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HEDGE FUNDS REVIEW

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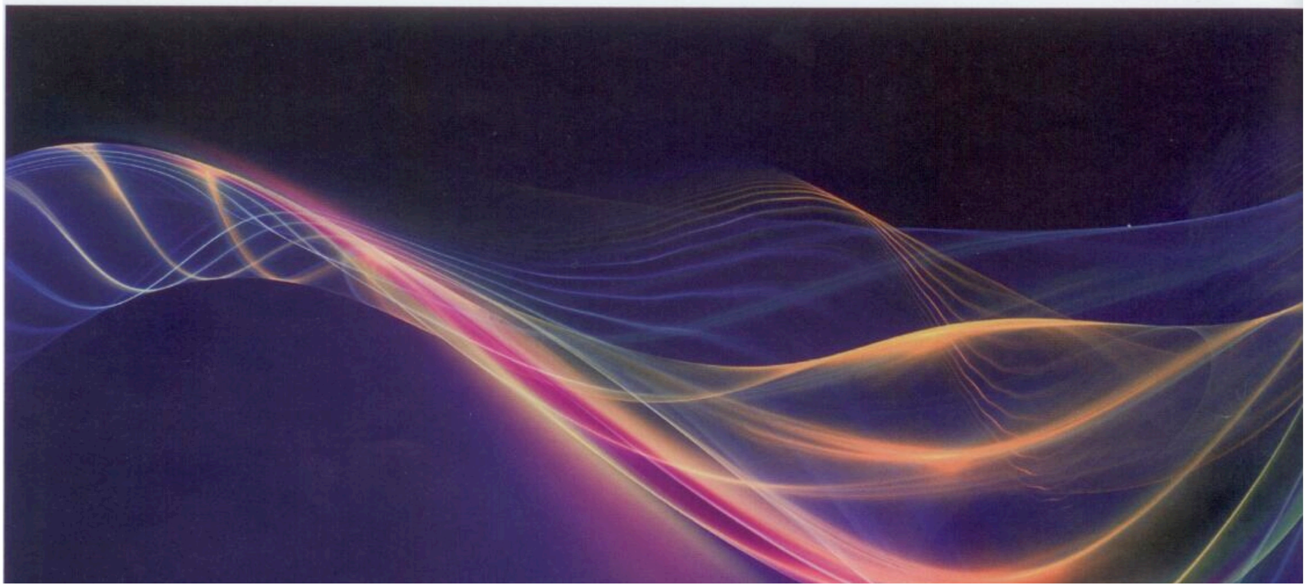
As quantitative easing comes to an end how will fixed-income absolute return products respond?

A redefined curve



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Absolute return fixed income funds have real potential to disappoint, not from losses, but from return compression to low single digits, where fee drag materially erodes portfolio returns – somewhat similar to the fate of equity market neutral funds during the 2009-13 rally. This can also lead to a situation where the investor and the manager have conflicting interests, with managers offering competitive management fees being particularly pro-active on that account.

Benchmark rates, which in fixed income form the foundation on which all other trading relationships are based, are clearly not yet at equilibrium. This is a direct reflection of the unprecedented policy intervention of recent years. The key risk is building an absolute return portfolio around relative value calibrated on political or central bank intervention, now clearly falling away. Fixed income strategies therefore, including those with a high degree of diversification, are likely to have a bumpy ride as the leading market drivers shift. Fixed income managers must be extremely agile as previously stable strategies are buffeted by the ongoing correction.

At the same time however, income demand from investors is only likely to grow as demographic forces gather momentum. Therefore, alternative thinking is needed to deliver robust income solutions for a wide array of macro scenarios and driven by return streams from differentiated asset classes. The volatility and net return characteristics of a diversified hedge fund portfolio can resemble those of investment-grade bond funds.

With the evergreening and inflation-advantaged dividends of a global large-cap equity portfolio, an investor can access a deep income stream. Total return potential – including equity capital gain – is also favourably skewed for the investor as a result, and this can be achieved without relying on net leverage. Finally, as is crucial for absolute return fixed income funds facing the rebasing of reference rates, a hedging toolkit properly deployed can critically deliver the loss avoidance that all investors expect from their active managers.

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Dispersion predicted in fixed income returns |
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