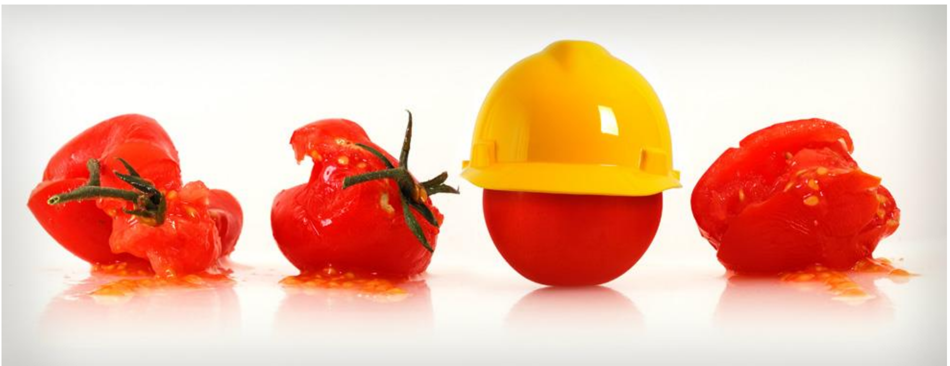
Absolute Return Partners

The Absolute Return Letter



September 2016
Increase Returns at No Added Risk

"Greed is good. Greed is right. Greed works. Greed cuts through, clarifies, and captures the essence of the evolutionary spirit."

Gordon Gekko

Following 17 months of mostly negative equity returns in Europe, very recently, I have noticed an inclination amongst European investors to increase the risk profile in their portfolios. They may not exactly be going for broke (yet), but the willingness to take more risk is clearly on the rise. The rising appetite for risk could be driven by one of two factors. Investors could *either* be turning more optimistic, *or* it could be the result of less benign factors, such as *a need* to generate higher returns, whether they really believe in such an outcome or not.

In short, I suspect investors are chasing returns that (I think) are unrealistic, and it is not the first time that happens. When investors are under extreme pressure, as I think many are now, they sometimes behave quite irrationally. They do things they would have sworn only a short while earlier they would *never* do.

I am not saying that we may not be heading for better times, at least in the short to medium term. Equities could very well enjoy a good spell over the next 6 to 12 months, driven by a cyclical upturn, or simply by psychological factors. That said, many years ago, I learned (the hard way) that Warren Buffett couldn't be more right when he uttered the now famous words:

"If you aren't thinking about owning a stock for 10 years, don't even think about owning it for 10 minutes."

In my current state of mind, I find it hard – almost impossible - to become overly enthusiastic about equities, even in the short term, as I am as convinced as I possibly can be that the long term outlook is rather grim. That got me thinking. Is there anything else investors could do to raise the overall return level and, in particular, to generate more income without necessarily taking more risk? That is what this month's Absolute Return Letter is about.

The starting point

In a low return environment if the overall objective is to raise (expected) returns without adding to risk, first and foremost, you need to think outside the box. A conventional approach, such as simply changing the asset allocation, is quite unlikely to lead to the promised land.

My own starting point is almost always the conjecture of structural trends that we have identified at Absolute Return Partners - structural trends that will happen regardless of the economic cycle and the monetary and/or fiscal policy being pursued. You need to ask yourself how these trends are going to affect financial markets in the years to come.

Changing demographics (we call that trend the retirement of the baby boomers) is probably the most important trend of them all. We know that populations throughout the world will age substantially between now and 2050, but how is that change likely to affect bonds and equities?

Chasing Alpha or Beta?

Secondly, ask yourself why you invest in equities in the first place - are you looking to generate alpha or beta[1]? Many investors will probably say they aim for both but, at least in our experience, better results are usually achieved when investors separate the two sources of return and let the overall objective (alpha or beta) drive the portfolio construction process.

If you primarily aim for beta, in a low return environment, fees charged by the vast majority of active investment managers are way too high, and you should not hesitate to switch to a passive investment strategy, which will cost you a fraction and, on average, deliver better returns (as the average alpha after fees is negative).

