March 2012 » White paper

Smoothing out the rough patches with absolute return

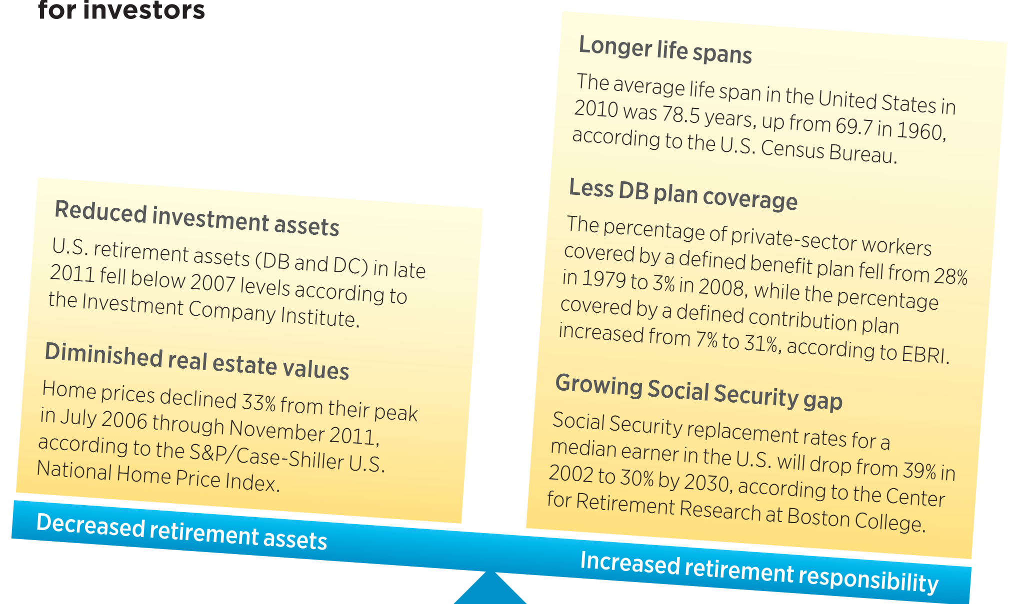
Key takeaways

- Absolute return investing has an established track record as an alternative to traditional relative return strategies.
- To help diversify portfolios, absolute return investing is designed to potentially reduce the impact of flat or declining markets.
- All kinds of investors can use absolute return funds to pursue a range of investment goals.
- Absolute return funds can be used in different combinations for investors with different time horizons.

U.S. investors have had to become increasingly self-reliant in order to fund a larger portion of their retirement income for a longer period of time (Figure 1). Meanwhile, global economic forces have converged to significantly deplete their retirement assets. Whether these circumstances represent the beginning of a "new normal" or simply serve as a reminder of what we always knew could happen, the fact remains that many investment strategies utilized today do not fully address the financial risks that most Americans face.

Though a diversified portfolio of traditional, or relative return, mutual funds has historically allowed investors to accumulate significant retirement savings over long periods of time, many of those already in retirement have become painfully aware of the toll that bear markets can take on their ability to generate a consistent, adequate source of income. The need to preserve assets through varying market conditions to help ensure the ability to meet future liabilities is behind the growing interest in absolute return investing.

Figure 1. Increased retirement responsibility has tipped the scales for investors



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History of absolute return investing

The concept of absolute return investing dates back to 1949, when Alfred Winslow Jones sought to manage a portfolio that could better neutralize market volatility by holding both long and short securities positions. Jones was a contemporary of Harry Markowitz, inventor of Modern Portfolio Theory (MPT), and it can be said that at that point in time, the investment industry diverged to follow two paths. The nascent mutual fund marketplace grew to embrace Markowitz's theory that a diversified portfolio of long-only mutual funds could optimize the risk/return equation, while Jones's absolute return philosophy became the foundation of the modern hedge fund industry. These two approaches peacefully coexisted for more than 50 years, with MPT serving the needs of individual investors, while hedge funds remained the exclusive domain of institutions and high-net-worth investors.

Absolute return strategies, often in the form of hedge funds, are utilized by institutions including foundations and endowments, pension plans, and insurance companies that must accrue assets at a specified rate to ensure their ability to meet future liabilities. This liability-driven investing approach seeks to increase the probability of meeting future liabilities by focusing on minimizing risk versus maximizing return.

