

Morningstar Insights: Absolute Return Funds

- ▶ **Ryan Leggio**
Mutual Fund Analyst

MORNINGSTAR®

© 2005 Morningstar, Inc. All rights reserved.

Overview

- ▶ Why are fund companies launching these funds now?
- ▶ What is an “absolute return” fund?
 - ▶ Benchmarks and Morningstar categories
 - ▶ Common traits
- ▶ Possible headwinds
- ▶ Who offers these funds?
 - ▶ Oldest, largest, and best performing funds
- ▶ Takeaways

MORNINGSTAR®

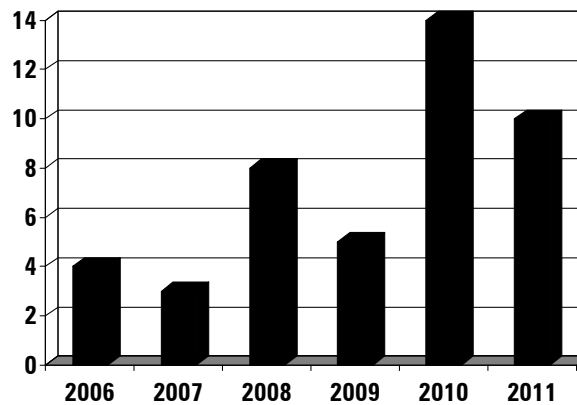
Why are fund companies launching absolute return funds now?

- ▶ Investors wary after 2008 bear market:
 - ▶ S&P 500: **-37%**
 - ▶ Bonds: 5%
 - ▶ Traditional asset allocation didn't provide shelter:
Vanguard Balanced Fund: **-22%**
- ▶ Inflation outpaces equity returns during the "Lost Decade" (2000-2010)
 - ▶ S&P 500: -0.95% (annualized)
 - ▶ Inflation (CPI-U): 2.52%
- ▶ Institutional/hedge-fund strategies launching as retail funds
 - ▶ Long-short, tactical allocation, alpha only, etc.

MORNINGSTAR®

Fund launches follow 2008 equity bear market

Funds launched with "absolute" or "real return" in name



MORNINGSTAR®

Fund flows finding absolute return funds

- ▶ Estimated net flows into absolute return funds:
 - ▶ \$6.8 billion in flows over past 12 months through April 2011
 - ▶ \$6.6 billion in flows over past three years
- ▶ Investors haven't realized funds' average gain:
 - ▶ Average 2010 total return for absolute return funds: 6.57%
 - ▶ Average 2010 investor (or asset-weighted) return: 5.85%



What is an "absolute return" fund?

- ▶ No universally accepted definition
- ▶ No guarantees
- ▶ Working definition: Any fund whose benchmark is tied to an index that is almost always positive, in either nominal or inflation-adjusted terms, over rolling five-year periods.
 - ▶ For example: CPI + 1%, Libor, T-bills, 5%, or CPI + 5%
 - ▶ Does not include broad market indexes such as S&P 500, MSCI World, or a blended index



Common traits for absolute return funds

- ▶ They are very different:
 - ▶ Different benchmarks and Morningstar categories
 - ▶ Different portfolio strategies and asset class exposures
 - ▶ Some are tactical, some aren't
 - ▶ Different investment time horizons (1-10 years)
- ▶ They are difficult to analyze
 - ▶ Portfolio positioning is dynamic
 - ▶ Holdings vary dramatically from fund to fund
- ▶ Many strategies are unproven
- ▶ The funds tend to be more tactical and sensitive to valuation changes



Funds use many different benchmarks

- ▶ Treasury bills or LIBOR:
 - ▶ Permanent Portfolio or PIMCO Unconstrained
- ▶ TIPS
 - ▶ PIMCO Real Return
- ▶ Treasury bills + 1%, 3%, 5%, or 7%
 - ▶ Putnam Absolute Return Series
- ▶ CPI + 5%, 6.5%, or 10%
 - ▶ PIMCO All Asset
- ▶ And the list goes on...



Funds compete in different Morningstar Categories

- ▶ 62 funds with either the phrase “absolute” or “real return” in their name as of August 2011.
- ▶ Some don’t have “real” or “absolute” in their name (for example, Permanent Portfolio or PIMCO All Asset).
- ▶ Morningstar categories that contain at least one absolute-return fund:
 - ▶ Inflation-Protected Bond
 - ▶ Multisector Bond, World Bond and Short-Term Bond
 - ▶ Conservative Allocation, Moderate Allocation and World Allocation
 - ▶ Multialternative
 - ▶ Mid Blend and Large Value
 - ▶ Real Estate



