defaqto

Modern Approaches to Absolute Return and the Value of Real Assets

August 2024

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Investments

Contents

Investors and financial advisers have often used the tried and tested guidepost of a 60:40 equity-to-bond asset allocation to build a low-risk portfolio, the split allowing for steady growth while also aiming to reduce volatility.

However, the approach, which has worked and stood the test of time, suffered a seismic downturn in 2022 as both equities and bonds fell in tandem, dispelling the myth that they are negatively correlated. From a global market perspective, since the Global Financial Crisis in 2008, through to COVID-19 in 2022, the more recent war in Ukraine and global tensions in the Middle East, investing has been a conundrum. Global markets were supplied with an unlimited amount of economic stimulus, all of which eventually led to a recent period of considerably higher inflation and increased interest rates.

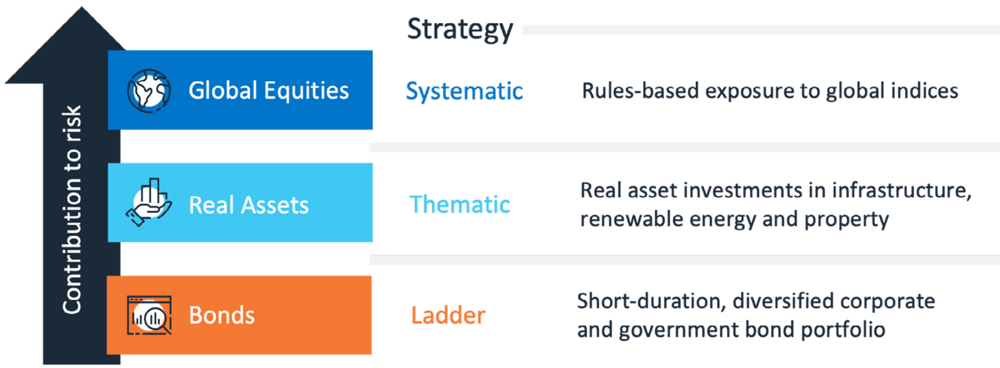
And while for the younger generations the recent period of sustained inflationary pressures and higher interest rates has led to a cost-of-living crisis, those of an older generation would argue that we have simply reverted back to the longer-term average seen prior to all of the events over the past 16 years!

The easiest way to understand what is meant by the negative correlation between equities and bonds, is to appreciate the way in which they respectively move given varying economic market conditions. When economies are growing, equity markets generally rise and so will underlying inflation which makes the fixed coupon of bonds less attractive. Whereas, when economies are declining, money is generally pulled from equity markets, seeking the safer and less volatile haven of bonds.

As we move through 2024, there may be further volatility ahead. As the transition from a higher interest rate and higher inflation environment plays out, for investors, it may mean seeking alternative investment strategies which provide less volatility, greater potential for capital growth and a rewarding income yield. More than simply equities and bonds, the inclusion of real assets through a well-diversified multi-asset strategy with strategic asset allocation will likely be rewarded in the long term. Additional diversification into low-risk assets such as money market funds, bonds, real estate investment trusts, exchange traded funds and real assets can be used to reduce volatility risk.

Low-risk investors will benefit from a well-balanced multi-asset solution. Multi-strategy investments employ various strategies to gain exposure to not only the traditional asset classes but also to alternatives as well. They may also aim towards an absolute return, which is defined by the Investment Association (IA) as being a fund with the aim of delivering positive returns in any market conditions. Returns are not guaranteed, however, and can be over a rolling period but generally no longer than three years. Absolute return funds tend to carry large amounts of cash as opposed to equity positions, but due to the climate of low interest rates, cash holdings made no returns and may have led to negative contributions as inflationary increases would have eroded their value. With interest rates currently being positive and the control of inflationary pressures in the UK, it has created a favourable environment for absolute return funds holding cash.

There are benefits afforded to this approach as the strategy is similar to hedge funds. Hedge funds are only accessible to sophisticated and accredited investors, but a multi-strategy approach can employ the same tactics and be offered to retail investors. An experienced manager can utilise their skills to include the use of derivatives, futures, options, leveraging, short selling, arbitrage and unconventional assets in a bid to build an approach which can benefit the investor in the long term.



