

Absolute Return Bond Guide

Concept

What is an absolute return bond fund?

Absolute return bond funds aim to achieve positive returns for clients in all market conditions regardless of whether interest rates are rising or falling. They can do this by investing in a combination of money market securities, bonds and bond market derivatives.

The new UCITS III regulations have made it possible to offer these groundbreaking funds to private clients and a short explanation of the use of derivatives is provided further on in this guide.

Effectively, the new UCITS III rules opened up a fresh area of opportunity. Previously, the use of derivatives had been limited to efficient portfolio management, such as currency hedging. The UCITS III regulations differentiate between older-type funds that are limited to using 'less sophisticated' derivative strategies, and those able to use 'more sophisticated' ones (ie more flexible derivative strategies). Absolute return bond funds look to make good use of these new investment powers.

Absolute & Total Return

The distinction between absolute and total return

It is important that clients fully appreciate the difference between the concepts of absolute and total return. In our view, the differences are as follows:

Total return funds - these invest so that their return comes from a combination of income and capital growth. A total return fund may often have an index or peer group benchmark.

Absolute return funds - in contrast, these funds aim to preserve a client's capital and consistently to achieve positive returns. Consequently, they are generally measured against cash, thereby having an 'absolute' benchmark.

Both total and absolute return funds can fall in value.

Benefits

Why consider an absolute return bond fund for clients?

In today's low interest rate environment, it is particularly difficult for clients who rely on the income from their savings to generate sufficient returns for their needs. The dilemma facing investors is how to obtain higher returns than those available on bank and building society accounts, without exposing their savings to substantially greater risk.

For clients who prefer a more cautious investment approach, bond investments have traditionally proved more attractive than equities, not only because they have tended to be less volatile but because they can also provide an attractive, regular income. However, in this low interest rate climate, even the yields on bonds are less appealing than they were. Absolute return bond funds represent an innovative solution to this problem.

Absolute return bond funds are likely to appeal to clients who would like to achieve better returns than from traditional cash deposits but with a fairly low risk approach. Even so, it is important for them to remember that there is still a risk of capital loss and volatility, and that unlike bank and building society accounts they may not get back the original amount invested and that some funds are not designed as alternatives to cash accounts.

Clients may even be able to invest in an absolute return bond fund tax efficiently through a stocks and shares Mini or Maxi ISA.

Clients

What type of client could these funds suit?

Absolute return bond funds should prove of interest to a variety of clients with different investment needs who are prepared to take some risk with their capital:

1. For clients wanting higher returns than cash deposits* but with relatively low risk

By aiming for better returns than ordinary bank and building society deposit accounts, absolute return bond funds can help to meet regular commitments, such as school fees, university tuition costs or nursing home charges. They could also represent a conservative option for self invested personal pensions.

*Please remember that absolute return bond funds are not a substitute for cash in a bank or building society account, where the client's money is secure.

2. For clients who want some protection from falling markets

Absolute return bond funds aim to achieve positive returns for investors regardless of market conditions, but this is not guaranteed.

3. For clients wanting to diversify their bond or equity portfolios

The performance of absolute return bond funds can be designed to have a low correlation with the overall direction of bond markets, and they may have a lower risk profile than equity funds. In this respect, for clients favouring a more cautious investment approach these funds could be incorporated into their portfolios to further diversify their risk exposure.

These funds could therefore be useful for clients:

- with a medium-term investment horizon- looking for a defensive product in an uncertain bond environment- seeking an asset class whose performance has a low correlation with that of bond or equity markets- favouring an absolute return product rather than an indexed fund- happy to have exposure to derivatives, and looking for instruments than can use both short and long strategies, but in a more regulated environment than a hedge fund

Returns

What types of returns are available?

Absolute return bond funds may have a variety of target returns that may be compared with the interest rates offered on cash. A fund with a large cash or near-cash position and a lower target return will normally have a lower risk profile than one which relies more extensively on the use of bond market derivatives.

How are these returns achieved?

Absolute return bond funds are designed to bring together the fund manager's best ideas from across the full spectrum of bond investments, while at the same time aiming to keep risk at a relatively low level. Absolute return bond funds may also include the use of sophisticated financial instruments known as 'derivatives' requiring specialist investment skills. It is important that companies have the necessary policies and processes in place to help control derivative instruments as they can be used to increase as well as decrease risk.

