REAL RETURN STRATEGIES: WHAT YOU NEED TO KNOW AND HOW TO USE THEM

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Scott Fletcher, Director, Client Investment Strategies peels back the complexity surrounding these misunderstood investment vehicles

The investor problem on the horizon

There's a lot of talk about the dawn of the 'lower return and higher volatility' investment environment.

We are looking at **lower returns** because, in recent years, the strong performance of equity and fixed income markets has pushed valuations of traditional asset classes into expensive territory. Although this has been great news for investors to date, it creates a problem when we start to look ahead and think about the returns we can expect over the next five years and beyond. The more expensive the asset, the lower the potential upside. Hence, it's no surprise that many fund managers and superannuation plans have been lowering their medium- to long-term return expectations significantly.

At the same time, **higher volatility** is increasingly becoming the new normal. There is a developing disconnect between low levels of monthly market volatility and the increasing frequency of large intra-month drawdowns along the way. Sharp, sudden spikes in volatility occur as markets oscillate between being willing to overlook extreme levels of political uncertainty and then being reminded what's at stake. With increasing political and policy uncertainty and an aging post-GFC economic cycle, the path ahead for investment returns looks anything but 'straight-line'.

This combination of lower returns with higher volatility creates a significant problem for investors. It means they may have to either take on more risk to achieve their same required return or accept a lower return and adjust their goals accordingly. Achieving the same desired return generally means taking on more equity-style risk. This can make investors vulnerable to large drawdowns, eroding long-term compound returns.

For pre-retirees this increases the impact of sequencing risk which can lead to big drops in their retirement savings, if drawdowns occur just as they enter retirement phase, causing dramatic changes to their future lifestyle.

Real return funds as a solution

Real return funds emerged as a solution for investors desiring a smoother path to their investment objective. In other words, the same destination but with a different, less volatile, experience along the way, i.e. less drawdown.

However, these investment solutions are often misunderstood when it comes to their use for financial advisers and their clients, partly because of confusion around their diversity in approach, and origin as a solution for institutional investors rather than retail ones. Appearing around 2003, these products were originally designed in the UK as solutions to manage downside volatility in defined benefit pension scheme surpluses. They then proliferated in response to demand from pension schemes.

But since the 2008 global financial crisis, demand for a 'smoother ride' has drawn these vehicles into the mainstream. As more and more investors have become concerned about volatility, we now have growing numbers of dynamic or multi-asset real return funds in the market place. But many financial advisers still struggle to see how and where they fit in a client's portfolio.

How do real return funds work?

These funds focus on outcome orientated objectives. They are designed for investors looking for steady performance, benchmarked at a certain point above inflation, such as CPI+4%. Importantly, they target this type of return with lower volatility and smaller drawdowns, reducing downside risk through adding diversification, value and dynamic management.

How exactly they do that differs from fund to fund, with a great diversity in approach and usage. Typically, a real return strategy will seek to harness market exposure (also known as 'beta') through the addition of: non-traditional asset classes to provide broader diversification; active, passive or smart beta implementation; more dynamic asset allocation; larger discretionary ranges; or a greater focus on downside limitation.

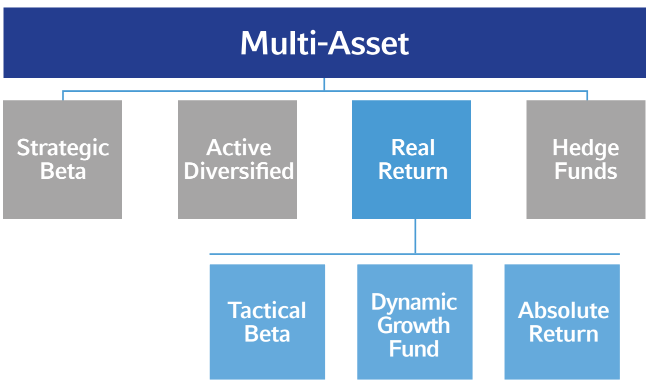
In other words, it's a broad and ill-defined category, which tends to add to the general confusion about these vehicles. Given the diversity of products available, there's a very real danger of comparing 'apples' with 'oranges'.

Real return or multi-asset – which is it?