Today, there is growing recognition that the needs of individual investors are not so different from those of institutions. However, the idea of adapting absolute return investment strategies for use in the retail market is being met with both optimism and skepticism. While some see it as an innovative way to offer more evolved management techniques to individual investors, others view it as a short-lived product initiative designed to capitalize on current investor fear.

In the minds of many, absolute return investing is inextricably linked to hedge funds. Because of this, it is important to understand how absolute return investing differs from both traditional (i.e., relative return) investing and hedge fund investing.

Differences between absolute return and traditional fund investing

Though 2008 represented the second bear market in less than ten years, it differed from the previous downturn in some very significant ways. The bear market of 2000 served primarily as a cautionary tale on the consequences of moving too far away from the principles of asset allocation. In retrospect, higher allocations to value and fixed-income investments prior to the downturn would have mitigated the losses suffered by many investors. On the other hand, 2008 saw the significant decline of nearly every equity asset class, with no style (i.e., growth, value, or core) or capitalization range (i.e., small, mid, or large) offering any more refuge than another (Figure 2). The year also highlighted that stock and bond markets do not necessarily react independently, with high-yield

Absolute return is:
An investment approach that seeks to deliver a positive return regardless of the market environment
A philosophy that prioritizes the pursuit of consistent growth and preservation of capital over maximization of returns
A strategy that offers the potential for expanded diversification and lower volatility compared with traditional funds
An active management style that is not constrained by traditional benchmark indexes
The utilization of modern tools at a manager's disposal to help reduce risk and enhance return

Absolute return is not:
An implied guarantee of positive returns
A highly leveraged strategy offered exclusively through hedge funds
An approach that can be evaluated against a traditional asset-class benchmark index

Absolute return investing involves certain risks, including the use of leverage and derivatives. Absolute return funds are not intended to outperform stocks and bonds during strong market rallies, and may have limited performance histories.

bonds and municipal bonds also delivering negative performance. Only the assets with the least perceived risk and lowest long-term return potential — U.S. government bonds and cash — delivered positive results.

The differences between these two bear markets provide context when assessing the attributes of absolute return funds and traditional funds. Traditional funds primarily pursue a beta strategy, establishing long-only securities positions and benchmarking their returns and risk exposure to a specified index. Though they are actively managed, their ability to deliver a positive return is unavoidably tied to the secular direction of the market, and they are largely limited to adding alpha through superior security selection.

Alternatively, absolute return funds may pursue a more diversified market exposure, or beta, strategy by providing exposure to more asset classes (e.g., currency, commodities, and precious metals) than traditional funds in order to diversify and to reduce systematic risk. Successful implementation of these strategies requires three elements:

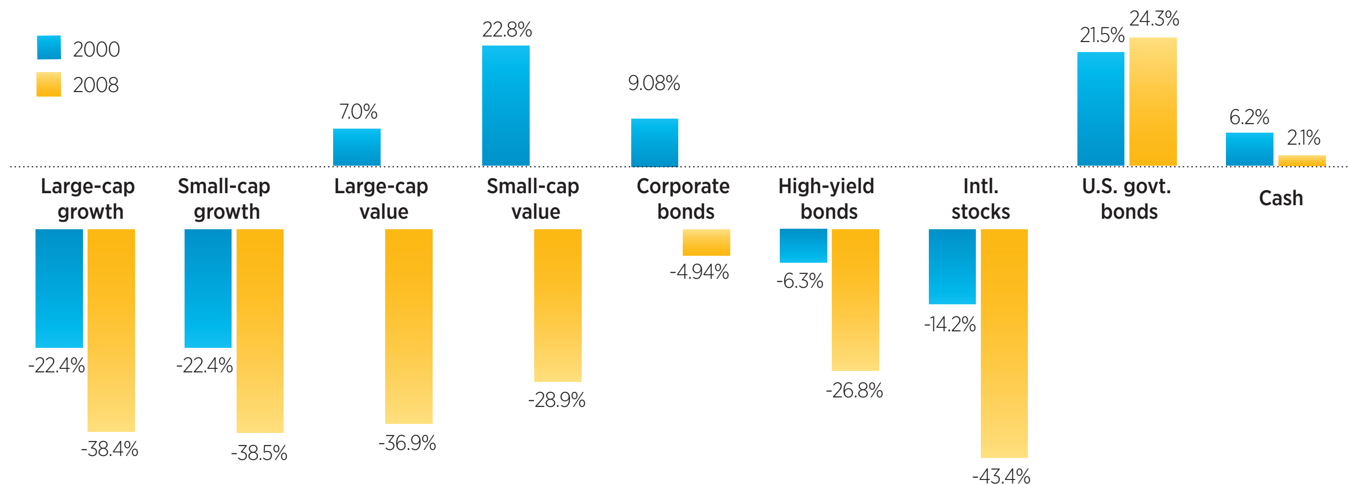
- Asset class flexibility
- Active management
- Use of derivatives for hedging purposes

To distinguish absolute return funds from their traditional counterparts, we contrast the practices of each with regard to asset class usage, management style, and the implementation of hedging strategies.

