Stock Market Perspective: Absolute and Relative Returns

Although the idea has been around for quite some time, *absolute investment returns* are getting a lot of play lately as several mutual funds have been started recently with absolute return objectives. By way of contrast, the traditional mutual fund hopes to produce superior *relative investment returns* when compared to a suitable benchmark. The goal of absolute returns is to show profits in most time periods and over a wide range of market conditions. For example, in a year when stocks fall by 10%, a typical mutual fund with a relative return objective will be considered to have had a good year if it is down by only 7%, but that would be a poor absolute return. However, if the market is up 15% in a year, a fund trying for absolute returns that gains 10% will be consistent with its objective while a fund judged on a relative return basis with that return would be considered to have had poor performance in the year.

Both absolute and relative return objectives can be appropriate. Sticking to a carefully designed investment plan is more important.

Interest in absolute returns increased during the severe drop in stock prices during 2000-02. The S&P fell by 45% from its peak in early 2000 to its low point in the fall of 2002. A fund that fell by 35% over that period may have done a good job on a relative basis, but investors suffering that type of drawdown likely did not consider that to be much of a benefit. During the same period, many hedge funds and a few mutual funds that have absolute return objectives showed profits, which naturally attracted investors' interest. Hedge funds have their own special considerations and many were not successful in producing good absolute returns. I am not going discuss them here. There are quite a few mutual funds now that strive for absolute returns that are practical alternatives to some types of hedge funds.

▶Isn't it better to seek absolute returns? After all, isn't it better to make money rather than lose it? Of course it is, but the issue is not that simple. We need to dig deeper to see how one can strive for absolute or relative returns and, more importantly, see that each may be appropriate for portions of one's portfolio.

Most traditional mutual funds seek returns that are better than an appropriate benchmark such as the S&P 500 index. To some extent, regulations concerning advertising encourage that because returns are supposed to be provided in the context of the market environment. Showing a profit of 10% in a year when the broad market is up 20% is not impressive, and many investors may then seek another mutual fund that came closer to or exceeded the market's gains. That may or may not be a good idea depending on several factors beyond the scope of this discussion. The traditional fund manager tries to achieve good relative returns by owning stocks that will do better than the benchmark. Peter Lynch was quite successful doing so when he ran the Fidelity Magellan fund. Moreover, a fund with good relative returns can be valuable for the portion of an investors portfolio designed to track stocks or a segment of the stock market.

On the other hand, one seeking absolute returns should not be upset with a gain of 10% in a year when stocks do much better if the fund produces gains, even modest ones, in years when stocks are down. That raises the question of how does a fund manager or investor seek absolute returns. There are many ways, and the key to most is holding positions in different types of markets such as stocks, bonds, commodities, and currencies in combination with hedging positions designed to move in the opposite direction of some instruments through short-sales, options, or futures. In other words, put your eggs in many baskets (diversification) and take some positions that benefit when the

eggs hatch and others that benefit when they end up scrambled. If done well, absolute returns by themselves or as part of a larger portfolio should prove to be much less risky—less volatility and smaller drawdowns—than investments that seek good relative returns.

To be consistently successful obtaining absolute returns probably requires at least as much skill as Peter Lynch demonstrated, although not necessarily in the same special categories. My feeling is that it is harder to be good at generating absolute returns than it is for relative ones. That means it can be difficult to evaluate those who claim they are seeking to produce good absolute returns. A long track record over a variety of market conditions can help, but you know what they say about past performance. Before investing in a hedge fund it is critical to understand all of its terms and conditions including limits on adding to or withdrawing all or part of your investments. Just about all hedge funds will have significant ones, and mutual funds seeking absolute returns typically have penalties if shares are sold within a year, or longer in some cases, of being purchased.

To answer the question of which is better, I would say neither is. Both objectives can be appropriate in a well designed and executed investment plan. One could say that adding absolute return instruments to the portfolio provides a different type of diversification. Most mutual funds or direct purchases of stocks seek superior relative returns, so adding an absolute return fund diversifies the types of techniques used and objectives. However, it is very important to understand the nature of absolute returns. While all investors will be pleased to show profits in years when the markets fall, many will be disappointed and seek “hotter” investments in years when the absolute return funds underperform the broad market. That is likely to be a mistake that undoes the design of the investment plan.

To take a broader view, I don’t think it is all that important to be concerned about whether the objectives are relative or absolute returns. It is much more important to have an investment plan that takes into account your current financial situation and where you want to be and when, and then takes positions that are designed to meet your needs consistent with your risk tolerance levels. Some ways of investing do not fit neatly into one of the two categories.

▶**Do your managed account programs seek absolute returns?** I don’t think most of my managed account programs can be classified as having definitely relative or definitely absolute objectives. Most are closer to relative, but to some extent the Tactical Asset Allocation (TAA) can be considered as leaning towards absolute returns.

Sector fund trading may well show losses in weak markets, but I hope to keep those losses to reasonable levels with tactics such as reducing exposure during poor market conditions. In strong markets, owning the right sectors can produce market beating profits. That puts its objectives closer to relative returns. To some extent that is also the case for the Dow Turnarounds program.

TAA when combined with conservative target allocations that hold a substantial portion in bond and money market funds can produce decent absolute returns. Hypothetical backtesting of such a portfolio has not shown a losing year in an over 40 year period. The trade-off, and there always is one, is that returns during strong bull markets like the one in the 1982-99 period are going to be less than buy and hold although the fluctuations and risk levels will be considerably lower.

Although the distinction is interesting and possibly helpful in some cases, it is far less important than formulating an appropriate investment plan, devising tactics to implement it, and then sticking to it until it is no longer appropriate, a judgment that should be quite infrequent.