

FUNDAMENTALS



ABSOLUTE RETURN

IF YOU ABSOLUTELY NEED POSITIVE RETURNS, A TRADITIONAL HEDGE FUND MAY BE THE BEST BET



James P. Owen

Even as the stock and bond markets recover, hedge fund strategies that promise steady returns year in and year out retain their appeal. Many advisers are looking to avoid another wild

ride in the equities market, but they aren't confident a rising interest rate scenario bodes well for bondholders.

For that reason, a number of wealth managers are now considering so-called absolute return strategies for the first time, while others are looking to increase their existing allocation to these strategies. One of the most outspoken advocates of absolute return investing is James P. Owen, a partner at Austin Capital Management, a hedge fund of funds company in Austin, Tex. Owen, who has been in the investment-management business for 35 years, is the author of two books, the most recent of which is *The Prudent Investor's Guide to Hedge Funds: Profiting from the Uncertainty and Volatility* (Wiley). He spoke recently about absolute return investing with BLOOMBERG WEALTH MANAGER editor Kieran Beer.

Can you define absolute return investing?

The important thing to realize is that the term *absolute return* doesn't refer to a product, and it's not an investment style, like value or growth. In my opinion, it's a philosophy, a set of principles for investing outside the

mainstream in pursuit of consistently positive annual returns. The goals of most folks who are investing in absolute return are threefold. First, they want to earn a positive return every year, regardless of market direction. Second, they want to avoid significant losses and preserve capital. And third, they want to limit portfolio volatility. Along with all this is the belief that absolute return performance would have a low correlation to the traditional stock and bond markets.

But the long-term direction of the stock market has been up. Why wouldn't a long-term investor simply ride that upward trend by staying long?

That's a good point, but consider it in the context of where we are now. Investors just went through the worst three-year market decline in anybody's memory. Now it's true we've had a strong market this year, but we've still not gone through the former highs.

So, you believe that it's not enough to say that the traditional markets will create wealth over the long term.

Most folks who are going into hedge funds or funds of funds are probably in the 55- to 65-year-old range. They've already created wealth, they have worked their tails off to create a business, and above all they don't want to lose money. They have no illusion that some financial planner or broker is going to make them a lot of money. What they want is to make, say, 8 percent a year.

I think the bad guy in all this is the traditional money manager, who

bought into relative performance. It sounds great in a bull market. But what happens in a bear market? When the market's down 22 percent and your account's only down 21 percent, most wealthy individuals aren't going to congratulate the money manager. Instead, they'll say, "you've cost me a lot of money."

How do you go about achieving returns year in and year out?

You have to go back to the genesis of hedge funds. Alfred Winslow Jones, a professor of sociology at Columbia University, created the first hedge fund in 1949. He had interviewed the best minds on the Street in those days, asking if they could predict the market, and not one claimed to be able to. He decided that if all these guys couldn't tell where the market was headed, he needed to create an investment strategy that would make the direction of the market less relevant.

He took \$100,000 and went to a brokerage firm and said I'd like to buy \$100,000 worth of stock. He then said to the broker, I'd like to short \$100,000 of stock—or almost \$100,000. Then he had \$100,000 long, \$100,000 short—and the shorts, by the way, were not considered using leverage. He then went to the same brokerage firm and said, "I want to borrow some money." According to New York Stock Exchange rules, a hedge fund manager, can borrow only 50 percent of capital. So with \$100,000 in capital, you can borrow \$50,000. Jones then had \$250,000 in

market opportunities. If you subtract the shorts from the longs, he had a \$50,000 net equity exposure, or as we say in the industry, he had a 50 percent net exposure.

That's the concept of true hedge investing. What he did was combine two speculative techniques, short selling and leverage, to lower portfolio volatility.

So when you talk about absolute return strategies, are you primarily talking about long-short funds? Or

top each and every year. But I'll tell you flat out that the strategy that offers the best risk-reward profile is the Jones model. Still, in any given year, distressed securities or convertible arbitrage could be at the top of the heap. There's a tremendous cyclical to all the strategies. Distressed, for example, has had a tremendous run over the past two years, but it would be a mistake to assume that you can put all your money into distressed debt over the next two or three years and

do well in a recovering economy. So the next question is, what should be the source of the money for investing in these strategies? For many advisers the answer could be the fixed-income portion of a client's account.

What portion of a client's total portfolio should be devoted to absolute return strategies?

I would never encourage someone to have more than a 10 to 15 percent allocation to start with, but I've seen investors put more than half their portfolio

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are there other strategies that fund managers follow?

This is a very critical question. The reason I use the Jones model is because it's easy to understand. Depending on how one slices and dices it, there are anywhere from 18 to 35 different hedge fund strategies. But less than half of these are absolute return strategies. A hedge fund strategy qualifies in my mind as absolute return if it is nondirectional by virtue of capitalizing on factors not tied to market trends or if it participates in offsetting market opportunities. An example would be an event-driven fund, like merger arbitrage, or a distressed securities fund, or a fund that follows the Jones model. One that doesn't qualify as absolute return would be global macro. Emerging markets funds would also not be absolute return strategies.

Traditionally, which strategy has the best risk-return profile?

If you look at the data, you'll conclude pretty quickly that there's no one strategy that is going to be at the

sit back and relax. Sometimes when too much money goes into a strategy, the returns get compressed. An example of that would be convertible arbitrage, where the opportunities are [literally] arbitrated away.

Are any of the strategies complementary, so that you might want to use them in tandem?

The only strategy that I would be comfortable using for a client who was going away for 10 years to a desert island would be the Jones model, or classic long-short. However, the other way to look at absolute return investing is not as an equity surrogate, but instead as a fixed-income surrogate. Let's say you believe the great bull market in bonds is over and you just don't see how putting clients into bonds at this point makes any sense. The question becomes, are there any strategies that will benefit from a rising interest rate environment? The answer is absolutely, and a lot of them are these event-driven strategies that we've been talking about. They're going to

in absolute returns. I don't think there's a scientific formula for allocation. It's more about what an investor's comfort level is. But I do know that most people that go down this path never go back to long-only investing.

What are the most important issues in selecting an absolute return manager?

We look for guys who above all hate to lose money. And we assume that guys who run hedge funds are smart and that they work hard. But we don't assume that they have personal integrity and character. Most of the mistakes we make are when we put our faith in people who don't deserve it. So we spend a lot of time on the qualitative side of the analysis. It's not just about number crunching and looking at track records or databases. It's about knowing and being able to trust the people. That's what makes this a fascinating business that's endlessly changing—and challenging.

Kieran Beer is an executive editor at WEALTH MANAGER.