

Improving portfolio efficiency with multi-asset absolute return strategies



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Most institutional investors are searching for strategies to improve risk-adjusted returns (Sharpe ratio) without sacrificing return. Two approaches dominate: pursuing a portfolio's desired rate of return with less volatility or seeking to increase returns without a significant boost in volatility. Investors have in recent years made progress towards these goals by refining the optimal asset allocation mix.

We believe a more powerful tool for further improvement comes from adding a new layer of diversification with absolute return strategies. In our investment research and practice, we find that absolute return strategies, which we define as unconstrained, benchmark-agnostic strategies that focus on more efficient returns with less systematic risk (beta), can help improve the overall efficiency of an investment plan.

Recent studies, by contrast, demonstrate a reliance on traditional asset classes. A Towers Watson study, analysing the 2012 asset allocations of 556 Fortune 1000 US pension plans, revealed a focus on traditional asset classes. Though there is a small allocation to alternative asset classes, such as REITs, private equity and hedge funds, the vast majority of the allocation consists of stocks and bonds.

Impact of absolute return on plan efficiency

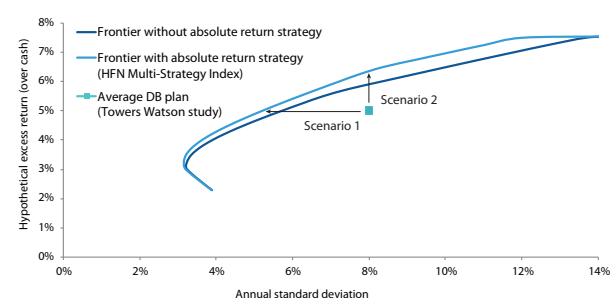
To test the effects that absolute return strategies can have on an overall plan, we constructed two efficient frontiers: one without absolute return strategies and one with absolute return strategies. The analysis used historical asset class returns since 1986.*

To represent absolute return, we chose an index that exhibits the characteristics we are seeking: unconstrained, benchmark-agnostic strategies that focus on more efficient returns with less systematic risk (beta). The HFN Multi-Strategy Index proved to be the best proxy with the most available data. From 1986 through 30 June, 2013, this index produced an annualised excess return over cash (Citigroup 3-month T-Bill Index) of 6.98%, with a standard deviation of 8.62%, 6.31% downside volatility, a Sharpe ratio of 0.81 and an equity beta of 0.36.

Figure 1 compares two efficient frontiers comprising asset classes used by most DB plans (stocks, bonds, private equity and real estate), one with and one without an allocation to absolute return strategies. Figure 1 also includes the hypothetical performance of the average pension plan allocation – held constant over the period in our illustration – that is outlined in the 2013 Towers Watson study. Notably, the hypothetical return for the average pension plan allocation falls considerably below both efficient frontiers.

For this analysis, the following constraints were imple-

Figure 1. The average defined benefit plan does not achieve optimal risk efficiency (31/3/86–30/6/13)



Sources: Towers Watson, Putnam Investments and Evestment

mented in order to limit complexity and maintain diversity:

- No negative asset class values (e.g., no shorts on an asset class/strategy)
- A fully invested portfolio (e.g., no leverage allowed)
- A constraint on private equity to a maximum exposure of 25% (Time-series data likely underestimate asset class volatility. The appropriate allocation to private equity is heavily dependent on manager access and liquidity.)

The analysis also shows that the inclusion of absolute return strategies in a broader portfolio context not only improved efficiency, but also shifted the entire efficient frontier up and to the left. This provides further evidence of the diversification benefit that comes with including strategies that are focused on producing attractive risk-adjusted returns whilst remaining less dependent on traditional benchmarks.

