

Real-Return Investing in a Volatile World

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Executive Summary

Amid expectations for continued challenging market conditions marked by heightened volatility and uncertainty, Newton's Iain Stewart argues that real return investment approaches might be more appropriate for today's environment than traditional benchmark-oriented strategies. By taking a more flexible, unconstrained and active approach, real return strategies, he says, have the potential to identify attractive opportunities across a wide array of asset classes in order to seek positive returns even as market conditions change.

Since the turn of the century, and especially since the global financial crisis of 2007-2009, financial markets have been volatile. Market sentiment has oscillated amid changing perceptions about both the economic outlook and the policy responses of leading central banks and governments. At the same time, there has been significant disillusionment among investors about the ability of the average investment manager to achieve consistent outperformance against a benchmark.

Patterns of asset-market returns since the bursting of the technology, media and telecommunications ("TMT") bubble in 2001 have been highly variable. Equity investors have experienced significant changes of fortune and, over the last three years, wider capital markets have displayed some seemingly contradictory trends. Yields on higher-quality government bonds have matched their Great Depression era lows, but the price of gold has reached an all-time high. For relative-return investors, being tied to an index-based performance benchmark may have felt akin to riding a rollercoaster.

But even if cumulative returns have been sufficient to meet their investment objectives, those returns are likely to have been accompanied by pronounced volatility. In this article, we explore the case for a real return approach to investing. Such an approach emphasizes the pursuit of an attractive, positive return from an investor's assets, linked to some measure of inflation or cash, which we believe provides a better representation of an investor's liabilities and investment objectives than an index-based benchmark.

¹ See disclosure on page 7.

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We believe real-return investing is likely to be particularly pertinent in the volatile and uncertain environment expected to face investors in the coming years, one likely to be characterized by lower returns, higher volatility and more potential divergence in performance between and within different asset classes. We examine the value of real-return investment approaches, and look at the characteristics that are likely to be desirable in such approaches in the period ahead.

The growing popularity of real-return-oriented investment strategies over the last decade is sometimes seen as having heralded a new model in asset management, when set against the long-standing preference among investors and intermediaries for benchmark-relative approaches. It is certainly true that great uncertainty about the economic and financial-market outlook, coupled with disillusionment with benchmark-relative returns, has fuelled interest in real-return strategies. However, the key attribute of real-return investing is one to which we believe investment managers should always aspire: the delivery of a positive inflation-adjusted total return over an appropriate timeframe. By contrast, a strong relative return is inadequate if it equates to a “shortfall” in absolute return when an investor’s liabilities must be met. As the adage goes, “one cannot eat relative performance.”

The vogue for relative-return investing essentially grew out of the bull market conditions throughout the 1980s and 1990s, when negative returns were few and far between. That period was in many ways a golden era for investors, with little demand for real-return solutions. Equity markets displayed bouts of heightened volatility, but the period was characterized broadly by declining interest rates and inflation, a succession of relatively benign economic cycles, and rising asset prices. Against that backdrop, U.S. equities returned an astonishing +18.1% on an annualized basis over the 20 years to the end of the last century, and world equities returned an annualized +15.9% over the same period.¹ In other words, real returns from a relative-return approach were likely to have been spectacular.

We believe an emphasis on relative returns is sound if one believes that the major risk to investors is being out of the market against which they assess their returns. With equity markets rising strongly during the 1980s and 1990s, that risk was indeed considerable. Measuring returns by reference to a peer-group or index-based benchmark is a straightforward means of assessing who, within a universe of investment managers, is performing well. It is understandable that in periods of falling markets, investors prefer to have entrusted their assets to a manager who loses them less, particularly if in the long run markets deliver strong real returns.

² Thomson Reuters Datastream.

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Expectations of substantial investment returns were fuelled in the last two decades of the 20th century not simply by investors' experiences of equity markets, but also by the plentiful availability of cheap credit in the global financial system. As a result, returns of, say, 4% above cash, or 5% above the rate of inflation, which might be challenging for a long-term investor to achieve, were seen as mediocre. Considerable leverage in the financial system led investors to expect returns that were unrealistic in our view over the longer term. Returns on leveraged investments are clearly highly favorable when asset prices are rising but, when asset prices fall, or sources of credit dry up, returns are naturally less favorable and the risks of leveraged investing become apparent.

Seeking a durable way to generate long-term real returns

We think disillusionment among investors and intermediaries about the average investment manager's ability to generate above-benchmark returns on a consistent basis has fuelled the search for more reliable approaches that seek to achieve real returns while avoiding devastating drawdowns.

Hedge funds, for example, have been seen by some investors as offering the Holy Grail of consistent, positive returns with low volatility. Hedge funds traditionally borrowed in order to multiply the effects of their managers' judgments, and to produce returns that appeared to be unrelated to movements within asset markets generally. This apparent lack of correlation, together with the allure of enhanced returns, convinced increasing numbers of investors to pay previously unprecedented fee levels to gain access to this new "alternative" asset class. Predictably, the asset management industry sought to take advantage of the increasing appeal of hedge funds, and launched them in droves. However, during the global credit crisis that started in 2007, investors became all too aware of the downside risks of leveraged investing. Many hedge funds failed to achieve that attractive combination of steady returns and low volatility.

