Funds that weather
the financial market storm

Absolute Return Funds essentially aim to make a positive return for investors in other words to make money over pre-defined time horizons (such as 1 or 3 years). Typically, they target an inflation-beating return with a dual aim of also preserving capital. Their success, however, depends on their ability to deliver on their aims regardless of the underlying investment market conditions e.g. a market downturn.

- Absolute Return Funds are frequently compared to traditional Balanced funds, however there are important differences between them:

- Absolute Return Funds usually offer more scope to take extreme asset allocation positions that enable capital preservation, whereas Balanced Funds have a more predictable and constrained asset allocation.

- Absolute Return Funds usually attempt to protect capital over shorter time periods (e.g rolling 12 months) while Balanced Funds usually don't have such capital protection objectives. This means that Absolute Return Funds frequently employ protective derivative structures.

- Absolute Return Funds generally tend to underperform Balanced Funds in bull markets, due to their less "market-directional" strategies, and vice versa. The best Absolute Return Funds are however able to capture high "upside participation" while also experiencing low drawdowns.

When are Absolute Return Funds meant to "shine"?

South African (SA) risk assets struggled during 2018, with SA equity markets down 8.5%, while the poorest performer being the listed property sector shed a staggering 25% of its value in the calendar year. Positive performance was generated predominantly by fixed income assets and offshore assets, which were cushioned by the weakening of the Rand. The only multi-asset ASISA category that managed to deliver positive returns (on average) was the Low Equity category, but this was attributable mainly to the maximum equity constraints applicable within this category.

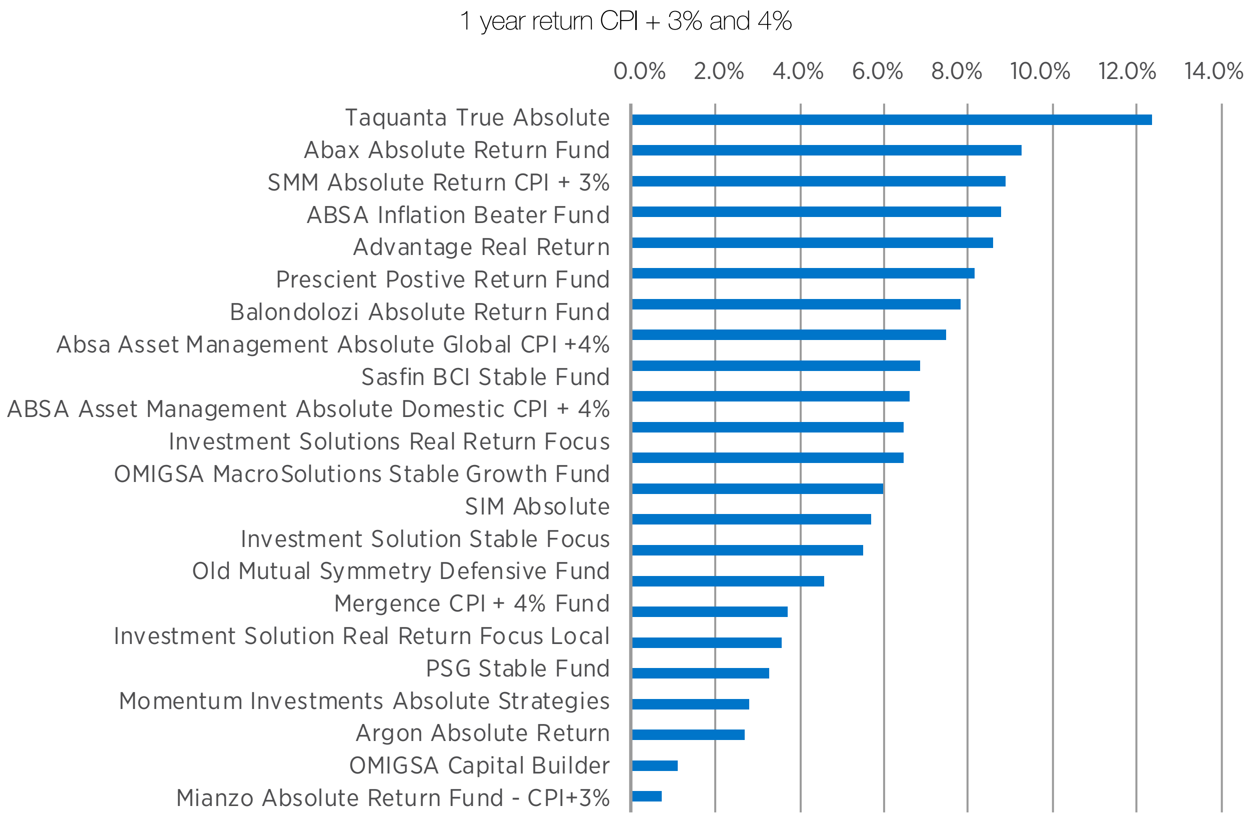
In years such as 2018, risk management is imperative. As American billionaire investor Seth Klarman stated, "Investors should always keep in mind that the most important metric is not the returns achieved but the returns weighed against the risks incurred. Ultimately, nothing should be more important to investors than the ability to sleep soundly at night."