As at April 2024, Sanlam, asset types and strategies for the Multi-Strategy Fund

One of the strategies used by multi-strategy funds is the long-short, whereby positions are bought and sold to profit from both rises and falls in market price. This method is designed to strike a balance between gaining profit and the amount of risk taken. An upside to this approach is the ability to deliver a positive return during falling markets and the flexibility to control the risk to reflect prevailing market conditions. A drawback to this strategy is that during periods of sharp rises in the stock market over a sustained period, the fund wouldn't be able to deliver the same high returns. There has also been an increased interest in holding real assets, especially those that are operational and already producing returns.

Real Assets

Real assets have had a surge in popularity in private markets against the backdrop of volatile listed equity markets, geopolitical risks and economic uncertainty, with the trend set to continue. So why is it they are a compelling alternative investment opportunity? The best way to view them is as tangible assets that have a value to society and are the bedrock of well-functioning economies. They include; infrastructure, property, renewable energy, healthcare, connectivity and commodities including oil and gas, all of which have extremely high barriers to entry and/or strong contractual inflation-linked revenue streams. The majority of these assets generally behave in a different way from the more volatile elements of the equity markets, thereby providing investors with a smoother investment journey. They also generally include a dividend stream with built-in increases, thereby keeping pace with inflation. The following heatmap shows the correlation between different asset classes and infrastructure.

Correlation Matrix

Time Period: 01/04/2019 to 31/03/2024

	1	2	3	4
1 IA Global Mixed Bond	1.00			
2 IA Global	0.63	1.00		
3 EAA Fund GBP Money Market	0.19	0.09	1.00	
4 IA Infrastructure	0.64	0.81	-0.09	1.00

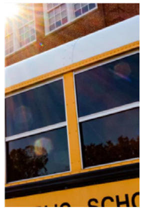
1.00 to 0.80 | 0.80 to 0.60 | 0.60 to 0.40
0.00 to -0.20 | -0.20 to -0.40 | -0.40 to -0.60

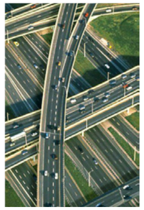
As at 31 March 2024, Morningstar

With the population growing globally and expected to increase by two billion over the next 30 years, governments around the world have introduced policies to address the concerns over the requirement for robust infrastructure. These policies will create opportunities to develop new residential and commercial properties, schools, hospitals and roads. Investment in infrastructure can be viewed as a stable source of revenue once operational and can also align with ESG goals alongside other real assets.

An example of this is the sharp increase in the participation rate of younger students looking to attend university after school. As the job market has placed an emphasis on university degrees, the increased number of students has been met with an under-supply of student accommodation. This has created a new opportunity to provide purpose-built student accommodation across many regions.

Sanlam's investments are focused on the theme of "pillars of a functioning economy" (detailed in the images below) which are sustainable in the long term, contribute towards a successful economy, and benefit from changing demographic trends.


Schools


Roads


Water


Housing


Healthcare


Connectivity

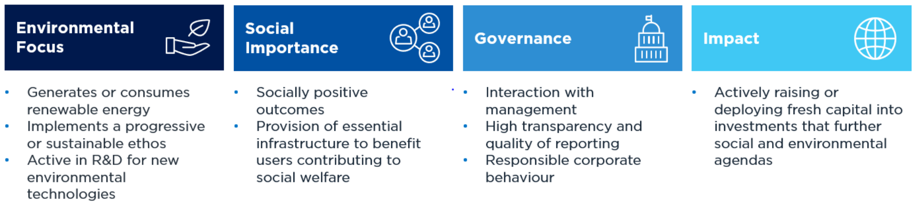

Renewable energy

Infrastructure investments are long term and can span the full lifecycle from the development and construction stages through to being operational and revenue producing. From inception to building, they are a high-cost investment as they require substantial capital to get them off the ground. They can take numerous years to build, but once completed they produce stable forecasted returns which can be used to smooth returns in fluctuating markets.

As they are high-cost investments at the outset, and the application process can be difficult, it creates a natural barrier for competition. Those that have investments within infrastructure tend not to have to worry about others coming into the market and impacting the longevity of returns.

