Absolute return or relative return investing?

The choice facing charity trustees.

Rathbones
Look forward

Contents

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.

Introduction

Over recent years, charity trustees have increasingly questioned whether they should take an 'absolute' or 'relative' return approach to their investment portfolio.

In this paper we will define absolute and relative return, consider the main features of the two approaches and look at why interest in this debate has increased over the past few years, before reviewing the factors that trustees should consider when deciding which approach to adopt. It is important to stress that there is no 'right answer' to this question. There are certain arguments in favour of each approach and some against. It is up to trustees to weigh up the respective advantages and disadvantages, and then make an informed decision having considered their charity's individual requirements.

Definitions

These are the definitions of absolute return and relative return as used throughout this paper.

Absolute return

Aiming for a positive return in all market conditions, the objective being to outperform cash deposits or some measure of inflation by a target percentage over a specified (shortish) time period.

Relative return

Aiming to outperform either a 'composite index' of stock market-based indices, or a 'peer group' benchmark over a specified time period.

An absolute return investor is aiming for a positive return all of the time. An investor who keeps their money on deposit clearly meets this definition. However, even when interest rates are at higher levels than now, most trustees will not be happy with the return offered by cash deposits for their longer-term investments. This is because no inflation protection is offered by cash once any interest is spent. Therefore, when we use the term 'absolute return' in this paper, we mean an investment approach that is aiming to outperform cash or inflation by a significant margin over a shortish period. For example, Retail Prices Index (RPI) +3% p.a. over, say, a three-year period (something that would be unachievable using cash deposits alone) would be a typical absolute return target.

Absolute and relative return approaches can produce varying results in the short-term. However, in the long-term, both aim to cater for the same broad objective that most charity trustees look to achieve; to produce sufficient capital growth to protect the portfolio from the impact of inflation after withdrawals are factored in. Both approaches are therefore perfectly valid and genuine alternatives for long-term investors.

Main features of absolute and relative return investing

Aim to achieve long-term real growth in capital

Relative return

Typical attributes
1. Index-based or peer group benchmark
2. Tactical asset allocation ranges
3. Consistent income
4. Higher volatility

Absolute return

Typical attributes
1. Cash/inflation +x% benchmark
2. Unconstrained
3. Variable income
4. Lower volatility

Source: Rathbones

The text to the left summarises the typical attributes of absolute and relative return investing.

It is in the nature of an absolute return approach to invest in a relatively 'unconstrained' manner. By unconstrained, we mean that the investment manager retains the flexibility to invest wherever they see the best potential for returns (or, at the very least, the chance not to lose money) in any given market environment. An absolute return strategy therefore suggests an investment approach that is highly responsive to changing market conditions, the aim being to tilt a portfolio aggressively towards more defensive assets (such as, for example, government bonds and cash) and/or employing hedging techniques as necessary when markets are expected to be weak. When markets are in a stronger phase, the idea is to try to capture much of the upside by being more exposed to higher risk assets such as equities or emerging market debt. Essentially though, absolute return is a 'go anywhere' approach. As a result, an absolute return strategy can have high portfolio turnover and the income produced tends to be a 'by-product' that will fluctuate through time, rather than being in any way targeted by the investment manager.

In contrast, a relative return approach aims to outperform either:

- a **'composite index'** of stock market-based indices that is broadly reflective of an agreed long-term strategic asset allocation of a portfolio. For example 35% FTSE All Share (representative of UK equities) / 35% FTSE World (ex UK) (overseas equities) / 10% FTSE UK Commercial Property (property) / 15% FTSE Government All Stocks (UK bonds) / 5% 7-day LIBOR (cash); or

- a **'peer group'** benchmark such as the UK Charity Fund Universe (previously provided by the WM but now by State Street) which, as at 31 December 2015, comprised 260 funds with invested assets of nearly £9 billion, allocated as follows: 32% UK equities, 37% overseas equities, 8% bonds, 7% property and 16% cash/alternative investments.

The benchmark for a charity adopting a relative return approach will tend to be biased towards 'real' (inflation protecting) assets such as equities with the aim of ensuring that the real value of the portfolio is maintained over the long-term.

The table below shows the current real (inflation-adjusted) value of £100 invested at the end of 1899 into each of UK equities, UK government bonds (otherwise known as gilts) and cash over the 116 years to the end of 2015. We have used the UK markets for these purposes as there is an extremely comprehensive historical data set, but a similar analysis of the US market (for which there are also long-term returns available) shows a similar picture. The table illustrates that over the long term equities tend to provide significantly more attractive returns than government bonds or cash and that is why this asset class accounts for the majority of most charities' portfolios.

Today's real value of £100 invested at the end of 1899

Asset class	Real value, income reinvested (total return)	Real value, income paid away (capital return)
UK Equities	£28,232	£177
UK Gilts	£454	£0.72
UK Cash	£256	£N/A

Source: Barclays Equity Gilt Study 2016 (data as at 31 December 2015)

The analysis shows how the position changes depending on whether income is reinvested or not. Most trustees will not reinvest their income because they have to spend it on their charitable causes. Alternatively, they will withdraw an amount (comprising income and/or capital gain) broadly equivalent to the income produced if they have adopted a total return approach, which amounts to much the same thing. 'Nominal' assets such as gilts can be observed to provide no capital protection from inflation over time, if the income produced by them is not reinvested. This is because the income that those asset classes produce effectively is their inflation protection. Cash and bonds are therefore far more 'risky' from an inflation perspective than equities over longer periods.

Also of interest is the following table which shows the probability of equities outperforming cash and gilts over different time horizons. The arguments in favour of material equity exposure for long-term investors are indeed compelling.

