Global insight

Developing investment ideas for global markets

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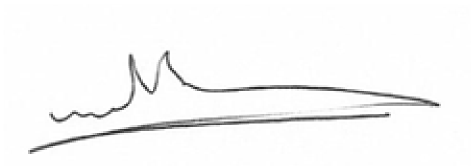
PERFORM

INTRODUCTION FROM WILLIAM LOW

When I started as a fresh-faced trainee investment manager, nearly a quarter of a century ago, the job was very different. We would rely on daily telexes as a major source of information from overseas markets; annual reports were much sought-after, but difficult to obtain; and Rory McIlroy was yet to arrive in this world for another two years.

Contrast this with the deluge of financial data that pours down on every fund manager nowadays. Of course, it's aimed at aiding our attempts to steer a course through an increasingly choppy investment environment. But the sheer volume of information can easily blow the manager off his chosen route. Separating the prize catches from the minnows is crucial. At SWIP, we believe our research team is skilled at doing just that.

All the companies in which we invest are thoroughly researched by analysts, whose financial models have a minimum forecast period of five years. We have to have astute and prescient views of the future investment environment. As part of this research process, we produce a variety of thought pieces. This new Global Insight document provides a selection of some of our most recent articles. We hope you find them useful in formulating your own strategies.



William Low
Head of Global Equities

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The value of investments and their income can go down as well as up. Investors may not get back the amount invested. Past performance is not a guide to future performance.

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INCOME INEQUALITY

From railroads to radio stocks, commodities to computing; the Japanese equity crash to the recent demise of the US housing market: history is littered with financial booms and busts in major industries and economies. Looking back at these events offers a useful insight for those of us investing in today's fraught economic climate – underestimate the importance of long-term trends at your peril. Getting on the wrong side of these secular movements can be financially (and politically) ruinous. The difficulty lies in evaluating the current situation and accurately predicting any changes.

Secular economic trends are influenced by periods of rising and falling interest rates; inflation and disinflation; and the accompanying accumulation or distribution of wealth. In cycles that are characterized by wealth accumulation, income disparity is likely to increase. When wealth distribution is prevalent, however, the opposite is true. Over the last 30 years wealth has accrued in the developed world, helped by continued disinflation and sharply lower bond yields. This may be viewed as a consequence of the free market policies put in place by Reagan and Thatcher, the actions of the Volcker Federal Reserve and increased trade liberalization.

Accompanying this developed world prosperity, however, has been a substantial dilation of the wealth gap between the rich and poor. In addition, social problems are escalating – they inevitably come into focus during times of economic stress. And the stress currently facing the global economy will likely be significant enough to draw this period of wealth accumulation to a close. An era of wealth redistribution is on the cards.

People, quite rightly, are angry. Populist protests have spread around the world this year as lower income groups seek to turn the political tide in their favor. This comes as little surprise when one considers the following:

- in the US, 17.1% of under-25s are unemployed;
- in Europe as a whole, the figure is 20.9%, but the Spanish youth unemployment rate is a staggering 46.2%;
- the outstanding stock of student loans in the US stands at more than $1 trillion.

Source: National Employment data / The Economist, November 30 2011

Young people are struggling to find work, can't afford housing, can't get credit and face high food and energy prices. Not only that, they face longer working lives, higher taxes and less generous benefits than their parents' generation. It's unsurprising, then, that those who took part in the UK's August riots felt they had little to lose. But the young are not the only ones feeling the pinch. The fate of middle-aged workers would appear to be continued falls in real wages and diminished pension rights. Inflation is eating away at savers' hard-earned capital at a pace of around 5% per annum here in the UK.

Source: UK CPI data (EU harmonized), November 30 2011

So, the grievances of the populace are broad and legitimate. Sympathizers believe that free-market economics have allowed the wealthy to reap the fruits of a series of asset bubbles, only for the resulting debt to be socialized when things go wrong. Meanwhile, European social democracy has promised financial benefits to citizens that are beyond the scope of state finances.