Another area of interest is renewable energy. Due to the growing energy demand year on year, it has been estimated that by 2050 the energy usage globally will be 50% greater than it is today but, at the same time, scientists are alerting us to the toll it is taking on the planet. An example of this increased energy demand is in the emergence and development of Artificial Intelligence (AI). It is estimated power consumption for data centres that run AI will take an ever-larger share of energy usage. For example, the United States is showing a near tripling in their consumption forecast over the next few years from 3% to 8%. In a bid to reduce or slow down the impact of rising temperature levels and greenhouse gas emissions, there have been directives set up globally on a united front paving the way for investments into the renewables sector to help combat the issue. For example, the new Labour government have pledged to fully decarbonise the UK's electricity system by 2030.

Sanlam has long been an active investor in real assets and has developed a process that integrates ESG factors into its investments. The pillars Sanlam has set align to the United Nations' Sustainable Development Goals and there is a focus on assets that have a long operational life and provide revenue which is inflation linked.

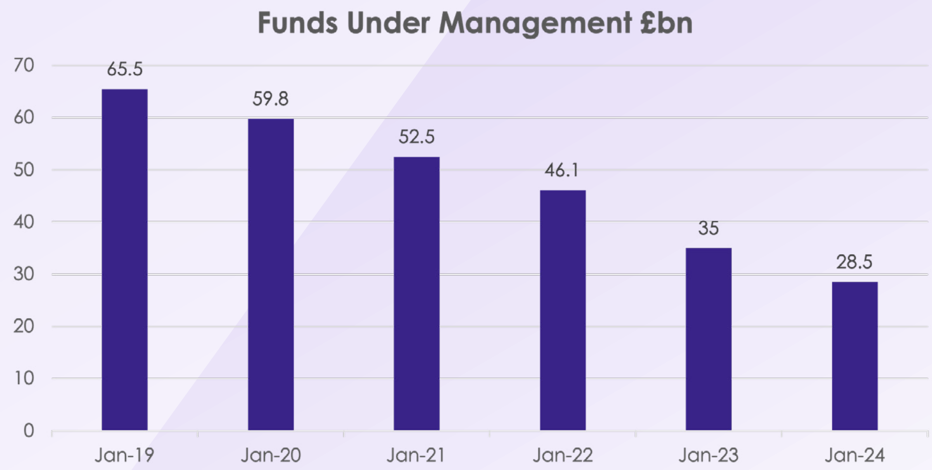


As at June 2024, Sanlam, ESG considerations

Absolute Return

The absolute return sector has significantly changed over the last few years with news of high-profile closures and mergers such as the Standard Life Global Absolute Return Strategies fund (GARS), which was the default fund in the sector, and further closures from M&G, Artemis, Jupiter and Invesco within the last year. The reasons behind the change have been put down to a lack of interest from investors as well as the funds failing to achieve their objectives due to not being able to keep their heads above water in the recent changing markets, which then led to a haemorrhaging of money.

Targeted absolute return assets have more than halved from their high in 2019 when they stood at £65.5bn in February 2019, as opposed to £28.5bn in February 2024, as shown in the graph. However, this decline must be viewed in the context of the downfall of the GARS fund until its closure towards the end of 2023, as its assets at their peak were £26.8bn.



As at 28 February 2024, Investment Association

It can be problematic if a fund is too big and has many assets. This applies not just to specific sectors but across all funds. A manager needs to take a larger stake in a company to build a meaningful position, but this can lead to future liquidity issues. To reduce exposure, it would mean selling large amounts of holdings, which can in turn push down the price and stifle the fund's performance. This has been illustrated, in part, by the troubles of the LF Woodford Equity Income Fund.

When measuring the performance of an absolute return fund it should be noted that they are independent of any benchmark. Instead, returns are measured against the cash deposit where only gains and losses are considered. Many of the funds in the sector aim to generate returns better than cash and seek to outperform an index such as UK Consumer Price Index (CPI) and cash deposit rates. Benchmarks such as the UK CPI, SONIA and the UK Base Rate can be used to measure the performance of the fund and check that returns meet the fund's objectives.

As with any investment it is important to note that there are benefits and drawbacks to the sector's strategy. On the one hand, absolute return funds are less likely to be affected by poor general market performance and can hold up better than other investments. On the other, in growing markets, the investment can underperform and not deliver as high a return as other funds. Absolute return funds also incur higher charges due to management costs, which can impact the net return to investors.

