

IMPLEMENTING ABSOLUTE RETURN IN A MULTI-ASSET FRAMEWORK



Christian J. Galipeau,
Senior Investment
Director, Putnam
Investments



Brendan T. Murray,
Senior Investment
Director, Putnam
Investments



Seamus S. Young,
CFA, Investment
Director, Putnam
Investments

Institutions face challenges in a low-return market environment frequently interrupted with phases of high volatility. Many are seeking to improve portfolio risk-adjusted returns (Sharpe ratio) without sacrificing return objectives. Logically, two approaches are possible: pursuing a portfolio's required rate of return with less volatility, or seeking to increase returns without a significant boost in volatility. Many institutions have made progress towards these goals by expanding the range of asset classes in which they invest, going beyond a split, or 60/40 equity and fixed income balance, whilst also refining the optimal mix of assets.

We believe including absolute return strategies may hold greater promise for improving an institutional pension scheme's portfolio efficiency. We define absolute return strategies as unconstrained, benchmark-agnostic approaches that focus on more efficient returns with less systematic risk (beta).

Survey data indicate, however, that many schemes continue to rely on expanding the range of traditional asset classes as a solution. Mercer's 2014 European Asset Allocation Survey of over 1,200 plans from 14 European countries shows that, even as institutions seek to reduce their reliance on equities within their home countries, multi-asset schemes are inclined to favor adding high yield, real estate, emerging markets (EM) equity and EM debt, along with other types of credit risk.

We believe it is important for institutions to consider how multi-asset absolute return strategies can potentially be a powerful tool to improve portfolio efficiency.

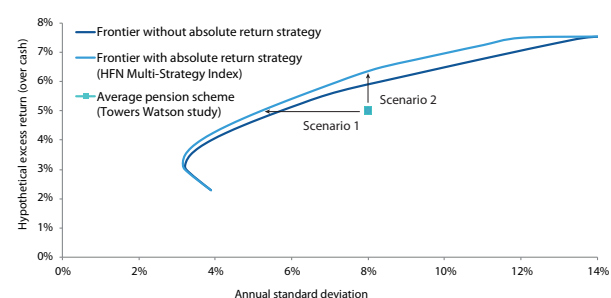
ASSESSING THE POTENTIAL IMPACT OF ABSOLUTE RETURN IN A PLAN

To test the effects that absolute return strategies can have on an overall scheme, we constructed two efficient frontiers for portfolios that include asset classes used by many pension plans (stocks, bonds, private equity and real estate) (Figure 1). One of the efficient frontiers includes an allocation to absolute return strategies and one does not. The analysis used historical asset class returns from 1986 to 2013.*

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 also includes the hypothetical performance of a pension scheme allocation – held constant over the period in our illustration – that is outlined in a Towers Watson study that analysed the 2012 asset allocations of 556 Fortune 1000 US pension schemes. Notably, the hypothetical return for this

Figure 1. The average multi-asset scheme does not achieve optimal risk efficiency (31/3/86–30/6/13)



Sources: Towers Watson, Putnam Investments and Evestment.

average pension scheme allocation falls considerably below both efficient frontiers.

For this analysis, the following constraints were implemented 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 shows that the inclusion of absolute return strategies in a broader portfolio context improved efficiency and shifted the entire efficient frontier up and to the left. This provides further evidence of the diversification benefit that may come with including strategies that are focused on producing attractive risk-adjusted returns whilst remaining less dependent on traditional benchmarks.

Two potential applications of absolute return strategies were tested: The first is to maintain the historic rate of return with less volatility, and the second is to increase returns without a significant boost in volatility. The arrows in Figure 1 – to the left, and upward – illustrate that both scenarios require the portfolio to move towards the efficient frontier.

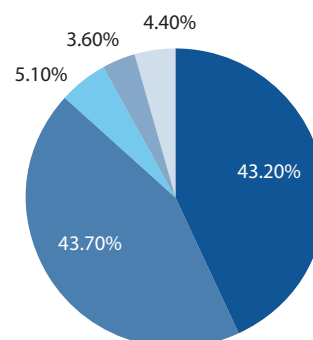
In Figure 2, we illustrate the two scenarios with different types of absolute return allocations to the average scheme. Notice that in Scenario 1, one is able to deliver the same excess return whilst reducing annualised volatility by 257 bps (7.85% less 5.28%). In Scenario 2, one is able to generate 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 pension scheme's allocation

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

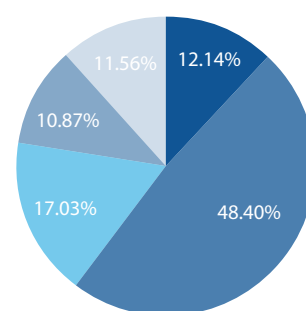
- Absolute return strategies
- Real estate
- Private equity
- Fixed income
- Equities



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%	0.95

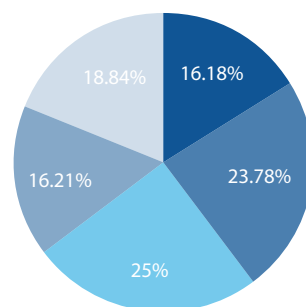
- Absolute return strategies
- Real estate
- Private equity
- Fixed income
- Equities



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
- Real estate
- Private equity
- Fixed income
- Equities



Absolute strategies were applied to the average pension scheme'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 offer an attractive addition to the choices available for multi-asset schemes and may offer a powerful tool for improving the scheme's portfolio efficiency.

FOOTNOTE

*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.



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