Asset class flexibility

Although often diversified at some level, the average traditional mutual fund is also constrained by investment parameters that permit managers to invest only in a defined set of securities. These narrowly defined objectives may, for example, confine managers to equities that fall within a specified capitalization range in a single market. However, even funds that traverse boundaries, such as balanced funds and funds of funds, set specific ranges for equity and bond investments, with most limited to investing in mid-to-large-cap stocks and investment-grade bonds.

Figure 2. Two different types of bear markets : Losses were more widespread in 2008



Large-cap growth stocks are represented by the Russell 1000 Growth Index, an unmanaged index of capitalization-weighted stocks chosen for their growth orientation. Small-cap growth stocks are represented by the Russell 2000 Growth Index, an unmanaged index of those companies in the Russell 2000 Index chosen for their growth orientation. Large-cap value stocks are represented by the Russell 1000 Value Index, an unmanaged index of capitalization-weighted stocks chosen for their value orientation. Small-cap value stocks are represented by the Russell 2000 Value Index, an unmanaged index of those companies in the Russell 2000 Index chosen for their value orientation. Corporate bonds are represented by the Barclays Capital U.S. Corporate Index, a broad-based benchmark that measures the investment-grade, fixed-rate, taxable, corporate bond market. High-yield bonds are represented by the JPMorgan Developed High Yield Index, an unmanaged index that measures the U.S. dollar high-yield debt market. International stocks are represented by the MSCI EAFE Index, an unmanaged index of international stocks from Europe, Australasia, and the Far East. U.S. government bonds are represented by the Ibbotson U.S. Long-term Government Bond Index, an unmanaged index used as a general measure of long-term government securities. Cash is represented by the BofA Merrill Lynch U.S. 3-month T-Bill Index, an unmanaged index used as a general measure for money market or cash instruments. Indexes are unmanaged and used as a broad measure of market performance. It is not possible to invest directly in an index. Past performance is not indicative of future results.

Figure 3. Absolute return funds offer increased flexibility

	Traditional balanced fund*	Putnam Absolute Return 500 Fund
Equity range	60%–70%	0–100%
Fixed-income range	30%–40%	0–100%
Equity allocation	Midsize to large companies	No fixed allocation
Fixed-income allocation	Investment-grade bonds	No fixed allocation
International allocation	None	No fixed allocation
Derivative strategies	At manager's discretion	Focused on return targets

* Lipper defines balanced funds as having stock/bond ratios of 60%/40%.

Absolute return fund managers, on the other hand, generally have few limitations on where they can invest. The funds have the ability to move among security types (i.e., stocks, bonds, cash, and alternatives), capitalization ranges, styles, durations, credit qualities, and geographic regions, often without constraints. This flexibility in terms of asset allocation offers the possibility of improved portfolio diversification, since there is a greater variety of potentially non-correlated asset classes. Figure 3 compares the investment policies of an average traditional balanced fund with Putnam Absolute Return 500 Fund, which is designed to replace a balanced fund allocation.

Active management

Most relative return funds are strategically managed and many pursue buy-and-hold investment approaches. Often, these funds are also concerned with maintaining investment turnover and tracking error within a particular range. In fact, some studies suggest that actively managed funds have become less active over time. For instance, a measure known as Active Share[1] indicates that active fund managers have gradually become more passive since the 1990s.

In contrast, many absolute return funds are more actively managed, allowing managers to liberally adjust positions to increase exposure to areas of the market they believe will appreciate, and perhaps more important, to help reduce or eliminate exposure to areas they expect will depreciate. Active management allows absolute return fund managers to utilize their skill and insight into the market to position the portfolio for volatile market and economic conditions.