Absolute return funds can be listed under a few areas:

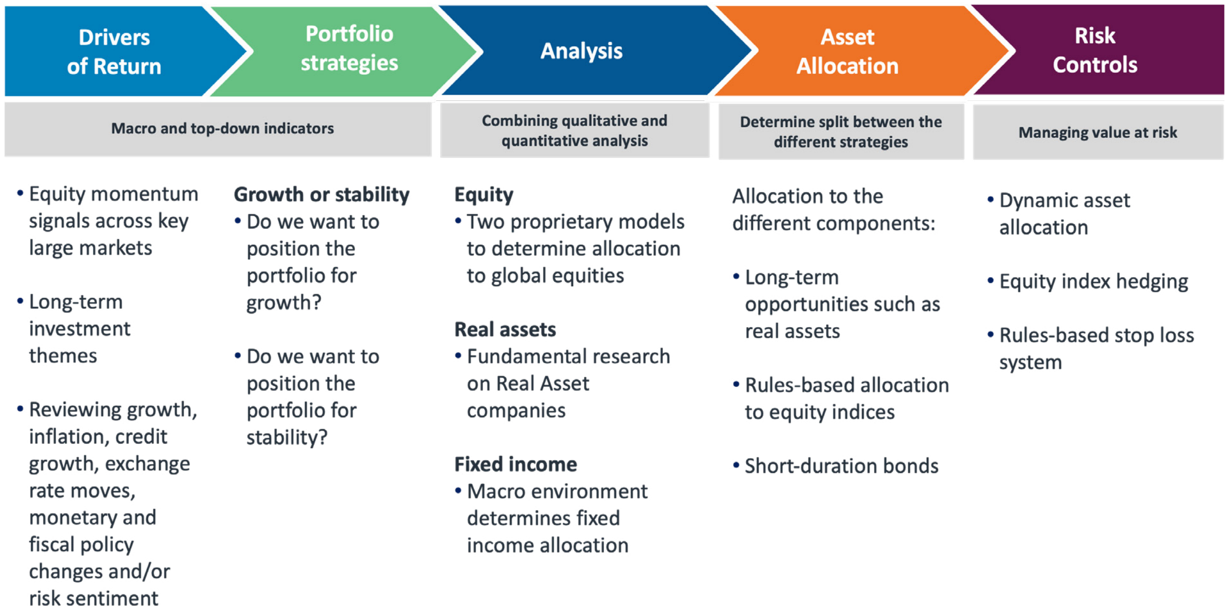
- Bond
- Multi-Strategy
- Alternative
- Equity
- Money Market

The sector has attracted attention in the past, especially in times of turmoil, as past performance has shown that they hold up well, however, past performance is not a reliable indicator for future performance.

Volatility measures the extent to which asset prices fall and rise over time and this can be daunting for some investors depending on their financial situation. There are those that may rely on income produced by investments and need consistent returns, others may need to draw from their investment pots in the near future. Instances where investors need liquidity at short notice may also be an area of concern. Therefore, having a fund that attempts to target absolute return and deliver smoothed returns for investors should form part of their consideration if they are identified as low-risk clients.

The potential trade-off of this approach is the fact that targeting lower volatility will come at the expense of investment returns that are dependent on market conditions. Even though a multi-asset and multi-strategy fund will rebalance holdings in the short term to account for any market fluctuations, if they are low risk then low returns should be expected. This approach will be better suited to investors who are willing to sacrifice any potential upside from a single asset fund to gain a limited downside of losses and are looking to preserve their capital.

Absolute return funds offer more scope to take extreme asset allocation positions compared to regular multi-asset funds which need to operate within sector limits and can't employ as many diverse strategies. The investment strategy of a fund needs to be taken into consideration when assessing the suitability of a fund. The diagram below shows Sanlam's investment process for the Multi-Strategy Fund.



As at June 2024, Sanlam, Investment process

Absolute Return vs Relative Return

While absolute return aims for a positive return in all market conditions and outperforming some measure of inflation, relative return is different. It aims to outperform a composite index based on stock market indices or a peer group over a specific period of time.

	Absolute Return Fund	Relative Return Fund
Aims	Deliver positive return in all market conditions	Outperform a benchmark
Market rising	Deliver positive return	Outperform the market
Market falling	Deliver positive or neutral return but can on occasion deliver a negative return	Outperform the market but can mean delivering a negative return
Market volatility	Low volatility over long term	Correlated with market volatility

Relative return funds tend to be market directional and have recently benefited from the recovery in the equity and bond markets, while absolute return funds have taken a neutral position. However, the performance of relative return funds cannot be taken in isolation from the last couple of years during a rising market because, historically, volatility has meant the market has experienced similar downturns where absolute return funds have fared better and provided investors with smoothed returns.

