Learning outcomes: 1. How asset prices have been affected by monetary policy 2. The range of absolute return style funds available to investors 3. How absolute return fund managers look for assets that are not correlated to mainstream markets 4. How changes in interest rates can affect the value of fixed income securities PRESENTER: Ian, it's probably worth starting at the targeted absolute return sector, where we've seen significant flows over the last 12 or 18 months. What do you believe are the reasons for this? IAN: Well for many years we've seen quite loose monetary policy from central banks, particularly in the developed markets. So you've got the Fed in the US, the Bank of England in the UK and obviously the ECB in Europe. This has created an environment of exceptionally low interest rates. It's the belief of the Premier Multi-Asset team that this has created an environment where asset inflation has generally pervaded for the last several years. We can see on this chart the general asset returns and volatilities of different asset classes over time. The grey spots indicate equities, and you can see over both one and three years equity returns have been quite strong. This to us would suggest that equity valuations can no longer be considered cheap. And so getting some diversification away from that could be a useful strategy to employ looking forward, particularly where we think expected returns may be much lower. We can also see that bond returns have also been similarly strong over both one and three years. This chart will also show, with the move in the green spots, how much bond volatility has picked up particularly over the last year. And the volatility is now at a level which is much higher than even UK equities within the UK market. So investors will probably be looking for alternatives to and diversification away from bonds in their portfolios. And bonds to us look as though they've entered the risk asset camp. And so the targeted absolute return sector may provide some opportunities for providing diversification away from bonds as well. We can also see on this chart that the average fund within the targeted absolute return sector has delivered low and stable volatility over time. And that's obviously of interest to investors looking for diversification, and more importantly it's delivered returns that are above cash, and when cash is at such historic lows this is quite a useful consideration to bear in mind. PRESENTER: So on that basis what do you think is a suitable investor for a targeted absolute return fund? IAN: Well, as we've already alluded to, I think investors are finding interest in the sector for diversification from both their equity allocations, and also more latterly from their bond allocations, seeing the rise of volatility in that particular asset class. I guess underpinning all of this is the fact that base rates remain low, and investors who are looking for a return greater than cash really need to look for other ideas than those two mainstream sectors of equities and bonds. PRESENTER: So if you were to look at the targeted absolute return sector as a whole, what do you see as the opportunities and the solutions that are available to investors in this sector? IAN: Within the UK funds market, we've seen the proliferation of liquid alternative strategies in recent years. Now these would typically be in funds investing in traditional assets, maybe with liquid instruments overlaid such as futures and options, in trying to target an absolute return as their outcome. Now the sector itself consists of about 120 funds, over £104bn worth of assets under management, although only 84 funds have more than a three year track record. We do see some concentration from advisers in the sector, and the 10 largest funds typically account for over 60% of the assets of that sector. Looking at the types of funds within the sector, you can see that just under half are invested in single strategy funds. Now these would be either absolute equity funds or absolute return bond funds, but the core of the sector, or about 40%, are invested in mixed asset funds. Now these would invest across both equities, bonds, maybe even currencies, in trying to deliver a more defined absolute return. And investors may be more familiar with the global absolute return strategies which make up the bulk of those types of funds. Looking at the breadth of aims and objectives that these funds go for, you'll see that more than half the sector is really targeting that cash or cash plus return. Although I would say that there is a sizeable minority of funds, given here in the green, which do have an equity linked performance benchmark. Investors need to be quite comfortable with those types of funds because of the volatility they're likely to produce. We must bear in mind that the sector has a whole has a requirement to deliver an absolute return over a rolling three-year basis. So that would mean any fund that is suffering a loss on any one year has quite a high hurdle to get back over to achieve its absolute return objective. So that may mean maintaining or even taking on more risk to achieve that particular aim. PRESENTER: So given the research that you've done on the sector as a whole, what conclusions do you draw? IAN: Given the wide variety of strategies within the sector, we are seeing quite a wide range of dispersion within the returns being generated. On screen, you may be able to see a chart which looks at the average annual dispersion between the best and worst performing funds within the sector on a discreet calendar year basis. This is quite large and averages about 40% over time. More interesting is looking at the range of dispersion in any discreet calendar year. And you'll see in both 2012 and 2013 these were good years for equity markets, in general, and the return of dispersion is more towards the upside there. In a year such as 2016, which was driven by quite big macro events, there was more market dislocation, and here the return is more evenly dispersed between upside and downside. That means investors need to be very careful when selecting funds within this sector, because not all of them will provide the comfort and consistency required in more challenging times. PRESENTER: Ian, based on what you've just said, it would appear to me that the sector is a real minefield of different alternative strategies and different investment solutions available to the adviser. So from your point of view