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Absolute Return

We recommend an at benchmark weight allocation to Absolute Return. Following a banner year for performance in 2020 we believe the opportunity for alpha generation will persist into 2021. Uncertainty surrounding the impact of the COVID-19 crisis has led to elevated market volatility and high dispersion between market "winners and losers", which we believe will continue to provide ample trading opportunities for a wide array of hedge fund strategies.

Offering a risk/return profile between fixed income and equities, and a return stream diversifying to both, we believe that absolute return plays a critical role in portfolios. Returns for equities and fixed income have been exceptional in recent years, driven largely by easy monetary policy. On a forward-looking basis however, we believe the future return potential for these asset classes may be more challenging given the high current valuations. As such, we believe the relative case for absolute return mandates has become more compelling.

Absolute return delivered alpha across most strategies in 2020, even though industry-wide deleveraging in February and March had a strong (but short-lived) negative impact.

Within the asset class, we remain focused on maintaining diversified allocations that incorporate the use of cash-efficient vehicles. As a result, we have grown our investments via managed accounts (vs. commingled funds) to achieve greater capital efficiency, improved transparency, the ability to tactically manage exposures and reduced fees. At the strategy level, we continue to see opportunities for skilled managers that can capitalise on elevated volatility in "core" areas such as event driven, equity market neutral, macro and fixed income relative value.

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Asset Class Definition

We define absolute return to include directional and relative value strategies that seek to generate returns independent of traditional market beta exposures of equity, interest rates, credit, inflation and property.

Absolute return managers often generate alpha by capitalising on market inefficiencies or behavioral biases of other investors, or by monetising exposure to various structural risk premia. Their investment processes may be systematic/quantitative, discretionary, or a combination of the two. We note that the opportunity set for alpha may evolve differently across strategy type. We therefore seek to build allocations that harness multiple sources of alpha in order to provide an overall return stream that is more robust to fluctuations in market environment.

Role in the portfolio

The role of absolute return in the portfolio is to provide attractive risk-adjusted returns that are uncorrelated to traditional liquid asset classes (such as equities, rates and credit).

The diversifying nature of absolute return strategies may enhance the overall risk-adjusted return of a multi-asset class portfolio. Additionally, we believe that the asset class serves as an increasingly valuable source of total return in the current market environment where, due to tight spreads and high valuations, traditional market exposures may struggle to generate attractive returns. Finally, while the absolute return allocation is not meant to serve as a direct hedge to equity markets, its lower volatility profile and low market correlation can provide capital preservation in a stress scenario. At times, however, equity market stress can lead to deleveraging events that negatively impact a variety of absolute return strategies simultaneously – March 2020 serves as an example of such a scenario. We do note that the opportunity set for hedge funds following one such senario is particularly strong, as we saw through the subsequent months of 2020. Despite the March drawdown, most absolute return strategies delivered positive alpha for the year.

Golden Rules

Absolute return is a challenging asset class to navigate given the complexity of underlying strategies, high fee burdens and increased competition for alpha. We continuously evaluate and evolve our asset class strategy, and have summarised our latest thinking on “golden rules” for absolute return investing below:

1. Strategies must be diversifying to rates, credit, and equity market risk.
2. Diversification across sources of alpha may result in higher risk-adjusted returns that are more robust across changing market environments.[1]
3. Capital-efficient structures are necessary to achieve client risk/return objectives within the context of a well-diversified portfolio.[1]
4. Further value can be added through structuring transparency, control, customisation, and negotiated fee reductions – these advantages are most often achieved with early-stage managers[1].
5. The search for alpha is often most fruitful in structurally inefficient and under-covered markets with limited capacity[3].
6. We focus on managers with sustainable competitive advantages, such as infrastructure and technological capabilities, proprietary data and systems, or the ability to attract and retain exceptional talent.

Market Overview

2020 was a strong year for absolute return, with many strategies delivering banner years in outperformance. The ongoing pandemic has led to a variety of dislocations, pricing discrepancies, volatility and dispersion, which fueled opportunities for a wide array of relative value and event driven trading strategies. Meanwhile, coordinated monetary policy interventions provided a strong liquidity backstop to markets. We saw these themes materialise within our own absolute return allocations.

As noted previously, the final three quarters of 2020 provided a strong opportunity for many absolute return strategies to generate alpha and we believe these conditions will persist into 2021. We therefore believe that diversified multi-strategy managers are best-placed to capitalise on the wide array of opportunities in a cash-efficient manner. We discuss our approach to multi-strategy funds in the next section but believe that those

[1] Developed Equities as measured by the MSCI World Hedged to USD Total Return Index. Cash as measured by the total return of 3-Month US Treasury Bills. The 0.1x Developed Market Equities / 0.9x Cash benchmark is compounded monthly.