Probability of UK equity out-performance (data since 1899)

	2 years	5 years	10 years	18 years
Probability of outperforming gilts	68%	72%	79%	86%
Probability of outperforming cash	68%	75%	91%	99%

Source: Barclays Equity Gilt Study 2016 (data as at 31 December 2015)

Trustees that adopt a relative return approach will give their investment manager some latitude around the agreed 'neutral' strategic asset allocation/benchmark to enable them to add value over and above the return produced by the benchmark. For example, in the case of the composite market index detailed earlier, the following ranges might be agreed:

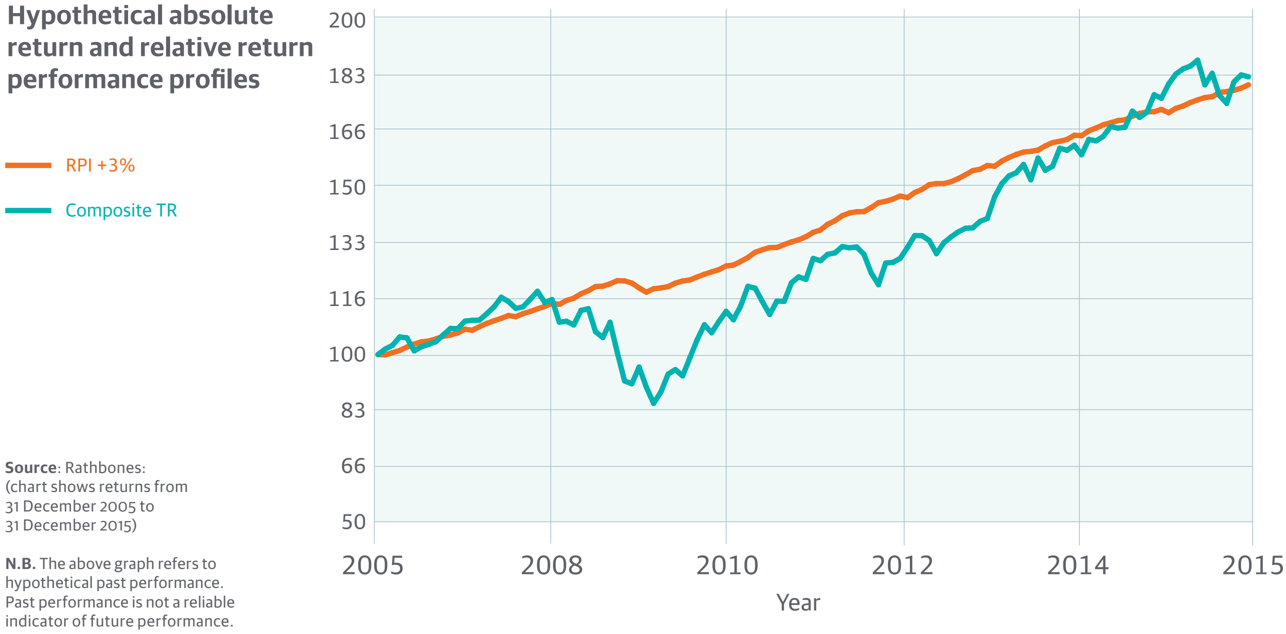
Tactical ranges example

Asset class	Strategic asset allocation	Tactical ranges	Index/ benchmark
UK Equities	35%	25-45%	FTSE All Share
Overseas Equities	35%	25-45%	FTSE World (ex UK)
Property	10%	0-20%	FTSE UK Property
UK Bonds	15%	0-25%	FT Gov't All Stocks
Cash	5%	0-20%	7-day LIBOR
Portfolio	**100%**	**N/A**	**Composite of the above**

An investment manager subject to a relative return benchmark could more easily achieve returns some way away from those achieved by the benchmark if allowed to act in unconstrained fashion. That is one of the reasons trustees typically impose tactical asset class ranges beyond which the investment manager may not stray. The ranges, in effect, help to protect the investment manager (and consequently the charity) from significant underperformance against the benchmark. They also reduce the possibility of the portfolio's real value being negatively impacted by inflation over time.

The chart below illustrates a hypothetical return profile for each approach. An absolute return investor has been represented by RPI +3% (the orange line), while a typical relative return investor is represented by the composite market index (the green line), the constituent components of which were detailed earlier.
The chart covers the period from the start of 2006 to the end of 2015, which encompassed strong equity markets (until mid 2007), and the financial crisis (mid 2007 to early 2009) followed by an equity market recovery. As expected, a typical relative return investor (having a bias to equity), would have performed better during periods of equity market strength. This analysis assumes that both types of investor performed in line with their respective benchmarks, something that would most unlikely be achieved in the real world. Note also that it should not be concluded from this that relative return approaches outperform absolute return over all 10-year periods. For example, the same indices plotted from the start of 2000 until the end of 2009 would have produced the opposite result.

Hypothetical absolute return and relative return performance profiles



Source: Rathbones: (chart shows returns from 31 December 2005 to 31 December 2015)

N.B. The above graph refers to hypothetical past performance. Past performance is not a reliable indicator of future performance.

Why has interest in this subject increased?

For many years, a relative return approach – not that it would have been labelled or even recognised as such – was the norm for many charities, as this sat comfortably with the investment practices and conditions of the time. It is worth asking what changed to initiate the debate that is the subject of this paper.

