Absolute Return Investing Whitepaper

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Welcome to CAMRADATA's Absolute Return Investing Whitepaper

Absolute return investing strategies – which seek to generate positive returns over time regardless of market conditions – should be able to thrive in the current uncertainty we find ourselves in.

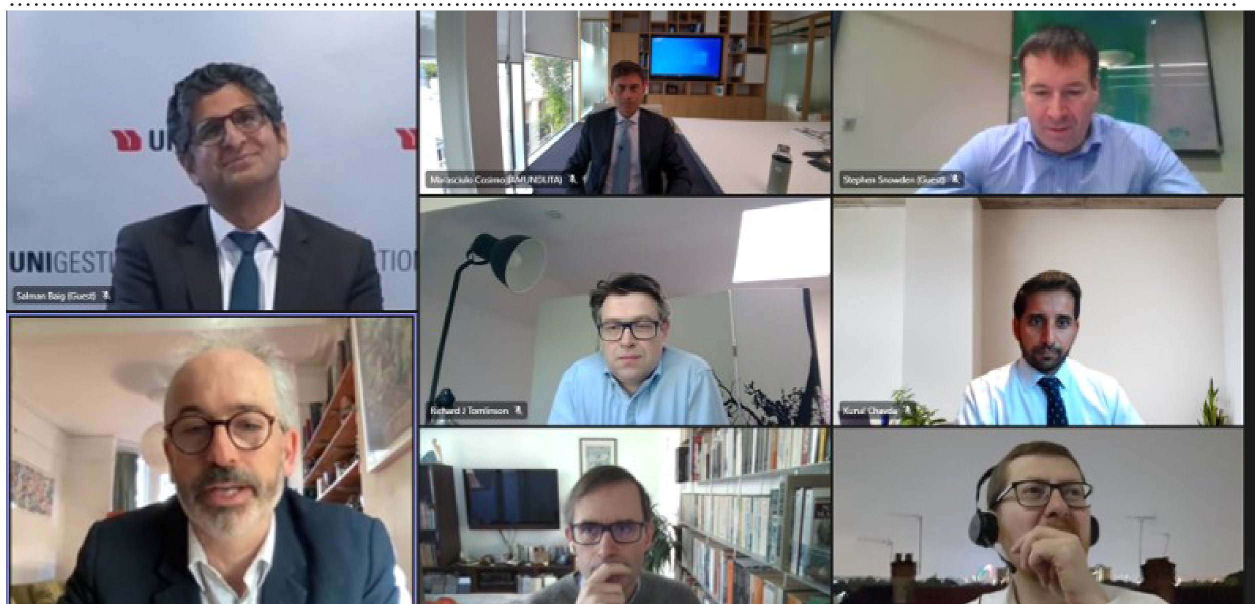
Unlike relative return, absolute return is concerned with the return of a particular asset without comparing it to another measure or benchmark. Returns can be both positive or negative, and are generally considered uncorrelated to other market activities.

With climate change, the pandemic, and social inequality, current market volatility is set to continue for the foreseeable future. Absolute return strategies, should be able to survive regardless. However, the absolute return space has been hit by some negative press of late, with one fund closing after around £1 billion of outflows, while another firm has been questioned over its own beleaguered strategy.

In this whitepaper, we'll discuss the place absolute return investment strategies have in the post-Covid paradigm, and also look at how managers are tackling inflation in their strategies.

Absolute Return Investing Roundtable

The CAMRADATA Absolute Return Investing Roundtable took place virtually in London on 5 October 2021.



"For asset owners to understand Absolute Return better, Tomlinson recommended thinking about it as a way of investing rather than an asset class. Then providers of Absolute Return strategies could be questioned on how they think about the world."

The 2021 CAMRADATA Absolute Return roundtable began by asking consultants and asset owners to give their definition of Absolute Return and its salient characteristics. Israel Cohen, CIO of Capita, a consultancy to institutional investors, answered first with a couple of variations. For equity replacements, in the same field as Diversified Growth Funds, Cohen suggested Absolute Return strategies should have one-third to one-half of the downside risk, broadly equating to 15-25% in the worst bear markets. For less aggressive, fixed income-replacement strategies, he reckoned a maximum drawdown of around 6%. Capita has mandated a lot of Absolute Return mandates over the last few years – approximately one a month, according to Cohen. In the fixed income space, "what we have been looking for here is a complement for the LDI portfolio," he said. "Absolute Return here would be a small portion of that total, providing a bit of upside above cash and a ready source of collateral if the scheme needed it."

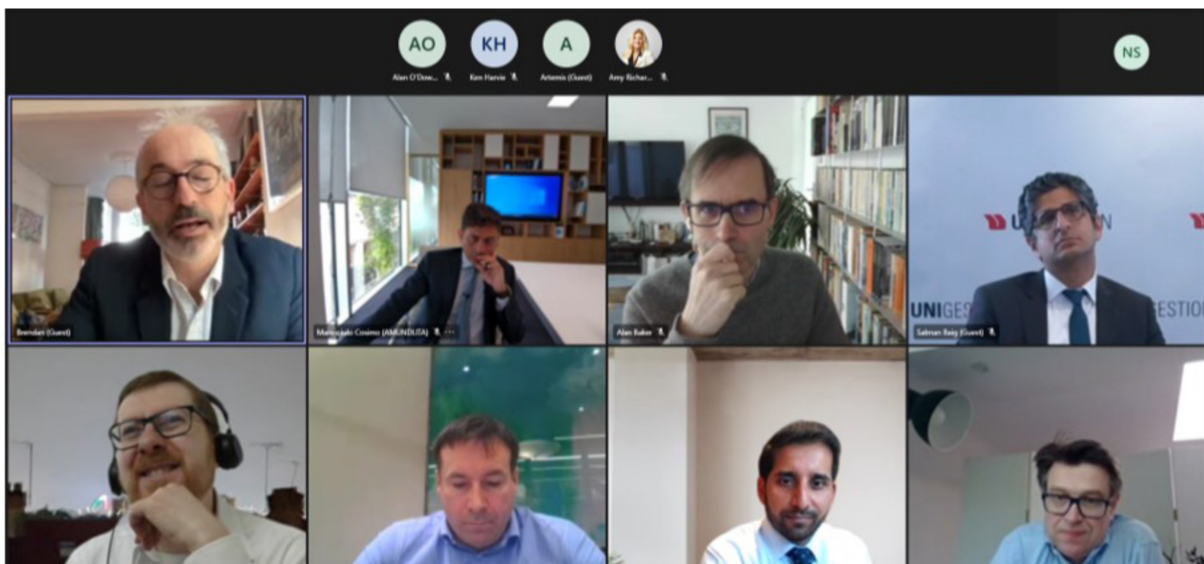
In all cases, Capita did not want any "risk surprises" from Absolute Return: a moot point given the stresses that occurred in March 2020 with the onset worldwide of COVID-19.

