

Targeted Absolute Return funds: Mind the gap!

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Tempo Structured Products and gbi2's first Debating Chamber paper shines a light on the Targeted Absolute Return funds sector. The paper considers why investors are attracted to the concept of 'absolute return' investing, looks back on the evolution of the UK Investment Association's Targeted Absolute Return funds sector, focuses on how the sector and funds in it have been marketed, and drills into fund performance data to objectively assess whether the sector's alluring marketing promise of 'positive returns in all market conditions' is actually being delivered to investors. The paper highlights the reasons why professional advisers and investors need to think carefully about the sector, and the risks that actively managed mutual funds per se make investors bear. It also highlights the merits and efficacy of structured products, and their potential to add value within investor portfolios, as an alternative to Targeted Absolute Return funds.

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1. Introduction

The catalyst for this first Debating Chamber paper was a growing sense, seemingly shared by an increasing number of industry commentators, wealth managers and professional advisers, that there is a significant gap between the marketing promises of the Targeted Absolute Return funds sector and the reality of the performance and risk / return profiles actually being delivered by funds in the sector to investors.

We wanted to take a close look at the founding principles and concept of the sector from an investor's perspective, and dive beneath the surface of the sector and its marketing, dissecting performance data and pulling it apart, to test a specific hypothesis: *that half of the Targeted Absolute Return funds sector may not be delivering what they promise half of the time*. In other words, that Targeted Absolute Return funds are not nearly so absolute as their name and marketing suggests.

We recognise that the objective of absolute return investing, i.e. positive returns in all market conditions, is understandably of fundamental interest to investors. While the past ten years saw exceptional market stimulus following the global financial crisis, driving 'easy returns' for fund managers and investors, we believe the next decade is set to offer far more challenging investment conditions. Consequently, we wanted to not only ask questions about the efficiency of Targeted Absolute Return funds but to also draw attention to structured products as a credible alternative, highlighting the merits of best of breed propositions and their efficacy within investor portfolios.

As the name of this new series of papers suggests, we wish to encourage debate across the wealth management and professional advisory industry.

We are delighted that David Stevenson, Financial Times, Investment Week and MoneyWeek columnist, and Graham Bentley, Managing Director of investment consultancy gbi2, a veteran of the asset management industry, and co-author of this first paper, are contributing to the Debating Chamber.

2. Executive summary

Analysis of the performance data of funds in the Targeted Absolute Return sector validates that our general sense and hypothesis - *half of Targeted Absolute Return funds do not work very well half of the time* - is tenable; based on the analysis undertaken for this paper, conducted by independent consultancy firm gbi2, we conclude that the typical Targeted Absolute Return funds does not work very well more than half of the time: producing positive returns in less than 50% of one-year rolling periods over the last five years; exceeding their own objectives in c. 49% of periods; and their own benchmarks in c. 41% of periods.

While the concept of absolute return investing is the holy grail for investors – after all, what investor does not want positive returns in all market conditions – we suggest that the Targeted Absolute Return funds sector is not delivering what it is promising and what investors are expecting and seeking.

Perhaps more provocatively, we suggest that the active mutual funds industry is not *capable* of delivering this, simply due to investment market fundamentals.

We draw attention to best-of-breed structured products, including specific strategies that Tempo has developed, that offer features neither active nor passive fund management is able to provide, highlighting that such products may be better placed to deliver the concept of absolute returns than Targeted Absolute Return funds, with notable differences:

- Instead of variable return, risk and charges, investors in structured products benefit from contractual, legal obligations, that define parameters and conditions for risk and return, with the variable instead being timing

We assert that structured products may better serve many investors.

This paper is a call to action: to think carefully about the Targeted Absolute Return funds sector; and to think objectively about 'best of breed' structured products.

3. Identifying the holy grail for investors: positive returns in all market conditions

If investors were able to design their own investment solutions, they might look something like this:

- **Positive returns**
- **No downside risk**
- **No charges**

Conceptually, this has been the holy grail for investors since the dawn of securities markets. However, most wealth managers and professional advisers understand that where stock markets are concerned, these aspirations are simply wishful thinking.

Investment returns are compensation for an investor's loss of use of their money, and the risk of not being compensated is inherent in the transaction.

Debt markets work on the basis that returns in the form of interest payments compensate lenders for lost opportunities to spend, or to have lent, elsewhere. Borrowers who are deemed less likely to make interest payments, or to repay the principle, have to pay more interest to compensate lenders / investors for taking that risk.

Medieval merchants wanting capital to finance trading trips recognised that the risk that their ships might sink and suffer a total loss was high, and so offered a share of the profits rather than a flat interest payment. The potential profits had to exceed any prevailing interest rate, to compensate for the risk of total loss. Centuries later, the industrial revolution created manufacturing companies bearing similar excess risks and spectacular opportunities. Today modern economies rely on investment markets in order to function effectively.

It is an inescapable truth that there is risk in any financial transaction. Indeed, the fund management industry has spent 150 years telling investors that risk and return are inextricably linked. Throughout that period, investment managers sought to persuade investors that through skill they can either provide excess compensation for a given level of risk, i.e. higher alpha, or offer a given level of return alongside a risk 'discount', i.e. lower beta. Alas, few managers have been able to demonstrate their ability to do that with any consistency.

Sailing is a relatively straightforward pastime, with a quality boat, a fair wind and calm waters. But the nature of the sea is to exhibit extremes of conditions, weather and geography, combining to potentially drown the most skilful mariner. Market conditions can similarly overwhelm investment managers and their investors, yet through a combination of (apparently) clever strategies and skills some investment managers claim to be able to provide the investment 'holy grail': positive investment returns in all market conditions.

These investment managers profess to have developed strategies and skills that enable them to provide an *absolute* return, rather than a return relative to a particular market index or benchmark. One can of course beat the benchmark, relatively speaking, by not losing as much money, but the primary aim of the Absolute Return / Targeted Absolute Return fund managers is to generate positive returns, i.e. greater than 0%, in all market conditions. A number of these managers have gone on to raise the stakes higher, in terms of the level of anticipated absolute performance, quoting their target returns to not just be above zero but to be a precise return in excess of a risk-free rate, e.g. LIBOR.

