Seeking solutions: investing in fixed income on an absolute return basis

Joanna Fidling
Director, Local Authorities
Insight Investment

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Financial markets have been on a roller coaster over the last three years and interest rates remain at record low levels. Today, in the face of uncertainties regarding rate hikes, inflation, and the unpredictable actions of governments and central banks, where can investors turn? One solution to consider is an investment approach which invests in fixed income on an absolute return basis.

An absolute return fund is typically designed to deliver the attractive combination of positive returns and lower volatility, irrespective of future market direction. It can provide some level of downside protection given that preserving existing capital is an essential pre-requisite to delivering a positive return. How much protection is provided inevitably depends on the investment approach, the performance objective and the skills of the fund management team. This contrasts with a traditional index-benchmarked fund, which will usually be expected to have a high correlation to the movements of the market it is invested in. Absolute return funds differ from traditional funds in three main ways:

- An investment objective to deliver returns in excess of cash.
- Greater investment flexibility.
- Broader use of investment techniques in order to be able to capture positive returns from both rising and falling markets.

A cash plus objective

In isolation, generating a positive return can be achieved simply by investing in cash. Liquidity funds can provide an attractive and very convenient means of doing this for institutional investors. However, as cash yields remain very low, the majority of long-term investors are seeking a higher return on their capital. Whereas traditional index-benchmarked funds aim to outperform the benchmark index of the relevant asset class, such as the FTSE All-Stocks Gilt index, the objective of an absolute return fund will typically be to beat a reference cash return such as 3 month LIBOR by a specified margin (e.g. 2% p.a.) over a specified time period (e.g. rolling 3 years).

Greater flexibility

Traditional index-benchmarked funds that aim to outperform a particular market will usually be restricted in terms of where they can invest according to the weighting of particular asset classes, countries or sectors within the reference index, with the majority of the fund held in benchmark or near-benchmark assets. In order to be able to generate positive returns, irrespective of market conditions, absolute return funds often have broader, more diverse investment guidelines to enable them to invest in whichever areas of the market they feel the best opportunities lie. This includes the option of having zero or even negative (short) allocations to asset classes or sectors which are unattractive, unlike traditional funds which may be forced to maintain an allocation to such holdings, even if on an underweight basis.