First, the choices available to investors were much more limited a few years ago. The Trustee Investments Act 1961 (now largely repealed and replaced by the Trustee Act 2000) also restricted what charities could invest in. As a result, a quarter of a century ago, most charities' investment portfolios were allocated almost entirely to UK equities and UK government bonds. Today's charity trustees have an increasingly diverse range of potential investment instruments, asset classes and strategies from which to choose. Corporate bonds, emerging market bonds, overseas equities, derivatives (i.e. any type of investment whose value is linked to the performance of another security) and 'alternative investments' such as hedge funds, absolute return funds, commodities, infrastructure, and private equity are now more mainstream. This huge increase in investment 'technology', as well as much improved computing power, led many investors in pursuit of the 'holy grail', namely a better portfolio risk/return trade-off than had been available to date. Whether that has been achieved remains a matter of debate. Relative return approaches can draw on well over a century of market index data. In contrast we believe there is not a long-enough data set for absolute return approaches to have been proved superior. In any case, there are so many different absolute return investment philosophies and their success is highly dependent on the skills of the manager in question. It is therefore difficult to imagine there ever being a time when one will be able to state that absolute return is superior to relative return in general terms. However, that is not to suggest that such an approach is not a perfectly valid alternative.

Second, two huge equity bear markets in the space of 10 years have also played their part in investors questioning whether it still makes sense to have such a high proportion of a portfolio in equities. The 'dot com bust' from 2000-2003 involved a drop of around 48% in the FTSE World Equity Index from peak to trough, while the financial crisis (2007-2009) led to a 33% fall. This has certainly increased the urgency of the debate.

Absolute return

Aiming for a positive return in all market conditions, the objective being to outperform cash deposits or some measure of inflation by a target percentage over a specified (shortish) time period.

Advantages of an absolute return approach

1. Direct alignment with investment objective

The aim of an absolute return approach is to produce a specified percentage return over a defined time period. The benchmark can be tailored, within the bounds of what is achievable in investment management terms, to meet the precise financial goals of the charity. This contrasts with a relative return approach where a charity aims to outperform a composite index of markets or a peer group benchmark, neither of which is directly related to the charity's own objectives. Having said that, history demonstrates that a relative return approach (assuming it is biased towards real asset classes such as equities) is indirectly aligned with most charities' investment objectives, as equities provide protection from inflation over the longer term, even after income has been withdrawn.

2. Unconstrained

One of the core elements of absolute return investing is its unconstrained nature. The investment manager retains the flexibility to 'go anywhere' to achieve the best risk-adjusted returns in any given market environment. Hopefully a skilful manager can use this flexibility to produce good returns. One feature of many absolute return strategies is the ability to use modern investment tools such as derivatives, including forward contracts, futures, swaps and options. These tools can be used to gain exposure to specific markets or sectors and to mitigate unwanted market risks through hedging. Derivatives can be used to help a portfolio perform more independently of overall 'market direction' and allow investment managers more easily to capture their overall investment view. While many traditional relative return investment strategies are permitted to employ hedging techniques, their use of these tools is not guided by a short-term absolute return goal. An absolute return strategy implements hedging as one of many approaches to achieve a focused objective. However, while derivatives can be a very useful tool, they are not a 'cure-all' that eliminates the risk of market declines. Derivatives can have an out-sized impact on performance and, when the decisions are wrong, this is a risk.

A relative return manager, even if given a great deal of flexibility (e.g. through wide asset allocation ranges), is likely to be influenced to some degree by the weightings of the various asset classes represented in the composite index benchmark that they seek to outperform. They will also be mindful of the sector weightings inherent within the individual markets represented in the composite index. This is because diverging from those weightings too much may risk undue performance variance. An index-based benchmark by virtue of its construction methodology will tend to be overweight to assets that have done well (and therefore could be argued to be overvalued) and underweight to assets that have done poorly (undervalued). For example, the technology sector amounted to around 6% of the US S&P 500 index in 1990; by 1999 this had grown to 28% on the back of the 'dot com boom'. The Japanese index represented c.42% of the FTSE World Index in 1989 after an exceptionally strong run, but is now just 9%. A relative return manager investing globally would have found it difficult not to hold the Japanese equity market in 1989 or the US technology sector in 1999. Both would subsequently have proved to be very poor decisions.

In contrast, an absolute return manager could easily have had no Japanese or technology exposure at those times, as there are no market index components within the benchmark to influence them one way or the other. There is no incentive to make the portfolio look similar to any market index. Instead, there is simply the incentive to avoid the risk of negative returns. The investment manager can, for example, determine when it might be beneficial to have broad diversification across a range of asset classes and when to focus on a handful of areas while reducing exposure to less attractive opportunities.

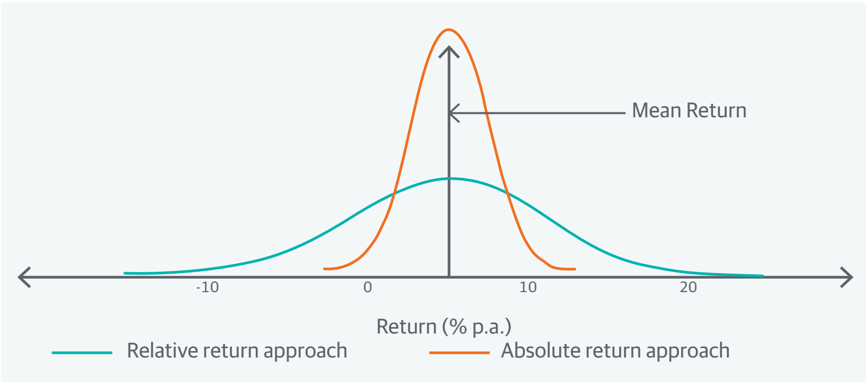
3. Greater certainty of outcome (less volatility) in the short term

By definition, an absolute return strategy is aiming for positive returns in all market conditions. Such an approach should therefore theoretically provide a fairly 'consistent' level of total return with a low probability of an extreme result, assuming the investment manager is performing to expectations (on which see more below). In contrast a relative return approach, which will almost invariably benefit directly from strong equity markets and vice versa, should logically produce a wider potential range of returns in the shorter term, both positive and negative. The hypothetical return profile of both approaches is demonstrated in the chart below.