For bfinance, Kunal Chavda, a director in the fixed income team, expected a focus on capital preservation. Although he said it was hard to quantify drawdown ranges, Chavda nevertheless suggested annualised returns of 1-3% for annualised volatility no more than 4% was acceptable. He noted that these strategies often had a highly quantitative approach relative to their long-only cousins. Synthetic overlays with a physical core focused on rates was common. He emphasised the need for liquidity to meet redemptions in risk-off environments.

Richard Tomlinson, chief investment officer for LPPI, the investment arm of a local authority pension pool in the UK, agreed with Cohen and Chavda. For asset owners to understand Absolute Return better, Tomlinson recommended thinking about it as a way of investing rather than an asset class. Then providers of Absolute Return strategies could be questioned on how they think about the world: whether their style is event-driven or a much broader quantitative approach. While avoiding a straight comparison with asset classes, Tomlinson nevertheless said it was crucial for providers to clarify where their alpha came from. "Everyone will tell you what they do is skill-based investing but to add value, there must be a credible source," he said.

For Law Debenture, Alan Baker, a professional trustee to UK pension schemes, echoed Cohen's definition. "We are looking for something like a DGF with less correlation to equity markets, ie some protection on the downside," he said.

The managers at the roundtable then joined in. Stephen Snowden,



"The concept of Absolute Return Bonds is not broken, but we have to be honest about what is possible."

portfolio manager of the Artemis Target Return Bond Fund, said he didn't believe Absolute Return strategies had fulfilled their own claims: "The vast majority of Absolute Return Bond (ARB) funds have suffered material downside. In the last 18 months, most have blown the hatches off." For Snowden, this means people have become conditioned to downside volatility. "There is good reason why we haven't labelled our strategy Absolute Return: it is impossible."

Snowden previously ran one of the largest ARBs in the UK, with almost £2bn in assets under management. He said that the downside protection there ensured lower volatility in down markets. But the consequence of consistency was annualised returns of about 1.5%, which were "middling or mediocre, depending on your perspective," said Snowden.

His concern with the nature of ARBs is that the pay-out ratio is skewed towards longs over shorts. Taking short positions means effectively betting against the house and paying out income. Snowden's observation was that over the last eight years since ARBs came to prominence in institutional investing, most managers could not do this effectively and so ended up being long even in down markets. "The concept of Absolute Return Bonds is not broken, but we have to be honest about what is possible," he said. The Artemis Target Return Bond Fund aims for at least 2.5% over the Bank of England base rate on a rolling three-year basis.

Cosimo Marasciulo, head of Absolute Return Fixed income at Amundi, said Snowden had raised an important point, namely the ability of managers to run net short positions in credit duration. For Marasciulo, if a manager is persistently long credit, then why would anyone buy Absolute Return? Speaking for the Amundi Absolute Return Global Opportunities (ARGO) strategy which he co-manages, Marasciulo said he did not see asymmetry in long/short positions. "ARGO has all the tools to run negative beta positions and a target of being positive in all market conditions," he said. He recognised that strategies paid out income on negative spreads – that ought to be mitigated by maximum loss positions in shorts. But the bigger picture was the need for low correlation with broader markets.

Unigestion's Global Macro strategy aims for cash plus 7%, so would sit in the equity-replacement category of Absolute Return defined by Cohen and Baker. Salman Baig, a portfolio manager in the Unigestion team said it targeted a diversified set of opportunities with low correlation to bonds and equities. "We are dynamically managing beta exposure. We can be long any asset but more dynamic and with more market timing," he said. "We are trading in and out of liquid instruments on any given day."

On volatility, Baig said that investors could help themselves by working through risk and return characteristics. "Our strategy volatility is 10%, so drawdown is higher. But for any strategy or asset, investors can draw cone charts to work out where one and two standard deviation probabilities occur."

Baig's point was that volatility numbers in isolation do not tell you much about risk, whereas calculating Sharpe Ratios and expected drawdowns can give a greater sense of whether a particular investment type or technique is worth pursuing.

Turning to his strategy's own workings, Baig said the Unigestion team had a pretty clear worldview: "over three to twelve months, macro forces are the key return drivers." But to understand what was going on with current economic conditions, the Unigestion team could not rely on official GDP figures and the like that are out-of-date for market practitioners by the time they are published. He said getting a timely read on indicators such as inflation and economic growth was challenging but Unigestion had developed systematic signals, or nowcasters, that incorporate various macroeconomic datasets such as retail sales, wage inflation, etc. These help with the systematic fundamental macro elements of the strategy and are complemented by a quantitative trading strategy. The third engine of their approach is discretionary macro.

Baig emphasised that the discretionary portfolio is not trying to override the models or systematic signals: "They look at market drivers not captured within the systematic process such as Central Bank meetings and elections," he explained.

Marasciulo touched on two of Baig's points. First, he agreed that recognising the current market regime was essential. After the huge volatility caused by the onset of COVID-19 last spring, he characterised 2021 as a carry-trade environment. "At the start of the year," Marasciuolo recalled, "we expected a return of 3% assuming historical risks and returns." But then the Amundi team adjusts this central expectation according to the market regime and how correlations move together. By October, for example, Marasciulo saw a turning-point in volatility.

The second point was that ARGO, like the Unigestion strategy, has three elements or pillars. For ARGO, they are core income, dynamic beta and alpha opportunities. The first is the easiest to understand and resembles a simple, long-only credit strategy. Dynamic beta makes adjustments to the portfolio in terms of duration, credit, currency and inflation. The third pillar, which is expected to contribute least in terms of return, is the diversified alpha sources, which come from the best ideas of the specialists within Amundi's fixed income team.

On diversifying sources of return, Snowden said: "I am sure that's what we all do." His point was that no one can predict the downside. Since its inception in 2019, the Artemis Target Bond Fund has been short rates and credit. But he reiterated that being outright short is not a 50/50 bet. "You have to be long income." He added that when markets dislocate, momentum takes you on a bit further than you would like. "You're offside before you're onside," Snowden explained. And one unwelcome consequence for popular, liquid funds is that having a down month forces the portfolio manager to make an explanation to the firm's bosses and possibly clients, which adds pressure to stay long thereafter. Describing the feeling of dropping the Absolute Return label, Snowden said: "it's great to take that burden off of your shoulders."

Tomlinson said he had lots of sympathy for Snowden's less complicated process. "Lots of funds in the ARB category are long low-quality and short high-quality," said Tomlinson. "When there is a train crash, they suffer from the flight to quality."

"Chavda agreed that almost no manager has been unaffected by the down years. He noted different drivers causing sell-offs in 2013, 2015 and 2018."

