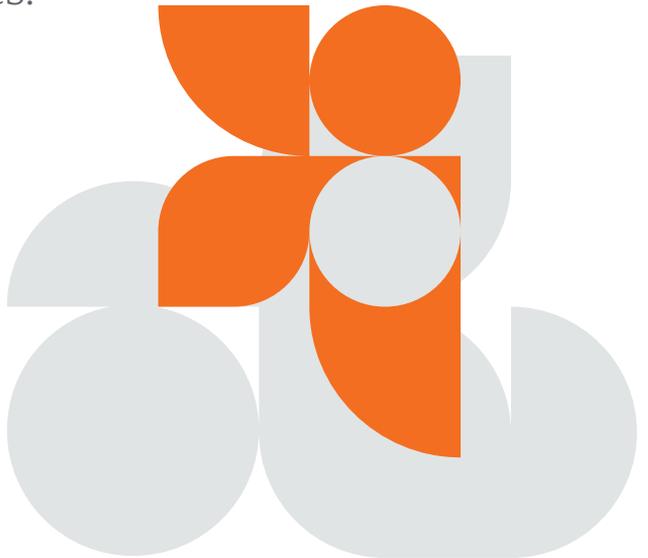


Absolute return or relative return investing?

What you need to know
about the choice facing
charity trustees.



Background

In a previous Rathbones white paper for charity trustees, we explored the choice they might need to make between total return and income-only investing. In parallel with those two portfolio management approaches, and often overlapping with them, are two additional approaches that may need trustees' attention when deciding on their investment strategy.

These additional approaches are an 'absolute return approach' and a 'relative return approach'. Understanding the difference is important for charity trustees. This booklet contains some of the key issues from our full white paper on the factors that trustees should consider when deciding which approach to adopt.

Have a question for us?

Call our charity team on [020 7965 7103](tel:02079657103) or email james.brennan@rathbones.com and we'll be happy to provide a solution.

The value of investments and income arising from them may fall as well as rise and you might get back less than you originally invested.

The two approaches

An **absolute return** approach aims to achieve a positive return regardless of market conditions. In this case the investment manager's objective is to outperform, by an agreed percentage over a specified timescale, either the return on cash deposits or a chosen inflation index. This approach implies an active investment management style.

A **relative return** approach aims to outperform either a 'composite' of stock market indices or a benchmark 'peer group' of investment funds, again over a specified timescale. This approach often means a less active investment management style, but not passive like a 'tracker' fund (which seeks to mirror rather than outperform its chosen benchmark).

Trustees must choose

Deciding upon an investment approach falls squarely on the shoulders of charity trustees. The decision is often a very fine judgment as both approaches have similar underlying objectives: to generate positive returns in support of charitable activities whilst protecting accumulated funds from long-term erosion through inflation.

Although investment advisers and managers cannot make the decision, they can help and support trustees in that task by clarifying the respective features of the absolute return and relative return approaches. Reliability of income, short-term volatility in portfolio value, diversification of risk and other issues come into play when making the comparisons.



Absolute return approach

The goal of a positive market return regardless of market conditions means that an absolute return investment manager needs the freedom to invest without unnecessary constraint in assets seen to offer the best potential for returns, or at least avoid exposing past gains to reversal. Active management that exploits a variety of asset classes is a key characteristic of this approach.

In response to weak stock market conditions, a portfolio may be tilted heavily towards more defensive assets such as government bonds and cash deposits; hedging techniques may also be deployed. When markets look stronger, the upside potential of higher risk assets including equities can be accessed. Portfolio turnover and fluctuating income may result.

Relative return approach

At the heart of this approach is a benchmark suited to the aims and needs of the investor, and an agreed time horizon towards which portfolio performance goals are set. If the chosen benchmark is a composite of market indices, this may comprise flexible target proportions for selected indices that offer geographical and asset class diversity.

Alternatively, the benchmark may be a peer group such as those provided by Teknometry and ARC. Portfolio turnover is often lower than for absolute return.