I am sure that I will get a few emails now from active equity managers saying that they are certainly capable of generating both beta and some alpha on top, and to those people I will most likely say, if you are that good, why haven't you done so consistently? Of course I bump into the odd exception but, in reality, there are very few, almost no, active equity managers who consistently generate a meaningful amount of positive alpha *after fees*.

With the beta sorted out, where should you go for your alpha? This is not the easiest question to answer, and I am not going to give you any names in this letter, but let me offer a couple of thoughts as to how the topic should be approached.

First, you need to validate an investment manager's claim to alpha; why has he or she actually outperformed? Many, who do so, use leverage. Leverage is not a bad thing when used appropriately, but some investment managers don't understand the meaning of the word appropriately.

Used excessively, the risk of accidents rises exponentially when the proverbial s*** hits the fan, and I would urge you not go down that road. One way to distinguish between skill (i.e. alpha) and luck is to track downside correlation – i.e. how well has the investment manager performed in falling markets?

You should also check the volatility of the investment manager's return stream. Many investment managers who outperform only do so by tolerating excessive levels of volatility and, in my experience, it is only a question of time before those investment managers run into more difficult times.

With few exceptions I find that the most consistent generators of alpha are those investment managers who have reduced their beta exposure to an absolute

[1] *Beta equals the market return, and alpha equals the deviation from that market return – positive or negative.*

minimum and, in order to do that, the manager in question needs to be able to go long *and* short, and that limits the universe quite dramatically.

One final note on active vs. passive equity management. You may subscribe to a particular investment style, e.g. value investing and, in that case, I fully understand that you may not really have an alternative to investing actively, but the other rules would still apply, i.e. only limited use of leverage, no excessive volatility, etc.

Desperate for income? What not to do

Allow me to return to the topic of changing demographics for a minute or two. Extraordinary low interest rates around the world have delivered a monumental blow to many investors. Falling interest rates have translated into rising liabilities for (defined benefit) pension plans and, secondly, millions of retirees, who depend on income from savings to take them through retirement, are struggling to make a decent living.

Consequently, investors take risks that they weren't previously prepared to take, some of which I am comfortable with, and some of which I am not. Take US corporate high yield bonds. The prevailing view seems to be that US corporates (ex. energy) are in very good shape with loads of cash on their balance sheet, and that they therefore offer a relatively attractive, and a comparatively safe, investment opportunity.

I beg to disagree. Firstly, we are late in the economic cycle, and it is usually a bad idea to buy corporate high yield bonds late in an economic upturn. Secondly, let me share some facts with you that undermine the perception outlined above[2]:

1. The 1% most cash-rich of all US companies control over 50% of all US corporate cash.
2. The five most cash-rich US companies (Apple, Microsoft, Google, Cisco and Oracle) control 30% of all US corporate cash.
3. Total US corporate debt (the other side of the balance sheet) was $5.03 trillion at the end of 2015 - up from $2.62 trillion at the end of 2007.
4. Net debt (i.e. debt ex. cash) amongst US corporates was $3.39 trillion at the end of 2015 vs. $1.88 trillion at the end of 2007.
5. US corporate debt has risen by $2.8 trillion over the last five years, while corporate cash has only risen by $600 billion.
6. If you back out the top 1% referred to in (1) above, the cash holdings of the remaining 99% fell 6% in 2015 to stand at just $900 billion by the end of December vs. $6.6 trillion of debt.

Based on those numbers, I think it is fair to say that, with the exception of a few extremely cash-rich companies, corporate America is increasingly indebted and not at all as cash-rich as widely perceived. This also explains why corporate investments in the US are at a 60-year low. As investments today drive profitability and economic growth tomorrow, the low cash and the high debt levels reinforce my firmly held belief that GDP growth as well as equity returns will disappoint for quite a while to come. Consequently, I am not comfortable with the solution chosen by many to seek income through corporate high yield bonds.

