

ABSOLUTE RETURN INVESTMENTS |

Absolutely serious...

...about protecting capital and achieving inflation-beating returns on top of that

THE PROPOSITION OF Old Mutual Investment Group SA's Absolute Return Investments boutique seems fairly simple: offer clients absolute, inflation-beating returns and protect their capital. However, achieving that – irrespective of what the equities market is doing – is far from simple, requiring a disciplined investment process and attaining a balance between returns and protection.

Beating inflation over the long-term needs equities in a portfolio. If there's a protracted downturn, however, capital could be lost. Protecting capital just needs a money market fund, but that won't always offer higher than



Balancing capital protection and CPI targets.
Tom Connell

inflation returns if interest rates are low.

"That's the balance we have to achieve to reach our targets – a balance between protecting capital and the CPI target," says Tom Connell, head of the Absolute Return Investments (ARI) boutique. Unlike equity investment boutiques, ARI uses all asset classes, including cash, fixed income investments, property and equities, as well as derivatives for downside protection where appropriate. Allocating those assets throughout a portfolio sets the ground for maintaining the balance between absolute returns and capital protection.

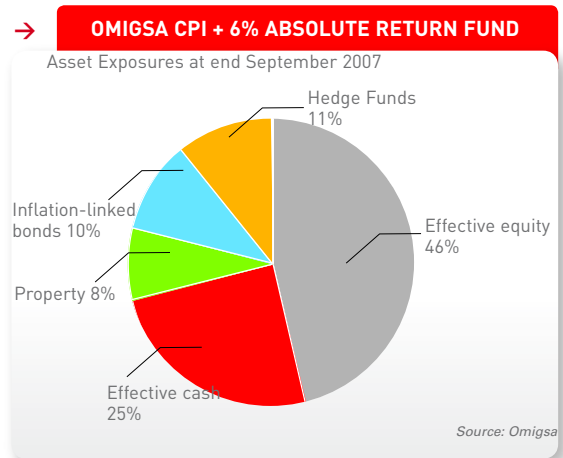
For example, the ARI's institutional Absolute Return Fund has a return target of CPI plus 6% over a rolling three-year period and a risk objective of positive returns over a rolling one-year period. To achieve that return the portfolio is invested across equities with an expected real return of 8%; alternative investments (possibly hedge funds) with an expected real return of 7%; inflation-linked bonds (real return 3%) and cash (offering a real return of 2%). Balance those out and the portfolio delivers the promised CPI plus 6%.

But what about capital protection? "That's achieved mainly through a combination of diversification (as seen above), protection using derivatives and dynamic hedging," says Connell.

But portfolio construction and asset allocation are only the starting point. Portfolios in the ARI are actively managed, with asset allocation adjusted as market conditions change. "Our clients need equities in their portfolio for growth

over the longer-term but we'll cut down on equity exposure to control risk in portfolios from time to time. Active management is essential as we switch between asset classes to capture the best possible performance, while also preserving capital."

Connell says the real focus – and common theme in all client portfolios, regardless of the risk mandate – is capital protection. ☒



ABSOLUTE RETURN INVESTMENTS BOUTIQUE: FACTS

- Nine investment professionals.
- Some 85 years of combined investing experience; extensive derivative skill base; quantitative skill base.
- R30bn in assets under management, of which R20bn are absolute return funds; R5bn structured products; R4bn US\$ hedge funds; R1bn SA hedge funds. ☒

Hedging risk

MULTI-MANAGING HEDGE funds for fund-of-hedge-fund (FoHF) portfolios is a specialised skill, especially when they're spread worldwide. The Absolute Return Investment (ARI) boutique's capabilities are up to speed on that track, having formed a joint venture with US-based Ivy Asset Management in 2001.

Ivy, which focuses on identifying and selecting suitable hedge fund managers for FoHF portfolios, has more than US\$15bn assets under

management. It co-manages around \$500m for ARI in two hedge fund programmes: the OMIGSA Absolute Return and OMIGSA Hedged Equity funds.