4. Selling investors what they want: marketing the holy grail

The holy grail of absolute returns, i.e. positive returns in all market conditions, is clearly an enticing prospect for investors who want to believe that it is achievable. It is also an attractive proposition for fund managers who want to increase their assets under management (AUM).

However, the fundamental question is whether fund managers have the ability to actually deliver what they promise, particularly as many investment professionals are of the opinion that delivering positive returns in all market conditions simply isn't a realistic expectation. But should a few niggling doubts and inescapable facts get in the way of a good marketing opportunity? Apparently not, if we look at the growth of the Targeted Absolute Return funds sector over the last decade.

Over the last decade, marketing of the absolute return holy grail has been well-crafted by the fund management industry and the largest Targeted Absolute Return fund managers. The nascent sector also benefitted from fortuitous timing, coinciding with the 2008 – 2009 global financial crisis.

The rapid acceptance of the new type of fund and the scale of the sector today shows just how alluring the concept is for investors, and how persuasive the fund managers have been, with investors flocking to invest.

The popularity of Absolute Return / Targeted Absolute Return funds has risen dramatically over the ten-year period that the sector has existed, particularly through 2011 to 2014, when more than half of the absolute return funds that exist today were launched. However, concerns about the sector and funds started to emerge relatively early on, and have been reverberating for a number of years, albeit perhaps only escalating more recently.

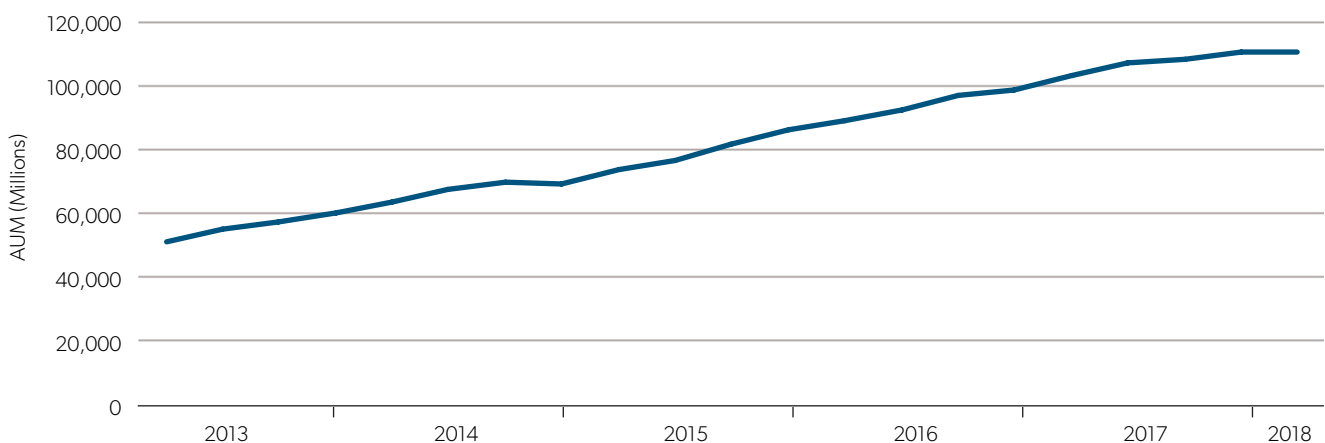
In 2013 the UK regulator, The Financial Services Authority (FSA), focused on the sector, voicing concerns that investors appeared to believe that ‘absolute return’ meant ‘guaranteed return’. It persuaded the Investment Association (IA) to change the sector’s name to ‘Targeted Absolute Return’. The IA also extended the time period over which the achievement of positive returns would be assessed (for whose benefit is not clear).

However this tinkering did nothing to stem the sector’s rush to launch the funds, or investor’s appetite to invest material sums into them. Since 2013, the number of funds in the sector has increased from 50 to 86, and assets have more than doubled. This has included some of the ‘flagship’ funds.

Pension freedoms announced in 2014, which took effect in 2015, contributed to even higher sales, with potential retirees evidently persuaded that a safe and secure solution to their decumulation portfolio requirements was on offer.

Today (to 30 June 2018), the sector’s total AUM stands at around £110 billion. Figure 1 shows the ascent of the sector’s AUM since 2013.

Figure 1: Targeted Absolute Return funds sector AUM



Source: Fundscape/gbi2, 30 June 2018

Yet as more fund groups leapt on the gravy train, it was already becoming clear that ‘doing what it says on the tin’ was more difficult to achieve than the simple marketing messages suggested. Perhaps the marketing of the Absolute Return / Targeted Absolute Return funds can be viewed in phases:

- Then: The well-crafted marketing of the apparently ground-breaking concept of the holy grail solution: positive returns in all market conditions;
- Now: The explanation that the holy grail is harder to achieve than the marketing promised; that this has been due to market conditions, that the future will prove that such strategies can work, suggesting that investors be patient and remain invested (while the fund managers extract their annual management charges);
- Next: We shall have to wait and see!

5. Regulatory scrutiny: increasing concerns

Increasing regulatory focus on and criticism of Targeted Absolute Return funds, and an increasing number of professional advisers openly questioning the ability of the funds to deliver the promised performance, were among the catalysts that led to this paper.

In its Asset Management Market Study, the Financial Conduct Authority (FCA) chose to single out the Targeted Absolute Return Funds sector for criticism, as opaque, complicated, not meeting their objectives and generally exhibiting poor performance:

“Our analysis suggested that customers face a relatively high likelihood of negative performance. We also found that funds in this category can have high volatility, with some funds showing an annualised volatility greater than 10%” FCA, MS15/2.3, Chapter 6 page 39

Specific points the regulator made included:

- Funds not reporting performance against a *relevant* target return;
- Funds disclosing performance against cash alone, which may be misleading investors “about the real outperformance compared to expectations”;
- Concerns about fund managers charging performance fees when returns are lower than the fund’s most ambitious performance target.

