Aurora Updates
Role of Absolute Return Funds in a Portfolio

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Executive Summary

- Today, hedge funds / absolute return funds / pure alpha strategies have two significant roles in any broad investment portfolio:
  - **Source of genuine diversification**, and
  - **Yield replacement strategies**.
- Australian superannuation portfolios have typically had a significant capital allocation to equities. This is equally true for retail funds, self-managed funds, corporate funds and industry funds. When viewed from the risk perspective this equity allocation becomes domineering. Moreover, superannuation funds looking to comply with new MySuper legislation will need to demonstrate 'appropriate level of diversification' over 'multiple risk factors'.
- With bond yields at 2.5% to 3.5%, the super-normal returns from fixed interest over the last decade are unlikely to be repeated, and investors are no longer getting compensated for duration risk.
- The Aurora Fortitude Absolute Return Fund is an example of a deeply diversifying, low risk investment that is expected to generate higher returns over the medium to long term compared to bonds. We quantify this **reduction in risk and increase in expected return** for a typical superannuation portfolio.

Disclaimer

Role of Absolute Return Funds in a Portfolio

'Hedge funds' / 'absolute return funds' / 'pure alpha strategies' have been available investment vehicles for decades, and have been a part of many Australian investor's portfolios for the last one to two decades. This note will explain the two main motivations for including these strategies in any portfolio today:

a) Source of genuine diversification, and

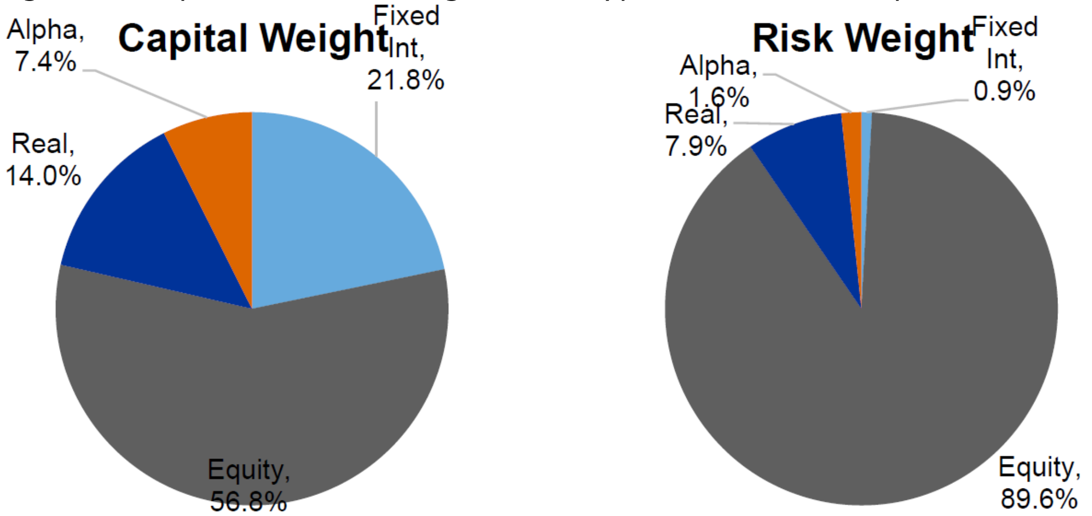
b) Yield replacement strategies.

These strategies have been given a variety of names, and as we shall see have a spectrum of risk characteristics and styles. For the purposes of this note, we shall use the term 'absolute return funds' as a generic term to represent the class of these investments. This name emphasises the lack of underlying benchmark in these investments – for many investments such as active equity, the benchmark characteristics mostly determines the investment risk and return.

Genuine Diversification

Most Australian retirement savings have a significant allocation to equity asset classes – Australian, international, emerging market and private. Typically, around 60% of assets are invested in these asset classes. The residual assets are typically invested in fixed interest (bonds, cash, and credit products of increasing risk, …), real assets (property, infrastructure, …) and lastly alpha strategies. Figure 1 below shows the capital allocation of a typical Australian superannuation fund in terms of capital allocation (left hand side) and then the implied risk allocation (right hand side). **The oversized risk weight to equities is a result of two factors** – 1) **weight in equities**, and 2) **volatility of equities** compared to other lower risk asset classes.

