Investment update
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When all around you are losing their heads

In markets characterised by extreme 'risk on, risk off' volatility, a market neutral strategy, focused on absolute returns, can offer a haven of consistency

Ian Heslop heads OMAM's quantitative strategies team. He joined OMAM in May 2004 and has over 13 years investment experience (9 years quantitative investment experience), including OMAM and BGI.

The team includes specialists in portfolio construction, research and systems development. The investment process is designed to exploit market inefficiencies and is based on a proprietary multi factor return model. The process calculates a forecast return for each stock and the resulting portfolio is optimised in terms of risk, cost and return.

Last year was extremely challenging for global equities. Many investors were wrong-footed in the early months by a series of non-financial events, including natural disasters in Australia and Japan and political unrest in the Middle East and North Africa, which impacted the price of oil. But it was ultimately the successive sovereign debt crises that roiled the eurozone that dominated markets in 2011.

The effect was a 'binary' market, driven by day to day and week to week switches between the extremes of risk on and risk off. It proved an almost impossible market for mainstream fund managers running concentrated portfolios with a significant element of market or 'beta' risk. However you were positioned, the swings were so quick and unforgiving that being on the right side was likely to be more luck than judgement, and unlikely to last for long.

Absolute return is a term covering a broad spectrum of investment strategies but in the worst of the turmoil in 2011, in August, funds in the IMA Absolute Return sector generally did well. Those offering a market neutral approach had the advantage of strategies which at least attempt to reap returns that are separated from market risk. Returns in these types of funds are sometimes criticised for being 'muted' but in the markets we saw in 2011 – and which many expect to continue in 2012 – you have to wonder if that is a bad thing. Market neutral funds do tend to miss the high points, but they also avoid the lows.

At its best, a market neutral absolute return fund will provide consistent positive returns over long periods. According to research we have done at Old Mutual, looking at 5000 randomly generated portfolios based on MSCI World regional indices, an allocation of 10% to market neutral will alter the risk/return ratio. At the extreme, in very high or very low risk portfolios, the ratio remains broadly constant. But in the middle areas of the spectrum, representing portfolios with moderate risk profiles, the market neutral allocation tended to reduce risk while maintaining returns.

Before we look ahead to 2012, it might pay to look in a bit more detail at sources of equity returns in 2011. Our own attribution analyses show a strong bias toward two of the factors core to our process. The first was considerations of 'quality', which dominated returns almost exclusively in July and August. The second was market dynamics, by which we measure changes to share prices. Both of these factors are designed in different ways to help foresee the impact of counter-cyclical events. The eurozone crisis was an excellent example – a macro event, driven by political considerations, which pushed investors into highly defensive positions at a time when global growth was broadly positive.

Looking at returns from the point of view of sectors and industries, we saw a distinct move towards classically defensive sectors in 2011. Performance reflected this, with consumer

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staples and healthcare outperforming the more cyclically exposed industrials and materials sectors. The rotation seen within sectors was if anything even more pronounced and reflected throughout the market. This move from more speculative stocks into those underpinned by solid balance sheet strength – in our view a key definition of 'quality' – actually began early in the year, somewhat ahead of the market commentators' 'mood music'.

Analysis of 2011 returns, however, throws up some interesting and less predictable insights. Consumer discretionary is typically a pro-cyclical sector and one which would be avoided by investors looking for defensive positions. In 2011, consumer discretionary stocks returned -5.6% in aggregate, compared to a return of -6.9% for the index as a whole. This slight discrepancy highlights the very peculiar characteristic of last year's market. Macro events were negative but underlying fundamentals were positive. Overall global growth in 2011 is likely to have been around 4% (according to the International Monetary Fund's September forecast) and this has been reflected in the generally strong financial position of global non-financial businesses.

And indeed, when we look at the constituents of the MSCI World index, we see that some of the companies had excellent returns. One example is Burberry, a well managed UK company able to provide relatively low cost access to good quality branded 'luxury' products in high growth emerging markets. Examples less familiar to UK readers – among many others – are Sega Sammy, pricline.com, Ross Stores and Coach. The point is that (and clearly I say this with the benefit of hindsight), securing good absolute returns in the market of extremes which we saw in 2011, and which we expect to continue to see in 2012, required more than a traditional analysis of 'defensives' and 'cyclicals'. The key was an asymmetric approach, combining sensitivity to macro issues and insight into stock specific 'quality'.

For equity investors, uncertainty is likely to continue for the foreseeable future. The similarity (or correlation) of returns among different asset classes is also likely to remain high, offering investors little in the way of easy answers. In my personal view, pragmatism and diversification will be the keys to successful absolute return strategies in 2012.

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