If that withering criticism was not enough, the regulator went on to chastise the investment managers for not using their stated benchmarks in marketing material, for being hazy about their objectives and associated time horizons and, worse, for using comparative measures in marketing materials that showed funds in a better light than if the managers had used their stated benchmarks.

Pretty strong stuff. But it would be too easy to simply use these regulatory criticisms as the basis for opining that Targeted Absolute Return Funds are not fit for purpose. We felt that a deeper dive was required.

6. The Targeted Absolute Return funds sector: strategies and types of funds

Before delving into the sector, the funds and their performance, a look back at the evolution of the concept of absolute return investing, in its various guises, may be helpful.

The idea of delivering positive returns in all market conditions is not new. Alfred Winslow Jones’s first hedge fund, in 1949, borrowed money to buy securities he thought would rise, while borrowing and subsequently selling shares he did not own in companies he thought would see share price falls. Buying these back at a lower price and returning them to the lender would crystallise a profit.

As investment theory developed through the 1950’s, the idea of combining low-correlating assets to reduce risk became the bedrock of the asset allocation processes which dominate the retail market today.

The principle of absolute return funds is that risk-reducing (combining low-correlating assets, etc.) strategies can be used alongside return-enhancing strategies (leveraging, etc.) to get the best of both worlds, i.e., positive returns in all market conditions.

The Targeted Absolute Return Funds sector is now ten years old. Its definition simply stipulates that funds within the sector must be managed with the aim of delivering positive returns in any market conditions; asset selection is at the discretion of the manager. Despite the IA updating the name of the sector from Absolute Return to *Targeted* Absolute Return in 2013, prompted by the FSA, many investors appear to still be confused by the various funds and approaches, given the ‘broad church’ of sector membership.

As capital markets have become ever more sophisticated, computing power and information availability have allowed investment strategies to become ever more complicated. At this point, it may also be helpful to

consider the difference between ‘complex’ and ‘complicated’: misunderstanding the difference can lead to investors (and professionals) misinterpreting the likely outcome of an investment strategy, consequently taking the wrong approach to solving a problem – or worse, to applying the right approach to the wrong problem.

Let’s think about systems, generally, before considering stock markets more specifically:

Systems can be observed in two dimensions – the first reflects the ‘set-up’ or ‘process’ of the system; the second is the ability to predict the system’s behaviour or outcome. Set up / process can be very easy to understand (simple) through to very hard to understand (complicated). For example, a glove is very simple, but a watch is very complicated (try taking it apart and re-assembling it).

Predictability of outcome, however, can depend on the initial set of conditions:

- **Ordered:** i.e. showing total predictability and no surprises (my glove and my watch)
- **Complex:** i.e. quite predictable but with some surprises (the education system)
- **Chaotic:** i.e. very unpredictable with constant surprises (the weather)

For example a double-rod pendulum is a simple system that is easy to assemble and to understand – it’s one pendulum attached to the bottom of another. However, the motion of a double-rod pendulum is chaotic, because of the high sensitivity to its set up.

When investment managers purport to offer simple routes to investment success, it is wise to bear in mind that a simple product like an OEIC is linked to a chaotic system, i.e. the stock market.

While complication does not have to lead to less predictability – as in our watch – actively managed investment strategies are not fixed, like the components of a watch. Instead, they are like our double-rod pendulum, as the behaviour of the moving investment parts become more complex, the predictability of the investment outcomes decreases.

And it is with this in mind that the notion of being able to generate positive returns in all market conditions, or even a claim that this is a likely outcome, is a challenging one for many professional advisers and (objective) observers of the Targeted Absolute Return funds sector. Unlike our initial investors designing their own investments, who were able to ignore conventional investment wisdom and constraints, investment professionals know this is basically not possible.

But let’s park this real world understanding for a moment and look at the range of Targeted Absolute Return fund strategies, that are apparently designed to deliver predictable returns from chaotic markets:

Long-short equity or bond

This is the Winslow-Jones model, buying what you think will go up in price, and shorting what you think will go down, such as the securities of companies. Apart from the obvious benefits (assuming you get it right), this approach reduces net exposure to the ‘direction’ of the underlying market, earning the attribute ‘equity market neutral’. This strategy can also be applied to the bond market.

Long-only multi asset

Professor Harry Markowitz and others extolled the virtues of reducing risk through the use of low-correlating assets, in other words, portfolio diversification. Long-only multi asset funds follow that credo, often using alternative investment areas, such as infrastructure and private equity, that are not normally accessible by retail investors.

Macro

Macro is aligned with the approach of multi-asset and long-short funds but is focused on forecasting ‘top down’ global macroeconomic themes and events rather than the ‘bottom up’ behaviour of particular companies. Macro funds are almost exclusively ‘top-down’ investments, often getting exposure to markets through the efficient use of futures and options; this allows both long and short positions to be held in a variety of securities and currencies.

Multi strategy

These funds use various non-correlating investment strategies, identifying perceived mispricing of the same or similar assets in different markets, and across various derivatives of those assets. They will also take positions in, or make 'bets' on, the potential for the prices of pairs of assets to diverge or converge, e.g. a particular sector versus the market as a whole, or between currencies, interest rates and so on. Market timing is also used, although managers prefer to use the term 'directional strategies'. Arbitraging between markets and derivatives is especially complicated; where a single strategy might have between 30 and 200 securities, and as the name suggests there may be many hundreds of strategies and trades being performed in a multi-strategy portfolio.

7. Sector overview: behemoths and minnows

There are currently 86 funds in the sector. Total sector assets are over £110 billion (as at 30 June 2018).

The largest fund in the sector is the well-known SLA Global Absolute Return Strategies, otherwise known as 'GARS'. This launched in 2008 and currently has £17 billion AUM (notably down from its AUM high of £20 billion: the fund was the largest fund in the UK, at one point).