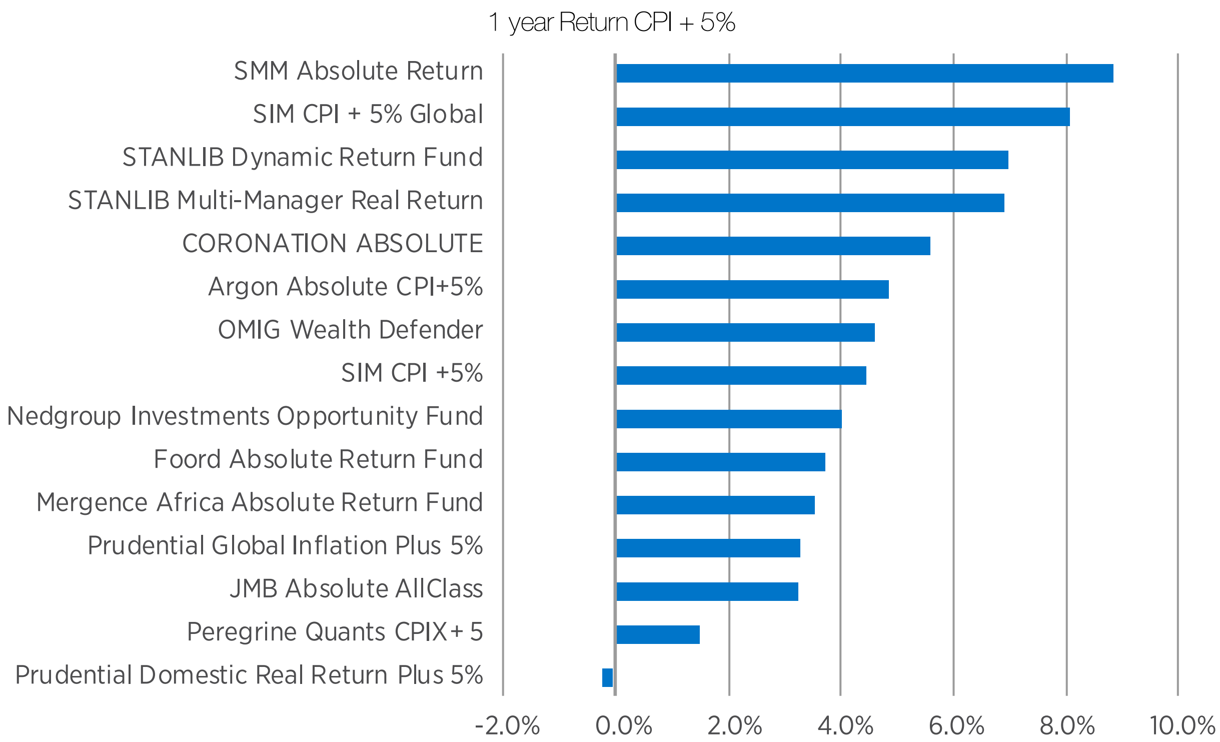
Risk, within an asset class, is usually defined as absolute volatility or tracking error against a benchmark (relative risk). 2018 however demonstrated that it is the risk of permanent capital loss that needs to be managed carefully, as it is the element that is most likely to keep one awake at night.

