Investment Planning Answer Book by Jay L. Shein, Absolute Return Versus Relative Return

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There are two major schools of thought on investment management. One is relative return, and the other is absolute return. Each of these has advantages and disadvantages. The most flexible school of thought is an absolute return focus. Some advisors will find that blending both schools of thought together for portfolio management can be advantageous.

The buy and hold investment strategy has been a disappointment to many financial advisors in recent history such as in 2002 and 2008. Advisors who wish to follow or at least emphasize absolute return investing should consider many investments and strategies on a macro basis. These macro strategies tend to be opportunistic, thematic, and have an understanding of some of the ways to protect portfolios from long negative return periods.

Investment Planning Answer Book by Jay L. Shein, Q 18:1, What are relative returns?

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Relative return is the performance of an investment compared to a benchmark. Relative return would be measured by comparing the investment's actual return to the benchmark. If the investment had a higher return than the benchmark, it would be positive on a relative basis, and if the investment had a lower return than the benchmark, it would be negative on a relative basis. For example, if a large core capitalization stock manager returned an average of 8 percent per year over some long period of time and the S&P 500 (the benchmark for this manager) returned 6.5 percent per year, on a relative basis, the manager did well. Another example is as follows: during some period of time, if the large core capitalization stock manager had a return of −15 percent per year and the S&P 500 had a return of −17 percent per year, on a relative basis, the manager did well. Separate account managers and mutual funds are typically evaluated on a relative return basis. The advisor looking at these investments on a relative basis would expect the manager to have higher returns than their benchmark.

One of the problems with relative returns is that the benchmark or peer group being used for a manager or portfolio may not be appropriate for the manager's investment style or methodology. Relative returns can force a manager to be constrained and remove flexibility to take advantage of opportunities as they are being evaluated against a benchmark that may constrain their decision making process. Another problem is that many investors are uncomfortable with relative return on the downside as it does not help them pay their bills. For instance, a manager returns −8 percent per year over the last five years while the benchmark returned −11 percent per year for the last five years. While the manager did well on a relative basis, the investor may be very disappointed and be unable to maintain their lifestyle or reach their goals such as retirement. Relative return seems to work better for institutions than private investors as the institutions are usually able to wait for a sufficient number of years for a poor performing manager to become a positive performing manager. Private investors tend to get frustrated with relative returns which cause them to buy high and sell low. Private investors have different time frames and different goals than institutions. Those whose mindset is on absolute returns may have a difficult problem staying with an investment philosophy that is predicated on relative returns.

Investment Planning Answer Book by Jay L. Shein, Q 18:2, What are absolute returns?

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Absolute returns are the actual return that an investment asset has over a particular period of time. For instance, if a particular investment or money manager had a return averaging 8 percent per year over the last ten years, the absolute return would be 8 percent per year. Absolute return is what it is; it is not compared to anything. Because absolute returns are just concerned with the actual returns of a particular investment, it differs from relative returns which compare returns to a benchmark or possibly a peer group. An investment that attempts to produce positive returns independent of any benchmark would be considered an absolute return strategy and would typically use techniques or multiple techniques that are different than a more traditional money manager or mutual fund. For instance, an absolute return manager may use options, derivatives, leverage, alternative assets, short selling, or arbitrage techniques.

Investment Planning Answer Book by Jay L. Shein, Q 18:3, Do absolute return managers define risk differently than relative return managers?

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An absolute return manager looks at risk from the perspective of a portfolio's total risk versus a relative return manager who looks at residual risk as their definition of risk. While standard finance theory would suggest looking at the long term when investing, this requires that the investor has a sufficient time horizon to take on a given level of risk. When focusing on absolute return, many investors (especially private investors) may not live long enough to see the results of long-term investing. Someone employing an absolute return strategy is interested in the terminal value of wealth in addition to the variance during the time period for the investor.