Chavda agreed that almost no manager has been unaffected by the down years. He noted different drivers causing sell-offs in 2013, 2015 and 2018. "That draws analyst attention to managers' sell discipline in this kind of environment," he noted. "Diversified alpha sources can certainly be beneficial in risk-on markets and provide room for manoeuvre in risk-off conditions, however without carefully considering the interconnections between them in the latter can catch managers short. We have seen a good number of funds allocating to High Yield, Emerging Markets and currencies to bolster returns given limited upside in Investment Grade and rates markets in recent years. Understanding correlations is key."

As an example, Chavda noted that many managers had suffered quite deep drawdowns in the first half of 2020 as the impact of the pandemic saw correlations across risk assets converge as well as challenging

many corporate issuers' business models.

Cohen then added his criticisms of tactical asset allocation. "From our perspective, we find it hard to justify the claim that managers can consistently and repeatedly generate alpha," he said. "At Capita, we are more interested in how they control beta in the construction of the portfolio. That means the focus is not on picking the right stock or credit, but how they put the entire portfolio together to maximise the beta per unit of risk."

Tomlinson supported this emphasis. "Genuine alpha is pretty rare," he said. "Alternative betas, on the other hand, are not pure idiosyncratic risk."

Cohen's next point was the rationale for any manager departing from the optimal risk-adjusted portfolio. "To justify moving away, you need the expectation of better risk-adjusted returns. What research justifies that move?" he asked the managers.

Baig responded first on the broad question of how to understand Absolute Return strategies. "We should always think about cash," he started. He believed it was right to study the competitor universe but cautioned on inappropriate categories. "I know that Morningstar Discretionary Global Macro has funds that are 100% systematic in there," said Baig. "The HFR Indexes might be a better proxy."

Regarding Cohen's scepticism about divergence from an optimally diversified portfolio, Baig said that there had to be for Absolute Return a long-term risk budget. Unigestion spreads the risk budget thus: forty per cent in systematic macro; forty per cent in discretionary macro and 20% in systematic trading. But at any point in time, one bucket can hold more risk than the others. With different data components for the three and different frameworks, they should be independent, or slightly negatively correlated. "That is where we get a lot of our performance," claimed Baig.

Going to the next level down, he pointed out that there was no set long/short in any instrument. And

the discretionary macro managers do not size their own positions. This is taken care of by risk modelling to protect the entire strategy from destabilisation.

Marasciulo then tackled the effects of volatility and tracking error over time. He said there was a call to be made whether the beta is right; and alpha can yield some good returns "But which market regime we are in is the big question," he said. "You have to adapt to this. It is a trade-off between drawdown and recoveries. There can be some very quick u-turns in the market."

He was, however, reluctant to confuse Absolute Return with long-term strategic asset allocation for asset owners. "With SAA, you end up going long-only. With liquid assets you can be more flexible and preserve the capital."

Snowden stuck with the theme of preserving capital and Chavda's point about downside management. "The pandemic proves that models could not cope. The only way to assess downside protection is to use Mark One eyeball: what is the drawdown in risk-off markets?"

He added that for the Artemis Target Return Bond Fund, the maximum drawdown had been in March 2020, at 362 basis points, comfortably less than half the ARB sector average.

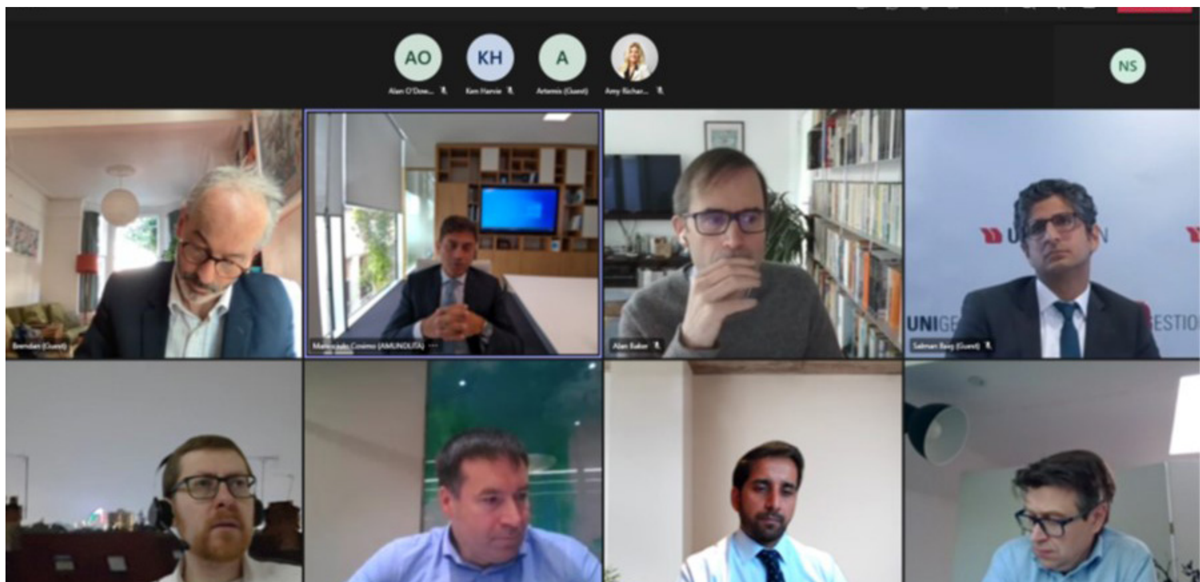
Great expectations

Tomlinson then returned to the theme of where Absolute Return strategies fit into total allocation and their role. He suggested some long-term, smoothed returns for major asset classes, starting with UK equities at 400bps over LIBOR; US equities at500 bps over LIBOR; High Yield at 400 bps over and Investment Grade at 100 bps over. "What are you replacing with Absolute Return and what exactly is its role in the portfolio?" he asked. "Asset owners need to be clear what they are asking of the manager."

For fixed income ARBs, Tomlinson suggested fixed income without the duration as a useful reference point.

The conversation progressed to salient characteristics of less directional strategies. Baig said that gross leverage of 8-12x was permitted for the Unigestion Global Macro strategy but in reality, the strategy had never been over 8x. He noted a range of wishes from

"Cohen's next point was the rationale for any manager departing from the optimal risk-adjusted portfolio. To justify moving away, you need the expectation of better risk-adjusted returns. What research justifies that move?"



prospective clients that could either increase or decrease the leverage employed in the strategy, starting with a target of cash +3% all the way up to cash +15%. Since inception in January 2015, the hit ratio has been above 60% and correlation with global equities has been slightly positive (about 30%); while correlation with global bonds has been flat.

The Artemis Target Bond Fund has a gross leverage limit of 2.8x, although it has never been more than 2.15x.

Amundi's ARGO has maximum leverage of 6x, average leverage is 4x and a win/loss ratio of 1.3. The drawdown in March 2020 was -1.3%.