Income

Investment values fall and rise over short periods of time as a result of market volatility, which can lead to investors making emotionally charged decisions. Investors buy when markets are high and sell when they are low. Investments which deliver an income may alleviate the pressure exerted on investors if they receive regular income payments and so may soften the emotions felt in volatile market conditions.

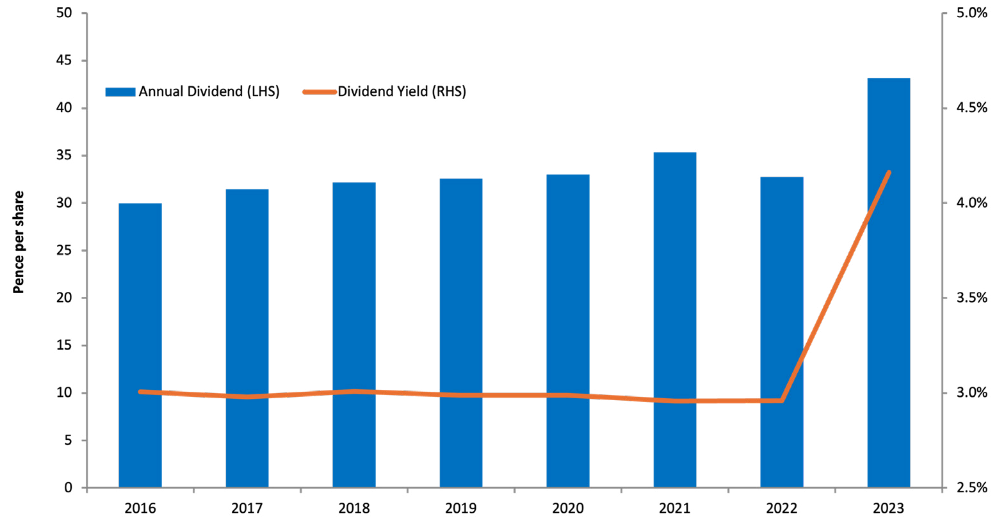
Investment income refers to the income return generated from investing capital in various financial instruments such as bonds, stocks, infrastructure and mutual funds. Investments which have been configured to generate a consistent stream of income can receive returns as interest payments from bonds and interest-bearing accounts, stock dividends and income from infrastructure such as rental properties, and usage and tariff fees. If an investment is sold for more than its purchase price, a capital gain will arise, which is a taxable event.

One of the primary benefits of investment income is its potential to grow wealth over time. Investment income can supplement an investor's monthly/annual income through earnings from assets owned, or it can be reinvested to take advantage of compounding returns over the long term. This can act as a hedge against inflation as historically returns from a diversified portfolio have helped to preserve the purchasing power of capital invested over time. Within a diversified portfolio, investment income can provide a low risk means of ensuring a constant cash flow. These types of funds are especially popular among retirement age investors who are looking to live off predictable monthly income generated from their portfolios. It is also of benefit to investors who may require income to supplement their daily spending needs.

Fund managers who offer income typically choose to invest in debt instruments. This allows for the investment to be secure, although return rates may be lower than other asset classes. Income funds tend to outperform bank deposits as well as offering high liquidity. The graph shows the current yield produced by indices which are based on stocks, bonds and infrastructure.

As at 31 July – 20 August 2024. Sources, MSCI, Financial Times, FTSE Russell

Sanlam Multi-Strategy Fund Pre Tax Income



As at 28 March 2024, Sanlam, Sanlam Multi-Strategy Fund

Offshore funds such as the Sanlam Multi-Strategy Fund can apply to become UK reporting funds. Due to the funds being offshore, investors must declare income from these funds on their tax return each year under Excess Reportable Income on the value that an offshore fund earns past the point of income they distribute as dividends or interest. There is no need to declare the returns if invested through an ISA or SIPP.

A list of the offshore funds that have successfully applied to the HMRC for reporting can be found at www.gov.uk/government/publications/offshore-funds-list-of-reporting-funds.

Cash Returns

Cash investments are usually short term and aim to provide interest payments as a return. They are suitable for low-risk and risk-adverse investors who are looking for a safe investment and to preserve their capital. The benefit of cash-type investments is that they provide great portfolio stability and have high liquidity. Cash investments can be accessed through a money market fund, high-yield savings accounts, short-term bonds and through investment vehicles such as cash management platforms.