The manager therefore needs to have efficient tools for monitoring risk on a continual basis. Indeed, in the case of derivatives, an effective risk management strategy is especially vital, as there are additional risks associated with investments in derivatives.

Bond market derivatives enable the fund manager to benefit from price movements in the underlying bonds without necessarily having to physically buy or sell the bonds. A comparatively small outlay for the derivative can therefore result in a much larger exposure to the underlying bonds than could otherwise be achieved for the same sum, so this exposure has to be managed carefully.

One way of controlling the degree of risk taken when managing an absolute return bond fund is to take a series of relatively small derivative positions rather than a few large exposures. This helps to reduce the impact on the fund should a particular strategy prove unsuccessful.

Management

Operational Risk Management

In addition to managing the risks inherent in the derivatives themselves, an absolute return bond fund will acquire 'incidental' exposure to the risk of default of the counterparty with whom the deal is transacted, and this also needs to be managed. There are industry-standard methods for mitigating this risk.

There are also risks associated with the valuation, administration and settlement of derivatives. Here positions should be marked-to-market and valuations carried out independently. Where practical, quotes from several market makers should be sourced, or if this is not practicable other means should be used to verify that the price supplied by the market maker when a position is marked-to-market provides a reasonable estimate of its underlying value.

Fund Management - What fund management credentials are needed?

To manage this type of fund successfully, it is essential that the fund manager has a thorough understanding and practical experience of the full range of global bond markets and of the derivative instruments based around them.

The manager therefore needs to have considerable knowledge of the major government bond markets, as well as a thorough grounding in the factors driving the smaller, higher yielding emerging markets of Asia, Latin America and Eastern Europe. The manager also needs to have a good understanding of the factors influencing corporate bond markets for both the investment grade and high yield sectors.

It is crucial that the manager has the necessary expertise to accurately gauge the factors driving the performance of these markets. In particular, he needs to be able to access a wide range of economic data to help determine the likely trends in economic growth, inflation and interest rates, which are particularly relevant for government bond markets. For corporate bonds, both the economic and company environment require careful analysis. A successful bond strategy also requires the rigorous assessment of the likely patterns of future supply and demand for the various types of bonds as well as the relative attractiveness of different bond classes.

Indeed, such is the complexity and diversity of today's bond markets and derivatives that it takes a large, well-resourced investment team to make the most of the opportunities available. It is helpful if the fund manager is also able to draw on the specialist expertise of his colleagues. Consequently, it is vital that the company managing an absolute return bond fund has the critical mass to run this type of portfolio. Rigorous controls, such as stop-loss limits and the permissible amount of leverage, are vital tools in the management of an absolute return bond fund.

Derivatives

Derivative instruments available to fund managers

Most absolute return bond funds make use of derivatives, a term used to describe a variety of futures and options contracts.

A wide range of bond market derivatives is available and the market is growing very rapidly, with new instruments continually being developed. Derivatives tend to be the preserve of highly experienced, professional investors and in the past it has been difficult for ordinary investors to gain exposure to this type of investment. However, the new UCITS III regulations have made it possible to launch funds for private

clients that include investments in derivatives.

We have detailed below some of the types of derivatives that can be used by managers of absolute return bond funds and their potential applications.

Bond market derivatives

Futures

Bond futures contracts are employed as a method to speculate on interest rate changes. A view that interest rates will fall (and bond prices will rise) will be expressed by buying bond futures contracts. Conversely a view that interest rates will rise will be expressed by selling bond futures contracts. A fund manager may also use bond futures contracts to hedge interest rate risk by selling a bond future against a specific asset, or to express a view on the relationship between interest rates of different maturities or currencies.

For example, a view that 5 year interest rates would rise by more than 30 year interest rates could be expressed by selling 5 year bond futures and buying 30 year bond futures. A view that US interest rates would rise by more than UK interest rates could be expressed by selling Treasury (US) bond futures and buying gilt (UK) bond futures.

Options

Options allow for more refined views on how much the market might move in either direction. The effect (negative or positive) of the market moving in the manager's favour or against him, can be greater than it would have been if he owned the underlying security.