Chavda said that the nature and drivers of Absolute Return strategies such as leverage were harder for clients to understand than traditional fixed income strategies that offer a relatively simpler long only approach. He applauded the sell-side for its work done in recent years to educate asset owners. But he said he was nervous about highly levered versions.

"He applauded the sell-side for its work done in recent years to educate asset owners. But he said he was nervous about highly levered versions."

"We have seen ARBs used alongside LDI strategies for many years now. We see them often used as cash proxies or even short-term funding vehicles for private markets strategies too. They can also be found at the short end of broader Cashflow-Driven Investing (CDI) strategies employed by mature defined benefit pension schemes, providing good liquidity for short-term liabilities and allowing managers to avoid in negative-yielding short-dated bonds," said Chavda. "Boring is good when it comes to ARBs. But too much focus on return-seeking can be dangerous because it can confuse the role ARBs play in investor portfolios." He was concerned in particular with ARB strategies that apply leverage to enhance target returns from the typical 1-3% range to 4-6%.

Baker then gave an example of one of his schemes which found that it would go to buyout five years early. This was primarily a function of excellent market returns. But it was also a cautionary tale that schemes need liquid assets in readiness for early buyout.

Looking ahead

The CAMRADATA panel on Absolute Return closed with managers' thoughts about the future, in particular the threats posed by inflation. Marasciulo pointed out that inflation was the hardest macroeconomic indicator to predict. But he saw it rising because the pandemic has seen governments taking dramatically greater roles in allocating capital and resources, "which they do less efficiently than the private sector."

Snowden believed inflation will be more transitory. He saw the trend to working from home as disinflationary, as it transformed commuting time into more labour hours. This especially benefited working mothers who might retire from the workforce or reduce their hours to raise children. He saw ageing populations as driving lower productivity, citing Japan as a useful example of how other advanced countries are likely to fare, notably having lower interest rates and lower bond yields. Snowden believes that the entire history of bond yields show they are much lower than the 1970s and 1980s suggest.

Baig emphasised that Unigestion doesn't do long-term forecasts. He said his team had been wrestling with inflation, not least because in the last period when it soared – the 1970s – the world was a very different place. Baig felt that the oil shocks which precipitated that era's double-digit inflation are not so central to the global economy. Moreover, as a systematic strategy, he struggled to find sufficient good data to compare and contrast then and now. He felt that "the elephant in the room" for the global economy was China, notably its policy on capital markets and climate change. For those in finance seeking to understand Chinese policy, Baig highlighted the challenges of an opaque political system.

Roundtable Participants

Cosimo Marasciulo

Head of Absolute Return Fixed Income &
Deputy Head of European Fixed Income

Personal Profile

Cosimo Marasciulo is Deputy Head of European Fixed Income at Amundi and a member of Amundi's Fixed Income Executive Committee. Based in Milan, Cosimo is responsible for a team of portfolio managers across the European Fixed Income hubs (Milan, Munich, and Vienna).

Cosimo joined Amundi (previously Pioneer Investments) in 2000 as a Fixed Income Portfolio Manager. In 2010, Cosimo was appointed Head of European Government Bonds, and in December 2016, he was promoted to Head of Fixed Income, Europe. In addition to his role, Cosimo has been instrumental in developing Amundi Asset Management's unique "Portable Alpha" Fixed Income investment process, starting in 2006.

Cosimo holds a degree in Industrial Engineering from Politecnico di Milano, and has 22 years of financial industry experience.

Amundi Asset Management

Company Profile

Amundi, the leading European asset manager, ranking among the top 10 global players[1], offers its 100 million clients - retail, institutional and corporate - a complete range of savings and investment solutions in active and passive management, in traditional or real assets.

With its six international investment hubs[2], financial and extra-financial research capabilities and longstanding commitment to responsible investment, Amundi is a key player in the asset management landscape.

Amundi clients benefit from the expertise and advice of 4,800 employees in more than 35 countries. A subsidiary of the Crédit Agricole group and listed on the stock exchange, Amundi currently manages nearly £1.5 trillion of assets[3].

1 Source: IPE "Top 500 Asset Managers" published in June 2021, based on assets under management as at 31/12/2020

2 Boston, Dublin, London, Milan, Paris and Tokyo

3 Amundi data as at 30/06/2021

Roundtable Participants

Stephen Snowden

Fund Manager, Fixed Income team

Personal Profile

With a BSc and a MSc in Finance from Queen's University, Belfast, in 1994 Stephen started his career at Aegon Asset Management (previously Kames Capital) as a US equity analyst and fund manager.

In 1998 he moved to fixed income, becoming manager of Kames' Sterling Corporate Bond Fund in June 2000. Stephen then joined Old Mutual Asset Managers and managed their Corporate Bond Fund from 2004 – 2011, when he returned to Kames.

There, as co-head of fixed income, he was co-manager of the Kames Investment Grade Bond Fund, the Investment Grade Global Bond Fund and the Absolute Return Bond Fund until November 2018.

In May 2019 Stephen joined Artemis as a partner, to lead our Edinburgh-based fixed income team.

Artemis

Company Profile

Artemis is a leading UK-based fund manager, offering a range of funds which invest in the UK, Europe, the US and around the world. As a dedicated, active investment house, we specialise in investment management for both retail and institutional investors.

The firm now manages some £27.7 bn* (€32.2bn / $38.2bn) across a range of funds, two investment trusts, a venture capital trust and both pooled and segregated institutional portfolios. A number of these funds are available to investors in continental Europe and Singapore.

Independent and owner-managed, the firm's aim has always been to offer exemplary performance and client service. All Artemis' staff share these two precepts – and the same flair and enthusiasm for fund management. Our managers invest in their own and their colleagues' funds, which aligns their interests directly with those of our investors.

*Source: Artemis as at 30 June 2021

Salman Baig

Portfolio Manager

Personal Profile

Salman Baig, PhD, Senior Vice President, is Portfolio Manager within the Cross Asset Solutions team. He joined Unigestion in March 2018.

Salman began his career in 2003 in the Advanced Strategies and Policy Division at Microsoft Corporation. In 2009, he joined the University of Washington as a Post-doctoral Researcher in the mathematics department.

In 2012 he became Mathematician and member of the Research Staff at the Institute for Defense Analyses. In 2013 Salman joined Bridgewater Associates as an Investment Associate focusing on fundamental macroeconomic research, systemization, portfolio construction, and risk management.

Salman holds a Bachelor in Mathematics and a Master in Finance both from Princeton University and a PhD in Mathematics from the University of Texas at Austin.

Unigestion

Company Profile

Unigestion is an independent, specialist asset manager providing innovative, tailored solutions for investors worldwide. Since our creation in 1971, we have stayed true to our conviction that intelligent risk-taking is key to delivering consistent returns over time.