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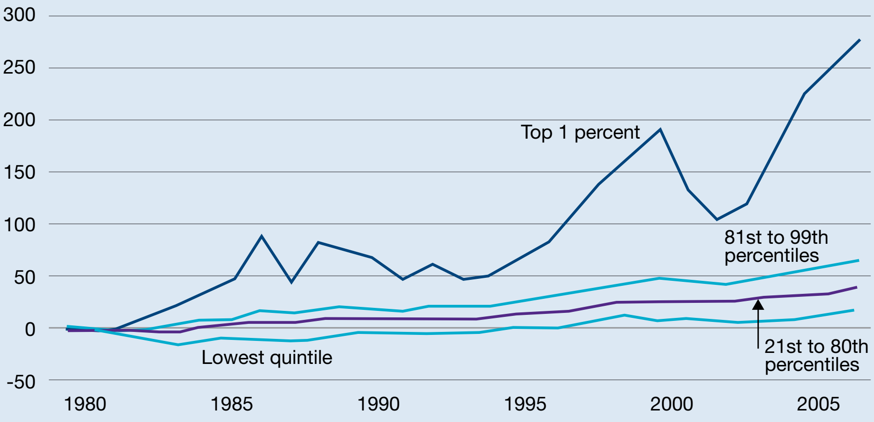
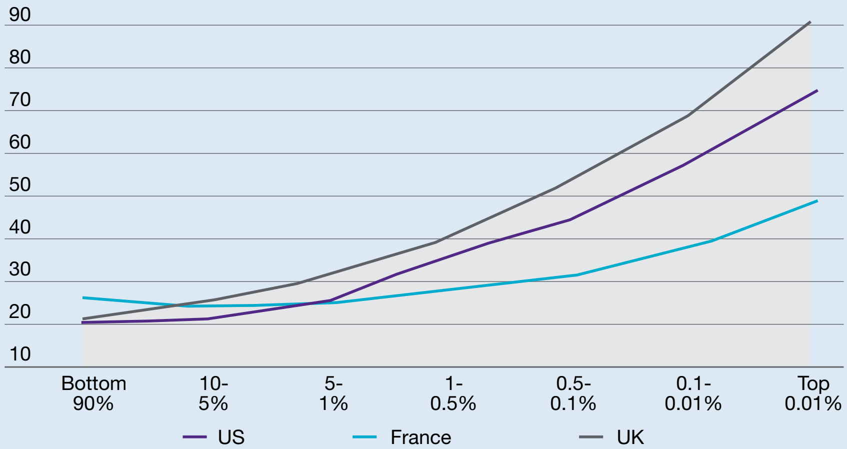
Percentage change in income since 1979, adjusted for inflation



Source: Congressional Budget Office, October 2011

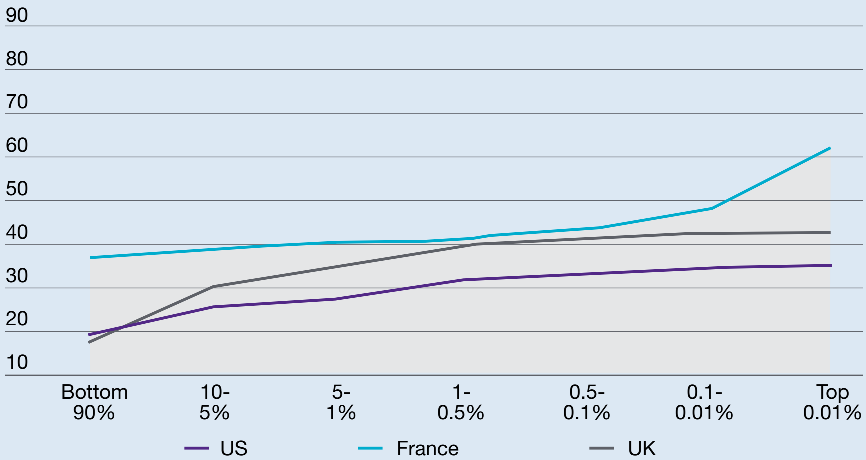
Rates across the income distribution

1970 (%)



Source: "How progressive is the US Federal Tax System? – A Historical and International Perspective", T Piketty & E Saez, 2007

Mid 2000s (%)



Source: "How progressive is the US Federal Tax System? – A Historical and International Perspective", T Piketty & E Saez, 2007

As the charts show, the growth in after-tax income for the highest 1% of earners in the US has totaled 275% during this period of wealth accumulation. Tax rates for the super rich have fallen sharply in the US and the UK, causing the net incomes of the wealthiest to soar. Meanwhile, real wages in lower income brackets have progressed at a fraction of this rate. The current economic climate brings this perceived injustice into much sharper focus.

The political response to shifting public opinion is of vital importance. A backlash against the trend of globalization and free trade risks missing the point. Admittedly, the rise of emerging market economies has put pressure on workers in the West, but other factors have had a far greater influence on the economic turmoil we find ourselves in today. These include excessive leverage in the financial system and governments who spent and promised too much during the boom years, only to renege on their healthcare and pensions obligations once the need for austerity became clear.