For example, if the manager feels that the US dollar is going to weaken against the yen, he could buy a 'put' option, ie an option to sell the US dollar at a specified price in the future (a 'call' option would confer the right to buy). If the dollar did indeed weaken and the manager had an option to sell it at a higher level, then he would be 'in the money' and could sell the option for a much greater price than he had paid for it. If the dollar did not weaken by the time the option expired, then the option would be worthless and the manager could simply take the loss of the price paid for that option, known as the premium.

It should be noted that whilst the above example shows an unlimited gain and a limited loss, there are also cases of futures and options trades where the loss can be unlimited.

Currency Risk and Currency Derivatives

The forward market allows the manager to take a view on what the relative value of a particular currency will be versus sterling in the future, by agreeing a price today at which he will buy that currency at a later date. In this way, the manager can use this contract to hedge a fund's foreign currency exposure back to the base currency. In addition, currency derivatives can be used to take advantage of expected changes in exchange rates between currencies other than the fund's base currency.

For example, the manager could take a long position in the Chinese renminbi if he felt that China's currency was likely to strengthen further, or a long position in the Canadian dollar, if he felt that interest rates could rise against the backdrop of a booming economy. In contrast, the manager could take a short position in a currency that he expects to weaken.

Credit Derivatives

Credit default swaps / iTraxx indices

A credit default swap (CDS) is essentially a transaction that allows the transference of credit exposure to an issuing entity between two parties. Put at its simplest, one party is insuring the other against the risk that the issuing entity defaults. In this way, the buyer of that insurance is taking a view on the creditworthiness of the issuer.

An iTraxx index takes a group of these CDSs and so creates an index that can be bought or sold. This will therefore allow the manager to take a view on how an entire section of the fixed income credit market will perform, without actually owning the underlying securities.

For example, if the manager believes that high yield is likely to outperform other sections of the market, he can trade the high yield index. This allows him to take a view on whether the spread between high yield and other credit markets will narrow or widen. By buying this basket, he is taking a view on the performance of the underlying credits.

Strategies

There are four main investment strategies:

Directional Strategies

Here the manager will take a view on the overall direction of a bond market. Within the portfolio, he can establish long and short positions reflecting his expectations for individual markets after careful analysis of the likely moves in interest rates or currencies.

For example, the manager may wish to establish a long position in short-dated gilts if he felt that the market was being too bearish on UK interest rates.

Factors other than interest rates can also exert a key influence on government bond markets.

For example, in the US potential pension reforms could increase the demand for long-dated US Treasury bonds. The manager may therefore seek to establish a long position in US government bonds if new pension proposals were likely to provide additional support to the market.

Relative Value Strategies

Here the fund manager will look at the relative value offered by different types of bonds. He may therefore go long one government market versus another.

For example, the manager may prefer the prospects for UK government bonds relative to US Treasuries, and therefore 'go long' in gilts. He may also look further afield, when looking at the relative attractiveness of yield spreads. For instance, he may favour the prospects for Australian government bonds over UK gilts if he anticipated that Australian interest rates were likely to fall in relation to UK interest rates.

Yield Curve Strategies

Here the manager will assess the relative merits of bonds from the same issuer but with different maturity dates. He can therefore establish long or short positions in the relevant securities and/or derivatives of the same issuer.

For example, the manager may take the view that the prospects for shorter-dated bonds issued by a given company are better than those at the long end of the market, or vice versa.

It is also possible to take a view of likely movements across the yield curve and adopt positions designed to benefit from either a general flattening or an overall steepening of the curve.

For example, the yield curve for the Euro zone might be expected to 'flatten' on signs of higher interest rates. Generally short-dated bond yields could be expected to rise on the prospect of higher short term interest rates. At the same time, yields for longer maturities could prove steadier as such bonds may benefit from pension fund demand that is less sensitive to the outlook for interest rates. In this instance, the fund manager might 'go short' in short-dated issues, and 'long' in long-dated issues.

Sector Strategies

The difference in yield spreads between the various sectors of the bond markets can vary over time. Therefore, the manager can seek to exploit movements in the spread between bond markets to add value.

