WHY ABSOLUTE RETURN MAKES SENSE NOW

The current interest rate environment presents an inflection point for investors: anticipating that interest rates will move higher but at the same time cognizant that fixed income will still feature in their asset allocations. Retail and institutional investors alike view fixed income as relatively safe and a lower risk allocation compared to equities and - perhaps - alternatives. However, in a rising rate environment, bond math requires that dollar prices fall for fixed income securities with positive duration. Most investors benchmark their fixed income portfolios against an index that has positive duration. Fixed income investors are currently facing a conundrum: even if they are able to outperform a market bond index consistently, the total return in a rising rate environment may be negative. Or in other words, a manager will have achieved only a slightly better, but still negative, result.

Expanding traditional core fixed income strategies to “Plus” sectors may not help in rising rate environments either. This is true not only because these portfolios are still benchmarked to an index with positive duration, but also because spread compression can only aid to enhance relative returns. To compensate for this, some investors may allow their managers to manage portfolio duration asymmetrically; that is, portfolio duration can range from 0 years to benchmark duration +2 years, for example. However, this still only mitigates the problem of likely realizing absolute negative returns. Going further takes us to an absolute return framework. Now portfolio interest rate risk can be positioned to benefit in both declining and rising rate environments. This means that portfolio duration is managed within an absolute duration constraint: for example +/-3 years.

WHAT IS ABSOLUTE RETURN?

Absolute return strategies can be explained by comparing them to relative return strategies. In summary, absolute return strategies are ones that are not managed relative to an index of assets. The table below summarizes the main differences:

<table>
<thead>
<tr>
<th></th>
<th>Relative Return</th>
<th>Absolute Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Performance Target</td>
<td>Combination of assets in universe (traditionally market cap weighted)</td>
<td>Something else (eg: cash+ x)</td>
</tr>
<tr>
<td>2 Neutral Opinion</td>
<td>Hold at benchmark weight</td>
<td>Do not hold at all</td>
</tr>
<tr>
<td>3 Negative Opinion</td>
<td>Underweight or Off-Index: both have consequences that limit the ability to express a negative view.</td>
<td>Freely express negative views (probably via derivatives)</td>
</tr>
</tbody>
</table>

Source: FFTW
• Firstly: the performance of a relative return strategy is typically measured against an index of assets from the permitted universe. By contrast, an absolute return strategy is measured against an index that is typically not a combination of assets (instead it could be measured against cash, another risk free rate or rate of inflation).

• Secondly: in a relative return strategy, if the manager has no opinion about an asset or asset class then it will be held at benchmark weight. By contrast, an absolute return manager will not hold the asset or asset class at all.

• Finally: in a relative return strategy, if the manager wants to express a negative opinion on an asset or an asset class, the alternatives are to underweight the index or take an off-index position. Neither option is costless. Underweighting is limited to the amount in the index (so small index weights restrict the degree of negative conviction that can be expressed) and an off-index position could create a large contribution to benchmark tracking error. By contrast, an absolute return manager is able to freely express negative options, most likely via derivatives.

Despite these differences, the opportunity sets of absolute return and a traditional relative return strategy—for example, Core Plus—are similar:

<table>
<thead>
<tr>
<th>Opportunity Set</th>
<th>Core Plus</th>
<th>Absolute Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governments</td>
<td>Structured Securities (MBS, CMBS, ABS)</td>
<td>Governments Structured Securities (MBS, CMBS, ABS)</td>
</tr>
<tr>
<td>Corporate Credit</td>
<td>Emerging Markets</td>
<td>Corporate Credit Emerging Markets</td>
</tr>
<tr>
<td>Currencies</td>
<td></td>
<td>Currencies</td>
</tr>
</tbody>
</table>

We observe the following:

• The opportunity sets for both strategies are global in nature.

• The assets within both Core Plus and absolute return strategies are similar; in the very least, they will be drawn from the same fixed income asset classes.

• However, the allocations to these sectors are likely to be substantially different between the two strategies. The absolute return strategy is not compelled to follow the sector allocations of the core plus benchmark. Instead it can be allocated according to opportunities.

On the following pages, we present why investing in an absolute return fixed income strategy may be an attractive proposition for investors in this environment.
THE CASE FOR ABSOLUTE RETURN FIXED INCOME

Since investors allocate in the context of a total portfolio, we can demonstrate how an absolute return allocation can enhance the risk-reward profile of a fixed income portfolio. For simplicity, we assume that investors are originally invested only in a US Core strategy (using the Barclays Capital US Aggregate Index as a proxy). The efficient frontier below illustrates the risk-reward characteristics of adding incremental allocations of 25% to an absolute return strategy as represented by FFTW’s Multi Strategy Alpha (USD) Composite.

Efficient Frontier: FFTW Absolute Return + US Core

The frontier above illustrates that moving away from 100% in the Barclays US Aggregate Index into a combination including 25% or 50% of an absolute return strategy would have significantly reduced volatility but only marginally reduced return. The impact of this would have been to increase the risk adjusted return of an investors fixed income portfolio.

In addition it is helpful to plot monthly returns versus yield changes. So next we illustrate the historical relationship among yield changes, the Barclays Capital US Aggregate Index and FFTW’s absolute return composite.