The OMIGSA Absolute Return Fund is a multi-strategy FoHF. Recent allocation information shows it incorporates four broad strategies using 25 different hedge fund managers. The gross annual targeted return is the London Interbank Offered Rate (Libor) plus 3% to 5%.

Ivy follows an intense and thorough investment process researching, visiting, screening and finally approving hedge-fund managers for the

FoHFs they multi-manage.

The OMIGSA Hedged Equity Fund has a more aggressive target of Libor plus 5% to 8%/year. Its strategy allocation is primarily to long/short equity funds run by 24 hedge fund managers.

Both funds have comfortably met their return objectives, with extremely low volatility, since their inception in 2001.

Hedge fund investments are "becoming pretty much mainstream" internationally, says boutique head Tom Connell. He also notes a rapidly growing interest in hedge funds in SA. ☒

ABSOLUTE RETURN INVESTMENTS

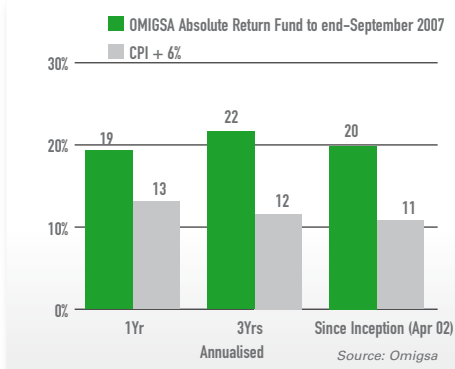
At the heart of the boutique

Capital invested indicates clients' preference

ABSOLUTE RETURN FUNDS cater for clients who need certainty about their capital invested and some stability in the returns they'll receive from that investment. It may sound

The fund's return objective is CPI plus 6% over rolling three-year periods, with a risk objective of positive returns over a rolling one-year period.

→ **OMIGSA CPI + 6% ABSOLUTE RETURN FUND - PERFORMANCE TO END-SEPT**



Since inception in April 2002 the Absolute Return Fund has strongly outperformed its return objective, recording 20% (annualised) against CPI plus 6% of 11%. The same trend is in place over three years: 22% versus 12% (see graph).

The same applies to capital protection. The lowest one-year return has been +8% (highest +41%), a period in which the market as measured by the JSE all-share index was -30% and balanced funds -14%. While consistent, inflation-beating returns are important this ability

to limit the downside is the fund's defining feature.

It's positioned towards the lower end of the risk scale, the spectrum between virtually risk-free but low return cash and much higher risk equities. Yet the fund's comparative position on the return scale, while lower than balanced and pure equity funds, is comfortably above inflation and in line with its CPI plus 6% target.

How is that achieved? Various strategies are in place, including a derivatives' protection programme,

like seeking the best of both words, but the Absolute Return Investments boutique's track record shows it's possible over the longer term. That's why absolute return funds are the heart of its offerings, capturing roughly two-thirds of the total R30bn assets under management.

There are other products clients can choose or use in conjunction with absolute return funds. The boutique will tailor-make investment strategies to match clients' risk and return objectives. Those include the

The boutique will tailor-make investment strategies to match clients' risk and return objectives.

Capital Growth Fund, the range of SA hedge funds and offshore fund-of-hedge-funds and structured products.

But the core Absolute Return Fund captures the essence of what the boutique has to offer: active asset management to provide the best possible performance while also preserving capital.

diversification across all asset classes and dynamic hedging. But the real strength lies in portfolio asset allocation and the active management of assets as market conditions change.

That demands a disciplined investment process and skillful and experienced fund managers. The boutique doesn't fall short here. ☒

Investors becoming cautious

Monitoring volatility



Understand and exploit volatility. John Gilchrist

VOLATILITY IS GENERALLY not an investor's friend. We want to know which way markets are moving to make informed investment decisions. When the market goes up and down with no clear trend it makes such decisions difficult.

