WASHINGTON TRUST BANK’S USE OF ABSOLUTE RETURN STRATEGIES

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EXECUTIVE SUMMARY

After the severe bear market of 2008, we at Washington Trust Bank began moving away from the traditional diversification practiced by individual investors, which limits investing to stocks and bonds. While we use stocks to produce growth, and bonds to produce income and reduce risk, we, like many institutional investors, use alternatives to broaden diversification and introduce other sources of return. Some of these alternatives include absolute return strategies, which are independent of traditional benchmarks.

Up until now, we have placed the absolute return strategies (except for global macro) in our growth allocation, which has allowed us to hedge equity risk proportionately as the growth allocation increased and the equity risk grew. While this improved risk adjusted returns, it made benchmarking difficult, due to the significantly reduced volatility in our portfolios relative to the benchmark. As a result, comparing performance to the benchmark became more convoluted.

To remove this complexity, we will move all our absolute return strategies to the fixed income allocation. This change will facilitate comparison to benchmarks with the same mix between growth and fixed income assets and enable us to devote a larger portion of the growth allocation to traditional stocks. This research shows that having absolute return strategies as part of the fixed income allocation will continue to improve risk adjusted returns, as it did as part of the equity allocation.

OVERVIEW

Individuals have become accustomed to diversifying their portfolio assets into three main categories: stocks, bonds, and cash. While equities have provided good long-term growth, they are volatile, and although firm-specific risk can be eliminated via diversification, market risk cannot. To reduce market risk, investors have turned to bonds and cash. High quality bonds are much less volatile than stocks and the movement in bond prices is generally not linked to the movement in stock prices. In fact, they often move in opposite directions. As a result, in addition to producing portfolio income, many investors invest in bonds to reduce market risk and portfolio volatility. Cash is often used to provide the same type of stability and risk reduction.
While institutions have been investing in alternative assets for many years, many individual investors have not yet embraced alternatives as an essential diversification tool. One reason for this is the lack of accessibility, having become available only recently through mutual funds. Another reason is their complexity. When we speak of alternatives, we tend to lump all alternatives into a single category, but the movement of alternatives varies significantly. Many — like private equity, hedged equity, and real return strategies — offer different sources of growth for the portfolio but do not reduce volatility. Other alternatives, on the other hand, like absolute return strategies, dampen volatility.

Absolute return strategies strive to produce positive returns regardless of market conditions and are independent from traditional benchmark indices. Many managers of these strategies attempt to produce returns above a risk free rate. Because the movement of these strategies is not tied to the movement in stocks, they can reduce market risk in a portfolio, similar to investing in bonds. And because their movement is also not tied to bonds, they can be added without increasing interest rate risk. This is not to say that investing in absolute return strategies is risk free. These strategies come with their own inherent risk, but the risk and return profiles are different from that of stocks and bonds.

What this research illustrates is that investors can replace a portion of their fixed income assets with absolute return strategies; thereby, reducing volatility and enhancing risk adjusted returns.

**OBJECTIVE**

Today, investors broaden their stock exposure beyond domestic large cap stocks to include mid-caps, small caps, international stocks, and emerging market stocks. The result is that, over time, investors have been able to expand the universe which increases the potential to find uncorrelated assets and improve the benefits of diversification (Booth & Fama, 1992). Although diversification eliminates firm-specific risk, it does not eliminate, nor reduce, systematic (market) risk (Raffestin, 2014).

To reduce equity market risk, investors have turned to bonds and cash. While cash is stable, it generally offers a low yield. Bonds provide higher yields than cash, but are not risk free. However, bonds are usually much less volatile than equities, and therefore act to reduce volatility in a portfolio that includes stocks. The trade-off being: as you increase the allocation to bonds, you reduce volatility but also reduce growth potential.

Unfortunately, the benefits from diversifying equity risk with bonds is variable. During periods when interest rates are rising and equity prices are falling (possibly in response to rising rates), stock and bond prices can be highly correlated. To diffuse volatility, investors can add exposure to alternative asset strategies that go beyond simply holding long positions in stocks and bonds. Research has shown that the addition of these alternative strategies improves diversification effects (Oderda, 2013).

To be sure, alternative asset strategies vary significantly and should not be lumped together. One class of alternatives, absolute return strategies, attempt to provide positive returns regardless of the direction of the market. They have different return and risk profiles from
traditional stocks and bonds and move independently. In addition, during periods when stocks and bonds are moving in tandem (i.e., stocks declining when interest rates are rising), absolute return strategies can provide the systematic risk buffer.

Most long-term investors will experience bullish and bearish market cycles. While growing assets is important during bullish cycles, protecting against loss is equally important in growing wealth during bearish cycles (Lebowitz, 2016). Diversification gains are driven mainly by a well-balanced allocation over different uncorrelated asset classes (Jacobs, Muller, Webber, 2014).

**STUDY**

To determine if replacing a portion of the fixed allocation with absolute return strategies improved overall portfolio performance, we compared the returns, standard deviations, and Sharpe ratios of a straight bond portfolio with that of a portfolio equally divided between bonds and absolute return strategies. The time period for the study was January 1, 2000, through June 30, 2018. We chose the Bloomberg Barclays Intermediate Global Total Return Index to represent a broad based global bond allocation.

To represent absolute return strategies, we chose three of the more common absolute return strategies offered via mutual funds and ETFs: market neutral, managed futures, and global macro strategies.

Market neutral strategies involve going both long and short the stock market at the same time, so your return is principally due to the manager’s ability to buy stocks that will increase in value and short stocks that will lose value, not by the movement in the overall market.

