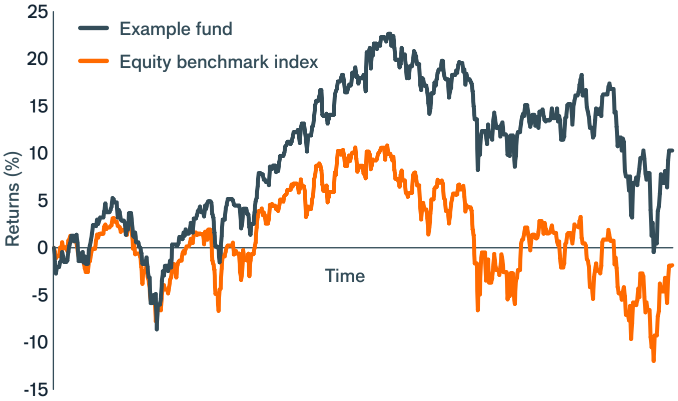
A SIMPLE GUIDE TO ABSOLUTE RETURN

Absolute return funds are a type of investment strategy that aims to deliver a positive ('absolute') return to investors, regardless of whether markets are rising or falling, although a positive return is not guaranteed. Performance will be impacted by market movements and the investment decisions made by the fund manager.

Absolute return investing can apply to many asset classes and various techniques, but this guide focuses on funds investing in company shares ('equities') using a 'long/short' approach. By speaking to a financial adviser, you can discuss whether investing in absolute return funds may be right for you.

How does absolute return investing differ from traditional investing?

Exhibit 1: 'Traditional' relative return funds aim to outperform a target benchmark

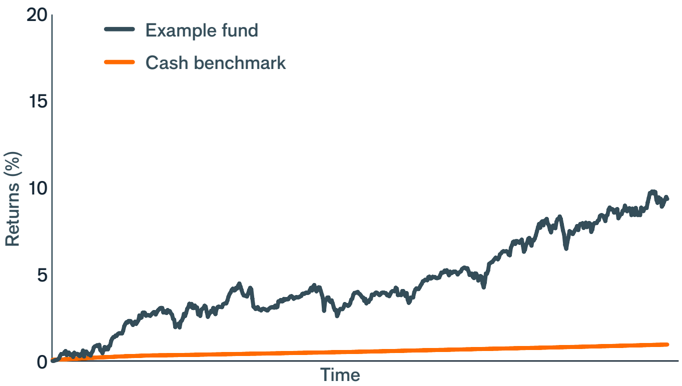


Traditional investment funds buy shares in companies that the fund manager believes will rise in value. Their success (or otherwise) is typically measured against an index of companies in the market or asset class where they invest, known as a 'benchmark'.

For example, a UK equities fund might be benchmarked against the FTSE All-Share Index, while for a US equities fund it might be the S&P 500 Index, and a European equities fund might be benchmarked against the MSCI Europe Index. These funds are said to be managed on a '**relative return**' basis, which means they aim to deliver better returns than the benchmark (**Exhibit 1**).

The manager of such a fund is likely to build a portfolio of companies from the stocks in that index, which means that it will still broadly rise and fall in line with that wider index. The drawback of this approach is that if the index is falling, the fund may do better on a 'relative' basis but the investor will still lose money in 'absolute' terms.

Exhibit 2: Absolute return funds aim to deliver a positive overall return



An **absolute return** fund seeks to do things differently. Instead of being measured against an index, they aim to deliver a positive return (ie. greater than zero), regardless of broader market conditions, generally with lower volatility than you would find with just holding stocks. With this aim in mind, the performance of absolute return funds tends to be compared against the return (interest) available from holding cash on deposit (**Exhibit 2**).

These charts are used for illustration purposes only. Past performance does not predict future returns. The value of your investment may go down as well as up and you may not get back the amount originally invested.

How does absolute return investing work?

The value of shares, and the income (dividends) from them varies over time, reflecting the underlying performance of companies, and broader (macro) market conditions. Absolute return funds using 'long/short' strategies are designed to make money from shares in companies that go down as well as up, making it possible to deliver a positive return for investors regardless of whether the market is rising or falling.

What is long/short investing?

A 'long' position is where a manager buys shares in a company (or index of companies), expecting them to rise in value. This is how a traditional relative return fund invests.