Figure 1: Capital and Risk Weights of a Typical Australian Superannuation Fund



Source: Russell Investments, typical growth fund June 2012

The key conclusion from this analysis is that **Australian superannuation funds have little diversification** due to the significant weight in high risk equities. Many funds have responded to this conclusion by increasing allocation to other 'flavours' of equity risk – emerging market, private equity, high yield credit, investment grade credit. But over the last two decades the common risk drivers of these asset classes has increased radically – the correlation between Australian, international and emerging listed equities was 0.0-0.4 twenty years ago compared to 0.8-0.9 today. A risk factor decomposition of a typical 60/40 fund bears out this point – **90% of the overall risk comes from a common equity risk factor** while the contribution from the styles of equity risk are between -1% and +1%.

Hence Australian superannuation funds effectively have 'all their eggs in one basket'. Moreover there is strong regulatory drivers with the Stronger Super / MySuper reforms:

- Superannuation funds must determine the **'appropriate level of diversification for each investment strategy'**.[1]

- For MySuper products, the superannuation fund must document that the investment strategy is **'diversified over multiple risk factors'**.[2]

The undeniable mathematical fact is that any 60/40 fund would find it very difficult arguing 90% of risk from one factor is in any way an 'appropriate level of diversification'.

Many have disputed the need for diversification given many superannuation funds have recovered losses borne in the global financial crisis 2007-09. Furthermore, many investors suggest they have the capacity to bear significant risk due to their long investment horizon. Neither argument addresses the key benefit of reducing downside through the investment period to deliver better and more stable long term returns. An everyday risk is a good example to illustrate – many home owners protect their investment through insurance because the potential losses are undesirable compared to the cost of protection. Few home owners consider the annual cost of insurance as a trading loss because their house has not burnt down in the last year!

Absolute return funds can demonstrate an adequate level of diversification. One such fund is the **Aurora Fortitude Absolute Return Fund** (AFARF) that uses a multi strategy process investing in listed Australian equities and debt instruments to deliver low risk absolute returns. Figure 2 below shows AFARF is a bona fide diversifier from the dominant equity risk factor.

Also shown on Figure 2 is an index of peer funds which demonstrate little diversification to that of equities. **Not all absolute return funds are the same.** Hence a clear understanding of where an absolute return fund falls into the total portfolio is required to select managers and benefit from their inclusion.

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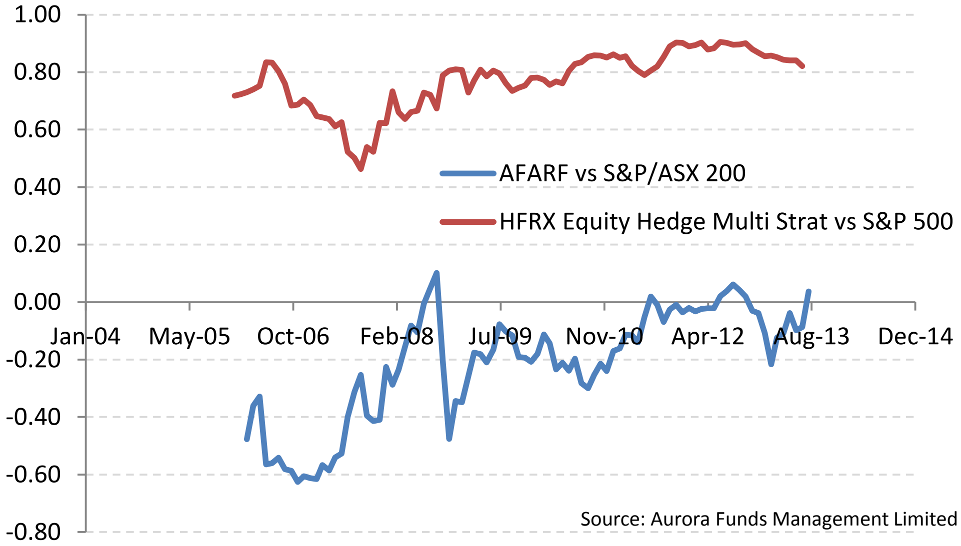
[1] Australian Prudential Regulation Authority, *Prudential Standard SPS 530: Investment Governance*, paragraph 18. From *Superannuation Industry (Supervision) Act 1993* (Cth), sections 52(6)(a)(ii) and 52(6)(c).