The relative return manager is looking to make profits above a benchmark's returns while the absolute return manager is trying to profit regardless of broad stock or bond markets' directions. A relative return manager's focus, unlike that of an absolute return manager, does not have a real incentive to avoid losses. The relative return manager's objective is simply to beat a benchmark. A good absolute return manager may not always avoid negative annual returns but usually attempts to do so. Because relative return managers follow a benchmark, they are sometimes considered a trend follower. One advantage of managers that use benchmarks is that the restrictions imposed upon them can limit the prospective negative or positive surprises.

Investment Planning Answer Book by Jay L. Shein, Q 18:4, What is negative compounding?

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Advisors or consultants that focus on absolute return are trying to reduce or avoid negative compounding. This type of strategy is a true wealth preservation strategy. If portfolios can reduce the effect of negative compounding, preservation of wealth is more likely to be attained. This is especially important when contributions or withdrawals are being made to or from a portfolio. Most assumptions of portfolio returns for long time horizons assume positive annualized returns. Negative compounding can significantly affect these returns as negative years can substantially increase the time it takes to realize the expected positive returns. An example of negative compounding is as follows: if a portfolio drops 50 percent in value, it has to achieve 100 percent positive return to break even. In the following chart, we see how negative returns can make it difficult for a portfolio to recover. Absolute return managers would attempt to avoid this negative compounding effect.

Percent drop in portfolio value	*Positive return needed for portfolio to break even*
10%	11%
15%	18%
20%	25%
25%	33%
30%	43%
40%	67%
50%	100%
60%	150%

Even though the objective of an absolute return strategy is to have capital preservation as a priority, there is never a guarantee that an absolute return manager or portfolio focus will avoid negative compounding.

Investment Planning Answer Book by Jay L. Shein, Q 18:5, What are asymmetric returns?

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Distributions of investment returns that depart from what is referred to as a normal distribution are not symmetrical. Therefore, the returns are said to be asymmetric. Asymmetric returns are what absolute return managers, advisors, and investors look for in an attempt to locate opportunities in the investment arena where the potential for making money is greater than the potential for losing it or where the likelihood of making money is higher than the likelihood of losing an amount of money of the same magnitude or combining these two opportunities. Successful active management is about taking advantage of these asymmetries. The law of active management shows that an investment advisor that has a small amount of information about a lot of different investment opportunities is more likely to succeed than an investment advisor that has a great deal of information concerning a few investment opportunities. For those advisors who seek absolute return or asymmetric return results, it is important that they observe this law of active management.

Investment Planning Answer Book by Jay L. Shein, Q 18:6, Is there evidence of the ability to predict opportunities in advance?

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Advisors and investors are always looking for some method to forecast with a high degree of reliability potential outcomes for investment decisions. Advisors that use an absolute return philosophy for a small portion or a large part of their portfolio management strategy look at both accepted and controversial methods of forecasting to look for investment opportunities. Economic models, statistical models, quantitative models, and technical models have been used, some with greater success than others. One answer to this question can be found in *A Non-Random Walk Down Wall Street.* [Andrew W. Lo and A. Craig MacKinlay, Princeton University Press, 1999] Andrew W. Lo is the Harris & Harris Group Professor of Finance at the MIT Sloan School of Management and the director of MIT's Laboratory for Financial Engineering. A. Craig MacKinlay is the Joseph P. Wargrove Professor of Finance at the Wharton School of the University of Pennsylvania. In this publication, the authors show "that predictable components are indeed present in the stock market." Their research shows that momentum strategies may be useful when looking for investment opportunities.

Many proponents of technical analysis (which looks at patterns and indicators) propose that historical information relative to prices and volume have the ability to assist in forecasting. Advisors who would like to get a perspective from some of the leading technical analysts on its value and methodologies should read *The Heretics of Finance.* [Andrew W. Lo and Jasmine Hasanhodzic, Bloomberg Press, 2009] Besides Andrew W. Lo being a Professor of Finance at MIT, he is the founder and chief scientific officer of AlphaSimplex Group, LLC which is a quantitative investment management company. Jasmine Hasanhodzic is a research scientist at AlphaSimplex, LLC and holds a Ph.D. from MIT's Department of Electrical Engineering and Computer Science. A lot of methods and strategies for managing portfolios on an absolute return basis can be gleaned from studying other successful managers and reading relative research.