'Short' investing is a form of investment that can profit if the underlying asset falls in value. The most common technique is to borrow an asset (for a fee), and then sell it, with the intention of buying it back for less than you sold it for, before returning it to the original owner. If correct, the strategy can make money from assets that are depreciating. The risk is that if the manager wrongly predicts a fall in price, the position will lose money.

A long/short equity fund targeting a positive absolute return combines the use of long and short investing; buying stocks that the manager believes will increase in value, while taking short positions in stocks that they believe will do less well or fall in value. How a fund performs will depend on the manager's ability to correctly identify stocks that fit the strategy as they entail higher risks..

Taking short positions can involve the use of 'derivatives', which are generally more complex types of investment than simply holding or borrowing shares. Their use comes with a financial cost, but they enable a manager to increase or decrease the risk being taken when making an investment. Investors in long/short funds need to be comfortable with the use of these strategies as they entail higher risks.

What are the benefits and risks of long/short investing?

Because absolute return funds have different investment objectives to relative return funds and use derivatives, they require a different skillset from their managers. It is important to assess the ability to deliver absolute returns in a variety of market conditions, while managing risk effectively.

Typically, investors look to strike a balance between seeking profits and the amount of risk they take, relative to their broader investment strategy and risk appetite. By investing in a fund that takes a mix of long and short positions, investors can take advantage of both rises and falls in the market.

However, a principal drawback of long/short strategies is that, during periods when stock markets rise rapidly over a sustained period, the fund is unlikely to deliver the same high return as a relative return fund. They can, however, deliver a steadier rate of return over the longer term.

The role of long/short absolute return strategies in a well-diversified portfolio:

- Smoother performance over time, reducing the impact of market volatility
- Improved diversification, with differentiated drivers of performance
- Flexibility to increase or decrease risk to reflect prevailing market conditions
- The potential to deliver a positive return during falling markets

Absolute return funds using long/short strategies are commonly used to improve diversification in a broader investment strategy. Mixing different fund types can help to spread risk, as different approaches generate returns in different ways and at different times. While one approach may be performing badly, another approach may perform well – the net result can be less volatile overall returns. More flexible strategies are also able to actively adjust the proportion of long or short investments held, which can improve their adaptability.

An overview: relative return vs absolute return funds

	Relative return fund	Absolute return fund
In a falling market	Aims to outperform the market, which could mean delivering a negative return	Aims to deliver a positive/neutral return
In a rising market	Aims to outperform the market	Aims to deliver positive returns
Market volatility	Likely to be correlated with volatility in the market	Should deliver lower volatility than the market over the long term
Performance target	Aims to outperform a benchmark index, such as the FTSE All-Share Index	Aims to deliver a positive return over time, regardless of the direction of the market.

Glossary

Correlation: A term used to describe how closely the price movements of two variables are linked, such as equity market performance and fund returns. If variables have a correlation of +1, then they move in the same direction. If they have a correlation of -1, they move in opposite directions (reverse correlation). A figure near zero suggests a weak or non-existent relationship between the two variables.

Derivative: A type of financial instrument where the price is derived from one or more underlying assets, such as shares. It is a contract between two parties. It does not imply any ownership of the underlying asset(s). Instead, it allows investors to take advantage of price movements in the asset(s).

Long position: A security that is bought in the expectation it will rise in value, such as purchasing shares in a company.

Short position: Fund managers use this technique to borrow then sell what they believe are overvalued assets, with the intention of buying them back for less when the price falls. The position profits if the security falls in value. Derivatives can be used to simulate a short position.

Volatility: The rate and extent at which the price of a portfolio, security or index, moves up and down. If the price swings up and down with large movements, it has high volatility. If the price moves more slowly and to a lesser extent, it has lower volatility. It is used as a measure of the riskiness of an investment.

Please see HGi.co/glossary for a glossary of financial terms used in this document.

At a glance

- Absolute return funds aim to deliver a positive return regardless of market conditions
- The use of ‘short’ positions allows a profit to be made if the value of a stock or index fall
- Absolute return funds tend to offer lower volatility relative to equity markets as well as portfolio diversification benefits
- An absolute return fund is likely to underperform a relative return fund when stock markets are rising strongly
- Absolute return funds may make use of more complex instruments and techniques to manage risk

By speaking to a financial adviser, you can discuss whether such an investment may be right for you.

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