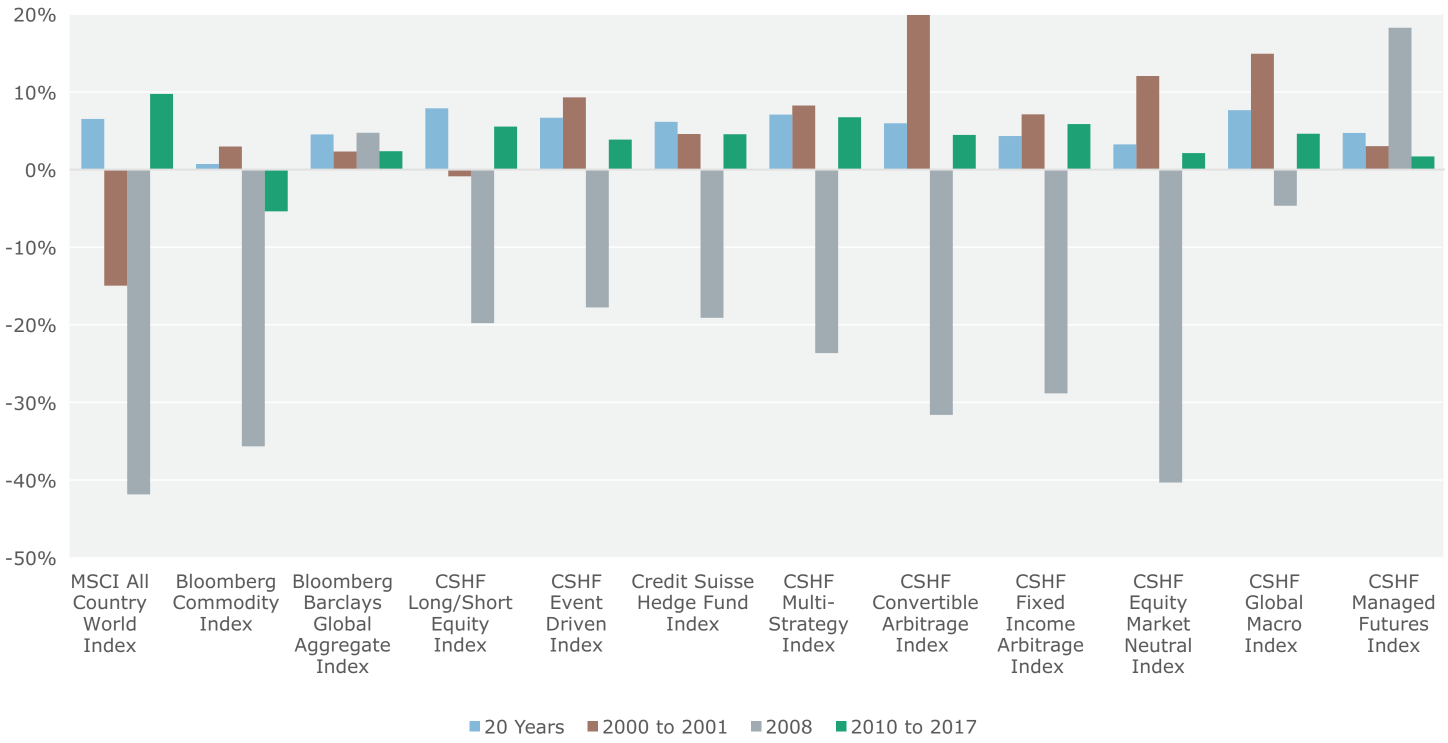
Returns

While correlation and volatility are important, they may not be your first thought when you're trying to cover your plan liabilities or meet return expectations. Positive returns are an expected feature of absolute return strategies. Unfortunately, providing consistent, positive returns is easier said than done.

Figure 4 illustrates the difficulty in generating positive returns. To get a better sense of the consistency in performance of absolute return strategies, we look at their results over various periods.

Returns are Positive Except When They're Not

FIGURE 4
RETURNS FOR VARIOUS ASSET CLASSES
January 1, 1998 to December 31, 2017



Source: FactSet. Credit Suisse Hedge Fund (CSHF) Index information is shown net of fees. Indexes are unmanaged and investors cannot invest directly in an index. Results reflect monthly data. Past performance does not predict future returns.

Generally, absolute return strategies appear to provide consistent, positive returns over the long-term. Combined with correlation, this return profile can provide you with more confidence in funding absolute return strategies; however, returns during the global financial crisis might give you pause. At that time, many absolute return strategies experienced significant negative performance. Even equity market neutral strategies, which are expected to fully hedge market risk, may have disappointed investors seeking positive returns.

You should expect that returns are not always positive in the short-term even for absolute return strategies. For many absolute return strategies, the global financial crisis demonstrated their "expected worst case" risk, or maximum drawdown.

Whether returns are positive or negative, we believe that returns should compensate you for risk. Risk-adjusted measures of return and drawdown are important. To illustrate the point, we compare and contrast the risk and return characteristics of traditional asset classes and alternative return strategies over the previous 10- and 20-year time periods in Figure 5.

We shouldn't be surprised that absolute return strategies' 10-year returns are lower than their 20-year returns given that cash rates have been close to zero more recently. Sharpe ratio is the most common risk-adjusted return measure. By dividing the return by the risk (as measured by standard deviation), we get a sense of the return compensation by unit of risk taken. On average, risk-adjusted returns for absolute return strategies have declined over the past 10 years. Yet, many of these strategies provided higher risk-adjusted returns relative to traditional asset classes over 10 and 20 years evidenced by higher Sharpe ratios.