Managed futures describes the category of alternative assets that specialize in using the global futures and options markets for investing. In place of stocks and bonds, managers, or commodity trading advisors (CTA), invest in futures contracts.

Global macro strategies focus on global economies and profit by investing in financial instruments whose prices are most directly influenced by macro events. Accordingly, they participate in all major markets: bonds, currencies, commodities, and equities. Currently, global macro is the only absolute return strategy that we place in the fixed income allocation due to its considerable allocation to bonds.

The data for these three strategies came from the Credit Suisse database.
As illustrated in Exhibit 1, the correlation of these strategies to bonds and stocks is low.

<table>
<thead>
<tr>
<th></th>
<th>Market Neutral¹</th>
<th>Global Macro²</th>
<th>Managed Futures³</th>
<th>Global Stocks⁴</th>
<th>Global Bonds⁵</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Neutral¹</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Global Macro²</td>
<td>0.066</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Managed Futures³</td>
<td>-0.014</td>
<td>0.486</td>
<td>1</td>
<td></td>
<td></td>
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<tr>
<td>Global Stocks⁴</td>
<td>0.279</td>
<td>0.278</td>
<td>-0.019</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Global Bonds⁵</td>
<td>0.058</td>
<td>0.253</td>
<td>0.278</td>
<td>0.226</td>
<td>1</td>
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¹ Credit Suisse Equity Market Neutral Index  
² Credit Suisse Global Macro Index  
³ Credit Suisse Managed Futures Index  
⁴ MSCI ACWI Index  
⁵ Bloomberg Barclays Global Agg Corp Interm Total Return Index

Finally, to examine how the addition of absolute return strategies would affect a portfolio that included stocks, we compared the returns, standard deviations, and Sharpe ratios of a portfolio that had a 50% allocation to stocks and a 50% allocation to bonds with a portfolio that had a 50% allocation to stocks, a 25% allocation to bonds and a 25% allocation to absolute return strategies. As before, the period under study was from January 1, 2000, through June 30, 2018. To represent a broad based global equity allocation, we chose the MSCI All Country World Index.

RESULTS

Exhibit 2 displays the total annualized return, the standard deviation, and the Sharpe ratio for the portfolio consisting of a 50% allocation to absolute return strategies, composed of market neutral, managed futures, and global macro strategies equally divided, and a 50% allocation to global bonds.

<table>
<thead>
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<th>Total Annualized Return</th>
<th>Standard Deviation</th>
<th>Sharpe Ratio</th>
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<tbody>
<tr>
<td>50% Absolute Return Strategies / 50% Bonds</td>
<td>4.44</td>
<td>4.98</td>
<td>0.59</td>
</tr>
<tr>
<td>100% Bonds</td>
<td>3.53</td>
<td>6.35</td>
<td>0.34</td>
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As the exhibit illustrates, the addition of absolute return strategies to an all bond portfolio improved all statistics — the return, the standard deviation, and the Sharpe ratio — considerably. Note that some of the return premium would be lost due to higher fees for mutual fund investors. When comparing fund expense ratios for absolute return strategy funds versus various bond funds, the absolute return strategy fund expense ratios tended to be higher. While expense ratios vary considerably, investors should expect to pay about 0.50% more for absolute return strategy funds versus bond funds. As a result,
the return premium would still exist, but it would decrease by approximately 0.25%.
To be clear, as with any asset class or strategy, there are periods when the diversification benefits wane. There were shorter periods in the study when returns suffered because of the broader diversification. This is no different than the effect of diversification from other asset classes and strategies, such as bonds (Ilmanen, 2003), real estate (Reynolds, 2015), and international stocks (Cloutier, 2018). There are periods when performance will lag. However, in every interval analyzed, volatility was reduced. And after all, diversification is primarily a tool for risk management, not return enhancement.

Finally, Exhibit 3 highlights the performance differential if the portfolio included stocks. The portfolio allocations were split so that 50% of the exposure was devoted to stocks. For the portfolio containing absolute return strategies, this meant the remaining 50% was equally divided between bonds and absolute return strategies. For the portfolio without absolute return strategies, this meant the remaining 50% was allocated entirely to bonds.

<table>
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<tr>
<td><strong>Total Annualized Return</strong></td>
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<tr>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td>50% Stocks / 25% Absolute Return / 25% Bonds</td>
</tr>
<tr>
<td>50% Stocks / 50% Bonds</td>
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As you would expect, given the previous data, for a portfolio that was equally divided between stocks and fixed income assets, the allocation that included absolute return strategies as part of the fixed income allocation provided a better Sharpe ratio, due to producing a higher return and a lower standard deviation through the study period. Again, for mutual fund investors, since absolute return funds generally have higher expense ratios than bonds funds, the return on the portfolio containing absolute return strategies should be reduced. In this case, since absolute return strategies comprise only 25% of the total portfolio, the return benefit should be reduced by approximately 0.125%, which decreases the gain but does not eliminate it.

**CONCLUSIONS**

Historically, investors have diversified their portfolios between two major asset class categories: stocks and bonds. Recently, however, through funds, individuals have been able to invest in a number of absolute return strategies. At Washington Trust Bank, we have used absolute return strategies as an important diversifier in our multi-asset class portfolios. This research has shown that shifting our mix and investing a portion of the fixed income allocation, rather than growth allocation, in absolute return strategies, will continue to improve portfolio performance. Absolute return strategies add diversity, reduce equity risk, and add an additional source of return that has low correlation to bonds and stocks.
REFERENCES


