

Insights

Understanding Absolute Return Funds

A new type of mutual fund is beginning to attract the attention of global investors. Absolute return funds — a mutual fund that has many of the attractive characteristics of a hedge fund — are beginning to appear on the product roster of some leading-edge financial institutions.

What are these funds and do they make sense in your wealth management plan? Absolute return funds are attractive to many clients because they offer many of the benefits of mutual funds — such as daily liquidity — yet functionally, they perform more like hedge funds, or other alternative investment vehicles.

Absolute return funds seek to produce positive returns over a period of time, regardless of whether the market is up or down. Unlike traditional mutual funds, which are considered relative return products because their performance is measured against a particular benchmark or index, absolute return funds are not measured by or tied to any market benchmark. For example, a mutual fund that is down 5% for the year might still be considered a good performer if, for the same period, the fund's benchmark is down 10%. On a relative basis, the mutual fund outperformed its benchmark. However, for the same time period, the absolute return fund would be considered a good performer only if it delivered a positive return and had low volatility due to aggressive risk management.

Absolute Origins

The absolute return strategy was born in the hedge fund marketplace, where professional investment managers use a variety of hedging techniques, long and short positions, derivatives and leverage to achieve their goals. As a result of regulatory changes in the investment industry in Europe, where the mutual fund families of many large financial institutions are domiciled, investment firms are now able to offer absolute return funds.

For investors seeking the potential for positive returns even in down markets and potential lower volatility through risk management, as well as greater diversification in the alternative investment slice of their investment portfolio, the addition of absolute return mutual funds might be a sound decision.

Absolute Diversification

These funds, which come in a variety of shapes and sizes, focus on alternative asset classes that include currencies, convertible bonds and emerging market debt and include certain derivative investments used to manage risk. Because they tend to perform differently than traditional mutual funds, they provide investors with the ability to achieve greater diversification because they are non-correlated to the broad market. Modern portfolio theory says investments that are non-correlated — that is, they tend to move in opposite directions — are an excellent way to diversify, particularly when the investments are carefully selected with the objective of optimising the overall investment portfolio's performance. For investors who want to hold a portion of their portfolio in alternative investments, absolute return funds can further diversify a portfolio that holds hedge funds only.

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