Figure 1: A smoother path to achieve objectives

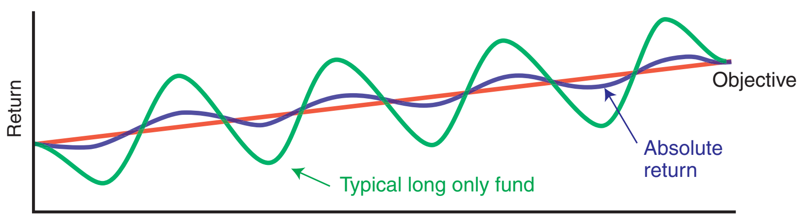
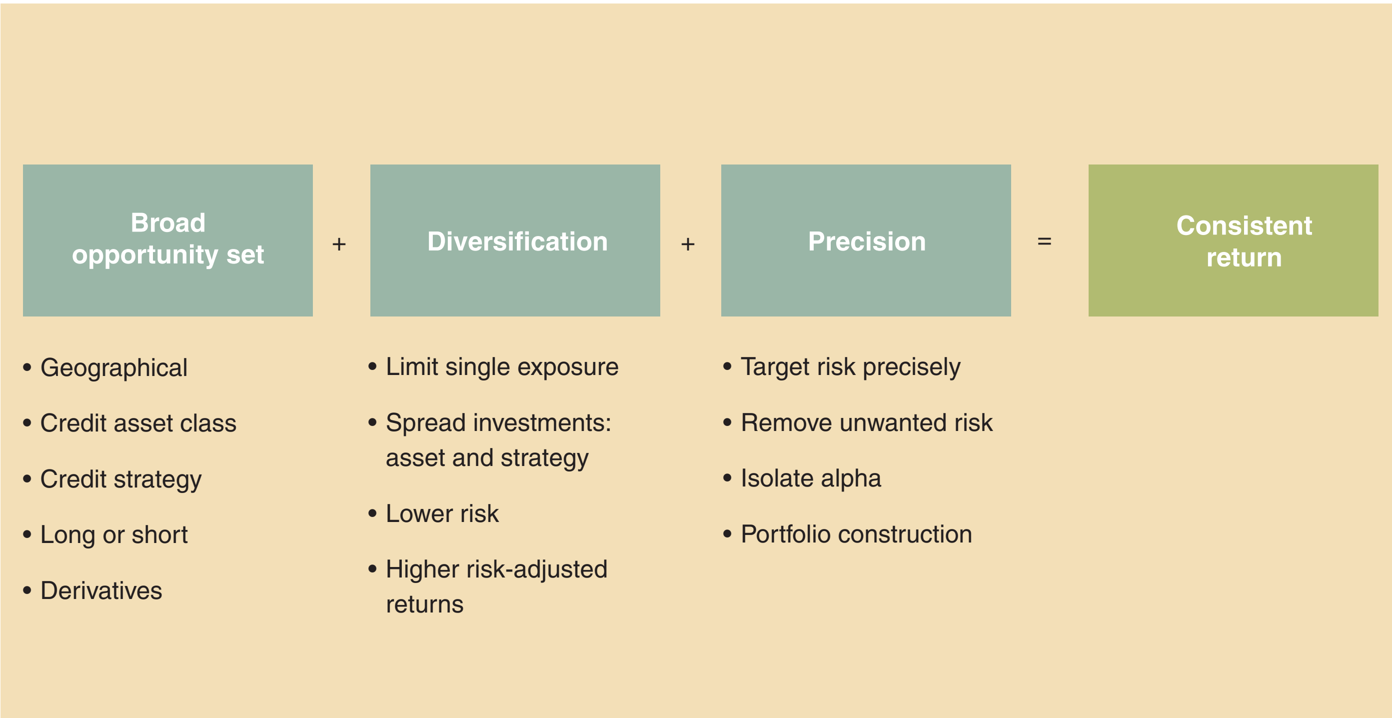


Figure 2: Key investment principles



Enhanced investment tools

In order for absolute return funds to both minimise or potentially eliminate downside risk, and make efficient investment decisions (including creating negative exposure to unattractive assets), they need to have the ability to utilise a much wider 'tool kit' of investment techniques, including derivatives. Whilst the use of some of these techniques is questioned by some, our view is that in the right hands, and within the right risk-management framework, they remain a powerful tool and can both improve risk-management and enhance returns. As well as enabling a fund to take short positions, derivatives can also provide exposure to markets which may ordinarily be prohibitively small or illiquid. It is important to note that such absolute return pooled funds, whilst sharing many of the characteristics of hedge funds, can be set up and regulated in the same way as other institutional pooled funds, providing full transparency in terms of portfolio construction, performance measurement and fee rates.

How Insight can help you achieve your objectives

Insight Investment is a specialist asset manager at the forefront of designing investment solutions to meet our clients' needs. Launched in 2002, we have £108.1 billion in assets under management[1], which includes our absolute return fixed income product range.

Within fixed income, our philosophy focuses on delivering consistent performance by virtue of three key investment principles: broad opportunity set, diversification and precision.