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

Relative return approach

Absolute return approach

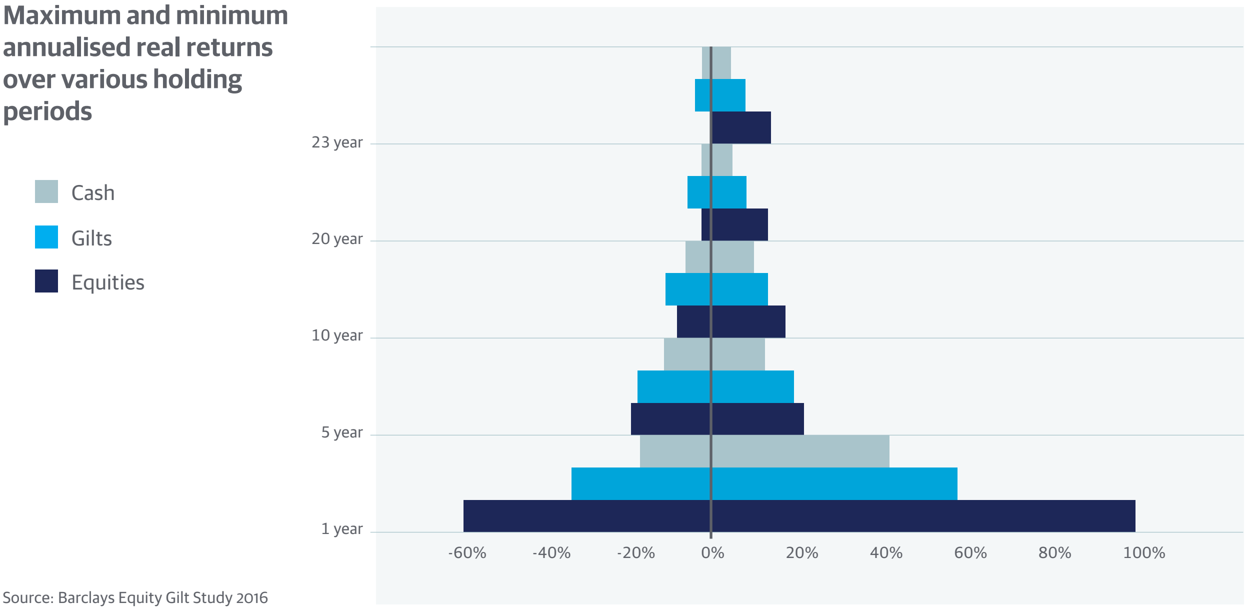


Source: Rathbones

It should be stressed that the above chart is, hypothetically, demonstrating the consistency of returns achieved by both approaches over the short term (by which we mean over, say, three years). However, in the longer term, equities (the major component of most relative return strategies) display a remarkable consistency of return. As a result, the 'fat tails' observed in the chart above for the relative return approach (the green line) converge quickly towards the 'slimmer tails' observed for the absolute return approach (the orange line) over longer time periods.

To evidence this effect, we have shown in the chart below the maximum and minimum real returns over different holding periods during the past 116 years (to 31 December 2015) for UK equities, gilts and cash.

Maximum and minimum annualised real returns over various holding periods



Source: Barclays Equity Gilt Study 2016

Over a one-year holding period, equities have been hugely volatile with a c.160% maximum range of returns observed (the best single year returning c.+100% and the worst c.-60%). It is this short-term volatility of potential outcomes that an absolute return approach seeks to counteract. As the holding period is extended, the variance of equities relative to less risky asset classes such as gilts (and versus an absolute return strategy which itself will often be aiming to produce its returns with bond-like volatility) falls dramatically. For example, over a five-year holding period, the range of annual returns observed for equities is only slightly higher than for gilts, at between - 20% and +20%. When equities are held for as long as 10 years, the range of returns observed for equities is on a par with gilts. As many charities have the luxury of a long-term time horizon (in spite of trustees often being appointed for a relatively short period), there should therefore logically be little need for trustees to become overly concerned about short-term volatility.

4. Consistent capital compounding

One argument sometimes advanced in favour of an absolute return approach is that if (and the word 'if' should be stressed) one can successfully avoid the worst of the down-drafts that markets inevitably deliver from time to time, then a portfolio has to work less hard to drag itself back into positive territory. This effect can be observed in the table below which shows the return that would be required by a portfolio in Year 2 to offset a negative return incurred in Year 1. For example, looking at the right hand column, if the value of a portfolio drops by 50%, then an increase in value of 100% is required to get back to its starting point. So, if one can avoid the down-drafts (an explicit aim of an absolute return approach), one has a better chance of earning good returns over the long run.