what would be an ideal solution and why? IAN: We've just looked at the dispersion of returns in the sector. It's also worth looking at their volatility as well. And here on this chart we've just selected the five largest funds within the targeted absolute return sector to see how they fit on the risk reward spectrum. You see a bit of clustering in the orange blobs of some of the largest funds there. And these would be typically your mixed asset funds, or one of them being a long short equity fund. You can see that one of the largest funds here on this chart offers quite considerable return over time, although it comes with some volatility as well. This particular fund is an emerging market absolute return bond fund, and although it's taking credit risk to deliver its return, it's also taking some currency and duration risk as well. So a fund such as this, which offers good return potential but also high volatility, just needs careful consideration as to whether it is the consistent profile that investors need from the sector. Our preferred approach is to really blend these single strategy funds so that we achieve actually a lower correlation and more consistent stable returns over time, and this we've able to achieve as represented by the blue dot here on the chart, and this is our Premier Multi-Asset Absolute Return Fund. PRESENTER: So, on that basis, how would you define an absolute return fund? IAN: Well I think an absolute return fund has to be one that delivers a positive return and a consistent return over time. Ideally, it should be providing diversification to both bonds and even equities. So it's about looking through to the correlation to achieve that diversification. More importantly, it's to generate that positive return which is over and above cash as well. Interestingly enough in the targeted absolute return sector there are only seven funds that have been able to achieve a positive return over each of the last discreet seven calendar years. PRESENTER: So on that basis then what absolute return strategies are you managing, and what are their core objectives? IAN: We run two funds here at Premier. The Premier Multi-Asset Absolute Return Fund, which has a cash plus two target, and a relative volatility ceiling of 30% against the FTSE All Share. Now returns here are ideally generated as capital-only style returns. We also run the Premier Multi-Asset Conservative Growth Fund. It has a slightly higher risk reward objective, and it's set as a cash plus 3% benchmark, whilst having a volatility ceiling of one third of the FTSE All Share. PRESENTER: So, given that you're managing absolute return strategies, it might be a good idea now if we start to have a look at some of the major asset classes. So let's have a look at equities, and how do you generate an absolute return from that particular asset class? IAN: Well the typical approach within the targeted absolute return sector would really be to look at an equity long/short fund. This would be a fund that takes equity long positions, and offsets that with either index or stock specific shorts to try and generate a more defined absolute outcome. We think there are more opportunities available than just those types of strategies, and one that we really like is to utilise the similar types of instruments in creating our own structure. So on screen you may be able to see that we have a particular product in mind in our funds. This particular holding has a put feature, which enables us to provide some capital protection up to a fall of 35% in the market. We define our own return objectives from this holding, and we set these at just over 8% per annum. Now the holding itself has an annual auto call feature, at which point the investment will either pay out its 8% coupon or continue to subsequent years. And here you can see that we've actually built quite a defensive profile to this particular instrument, because although in years one to three we have set the hurdle at 100% of the initial strike barrier, in this case a euro stocks index level of 3,188. When it gets to years four, five and six we have a much lower index hurdle to get over in achieving our coupon objectives. So here we can actually achieve quite a useful absolute return even against the backdrop of falling markets. PRESENTER: Most advisers would know structured investments or structured products as fixed-term products. So, given that you're managing a fund, how do you trade those on a daily basis, or can you trade them on a daily basis? IAN: Well these types of instruments we're writing are direct with the investment bank houses themselves. So these aren't the mass produced retail structured products that investors will typically see. Now although they are not exchanged traded, they do have live pricing. So it does enable us to actually trade these throughout the life of the investment period. So although in many cases we will look to hold these to maturity, we can trade these and have done so in the past where we see the opportunities available to us. PRESENTER: So, Ian, where would you typically get those structured investments from? IAN: Well typically we're focusing on the largest most respected financially strong banks and financial institutions. In that example it was HSBC. We like the banks which have high regulation and good strong capital buffers as a way of providing principal protection to us. PRESENTER: So, given where you access these structured investments from, how do you manage the counterparty risk? IAN: The counterparty risk is very important to us. These types of instruments are effectively a senior or unsecured credit to those banks and institutions we're using. So we have to be comfortable with them on that basis. And we can also use internal maximum allocations in controlling our overall exposure, and ensuring that we have diversification across the counterparties we use. PRESENTER: Thanks Ian. So we've looked at equities in some detail. Moving on to the bond market, how do you generate an absolute return in the bond market? IAN: Within the targeted absolute return sector there are many absolute return bond funds that we could access. Now these would be funds that are typically looking to make a return from both going long and short a credit decision. Unfortunately for us too many of these funds also take on duration and currency risk as well, and they're not the typical types of risk we want to take on, or types of funds we want to hold. As such we look