The longest running / oldest surviving fund, launched in 1993, is Newton Real Return, which is also the third-largest fund in the sector, with AUM of almost £9 billion.

The five biggest funds in the sector hold over £50 billion AUM, nearly half of the sector's total AUM. The 27 biggest funds in the sector own 85% of its assets.

Figure 2 shows the 5 biggest funds in the sector, by AUM, as at 30 June 2018:

Figure 2: The 5 biggest funds in sector

Fund	Launched	AUM (£ millions)	% of Sector
SLA Global Absolute Return Strategies	28 Oct 2008	19,064	17
Invesco Perpetual Global Targeted Returns	09 Sep 2013	12,412	11
Old Mutual Global Equity Absolute Return	30 Jun 2009	10,497	10
Newton Real Return	01 Sep 1993	9,530	9
Aviva Investors Multi-Strategy Target Return	01 Jul 2014	5,562	5

Source: FE Analytics, gbi2, as at 30 June 2018

However, not all funds are behemoths. As more managers attempted to leap on the sector's bandwagon the majority of funds have been rather less successful in gathering assets.

36 funds, or 42% of the total number of managers, have raised less than £100 million AUM.

8. Does it actually work?

We began this paper by suggesting that investors might want the following, if able to design their own investments:

- positive returns (let's colour that in a little, and say positive returns greater than cash and inflation);
- no downside risk (let's say risk controlled); and
- no charges (or low charges).

However, an understanding of the aims and objectives of Targeted Absolute Return funds is needed, before testing their efficacy against their own stated objectives, the marketing promises being made, and these three basic points of interest for investors.

A moving feast of aims, objectives, benchmarks and timeframes: or 'hopes', as opposed to contractual, legal obligations ...

Before we get into the detail of specific funds' aims and objectives, let's firstly pick up on a fundamental fact about active fund management: simply put, the aims and objectives of funds are basically nothing more than 'hopes'. And hopes are not promises ... and they are certainly not contractual legal obligations to actually deliver what is stated.

Contrast this with the explicit, contractual legal obligations that are created by structured products and some important points come to the fore.

We will draw further attention to these important points for professional advisers and investors to understand in the latter sections. But first let's investigate the specifics of Targeted Absolute Return funds' aims and objectives.

Aims and objectives

While around 50% of the investment managers conform to an obvious definition of positive return, i.e. greater than 0%, others are more circumspect. For example, one manager's objective reads "To seek to achieve an attractive return on capital while simultaneously attempting to limit the risk of capital loss". The aim here appears to be the seeking, rather than achieving; and there is no definition of attractive, or the degree of limitation of loss.

Another manager hedges his bets by stating that the fund "seeks to generate returns through different market conditions and with an expected level of risk lower than equity markets". Yet more 'seeking' going on, and in that team's case, they cannot bring themselves to use the word 'positive'.

A number of managers garnish the phrase 'positive returns' with adjectives like 'attractive' or 'strong', but again there is no definition – and clearly one man's 'attractive' may be another woman's 'meagre', or downright ugly.

One mixed-asset fund defines its aims as "long-term steady growth" – which we would suggest is a fairly meaningless differentiator from any of the general mixed-asset sectors and one wonders why the fund chooses to belong to the Targeted Absolute Return funds sector, other than to bask in its asset-raising glory.

Benchmarks

The subjective approach to defining an aim can also be supplemented by the use of a benchmark. Here the managers have set *themselves* a target...or not.

Almost a quarter of the funds in the sector have no benchmark, or a benchmark designated as "No specified benchmark".

Confusingly, one fund with no *specified* benchmark has an aim that looks extraordinarily *like* a benchmark "...2-3% above the London Interbank Offered Rate (LIBOR) 90 Day (GBP) over a full market cycle (being 3-5 years)".

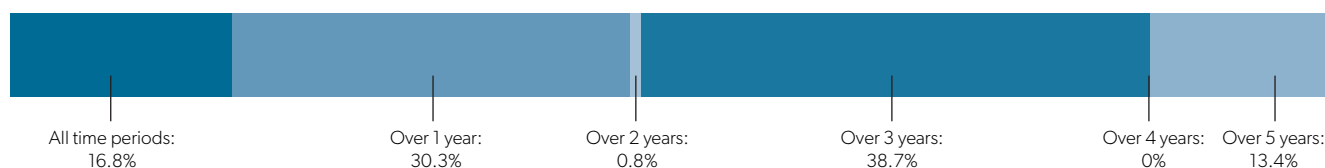
When funds do use benchmarks, they are varied, with an astonishing 48 different comparative measures being used. Three funds are content to measure themselves against their peers via the sector average, despite the sector being far from homogenous.

Timeframes

If investors were not confused enough by a multiplicity of aims, objectives and benchmarks, the majority of Targeted Absolute Return managers also ask their investors to judge the efficacy of their strategies over a variety of time frames, that themselves have changed over time.

When the sector was first constructed, the time horizon for funds to demonstrate their ability to provide permanently positive returns was a year. Today, there are a variety of time horizons, with less than 1-in-5 (just under 17%) daring to promise positive returns over all periods. The greatest proportion of funds choose to measure themselves over three years. Figure 3 shows the different timeframes used by the sector's funds.

Figure 3: A mishmash of timeframes



Source: FE, 30 June 2018

Returns

Let's look at the first component of our investors' self-designed investment solution: returns. We drilled into the performance of the sector and specific funds, including the best, the biggest and the worst, to assess what is actually being delivered, versus what is being 'promised'.

We assessed performance over the last five years, the longest time horizon that fund managers might reasonably expect to be able to use to demonstrate the efficacy of their strategies, including breaking this down into 49 rolling one-year periods.