The 1930s provides a chilling example of where nationalist policies may lead in the aftermath of great economic stress. We can only hope that today's politicians avoid such an outcome.

There are, however, indications of a change in the political zeitgeist. Contrary to the trend of the last 30 years, the sentiment of a certain founding father is now gaining traction in Washington:

> "Another means of silently lessening the inequality of property is to exempt all from taxation below a certain point and to tax the higher portions of property in geometric progression as they rise"
>
> **Thomas Jefferson, 3rd US President**

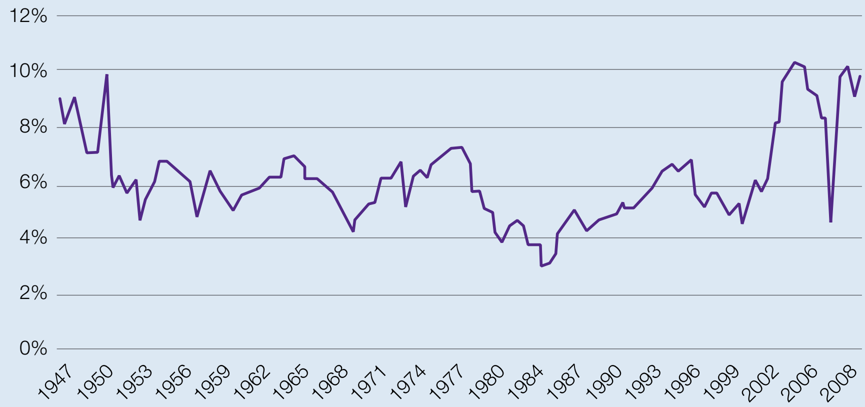
INCOME INEQUALITY

Billionaire investor Warren Buffett has also recently made his thoughts clear on the subject, proclaiming: "While the poor and middle class fight for us in Afghanistan, and while most Americans struggle to make ends meet, we mega-rich continue to get our extraordinary tax breaks." A recent article in the Financial Times suggests the Obama administration is designing a political strategy to match Roosevelt's in the 1930s. This policy of raising taxation on America's wealth would ordinarily be political suicide, but these are not ordinary times. White House officials are already pointing out that the Republicans want to give the average millionaire a tax cut of some $200,000, despite the struggles of the middle classes. The long cycle of declining taxation on the wealthy in the West appears to be drawing to a close, and with it, 30 years of ever-widening income inequality.

An increase in taxation for the wealthy may seem a sure thing, but there's another potentially lucrative source of income likely to be pursued by governments, namely, the corporate sector.

This becomes even more evident when one remembers that while large companies may fund political campaigns, they cast few votes.

Corporate profits after tax (CP)/GDP



Source: Federal Reserve Bank of St Louis, 01/1947-04/2011

The corporate sector is in rude health – share of profits as a percentage of GDP are at a record level for the post-war era. The direction of tax rates seems clear. Particularly so when one considers the effective tax rates of the following large, highly-profitable companies:

Company	Net income for shareholders (last 12 months)	Effective tax rate
General Electric	$11.3bn	7.39%
Ford Motor	$6.6bn	8.28%
Pfizer	$8.3bn	11.90%
Coca-Cola	$11.8bn	16.70%
Vodafone	$11.8bn	17.10%
Total	**$49.8bn**	**12.76%**

Source: SWIP, November 30 2011

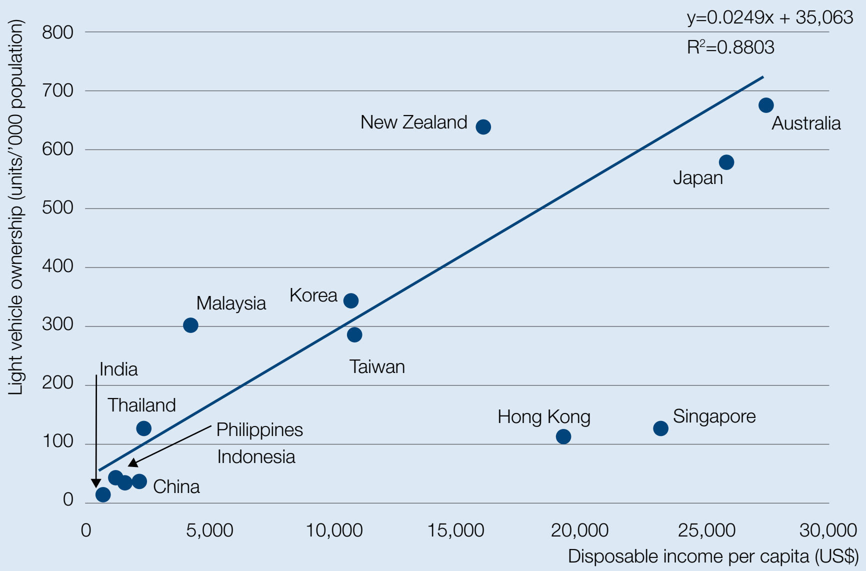
As governments become more desperate for income, large companies that have spent years developing elaborate means to lower their effective tax rates are obvious targets. Governments may decide to tighten legislation on the repatriation of overseas income, or employ special one-off taxes for specific industries. The recent energy and utility windfall taxes are examples of the latter, as is the proposed financial transaction tax in Europe.