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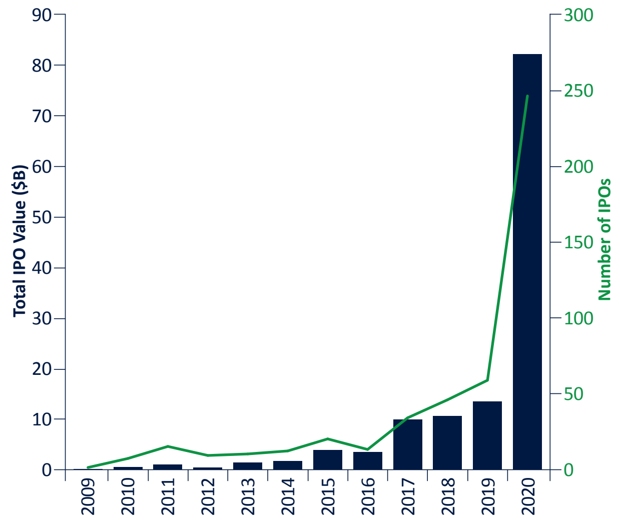
with exposure to event driven, equity market neutral, macro and fixed income relative value strategies are well-positioned for the year ahead.

Event driven: Event driven strategies endured a rocky 2020 but ended the year in positive territory. Q1 was a particularly challenging period, as market stress led to increased concerns regarding the timing and likelihood of security-related catalysts. However, as markets rebounded through year-end, many event strategies recovered strongly. Strategies with exposure to Special Purpose Acquisition Companies ("SPACs") performed particularly well among an explosion of issuance in the space. SPACs are "blank check" entities that trade on public exchanges and are formed to take a private company public. SPAC issuance quadrupled in 2020 to over $80B[2], driven by the efficiency of the structure, improvements in sponsor quality, and improving market sentiment about deal prospects. We believe the sharp increase in universe size may create more opportunities for experienced SPAC managers.

Outside of SPACs, we believe the opportunity set for merger arbitrage managers also improved into year-end. While M&A activity slowed to multi-year lows in the early days of the pandemic, it began to increase later in the year as markets stabilised and corporations grew more comfortable with the future regulatory environment. The last quarter of the year saw a significant rebound in M&A activity with the number of announced deals reaching record levels once again.

Exhibit 1

SPAC issuance increased from c. $13B in 2019 to over $80B in 2020

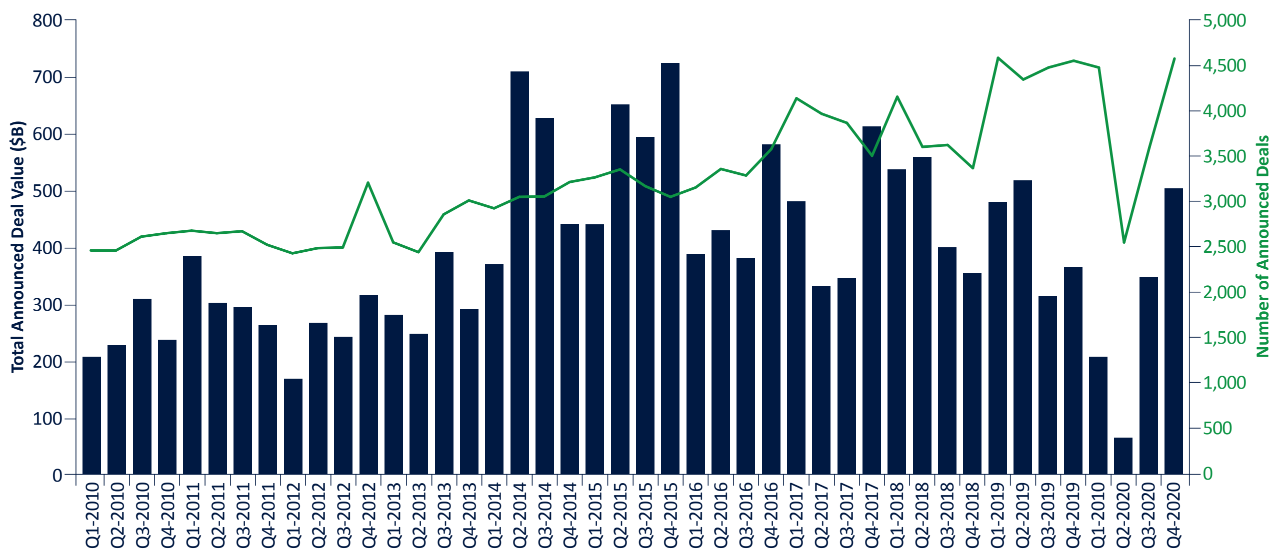


Source: *SPACInsider*

[2] Data per SPACInsider.com.

