

Monthly Investment Commentary



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Following a rough January for most equity asset classes, February was a welcome turnabout. Domestic stocks gained ground, with the large-cap Vanguard 500 Index up 3.1%, while the iShares Russell Midcap gained 5%, and the small-cap iShares Russell 2000 returned 4.5%. The mid- and smaller-cap benchmarks are now in the black for the year to date (1.5% and 0.6%, respectively), while the large-cap index remains down 0.6%. International stocks (based on the Vanguard Total International Stock Index Fund) were flat for the month, and are still almost 5% in the red for the year so far, but emerging-markets stocks and bonds saw matching 1.1% gains. Year to date, however, the Vanguard Emerging Market Stock Index is down 5.3% while the JPMorgan GBI-Emerging Market Global Diversified Index is up 1.4%. Domestic high-quality intermediate-term and high-yield bonds both eked out gains for the month, adding slightly to the solid gains earned in January (both the Vanguard Total Bond Market Index Fund and the Merrill Lynch U.S. High Yield Cash Pay Index are up close to 2% through the first two months).

Over the past few years we have expanded our research into many different asset classes; one of the areas that we have been recently researching is absolute-return-oriented (ARO) investment strategies. These are strategies designed to generate consistent, mid-single-digit returns in almost any market environment, with relatively low volatility and downside risk, and low correlation to traditional asset classes and risk factors (such as equity risk, credit risk, and interest risk).

Our increase focus on absolute return strategies is driven by several factors:

1. The potential for stock markets to remain in a broad trading range for several years (modest returns)
2. A concern that fixed income markets could enter a “low-grade” bear market; meaning that interest rates gradually rise over the next few years, leading to low total returns
3. The increasing availability of absolute-return-oriented strategies in the mutual fund and ETF space the past few years. Many of the strategies available in this space have an inherent advantage over hedge funds due to significantly lower fees, greater transparency (we can see what they’re doing) and daily liquidity (no lock-ups)

One of our trusted research providers, Litman/Gregory, has done a lot of research on ARO strategies and is allowing us to share some of their finding with our readers. Below is a recent research article written by Litman/Gregory that discusses some of the pro’s and con’s of ARO strategies and how to evaluate them, we hope you find it informative:

Absolute-Return-Oriented Strategies—Research Overview

Litman/Gregory has spent the last 20 years primarily investing in traditional equity and fixed-

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income asset classes, and strategies and fund managers that operate within the boundaries of these asset classes. We have also assessed various “alternative” strategies over the years, and occasionally used them in models, but they have not been our primary focus. We don’t believe alternative investments are necessary for building portfolios that can meet client risk/return objectives. However, over the last year we have expanded and intensified our due diligence on investment managers who run absolute-return-oriented (ARO) strategies due to our assessment that the returns for broad stock and bond indexes over the next five years are likely to be subpar (i.e., below their longer-term averages and not adequate to fully compensate for their potential risks), and therefore that the attractiveness of absolute-return strategies relative to traditional investments has increased.

We also see the potential for a strategic (long term) portfolio role for well-executed ARO strategies in our balanced portfolios. That is, if we identify managers/strategies that we are highly confident can deliver on their return objective with low downside risk and volatility and low correlation to traditional asset classes, then adding them to our portfolios should increase the expected risk-adjusted return.

While adding ARO strategies to a portfolio may seem compelling in theory, we believe the devil is in the details—in evaluating the risk and return characteristics of each type of ARO strategy (there are a wide variety of strategies that fall under the ARO umbrella), each manager’s investment process, and their skill in executing their strategy. And finally, we need to be honest with ourselves about our circle of competence and our ability to reach a high-conviction opinion about such strategies and managers given both the complexity of many of the strategies and our relatively limited frame of reference for analyzing them (certainly as compared to our deep experience in “traditional” manager due diligence).

Among the issues we confront when analyzing ARO strategies and funds are the following:

Lack of Track Record: Many, if not most, of the ARO mutual funds and ETFs that have been introduced over the past couple of years do not have a historical performance track record that can be analyzed to see if the manager was successful in meeting the strategy’s objectives (e.g., JPMorgan Strategic Income Opportunities and PIMCO Unconstrained). A track record is also useful in understanding what kind of performance we might expect in various historical market environments and serves as a basis for questioning the manager about their investment process and their decision-making in those periods. By definition, a new fund won’t have a track record. But in some cases, the manager of the fund may have a track record running a similar strategy in a hedge fund vehicle that they can share with us. This is certainly helpful in assessing a manager’s skill and ability to execute. But, as we discussed in our recent report on AQR Diversified Arbitrage, there may be material differences in the manager’s hedge fund mandate (e.g., use of leverage, risk/return objective, investment uni-

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verse/opportunity set) that limit the usefulness of the data in evaluating the mutual fund.

With some ARO strategies, in place of an actual track record the manager may display back-tested results, i.e., hypothetical returns that the strategy would allegedly have produced had it been in existence for the prior 10, 15, or 20 years. We've seen this particularly on the ETF side. We take such back-tested results with a large grain of salt —almost anyone can come up with a strategy that looks compelling based on back-tested returns. In our due diligence on such funds/strategies, we need to deeply understand what drove those returns in the past and assess whether they are likely to continue going forward.

