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The funds that are on the rocks

Absolute return funds are failing to live up to their purpose. Could this become the next mis-selling scandal?

Targeted Absolute return funds are billed as the ideal place for investors to park their money in the face of stock market turmoil. Yet a study by AJ Bell, an investment platform, shows that these funds, which aim to provide positive returns in all market conditions, and which hold more than £72 billion of investors' money, are not living up to their promise.

Many flock to these investments that act as a kind of comfort blanket for the nervous. More than £7.2 billion has been ploughed into the funds in the past three years as worries grow over the impact of Brexit, global tariff wars and general economic slowdown. However, AJ Bell says that only 64 absolute return funds of 105 generated a positive return over that time, and 59 beat the 0.6 per cent average return on an easy-access savings account. Some financial experts are warning that they could be the next mis-selling scandal. Here's what you should know.

Performance

Laura Suter, a personal finance analyst at AJ Bell, says: "Only one fund, Natixis H2O Multi Returns, run by the French investment bank, delivered a positive return in each of the three years, and only just scraped by in 2016 with a return of 0.1 per cent after fees. A total of 61 funds had a positive return in 2016 and 2017, but 2018 was the killer year, with only one fund managing to do it."

She says that four absolute return funds registered losses in each of the past three years: Insight Absolute Insight Currency, Kames UK Equity Absolute Return, Schroder European Equity Absolute return and Threadneedle Absolute Return Bond.

There has been a large disparity in returns over the past three years contradicting claims that the absolute return sector is full of stable funds that preserve investors' wealth year in, year out.

Polar Capital UK Absolute Equity fund produced a spectacular return of 57.2 per cent, streets ahead of second-placed Man GLG Alpha Select Alternative (19.9 per cent) and Natixis (18.2 per cent). At the other end was Argonaut Absolute Return, which made a loss of 23 per cent, while Merian UK Opportunities lost 16.7 per cent. Other big losers were City Financial Absolute Equity, which lost 13.5 per cent, and the Odey Absolute Return fund, run by Crispin Odey, the Brexit-backing billionaire hedge-fund manager, which left investors poorer by 12.2 per cent. Funds run by GAM, a Swiss fund manager, filled three of the bottom ten slots.

Suter asks: "Can a fund that delivered a 23 per cent loss over three years be considered an absolute return fund?"

The failure of the giants

A large chunk of investors' money in this sector is riding on the fortunes of a handful of giant funds, which together account for more than half the total. If they lose money, so do most investors.

Standard Life Global Absolute Return Strategies (GARS), the second-biggest fund at £12.6 billion, has "rewarded" its army of investors with a loss of 6.5 per cent over three years. Invesco Perpetual Global Targeted Returns (£11.6 billion) — the third largest — has returned a meagre 0.7 per cent over the same time, a loss in real terms. Aviva Investors Multi Strategy Target Return (£4.9 billion), the sixth biggest fund, posted a 7.2 per cent loss.

The message seems to be getting through to investors, who pulled £756 million out of absolute return funds in November, making it the worst-selling sector that month.

The problems

Thomas McMahon of Kepler Partners, an investment research specialist, says that continued ultra-low interest rates have limited these and other funds' ability to make money through trading because there are more money-making opportunities when rates are moving up and down.

"With all three funds sitting on large sums of money, there is the potential for managers' incentives to change: rather than reaching for returns, they may feel it better to adopt a 'don't mess it up' mentality," he says.

Brian Dennehy from Fundexpert, a fund research group, says that the sector's name implies low risk and suggests that you will make money. Yet many funds don't, even over three years.

He says: "The problem is a mix of poor performance, inappropriate volatility and complexity. For example, the sector includes funds that, on our measures, are more volatile than the UK stock market, such as City Financial Absolute Equity. This doesn't mean this fund, and others like it, are bad, it's just that it is in an inappropriate sector."

Another problem, he says, is that many funds are difficult for ordinary investors to understand. "A classic example is Standard Life GARS, which adopts several dozen strategies that are extremely difficult to follow," he says.

"A similar problem applies to the many funds, including GARS, that use complex financial instruments known as derivatives. These can make money in rising and falling markets by taking bets that a particular investment will go up or down, but it is difficult for even the most experienced investors to grasp the potential risks and returns involved."

The high charges

To add insult to injury, a number of absolute return funds are charging hedge-fund-style fees of 2 per cent annually plus a 20 per cent performance fee. Ryan Hughes of AJ Bell says: "A lot of funds set the return required to trigger a performance fee very low, so investors end up paying over the odds for mediocre performance. Often the return to beat is the one-month Libor [London Interbank Offered Rate], which is about 0.5 per cent per annum. So a fund could return less than you can get on many savings accounts and still be entitled to a performance fee."

Alan Miller of SCM Direct, an online wealth manager, says: "These funds are touting the impossible dream of high returns and low volatility in price. The truth is that many funds in this category produce low or even negative returns with high charges. We are concerned that some have been mis-sold to retail investors due to their failure to properly explain their highly complex strategies, their significant risks, and their fundamentally unachievable aims."

Standard Life Aberdeen, an investment company, says: "While we have not met our return target in recent periods, GARS remains well diversified. As a result, the volatility of the portfolio has remained consistent with our expectations, as has our long-term performance track record."

GAM did not comment.

The experts' picks

If you want an alternative to absolute return funds, Thomas McMahon favours Ruffer and RIT Capital investment trust. He says: "The Ruffer trust invests in a range of assets. RIT is another multi-asset trust that aims to grow capital over the long term while preserving it in rough markets. Lord Rothschild and family own a fifth of the shares."

Ryan Hughes goes for Ruffer's Total Return fund and the Royal London Short Duration Global High Yield Bond fund. "The Ruffer fund has a focus on low volatility and has, over the past three years, returned 12.3 per cent. The Royal London fund generates income, but also some capital repayment. It has returned 7.7 per cent"

Jason Hollands of Tilney Group, likes Personal Assets investment trust and Troy Trojan fund. "These portfolios will lag during bull runs, but they do come into their own during tougher periods."

Hughes adds that if you still like the idea of total return funds, he would go for Janus Henderson UK Absolute Return and Newton Global Dynamic Bond.

"The Janus Henderson fund adopts a risk-averse approach that has been tried and tested in a range of market conditions and comes into its own when markets are falling. The Newton fund benefits from the strength of the fixed income team and the flexibility of its investment mandate."