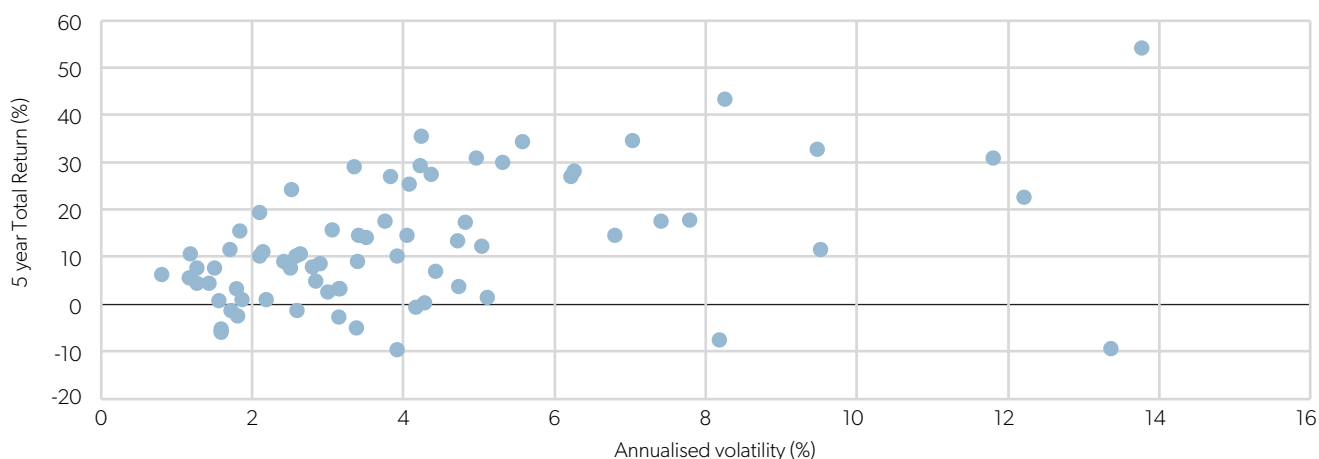
As with all of the fund performance data and analysis behind this paper, we have looked at funds on a bid to bid, net distributions reinvested, net of charges basis.

Wide variance in fund returns across the sector ...

Although Targeted Absolute Return funds have a variety of aims, objectives and benchmarks, their key message, broadly, is the provision of positive returns in all market conditions.

Consequently, one might expect that there would be a clustering of returns, with a narrow range of volatility. Given the points that we've already made, however, it may not be surprising that the range of returns being delivered is, on the contrary, very wide. Figure 4 highlights the variance in funds' returns:

Figure 4: Variance of returns of Targeted Absolute Return funds

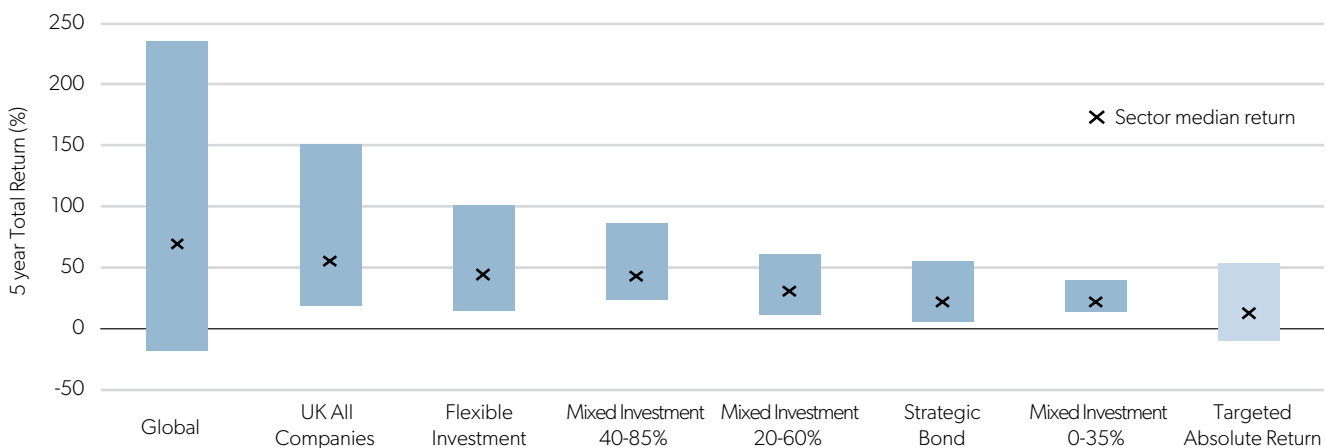


Source: gbi2/FE Analytics, 5 years to 30 June 2018

The immediate observation to draw attention to is that over the past five years, 15% of Targeted Absolute Return funds have produced negative returns. Over three years, the percentage is higher still: 30% have failed to produce a positive return.

Comparing the variance of returns of the Targeted Absolute Return funds sector to other sectors is also illuminating. Figure 5 highlights this, indicating each sector's median return.

Figure 5: Variance of returns, including median return, by sector



Source: gbi2/FE Analytics, 5 yrs to 30 June 2018

As one might expect, the median return for the Targeted Absolute Return funds is the lowest of the sectors shown. But more surprisingly, so is the performance of the worst fund.

In other words, investing in a plain old multi-asset Mixed Investment fund would have been a safer choice - with hindsight. And, in fact, none of the Mixed Investment 0-35% or 20%-60% funds produced negative returns.

Now let's consider returns delivered: including the best performing, biggest, and worst performing funds in the sector.

Performance of the best performing funds, over the last five years ...

Let's start by looking at the best performing funds. Figure 6 shows the details:

Figure 6: Performance of the best Targeted Absolute Return funds

Fund	£AUM (m)	5 year total return (%)	5 year comp ann return (%)	Volatility (%)	Negative ann periods	Positive ann periods
City Financial Absolute Equity	279.6	54.17	9.04	13.77	12	37
JPMorgan Global Macro Opportunities	1,013.3	43.34	7.47	8.26	12	37
Man GLG Alpha Select Alternative	761.4	35.54	6.27	4.24	7	42
7IM Real Return	73.9	34.58	6.12	7.04	7	42
Schroder UK Dynamic Absolute Return	319.7	34.38	6.09	5.59	14	35

Source: FE Analytics. 5yrs to 30 June 2018

Over the past five years, to 30 June 2018, the best performing fund was City Financial Absolute Equity, returning 54.17%, or a little over 9% p.a. compound. Closer inspection reveals that over the period the fund also had the highest volatility in the sector and exhibited wildly diverse returns, between 36% and -17% over rolling one-year periods, twelve of which were negative. This investment journey is not exactly 'positive returns in all market conditions'.