However, times of market volatility are also the times when absolute return and hedge funds tend to show

their mettle. Not surprisingly, Absolute Return Investments boutique closely monitors volatility.

Since early this year the JSE has constructed and published the South African Volatility Index (Savi). It shows the short-dated implied volatility of the JSE Top 40 index. As portfolio manager John Gilchrist says, the Savi can be used as "a market fear indicator" – showing what volatility investors expect and how much they're prepared to pay for insuring against it.

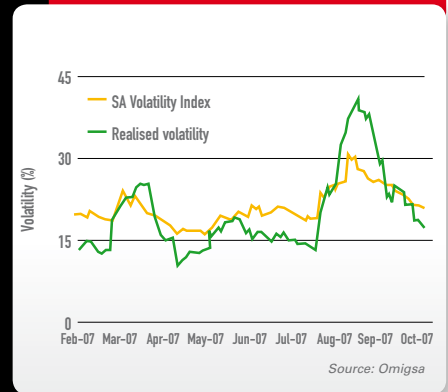
Gilchrist says, generally, an increase in realised volatility is associated with an increase in implied volatility and therefore an increase in the Savi. Normally, the opposite would also apply – a decrease in realised volatility means a decline in the Savi.

But as Gilchrist highlighted earlier this year, the Savi remained relatively high in June despite a decline in

realised volatility. He concluded that investors were cautious about the markets and putting defensive strategies in place.

Given the extreme market moves in July and August, those strategies would have generated substantial returns. "Understanding and exploiting volatility opportunities form an integral part of our portfolio management process," Gilchrist says. ☒

→ **REALISED VOLATILITY OF TOP-40 VS IMPLIED VOLATILITY**



ABSOLUTE RETURN INVESTMENTS

The floor is moving!

Don't worry, it's just some active asset allocation



Strategy is important
Garth Taljard

THE OLD MUTUAL Dynamic Floor Fund is a popular retail offering in the Absolute Return Investments boutique, though as a product conforming to retirement fund legislation it's also suitable for institutional investors.

With more than R3bn of assets under management, it's run by Garth Taljard, who also manages the boutique's other absolute return funds and was responsible for developing other SA and international hedge fund products. The fund aims at long-term capital growth and a measure of capital protection. Taljard describes the typical retail investor suited to

the fund as conservative. "Probably a retired investor; a person who can't risk capital and needs income. The first requirement is capital protection. And that's aided by the dynamic floor risk management model (see below). At all times we therefore ensure we have sufficient cash in the portfolio in the event that the market starts to fall." That's reflected in the asset allocation. Around 40% of the portfolio is effective equity exposure (though that can be changed quickly, depending on market conditions), a similar percentage is held in cash and money market funds and the remainder in listed property and inflation-linked bonds.

"If the market starts falling we allocate away from equities," says Taljard. "But you can't wait too long before reacting. You have to manage the portfolio all the time – this is a very actively managed fund."

For example, through the volatile month of August the fund's equity exposure was reduced from about 40% to around 30% over a couple of weeks as the market began falling. Then the market went up again, so equity exposure was again upped to around 40%. The end result was that when the market lost about 9% during the month, the Dynamic Floor Fund only lost 3%.

Other "safety measures" for capital protection are also in place. Taljard says some put options are included in the fund (contracts that allow the holder to sell shares at a higher price should share prices decline). That will shield the fund against a sudden sharp downward correction in the market. The put options are typically

on the Top 40 and Findi 30 indices.

The boutique is responsible for asset allocation in the fund, but once decided certain assets that require specialised management – some equities and bonds – are "outsourced" to the relevant OMIGSA boutiques.