Real return is a type of multi-asset strategy – sitting alongside strategic beta, active diversified and hedge funds. Real return then splits into three categories:

- **Tactical Beta** – strategic asset allocation, passive implementation with a high degree of dynamic management
- **Dynamic Growth** (DGF) – most aligned to balanced fund portfolios but with a more dynamic allocation and some combination of factor exposures
- **Absolute Return** – a skills-based strategy, more like a hedge fund

Where real return fits in the multi-asset spectrum:



Reducing downside risk is good for advisers and clients alike

Why is addressing volatility important for advisers? Large drawdowns don't just erode long-term compound returns, they also spook your clients. Drawdowns that generate front-page headlines have a disproportionate impact on investors, who are substantially more pessimistic than advisers. Russell Investments conducts a regular survey that asks investors and advisers whether they are optimistic or pessimistic about markets over the next three years.[1] During periods of market volatility, we found investors moving negative while advisers remained relatively positive. This gap is bad for advisers and clients alike. When investors are fearful they are less engaged with their adviser and more likely to 'shop around' or make emotional investment decisions.

Do real return funds work?

Early forms of real return funds have been in Australia for around a decade, though the vast majority of those now available have around five years or so of performance history. Despite this, there is growing evidence that on average they are true to label. The average maximum drawdown is around 20% lower than traditional funds. But there's no free lunch for lower drawdowns.

On the whole, real return funds seem to behave largely as expected. They tend to lag in strong bull markets, keep pace during volatile markets and outperform during market drawdown periods. This performance pattern is consistent with a strategy focused on achieving an outcome at lower volatility – de-risking as assets become more expensive in order to reduce downside risk. Tactical beta and absolute return strategies are the most variable, while dynamic growth fund (DGF) versions have generally provided a more consistent experience – though there is a wide spread of return outcomes in this group also.

[1] Source: Russell Investments, Financial Professional Outlook (April 2016)

How to use real return strategies

Real return funds give your clients access to traditional and non-traditional asset classes – including equities, fixed income, real assets, alternative yield sources, non-directional absolute return strategies and esoteric investment strategies – that may not be accessible to the average investor. Your clients may be interested in the ability of real return funds to give them access to:

› Long- or short-term absolute return strategies that do not depend on the underlying direction of the share market

› Volatility strategies that reduce the funds' reliance on traditional equity risk premia

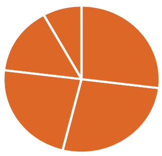
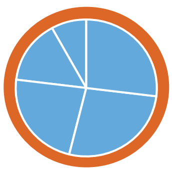
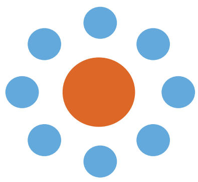
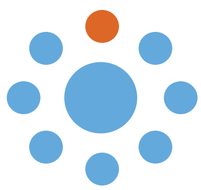
› Robust strategies that invest in quality high-yield credit securities

› Alternative yield sources, such as senior bank loans, that reduce exposure to rising interest rates

› Alternative real assets, such as global listed property, infrastructure and commodities

In an environment where volatility is expected to increasingly become the new normal, many investors – especially those close to or in retirement – have strong preferences for smoother return streams that avoid significant drawdowns and reduce reliance on the equity-risk premium. For these and other downside-sensitive investors, real returns have an important part to play in portfolio construction.

Real return strategies

Strategy	Description	Real return strategy typically employed
TOTAL PORTFOLIO 	For clients nervous of drawdowns, use DGF to aim for smoother path of returns above inflation with investment manager actively managing risk by adjusting asset allocation and portfolio componentry.	› Dynamic growth
RISK CONTROL 	For those pre-retirement or retirees, use DGF and tactical beta to improve the path of returns of a less diversified core that is more susceptible to drawdown risk. Many recently retired Australians suffered heavy losses at a time when they had less chance of recovering, calling into question many of the traditional tenets of investment portfolio construction. Real return funds may offer a solution to this dilemma by allowing investors to remain in the market while improving their chances of achieving their portfolio objectives.	› Dynamic growth › Tactical Beta
CORE 	Use DGF and tactical beta to provide a foundation for a portfolio with a smoother path of returns above inflation with potential to add satellite investments for a more tailored outcome.	› Dynamic growth › Tactical Beta
SATELLITE 	Use absolute return and tactical beta as part of a non-traditional risk control / volatility dampener allocation when you are managing the asset allocation and overall portfolio risk.	› Absolute return › Tactical Beta

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