It is also worth bearing in mind that the average UK All Companies fund, over the same period – which was a period when many investors, both professional and private, comfortably made positive returns – had only 6 negative periods, with an average return greater than the best Targeted Absolute Return fund.

Performance of the biggest funds, over the last five years ...

Having looked at the best performing funds, let's turn to the performance of the biggest. Figure 7 shows the details:

Figure 7: Performance of the biggest Targeted Absolute Return funds

Fund	£AUM (m)	5 year total return (%)	5 year comp ann return (%)	Volatility (%)	Negative ann periods	Positive ann periods
SLA Global Absolute Return Strategies	19,064	6.80	1.32	4.43	17	32
Invesco Perpetual Global Targeted Returns	12,412	N/A	N/A	N/A	N/A	N/A
Old Mutual Global Equity Absolute Return	10,497	27.35	4.95	4.38	0	49
Newton Real Return	9,530	13.4	2.55	4.72	11	38
Aviva Multi-Strategy Target Return	5,562	N/A	N/A	N/A	N/A	N/A

Source: FE Analytics. 5yrs to 30 June 2018. Invesco and Aviva funds do not have 5 year histories.

Performance of the worst performing funds, over the last five years ...

And for completeness, we passed our slide rule over the worst performing funds.

Among the worst Targeted Absolute Return fund performances were fixed income focused funds, investing in apparently 'safer' bond investments:

Figure 8: Performance of the worst Targeted Absolute Return funds

Fund	£AUM (m)	5 year total return (%)	5 year comp ann return (%)	Volatility (%)	Negative ann periods	Positive ann periods
Threadneedle Absolute Return Bond	29	-9.07	-1.88	3.92	36	13
GAM Star Discretionary FX	86	-9.52	-1.98	13.37	26	23
GAM Star Global Rates	790	-7.68	-1.59	8.19	28	21
IFML Vitality Targeted Absolute Return Bond	2	-5.95	-1.22	1.59	28	21
Investec Target Return Bond	268	-5.4	-1.10	1.59	27	22

Source: FE Analytics. 5yrs to 30 June 2018

Not exactly positive returns in all market conditions. Meanwhile also noting that the average Sterling Strategic Bond fund saw only 5 negative one-year periods, over those same 49 rolling one-year periods.

It is hard to draw a conclusion other than in the main, the managers of these funds have exhibited zero value versus their long-only counterparts.

How likely is it that Targeted Absolute Return funds will generate positive returns?

We sought to measure and analyse this by looking at 49 monthly rolling one-year periods over the last five years, to see what proportion of those periods resulted in: a) positive returns and b) returns in excess of the benchmark.

Of 73 funds with 49 rolling one-year performance period histories:

- Only 2 funds produced positive returns in every period. Typically, funds produced a positive return in less than 50% of the rolling one-year periods: exceeded their own objectives in c. 49% of periods: and their own benchmarks in c. 41% of the periods.

The thesis for our first Debating Chamber paper was that *'half of absolute return funds don't seem to work very well half of the time'*.

Our analysis of performance data, looking firstly at returns, is showing that the typical Targeted Absolute Return fund does not appear to work very well more than half of the time.

Risk

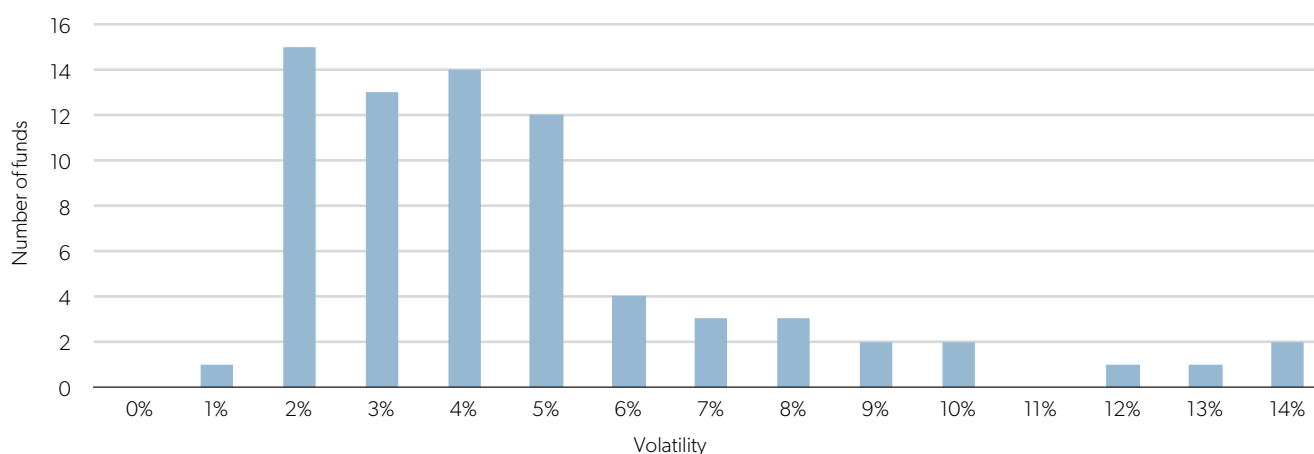
But what about risk?

The risk inherent in an investment fund relates to the predictability of a desired outcome. Statistically, risk is often measured by the standard deviation of returns, establishing the volatility of the price.

