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Rethinking strategy for the long run

A focus on absolute return may provide a new way to approach retirement investing

RETIREMENT WATCH

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Managing retirement portfolios often requires balancing capital appreciation and capital preservation objectives.

The traditional method of meeting those dual objectives involves careful diversification across asset classes in order to balance risk and return throughout multiple market cycles.

Given the gale-force macroeconomic winds that have pummeled retirement assets, those of us in the asset management business must ask whether the traditional ways of thinking about investment management for the long term went awry. This points to three important lessons:

1) *The long-term benefits of diversification don't include a shield against periods of significant stress.*

In a market driven by fundamentals, diversification helps ensure that investors aren't concentrating their bets. Market meltdowns push fundamentals to the sidelines, but with a strong tendency for assets to cluster on the downside.

Why do asset classes become highly correlated exactly when you don't want them to? Real economic drivers often have the same directional im-

pact across asset classes.

Equally important, global liquidity flows have become more interconnected.

2) *Some risks can't be modeled.*

Recent structural and regulatory forces have magnified the influence of global liquidity flows. Changes in margin requirements, short-selling restrictions and the need to raise regulatory capital overwhelmed fundamentals and traditional asset class distinctions in favor of liquidity needs.

Another powerful factor has been the systemic unwinding of debt by consumers and businesses. None of these risks can be readily modeled, nor can the way that hedge funds, with their flexible mandates, have skewed the broader investment landscape.

3) *The lines separating equities, debt instruments, futures, options and other derivatives have blurred.*

The economic drivers fueling the market turmoil in the fall were a primary factor influencing returns; whether you owned equity or debt was secondary. The legal and contractual distinctions between stocks, bonds and derivatives remain, of course, but the same drivers that crushed stock prices also drove down prices in most bond classes, blunting traditional diversification benefits.

We must ask deeper questions about portfolio allocations when such

a storm cloud blots out the traditional assumptions about asset classes. Many stocks are valued so low, they all but mimic call options on future cash flows, while corporate-bond valuations have taken on the upside profile of equities.

One possible approach to the challenge of managing retirement portfolios is absolute return — a term that is frequently misinterpreted and popularly associated with hedge funds. I prefer to think of absolute return as a way of looking for investment opportunity that is agnostic about indexes, categories and conventional descriptions.

For example, if you think that corporate America has been oversold based on the fundamentals, you may seek to buy corporate debt, which relies on balance sheet fidelity and claims-paying ability, and equity, which represents a bet on future business and cash flow growth. Both security classes are being shaped by the same drivers.

Under an absolute-return mandate, you would be concerned with finding the strongest risk/reward trade-off rather than meeting a rigid asset allocation requirement. Ultimately, a relative-value position might be established by selling stock short and buying a bond issued by the same corporation, for example.

An absolute-return approach might bypass the shares of a multinational conglomerate that just happens to be

based in India and is classified as an emerging-markets stock, since it may be more influenced by global cash flows than an Indian company focused on the domestic market. Instead, the absolute-return investor might participate in emerging markets by buying stocks of European companies that derive significant profits from emerging-markets demand.

Perhaps the most significant lesson to be drawn from absolute-return strategies is the need to tie diversification and asset allocation strategies to fundamental and structural challenges rather than historical averages and traditional definitions.

Using an absolute-return viewpoint requires combining quantitative and qualitative approaches when

evaluating opportunity and a great deal of skill in evaluating and managing risk at the portfolio level. The increased flexibility of the approach, however, may make balancing retirement objectives easier.

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