Passive approaches, which generally have lower fees than their active counterparts, are popular in bull markets, given the strong returns that derive merely from tracking rising indices. However, passive investments expose investors to "market risk"; when asset prices fall, an index-tracking investment strategy entrenches negative returns. In short, passive funds, by definition, fail to address the risks inherent in the index they track.

In short, because the world is constantly changing, we believe there can be no universal blueprint or mathematical solution for achieving superior absolute investment returns.

Some investors have sought to overcome their disillusionment with what they regard as inadequate investment returns by pursuing **quantitative approaches**. On an individual basis, quantitative investment strategies may be successful. However, in aggregate (and therefore for the average investor), we believe their reliance on historic financial-market relationships can render them suddenly vulnerable to changes in the investment environment. The failure of several model-based quantitative approaches in the midst of the global financial crisis in the summer of 2007 provided a salient lesson in the limitations of backward-looking mathematics as a means to exploit forward-looking asset markets.

Diversified approaches to investing, for example, those adopted by the endowment funds of universities such as Yale and Harvard, achieved strong returns for many years, and received significant acclaim for doing so. Those funds encouraged a raft of similar funds, their shared notion being that investors could achieve a low-risk stream of “equity-like” returns by diversifying their investments across a range of traditional and “alternative” assets.

We believe that diversification does, of course, have its advantages over the longer term. However, the events associated with the global credit crisis provided a stark reminder that one of the few things that do rise in a bear market are correlations. In 2007 and 2008, most asset prices fell and, as a result, diversification did not produce the benefits anticipated by backward-looking models.

In short, because the world is constantly changing, we believe there can be no universal blueprint or mathematical solution for achieving superior absolute investment returns. In our view, models that depend on the past as a guide to the future rely upon the maintenance of the status quo for their success. When conditions change, as invariably they do, models tend to break down, to investors’ obvious cost.

Ideally, as with other strategies, we believe a real-return approach should encompass strong ideas about the way in which the world is changing, and be supported by a process that translates those ideas into consistent and attractive investment returns.

The likely attributes of successful real-return investing

There is a substantial range of real-return-oriented strategies from which investors may choose, including tactical asset allocation, diversified growth, absolute bond, and “equity market neutral” approaches. An investor may favor one such strategy in particular, or a combination.

Ideally, as with other strategies, we believe a real-return approach should encompass strong ideas about the way in which the world is changing, and be supported by a process that translates those ideas into consistent and attractive investment returns. In our opinion, such returns are more likely to be produced by managers who are able to harness the characteristics of a wide range of assets, rather than by those who are restricted to a single asset class approach. Equities have attractive growth characteristics, but their returns tend to be volatile. By contrast, we believe that investing across the capital structure of businesses provides the potential for investors to spread risk and dampen volatility.

In the more volatile asset-market conditions that have existed over recent years, and which we anticipate will persist in the period ahead, we believe there is likely to be no substitute for an active, flexible investment approach in which an investment manager evaluates opportunities within and between asset classes. From our perspective, such an approach should be founded on a commitment to produce positive returns in whichever environment prevails at the time, which distinguishes it from more passive or pre-ordained forms of diversification.

In essence, we believe the key purpose of real-return-oriented strategies is to provide a solution for “all seasons.” In our opinion, the discipline of a positive return target demands a more balanced appraisal of the implications of making and losing money than we would expect to be evident in the approach of a relative-return-oriented investment manager. We would suggest that the former is more likely to match most investors’ tolerance of risk than the latter.

We believe real-return strategies may play a key role in helping to meet investment objectives, especially given consensus views about the persistence of challenging market conditions marked by lower returns, higher volatility and more potential divergence between asset market returns.

Where real-return strategies add genuine value in meeting a client's investment objectives, we believe they are likely to provide an attractive alternative to the use of hedge funds, and particularly to the use of funds of hedge funds. Compared with hedge funds, such strategies are generally simpler and more transparent, and they entail lower costs. Their objective of generating consistently attractive returns in a risk-controlled manner renders them highly suitable as investments for many endowments and foundations, as well as for defined contribution and defined benefit pension plans. Where trustees or their advisors wish to retain control over asset allocation, rather than relinquish it to an investment manager, flexible real-return strategies have the potential to provide a useful "swing" asset class, sitting between riskier strategies, such as global equities, and an investor's liability-matching assets.

Conclusion

We believe real-return strategies may play a key role in helping to meet investment objectives, especially given consensus views about the persistence of challenging market conditions marked by lower returns, higher volatility and more potential divergence between asset market returns. As mentioned, investors have a range of strategy choices for targeting attractive real returns. Whichever approach investors choose, we believe it is vital that they gain a thorough understanding of both the investment culture that underpins an investment manager's particular offering as well as the process it follows to ensure that its best ideas are implemented smoothly and consistently.

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