Today, we are responsible for USD 21.5bn in assets under management across our four areas of expertise – equities, private equity, liquid alternatives and multi asset. (Source: Unigestion, as at 31.03.2021)

Helping our clients achieve investment success drives everything we do. We take the time to truly understand their requirements and work with them to create tailored solutions that meet their specific needs. We have decades of experience in running bespoke mandates, which today account for the majority of our assets under management.

Our focus on understanding and anticipating risk as a means to outperform sets us apart. By taking risk in a measured, informed way, we aim to deliver superior performance for our clients. Risk management is part of our DNA, our culture and defines everything we do.

Headquartered in Geneva, Unigestion has a global presence that extends across Europe, North America and Asia. We are privately owned, with a shareholder structure designed to ensure our long-term stability and align our interests with those of our clients.

Roundtable Participants

Kunal Chavda

Director, Fixed Income

Kunal is a Director within the Fixed Income team focusing on multi-sector fixed income strategies, structured credit and LDI solutions. Prior to joining bfinance in March 2020, Kunal worked as a Senior Consultant at Buck, where he led all public and private market fixed income research and strategy for UK pension schemes.

Kunal previously worked as a portfolio manager at Barclays Wealth & Investment Management, running a book of multi-asset and fixed income portfolios focusing on Court of Protection, charity and corporate clients. Prior to this he worked at the bank's corporate banking arm. Kunal holds a degree in Mathematics from the University of Birmingham.

Israel Cohen

Chief Investment Officer

Experience

• Over 20 years' experience in investment management and consulting
• Joined Capita in 2020
• Lead responsibility for Capita's Investment Process
• Investment Consultant to a range of Capita clients
• Prior experience of both actuarial and investment consulting
• Recent experience managing large books of insurance business
• Extensive knowledge of all the major asset classes
• Expertise in portfolio construction and asset allocation
• Completed due diligence on numerous investment funds across asset classes

Qualifications

• Investment Management Certificate in 2000
• Physics degree from University College London

Alan Baker

Trustee Director

Acting as trustee on 10 pensions schemes ranging from £7m to £2bn, including chairing two and leading on five sole trustee clients. Alan leads Law Debenture's sole trustee business and is a member of the Association of Professional Pension Trustees' sub-committee on the code of practice for professional corporate sole trustees.

Broad experience of investment strategy and risk management including asset allocation, fiduciary management and the development of cash flow matching strategies and hedging solutions. Also extensive experience of de-risking through bulk annuities as trustee and adviser; currently working with two schemes going to market as well as others developing longer term plans.

Alan has worked with sponsors to develop innovative solutions

LawDebenture

Richard J. Tomlinson

Chief Investment Officer

Richard is CIO at LPPI and has responsibility for management of all investment and client activity.

Richard has over 19 years of investment experience. Prior to joining LPP in 2017, Richard was Head of Portfolio Advisory (EMEA) at Albourne Partners for six years where he advised European investors on alternative investments, portfolio construction and risk management.

Earlier in his career, Richard was Head of Multi-Strategy at Old Mutual Asset Managers and prior to this, an analyst at GNI Fund Management.

Richard holds a degree and a master's degree in Engineering from the University of Cambridge and is a Chartered Alternative Investment Analyst.

LPP
Local Pensions Partnership

Moderator

Brendan Maton

Freelance Jounalist

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.
Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles. Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.
Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.

The No. 1 European Asset Manager[1]

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YOUR TRUSTED PARTNER

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To meet our clients evolving needs, Amundi offers industry-leading investment solutions, the strength and scale of a global leader and a firm commitment to responsible investment.

- €1.794 trillion in assets under management[2]
- A presence in more than 35 countries with 6 investment hubs
- Active, passive and real assets investment solutions

Because that's what you expect from a trusted partner.

amundi.com

Confidence must be earned

Amundi ASSET MANAGEMENT

FOR PROFESSIONAL CLIENTS ONLY.
(1) Source IPE "Top 500 asset managers" published in June 2021 and based on AUM as of end December 2020. (2) Amundi figures as of June 30, 2021. In the UK, this promotion is issued by Amundi (UK) Limited, registered office: 77 Coleman Street, London, EC2R 5BJ, United Kingdom. Amundi (UK) Limited is authorised and regulated by the Financial Conduct Authority under number 114503. This document is not intended for any citizens or residents of the United States of America or any "U.S. Person" as defined by "Regulation S" of under the US Securities Act of 1933. The content of this advertisement is for information purposes only and does not constitute a recommendation to buy or sell. amundi.com. August 2021. | WALK

“ Firstly, an absolute return strategy should be able deliver positive performance in different market configurations, irrespective of the market direction. This implies that the investment team should not only have the tools but also the conviction to implement trades that can perform in different market environments. ”

Within Absolute Return Fixed income at Amundi, we strongly believe that true absolute return strategies should target three complementary objectives: positive performance in all market conditions, diversification relative to traditional asset classes and strong downside protection. It is with these three aims in mind that we have developed, and have managed the Absolute Return Global Opportunities (ARGO) strategies since inception in 2018.

Firstly, an absolute return strategy should be able to deliver positive performance in different market configurations, irrespective of the market direction. This implies that the investment team should not only have the tools (use of derivatives, leverage etc.) but also the conviction to implement trades that can perform in different market environments. For instance, over the past few years, the team has frequently implemented a negative corporate credit beta exposure in the ARGO strategy and this performed strongly in periods of market stress during the Covid crisis. This first characteristic also clearly illustrates the difference between absolute return and total return strategies, with the latter being long-biased and outperforming only when its underlying universe does.

The returns generated from an absolute return strategy should be achieved with a low correlation to traditional asset classes. Indeed, investors expect diversification from their absolute return investments and the benefit would be drastically lower if the correlation to equities or bonds was close to one. On this basis, the ARGO strategy has provided investors with a minimal correlation to most traditional asset classes (equities, treasuries or credit) since inception.

Finally, absolute return should not come with excessive downside risk, especially in fixed income where the upside potential is capped. When investors experience volatility across their portfolio’s holdings, absolute return must play its part and limit the drawdowns. This comes with having explicit downside risk tolerance and adequate downside risk (and recovery) mechanisms in place. In the midst of the Covid crisis, in March 2020, clearly defined risk tolerance and effective downside risk management protocols enabled Cosimo to protect the portfolio and consequently to sustain a far smaller drawdown than our peers and to bounce back very swiftly when the market recovered.

The ARGO strategy is constructed using three Investment pillars, each of which have distinct performance engines and risk profiles. They have been designed and are implemented to collectively deliver on the three aforementioned objectives: positive performance irrespective of market direction, high diversification to traditional asset classes and strong downside protection.