Cash invested in foreign currency such as the dollar, yen and euro are reliant on the economic factors and government policies of the country and region in which they exist. As cash is largely risk free, it can't partake in upsides like other investments when it comes to risk premiums. This also means that inflation may erode the future purchasing power of the capital invested. Cash should therefore form part of a diversified portfolio to decrease risk exposure rather than being taken as a single asset holding option, as it can provide low-risk investors with ready accessibility to their money. The challenge and dilemma that investors are always eventually faced with, is as interest rates start to fall and to ensure those savings have the potential to grow, they may need to start considering lower risk investments outside of the safety net of cash.

Consumer Duty

The Financial Conduct Authority's (FCA) Consumer Duty came into force at the end of July 2023 following a mandate from parliament which established standards for businesses to improve product oversight and governance. It also requires them to act to deliver good outcomes for customers. The Consumer Duty sets out four areas so business approaches can be better understood and provide higher and clearer standards of consumer protection. The four areas are:

- Products and service
- Price and value
- Consumer understanding
- Consumer support

For the investor, these changes will allow them to make an informed decision about the suitability of an investment while also receiving fair value. It is important to note that Consumer Duty only applies to retail and high net worth clients and not to professional clients. The Consumer Duty aims to support investors in the pursuit of their financial objectives by offering robust protection.

Consumer Duty promotes competition between businesses based on the merit of the services provided, as firms will compete to innovate and to retain and attract new clients.

It will make it easier for investors to cancel or switch products to more suitable investments if recommended to them by their financial adviser. It is a welcome benefit, as should an investment no longer meet an investor's needs or objectives are not being met as specified, switching will be easy. Customer support improvements will also help if an investor is in a vulnerable situation perhaps due to poor health or if suffering financial troubles.

defaqto engage

Currently in use by over 8,000 UK financial advisers, Defaqto's Engage tool offers advisers an end to end solution for all their clients' evolving needs. Supported by strong provider relationships and expert in-house research and analysis, it provides advisers with the ability to take clients through the whole customer journey and help make smarter financial decisions. It offers tools for risk scoring and suitability reports all the way to shortlisting suitable funds, products and platforms for investors. There is also the ability to view pension and fund switching, return on yield estimated calculations and oversee client reviews.

As of May 2024, Engage held data for 89 funds under the IA's Targeted Absolute Return Sector. Using the below filters as an example of screening can create a short list of funds which are multi-asset and potentially suitable for low-risk investors.

Approach	Currency	Fund Size	Defaqto Risk Level	Sector	Asset Management	Performance Quartile
RDR Compliant	GBP	>£50m	2 to 4	IA TAR	Multi Asset	5yr in top 2 quartiles

The example filtering reduces the number of funds to five that fit the criteria selected. In alphabetical order these are:

1. BNY Mellon – Newton Real Return
2. CT Dynamic Real Return
3. Sanlam Multi Strategy
4. SVS Brooks Macdonald Defensive Capital
5. TM Diversified Core Absolute Return

Conclusion

Investing undeniably involves risk which includes the possible loss of capital. Depending on the individual, their financial circumstances, and factors such as their age and retirement status, portfolios can reside from low risk to high risk depending on where the client is in their investment cycle. Low-risk investors have often used bonds to offset any market fluctuation caused by equities, adjusting their holdings when it may have been needed. As there was a convergence of the two asset classes (equities and bonds both fell) in 2022, and both are now performing well for the time being, a different way to offset risk needs to be considered. Multi-asset funds which employ a multi-strategy methodology is one for consideration within a portfolio. The risk-to-reward ratio for a low-risk fund may be of benefit to an investor who sits within that risk profile. They may not be able to exclusively partake in the upside of a growing market, but it provides the benefit of smoothed returns over the long run and in times of downward trends. The objective of capital growth alongside producing regular income will be one that is well received by investors.

The funds produce a means to further diversify assets which are negatively correlated and may also afford the opportunity to invest in real assets. Real assets over a long-term investment horizon can generate predictable income streams which may be suitable for investors who require liquidity in the short term or allow for them to grow their investment for retirement without taking on additional unneeded risk. Funds and strategies need to be carefully analysed to determine which approach best suits the investor's needs.

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