

# ABSOLUTE RETURN FUNDS

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## Introduction

The description “absolute return fund” is a generic term used to describe a very wide range of funds that utilise non-traditional investment methods. These funds (also commonly referred to as ‘hedge funds’) are private investments and are typically only available to large customers and/or wealthy individuals. Because they are private investment pools, ARF’s are able to operate in a largely unregulated environment, giving managers the ability to pursue more speculative strategies that are otherwise not available to mutual fund managers.

The absolute return fund is not a new concept. In fact, they have been in existence since the early 1950’s. It has only been in the past decade that absolute return funds have seen

widespread use. This is due, in part, to the greater availability of information and increased sophistication of investment techniques.

Amongst the major attractions of the asset class is the ability of absolute return funds to produce consistent positive returns whilst having minimal correlation with the other major asset types. This means that even when bond and equity prices are falling, ARF’s are able to produce positive returns, effectively ‘hedging’ the overall risk within a given portfolio and reducing volatility. Hedge funds can provide valuable diversification for the investor who holds a traditional balanced portfolio of equities and bonds.

## Types of Funds

Absolute return funds vary considerably in terms of the risk involved, level of borrowing or leverage and strategies utilised. There are, however, certain common features that they all share:

- They do not normally limit the scope of their investment activities to outright ownership of securities but rather seek to achieve an absolute return without reference to a benchmark.
- They focus on preservation of capital and seek to secure higher rates of return, adjusted for the risk taken, through the use of hedging techniques.
- Many pursue investment strategies aimed at exploiting mispriced securities without incurring excessive levels of risk.

These strategies have improved over the past decades in line with the mature development of financial futures, options and other derivatives. Consequently, the skill level involved in managing hedge funds is significantly greater than in the management of other asset classes.

Overall, there are at least a dozen distinct investment strategies that can be applied to hedge funds. These, however, can be consolidated into five main categories:

### Long/Short Equities

This type of fund invests in equities and combines ownership of equities with short sales of individual securities or derivatives to reduce the overall market exposure. The majority of funds maintain a bias toward the market, i.e. the market value of the short securities is intentionally greater or

less than the securities owned outright. Some hedge funds, however, prefer not to take this directional market risk and balance the market value of the securities they are short of with the value of the owned securities.

### Fixed Income

Similar to Long/Short Equities but restricted to fixed income securities. In this strategy the managers attempt to take advantage of yield curve or credit anomalies.

### Relative Value Strategies

These funds, whilst often maintaining market-neutral strategies, seek to achieve their objective through exploiting the pricing inefficiencies between related instruments. Examples of specific types of these strategies are:

- a) Convertible bond arbitrage,
- b) Quantitative equity arbitrage,
- c) Fixed income arbitrage,
- d) Mortgage-Backed securities arbitrage.

### Event Driven Strategies

Funds that fall into this category seek to gain from price movements connected to anticipated or announced events. The strategies seek to gain from pricing inefficiencies arising from mergers or acquisitions and are, therefore, often linked to a specific activity in a single or small group of securities.

Whilst not correlated with equity or fixed income markets, these types of funds perform better in strong market conditions. This category would for instance contain funds that utilise the following strategies:

- a) Merger arbitrage,
- b) Distressed securities,
- c) Private equity or small-cap securities.

### Tactical Trading (Macro) Strategies

These funds trade in bonds, equities, precious metals, commodities and foreign exchange with strategies designed to meet the manager's interpretation of global macro-economic factors. Some funds often employ intuitive, opportunistic top-down strategies whilst others rely heavily on quantitative modelling. The results of these funds have often been volatile because of the high level of gearing used.

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There are between four and five thousand absolute return funds and each has its own combination of investment strategy, performance record and risk profile. Similarly each management group has its own level of expertise and bias.

For the potential investor to invest in one fund, dependent upon one strategy, would concentrate the capital and performance risk to an unacceptable degree. A more sensible approach would be to take advantage of the benefits of diversification through a spread of risk achieved by the investment in a number of funds employing different strategies. This "fund of funds" approach is well established and there are a large number of providers with considerable experience.

Thomas Miller Investment offers its own absolute return fund of funds named Gibbs Hill. To find more information on this fund or to read more about the "fund of funds" approach, visit our website at [www.tminvestment.com](http://www.tminvestment.com) or contact us at [invest@thomasmiller.com](mailto:invest@thomasmiller.com).

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