Implementation of hedging strategies

Many traditional long-only funds have the ability to use derivatives to help manage risk, but they pursue returns with a relatively greater reliance on market risk, or beta, than absolute return funds, which incorporate beta in combination with other return sources. Absolute return funds frequently utilize a variety of derivatives to establish overlays that seek to protect the portfolio from declining markets and improve return efficiency. In addition to tail risk hedging, absolute return strategies target specific risks, such as rising interest rates and the threat of inflation.

- Futures and forwards lock in a certain price for the future, removing the uncertainty of price movements. For instance, a manager might sell Treasury futures to hedge the impact of rising interest rates on a portfolio's long positions in bonds.
- Options give the right to purchase or sell securities at a specified price at a particular point in time. For example, a manager might buy S&P 500 put options to hedge against falling stock prices.

1 Active Share is a measure that compares the holdings of actively managed mutual funds against their most applicable benchmark indices. It was developed by two researchers from the Yale University School of Management, Martijn Cremers and Antti Petajisto. The results of their analysis were presented in a 2007 paper entitled *"How Active is Your Fund Manager? A New Measure That Predicts Performance."*

- Interest-rate swaps exchange fixed-interest payments for floating-rate interest payments based on a notional principal. For instance, a manager might enter into a swap agreement to pay a fixed-interest rate and receive a variable rate.

The potential advantages offered by absolute return funds at the individual fund level can be extrapolated to the portfolio level where they complement allocations to traditional funds. Achieving sufficient diversification using traditional mutual funds can be challenging for ordinary investors during declining markets.

As shown in the correlation matrix (Figure 4) that examines the most recent 3-year period, the domestic equity categories (i.e., large, mid, and small cap) were highly correlated to each other, suggesting there was little diversification benefit to spreading assets among the three capitalization segments. Even healthy allocations to international equities, as represented by the MSCI EAFE Index, would not have provided significant diversification in recent years. Additionally, bonds did not offer negative correlation to large-cap equities, as has historically been the case, with the Barclays Capital U.S. Aggregate Bond Index reflecting a correlation of 0.00 to the S&P 500 for the period 2008 through 2011. Though the correlations between commodities and other asset classes were also higher during this period, they continued to provide superior diversification relative to most other asset classes.

The addition of absolute return funds to a portfolio of traditional funds can provide exposure to more asset classes, such as real estate, commodities, and currencies, than investors might be able to find using individual asset-class-specific mutual funds, thereby helping to enhance diversification of the overall portfolio. Of course, diversification does not assure a profit or protect against loss. It is possible to lose money in a diversified portfolio.

Ability to address specific risks

The use of absolute return funds in conjunction with traditional funds also offers active management of more than just market risk, as managers are continually assessing the economic landscape and positioning the funds to reduce interest-rate, credit, and inflation risks.

Interest-rate risk

Unlike many traditional bond funds whose objectives confine them to a specified duration range, absolute return funds can seek to adjust portfolio duration to the desired level of interest-rate risk.

Credit risk

Absolute return funds can also actively adjust holdings and weightings to manage credit risk. For example, they can seek to keep credit risk low or make allocations to below-investment-grade high-yield bonds to pursue their higher return targets. They can own high-yield securities or credit default swaps to establish risk positioning.

Figure 4. Correlations across asset classes over three years ended 12/31/11

	Large-cap equity	Mid-cap equity	Small-cap equity	International equity	U.S. bonds	U.S. real estate	Commodities
Large-cap equity	1.00						
Mid-cap equity	0.97	1.00					
Small-cap equity	0.95	0.98	1.00				
International equity	0.93	0.89	0.85	1.00			
U.S. bonds	0.00	-0.09	-0.13	0.04	1.00		
U.S. real estate	0.84	0.87	0.85	0.81	0.14	1.00	
Commodities	0.70	0.62	0.61	0.72	-0.11	0.42	1.00

Large-cap equity is represented by the S&P 500 Index, mid-cap equity is represented by the Russell Midcap Index, small-cap equity is represented by the Russell 2000 Index, international equity is represented by the MSCI EAFE Index, U.S. bonds are represented by the Barclays Capital U.S. Aggregate Bond Index, U.S. real estate is represented by the MSCI US REIT Index, and commodities are represented by S&P GSCI. Indexes are unmanaged and represent broad market performance. It is not possible to invest directly in an index.

Inflation risk

Managers also have a number of tools at their disposal to manage the specter of rising inflation, including investments in commodities and currencies.