FIGURE 5

RISK-RETURN CHARACTERISTICS OF ABSOLUTE RETURN AND OTHER INVESTMENTS

January 1, 1998 to December 31, 2017

	MSCI All Country World Index	Bloomberg Commodity Index	Bloomberg Barclays Global Aggregate Index	CSHF Long/Short Equity Index	CSHF Event Driven Index	Credit Suisse Hedge Fund Index	CSHF Multi-Strategy Index	CSHF Convertible Arbitrage Index	CSHF Fixed Income Arbitrage Index	CSHF Equity Market Neutral Index	CSHF Global Macro Index	CSHF Managed Futures Index
Return	6.57%	0.76%	4.58%	7.94%	6.73%	6.20%	7.13%	6.01%	4.37%	3.29%	7.70%	4.77%
Standard Deviation	15.56%	16.24%	5.61%	9.08%	6.21%	6.14%	4.70%	6.61%	5.39%	9.94%	7.06%	11.38%
Sharpe Ratio	0.30	-0.07	0.46	0.66	0.77	0.69	1.10	0.61	0.44	0.13	0.81	0.25
Max Drawdown	54.57%	67.03%	10.08%	22.00%	19.15%	19.68%	24.72%	32.88%	29.02%	45.10%	26.79%	17.77%
Return / Drawdown	0.12	0.01	0.45	0.36	0.35	0.32	0.29	0.18	0.15	0.07	0.29	0.27
Drawdown / Volatility	3.51	4.13	1.80	2.42	3.09	3.20	5.26	4.97	5.38	4.54	3.79	1.56

Source: FactSet. Credit Suisse Hedge Fund (CSHF) Index information is shown net of fees. Indexes are unmanaged and investors cannot invest directly in an index. Results reflect monthly data. All information is presented as of the date range shown. Information for other periods and more current periods will be different. Past performance does not predict future returns.

Another measure of risk is the maximum drawdown or percentage decline from a market high to a market low. After all, investors are concerned by risk to the extent that it translates into losses. We observe that the maximum drawdown for absolute return strategies was generally less than that for global equities since they protect against downside risk. Another helpful measure of risk-adjusted return can be calculated by dividing a strategy's annualized return by the maximum drawdown over the same period.[4] A higher maximum drawdown lowers this ratio and reflects that the return realized comes with periods of higher losses. By limiting downside risk, you can see that this ratio is generally higher for absolute return strategies than that offered by the MSCI All Country World for both 10 and 20 year time frames.

Application

Returns fund your liabilities, but headline figures can set the wrong expectations for absolute return strategies. You're likely to see both positive and negative returns, depending on the risk environment. Accounting for the risk taken by a strategy to generate returns is always an important consideration.

A strategy's Sharpe ratio indicates the extra return a strategy generates adjusted by the realized risk over time. A good outcome for an absolute return strategy is to provide a higher Sharpe ratio than the traditional equity and fixed income asset classes.

Additionally, the expectation for positive returns from absolute return strategies requires understanding those returns against a different risk: drawdown. For common time periods, you can use the maximum drawdown adjusted return as a simple way to understand how well strategies have been compensated given their worst-case return scenario.

Simple measures can provide good reference points along the lines of return relative to volatility (Sharpe ratio) and return relative to drawdown. Of course, risk-adjusted measurements don't stop here, but the point is undeniable: returns may be absolute, but you should always view them through a lens of risk.

Beware of the Impact of Incentive Fees on Risk-Adjusted Returns.

The returns of absolute return strategies in fund databases are generally net of management fees and incentive fees. These fees are *accrued* monthly, which reduces volatility and increases the Sharpe ratio of a strategy. They do this by *lowering* returns during positive performance months and *raising* them during negative months. For example, if a fund has a positive gross return in one month then a negative gross return the next month, the fund is credited back what it was overcharged in the prior month when it had a positive return. As a general rule: The higher the incentive fee, the lower the volatility and the higher the Sharpe ratio (even though total return is reduced). Incentive fees not only reduce the fund's performance but it also decreases its volatility.

[4] The Calmar Ratio and Managed Account Reports (MAR) Ratio are additional measurements for drawdown adjusted returns.

Conclusion

Today's allocations to return-seeking investments requires a keener eye managing portfolio-level risk and institutions are often turning to absolute return strategies as a solution. But absolute return strategies are not a homogeneous group of investments. It's critical to determine if these strategies are different enough from traditional and other alternative assets classes to provide diversification opportunities while providing the returns you need to fund liabilities.

In this paper, we demonstrated how straightforward measures of diversification can be helpful in assessing the application of absolute return strategies in a multiple-asset portfolio. Taking a close look at diversification properties – correlation and volatility – we present practical use cases for absolute return strategies.

To help establish return expectations, we also examined the persistency of "absolute" returns over different market environments. We show that despite their unique performance contours, absolute return strategies are like their traditional counterparts when it comes to performance evaluation. You must use risk-adjusted metrics.

Absolute return strategies can help you preserve recent gains from exposure to stock markets and can protect against the comeback in volatility. We hope this simple picture of correlations, volatility and returns provides you with a framework for assessing the potential for absolute return strategies.

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Locations

HEADQUARTERS
250 South Australian Avenue
Suite 1800
West Palm Beach, FL, 33401
United States of America
+1-561-775-1100

INTERNATIONAL OFFICE
201 Bishopsgate
London
EC2M 3AE
United Kingdom
+44 (0)20 7818 5600

Contacts

NORTH AMERICA
John F. Brown
EVP, Head of Global Client Development
jbrown@intechinvestments.com
1-561-775-1163

INTERNATIONAL
David Schofield
President, International
dschofield@intechinvestments.com
+44 (0)20 7818 5600

Intech®