- The Alpha Opportunities pillar provides a diversified alpha exposure via a blend of different views, regional allocation, asset classes, trading styles, and time horizons. The pillar incorporates a number of absolute return strategies (relative value, arbitrage, systematic trading) across fixed income and currency markets, which deliver a steady alpha profile over time. This pillar is designed to outperform when markets trade to fundamentals.

- The Core Income pillar optimises the portfolio’s current income through a multi-sector allocation to global bond markets with a sustainability lens. The team leverages on Amundi’s in-depth ESG resources which includes 27 investment professionals responsible for ESG analysis, engagement and voting. This pillar is designed to outperform when yields and spreads are stable or tightening.

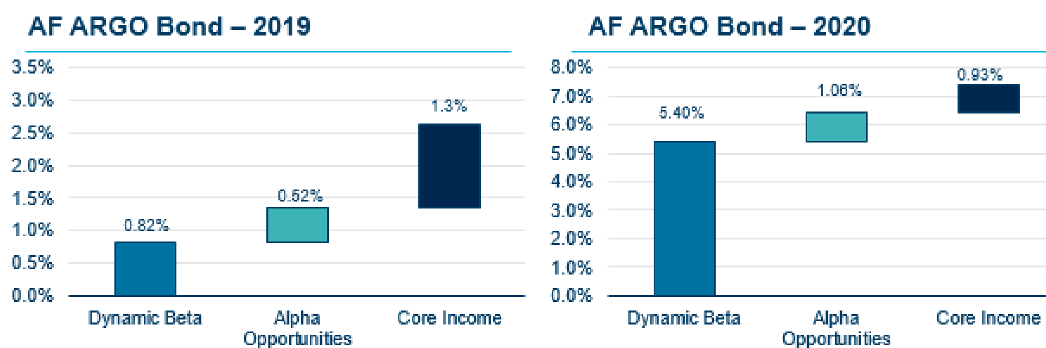
- The Dynamic Beta pillar steers the portfolio by setting the longer-term course while navigating potential obstacles that arise in the near-term. The team will implement long and short macro positions on key markets (duration, credit and USD) to take advantage of market moves. This pillar is designed to perform when markets are volatile and experience large up and/or down movements.

These three complementary pillars permit the strategy to efficiently navigate completely different market regimes (for instance 2019 and 2020 as illustrated in the charts) with low correlation to markets and low downside risk.

For instance, 2019 was characterised by very low volatility as well as tighter credit spreads, an optimal environment for the core income pillar. Conversely, 2020 was a volatile year with sharp market shocks, when Dynamic Beta was an outstanding contributor thanks to both long and short positions benefiting from large market moves.

Author:

Cosimo Marasciulo
Head of Absolute Return Fixed Income & Deputy Head of European Fixed Income.



We are convinced now more than ever that absolute return has an important role to play in investor portfolios. As long only strategies have been rising steadily since March 2020; the valuations of risk assets have now reached record highs, clearly shifting portfolio risk-return asymmetry to the downside and providing little room for manoeuvre.

Moreover, after record stimulus and a very high level of forward guidance from central banks, investor visibility is receding and volatility is clearly on the rise. Notably driven by the difficulty in anticipating the inflation path but also the slowing global economy. This means that central banks have low, if indeed any margin for error. Allocating to absolute return strategies, like ARGO, positioned to perform in such an environment with low correlation to markets and high downside protection can provide a clear benefit.

Amundi offers two fund vehicles within the ARGO strategy, managed pari passu but with different level of performance and volatility objectives:

- cash + 3-4% return and 3-4% volatility for AF ARGO bond
- cash + 6-8% performance and 6-8% volatility for AF ARGO Bond Dynamic

Please contact us for further details, or a marketing presentation of these funds.

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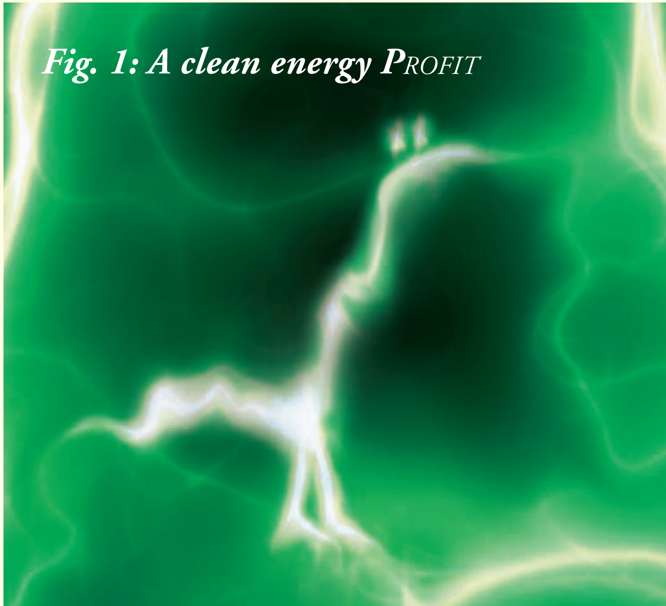

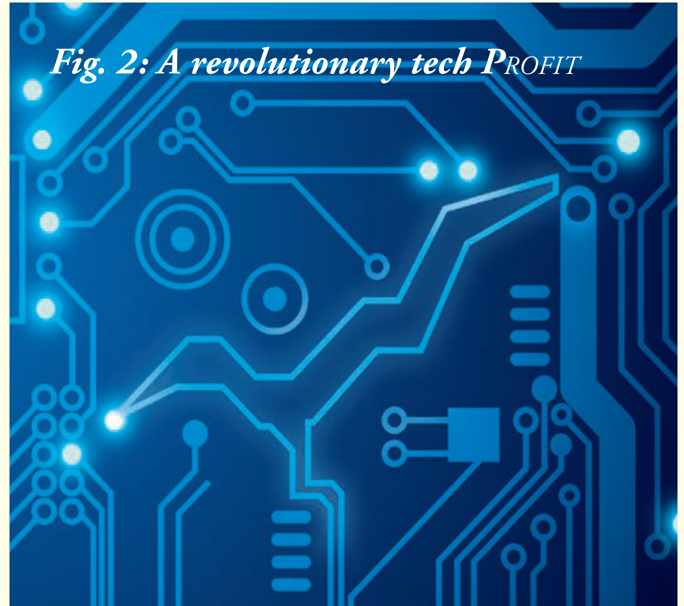

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ARTEMIS
The Profit Hunter

In the aftermath of the global financial crisis, a wave of 'absolute return' bond funds was unleashed. At the time, the need seemed obvious. After a 20-year bull market in bonds, and amid huge money printing, the orthodox wisdom was that the bond market was primed for a fall. In January 2010, bond market veteran Bill Gross warned that "UK gilts are resting on a bed of nitro-glycerine".

As it turned out, however, QE did not create inflation and the 20-year bull market in bonds turned into a 30-year bull market. The most famous bond manager of his era got it famously wrong: 10-year gilt yields fell from 3.9% at the time of his comment to 1.0% today[1] .