Beyond offering access to more asset classes, along with progressive risk management, absolute return funds also provide "diversification by philosophy." Absolute return funds seek to navigate the investment universe in an active way that utilizes all the management tools at their disposal. This approach differs significantly from the way most actively managed mutual funds are managed and is diametrically opposed to the way passive mutual funds are managed. However, just as investors diversify their risk across asset classes, incorporating more than one investment philosophy into a portfolio strategy may also serve to mitigate overall risk.

Managing the impact of bear markets

As discussed at the beginning of this paper, volatility can have a dramatic impact on investors in or entering the withdrawal phase. The issue is one of timing. Predicting market and economic conditions at a specified time in the future is nearly impossible. As a result, two investors can employ the same disciplined approach to investing over nearly the same length of time, but have very different retirement experiences depending on when they choose to begin withdrawals. While one may have the good fortune of retiring during a bull market/expansionary period, the other may choose to — or have no choice but to — retire during a down market. The implications of this one factor can be significant.

Often, investors faced with a market decline will add to their misfortune by moving assets into investments that are too conservative just as the market is reaching its trough. The effect is that they are never able to recoup their losses. For instance, if an investor lost 30% in 2008, then moved to an interest-bearing account earning 0.5% annually, it would require 71 years to earn back those losses. Even if an investor simply sat out the year following the downturn — 2009, in this case — he or she would have missed one of the sharpest rebounds in a generation and demonstrably prolonged the time required to recoup losses.

An absolute return approach may help in two ways. First, by seeking to reduce volatility and by implementing hedging strategies, an absolute return portfolio helps to prevent retiree accounts from reaching the depths of traditional accounts during a bear market, thereby making the timing of retirement a less crucial decision. Second, by quickly adjusting to take advantage of market opportunities coming out of a recession, absolute return portfolios can participate partially in the market and economic recovery, while still maintaining low volatility. The result is that if annual returns fall within a narrower range, retirees may be able to maintain a more consistent level of withdrawals.

The ability of active management, in general, to reduce downside risk is adding another layer to the active versus passive debate. Though the results of some empirical studies show that passive strategies outperform active ones over long periods of time, active managers have greater potential to outperform during bear markets versus bull markets. Recognizing the importance of consistency, the discussion, particularly as it relates to retirees, is moving away from an exclusive focus on total accumulation to examining the impact of volatility and the ability of active management to provide downside protection.

Possible uses of absolute return strategies

Absolute return strategies can be used as stand-alone investment options or in conjunction with traditional portfolios to help provide diversification and reduce overall portfolio volatility. As indicated in Figure 5, each of the four Putnam Absolute Return Funds is designed to fulfill a particular type of asset class exposure. For instance, Putnam Absolute Return 300 Fund could serve as a full or partial replacement for an investor's allocation to bond funds.

The following are some examples of how absolute return funds can be utilized and the types of investors for whom these uses might be appropriate.

Stand-alone or core investment option

Due to their ability to invest actively in multiple asset classes, absolute return funds can be used as a stand-alone investment option or as the core of a portfolio.

- A very risk-averse investor who is currently on the sidelines in cash could use Absolute Return 100 Fund to hedge against inflation while gaining modest exposure to fixed-income investments.

Figure 5. Putnam Absolute Return Funds

	Absolute Return 100 Fund	Absolute Return 300 Fund	Absolute Return 500 Fund	Absolute Return 700 Fund
Return target	1% above T-bills	3% above T-bills	5% above T-bills	7% above T-bills
Holdings	Global bonds	Global bonds	Global bonds, stocks, and alternative asset classes	Global bonds, stocks, and alternative asset classes
Alternative to	Short-term securities	Bond fund	Balanced fund	Stock fund

- An investor approaching retirement who wants to reduce volatility but still participate in the market could use Absolute Return 300 Fund as a core investment, supplemented by smaller allocations to various equity and fixed-income asset classes.
- A mid-career IRA rollover investor who doesn't wish to adjust allocations could use Absolute Return 500 Fund in place of a balanced or target-risk fund.
- A young investor just entering the market could use Absolute Return 700 Fund to help provide diversification as assets begin to accrue.

Complement to a portfolio of traditional funds

Recognizing that the strategies utilized by absolute return funds are a departure from how most investors and advisors have historically invested, some may choose to use absolute return funds in smaller allocations to complement existing strategies. What follows are some examples of how absolute return funds can be incorporated into a portfolio of traditional funds to partially fulfill specific exposures.

Investor in retirement

For this investor, who is likely to be predominantly in bond funds, Absolute Return 100 Fund could replace a short-term securities fund, while Absolute Return 300 Fund could fulfill part of the bond allocation.