If there is a specific date on which an investment 'matures', at a predictable value, price volatility in during the term of holding the investment would be irrelevant. For example, the price of a Government Gilt may fluctuate significantly over its life, but its price will be £100 at maturity and it will pay a regular fixed coupon over the period. If income and a return of a certain capital are your objectives, the volatility of the price along the way is irrelevant. Of course, the more volatile the price, the more likely it is that on a specific day the price may be lower than the purchase price; the less certain an investor may be about the time when he or she may need to access their money, the riskier the investment.

Despite the common aims and objectives of positive returns in all market conditions, as with the variance of returns, the variance of volatilities across the Targeted Absolute Returns funds sector is also wide, as can be seen in Figure 9:

Figure 9: Variance of annualised volatility of Targeted Absolute Return funds

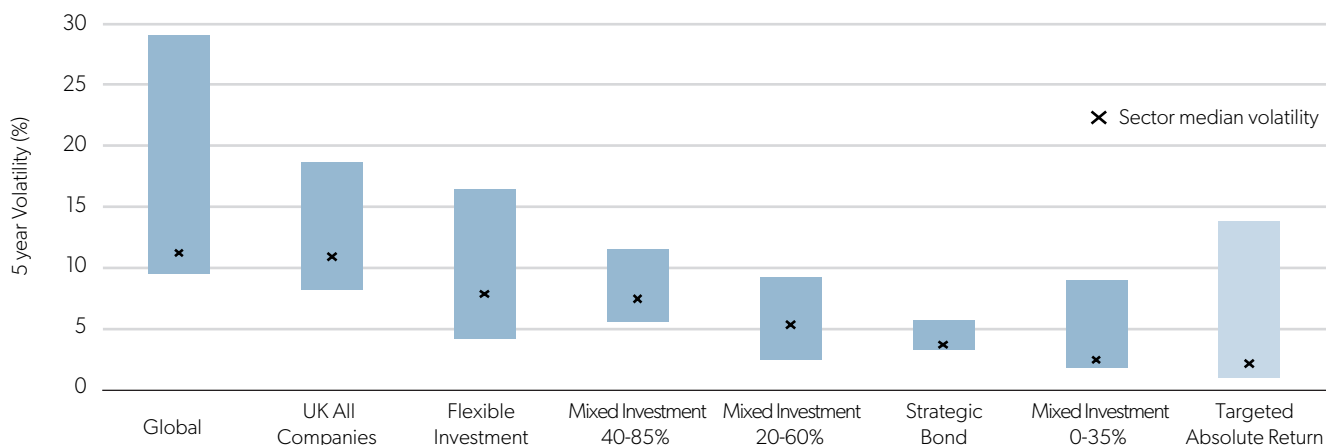


Source: FE Analytics, 5 years to 30 June 2018

The simple fact is that the wide range of strategies prevailing in the sector produces a wide range of volatilities. Professional advisers and investors might assume that the common aim of producing positive returns in all market conditions implies lower risk is being taken. So, we felt we should consider the range of volatility exhibited by funds in the Targeted Absolute Return funds sector versus other sectors.

Figure 10 shows the range of volatilities, including the median volatility, for the sectors.

Figure 10: Range of volatility by sector, including median volatility

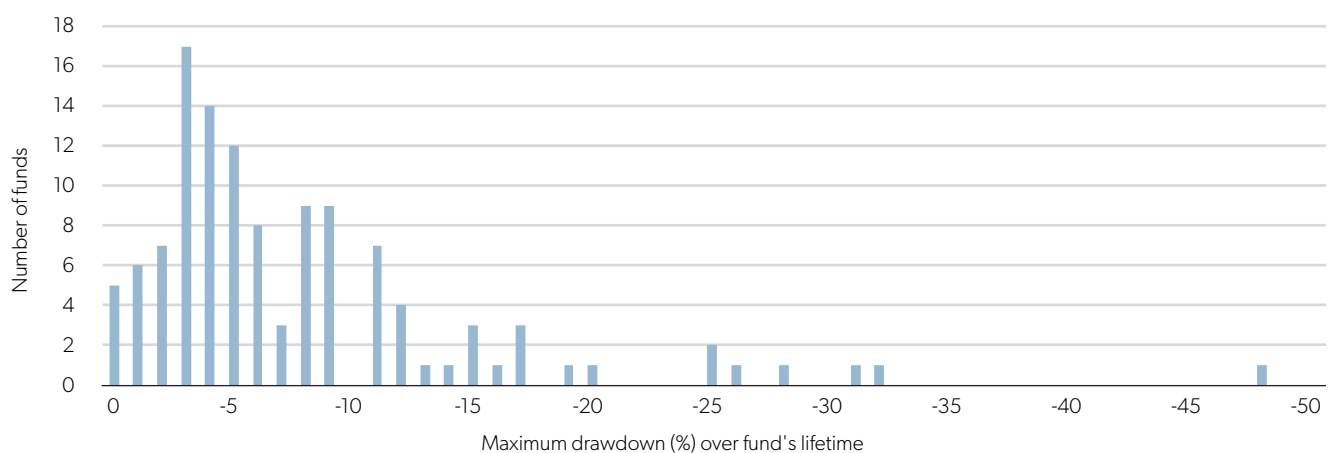


Source: FE, 5 years to 30 June 2018.

As can be seen, while the median risk in the sector is lowest among the sectors: the *range* of risk is greater than the UK All Companies sector and is only exceeded by that of Global Equity.

But there are more ways to consider risk. For example, consideration of a worst-case scenario, measured by 'maximum drawdown', in other words, the worst loss that an investor might have suffered in the fund over the timeframe observed. Figure 11 shows the maximum drawdown of Targeted Absolute Return funds, over their lifetime:

Figure 11: Distribution of lifetime maximum drawdown of Targeted Absolute Returns funds



Source: FE Analytics, to 30 June 2018.

Maximum drawdown is a pertinent measure for a sector promising positive returns in all market conditions. And the fact is, despite the promise and the allure of the sector, every fund in the sector suffered a loss as its worst-case maximum drawdown. In fact, Newton Real Return, the third biggest fund in the sector currently, would have lost investors nearly half their capital had they elected to sell at one point during the financial crisis of 2007-2009.