The Barclays Capital US Aggregate Index has a clear negative correlation with 1 month rate changes (left hand chart below). The right hand chart shows the relationship between rate change and return of FFTW’s Multi Strategy Alpha (USD) composite. The strong negative relationship is absent; in fact, the correlation is negligible (0.09).  

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1 There can be no representation or warranty these relationships will persist in the future.
While the charts above clearly demonstrate several attractive features of absolute return strategies such as FFTW's, these use historical data and the period in question had the headwind of falling interest rates for our absolute return strategy (falling rates are a tailwind to traditional strategies). Accordingly, consider the risk-reward surface on a forward looking basis, utilizing the generally held belief that interest rates are to rise over the medium term. Under these circumstances, the headwind could easily become a tailwind for absolute return strategies.

**Risk-Return Surface: US Core + Absolute Return Frontier in Rising Rates**

_FFTW V350 Modified Duration: -1.09 as of 31Dec 2013, Typically in the range of +/-2, Source: FFTW Barclay's US Agg Modified Duration: LBUSMD Index, 5.55 as of 31Dec2013, Source: Bloomberg_
The surface above shows the relationship between portfolio duration, yield change and the resulting return of a portfolio. Portfolios with durations near zero experience no return regardless of yield change (white shaded surface). Portfolios with positive duration experience losses as yields rise (red shaded surface). Portfolios with negative duration experience gains as yields rise (green shaded surface). In a period of rising rates, an absolute return allocation - with the ability to take short duration exposure - could improve the total return of a fixed income investment program.

WHY FFTW ABSOLUTE RETURN

FFTW has developed an absolute return capability that is implemented within a robust risk controlled environment. In addition, FFTW has an independent investment risk management function that monitors and measures portfolio risks using a dynamic set of tools. This approach has yielded positive absolute and risk-adjusted returns over time. Specifically, FFTW’s absolute return Multi Strategy Alpha (USD) composite has delivered positive returns in 23 out of 29 quarters since inception with an information ratio of 1.00 (as of December 31, 2013).

Within a larger investment program, it is notable that this composite has similar risk-adjusted return characteristics to Barclays Capital US Aggregate Index, but the FFTW returns are uncorrelated to this index. Specifically, over the October 2006 – January 2014 period, FFTW’s absolute return Multi Strategy Alpha (USD) composite shows a 0.081 correlation with the Barclays Capital US Aggregate Index. Using the mean monthly returns for the Barclays Capital US Aggregate and the FFTW Multi Strategy Alpha (USD) composite over the same periods, the Barclays Capital US Aggregate had a return-to-risk ratio of 1.46 and the FFTW composite had a return-to-risk ratio of 1.50.

In addition, given consensus forecasts of a rising rate environment from here, it is worth noting how the strategy has performed in historical cases of rate rises. As the following chart shows, FFTW’s absolute return composite has been positive in 6 of the 10 months of largest rate rise - in contrast, the Barclays US Aggregate was positive only twice.

The 10 largest Yield Changes


Ben Steiner, Senior Portfolio Manager, Absolute Return Fixed Income
Alex Johnson, Head of Absolute Return Fixed Income

2 Correlation information for the representative portfolio is provided for illustrative purposes only and relates solely to the representative portfolio for the relevant period.
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Performance results presented are gross of all fees, including management fees and, if applicable, performance fees. A portfolio’s returns will be reduced by all applicable fees and expenses. A description of management and performance fees is included in Part II of FFTW’s Form ADV.

Below is an illustration of the effect of management and performance fees (where applicable) on portfolio returns. The illustration assumes that (i) the portfolio had a steady excess return, gross of fees, of 1% per year (examples A & B), (ii) the portfolio was subject to a yearly management fee of 15 basis points of the market value of the portfolio (examples A & B), (iii) the portfolio was subject to an annual performance fee of 20 percent of the net excess return of the portfolio for the year (example B only), and (iv) there were no cash flows during the period (examples A & B). The illustration shows the compounding effect of management and performance fees (where applicable) on portfolio returns over time, assuming that other factors such as investment return and fees remain constant. The illustration below is simplified. The difference between gross-of-fees and net-of-fees performance return will in practice depend on a variety of factors. The illustration below is cumulative and not annualized.

### Example A: Base Management Fee

<table>
<thead>
<tr>
<th>Period</th>
<th>Gross Cumulative Excess Return</th>
<th>Net Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 year</td>
<td>1.00%</td>
<td>0.85%</td>
</tr>
<tr>
<td>2 years</td>
<td>2.01%</td>
<td>1.71%</td>
</tr>
<tr>
<td>5 years</td>
<td>5.10%</td>
<td>4.32%</td>
</tr>
</tbody>
</table>

### Example B: Base Management and Performance Fee

<table>
<thead>
<tr>
<th>Period</th>
<th>Gross Cumulative Excess Return</th>
<th>Net Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 year</td>
<td>1.00%</td>
<td>0.68%</td>
</tr>
<tr>
<td>2 years</td>
<td>2.01%</td>
<td>1.33%</td>
</tr>
<tr>
<td>5 years</td>
<td>5.10%</td>
<td>3.32%</td>
</tr>
</tbody>
</table>

These performance results may be presented by consultants to clients (or prospective clients) only in accordance with applicable law, including on a one-on-one basis and with required disclosures.

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