Ten years on, it is time to reflect on what absolute return bond funds have been doing – and delivering for the past decade. Are there any lessons we should learn? And might there be a better way of doing things? (To anticipate our conclusion, we think there is: although it shares some techniques and (rightly) sits within the IA Target Absolute Return sector our fund is explicitly a 'target return' fund).

The two problems with shorting bonds

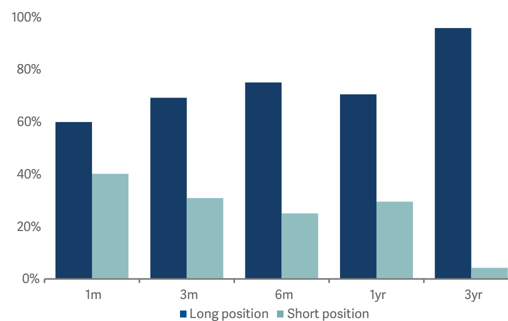
The bond market presents two major challenges to delivering absolute returns: bonds are expensive to short and they are less volatile than equities.

i) Bonds are expensive to short

> ***" It is an unbreakable law that returns can only come if we accept risk."***

The bond market is not a 50/50 bet. If you own a bond you receive income. Therefore it follows logically if you short a bond you will pay out income. That difference between earning income and paying out income skews the likelihood of making money by shorting bonds or other fixed-income securities.

Chart 1: Being short is expensive



Source: Bloomberg as at 8 September 2020. XoverCDS is an European High Yield Index. Data from September 2006 to September 2020.

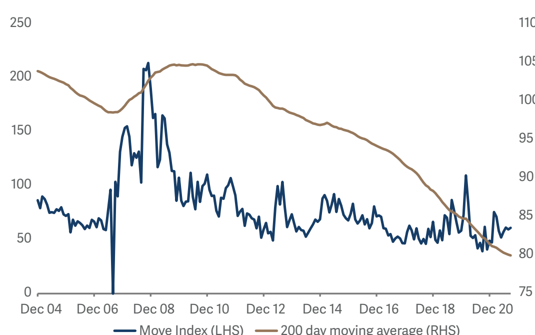
Moreover, the more time you spend being short of a fixed-income asset, the more income you must pay out - so the likelihood of profiting from a short position steadily deteriorates over time. The odds are stacked against you. Not only do you need to be right, but you need to be right fairly quickly.

ii) Bonds are less volatile than equities

The ability to make money from a classic pair-trade in the bond market is clearly a fraction of what can be achieved in the equity market.

Absolute return bond funds prosper best in volatile markets. The greater the volatility, the greater the dislocations in markets, and therefore the greater the opportunity to put on positions that will profit from the longer run normalisation of markets. Chart 2 plots the evolution of the Merrill Lynch Options Volatility Estimate (the MOVE index - a measure of uncertainty about interest rates) over time. It shows us that volatility was high when many absolute bond funds were being designed and launched in 2008-09. That volatility, however, did not persist; it has fallen. That has made it increasingly hard to generate returns.

Chart 2: Falling volatility in the bond market has made it increasingly difficult to for absolute return bond funds to generate returns



Source: Bloomberg. As at 6.10.2021

[1] Data as at 6 October 2021.

Author:

**Stephen Snowden,
Head of fixed income**

Lessons learned in the last decade

For these two reasons, absolute return bond funds have struggled to match the expectations of their investors over the past decade. Most have repeatedly failed to protect them in down markets. And where funds have protected their investors from drawdowns, it has generally come at the expense of generating long-term returns.

In the absence of a crystal ball, the only way to suppress market volatility is to run a lot of short positions to cancel out market movements. But as we have seen, running short positions in the bond market over the long term simply means repeatedly paying out lots of money…

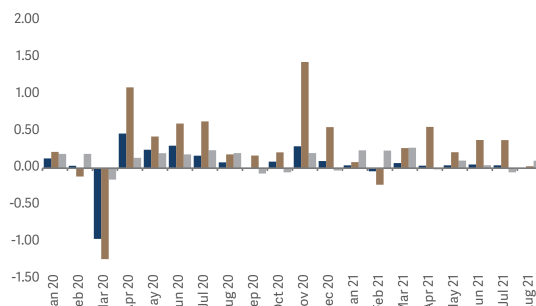
My co-manager Juan and I have 20 years' combined experience in managing absolute return bond funds – including a decade spent running a large absolute return fund together. We learned a lot of valuable lessons in that time. The most important one is this: attempting to deliver positive returns in all market conditions is a noble quest – but it is doomed to fail. It is an unbreakable law that returns can only come *if we accept risk.*

From 'absolute return' to 'target return'…

Many of the concepts and techniques used by managers of absolute return bond funds remain perfectly valid and fit for purpose. But we must accept the limitations of the asset class. Fund managers should be straight with investors as to what can be achieved within the fixed income market – and what can't. This is why our new fund is explicitly a 'target return' fund, which aims to deliver 2.5% per annum above the Bank of England's base rate, rather than an 'absolute return' fund. We wouldn't be able to meet that target if the income that is naturally generated by owning bonds goes immediately back out the door through persistent hedging.

We therefore take measured risks across three distinct modules:
•A carry module (the most defensive part of the fund, holding short-dated investment-grade bonds)
• A credit module (absolute and relative positions in the investment-grade, high-yield and emerging bond markets);
• A rates module (looking for opportunities – whether through curve trades, cross-market trades or inflation positions – in government bond markets).

Chart 3: Performance attribution by module



Source: Artemis. As at 31 August 2021.

We limit the proportion of the fund that can be invested in any one of these modules, and so limit the fund's exposure to particular forms of risk (such as interest-rate risk or credit risk). Yet we accept there will be some modest degree of volatility in the short term. Our experience over the past decade has shown that the short-term bumps will be naturally smoothed out in time. As the fund's returns since launch suggest, we think that is a trade-off well worth making – and that the move from 'absolute return' to 'target return' is

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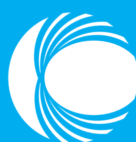
Business Development Manager, UK Asset Manager



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UNIGESTION

UNIGESTION ADAPTIVE 10
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Unigestion's Global Macro Strategy aims to deliver absolute returns by managing long and short exposure across and within asset classes, and offers the following benefits:

- A source of absolute and risk-adjusted returns
- Combines a set of three independent systematic and discretionary investment approaches
- Low correlation to markets and to traditional and alternative managers
- Liquid, transparent and cost-efficient access to global macro opportunities

Our background in multi asset investing dates back to 1993 and our Cross Asset Solutions team manages over USD 1.7bn in multi asset strategies anchored around the firm's macro risk-based philosophy.