If we are now entering a secular period of wealth distribution in developed economies – where the highest earners and large companies carry a greater tax burden – what is the trend in emerging countries? Ironically, given their relatively high levels of poverty, income gaps in emerging economies are far wider than in the developed world. In Brazil, the richest 20% of the population earns 21 times as much as the poorest 20%. This compares with 7.2 times as much in the UK, 8.4 in the US and 3.4 times in egalitarian Japan. In China, the rich earn 12 times as much as the poorest segments of the population*.

*Source: The UN Development Programme – Human Development Report, December 31 2009

These gaps have existed for many years in emerging economies and governments are well aware of the effects they have on social mobility, educational attainment, life expectancy and crime. The pursuit of pro-growth macroeconomic policy is not only in the wider interest of these societies, but is also of paramount importance to the self-interest of the ruling elites. (The massive expansion in social housing provision in China over the last 2 years is a good example: prices for private sector properties – predominantly owned by the wealthy – have soared). The challenge comes in periods of rising inflation driven by high food and energy prices as we have experienced in the last two years. This leaves policymakers with a delicate balancing act to strike. Demand growth must slow enough to ease the pressure on prices, but it must also remain robust enough to allow real incomes to continue to rise.

Car ownership and disposable income per capita



Source: CLSA, April 2011

Regardless of whether this balance can be struck in the near term, the longer-term trend of rising disposable income (particularly relative to the West) is impossible to ignore. The swelling numbers of the middle classes – bolstered by more people finding themselves with $3,000 or more of disposable income – will have considerable implications for consumption (see chart above).

Over time, a longer-term increase in the availability of consumer credit will combine with this aspiring middle class to allow for an improved balance in emerging countries' economic growth. This will take time, however, and there will inevitably be bumps along the way. The change should be a boon for consumer-facing companies – whether they are of Western or local origin. But timing – as in the theatre of comedy – is crucial.

For the developed world, then, an extended period of wealth redistribution is likely. But it will not be driven by economic growth lifting more of the populace out of poverty; rather, the mechanism will be increased taxation on the rich. Meanwhile, the propensity for the middle classes to fund their consuming habits with credit will be hindered for a generation as the financial system deals with the aftermath of debt-fuelled asset bubbles.

By contrast, there is greater scope for income gaps in emerging countries to narrow. There, economic growth will begin to counter deprivation and the aspiring middle classes will obtain more access to credit. Companies are positioning themselves to take advantage of these trends and investors should do likewise. Credit quality in emerging markets should wax and wane, meaning cyclical risks will linger. This should only enhance their attraction for investors as the quality (and equality) of future growth improves.

WILL A CRISIS LEAD TO CONVERGENCE?

That Greece is even a member of the euro is demonstration enough that the single currency is a political rather than economic project.

Back in 2000, the Treaty of Maastricht set out five criteria to be met if a country wanted to adopt the single currency. These included a national budget deficit at or below 3 per cent of GDP, and national public debt not exceeding 60 per cent of GDP.

The fact is that Greece's fleeting achievement of these criteria in 2000 raised eyebrows at the time, and that was before we knew the full detail of the creativity of their accountants.

The hope from the politicians (and many economists) was always that once in the single currency, member countries' economies would converge – despite the obvious deficiencies in performance at the outset. Meeting the Maastricht criteria provided cover for the Bundesbank and its northern peers to allow Greek entry, but the only way that the new currency would work would be with sustainable convergence in the succeeding years.

But as we now know to our cost, the opposite occurred. Now, an increasing number of investors are already making preparations for, and placing bets on its demise. So is there any hope for the euro?