Same benchmark doesn’t mean same approach

- ▶ Benchmarks may be similar, but time horizons or risks may differ
 - ▶ Putnam Absolute Return 100, PIMCO Unconstrained and Permanent Portfolio have similar benchmarks
 - ▶ But the Putnam and PIMCO fund own mostly bonds while Permanent Portfolio owns gold, stocks and bonds

| Name | Ticker | Morningstar Category | Primary Prospectus Benchmark | Total Return 1 Yr | Standard Deviation 1 Yr |
|----------------------------|--------|-------------------------|---------------------------------|-------------------|-------------------------|
| PIMCO Unconstrained Bond | PUBDX | Multisector Bond | BofA Libor 3 Month USD | 1.88 | 2.08 |
| Permanent Portfolio | PRPFX | Conservative Allocation | Citi Treasury Bill 3 Mon USD | 23.34 | 7.54 |
| Putnam Absolute Return 100 | PARTX | Short-Term Bond | BofAML US Treasury Bills TR USD | 1.45 | 1.05 |

Source: Morningstar, Inc. Data through 8/8/2011



Absolute return funds' headwinds

- ▶ Funds can lose money
 - ▶ A fund could beat a CPI + 1% benchmark and still have a negative nominal return
- ▶ Funds may have trouble beating inflation
 - ▶ A fund could beat a 5% benchmark and still not beat inflation (returns after inflation are known as real return)



Absolute return funds' headwinds

- ▶ Funds are expensive

| Name | Ticker | Morningstar Category | Inception Date | Net Assets \$B | Annual Report Net Expense Ratio | Morningstar Fee Level |
|--|--------|--------------------------|----------------|----------------|---------------------------------|-----------------------|
| PIMCO Real Return A | PRTNX | Inflation-Protected Bond | 1/29/1997 | 19.6 | 0.90 | Above Avg |
| Eaton Vance Gbl Macr Absolute Return A | EAGMX | World Bond | 6/27/2007 | 7.6 | 1.00 | Below Avg |
| Fidelity Advisor Strategic Real Return A | FSRAX | Conservative Allocation | 9/7/2005 | 6.5 | 1.02 | Below Avg |
| JPMorgan Tax Aware Real Return A | TXRAX | Muni National Intern | 8/31/2005 | 3.0 | 0.74 | Below Avg |
| PIMCO Real Estate Real Return Strategy A | PETAX | Real Estate | 10/30/2003 | 1.7 | 1.19 | Low |
| Goldman Sachs Absolute Return Tracker A | GARTX | Multialternative | 5/30/2008 | 1.7 | 1.59 | Below Avg |
| Putnam Absolute Return 300 A | PTRNX | Short-Term Bond | 12/23/2008 | 1.5 | 1.09 | N/A |
| Putnam Absolute Return 500 A | PJMDX | Moderate Allocation | 12/23/2008 | 0.8 | 1.47 | High |
| Putnam Absolute Return 700 A | PDMAX | Moderate Allocation | 12/23/2008 | 0.7 | 1.63 | High |

Source: Morningstar, Inc. Data through 4/30/2011



Absolute return funds' headwinds

"Absolute Return and the All Weather Portfolio sound great, but require incredible skill to deliver. It is just a claim that you can add alpha. Taken literally, an all-weather portfolio (other than a hedge fund that is purely market-neutral and hedged against all beta exposures) cannot exist, because there are only four kinds of weather that matter: stocks up, stocks down, bonds up, bonds down. If you can do well in all these environments then you have a zero equity and bond beta and a high alpha."

-Thomas Idzorek, CFA
Global Chief Investment Officer, Morningstar, Inc.
(unreleased working paper "Caveat Emptor!")



Equities have outperformed bonds over the long term

| Name | Return 1-1-1957 to 12-31-2010 % |
|--|--|
| US Inflation | 3.91 |
| S&P 500 Index | 9.73 |
| S&P 500 Inflation Adjusted | 5.60 |
| US 30 Day TBill | 5.07 |
| US 30 Day TBill Inflation Adjusted | 1.12 |
| US Intermediate-Term Government | 6.82 |
| US Intermediate-Term Government Inflation Adjusted | 2.80 |
| US Long-Term Government | 6.77 |
| US Long-Term Government Inflation Adjusted | 2.75 |

Source: Morningstar, Inc. Data through 4/30/2011



But equities have lagged over long periods

| Name | Return 1-1-1966 to 12-31-1981 | Return 1-1-2000 to 12-31-2009 |
|--|-------------------------------------|-------------------------------------|
| | % | % |
| US Inflation | 7.00 | 2.52 |
| S&P 500 | 5.95 | -0.95 |
| S&P 500 Inflation Adjusted | -0.98 | -3.39 |
| US 30 Day TBill | 6.83 | 2.76 |
| US 30 Day TBill Inflation Adjusted | -0.15 | 0.23 |
| US Intermediate-Term Government | 5.76 | 6.17 |
| US Intermediate-Term Government Inflation Adjusted | -1.15 | 3.56 |
| US Long-Term Government | 2.53 | 7.69 |
| US Long-Term Government Inflation Adjusted | -4.17 | 5.04 |