Exhibit 2

M&A activity has increased significantly from its H1 2020 lows



Source: *IMAA Institute, Thomson Reuters, CapitalIQ*

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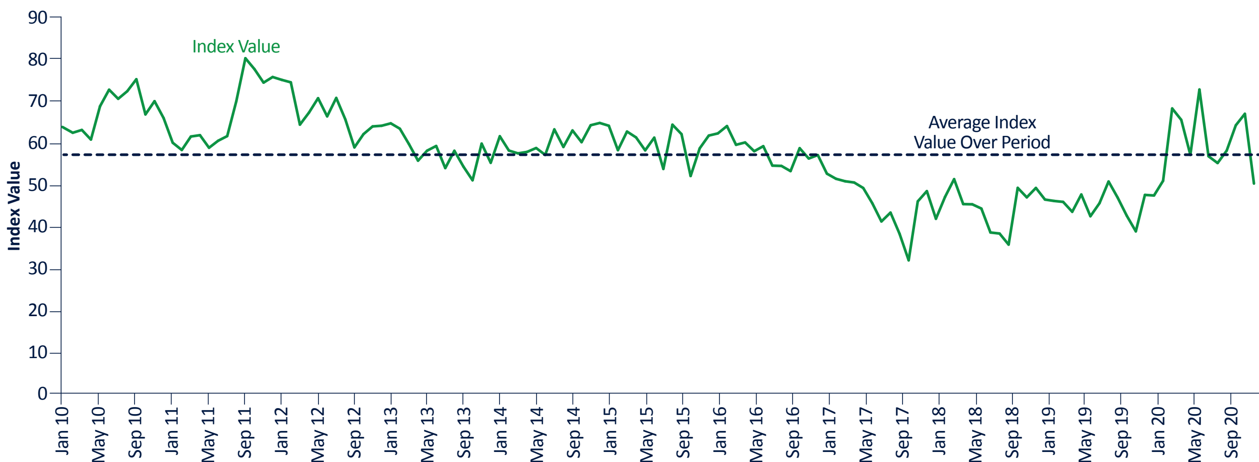
Equity market neutral: We believe that high levels of dispersion in equity markets may improve the opportunity set for stock selection alpha by quantitative or discretionary managers. Exhibit 3 shows that, while inter-stock correlations spiked briefly in 2020 (i.e. low stock dispersion), they have since dropped to lower levels versus history (higher stock dispersion). We are most focused on managers that we believe have strong risk management frameworks that aim to isolate stock-specific risks rather than take exposure to the market, sectors and/or common style factors (e.g. momentum, value).

Macro: We seek to maintain exposure to macro, which we believe can be diversifying relative to other absolute return strategies and equity markets. Exhibit 4 displays the low correlation that macro managers have historically realised to other notable absolute return strategies. Furthermore, macro, which can be implemented on a discretionary or systematic basis, is a cash-efficient strategy because it trades highly liquid instruments that are easy to leverage. Therefore, investors holding macro through an advantaged structure such as a managed account can achieve the desired level of exposure with very little cash outlay – these cash "savings" can be reinvested elsewhere into alpha-generating opportunities.