The bottom line is that without an actual track record, it is more difficult for us to gain the high level of confidence we require in order to make any investment. It doesn't mean we can't get there, but it may take longer and mean that we establish smaller positions in such funds than is our norm. As we wrote in our AQR report: "While our assessment of a manager is always forward-looking, and strong past performance is not predictive in and of itself of strong future performance, the lack of a track record does reduce the ultimate level of confidence we can have in a manager, no matter how positive our qualitative assessment of their process, skill, and ability to execute may be."

Complexity of ARO Strategies: Even for ARO managers that have a historical performance record (such as Eaton Vance Global Macro Absolute Return), the complexity of the strategy and breadth of the investment opportunity set (global, long, short, currencies, bonds, equities, derivatives) creates a much more challenging task for us to analyze and, ultimately, gain conviction. Unlike traditional long-only managers who are focused on a particular asset class (e.g., larger-cap growth stocks or emerging-markets bonds), funds such as Eaton Vance Global Macro and JPMorgan Strategic Income have tremendous latitude in the investments and instruments they may use—some of which may be pretty esoteric—to try to achieve their objectives. And with ARO strategies, risk management is obviously of critical importance, since one is buying an ARO fund with an expectation of limited downside risk/volatility. So we must understand why and how the manager uses various instruments to hedge and manage the portfolio's overall risk. This takes significant due diligence time and effort (as well as significant access to the managers) for us to confidently assess.

Benchmarking: Another hurdle we must overcome in reaching a recommendation for an ARO fund is determining the appropriate benchmark against which to evaluate its performance. (This is a relatively straightforward exercise for traditional mutual funds investing in traditional asset classes.) The benchmark used by most managers of ARO strategies is a short-term risk-free return such as T-bills or LIBOR, with the managers expecting to generate returns anywhere from 200 to 800 basis points above the risk-free return. For the ARO fixed-income funds that we follow (such as FPA New Income, JPMorgan Strategic Income Opportunities, Osterweis Strategic Income, and PIMCO Unconstrained), we have adopted T-bills as

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one of our benchmarks. We also plan to assess the funds' performance relative to the core Barclays Aggregate Bond Index (as measured by the Vanguard Total Bond Market Index, our investable proxy), because we view these ARO fixed-income funds as potentially competing with our core fixed-income exposure within our client portfolios. (Indeed, if one analyzes the long-term performance of PIMCO Total Return—our core investment-grade bond fund—it looks like an excellent ARO fund, generating mid- to upper-single-digit returns with very low volatility and downside risk and low correlation with equities. However, it is highly correlated to interest rates, and in a rising-rate environment we don't expect it to perform as well as in the past, given its limited flexibility to reduce the portfolio's duration.)

Given the very low current T-bill rates, we would probably not invest in any ARO fund unless we had confidence that it would outperform the risk-free rate by a wide margin, say 400 basis points or more. But we need to be flexible in this, and in different interest-rate environments our relative performance expectations versus T-bills and the Barclays Aggregate Bond Index could change.

As another performance benchmark, we will also look at an ARO manager's risk and return relative to its peer group. However, while the ARO mutual fund universe is growing, the vast preponderance of ARO assets are in hedge funds, and there are many well-known problems with the accuracy/reliability of hedge fund indexes (e.g., self-reporting and survivorship bias) in addition to potentially mixing and matching funds with different mandates within a single-strategy category. So we will be cautious in drawing conclusions from such peer-group comparisons.

Role in a Diversified Portfolio—Assessing Risks, Correlations, and Performance in Different Scenarios: Assuming we have gained a sufficient level of confidence in the ability of an ARO manager to achieve their performance objectives, we then confront the question of whether to add the fund to our diversified portfolios. Obviously, in order to fund the ARO position we need to sell existing investments. Because our model portfolios are anchored by their respective 12-month loss thresholds, we need to think carefully about the downside risk of each type of ARO fund across various risk scenarios because the different strategies can be expected to perform differently despite all of them having an absolute-return orientation. This is why it is so critical that we gain a deep understanding from our due diligence of the key fundamental drivers of the fund's returns and the managers' risk management process.

Because we expect equities to outperform bonds, generally speaking, over our five-year tactical investment horizon as well as over the long-term strategic horizon, we would ideally fund an ARO position out of our fixed-income exposure and thereby improve the portfolio's potential return more than if the ARO position was funded out of equities. However, the shorter-term downside risk for bonds is obviously much lower than it is for equities, even if

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one assumes a rising interest rate environment. So we must weigh the potential additional shorter-term risk against the potential improvement in longer-term absolute and risk-adjusted returns.

Additionally, while all ARO funds seek to have low correlations versus traditional asset classes, the degree of correlation and beta will vary across ARO strategies. For example, in our AQR report we noted that the beta between merger arbitrage returns and equities typically increases during periods of sharp equity-market declines, just when you'd most like to have no correlation. On the other hand, other ARO funds/strategies might be expected to have little equity correlation (or beta) in that circumstance.

What's Next?

At CB&T we have done our own due diligence on some of these funds and are comfortable selectively using them and we are currently assessing how these funds might fit within our overall portfolios, weighing their potential contribution to the portfolios' risk/return in various scenarios based on various ways we might fund the new positions. As always, we aim to be methodical and thorough in our analysis—with a particular focus on how we could be wrong—before we make any decisions in this regard. We also continue to do work on new ARO funds/strategies, and we view this as an area of ongoing research focus for us.

- CB&T Investment Team 3/2010

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