What to do instead

Financial markets offer a number of solutions to investors starved of income - two that I am comfortable with and many that I am not. In the traditional investment space, high yielding European equities offer the best opportunity and, in the

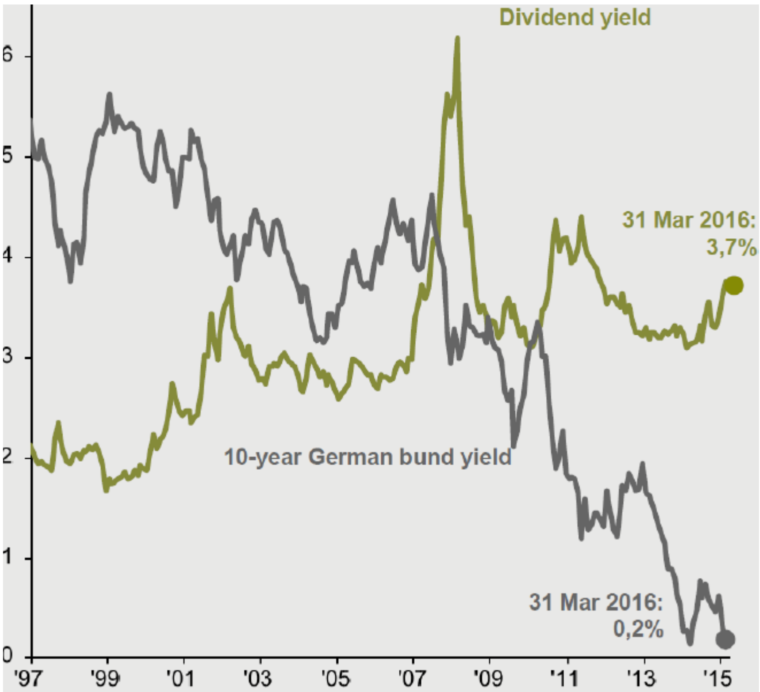
[2] *Courtesy of The Credit Strategist, Standard & Poors and Moody's, June 2016.*

alternative investment space, various alternative lending strategies do the same – more about that opportunity set later.

Seek income through dividend yields

For many years to come a rapidly ageing European populace will increasingly look to equities for the income that is no longer achievable in bonds, whereas dividend yields on European equities are still respectable (chart 1).

Chart 1: Dividend yield on MSCI Europe vs. yield on 10-year German Bunds



Source: JP Morgan Asset Management, April 2016.

Not only are dividend yields, on average, much higher in Europe than they are in the US, but equity ownership amongst private investors is typically lower. That could possibly generate an interesting dynamic. All the research I have seen over the years suggest that people sell their equities and buy bonds instead, as they approach retirement, and I would fully expect that to happen in the US.

European equities, on the other hand, could quite possibly benefit from an ageing population. Assuming European bond yields remain low (as I think they will), ageing investors could quite possibly sell bonds and buy equities instead, potentially reducing the significant valuation gap between US and European equities. For several years now, I have expected that to happen eventually, but have wondered what the catalyst might be. Could this be it?

You would actually accomplish two things by investing in a portfolio of high yield European equities. Not only would your income level rise when compared to most bond investments at present; you would also most likely outperform European equities in general (at least in the long term), as more and more investors look to equities for income, driving valuations of those types of equities higher over time.

Even better, the beta risk can be hedged away, effectively turning the strategy into a combination of an income and an alpha strategy. There are admittedly some issues (to do with correlation risk and tax obligations), but it is nevertheless an interesting concept.

There is a ***but***, though. A growing number of companies pay a dividend they can't really afford; hence you need to do your homework and make sure you not only invest in a portfolio of high yielding equities. You actually invest in corporates that can afford to pay such an attractive dividend.

Seek income through alternative lending

Another one of 'our' structural trends comes into play here. Banks all over the world are under regulatory pressure to reduce the size of their loan books, making it particularly difficult for them to service the SME[3] segment, and the retail market is also under pressure. Only tier one corporate clients appear to be unaffected.

Consequently, lending originated outside the commercial banking industry is growing rapidly. We call that structural trend *regulatory arbitrage*, and I expect banks to lose significant market share to alternative sources of lending in the years to come. Much of that lending is traditional corporate lending (which is often called direct lending), but many other sorts of lending is also increasingly taking place away from commercial banks.