Exhibit 3

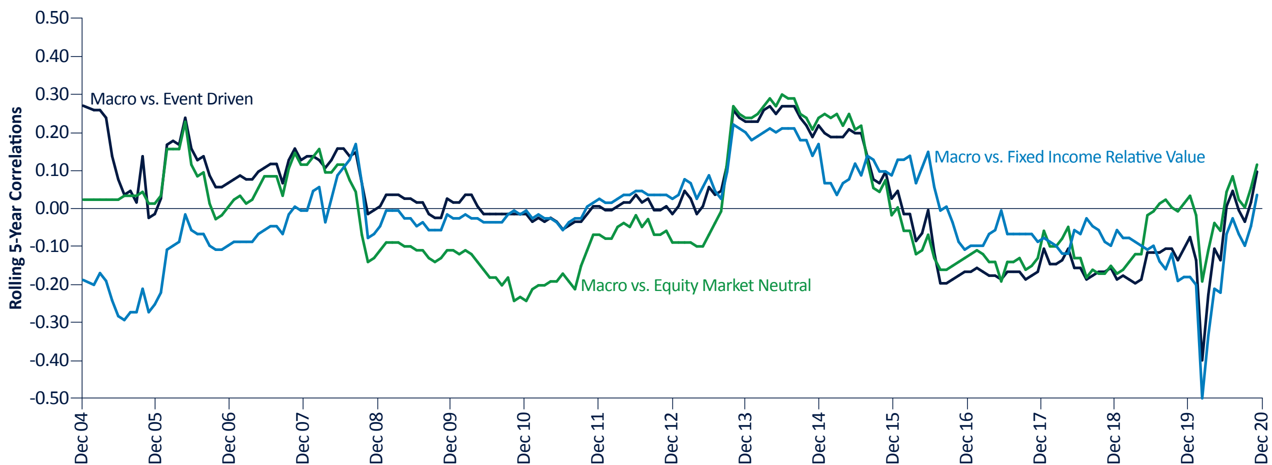
Inter-stock correlations remain low, which may improve the opportunity set for stock selection alpha



Source: *CBOE S&P 500 Implied Correlation Index, Bloomberg*

Exhibit 4

Macro has historically realised a low correlation to event driven, equity market neutral and fixed income relative value sub-strategies



Macro: CS/Tremont Global Macro Index. Event Driven: HFRI Event Driven Index. Equity Market Neutral: HFRI Equity Market Neutral Index. Fixed Income Relative Value: CS/Tremont Fixed Income Sovereign Index

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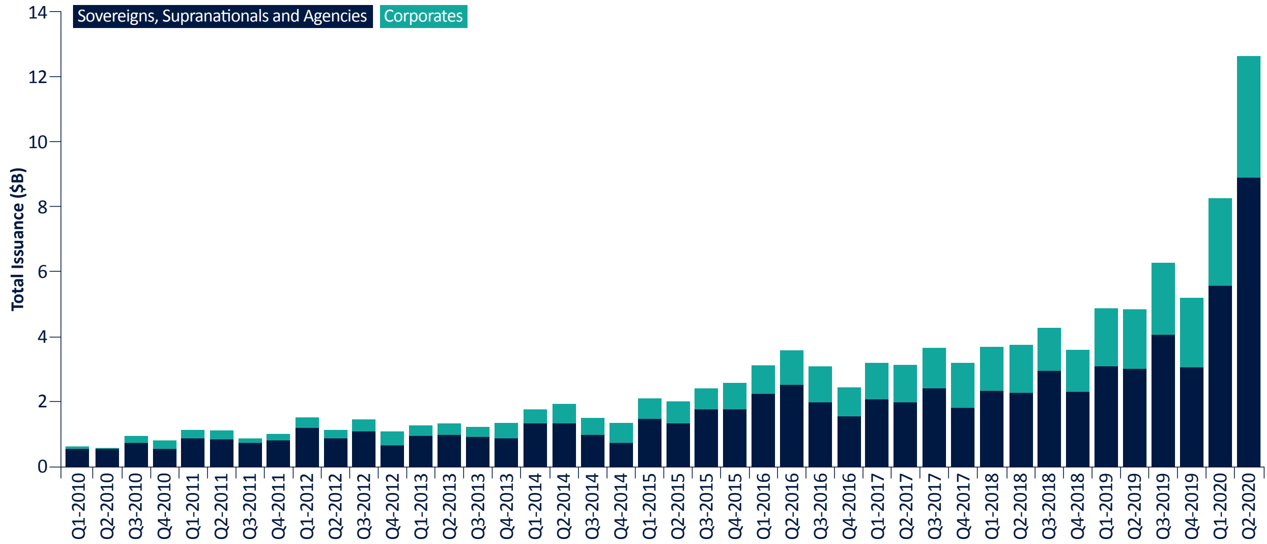
Exhibit 5

Quarterly Bond Issuance ($B) from Q1 2010 – Q2 2020 (Government Issuance in Blue)[17]