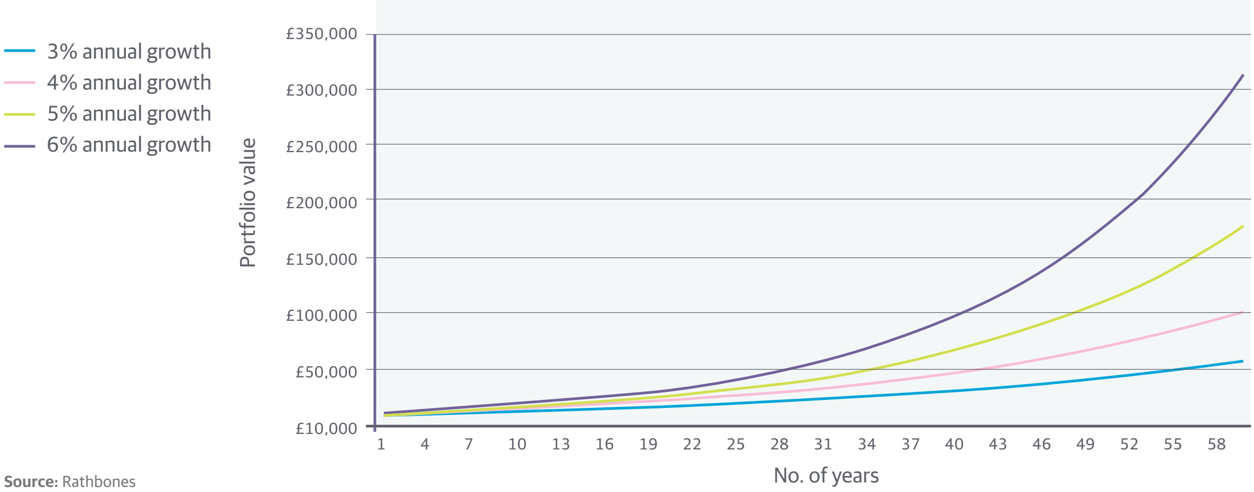
Returns required in year 2 to offset losses incurred in year 1

Year 1	-10%	-20%	-30%	-40%	-50%
Year 2	+11%	+25%	+43%	+67%	+100%

Source: Rathbones

The enormous power of consistent compounding, allegedly described by Albert Einstein as the 'most powerful force in the universe' and the 'eighth wonder of the world', can be observed in the chart below. This shows that a 6% compound annual return produces over five times the cumulative return of a 3% compound annual return over a 60-year period, even though 6% is only double 3%.

The power of consistency

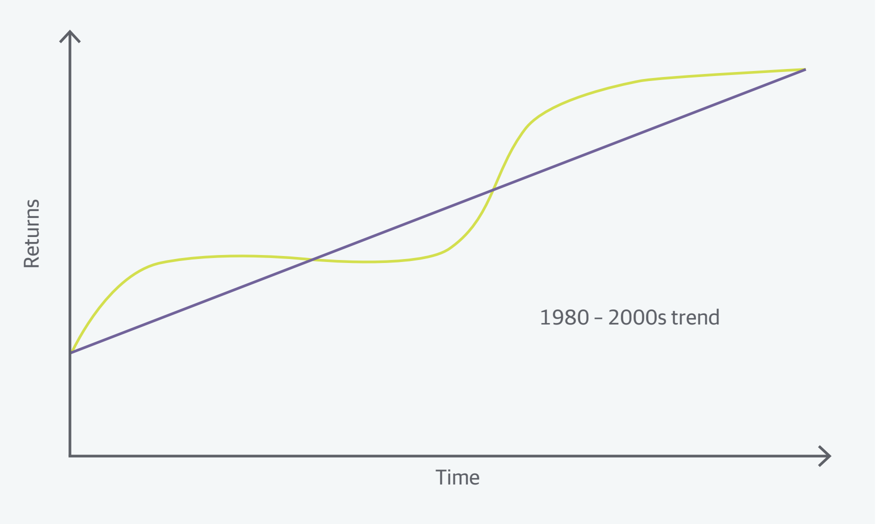


Source: Rathbones

5. Current environment better suited to absolute return investing?

Since the initial phase of the credit crisis in 2008, we believe that we are now in a somewhat different world from that which prevailed for much of the 30 years prior to that. We would argue that we are experiencing a transition to an investment environment characterised by lower returns and possibly greater volatility. The dominant feature of the 1980s, 1990s and early 2000s was falling levels of inflation and consequently lower bond yields, which in turn, via the progressively lower 'discount rates' applied to anticipated future cash flows, supported higher prices for almost all asset classes. With hindsight we believe that a range of trends, including reducing interest rates, globalisation, favourable demographics, deregulation, financial and technical innovation, and ever higher levels of debt coincided to produce an extremely positive environment for asset prices generally. The net result was one of the greatest bull markets that the world has witnessed. Relative return strategies, not surprisingly, worked extremely well in this environment and 'risk' somewhat bizarrely came to be increasingly associated with being 'out of the market', i.e. not owning real assets such as equities, real estate etc., rather than being invested in it.

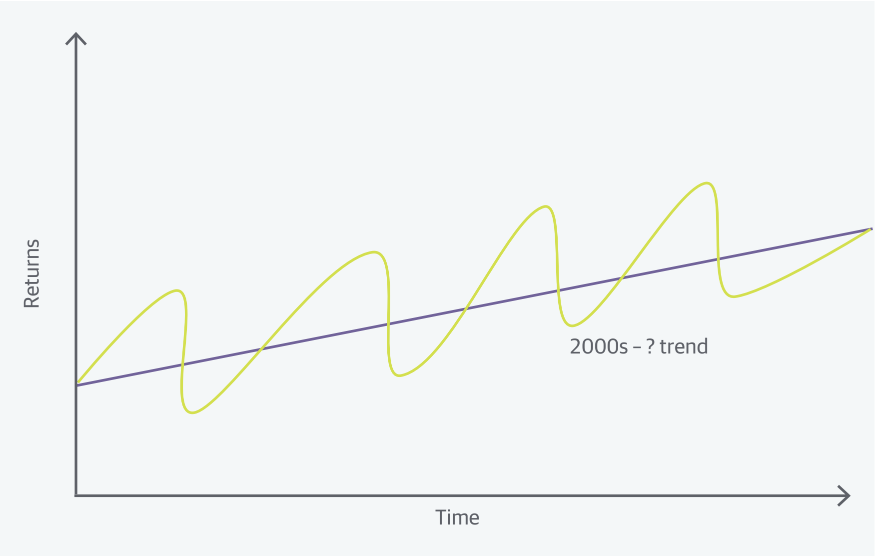
Higher returns, lower volatility



N.B. The above chart is illustrative and intended to be a theoretical representation