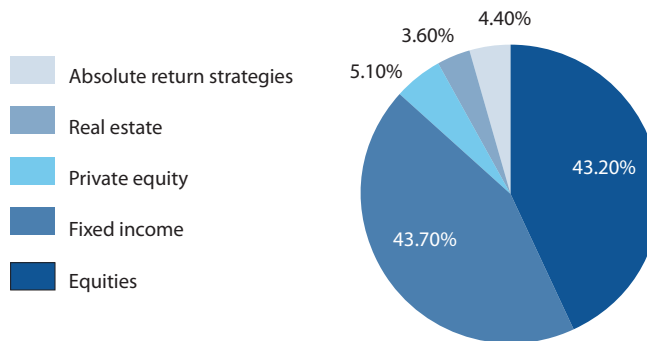
To improve the average DB plan's overall efficiency, two scenarios were tested: (1) maintain the historic rate of return with less volatility; and (2) increase returns without a significant boost in volatility. As Figure 1 illustrates, both scenarios require the portfolio to move towards the efficient frontier, either to the left or up.

In Figure 2, we illustrate the two scenarios. Notice that in Scenario 1, one is able to deliver the same excess return while reducing annualised volatility by 257 bps (7.85% less 5.28%). In Scenario 2, one is able to generate an additional 131 bps of annualised excess return (6.36% less 5.04%) with similar volatility. In Scenario 1, the portfolio has 12% in absolute return; increased exposure to bonds, REITs and private equity; and a significantly lower allocation to equity. Scenario 2 has a still greater allocation to absolute return, at 19%, with nearly half the portfolio in equalised allocations to fixed income and private equity, increased exposure to REITs, and a relatively modest 16% in equities.

Figure 2. Funding an absolute return strategy depends upon investor goals

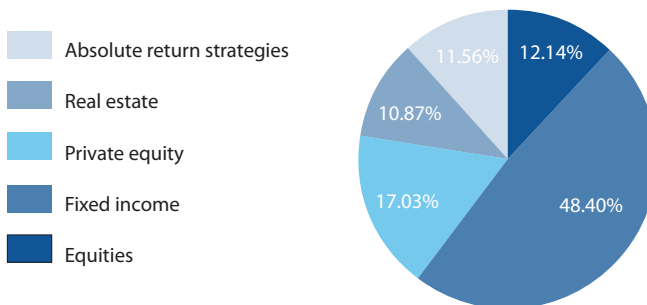
Average DB plan's allocation

Hypothetical excess return (31/3/86-30/6/13)	Standard deviation	Sharpe ratio
5.04%	7.85%	0.64



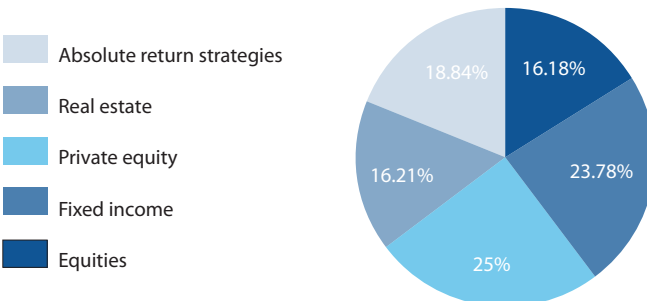
Scenario 1: Applying absolute strategies to maintain return with lower volatility

Hypothetical excess return (31/3/86-30/6/13)	Standard deviation	Sharpe ratio
5.04%	5.28%	0.64



Scenario 2: Applying absolute strategies to increase return, while maintaining lower volatility

Hypothetical excess return (31/3/86-30/6/13)	Standard deviation	Sharpe ratio
6.36%	7.85%	0.81



Absolute return strategies were applied to the average defined benefit plan's allocation as defined by the Towers Watson study "2012 Asset Allocation in Fortune 1000 Pension Plans," November 2013. Sources: Towers Watson, Putnam Investments and Evestment.

Conclusion

The goal of absolute return strategies is not to be the highest-returning asset class, but to provide higher efficiency with lower equity beta. This analysis provides strong evidence that unconstrained, benchmark-agnostic strategies that focus on more efficient returns with less systematic risk (beta) can be a powerful tool for improving the efficiency of an investment plan.

* For our analysis, equities are represented by the S&P 500 Index; fixed income by Barclays Intermediate Treasury Index; private equity by Cambridge Associates US Private Equity Index; real estate by FTSE EPRA/NAREIT US Index; and absolute return strategies by HFN Multi-Strategy Index. Indices are unmanaged and do not incur expenses. You cannot invest directly in an index. Past performance is not a guarantee of future results.

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