***Source:** ICMA Group, Bloomberg*

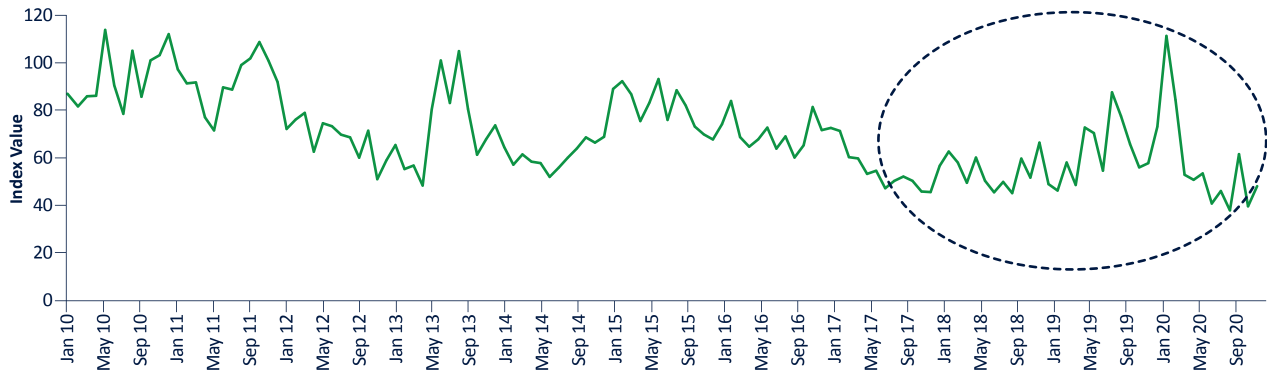
Fixed income relative value: We seek to selectively increase exposure to fixed income relative value managers that generate alpha via trading. Increasingly, we are housing these allocations in managed account structures which allow for increasing exposure quickly as the opportunity set improves. As we look forward into 2021, large anticipated fiscal deficits may require similarly sized increases in issuance, which could create volatility along the curve and lead to a range of relative value trading opportunities. Additionally, ongoing central bank buying programs, potential inflationary pressures from fiscal stimulus and economic recovery and the potential for political and policy uncertainty could support the opportunity set for skilled managers to exploit micro-dislocations across global bond curves.

Investment Strategy for 2021

We expect the COVID-19 pandemic to color the opportunity set for absolute return strategies in 2021. The fast-evolving policy response, infection rates, etc. demand tactical management of investment exposures. We believe that one of the attractive features of absolute return is that manager alpha production can adapt quickly to changing economic environments. While the current environment – defined by strong government support for markets and healthy levels of volatility – is favorable for many strategies, a shift to a low-volatility regime (e.g., complete crisis resolution) or sharp market disruption (e.g., more severe COVID wave) could have a negative impact on the asset class. We therefore maintain balance across a diversified set of strategies to improve the portfolio's robustness in wide variety of economic scenarios.

Exhibit 6

While bond volatility has declined over time, we have seen periodic spikes in volatility in recent years



***Source:** ICE Bank of America MOVE Index of Bond Volatility, Bloomberg*

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We continue to focus on driving efficiencies when constructing absolute return portfolios. As such, our allocation to multi -strategy managers has grown. We view these managers as "core" allocations in client portfolios and believe they can provide attractive risk/return potential while maintaining high look-through strategy diversification. Meanwhile these structures can maximise efficiencies in leverage, financing, trading execution, and risk optimisation. In this vein, we also remain focused on building out our own multi -strategy portfolios via managed accounts. While investing in third-party funds reduces complexity, we believe our proprietary managed account platform ("MAP") vehicles can off er further benefits such as:

i. **Capital Efficiency:** Adjust funding levels/leverage to achieve total return or risk targets

ii. **Mandate Flexibility:** Create customised investment parameters and/or allocate to specific tactical opportunities, strategies, or portfolio managers

iii. **Transparency and Control:** Maintain daily visibility into all positions held across the portfolio and ability to actively shape investment exposures

iv. **Fee Savings:** Avoid the additional layer of fund-level fees charged by "platform" funds

v. **Improved Liquidity:** Adjust exposures outside of "standard" commingled fund liquidity windows

Finally, we believe that absolute return allocations can benefit from an allocation to liquid managers (with at least weekly dealing frequency) with a negative correlation to equities - in particular, managers which offer some degree of tail risk protection. The capital from these investments can be harvested and redeployed in a period of stress – either into risk assets elsewhere in the portfolio (e.g., equities, credit), or into certain absolute return strategies that may experience mark-to-market dislocations (but not necessarily capital impairment) in an equity market drawdown (e.g., merger arbitrage). However, we do note that any actions we take in a recessionary environment would depend upon specific market conditions.

[17] Data per ICMA Group using Bloomberg data as of August 2020.

[18] Data per ICE Bank of America MOVE Index of bond volatility, sourced via Bloomberg.

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