The two most important questions you need to ask yourself, before you begin to walk down this road, are the following:

1. Does the investment manager in question really understand what he is trying to talk you into (in 2008, many did not); *and*
2. How liquid do you need your investment to be?

The alternative lending space is a colourful mix of opportunists (who often don't fully understand what they are getting involved in) and breakout groups of experienced credit people from commercial banks, who saw the writing on the wall. Needless to say, you should aim for the latter, and the greyer the hair, the better.

We divide the universe of alternative lending strategies into four categories:

a. Secured, asset backed lending;
b. Secured, cash flow backed lending;
c. Unsecured, corporate lending; and
d. Unsecured, private lending.

Generally, but not always, both risk and returns are the lowest in (a) and the highest in (d). The most extreme example would probably be payday loans, where returns can be extraordinarily high, but the investment style is such that you don't necessarily want to be associated with that type of lending. There is no point in being greedy when other, and soberer, lending strategies offer double digit returns.

As far as liquidity is concerned, most alternative lending strategies are multi-year in nature, which precludes many investors from participating. That said, due to a still meaningful illiquidity premium, attractive double-digit returns are on offer in many of these strategies.

Since the financial crisis almost flattened the financial system back in the autumn of 2008, investors have had an extraordinary desire for liquidity, resulting in a significant illiquidity premium. Although that premium continues to fall, it is still meaningful, in particular if you are prepared to tie up your capital for 3-4 years or longer.

I would recommend that you take advantage of that illiquidity premium as much as you possibly can. In so doing, don't be fooled by funds offering good liquidity terms, but where there is a liquidity mismatch on the underlying investment being made vs. the liquidity offered to investors. Here, you would be taking on liquidity risk, even though it is not apparent in the terms offered to investors.

[3] *Small-to-medium sized enterprises.*

Blu Family Office

A quick disclaimer: Skip the next paragraph, if you want to avoid my 30-second commercial!

Our family office arm, Blu (see www.blu-fo.com) is about to launch an income fund. The redemption terms have been kept as short as possible (quarterly), which is why double digit returns are entirely unrealistic for this particular fund. We expect the net return to investors to be in the region of 6% per annum.

Blu will make sure that the asset side is matched with the liability side, and we think that we, this way, can offer investors a real "liquid" alternative to what is available in the marketplace at present (assuming you consider quarterly access to your capital liquid enough).

Behavioural opportunities

Apart from the opportunity sets already mentioned, there are other ways to improve overall return levels without adding to risk. Take the risk-on, risk-off mentality which has crept in since 2008 and turned many investors into sheep. You can certainly take advantage of that, if you are prepared to stick your neck out occasionally.

Because investors are so afraid of a repeat of 2008, they do things that are not always logical, which shrewd investors can take advantage of. This could be something as simple as adding to your equity exposure when markets are very weak or, in the alternative space, it could be to invest more in systematic macro funds, some of which have an excellent record of taking advantage of herding.

Strong intellectual property

Weak economic growth is almost always associated with poor pricing power, and with that comes weak earnings growth and poor equity returns. In a low growth environment, and in particular when inflation is subdued, pricing power is critical. Pricing power is most easily achieved when your intellectual property is strong. I should point out that investment opportunities with strong intellectual property can be found in traditional as well as alternative investment strategies.

Life cycle dynamics

Life cycle dynamics apply everywhere, whether you invest directly or through other investment managers. Back in the 1980s, when I joined the industry, IBM was the best thing since sliced bread, but it no longer is. Today, most investors think Apple is, but the day will arrive when it is also pushed aside.

In the fund management industry, life cycle dynamics also apply. Many larger fund managers have delivered very disappointing results in recent years. The near zero risk-free rate of return is undoubtedly part of the reason behind the relatively poor performance, but another reason, I believe, is size (assets under management).

Post 2008, many investors consolidated their investments. In principle, that was not a bad decision, but in practise it was, as deteriorating liquidity made, and continues to make, life difficult for many large investment firms.