For example, non-government bonds could be sold in relation to government bonds if the manager expected the spread between the two asset classes to widen.

Given that the fund manager is not restricted to holding physical investments, instead of purchasing the bonds themselves, he could use derivative trades to exploit the movements in spread between the government and credit markets.

The manager may also take advantage of specific opportunities that arise within any given sector. For example, he may build a long physical position in an attractive new corporate issue that comes to market.

Conclusion

In summary, an absolute return bond fund is able to achieve a broad range of investment strategies. The manager can adopt directional and relative value strategies to exploit expected movements in interest rates, credit markets and currencies. Moreover, the manager is able to implement these strategies through the use of derivatives, as well as direct physical investment in securities, such as government bonds. Indeed, derivatives can often provide a more precise way to express investment views.

A final word of caution

Managers of absolute return bond funds will use a range of techniques to achieve the required returns. Some do so through very active management of the assets of the fund. Others use derivatives entirely. The use of derivatives involves complexities over and above those of traditional funds and consequently requires fund managers with a greater skill set. In short, managers of these new, complex funds need to know exactly what they are doing. This means that before recommending any fund targeting absolute return, you should ask for concrete proof that the fund managers:

- Have a detailed risk management and control process in place and can illustrate that they are able to carry out this process, so as to manage the funds effectively and safely
- Have a sophisticated fund accounting system to price the derivative instruments on a daily basis and to value the fund
- Can prove that they have experience of short/long management
- Are able easily to explain what they are doing with the derivatives they are using

Glossary

Absolute Return Fund

A fund that targets positive investment returns rather than investment returns that are compared to the performance of market indices.

Counterparty Risk

The risk that the other party to a contract will default on their obligations.

ETF

An exchange-traded fund is designed to replicate the return on a specific index. Essentially the ETF trades as a security tracking the performance of an index and just like an index fund it comprises a basket of securities. Ownership of an ETF offers the diversification benefits of an index fund as well as the ability to sell short. As with an individual security, the price of an ETF will vary throughout the trading day.

Gearing

Derivative instruments are said to be 'geared' in that only a proportion of their total market exposure has to be paid to open a position. In the futures market, this proportion is referred to as 'margin' and in the options market it is known as the 'premium'.

Going short, shorting or short selling

This describes the sale of a security that the seller does not own. The seller borrows that security to sell it on. However, the seller is committed to eventually buy back that security at a later stage. The aim of such a technique is to benefit from an expected decline in the price of the security.

Going long

This describes the act of buying a security and holding on to that security. The aim is to benefit from an expected increase in the price of the security.

Gross exposure

This is a measure of how much capital is being deployed by the fund in the markets. This measure is derived by adding a portfolio's long and short positions together. It is different from the net exposure. Money market futures positions can be excluded when calculating the gross exposure.

Leverage

For an absolute return bond fund, leverage can be achieved through the use of derivatives such as futures and options. Leverage is calculated by dividing the Fund's gross global exposure (in excess of its Net Asset Value) by the Fund's current NAV.

Long-Only strategy

This strategy does not eliminate or control the exposure to underlying market movements.

Long/Short

An absolute return bond fund can use this strategy to invest in bond markets by combining long positions with short positions to reduce, but not necessarily eliminate, the exposure to the market. These strategies are therefore somewhat directional and their returns typically exhibit some correlation with the underlying markets.

For an absolute return bond fund, the manager would be able to take long and short positions in areas such as government bonds, currencies and interest rate futures. By definition, a currency trade is always a long/short trade.

The Manager can therefore use this strategy to exploit the relative pricing differentials between two different markets and not necessarily as a means of reducing the level of risk.

Net exposure

This is a measure of how much capital is exposed to market movements. This measure is derived by adding a portfolio's long positions and subtracting a portfolio's short positions.

Stop-Loss measures

Stop-loss limits can be set at a security level, with a view to limiting trading losses. This entails the automatic sale of a security when it reaches a specific price. Stop-loss measures can also be instigated at a strategy level for positions that form part of larger well-defined strategies that in normal circumstances would all be traded together.

Strike price

This is the specified price at which an options contract may be exercised. It is also known as the exercise price.

Details correct as at 30-3-06.

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