Investment Planning Answer Book by Jay L. Shein, Q 18:7, Are absolute return strategies just a form of market timing?

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It is this author's opinion that any investment strategy other than a strictly buy and hold strategy has some element of market timing in it. Those who are proponents of a buy and hold strategy and the Efficient Market Hypothesis (EMH) argue that because the capital markets are efficient, investors cannot outperform and therefore would be best served by a long-term buy and hold approach. These people also believe that the markets are random. This concept that the markets are random has been rejected in the book *A Non-Random Walk Down Wall Street.* [Lo and MacKinlay] There is much evidence today that there are opportunities that can be taken advantage of which are contrary to EMH and the Random Walk Hypothesis.

Managers who take an active approach such as an absolute returns approach do not believe that the capital markets are homogeneous. Some sectors of the market perform better during different time periods than others. For an advisor or investor that can take advantage of these periods of times when certain parts of the market are more opportunistic, they may be able to do better on a risk-adjusted basis. Absolute return advisors may also include some element of timing that being invested in stocks, bonds, or some other asset class or cash. One of the arguments against this type of opportunistic thinking is that missing the best periods of time such as the best ten days or ten weeks out of a ten year period can hurt returns. The other side of this argument is that missing the worse periods of time can usually improve portfolio returns significantly. Missing the best periods and the worst periods usually can improve returns because stocks generally fall faster than they rise.

Buy and hold strategies can be very difficult for the advisor and private investor to hold fast to. Institutional investors seem to have been better at holding on during significant market declines. This approach significantly hurt institutional investors in 2008. A buy and hold strategy seems to always work well in theory but is very hard for many to stick with. The reality is that many private investors cannot resist the panic selling in a severe bear market and will typically buy back after the market moves significantly higher. Advisors may find it difficult to explain to a client why their portfolio is down 40 percent and to advise them to stick to their allocation. An absolute return policy may avoid some of this downside risk. One of this author's clients once stated that he would rather lose a little opportunity than principal. One of the advantages of being opportunistic and focusing on avoiding too much downside compounding is that investors may have higher terminal wealth in the end as they may be able to lower the volatility of their portfolio, especially during times of portfolio contributions or withdrawals.

Investment Planning Answer Book by Jay L. Shein, Q 18:8, What are some themes that advisors can use for investing from recessions to recovery?

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Economies of the world always go through business cycles from recession to recovery, to a peak, back to recession, and then the cycle begins again. A thematic financial advisor might look at investment themes that tend to do well in the different stages of the stock market. There are no guarantees that these will hold true, but they do deserve a macro or absolute return advisor's contemplation.

At the beginning of a bear market, investment advisors might want to consider non-cyclical consumer goods such as food, drugs, and healthcare. As the bear market progresses, utility stocks might be an option. Later in the recession or bear market, financial stocks (e.g., banks and insurance companies) and cyclical consumer goods (e.g., housing, appliances, automobile companies) seem to do well at the last part of a bear market or the beginning of a bull market. Technology and transportation stocks can do well in the early stages of a bull market. Capital goods (e.g., heavy equipment) and basic materials (e.g., copper, steel, paper, and chemicals) are more likely to do well during the middle to late stages of a bull market.

The stock market is usually a leading indicator that will turn up before the business cycle does. Typically, it will also bottom out before the business cycle bottoms. Looking for opportunities in the business cycle is just one of the many strategies considered when a macro-opportunistic approach to investing is being used.

Investment Planning Answer Book by Jay L. Shein, Q 18:9, Does the Adaptive Market Hypothesis (AMH) have practical use?