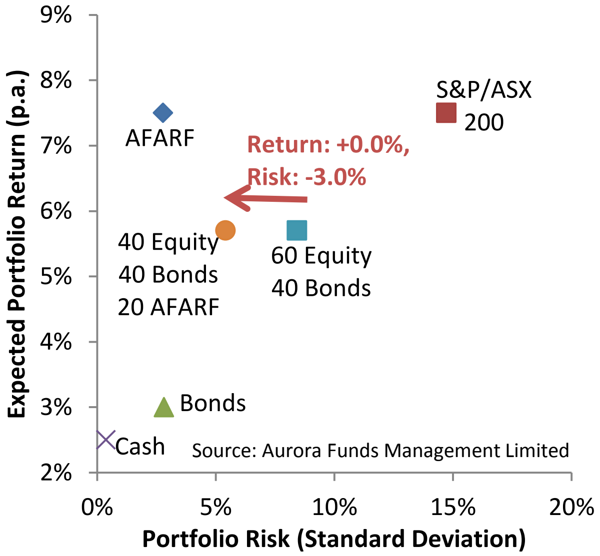
[2] Australian Prudential Regulation Authority, *Prudential Standard SPS 530: Investment Governance*, paragraph 21(a).

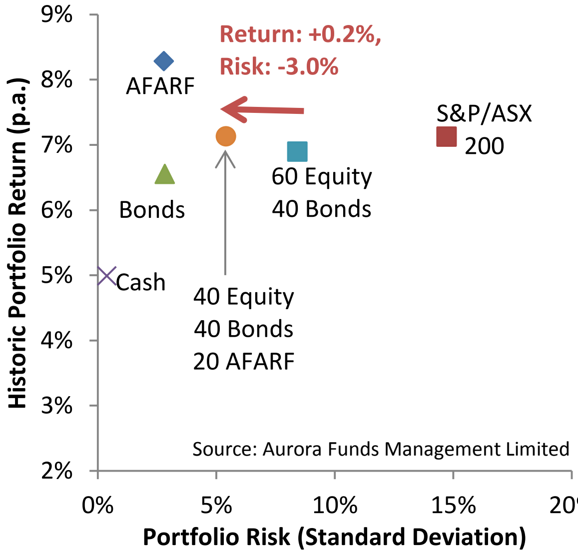
Figure 2: Correlation of Absolute Return Funds with Dominant Equity Risk



Including an absolute return fund into a standard superannuation fund with 60% weighted to equity can have a number of benefits – mainly a decrease in risk due to diversification, and/or increase in return. To demonstrate the first benefit, consider funding a 20% allocation into AFARF from the equity allocation. The impact of this change on the total portfolio risk and return[3] is to leave the expected return broadly unchanged and **significantly decrease portfolio risk**. See Figure 3 below.

Figure 3: Impact of Including Absolute Return Fund on Overall Portfolio Risk & Return





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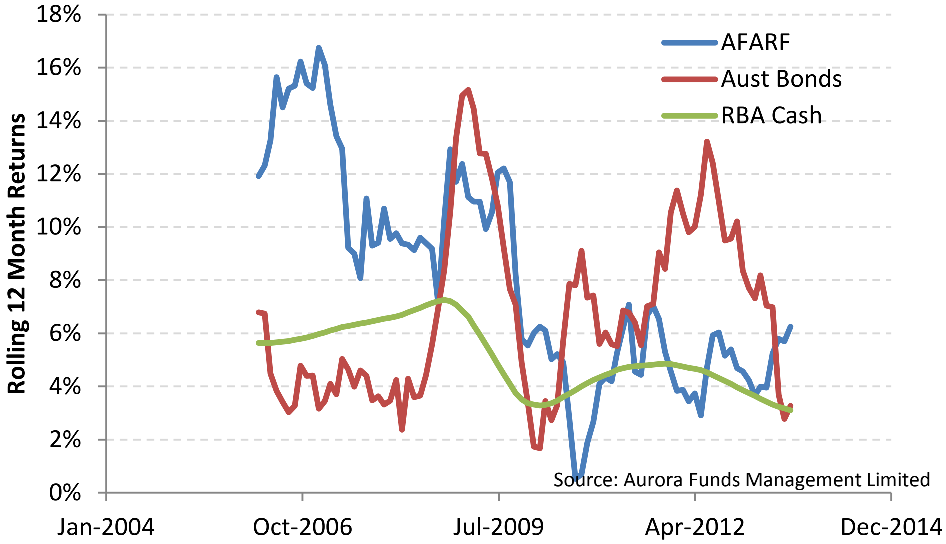
[3] This analysis uses expected returns where cash is assumed to return 2.5%, 5 year AUD sovereign risk bond term premium of 0.5%, equities are assumed to have a risk premium of 4.5% over bonds while AFARF is assumed to return 5.0% over cash. Historic returns and risk characteristics are derived from monthly returns since February 2005 when AFARF was launched.