beyond just those types of instruments for areas of interesting opportunity. Now, within the fund we own this particular position, which is a bond fund which is backed by residential mortgage securities. Now these are very high grade quality instruments where there's been no credit default events throughout their life, so really strong robust instruments. And as you can see compared to gilts they've provided very good attractive returns, but more importantly their risk adjusted returns are very strong. And this is because these types of instruments are generally floating rate in nature, so it removes a lot of that duration risk and duration volatility away from the returns being generated. PRESENTER: You just highlighted duration there. What do you actually mean by duration and why is important? IAN: Well duration is a measure of a bond's sensitivity to interest rates. And this is a very topical discussion given that we have seen in recent years a move from seven-year duration in the UK market to nearer to nine years over recent times. What that effectively means is for every one percentage move in interest rates, the bond prices can move by +/-9%. So this is a type of risk we're very mindful of and want to actually reduce given that duration keeps on extending out at the current time. PRESENTER: So moving on from bonds, what other assets do you look at, and what other assets do you currently favour? IAN: Well property has been generally seen as a good useful portfolio diversifier for some time, and we do like the asset class given the relatively low stable returns it can offer. There are many ways to access property. As we've seen in recent years doing so through an open ended fund can prove challenging. The alternatives would be to use either real estate investment trusts or even listed REIT funds as a way of gaining a similar type of exposure. Now the problem with using property share funds is the fact that their volatility in the very near term is almost akin to equity, and you really need to be holding that type of fund for more than three years to see the correlation to property come through. Within our portfolios we've been able to find and access a fund which invests in those property shares, which will give us the long-term property style returns we're after. But he does so in a long/short approach to actually remove a lot of the near-term equity risk from his fund. And as you can see from the chart on screen it's delivered some really good risk-adjusted returns by removing a lot of that equity volatility from that position. PRESENTER: Ian, we've talked about equities, bonds and property. So what alternative assets do you utilise within your absolute return strategies? IAN: Well it's worth bearing in mind that alternatives by their very nature should be providing genuine diversification to portfolios. So if you're looking beyond just equities and bonds, you have to look at the liquidity considerations around that, and how you access those types of instruments. Now we are very fortunate in the UK that we have the London Stock Exchange which has become a haven for listed funds, particularly those that are targeted alternative assets, and this is market segment that has really grown in the last 10 years. Now, what I would say is when we've seen these types of developments what may be a niche and unfamiliar asset class today may well become quite mainstream in the future; something like infrastructure funds have done over the last 10 years. PRESENTER: You highlight infrastructure, obviously that's an asset class that is being discussed a lot, so what's your, how have you played that particular asset class over the last three or four years say? IAN: Well we were very early into infrastructure back, all the way back into 2006 when the first fund was launched. That was HSBC Infrastructure Fund, now called HICKLE. And within six months or so we had done our work to actually identify the return and risk stream that we felt appropriate for our funds. Quite a lot stable asset base providing a good consistency of return, which we thought would be useful not just in income mandates but also in absolute return mandates as well. However, as this asset has become a lot more mainstream, we have seen the valuations of these particular assets move up quite considerably. They now trade at quite healthy premiums to their underlying net asset values. So therefore we have to utilise them in a very productive way to ensure that we are maintaining our risk reward dynamics from these particular holdings. Certainly the more the price of these instruments moves up, the greater the downside risk becomes. So we have found that we've had to trade these positions a bit more regularly as we see the opportunity. Now fortunately this is an area of the market which has seen considerable growth over the 10 years it's been in existence. It now consists of 13 funds running over £13½bn. So there's a regular flow of invested capital requirements needed to help fund the growth of this sector. So we use that as a useful entry point to build on our positions, and when we find that valuations start to run away from us and the downside risk starts to build, we do look to trade those positions and move on into more better risk-adjusted returns elsewhere. PRESENTER: Ian, that takes us on quite nicely to liquidity as you've just mentioned, and you're obviously getting more and more involved in these investment companies. So how do you actually manage liquidity risk within your portfolios? IAN: Well liquidity risk is an important consideration for how we build our portfolios and manage them. We think you can achieve very good liquidity by using a range of investment instruments within the portfolios. And whilst open-ended funds, UCITS funds will make up the core of that allocation, you shouldn't restrict your investment opportunity set too much. And so whilst we use cash and structured investments as you've already seen, we do make use of these listed funds as well, particularly where we can access some really interesting investment opportunities. At the current time we have about 10% of the Premier Multi-Asset Absolute Return Fund in listed funds, and we have 20% of listed funds held in the Premier Multi-Asset Conservative Growth Fund. With regards to liquidity an important consideration for us is to look at the growth of a particular asset class over time, and we've seen that already with infrastructure, and I expect we'll be seeing