It is our contention that we are unlikely to be on the cusp of a major new 'bull phase' for real assets as many of the factors which so strongly supported the markets over much of the past three decades are unlikely to be repeated. Crucially, monetary policy, after eight years of ultra-low interest rates and quantitative easing (which some would contend have raised asset prices artificially) by many of the world's central banks, is close to its limits. We also believe that we are in the midst of an extended period of deleveraging (debt repayment). Policy measures are likely to remain focused on treating the symptoms of over-indebtedness, rather than the root causes. That suggests that interest rates will remain low, thus magnifying the distortions already apparent in the financial system. As a result, we believe that risk will continue to be mispriced. This is a recipe for heightened volatility. This suggests that absolute return strategies designed to preserve capital in weak markets could become more popular with charities and indeed investors generally.

Lower returns, higher volatility



N.B. The chart is illustrative and intended to be a theoretical representation

Disadvantages of an absolute return approach

1. More heavily reliant on 'manager skill'

We have already explained that an absolute return approach tends to impose fewer constraints on an investment manager. This gives the manager the flexibility to invest wherever they see the best potential for returns.

Timing one's entry into, and exit out of, markets (a relatively common feature of absolute return investing) is an extremely difficult thing to achieve on a consistently successful basis. Significant falls in stock markets are also often concentrated in short periods of time. Similarly the biggest gains are often clustered together. Accordingly an investor who tries to aggressively anticipate when the best time is to invest (or not invest) runs a risk of missing the best gains. To help illustrate this, we have detailed below the average annual returns from some of the major stock markets during the period from 1998 to 2013 and shown the impact of missing just a few of the best days. The health of an investment portfolio can be seriously damaged if a small number of 'good' days are missed.

Effect of missing best days – annualised returns over 15 years to end May 2013

Index	Fully invested	Number of best days missed			
		10 days	20 days	30 days	40 days
FTSE All Share	4.7%	0.6%	-2.2%	-4.5%	-6.5%
S&P 500	4.6%	-0.1%	-3.2%	-5.8%	-8.2%
DAX 30	2.7%	-2.6%	-6.3%	-9.4%	-12.1%
CAC 40	3.1%	-2.4%	-6.0%	-8.9%	-11.4%
Hang	9.8%	3.1%	-0.9%	-4.2%	-7.0%

All figures show annualised total returns with net income reinvested in local currency terms. The period covered is from 31 May 1998 to 31 May 2013.

Source: Fidelity

Note that not all absolute return approaches employ aggressive market timing approaches. It tends though to be a more dominant feature of absolute return compared to relative return.

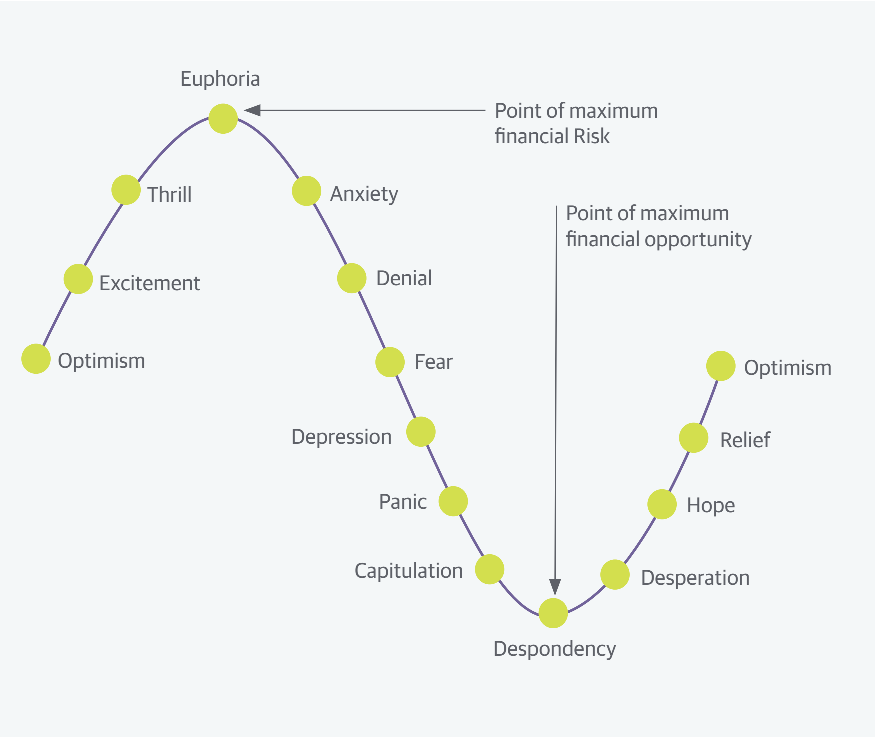
An investment manager employing a relative return approach has some protection from the difficulties involved in market timing automatically built in. There is generally a limited amount of latitude around the agreed 'neutral' benchmark, in the form of the agreed tactical asset allocation ranges. This reduces the risk of not participating in strong phases in markets, but of course increases the risk of falling with the market in periods of weakness. However, as markets tend to go up more than they go down, then this may be seen as an advantage of a relative return strategy over an absolute return one.

2. Tends to underperform relative return in strong markets

In strong market conditions, a relative return manager should capture a great deal of the upside by virtue of being substantially invested in equities at all times (even if underperforming the benchmark). In contrast, an absolute return manager may underperform a relative return manager, as the former has to ensure that the portfolio is constructed with half an eye on limiting the downside if markets were to sell off. Such a scenario may feel uncomfortable for many trustees that have adopted an absolute return strategy, and increasingly so for the longer that markets continue to rise.