On top of that, if you earn 2% in management fees on $10 billion of AuM (as some of the larger hedge funds do), your annual fee income *before* having delivered any returns at all is $200 million, and that sort of money buys a pretty decent lifestyle. Most of these people will not admit it, but size creates complacency. Suddenly the yacht in the Mediterranean becomes a more important gadget than the mobile phone, and that is a slippery slope.

My advice is to always consider life cycle dynamics. Don't use this argument as an excuse to seed new investment managers, but be prepared to jump on the bandwagon relatively early, as younger, smaller, and nimbler investment managers often deliver superior returns.

Secondary opportunities

Talking about investing in funds, I have noticed that, in the post-2008 environment, investors don't always 'respect' redemption terms, which has created a meaningful secondary market in funds with longer liquidity terms.

An investor may be exiting a fund prematurely for all kinds of reasons that have nothing whatsoever to do with performance, and that can be taken advantage of. Don't let your investment decisions be driven by what's on offer at the moment but check, once the decision to invest has been made, whether the fund in question can actually be acquired at a discount in the secondary market.

Vote with your feet

Finally, I suggest you vote with your feet every now and then. In a low return environment, fund managers are unlikely to perform sudden miracles and deliver outsized returns so, in that respect, you have to be realistic.

Fund managers, on the other hand, also need to wake up. They simply cannot justify running with an unchanged fee structure when returns are a fraction of what they used to be and, in my experience, most investment managers only respect one thing. Vote with your feet, if you are not happy. Nothing else will have any effect whatsoever.

Whilst I entirely agree with the overriding philosophy that it is the net return after fees that really matters, in a low return environment, fees do make a big difference to the bottom line.

The risk premium

The risk premium is defined as the long-term excess return on risk assets over the risk-free rate of return. The risk premium has varied over time and is not the same for all asset classes. To complicate matters further, when talking about the risk-free rate of return, some use yields at the very short end, whereas others use longer-dated government bond yields. However, for the sake of simplicity, let's assume that we only talk about the equity risk premium, and let's also assume that policy rates (such as the Fed funds rate) are akin to the risk-free rate of return.

On that basis, it would be fair to say that the risk premium over the past century (on average) has been around 4-5%. Consequently, one shouldn't really be surprised that equity returns at the moment are quite subdued, and one shouldn't be surprised at all, if that continues to be the case, as long as the risk-free rate of return remains close to 0%.

Final comments

If you were to rigorously pursue the opportunity set listed above, the risk premium would no longer be 4-5%, but almost twice that. The exact number would obviously depend on how the portfolio is actually constructed – in particular how much is allocated to less liquid investment strategies, as picking up the illiquidity premium is one of the simplest ways to increase your risk premium.

That said, I would encourage investors not to think about the portfolio construction process as a choice between traditional and alternative investment strategies; don't think of it as a choice between asset classes at all.

Instead, you should focus on risk classes and seek to gain exposure (as efficiently as possible) to different categories of risk, where the return drivers are entirely independent of each other. Too often, several risks are combined within an asset class, making it very difficult to determine exactly what types of risk you are exposed to. Thinking about 'pure' risk categories will help you achieve genuine diversification in an environment where this is increasingly difficult to achieve.

Niels Jensen
1 September 2016

Important Notice

Absolute Return Partners

Absolute Return Partners LLP is a London based client-driven, alternative investment boutique. We provide independent asset management and investment advisory services globally to institutional investors.

We are a company with a simple mission – delivering superior risk-adjusted returns to our clients. We believe that we can achieve this through a disciplined risk management approach and an investment process based on our open architecture platform.

Our focus is strictly on absolute returns and our thinking, product development, asset allocation and portfolio construction are all driven by a series of long-term macro themes, some of which we express in the Absolute Return Letter.

We have eliminated all conflicts of interest with our transparent business model and we offer flexible solutions, tailored to match specific needs.

We are authorised and regulated by the Financial Conduct Authority in the UK.

Visit www.arpinvestments.com to learn more about us.

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