Yield Replacement Strategy

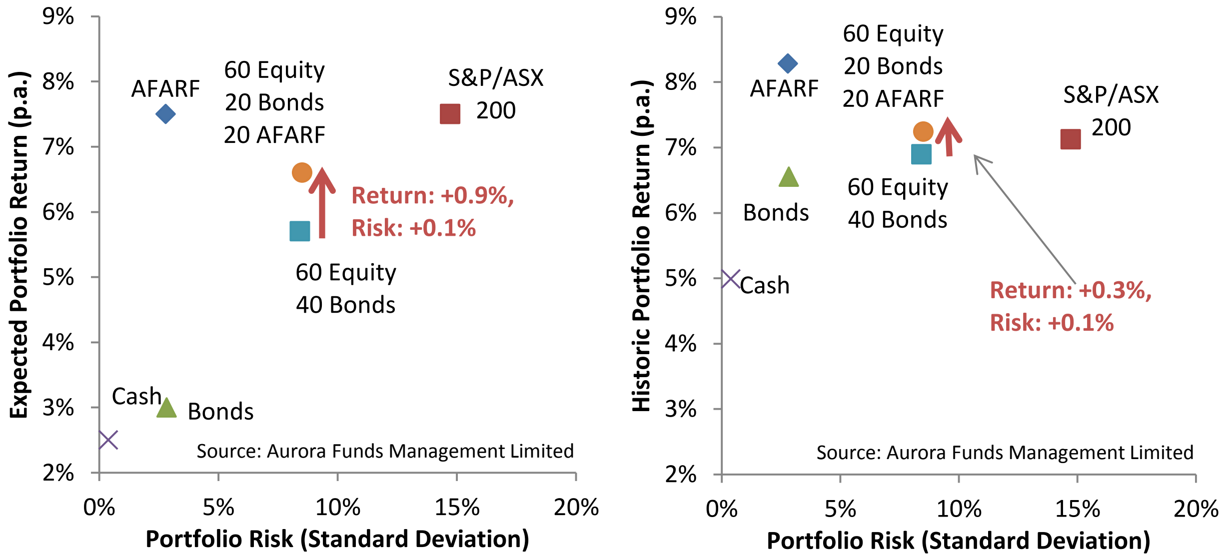
With bond yields falling globally and locally, there are strong arguments to suggest that fixed interest has only downside from these levels. Alternatively, if a spike in yields is not expected, with 3% bond yields (5 year), the most optimistic result is that the super-normal returns of the last decade are long gone. See Figure 4 below.

Figure 4: Historic Annual Returns for Different Investments



To demonstrate the increase in expected return that can be achieved by allocating to absolute return funds consider funding a 20% allocation into AFARF from the bond allocation of a 60/40 portfolio. The impact of this change on the total portfolio risk and return is to leave the expected risk broadly unchanged and **increase portfolio expected return**. See Figure 5 below.

Figure 5: Impact of Including Absolute Return Fund on Overall Portfolio Risk & Return



Access to Absolute Return Strategies

Historically, access to absolute return funds has been problematic and expensive for all but the very largest investors. Today investors can chose a variety of methods to invest in the AFARF:

- Retail investment by unlisted fund available on a number of platforms.
- Investment direct into ASX listed fund (ASX code: ABW).
- Institutional mandate for a managed account giving investors ultimate security over their investment and assets.
- Institutional investment in unlisted Cayman domiciled fund in a variety of currencies.

All of these mechanisms offer daily liquidity and no lock-ups or redemption gates. Investors can access the AFARF strategy with as little capital as $1.07.[4]

Note

The Aurora Fortitude Absolute Return Fund (ARSN 145 894 800, APIR Code AFM0005AU) has been issued by Aurora Funds Management Limited.

Disclaimer

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[4] Offer price on ASX on 14 August 2013 for ABW.