This highlights one of the great dilemmas between absolute and relative return investing. It feels good to be an absolute return investor when markets are weak (assuming the investment manager is performing to expectations), but less so when markets are strong. Equally, it feels good to be a relative return investor when markets are strong, but not at all when markets are weak. However, having decided on one approach or the other, trustees should remain disciplined and stick to their chosen strategy (assuming they remain confident about their investment manager). As the chart below illustrates, all investors (even if only subconsciously) go through a range of emotions at different points of a market cycle. As markets peak, investor sentiment runs high and it can feel as though the 'good times' will last forever. This is often the point of maximum financial risk and yet this will be the point at which relative return strategies are in vogue (when in fact the opposite should logically be the case). Similarly when markets have sold off heavily, investors can become overly negative. Absolute return approaches then typically become more fashionable and probably never more so than at what may subsequently prove to have been the point of maximum financial opportunity (which would typically benefit relative return approaches more as markets subsequently rebound).

The roller coaster of investor emotions



3. Less adaptable for constraints/restrictions

We have already discussed absolute return investing in terms of being unconstrained in nature. Any constraints that are imposed, for example in the form of ethical restrictions or perhaps a bespoke income target, will obviously limit the unconstrained nature of such a strategy as the opportunity set of potential investments is reduced. The potential impact of this will depend on the precise restrictions being imposed in each case. By way of example, the most common ethical restriction adopted by charities covers tobacco producers. Such shares have typically displayed defensive characteristics when markets have sold off and, as such, can be useful investments for absolute return managers.

Perhaps of more relevance in this context is the fact that many absolute return strategies are offered in pooled format only (rather than being offered on a segregated or directly-invested basis), so that any constraints, even simple ones that a charity may wish to impose cannot physically be entertained on a bespoke basis. In addition, there are not currently many absolute return pooled funds that have ethical restrictions built in to their mandate.

4. Less compatible with an income-only approach

It can be difficult to utilise an absolute return investment strategy if an income target is set, especially if the income requirement is at all demanding. As mentioned earlier, absolute return approaches tend to be highly responsive to changing market conditions. As a result, an absolute return approach can display high portfolio turnover. The income produced by such a strategy tends to be a 'by-product' of the investment process that will fluctuate through time, rather than being in any way something that is targeted directly by the investment manager. Many hedge funds (typically considered to be absolute return investment strategies) don't even pay a dividend as any income produced by the underlying investments held by the fund is reinvested within the fund (thus increasing the capital value of the units of the fund). It is therefore fair to say that most absolute return strategies are incompatible with a formal income target.

This is less of an issue these days as most charities (even those that are permanently endowed, following recent regulatory changes) are free to adopt a total return approach, enabling them to fund regular portfolio withdrawals from income and capital growth.

5. More expensive

Absolute return approaches can be more expensive than relative return strategies. This is sometimes justified on the basis that it is more complex to manage an absolute return mandate.

6. More complicated

In contrast to many relative return approaches, absolute return managers often use derivative, hedging and/or gearing strategies. These can be more difficult for some charity trustees to understand.

7. Less liquidity

Some absolute return approaches can be more illiquid (less easily bought and sold for cash) than more traditional relative return strategies. For example, certain types of hedge fund became completely illiquid during the financial crisis in 2007 and 2008, resulting in investors not being able to sell their investments and realise cash. This is less of an issue for the more 'vanilla' absolute return approaches that only make use of relatively simple and liquid instruments.

8. Less regulatory protection

Some absolute return strategies (for example, certain hedge funds) are not subject to the same degree of regulation as relative return strategies. Hence there can be less investor protection in place for when things 'go wrong' as well as less transparency. That said, regulatory developments in the UK over the past few years have placed an enhanced set of tools at the disposal of absolute return investment managers, giving them greater flexibility to meet the demands of investors, while still keeping portfolios within the mainstream regulatory framework.

Relative return

Aiming to outperform either a 'composite index' of stock market-based indices, or a 'peer group' benchmark over a specified time period.

Advantages of a relative return approach

The advantages of a relative return approach are largely the 'flip-side' of the disadvantages of an absolute return approach covered previously.

1. Less heavily reliant on 'manager skill'

The benchmark for a relative return investor will tend to be biased towards real asset classes such as equities to ensure that the real value of the portfolio is maintained over time. An investment manager employing a relative return approach has some protection from the difficulties involved in market timing automatically built in, as there will generally be a limited amount of latitude around the agreed 'neutral' benchmark, in the form of tactical asset allocation ranges. This reduces the risk of not participating in the strong phases in markets (but does of course increase the risk of falling with the market when markets are weak). As markets tend to go up more than they go down, then this may be seen as an advantage of a relative return strategy over an absolute return one.

Note that we are not suggesting that relative return managers need little skill to do their job well (unless investing passively, i.e. index tracking). It is clearly important for investment managers to be able to pick stocks that will perform well. But many studies have shown that asset class selection (for example whether to invest in equities or not) has a greater influence on the returns of a reasonably well-diversified portfolio than whether to invest in stock A or B (e.g. BP or Shell).

2. Tends to outperform absolute return in strong markets

A relative return manager should capture a great deal of the upside in strong equity markets by virtue of being substantially invested in equities at all times (even if 'underweight' the equity benchmark weighting). In contrast, an absolute return manager is likely to underperform as the portfolio must always be constructed with half an eye on limiting the downside if markets were to sell off.