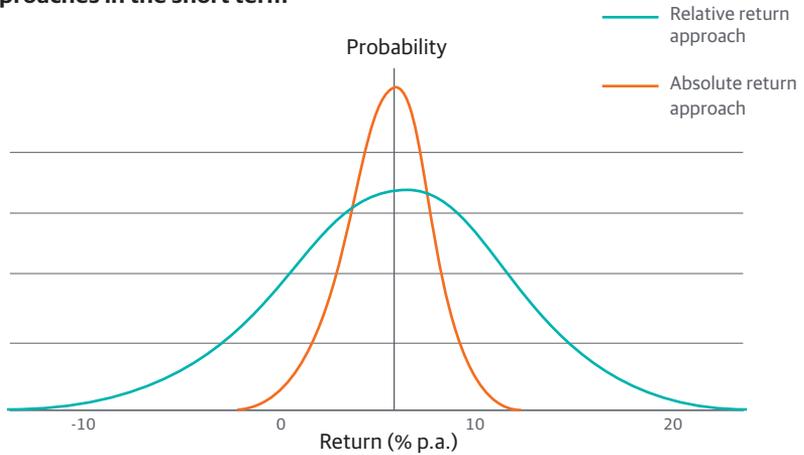
Absolute return – key advantages over relative return

Direct alignment with investment objective. For absolute return, the target return is clearly defined. For relative return, outperforming the benchmark may still mean a negative, or disappointing return if the chosen indices have performed badly. In the past, however, equities (often a key component of a relative return strategy) have protected from inflation over the long term, even with income withdrawn.

Unconstrained mandate. Absolute return investment managers may have scope to dash for cash, use derivatives with care to hedge risks, swiftly cut equity exposure and potentially achieve returns when mainstream stock markets are in negative mode. Some relative return strategies also permit hedging techniques, but generally not a substantial exit from equities.

Less volatile total return in the short term. The aim of a positive return in all market conditions through diversified investments and nimble reaction to market changes should, with effective portfolio management, make for a fairly consistent total return. A relative return portfolio biased towards equities is prone to a more variable total return when markets are jittery.

Hypothetical return profile of absolute and relative return approaches in the short term



Source: Rathbones

Relative return – key advantages over absolute return

Relies less on manager skill and market timing. Assuming a benchmark weighted towards equities and an expectation (not a guarantee) that the real value of a relative return portfolio will stand up well over the long term, the investment manager is less reliant on market timing for success; in any case, permitted flexibility to stray from benchmark asset allocations is generally limited.

Tends to outperform in rising markets. During stock market bull phases, relative return portfolios should benefit more, by virtue of substantial equity holdings compatible with benchmark weightings. Absolute return portfolios, on the other hand, are likely to be holding less in equities to cover the risk of significant losses if caught out by a surprise downturn.

More adaptable to varied objectives. Relative return strategies can be adapted more readily to particular requirements such as ethical investment or income targets.

Today's investment climate

We ignore history at our peril but there are also hazards in placing too much reliance on the past to guide ongoing investment strategy. The remarkable performance of equity investments over a period of many decades reflects factors that may not repeat themselves in the near term.

The ultra-low UK base rate prevailing since 2009 and the increased market volatility of recent years suggest that the future could be challenging. Investors, including charities, are witnessing a transition to an environment of more modest investment returns and sometimes unnerving volatility. This all makes a properly considered strategy even more important.

No standout winner

Unfortunately there is no standout winner in the contest between absolute return and relative return. Each has its pros and its cons. It remains up to trustees to weigh these against their own charities' objectives, albeit with all the appropriate tailored guidance that their advisers can provide.

Areas on which to focus in mulling over the choice include the trustees' order of priority for such issues as consistency of total return, diversification of risk, minimising management costs and maintaining portfolio value. Where absolute return and relative return approaches create differing outcomes in the short term, that performance gap may well narrow the longer the timescale.

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So which approach should
your charity choose:
absolute or **relative** return?

Our team would be delighted to explain the pros and cons of an absolute return approach, and introduce the alternative of relative return investing.

Our charities team has considerable experience in helping charities to better understand complex choices like these. Call us today and let's discuss your charity's future.

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Rathbones

Look forward

 rathbones.com/charity-white-paper

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