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Where do Absolute Return Funds belong?

As investors have sought refuge from tumbling equity markets, we have witnessed unparalleled growth in the number of absolute return funds available to investors. The idea of absolute return funds is not a new phenomenon – they have been in existence since 1949, when Alfred Jones established the first such fund in the US. They are skill-based funds whose investment returns (alpha) are a function of the manager's particular skill, rather than the return provided by a broader market or asset class. Notwithstanding, the majority of managers operating these funds today have limited track records.

At Orbis, we have been managing absolute return funds for in excess of 13 years and have recently been granted approval by the FSB to offer our Orbis Optimal (US$) Fund to SA investors. Optimal's objective is to make money over the long-term, regardless of the direction of the stockmarket. Orbis Optimal achieves this by investing in our preferred global stocks and at the same time reduces the inherited stockmarket exposure by selling stock index futures short. This combination of stocks and futures leaves Orbis Optimal exposed to the difference in returns between our preferred equities and their respective stockmarkets (plus the returns from cash earned from the futures sold). Simply put, the performance of our Orbis Optimal Fund is driven by our ability as managers to buy stocks that outperform stockmarkets over the long-term.

A client recently asked - why would I include an absolute return fund like Orbis Optimal in my portfolio? Simple answer – by including an asset (fund) that has a low correlation, you can reduce the risk of that portfolio. Further, if you are able to find an asset that also has a high-expected return, you can not only reduce risk, but also increase return.

How is this possible? Overall portfolio volatility (variation of returns over time) is a function of the volatility of the individual portfolio assets, the respective weight of the assets, and the degree to which these assets returns are correlated with each other. When building a portfolio, investors prefer low correlation between the assets since the portfolio's volatility (risk) will be lower than a portfolio whose assets are highly correlated. In the case of a balanced fund, there is not only low correlation between stocks or bonds and cash, but also lower risk. The combination of these three asset classes has the effect of reducing the overall portfolios risk compared with an all-share portfolio. All things equal, it is desirable to include an asset into a portfolio whose returns are not correlated with the existing portfolio's returns. Significantly larger benefits can be attained if in addition to the low correlation, the asset also has high-expected returns.

The table below shows the return and risk statistics for Orbis Optimal Fund, the major asset classes, a typical balanced portfolio of 60% equities, 30% bonds and 10% cash and two hypothetical portfolios. The first hypothetical portfolio is Orbis Optimal being included as an absolute return fund within a balanced portfolio and the second portfolio is using Optimal as a substitute for the bonds and cash element of a balanced fund. Compare the hypothetical portfolios to the other asset classes to see the effects of low correlation and high-expected return on a portfolio.

	Total Returns		Maximum	Annualised	Correlation
	Cumulative	p.a.	Loss	Monthly Volatility	vs World Index
			(since 1 January 1990)		
	%	%	%	%	%
Orbis Optimal (US$)	406	13.3	17	9.9	(0.2)
US$ Bank Deposits	94	5.2	0	0.5	0.0
Average Global Equity Fund	56	3.5	45	12.7	0.9
Average US$ Bond Fund	125	6.4	5	3.3	0.2
Traditional Balanced Portfolio	**82**	4.7	**25**	**7.9**	**0.9**
80% Balanced Portfolio, 20% Optimal	**128**	6.5	**12**	**6.5**	**0.8**
60% Equities, 40% Optimal	**161**	7.6	**15**	**8.4**	**0.7**

Orbis Optimal's low correlation with traditional asset classes, coupled with its potential for superior returns, has been a powerful combination in portfolio construction. Incorporating Orbis Optimal into a typical balanced portfolio would not only have significantly increased the portfolio's return, but also decreased its risk of loss. Orbis Optimal's low correlations with other hedge fund styles also make it a compelling addition to a pure hedge fund portfolio.

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