



Making sense of
Targeting
absolute returns

Targeting absolute returns

Making money from investments whatever the conditions, even in a falling market, can be a tall order. It is, however, the overarching goal of funds that aim to achieve an 'absolute return'.

By using a range of investment tools to profit from the downs, as well as the ups, that markets experience, managers of absolute return funds usually look to target steady positive returns while minimising potential losses when markets are falling.

Here is our guide to this investment approach and how it works in practice. Please refer to the glossary for an explanation of the words highlighted in bold throughout this brochure.

'Absolute' vs 'relative' returns – what's the difference?

Each fund has its own investment objective, which outlines what the fund aims to achieve on behalf of its investors.

Some funds aim to beat a particular market benchmark. In other words, their objective is to achieve 'relative' returns. A fund that invests in UK company shares might logically aim to outperform an **index** of the UK stockmarket, like the FTSE 100, for example.

The investment objective of an absolute return fund will typically be to target a specific return, seeking to outperform either the interest rates on cash savings or the **inflation** rate, by a certain amount and over

a given timeframe. For example, a fund might target **total returns** (income and growth of **capital**) of 2% above returns on cash over any three-year period.

How can they perform in all market conditions?

Over the short term, markets will often deviate from how we might expect them to perform over the long term. The period of uncertainty following an important political moment, such as the UK's vote to leave the European Union, is a case in point.

The manager of a fund that targets absolute returns can hold a mix of different types of **assets** that will be expected to perform well under different circumstances. The manager can also hold the same type of assets but each with different characteristics to achieve a similar effect.

While it may be counterintuitive, there are also ways to make money when asset prices are falling. Fund managers can combine a traditional '**long** investing' approach – buying assets that they believe will do well and rise in price – with other investment techniques.

The opposite of long investing – '**short** investing' – allows a fund manager to make money from assets where they expect the price to fall. One way of taking a 'short' position is by selling borrowed assets and buying them back later, at a lower cost if their price has indeed fallen. Of course, if the price has risen contrary to expectations, the fund manager will lose money as the assets would have to be bought back at a higher price than they were initially sold for.

How does M&G define 'absolute returns'?

The notion of 'absolute returns' can mean different things to different people. Above all, it's important to know that the returns you might receive from funds that target an 'absolute return' – as with any investment – are neither fixed nor guaranteed.

To make this absolutely clear, we think it makes sense to consider these funds as target absolute return funds. At M&G, we define target absolute return funds as those that target (but do not guarantee) positive returns over a stated investment horizon up to a maximum of three years. In our view, they have two key features:

- Returns will generally have a low connection with the performance of funds that adopt a long investing approach, holding a particular asset class (such as bonds or company shares)
 - Returns will typically rise and fall less than returns from most other types of investment, so they are viewed as more stable or less changeable
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In practice, the more common approach to “short” an asset is through the use of **derivatives**. These are financial contracts whose value is derived from one or more underlying assets. These underlying assets will generally include **bonds** (loans to governments or companies paying a rate of interest), company shares and currencies.

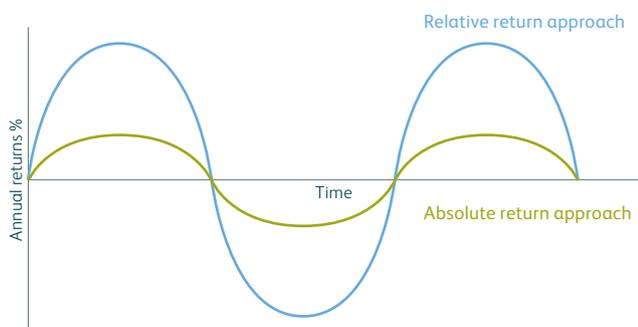
Picking the right combination of investment tools and techniques can involve a high degree of expertise and skill. For this reason, the experience of fund managers and the team supporting them might be an important consideration for investors.

Why does low volatility matter?

Volatility, being the extent to which asset prices rise and fall over a given period, can be especially uncomfortable for some investors. There are investors who rely on their investments to deliver consistent returns, as well as others who need to draw on them in the near future, for whom volatile markets could spell a financial shortfall.

Target absolute return funds attempt to deliver smoother returns for investors and, in this respect, can offer a less volatile investment proposition.

Investment return profiles of absolute and relative return approaches



Source: M&G, for illustrative purposes only.