Despite the market turmoil, Absolute Return Funds were well equipped to weather the 2018 financial market storm. With the primary objective for such funds being risk management and protecting capital in down markets, they were ideally positioned to shine in adverse market conditions. Long-term returns and outperformance are generated largely as a result of the protection against significant short term losses.

The performance

While equity markets did show some recovery over the first two months of 2019, Absolute Return Funds were able to both protect capital during the 2018 downturn, as well as capture upside during the short-term market recovery in 2019. The graphs below, showing the 1 and 3 year returns (to 28 February 2019) of a selection of popular Absolute Return Funds, bear testimony to the robustness of these strategies.





Source: Alexander Forbes Absolute Return Survey and Sanlam Investments

All the funds included in the above graphs had a market beta of less than 0.5 to the equity market, which is no small feat within the context of the negative equity market environment. Within the CPI + 3% and CPI + 4% category, 85% of funds managed to produce positive returns, while only 45% of the funds in the corresponding ASISA Multi Asset Low Equity category managed to do the same. Within the CPI + 5% and CPI + 6% categories, the success rate for protecting capital was 47% and 43% respectively, while for the corresponding ASISA Multi Asset High Equity category the proportion was 15%.

This demonstrates that Absolute Return Funds' unique approach generally allows them to outperform other multi-asset class balanced funds when markets take a turn for the worse. While different asset managers have different approaches, the average Absolute Return Fund was able to produce superior outcomes in down markets.

Natasha Narsingh, Absolute Return Portfolio Manager at Sanlam Investments, stated that there is an inherent and implicit requirement to ensure portfolios are built with the robustness and sturdiness required to weather the storms and deliver especially during tough market environments. She mentioned that their track record over the years demonstrates that consistency in approach can lead to consistency in delivery of solid risk-adjusted returns at low-to-medium volatility. Their Absolute Return Funds are strategically constructed to ensure first and foremost that capital preservation over the shorter-term 12 month rolling period is as far as possible not compromised, and that fund drawdown risk is actively reduced. She stressed that there needs to be a careful balance of the risk budget to allow for an appropriate mix of asset classes and instruments within various asset classes to be able to deliver on capital protection objectives whilst maintaining a competitive return outcome for clients.

Lillian Lerm, Absolute Return Portfolio Manager for the multi manager at Sanlam Investments, recent winner of a Raging Bull award for Best SA Multi-Asset Equity Fund on a Risk-Adjusted Basis category, described how their approach is to utilise absolute or real return strategies that offer an asymmetric payoff profile versus traditional beta investments. By combining such strategies within a rigorous risk budgeting process, while taking into account how the strategies behave relative to each other and in different market conditions, they are able to protect capital in market downturns as well as participate meaningfully in market upswings.

The weather forecast

The year 2018 was certainly a challenging test that set many managers on the back foot with poor returns across the majority of asset classes. As demonstrated by the performance, it was also a year in which the process and philosophy governing Absolute Return Funds, and in particular those of Sanlam Investments, proved their mettle once again. Going forward, the expectation is that these Absolute Return Funds will continue to deliver robust outcomes during the volatile market conditions that are currently being experienced.

Sanlam Investments offers Retirement Funds the ability to access a range of Absolute Return Funds, which have a broad spectrum of inflation-related performance objectives and capital protection constraints.

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