For further information, please contact:

clients@unigestion.com or visit www.unigestion.com

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Unigestion Global Macro: A Unified Approach for Systematic and Discretionary Investing

UNIGESTION

“ In order to achieve our objective of delivering attractive absolute and risk-adjusted returns in any environment, it is critical to assess multiple market drivers and adapt our strategy accordingly.”

Global Macro and Its Role in a Broader Investor Portfolio

All investors construct their portfolios to achieve the goals that matter most to them, while contending with their constraints. These goals and constraints vary, but most investors are aiming to achieve a level of return while mitigating the risks they bear to meet the return objective. While risk is sometimes discussed as an abstract concept, it is concrete and failure to manage it could have severe consequences. The role of diversification and how best to achieve it are thus key questions for investors. Within a broader portfolio context, global macro strategies can offer some key benefits: a dynamic investment approach that has benefited in the past from significant market dislocations, typically a broad and liquid opportunity set across asset classes and economies, and a returns source exhibiting low correlation to traditional assets. However, a plethora of styles and approaches to global macro investing can lead to a significant dispersion in returns and high manager selection risk.

Our Approach: Unigestion Global Macro

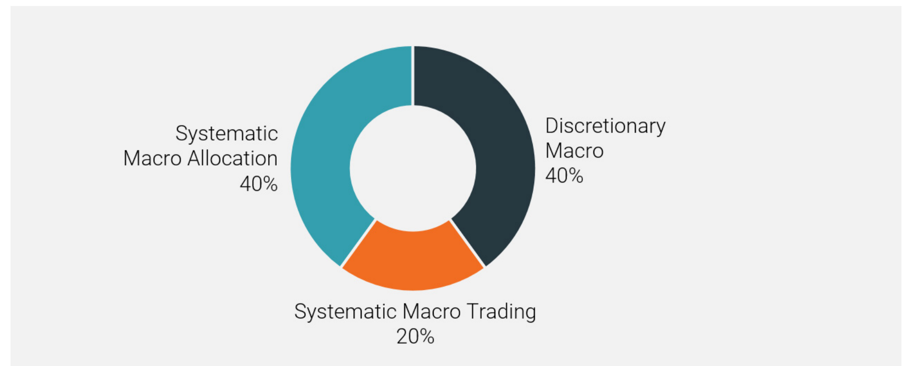
At the core of our investment approach is the belief that macro fundamentals are the ultimate drivers of financial returns over the medium- to long-term. At the same time, we know that other market drivers can dominate over the short-term and that ignoring them can destroy capital. Therefore, in order to achieve our objective of delivering attractive absolute and risk-adjusted returns in any environment, it is critical to assess multiple market drivers and adapt our strategy accordingly.
From our experience as macroeconomists, traders, and quants, we know that some drivers are best captured systematically, while others should be handled on a discretionary basis. From the beginning, our systematic and discretionary engines were viewed as peers with a common investment universe on which to form views that would then be translated to a portfolio using a common risk model.
This approach has a few key consequences that are noteworthy:

- The discretionary process is neither a validation of the systematic signals nor an override;
- As peers expected to generate diversifying returns, the systematic and discretionary engines must capture different drivers and generate independent signals;
- These signals may offset each other, leading to a low conviction view that will directly correspond to a small exposure, or they may reinforce each other, leading to a high conviction view and large exposure;
- A unified and harmonised framework is necessary to capture both systematic and discretionary signals and translate them into a portfolio.

Figure 1 shows the high level composition of the strategy, indicating the three sub-strategies and their long-term target risk budget:

- Systematic Macro Allocation (40%): a regime-based asset allocation approach that assesses the prevailing macro and market regime and takes long/short views on global assets;
- Discretionary Macro Allocation (40%): a team of experienced portfolio managers that have flexibility to express their views across and within assets;
- Systematic Macro Trading (20%): a suite of rules-based quantitative signals, using both fundamental and technical analysis, on individual financial securities.

Figure 1: Target Risk Allocation of Unigestion Global Macro by Component



Source: Unigestion.

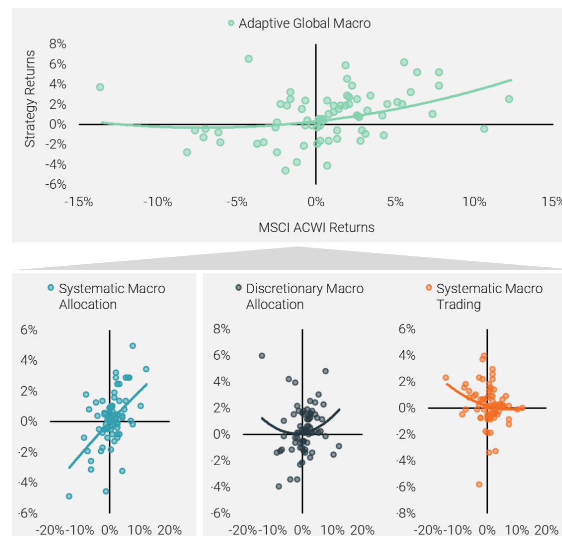
Author:

Salman Baig
Portfolio Manager,
Cross Asset
Solutions

Each of these three books represents an approach to global macro investing, with its own information sets, decision frameworks, and return profiles. Many investors are already aware of the benefit of combining these strategies in their portfolio. However, by constructing and managing these strategies ourselves, we are able to reap netting benefits with lower fees for investors as well as profit from the complementary nature of the books.

Figure 2 compares the monthly returns of the Global Macro strategy to global equities, illustrating its strong upside and limited downside participation. It also shows the complementary return profiles of the sub-strategies: Systematic Macro Allocation is the reliable but linear return engine, Discretionary Macro Allocation provides good convexity on both upside and downside but is less reliable as humans can err, and Systematic Macro Allocation provides reliable downside convexity without degrading returns on the upside. This behaviour underscores the rationale for combining the books as we do.

Figure 2: Strategy Returns Against Global Equity Returns with Quadratic Fit



Source: Unigestion, Bloomberg.

Expectations for Unigestion Global Macro in Changing Environments

A successful global macro strategy should be resilient to many environments, adjusting its exposures dynamically to profit from opportunities and avoid risks. The Global Macro strategy is designed to navigate and adapt to any macro environment, but three different scenarios that are especially relevant today:

- a central scenario of solid growth with strong but contained inflation pressures;
- a tail scenario of stagflation with tepid growth and surging inflation;
- a correlation shock with higher bond yields and lower equity markets.

While the strategy is expected to perform reasonably well under all three scenarios, even if none of them transpire, we believe it will adjust to the emergent environment in due time and deliver on its objectives.

Meet the Team!

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Managing Director

Natasha Silva

Managing Director,
Client Relations

Amy Richardson

Senior Director,
Business Development

Sam Buttress

Associate, Business Development

Mithursha Kesavan

Database and Publication Support
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