The first question to address is: why did convergence not happen in the first place?

Politicians had hoped – even expected – that sound money and price transparency would lead to faster economic growth. Without the "easy" devaluations of the previous decades countries would be forced to compete directly with the best in the currency area. Labor markets would have to become more flexible and productivity would rise. This would be the mechanism through which current accounts would balance within the single currency area.

What actually happened was that in the very early days of the single currency, member states experienced "reform fatigue". (This is the European Commission's own description.) Countries – or their accountants – had worked so hard to get the books into shape to meet the Maastricht criteria that they didn't really want to do any more. They saw the formation of the single currency as an end rather than a beginning. The exam had been passed; there were no more papers to be taken.

Also, and perhaps more reasonably, the advent of the euro coincided with a period of world economic history characterized by low interest rates and low inflation – the "Great Moderation". There were many causes of this; the principal one was the importation of deflation from China and other emerging markets. The one thing that didn't cause it was central banker and government skill. However, for the purposes of self-aggrandizement, the latter reason was understandably the one advanced by eurozone central bankers and governments. As a result, the all-too-difficult, but vital supply-side reforms were put firmly in the "important, but not urgent" pile.

The result? A decade where there was little improvement in the underlying growth rate of the eurozone versus the previous decade. This was a tragically wasted opportunity, given the undoubted and demonstrable benefits of price transparency, lower transaction costs and generally easy money. Unit labor costs rose across the eurozone in the first decade (i.e. wage growth was ahead of productivity growth).

Richard Dunbar
Investment Director,
SWIP

What's more, the worst offenders were those countries that needed discipline the most – Portugal, Ireland, Italy, Greece and Spain (now known collectively as the PIIGS). Germany, a country with a proven track record of productivity improvement over decades, continued to add to its record.

Money found its way into unproductive assets (principally residential and commercial real estate). Little thought was given to what would happen if the attractions of these assets diminished.

The net result was a club which – rather than forcing convergence – actually made it easier to continue the bad habits of before. There was a great party at the club; no one stopped to consider why those Maastricht criteria remained important and why those supply-side reforms that seemed so crucial all those years ago remained key to the success of the project.

So the party is now firmly over. As we enter our fourth year of crippling hangover, is there any hope that these supply-side reforms may find their way into the underused tray marked "important and urgent"?

There are some straws in the wind that provide a glimmer of optimism. After more than a decade of falling productivity, labor market reforms are being implemented in Italy and Spain. While in Spain there remains an element of collective bargaining at national level, it is now possible for salary scales to be settled at company level. Firms can also opt out of collective bargaining in more difficult economic times. The changes have a basis in the Hartz reforms to welfare benefits in Germany, implemented between 2003 and 2005. These were themselves a reaction to a decade of high unemployment, and are generally agreed to have been successful.

WILL A CRISIS LEAD TO CONVERGENCE?

> "After more than a decade of falling productivity, labor market reforms are being implemented in Italy and Spain."

Meanwhile in Italy, increased labor productivity was one of the demands attached to the European Central Bank's support of the Italian bond market. As in Spain, new legislation seeks to align wage growth with productivity growth. As with Spain, the hoped-for result is much more flexibility beneath the national collective bargaining arrangements. The productivity numbers in Italy are so appalling that it is increasingly hard to argue against reform. Following the resignation of Silvio Berlusconi as the country's prime minister, a technocratic government has been installed, headed up by respected economist Mario Monti. Perhaps this will counter the chronically weak political leadership that has consistently hampered progress in Italy.

Greece's prime minister, George Papandreou, also stood down in November, and his administration has been replaced by a coalition led by former ECB vice-president Lucas Papademos.

The mooted reforms in Greece and Italy are allied to a sense of urgency in the restructuring of the corporate sector. During 2011 we saw a merger of EFG Eurobank and Alpha Bank with Qatari involvement as part of the transaction. The sale of a further 10% stake in Hellenic Telecom also shows resolve – albeit this has been driven by necessity.

But perhaps the best – and certainly the most developed – example of this supply-side reform is in Ireland. In the last two years unit labor costs have fallen 9% relative to the rest of the eurozone*.

*Source: Goodbody Stockbrokers, May 25 2011

They are still falling. A near-halving of office rents, while painful for the owners and their banks, puts Ireland back in the pack as regards office costs. Exports are up. Foreign direct investment is rising as Ireland capitalizes on its advantages – a well-educated, English-speaking workforce, in the right time zone, with a low tax regime and in the euro – and now, all at a lower price. Ireland's economy is still in trouble, but at least it has a political leadership and a population that appreciates the problem. With resolve, Ireland is plotting a course out of its problems.