it a lot more with some of these other alternative instruments that are currently around in the market. What may well be a familiar and niche asset class at the current time is likely to prove to be more mainstream in the future. PRESENTER: Other than infrastructure have you got some other examples of that say in the property area? IAN: Yes, another good example we have is a property fund called Tritax. Now we've used this in some of our absolute return funds in the past. Now Tritax is a property fund that is invested in largescale warehouse facilities up and down the UK. Now what's interesting about this particular asset class is the fact that due to the high fit-out costs of these units the tenants typically want very long leases to feel comfortable that they can remain in situ for some time. So what we're seeing here is typically a lease structure of 15 to 20 years, which provides good stable rental income, a low volatility asset base, and overall a total return which should be low and stable but consistent throughout time. That to us is a useful asset to be considering for these types of funds. PRESENTER: One of the asset classes that you highlight within the alternative assets is what you refer to as market neutral. What do you actually mean by that, and what are the types of assets that you're looking at in that particular sector? IAN: Well market neutral most easily is really an extension of a long/short equity fund. Now most typical long/short equity funds will still have a net long bias, which will give them a beta to the market still of anywhere between 10 to 30%. A market neutral fund is trying to remove all of the beta from their particular holdings so that their net bias is actually zero. So here what they're trying to do is just extract and manage stock picking alpha without having any of the market beta which can dominate returns. PRESENTER: And looking at another one, litigation finance, talk me through that particular type of asset. IAN: Well this was an asset we have used in the past. We don't currently have a position here. But here it's effectively an alternative return stream by looking at corporate litigation and having an investment which is really determined by the success or failure of that litigation in court. So it's almost akin to a no win, no loss scenario with regard to a corporate legal case. These types of return streams are going to be very insensitive to what's going on in the markets, and more driven by the court rulings the jurisdictions in which these cases are being tried. There are two such funds that investors can look at in this space: Burford Capital and Juridica Investments, both of which have been around for a couple of years. PRESENTER: And just out of interest why are you not using that particular asset class at present? IAN: Well it performed particularly well in our multi-asset return fund several years ago, and we decided to take our profits and look around for some other opportunities. PRESENTER: How do you actually go about generating new ideas for the portfolio? IAN: Well we're quite fortunate here at Premier that we've had long experience in trying to find these alternative types of assets, and we've built up a reputation where we're seen as a recognised and respected investor in this particular area, and so we get really good access to these types of strategies as they've become available. And it's having that market presence and the scale of our funds enables us to get access and then achieve independent evaluation of these different strategies to see how they blend well within our portfolios. PRESENTER: So you've generated the ideas, how do you go about then incorporating that to within the portfolio? IAN: Well the first stage is to evaluate the return potential: how sustainable and how replicable is it? Once we get some comfort around that it's about trying to understand the experience and expertise of the manager as well to ensure that we're buying something that has some longevity. But beyond just the return aspect we need to be quite comfortable with what the risks are to the downside as well. So it's ensuring how volatile the underlying asset could be, and if things do go wrong what the downside risks could be. And with that in mind it helps us build a much clearer picture of what the risk adjusted return potential of any particular holding can be. Finally we need to look at how the investment will fit into the portfolio. So it's a case of looking at the correlation to the existing assets held, and if we can achieve low correlation we’re getting some diversification, which is good. If actually we find the asset correlates quite highly with an existing holding, then helps challenge whether we’ve got a better idea, and can help us actually replace an existing holding with an even better investment to take its place. PRESENTER: So in your view what is the best structure to access the range of assets that are available to you? IAN: Well this is a very topical consideration. It’s certainly our view at Premier that the underlying structure should be no more liquid than the asset it’s investing in. And we’ve seen that with property just recently. Twice in the last 10 years investors have found that trying to realise property assets to meet investor redemption needs can’t always be attained. So actually having an appropriate structure is very key to accessing assets, and particularly those that are non-mainstream. So for us it makes a great deal of sense to access some of these more esoteric investment areas with a listed fund, because this in effect is a committed capital vehicle where the manager doesn’t have to worry about investor inflows and outflows disturbing his investment into the underlying asset. PRESENTER: So, to summarise then, Ian, in terms of your Head of Research capability at Premier, what you’re effectively saying is to dampen down volatility, which is an objective that you consider important for clients. It’s all about looking at a vast range of different asset classes that are non-correlated to each other, and therefore delivering the types of returns that clients will be looking for from an absolute return fund. IAN: Well, yes, I think a multi strategy approach which is trying to blend the best of breed managers into a single proposition helps achieve lower volatility while still trying to generate returns that are much greater than cash. PRESENTER: Ian, thank you very much for your time today. Thank you. IAN: Thank you.