Investor nearing retirement (5 years from retirement)

This investor may wish to preserve capital, but still benefit from some of the market's upside potential. In this case, Absolute Return 300 Fund could fulfill part of the bond allocation, while Absolute Return 500 Fund could take the place of a balanced fund option.

Investor in mid-accumulation (20 years from retirement)

Though this investor is still several years away from retirement, the market's dramatic decline in 2008 likely reduced assets by one third, depending on the concentration in equities. Wishing to lower risk and introduce more consistency to a predominantly equity portfolio, this investor could use Absolute Return 700 Fund to offset some of the combined exposure to domestic and international stock funds.

Investor beginning accumulation (35 years from retirement)

This investor has the advantage of time to help overcome the market's volatility, and can afford significant weightings in equities. Nevertheless, bear markets or sustained periods of volatility can still damage long-term wealth accumulation. Absolute Return 500 Fund and 700 Fund can help to keep performance on track on a more consistent basis.

Recurring market downturns and the recent economic recession highlight the imbalance between the retirement funding needs of individual investors and the investment strategies utilized in the traditional mutual fund market. The use of absolute return strategies in combination with traditional, relative return investments can help align portfolio objectives with investor goals by seeking to provide a less volatile investment experience through varying market and economic conditions.

Consider these risks before investing: Our allocation of assets among permitted asset categories may hurt performance. Our active trading strategy may lose money or not earn a return sufficient to cover associated trading and other costs. Funds that invest in bonds are subject to certain risks including interest-rate risk, credit risk, and inflation risk. As interest rates rise, the prices of bonds fall. Long-term bonds are more exposed to interest-rate risk than short-term bonds. Unlike bonds, bond funds have ongoing fees and expenses. Lower-rated bonds may offer higher yields in return for more risk. Funds that invest in government securities are not guaranteed. Mortgage-backed securities are subject to prepayment risk. International investing involves certain risks, such as currency fluctuations, economic instability, and political developments. Additional risks may be associated with emerging-market securities, including illiquidity and volatility. The use of derivatives involves additional risks, such as the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. REITs involve the risks of real estate investing, including declining property values. Commodities involve the risks of changes in market, political, regulatory, and natural conditions. Investments in small and/or midsize companies increase the risk of greater price fluctuations. Growth stocks may be more susceptible to earnings disappointments, and value stocks may fail to rebound. Additional risks are listed in the funds' prospectus.

Alpha is a measure of performance on a risk-adjusted basis. Alpha takes the volatility of a mutual fund and compares its risk-adjusted performance to a benchmark index. The excess return of the fund relative to the return of the benchmark index is a fund's alpha. Beta measures volatility in relation to the fund's benchmark. A beta of less than 1.0 indicates lower volatility; a beta of more than 1.0, higher volatility than the benchmark.

Request a prospectus, or a summary prospectus if available, from your financial representative or by calling Putnam at 1-800-225-1581. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

Frequently asked questions about absolute return funds	
How can I evaluate my investment performance without a benchmark?	While absolute return strategies cannot be measured against a benchmark index, they can be directly measured against their stated objective (e.g., 5% above T-bills over three years for Absolute Return 500 Fund), which offers a more concrete way to evaluate success and gauge results against retirement savings and goals.
Why is my investment in absolute return not rising as fast as the market?	It is critical that investors understand that there are trade-offs to absolute return investing. Though absolute return strategies strive for lower volatility than traditional funds and have the ability to deliver positive returns in declining markets, in exchange for this, they are likely to trail their traditional counterparts during market rallies.
Aren't absolute return strategies a lot more expensive than traditional funds?	The answer to this question depends on the competitive landscape. For instance, Absolute Return 700 Fund's class A shares have an expense ratio of 1.39%, making the fund's pricing competitive relative to a sizable percentage of traditional stock funds.
Does the lack of investment constraints mean that absolute return fund managers can take unlimited risk?	In the case of Putnam Absolute Return Funds, the latitude that portfolio managers are given to use many security types and asset classes is designed to help them better manage risk, not to take speculative positions on the directions of the market.
Doesn't the use of derivatives mean that I could lose all of my investment, or more?	Though the use of some derivatives can create leverage, which can magnify investment losses, derivative positions of Putnam Absolute Return Funds are primarily taken to hedge the risk of long positions and to gain exposure to attractive areas of the market, not to leverage returns.