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Absolute Return Funds – tailored solutions for risk-averse investors

Much like the rest of the developed world, South Africa's investment landscape has been re-shaped over the past few years by growing demand from investors for investment solutions designed specifically to meet their unique needs.

Absolute return funds are but one example of the sophisticated solutions being developed these days by asset managers in answer to this need. After three years of strong growth, a huge variety of these funds are now available in South Africa, however all have the common goal of limiting downside risk while achieving real, above-inflation returns.

Absolute return funds – sometimes also called real return or targeted funds – are generally structured for the more risk-averse investor whose priority is capital preservation, but who still wants to benefit from a rising equity market. They offer a targeted level of capital growth with some capital protection, but there is no guarantee against losses. Implicit in this risk-return balance is the understanding that some of the potential returns may need to be sacrificed in order to achieve the mandate set for the fund.

The funds invest across most major asset classes, including fixed income, cash, property and equities, and many also use some derivative instruments like futures and options to limit downside market risk and lock in returns as they are earned. Cash and money market funds have generally been preferred investments due to their low risk nature, while inflation-linked bonds have also proven to be particularly popular given their inflation-hedging characteristics.

According to the Association of Collective Investments (ACI), the number of absolute return funds on offer (both retail and institutional) has more than quadrupled in less than three years, to stand at 68, compared to the 16 that were available at the end of 2003. This proliferation of absolute return funds has also attracted substantial asset inflows from investors over the past three years. As of mid-2006, assets in absolute return funds totaled R22.9bn and accounted for 5% of total assets under management in the local collective investments industry. This compares to only R5.1bn, or 2% of industry funds under management in December 2003. The popularity of these funds would appear to be the result of heightened risk aversion amongst investors arising from a number of factors, including: the global bear market of 2000 to 2003; an increasingly regulated investment environment that has made investment advisers more cautious; and a greater desire for a focus on absolute rather than relative returns within portfolios.

Of course, where one has this many similar funds, you will also find a significant amount of innovation as each attempts to differentiate itself from the competition. Within the absolute return category, there are almost as many different performance targets and levels of risk and capital protection as there are funds, and these are achieved within varying timeframes. While such a diversity of options can be appealing to investors, increased choice brings with it the need for greater diligence in research prior to investing. Rather than merely opting for the absolute return fund that has shown the best returns over the past three years, investors need to ensure that their choice of fund appropriately matches their risk and return profile with due attention given to the timeframe in which they hope to achieve their investment objective.

ABSOLUTE FUND INVESTMENT STRATEGIES

It is worth noting that the managers of absolute funds employ very different investment strategies, resulting in varying fund performances and risk levels. The four most popular strategies appear to broadly be as follows:

1. High cash with stock picking

In this approach, the manager will use a high proportion of cash and market hedging to keep risks low and rely on superior equity analysis (or stock picking) to achieve the desired return. While effective at capital preservation, the success of the strategy is largely dependant on the manager's stock-picking skills to generate the required returns.

2. High cash with diversification

The second strategy also involves a low degree of equity exposure, instead generating returns through contributions from shorter-term asset allocation. This means the manager invests across a diversified portfolio of assets, with the bulk of funds in cash to provide stability. The approach is likely to succeed in preserving capital, but investors may be left wondering how much of their potential returns are being sacrificed in the process.

3. Active management

The third strategy, as used in the Old Mutual Dynamic Floor Fund* amongst others, focuses on active management of equity exposure. It takes advantage of periods of strong equity market performance to maximise returns, while shifting into other asset classes in response to equity market downturns. Funds managed in this way generally feature a high level of capital protection, with some using derivatives to lock in previous returns. The idea behind this strategy is essentially to have the fund perform well during a bull market, while protecting capital during bear markets. It does, however, become difficult to record high returns in extremely volatile conditions where there is no clear trend.

4. Low cash with stock picking

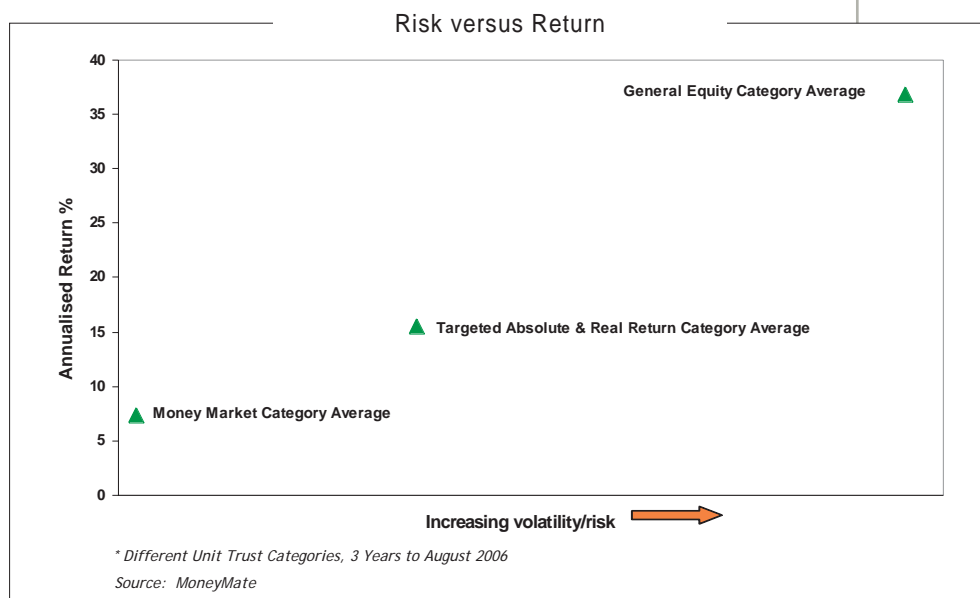
The final strategy also opts for lower cash holdings, while relying on either tactical (short-term) asset allocation or accurate stock-picking to generate the desired returns. Risk is managed through the use of derivatives and depends to a large extent on the ability of the fund manager to foresee equity market falls and identify less risky, undervalued shares.

It would be fair to describe the first two strategies as more "defensive" in nature, while the last two undoubtedly constitute a more "aggressive" approach.

Although many absolute return funds do not have a track record longer than three years - during which time South Africa has enjoyed a bull market - their performance history demonstrates that the category has indeed performed as it was designed to.

As shown in the accompanying graph, the average category returns of 15.5% p.a. over three years have comfortably beaten inflation and the money market fund category average of 7.4%. Importantly, this has come at a much lower risk than the equity market, where the average general equity fund returned 37.0% per annum over the period.

Despite the lower-risk characteristics of absolute return funds, prudence is still advised when investing - as is the case with any investment. Most importantly, investors must carefully consider



whether the fund's mandate suits their specific needs, and whether the fund appears likely to deliver on its mandate.

* The Old Mutual Dynamic Floor Fund, one of several absolute return funds managed by OMAM, aims to protect at least 90% of net capital invested over a 12-month period, while also returning CPI+4% per annum on a rolling three-year basis. The fund has outperformed both the category average and its benchmark, returning 18.3% p.a. for the three years to end-August 2006, compared to 6.9% p.a. for the benchmark (CPI+4%).