Says Taljard: "Strategy is very important. There are some other absolute return funds similar to us. But what differentiates us is the size of our team and its depth of experience. For example, we have a very good trading team, though we try not to trade too much to minimise costs. More efficient at times is using futures rather than options, typically on the Top 40 index. We try to maintain a balance between put options, which are more expensive, futures and our own asset allocation."

Since its launch in November 2002 the Dynamic Floor Fund has provided a return of 14%/year, against the 8% of its benchmark (CPI plus 4%). And through all its rolling 12-month periods it's never lost capital.

The conservative yet income-generating capacity of the fund is reflected in its top 10 holdings, dominated by negotiable certificates of deposit issued by SA's large retail banks. It has a risk rating of three (moderate risk) based on Old Mutual's risk rating scale of one to five.

Taljard also manages the Wealth Defender and Wealth Defender Income funds, which unlike the Dynamic Floor Fund aren't unit trusts but life funds. However, he says the investment mandate is similar and the dynamic floor technology is also used in those funds, so performance will be similar. ☒

Moving stairs

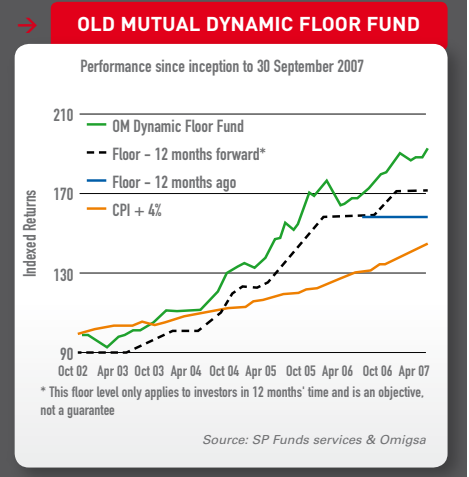
SO HOW DOES the "dynamic floor" in the Old Mutual Dynamic Floor Fund work? It's a unique feature of the fund and, in essence, serves two purposes: a mechanism to protect against capital losses in a falling market and to lock in gains in a rising market.

The pre-determined "floor" is set at a value of the fund above its risk benchmark of not dropping below 90% of the capital invested in the fund over a rolling one-year period. Using a quantitative risk model the fund will reduce equity exposure in the portfolio and

switch into fixed interest investments if the fund's value drops toward the floor.

The opposite applies in a rising market. Holdings in shares will be increased and if the market continues to rise the floor will be raised and set at a new level. The idea is that when the market again falls capital gains made up to the latest floor level should be captured.

However, it should be noted that the floor level is a strategic objective but not a guarantee. ☒



ABSOLUTE RETURN INVESTMENTS

Intelligent use of hedge funds

'They're very useful alternative investments to use.'

HEDGE FUNDS TEND to provoke a lot of bad press. It's probably because most retail investors don't know much about hedge funds or how they work. Managers are also partly to blame, as information about hedge funds and disclosure of the strategies employed are often kept close to the manager's chest – they don't want the competition to know too much about what they're doing.

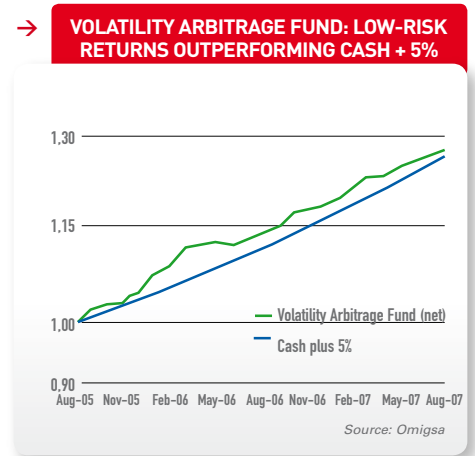
But when investors do read about hedge funds it's most often after one of them has blown out. However, a properly managed fund can be an excellent investment vehicle for clients seeking capital protection and positive returns, whether the market is going up or down.