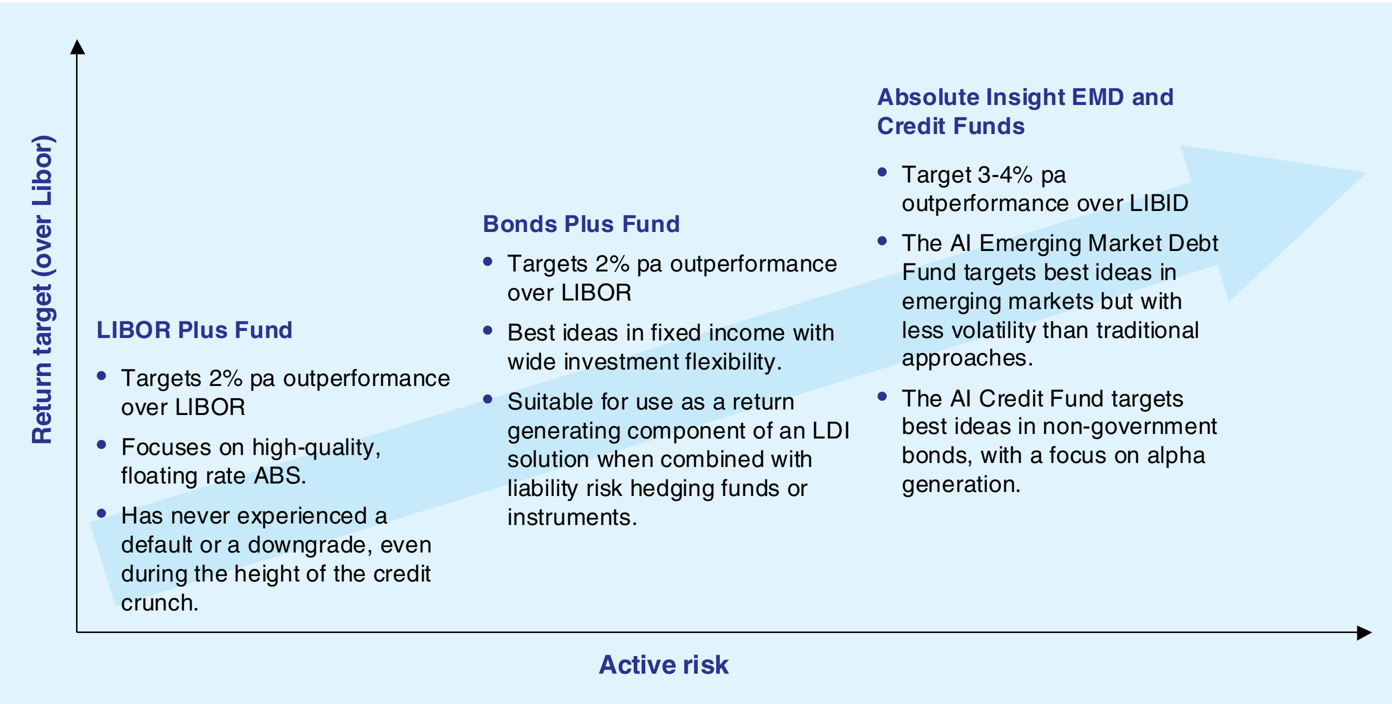
Whilst these concepts, if looked at individually, are not necessarily unique, it is the way our investment managers combine and apply them that we believe is a unique approach to investment management:

- The broad opportunity set gives portfolio managers the flexibility to adjust investment strategy to changing market conditions.
- Diversification across credit strategy and instrument minimises the risk particular to a single entity, lowers volatility and increases risk-adjusted returns.
- We use precision when targeting investments, seeking to add value through the active management of risk and return and using proprietary portfolio construction techniques.

Our experienced fixed income team

We have one of the best-resourced and highly experienced fixed income teams in the UK. Led by Adrian Grey, Head of Fixed Income, our team

Figure 3: Funds at a glance: Insight's fixed income strategy spectrum
Exploiting opportunities for higher returns in fixed income



of 47 fixed income investment professionals has an average of 14 years' industry experience[1]. The team is built on specialist knowledge, experience and proven ability to generate strong performance and is organised by specialisation, including government bonds, corporate bonds, emerging market debt, high yield, loans and asset-backed securities (see Figure 3).

Our solutions

With interest rates at record lows and the outlook for growth and inflation so uncertain, it can be a challenge deciding not only what long-term fixed income investment strategy to pursue, but how to pursue it.

The Insight Investment range includes: the Insight Bonds Plus Fund, the Insight LIBOR Plus Fund, the Absolute Insight Credit Fund and the Absolute Insight Emerging Market Debt Fund.

Please note the value of investments and any income from them will fluctuate and is not guaranteed (this may be partly due to exchange rate fluctuations). For professional investors only, not to be distributed to retail clients.

[1] As at end December 2010