But the "profligate southerners", as the Germans might see them, are not the only ones in need of policy action. Germany's huge 5% current account surplus is the other side of the equation. Threats by corporate Germany to relocate jobs to eastern Europe have resulted in remarkably low wage growth over the past decade, and consequent strong productivity growth. Domestic demand has been depressed and exports have soared. With a floating currency, the Deutschmark would probably have appreciated, forcing a policy response to deal with weakness in domestic demand. So while most eurozone nations would much rather be in Germany's fiscal position, Germany too has questions to answer following its own policy inaction on joining the euro.

Wim Duisenberg, the first president of the European Central Bank, once said: "The Euro is much more than just a currency. It is a symbol of European integration in every sense of the word." He was right in 2001 and he remains right today. The chaos in the eurozone reflects accurately the current state of European integration, leadership, mutual trust and respect.

However, all is not lost. While the economist in me remains skeptical of the whole euro project, perhaps this crash course in convergence may be part of a formula that eventually settles markets.

At the time of writing, the political leaders of France and Germany were proposing a number of fiscal rules in the hope of doing just that.

The main points included:

- automatic sanctions for countries that breach the Maastricht rule not to exceed 3 per cent of GDP;
- a provision that private sector bond holders will not suffer losses in a future debt restructuring;
- the European Stability Mechanism to launch in 2012.

Monsieur Sarkozy and Frau Merkel would prefer the Treaty change to apply to all 27 EU members, but say a Treaty for the 17 eurozone members could be accepted.

The risk of course (and unfortunately the most likely outcome) is that it is too little too late, and that markets dictate the fate of the euro before we see any benefit from belated attempts to converge.

This would be unfortunate, to put it mildly. Supply-side reforms will be painful, but they will have to happen anyway – whatever happens to the euro. In their heart of hearts, the politicians know this. The cost of inaction and the resultant break-up of the euro would be painful indeed, but would still leave the same problem for the politicians and their electorates to solve.

GDP GROWTH VS STOCK MARKET RETURNS…

We're constantly being told that we should look to the growing economies of the world for investment opportunities. On the surface, this sounds seductive – after all, wouldn't you prefer to share in China's rampant 9% annual growth rather than the dismal "age of austerity" stagnation that threatens to suffocate the West? But as Richard Dunbar notes, strong GDP growth does not necessarily translate into healthy investment returns.

As learned commentators point us in the direction of Asian expansion or Latin American opportunity, it is interesting to note that the academic research does not support this collective enthusiasm for chasing GDP growth. When strategists lay out the prospects for economic growth, sensible investors should make a mental note to look elsewhere in the presentation for the data that really matters.

Jay Ritter in his 2004 paper, and Dimson et al in their 2002 paper, have analyzed returns over a century – a timescale within most investors' definition of the long term. Ritter says most investors believe that economic growth benefits shareholders. But his study finds that the cross-country correlation of real stock returns and per-capita GDP growth is actually negative.

For stock returns, what matters is how much of an economy's growth comes from reinvestment of earnings into profitable investments in existing publicly-traded companies.

Ritter argues that the existing owners of capital frequently fail to gain from a nation's economic growth in the shape of higher returns. The biggest beneficiaries are often private companies or buyers of new equity from existing companies.

Looking back over the past few decades, examples of Ritter's observations are easy to find. In virtually every corner of the world, higher savings rates have led to an application of new capital, resulting in economic growth. In the emerging markets, growth has been generated by the more efficient utilization of labor (mainly via urbanization, a phenomenon mentioned in virtually every developing world market strategy note). But that growth has not necessarily translated into higher returns for the original owners of equity capital.

Fellow academic Jeremy Siegel did similar research over the shorter time period from 1970 to 1997, finding the same negative correlation. He suggested two reasons for this, which perhaps may chime with the current generation of investors. He noted first that the largest firms on an exchange may be multi-nationals, whose profits depend on worldwide rather than domestic economic growth. Take the UK's FTSE 100 index – two-thirds of the profits from the constituents are derived from outside the UK. Siegel also notes that over this shorter timescale the high valuation ascribed to Japanese stocks at the start of the period reflected more than was even possible with the growth that came (and then went). Indeed, investors in today's Japan are still suffering the hangover from that overvaluation after the bubble burst at the end of the 1980s.

These are reasonable explanations. But the data backing Siegel and Ritter's work is compelling and, if nothing else, suggests that investors should take care.