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The Adaptive Market Hypothesis (AMH) is a new framework that was proposed by Andrew W. Lo in a groundbreaking paper titled "The Adaptive Market Hypothesis: Market Efficiency from an Evolutionary Perspective." [*J. of Portfolio Mgmt,* 30th Anniversary issue, 2004] It gives some interesting information that advisors may find of value when thinking about investment opportunities. In this paper, he implies that because of the changing nature of markets and risk and reward that arbitrage opportunities are available during certain periods of time. New opportunities are frequently being created. He also implies that various investment strategies come and go and may perform well during some situations and not others. Another important implication in this paper is that a more dependable level of expected returns can be achieved by adjusting to altering market conditions.

Investment Planning Answer Book by Jay L. Shein, Q 18:10, Can an absolute return strategy use a tactical approach?

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Tactical asset allocation takes relative value asset pricing into account. It can be used in isolation or to compliment a strategic portfolio. Tactical asset allocation can include over weighting or under weighting certain asset classes including cash and can fit into an absolute return approach. Tactical asset allocation tends to add value by reducing volatility and taking advantage of undervalued or overvalued asset classes. Tactical asset allocation can be considered a type of absolute return strategy.

Investment Planning Answer Book by Jay L. Shein, Q 18:11, What are some good money management rules for absolute return investing?

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One major rule to absolute return money management is to cut your losses. Research in behavioral finance has indicated that investors tend to hold onto their losers too long. Another good rule for absolute return investing is to let your winners or profits run. Research in behavioral finance has shown that investors tend to sell their winners too soon. Obviously, this is a poor strategy. Investment capital needs to have a high probability of growing. If the advisor can reduce their losses quickly and let their winners grow, they can probably be wrong over half of the time and still increase the value of the portfolio. Let's see how this might work for an absolute return advisor. Let's say over a period of time you make 50 different investment decisions and only 20 of those are successful. The advisor would still have reasonable success if their average loss was 6 percent and their average gain was 12 percent. This is why it is important not to sell your winners too soon or hold your losers too long. It is also important not to let an extremely successful investment decision become a losing investment decision.

Investment Planning Answer Book by Jay L. Shein, Q 18:12, How can financial advisors implement absolute return strategies when managing or overseeing portfolios?

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Absolute return strategies or any strategy that has some element of timing (opportunistic investing) in it is not considered appropriate by many advisors and academics. Many in the investment community would suggest a buy and hold strategy or a strategic allocation with rebalancing. If the focus of the advisor is to keep their client's wealth and secondarily to grow it, then some type of absolute return strategy may be appropriate. The controversy surrounding strategic asset allocation and opportunistic types of investing (like absolute return) will probably go on for decades. Advisors can take a stance in one camp or the other or meet somewhere in the middle by adapting the best of both types of thinking.

Advisors that want to adapt both types of thinking can do so in the following manner: part of their portfolio could be managed strategically as a straight buy and hold or a strategic asset allocation with rebalancing; the other part of the portfolio could be more opportunistic employing various strategies and investments in an attempt to reduce the magnitude of negative returns. Using other strategies to manage risk such as but not limited to buying puts, tactical asset allocation, increasing cash positions, diversifying across various asset classes, shorting (and taking positions that are inverse to the markets), can significantly reduce downside portfolio volatility. For advisors who want some absolute return strategies in their client portfolios but want to limit their direct involvement, they can hire various managers (e.g., alternative investment strategies) as part of the allocation to client portfolios. Hiring outside managers will require the advisor to do research and analysis on the managers and to monitor them. Some advisors prefer to be in more direct control than outsourcing absolute return strategies. Other advisors may find it beneficial to outsource some of the absolute return strategies and directly manage others including some risk management strategies. For those advisors who want to take this approach, they will have to seek out additional investment education, read appropriate books, subscribe to additional publications, and stretch their knowledge. An absolute return approach is much more difficult to implement, but for some advisors and their clients, it may be very rewarding.