3. More adaptable for constraints/restrictions

Relative return strategies are, by definition, inherently subject to some constraints that are ‘embedded’ as a result of the constitution of the benchmark and associated tactical asset allocation ranges. Furthermore they can generally be adapted to cater for bespoke ethical restrictions or income constraints, as these strategies are commonly offered in a segregated/directly-invested format. As observed earlier, many absolute return strategies are offered in a pooled format only. Even if it is possible to find an investment manager who is prepared to run a segregated/directly-invested absolute return portfolio, they are unlikely to be willing to accept too many constraints as this will limit the unconstrained nature of absolute return investing that is so fundamental to the approach itself.

4. More compatible with an income-only approach

A relative return approach can generally be adapted if necessary to meet an income target, in contrast to many types of absolute return approach.

5. Less expensive

Many relative return strategies are cheaper than their absolute return equivalents.

6. Less complicated

Many relative return investors use derivative, hedging and gearing strategies more sparingly than their absolute return equivalents. ‘Vanilla’ (i.e. straightforward) instruments tend to be the order of the day.

7. Better liquidity

Most relative return strategies did not experience liquidity problems in 2007 and 2008 unlike certain absolute return approaches (notably hedge funds). Having said that, potentially illiquid investments such as property funds and even hedge funds can be a component of a relative return strategy.

8. More regulatory protection

Relative return approaches can be more highly regulated than their absolute return equivalents. This leads to better investor protection and more transparency.

Finally, it is perhaps worth adding that it is possible to incorporate an absolute return element into an otherwise relative return portfolio. For example, trustees could specify that part of the composite market index against which returns are measured is allocated to a cash/inflation +x% target. This may serve to increase the diversification of a portfolio and consequently reduce the short-term volatility observed.

Disadvantages of a relative return approach

The disadvantages of a relative return approach are largely the 'flip-side' of the advantages of an absolute return approach covered previously.

1. Indirect (rather than direct) alignment with investment objective

With a relative return approach, a charity is aiming to outperform a composite index of markets, or a peer group benchmark, neither of which is directly related to the charity's own financial objectives. The aim of an absolute return approach, in contrast, is to produce a specified percentage return over a defined time horizon to meet the precise financial goals of the charity. Having said that, history demonstrates that a relative return approach (assuming it is biased towards real asset classes such as equities) is indirectly aligned with most charity's investment objectives, as equities tend to offer protection from inflation over the longer term, even after income has been withdrawn.

2. Constrained (to some extent)

Trustees that adopt a relative return approach will generally give their investment manager some latitude around the agreed 'neutral' strategic asset allocation/benchmark for them to add value over and above the return produced by the benchmark. But relative return managers do not have the same unconstrained freedom that absolute return managers enjoy. A relative return manager, even if given a great deal of flexibility, is likely to be influenced to some degree by the weightings of the various asset classes represented in the composite index benchmark they are seeking to outperform. They must also be mindful of the sector weightings inherent within the individual markets represented in the composite index. In contrast, an absolute return manager has no market index components within the benchmark to influence them one way or the other. Instead flexibility is retained to 'go anywhere' to achieve the best risk-adjusted returns.

3. Less certainty of outcome in the short-term

Relative return approaches are likely to produce negative returns in the short-term if markets are weak, even if the investment manager is outperforming the benchmark. This is because the impact of being invested in equities generally is likely to outweigh any benefits that may be offered by good stock selection (for example, investing in GlaxoSmithKline or in AstraZeneca). As the holding period is extended though, the variance of a relative return approach versus an absolute return strategy falls dramatically.

The issue of short-term volatility highlights one of the problems of marrying a charity with a long-term investment horizon (say 10+ years and often very much longer than that) with a governance structure that employs trustees that will typically only serve for a few years (perhaps five). Trustees need to adopt the 'persona' of the charity they are responsible for, rather than superimposing their own more limited time-frames on investment strategy. Short-term volatility should not be a major concern for charities that are aiming to be in existence in perpetuity.

4. Less effort explicitly made to consistently compound capital

A major feature of most relative return approaches is that there is no explicit mandate to reduce any downside when markets are weak. A relative return manager is not subject to an upward-only target in the way that an absolute return manager is. Having said that, many relative return managers will keep an eye on downside risk, not least because if markets do fall and they have picked stocks that fall less than the market they are being benchmarked against (as a result of having particular 'defensive' qualities) then they will outperform.

5. Current environment less suited to relative return investing?

We previously argued above that investors including charities are experiencing a transition to an investment environment characterised by lower returns and potentially greater volatility. This suggests that absolute return strategies designed to preserve capital in weak markets could become more popular with charities and indeed investors more generally.

Conclusion

Absolute and relative return investing have many different features. It is not possible to state that one is 'better' than the other in the absence of further information about the objectives of a particular investor. Both approaches offer distinct advantages that will appeal to different types of investor. In the end though, while absolute and relative return approaches can produce varying results in the short term, in the long run both are generally aiming to cater for the same broad objective that many charity trustees will be looking to achieve; namely to produce sufficient capital growth to protect against inflation after withdrawals are factored in. In that sense, both approaches are perfectly valid and genuine alternatives.

That said, one of the distinguishing features of charities compared to other types of investor, such as individuals or pension funds, is that many of them have extremely long time horizons, by virtue of the fact that they are perpetual in nature. This should, logically, reduce the need for trustees to focus so much on reducing short-term portfolio volatility. As volatility reduction is one of the key features of absolute return investing, this perhaps makes the argument for absolute return somewhat less compelling for charities than for other types of investor.

Speak to one of our charity investment specialists today to know more about the issues raised in this white paper or Rathbones' services for charities.

Please contact: Andrew Pitt (Head of Charities - London) on 020 7399 0296.

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