When we add technology to the mix alongside the increased inputs of capital and labor fueling economic growth, more warning bells start to ring. Studies by Buffett, Siegel and Arnott argue that technological change will benefit consumers. But in a competitive economy, the owners of capital do not necessarily share in these advances.

The authors highlight industries like automobiles and airlines. There, consumers have witnessed almost unbelievable advances in the products they own and operate. But the benefits have been enjoyed almost exclusively by the customers – not the shareholder. Contrast that with an industry like tobacco, where the product has stayed essentially the same. True, companies have lost some

Richard Dunbar
Investment Director,
SWIP

profits to litigation. Nevertheless, barriers to entry have remained high and companies have re-invested wisely.

Ritter also touches on corporate governance. Poor governance is a plausible explanation for GDP growth failing to translate into high shareholder returns. It is all too common for investors to buy into companies or markets, only to find that growth and cash flows fall short of expectations.

Latin America provides a good contemporary example. This year, Peruvian mining companies have “agreed” to a $1 billion windfall tax on profits. This tax is destined for the alleviation of poverty – a worthy cause, but not what shareholders were expecting. This share of Peru’s growth – originally earmarked for shareholders – has gone elsewhere. In Australia, the government is keen to share financially in the world’s enthusiasm for metals. It plans an $8 billion windfall tax on its mining sector. Once more, this is doubtless for a worthy cause, but not altogether helpful for shareholders.

Then there is Russia. Investors in the world’s largest kleptocracy only need to head to the marinas of Monaco and St Tropez to understand where much of the expected returns from the Russian growth story ends up. Perhaps this is what was expected by many – but certainly not by all.

Substantial shares of economic growth often also accrue to companies’ management and staff rather than to shareholders. Should you doubt this, ask any long-term investor in the investment banking industry. All will bear the scars of this value leakage. The beneficiaries can probably also be found at Monaco or St Tropez.

Ritter is not asserting that growth is bad – far from it. He cites a close correlation between higher per capita incomes and longer life spans and lower infant mortality. But he is reminding us that shareholders may not be the beneficiaries of this forecast growth. It’s a heads-up to investors – do your homework, and don’t assume that all this GDP growth will end up in your investee companies’ profit and loss accounts.

So where does all this leave us? Ritter’s observation of a negative correlation between GDP per capita growth and returns may be partially caused by the fact that in any given period, the prospect for good economic returns has already been reflected in share prices. As stock prices rise, more capital must be invested to achieve the same stream of cash flows. Unless growth is higher than had been initially expected, disappointment generally results. Be wary of chasing markets – don’t pay the seller a price that reflects all of – or indeed more than – the returns you are expecting.

As ever, past performance is no guide to the future. But Ritter and others argue that the future performance of the economy in which companies do business may not be either. The academics are telling us to make sure we know what we own. We have to ensure that we take stock of all the other “stakeholders” with a potential charge over current or future cash flows. We must be wary of naively forecasting that the fruits of abundant GDP growth end up in the quoted sector of any economy. And, above all, we must make certain we don’t pay a premium for growth that is already recognized in share prices.

ABSOLUTE-RETURN FUNDS: LOOKING BEYOND THE LABEL

In the UK, a popular brand of woodstain is advertised on the basis that "it does exactly what it says on the tin". As a slogan, its modesty is appealing. It would be nice if a similar restraint applied to the marketing of investment products.

In reality, however, investment funds are often given labels (alpha, growth) that are expressions of wishful thinking rather than a guarantee of what investors might actually see.

That problem is particularly acute in the burgeoning absolute-return sector. The UK's Investment Management Association (IMA) defines absolute-return funds as being those that are managed with the aim of delivering absolute returns in any market environment: "typically funds in this sector would normally expect to deliver absolute (more than zero) returns on a 12-month basis". No ambiguity there. But as a glance at the performance tables in leading investment magazines will demonstrate, many are failing to satisfy that definition. Over the year to 7 October, Morningstar tracked the performance of 63 funds in the IMA absolute-return sector. Over that period some 32 of those funds produced negative returns, meaning a slim majority of absolute-return funds have singularly failed to do what they say on the tin.

Different strokes

Thankfully, advisers are a cynical bunch. Not only have they developed a healthy skepticism towards fund labels, they also realize that their clients' expectations can sometimes be unrealistic. Indeed, some investors' expectations seem to remain anchored to pre-crisis levels. It may not sound like it, but if cash is yielding somewhere between zero and 1% then an annual return of 5% is pretty good going.