Source: Morningstar, Inc. Data through 4/30/2011

MORNINGSTAR®

And bond returns don't always surpass inflation

| Name | Return 1-1-1946 to 12-31-1975 |
|--|-------------------------------------|
| | % |
| US Inflation | 3.79 |
| S&P 500 | 10.20 |
| S&P 500 Inflation Adjusted | 6.18 |
| US 30 Day TBill | 3.17 |
| US 30 Day TBill Inflation Adjusted | -0.59 |
| US Intermediate-Term Government | 3.39 |
| US Intermediate-Term Government Inflation Adjusted | -0.38 |
| US Long-Term Government | 2.08 |
| US Long-Term Government Inflation Adjusted | -1.64 |

Source: Morningstar, Inc. Data through 4/30/2011

MORNINGSTAR®

Other headwinds

- ▶ Returns are not guaranteed, but some investors think they are
- ▶ Many of these funds have above-average expense ratios
 - ▶ What are you getting for added expenses?
- ▶ Many managers and strategies are unproven
- ▶ Uncertain how some strategies will fare if fund flows take a sudden turn for the worse during a challenging market environment



Case Study: Longleaf Partners

- ▶ Large-blend fund launched in 1987
- ▶ Asset classes: Equity and fixed-income
- ▶ Absolute Return Benchmark: Inflation + 10%
- ▶ Results through 3/31/11:
 - ▶ Benchmark: 12.92%
 - ▶ Fund: 11.50%
 - ▶ S&P 500: 8.97%
 - ▶ Top performing fund long-term despite frequent cash stake



Case Study: Permanent Portfolio

- ▶ Conservative-allocation fund launched in 1982
- ▶ Asset classes: Gold, silver, swiss francs, stocks, bonds
- ▶ Absolute Return Benchmark: 3-Month Treasury Bill
- ▶ Results through 6/30/11:
 - ▶ Benchmark: 4.67%
 - ▶ Fund: 7.04%
 - ▶ S&P 500: 11.02%
 - ▶ Top performing fund now thanks in part to gold
 - ▶ Lagged in 1990s and 1980s thanks in part to gold



Oldest, Biggest, and Best

| Name | Ticker | Morningstar Category | Inception Date | Total Assets \$ | Total Return 1 Yr % | Category Rank 1 Yr | Total Return 3 Yr Annualized % | Category Rank 3 Yr |
|---------------------------------------|--------|-------------------------|----------------|-----------------|---------------------|--------------------|--------------------------------|--------------------|
| Permanent Portfolio | PRPFX | Conservative Allocation | 12/1/1982 | 13 | 20.5 | 2 | 9.2 | 1 |
| PIMCO All Asset Instl | PAAIX | Moderate Allocation | 7/31/2002 | 22 | 14.4 | 11 | 6.8 | 3 |
| BlackRock Strategic Income Opps Instl | BSIIX | Multisector Bond | 2/5/2008 | 2 | 10.9 | 33 | 7.3 | 61 |
| PIMCO Unconstrained Bond Inst | PFIUX | Multisector Bond | 6/30/2008 | 17 | 4.1 | 90 | | |
| JPMorgan Strategic Income Opps A | JSOAX | Multisector Bond | 10/10/2008 | 14 | 5.5 | 82 | | |
| Putnam Absolute Return 300 A | PTRNX | Short-Term Bond | 12/23/2008 | 1 | 4.5 | 15 | | |
| Loomis Sayles Absolute Strategies A | LABAX | Multisector Bond | 12/15/2010 | 1 | | | | |
| US Inflation | | | | | 2.7 | | 1.5 | |

Source: Morningstar, Inc. Data through 4/30/2011



Key takeaways

- ▶ These funds are not magic – if the managers aren't good, the fund won't be either
- ▶ None of these funds can guarantee a positive return
- ▶ Many of these funds are very expensive
- ▶ If the managers and strategies don't pick undervalued securities or asset classes, investors would be better off in a much cheaper passive vehicle
- ▶ Many of these funds are attracting "hot money" due to marketing and investor interest
- ▶ Stick with proven strategies that have managed through a full market cycle
 - ▶ Example: Rob Arnott's PIMCO All Asset (PASDX)



Questions?

- ▶ Further Reading: "In Practice: Tactical Strategies Miss Their Mark"
 - ▶ By Jeff Ptak, CIO of Morningstar Investment Service
- ▶ Follow-Up: Ryan_Leggio@morningstar.com



Recent performance

| Name | Ticker | Morningstar Category | Total Return 1 Week % |
|---------------------------------------|--------|-------------------------|-----------------------|
| Permanent Portfolio | PRPFX | Conservative Allocation | -3.51 |
| PIMCO All Asset Instl | PAAIX | Moderate Allocation | -3.64 |
| BlackRock Strategic Income Opps Instl | BSIIX | Multisector Bond | -1.33 |
| PIMCO Unconstrained Bond Inst | PFIUX | Multisector Bond | -0.25 |
| JPMorgan Strategic Income Opps A | JSOAX | Multisector Bond | -2.29 |
| Putnam Absolute Return 300 A | PTRNX | Short-Term Bond | -1.49 |
| Loomis Sayles Absolute Strategies A | LABAX | Multisector Bond | -1.70 |
| S&P 500 | | | -12.96 |

Source: Morningstar, Inc. Data through 8/8/2011

MORNINGSTAR®

MORNINGSTAR®