"Though hedge funds have had some spectacular crashes they're very useful alternative investments to use," says boutique head Tom Connell. "I think the unknown factor regarding SA hedge funds is that most are

equities orientated. We've had a long bull run and it's hard to tell whether hedge funds have performed well just because they've been lucky to have high exposure to equities, or whether other skills and strategies are being used."

Portfolio managers John Gilchrist and Saul Burman are both actively involved in the hedge fund part of the boutique's business. "We've developed hedge funds that are different from other funds typically found in SA. Currently, we manage two hedge funds – the Multistrategy Hedge Fund and the Volatility Arbitrage Hedge Fund – that exploit parts of the market that others generally don't, notably private equity and volatility," says Burman.

For example, the low-risk Volatility Arbitrage Fund has generated net returns above the objective of cash-plus 5% since inception (September 2005), with a volatility of 2,4% and only one negative month (see graph).



"What's particularly pleasing is that these returns are uncorrelated to the equity market – the Volatility Arbitrage Fund generates similar returns during both positive and negative equity markets," says Gilchrist. ▣

Guaranteeing capital protection . . .

. . .and getting quarterly positive returns

LOWER-RISK INVESTORS want capital protection plus inflation-beating returns. That's the implicit promise of absolute return funds and one of the reasons they've become so popular. But capital protection and growth are aims and objectives – there's no guarantee they'll be provided under extreme market conditions. That's where the Old Mutual Capital Growth fund is unique, locking in quarterly capital gains through a guarantee backed by the large Old Mutual group.

"Over the past few years the growth in assets within the absolute return sector of the market has been nothing short of spectacular," says John Gilchrist, Absolute Return Investments portfolio manager who runs the Capital Growth Fund. "Much of that growth was driven by a switch out of traditional guaranteed and smoothed bonus products as investors became disillusioned with the perceived lack of transparency, liquidity constraints and high fees associated with some of those products."

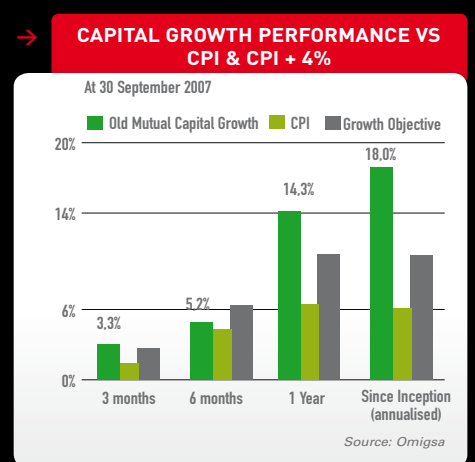
But where do these investors go now? The four-year equity bull market, combined with

recent market volatility, has them reassessing their risk tolerances. "Many absolute return funds have targeted protection levels, most of which have never been tested." Under volatile market conditions the more risk-averse investors will find an explicit capital guarantee attractive, says Gilchrist.

How does the guarantee work? The daily unit prices of the fund are tracked, reflecting growth in the portfolio. That may fluctuate, but Old Mutual guarantees unit prices won't fall below the minimum unit price set for that investment quarter.

To provide that capital guarantee to investors managers use a combination of four techniques, managed together in a highly flexible and efficient way. They are: stock selection (often focusing on the JSE's large market capitalisation shares), derivatives structures, dynamic asset allocation and a capital-backed risk management reserve.

Since inception in December 2005, Old Mutual Capital Growth has delivered 16,6%/year (net of fees but before tax). By comparison, infla-



tion as measured by CPI has been slightly more than 6% over the period and the return target of CPI plus 4%/year almost 11% (see graph).

"For a fully capital-guaranteed product we feel the returns are exceptional and demonstrate the successful generation of excess returns through innovative portfolio management," Gilchrist says.

Bryn Hatty, who assists Gilchrist in managing the fund, adds that it "addresses the concerns that investors had with traditional guaranteed and smoothed-bonus products. We believe it provides the best of both worlds." ▣