But if it is disappointing that almost half of absolute-return funds have failed to live up to their billing, it could be argued that the absolute-return designation does damage in a second, more insidious way. It masks the huge degree of diversity that exists across the sector and implies a commonality of approach that doesn't exist.

So we would suggest the real challenge facing advisers is not to understand if an investment manager is generating an absolute return but to understand how they are doing it. Only then can they make a balanced judgment as to whether their performance is likely to persist – and of what future volatility might await their clients.

Small gain, small gain, large loss

Fund performance is most commonly measured on a three-year time horizon. Whilst past performance is not guaranteed, over that attenuated period, many absolute-return funds may seem to offer the steady cumulative returns that investors crave. The most attractive will offer small consistent annual returns which, through the magic of compounding, build wealth without the gaudy gains that might serve as a warning that too much risk is being taken. Looked at on a three-year view, an attractive absolute-return fund might show: small return, small return, small return. But as the financial crisis – with its supposedly improbable 'sixteen sigma' events – demonstrated, there can be a 'Taleb distribution' of returns: small return; small return; small return; large, catastrophic loss. Under this scenario, the fund manager appears to be very smart (small gain, small gain, small gain) until they're shown not to be so smart (large loss) after all.

James Clunie
Investment Director

What sort of approaches might exhibit this sort of return pattern? Merger-arbitrage strategies offer one example. When a takeover bid for a company is announced, the target company's share price soars to a level just below the indicative offer price. At this point, conventional long-only fund managers often seek to lock in gains by selling their holdings. Rather than taking the risk that the bid might be delayed or derailed, they sacrifice some upside to take profits and invest elsewhere. That creates an opportunity for merger arbitrageurs, who earn their crust in the gap between the price of a target company following the announcement of a takeover and the actual price the acquiring company will eventually pay. That gap may be small but can, if leverage is employed, be a low-risk way to generate a return (i.e.: small gain; small gain; small gain).

On occasion, however, takeover attempts fall apart at the last minute. In this situation, the would-be arbitrageur is left holding a pile of stock that is suddenly worth far less than he or she paid for it. If leverage is involved, those losses are multiplied. So frequent small gains can be punctuated with the occasional large loss. That is particularly the case during periods of extreme market volatility when takeovers are more likely to be aborted. The timing, of course, could hardly be worse: it is during periods of extreme market volatility that investors look to absolute-return funds for some stability.

Taking the rough with the smooth

None of this is to decry merger-arbitrage strategies. Rather, it is to acknowledge that – as with all strategies – you have to take the rough with the smooth. Performance history based on just a few years could fail to capture the true volatility of returns. It is vital, then, that advisers understand the process and the potentially uneven distribution of returns.

Similarly, short selling is attractive in down markets but can introduce new risks. As there is no upper limit to a stock price, there is (theoretically) no limit to the loss that a short seller can incur. Just like merger-arbitrage, some long-short strategies produce a 'skewed' distribution of returns.

As a result, the onus is on advisers to understand the strategies in which they invest. It is not enough to look at whether investment managers have achieved their goal of generating an absolute return. The sector is a hotchpotch of different strategies, with some funds using market neutral long/short stock selection while others follow macro trends, use technical analysis or employ various forms of arbitrage. Many of these strategies are more complex and carry more risk than may initially be apparent. And while this complexity is not, in and of itself, a bad thing, investors and independent financial advisers should be aware of it. Most managers should be happy to explain their strategy, but if a fund manager is evasive – or if the process is a 'black box' – there may be hidden risks. And while being skeptical about absolute-return funds needn't debar you from investing in them, we would counsel investors to be cautious when investing in complex products.

This may sound like a rather negative view of absolute-return investing. It isn't. I firmly believe that absolute-return strategies have an important role to play; their embrace by a wider constituency of investors is to be welcomed. In fact, in a spirit of transparency I should disclose that I manage a similar strategy myself. But while it was considered an absolute-return approach, it is now more properly labeled as a "flexible strategy". In contrast to some of its peers, it does exactly what it says on the tin.

Jargon buster: Taleb distributions

A Taleb distribution describes a return profile that appears at times deceptively low-risk with steady returns but which periodically experiences catastrophic drawdowns. i.e. there is a high probability of a small gain coupled with a small probability of a very large loss that could more than outweighs the gains. It recognizes the idea, as popularized by Nassim Nicholas Taleb in his book Fooled By Randomness, that extreme events play a bigger role in overall returns than we think.

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