

DIVERSIFYING WITH ALTERNATIVE INVESTMENTS

Investors want to maximise their returns. However, most of them search only for under priced securities. The average investor has not fully utilised the tools at his disposal. Investors can take advantage of overpriced securities by short selling. By forgoing short selling, investors appear to be overlooking a significant portion of mispriced investment opportunities.

For those who shun short selling for their own reasons, such as perceived higher risks, they may participate in the broader scope of investment by investing in absolute return funds or portfolios managed by professionals specialising in this field.

The typical absolute return portfolio manager takes both long and short positions in stocks, bonds, commodities or any other financial instruments, so that the portfolio is largely unaffected by movement in the market. In a market that is moving up, generally, the longs will be profitable but the shorts will not. The opposite happens in a down market. The portfolio manager thus hedges away market risks also known as Beta in the portfolio. This is known as a paired trade, a part of market neutral strategies.

Does this seem like a fruitless

exercise? Not if the portfolio manager has selected wisely because the profits from long positions in a rising market will more than compensate for the losses incurred in the short positions.

Absolute return strategies are more complex, often involving various instruments such as derivatives and /or leverage. However, the basic principle of absolute return strategies remains the same: the ability of the portfolio manager to simultaneously buy and sell securities to benefit from the relative price movements. Assuming low market risks, the absolute return portfolio's performance is determined by the portfolio manager's asset allocation skills or stock picking abilities. This is known as having a positive Alpha.

Absolute return funds or portfolios are usually organised in the form of hedge funds, in offshore limited partnerships. As such, the level of transparency as to how the investors' funds are being invested is rather low. The barriers to entry in this exclusive club are rather prohibitive. Initial investments usually start at US\$500,000 or higher. Lock-in periods of between 1 to 3 years are common.

Returns of over 100 percent in a good year are possible, but most absolute return portfolios aim for a

consistent annual return of 10 to 15 percent, while maintaining a low volatility or risk profile similar to that of a fixed income portfolio. Management fees are in the region of one to two percent, not including a "carry" or profit sharing fee component of usually 20 percent.

Many high net worth individuals and family offices have to invest hundreds of millions of dollars in them, in search of higher risk-adjusted returns. Absolute return funds or portfolios strategies provide an alternative investment choice for well-heeled investors to diversify risks inherent in their traditional investments.

Finally, in deciding to invest in absolute return products we must understand our own investment profile. According to Benjamin Graham: "An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative." In other words, the investment selection process is what matters most.

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