Next week, we dive into...
Chinese Equities

Freddie Lait *Economist*

'A melting pot of strategies'

THE ABSOLUTE RETURN SECTOR IS a wonderful melting pot of investment strategies. It has caused little surprise to see the strong growth of the sector, as asset allocators and direct investors alike seek diversified returns in this uncertain market environment.

The diversity of approaches taken by managers within the sector is one of its key strengths. Undeniably, the sector's somewhat opaque name also leads to confusion about precisely what each strategy is trying to achieve, and how they go about it.

We broadly think about the sector as a collection of three sub-sectors: quantitative/systematic, alternative, and traditional. At Latitude Investment Management, we sit firmly in the last category.

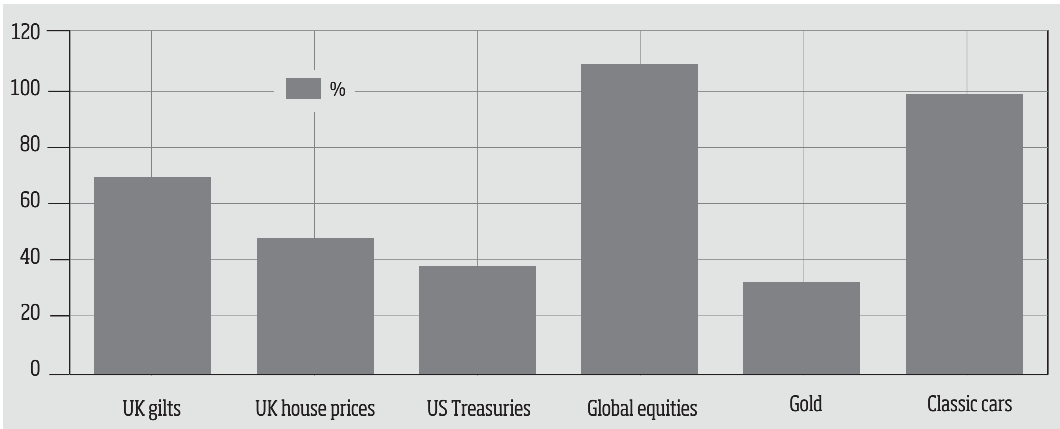
Many funds deploy quantitative or systematic strategies, often using a long-short equity or relative value approach to time markets and generate returns for investors. The benefit is a lower correlation to major asset classes, although the potential for miscalculating risk can lead to sharp drawdowns.

Moreover, these strategies involve frequent trading and portfolio turnover, adding cost and increasing the likelihood that past performance will not be replicable.

These strategies often also involve leverage and options, both of which cost investors through time, and these costs are hidden from the ongoing charge figures used to compare fund charges.

Then, there are those funds using alternative assets to increase returns for their clients. The opportunity to do so has increased dramatically as financial engineers have opened up investments in aircraft leasing, music royalties, catastrophe insurance and more. While these investments offer appealing headline returns, we doubt they will truly diversify a portfolio through the cycle and expect many to have simply benefitted from generally rising markets and falling interest rates, which has repriced the cost of risk. Moreover, these strategies can be highly illiquid and, despite recent headlines, illiquidity is one of the most underappreciated risks in the market right now.

The bull market in everything 2011-2020



13.6%

Increase of interest in TAR funds since Q4 2020 on Square Mile's website

2.6%

Average return of IA TAR fund in 2020

Traditional approaches to managing an absolute return portfolio centre around asset allocation to the major, liquid, asset classes such as bonds, stocks, currencies and commodities. Within this allocation, security selection is absolutely critical in generating long-term outperformance.

While some managers choose to allocate capital to other managers using funds, we invest directly. Using our investment team to select each investment allows us to build more complete risk controls at the portfolio level, as well as gain precise exposure where we choose to for our clients. Not to mention removing a layer of fees.

For example, it is our long-held belief that choosing a diversified portfolio of global stocks from the bottom-up, as opposed to investing according to a given theme, sector or country, gives us greater understanding of our portfolio and a greater chance of sustained strong performance. This is particularly true in the long run. Themes fall out of fashion but quality businesses carry on compounding returns.

> Themes fall out of fashion but quality businesses carry on compounding returns

Using non-equity investments such as gold or inflation-linked bonds to offset downside risk from inflation or macro-economic uncertainty further decreases risk and offers incremental upside for clients when times are tougher.

The traditional model has been overlooked during the heady "bull market in everything" of the past few years, not due to performance, which has been very strong, but to a perception of risk which centres around correlation. We have done a lot of work dissecting asset allocation models which simply use volatility and correlation to measure risk. Suffice to say, they are not fit for purpose at this point in the cycle.

We believe it is highly likely many of the alternative assets of the present will fail to live up to their promises over time. Likewise, when the through-cycle costs of frequent trading, deploying leverage, and buying option "protection" are counted, in many cases they will have eroded any outperformance generated by quantitative funds.

Allocating client capital in a traditional way may sound simple, but it has worked very well through time. While some of the absolute return sector's increasing complexity clearly has merits, we believe that often the greatest ideas are actually the simplest.

Freddie Lait is CIO at Latitude Investment Management

CREDITS