What is the potential trade-off?

It is possible that targeting lower volatility might come at the expense of investment returns, depending on how the wider market fares.

During periods when the prices of assets deemed to carry greater investment **risk**, such as company shares, are rising, it is possible that a target absolute return fund could underperform funds that invest solely in company shares. This is because large exposure to more volatile assets is normally inconsistent with investment strategies that target an absolute return.

Are absolute return funds right for me?

The suitability of any investment will always depend on your circumstances and attitude towards risk and return. **If you're at all unsure, please speak to a financial adviser.**

Absolute return funds are typically suited to investors who are willing to sacrifice some potential upside, in the form of investment returns, in favour of limited potential downside, in the form of investment losses.

For investors who are looking to preserve their capital but would also like positive investment returns – but who do not want their investments to experience sharp falls – there has arguably never been a more challenging market environment. Assets traditionally viewed as low risk – such as cash or the **government bonds** (loans to governments) of the largest economies – today offer low returns.

It's also important to note that absolute return investing might not be a suitable strategy for investors looking to achieve consistently positive returns over shorter timeframes. It is possible, even over the medium or long term, that returns may not be positive.

When you're deciding how to invest, always remember that the value of investments goes up and down. So how much your investments are worth will change over time, and you may not get back the amount you originally invested.

Pros and cons of absolute return funds

- ✓ Investment returns depend less on the overall market performing well
- ✓ In a falling market, when the value of higher risk assets is going down, these funds have the potential to hold up better
- ✓ They can therefore add **diversification** within a portfolio of investments
- ✗ Positive returns can never be guaranteed – and should not be relied upon
- ✗ In a rising market, when the value of higher risk assets is going up, these funds can underperform the overall market

Glossary

Asset: Anything having commercial or exchange value that is owned by a business, institution or individual.

Asset class: Category of assets, such as cash, company shares, fixed income securities and their sub categories, as well as tangible assets such as real estate.

Bond: A loan in the form of a security, usually issued by a government or company, which normally pays a fixed rate of interest over a given time period, at the end of which the initial amount borrowed is repaid.

Capital: Refers to the financial assets, or resources, that a company has to fund its business operations.

Derivatives: Financial instruments whose value, and price, are dependent on one or more underlying assets. Derivatives can be used to gain exposure to, or to help protect against, expected changes in the value of the underlying investments. Derivatives may be traded on a regulated exchange or traded over the counter.

Diversification: The practice of investing in a variety of assets. This is a risk management technique where, in a well-diversified portfolio, any loss from an individual holding should be offset by gains in other holdings, thereby lessening the impact on the overall portfolio.

Government bonds: Fixed income securities issued by governments, that normally pay a fixed rate of interest over a given time period, at the end of which the initial investment is repaid.

Index: An index represents a particular market or a portion of it, serving as a performance indicator for that market.

Inflation: The rate of increase in the cost of living. Inflation is usually quoted as an annual percentage, comparing the average price this month with the same month a year earlier.

Long position: Refers to ownership of a security held in the expectation that the security will rise in value.

Risk: The chance that an investment's return will be different to what is expected. Risk includes the possibility of losing some or all of the original investment.

Short position: A way for a fund manager to express his or her view that the market might fall in value.

Total return: The term for the gain or loss derived from an investment over a particular period. Total return includes income (in the form of interest or dividend payments) and capital gains.

Volatility: The degree to which a given security, fund, or index rapidly changes. It is calculated as the degree of deviation from the norm for that type of investment over a given time period. The higher the volatility, the riskier the security tends to be.

How to contact us

Customer Relations*

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If you have a query regarding your M&G investment, our Customer Relations team can be contacted from 08:00 to 18:00, Monday to Friday, and from 09:00 to 13:00 on Saturday.

Investment Helpline*

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If you would like to request further information on a new or additional investment, or want to read more about our products and services, call our Investment Helpline from 08:00 to 18:00, Monday to Friday, and from 09:00 to 13:00 on Saturday.

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* For security purposes and to improve the quality of our service, we may record and monitor telephone calls.

† Please note that information contained within an email cannot be guaranteed as secure. We advise that you do not include any sensitive information when corresponding with M&G in this way.

We are unable to give you financial advice. If you are unsure about the suitability of your investment, please speak to your financial adviser.