The risks of Targeted Absolute Return funds, including volatility and loss being experienced more often than investors might be aware, understand or like, is clearly a concern. Better understanding is called for.

The risks of Targeted Absolute Return funds, including volatility and loss being experienced more often than investors might be aware, is clearly a concern. Better understanding of the sector is called for.

Charges

Lastly, let's think about charges. Figure 12 shows the AMCs for the biggest funds in the sector.

The average ongoing charge figure (OCF) for the sector is 102 basis points (bps). This compares fractionally favourably against 103 bps for Mixed Investment 0-35% and considerably better than 117bps for Mixed Investment 20-60%. However, since the returns of the sector are typically lower than other sectors, the impact of the OCF is higher.

And the charges do not stop there, either. Trading / transaction charges need to be considered. The complicated strategies of Targeted Absolute Return funds involve a frequency of trading that can exceed that of long-only funds. Consequently, transaction charges can exceed 65bps, according to the funds' disclosures.

The sector is also notorious for its use of performance fees, taking a leaf out of the hedge fund manual. Almost half of Targeted Absolute Return funds currently charge these fees, and since the replacement of Total Expense Ratio (TER) as a measure of fund costs by OCF, the impact of these costs on performance is not visible.

The majority of the sector's investment managers charging performance fees claw back 20% of the performance, with a number of them not specifying a percentage hurdle that they need to achieve, or a benchmark to exceed. One wonders what the annual management charge (AMC) is for?

Others require the manager to exceed a profit hurdle first, e.g. the benchmark or a fixed percentage, but with no high-water mark. In other words, the fund can fall back to its original price and pay the same fee to the manager again... simply for a repeat of the performance that they gave back. Only six funds explicitly declare that they use a high-water mark, i.e. only calculating fees where the fund price exceeds its highest ever previous price.

Figure 12: AMCs and OCFs for the 5 biggest Targeted Absolute Return funds

Fund	AUM (£m)	AMC	AMC (£m)	OCF	OCF (£m)
SLA Global Absolute Return Strategies	19,064	0.75%	143	0.89%	170
Invesco Perpetual Global Targeted Returns	12,412	0.00%	-	0.87%	108
Old Mutual Global Equity Absolute Return	10,497	0.75%	79	0.81%	85
Newton Real Return	9,530	0.75%	71	0.80%	76
Aviva Multi-Strategy Target Return	5,562	0.00%	-	0.85%	47

Source: FE Analytics, 30 June 2018.

Levels of fees enjoyed by fund managers, even if investors may not be enjoying returns, highlight why this sector is so appealing... to fund management groups.

Asset allocation and portfolio modelling considerations

It has been suggested in some quarters that 'sequence risk', whereby a sequence of negative returns can have a devastating effect on portfolios, can be mitigated through including Targeted Absolute Return funds in portfolios, due to the belief that they dampen volatility while delivering positive returns. But the performance data highlights that this belief may at best be questionable.

In addition, we note that the sector (and some wealth managers and professional advisers who have been keen to use the funds), has been putting pressure on asset allocators and platform portfolio models to add Targeted Absolute Return funds into the mix. This is difficult - if the funds measure themselves using dozens of different benchmarks. Consequently, the standard portfolio construction processes are being circumvented in an attempt to adopt the funds for their supposed dilution effect on volatility. But as we have seen above, there is little evidence that these funds actually add value to a portfolio and, in fact, the range of returns and risks may be detrimental to more predictable portfolio outcomes.

Portfolio modelling needs to be a robust and repeatable process. We would suggest that using Targeted Absolute Return funds, particularly without drilling into the reality of what is being delivered, doesn't appear to aid this.

Summary findings and views regarding Targeted Absolute Return funds

One of the catalysts for this paper was an increasingly widely held view that half of Targeted Absolute Return funds do not seem to work very well half of the time. We wanted to undertake objective, empirical analysis of the sector's funds to ascertain this.

The FCA's singling out of the sector for particular scrutiny and criticism was an additional catalyst.

Our dive beneath the surface of the marketing of the sector and its funds, and identification and analysis of the performance data that evidences the returns, risks, charges, and other factors, pertinent to understanding what is actually being delivered (and what is not), has shown that the typical Targeted Absolute Return fund in the sector is failing to deliver what it promises more than half of time: producing positive returns in less than 50% of one-year rolling periods over the last five years; exceeding their own objectives in c. 49% of periods; and their own benchmarks in c. 41% of periods.

Nothing we have found in our research and consideration of the sector leads us to disagree with the regulator. We would certainly suggest that professional advisers and investors pay some attention to the points that the FCA has been making.

The Targeted Absolute Return funds sector has proliferated and raised significant investor assets during a positive market environment, buoyed by policies that took global interest rates to historic lows, with unprecedented quantitative easing. It has been difficult not to make money in this environment over the last decade, yet a significant number of the funds in the sector have managed to produce investor detriment.

Many commentators anticipate we are now entering a more difficult era, as global policy shifts from easing to tightening, with various risks to markets and asset classes evident at this point. If we are now entering a potentially lower-return environment, professional advisers and investors may feel they are 'stuck between rocks and hard places', in their asset allocation and portfolio construction choices. Cash is delivering negative real returns. Fixed income / bonds is an asset class that seems to have morphed after a 30 year bull market run. And equity markets may appear fully-valued at current levels.

We think it may prove harder to make such strong returns in the foreseeable years ahead as in recent years, and that as a result portfolios will need to work harder, and be more wisely diversified. Yet we are not persuaded that the Targeted Absolute Return funds sector has much to offer. On the evidence, the Targeted Absolute Return funds have exhibited little (and sometimes zero) value versus their long-only counterparts.

If Hans Christian Anderson were alive today, he might find Targeted Absolute Return funds a good re-enactment of 'The Emperor's New Clothes'.

It is also important to consider why Targeted Absolute Return funds are failing. Our view is that investment market fundamentals mean active fund management simply isn't *capable* of delivering the sector's aims, of positive returns in all market conditions.

However, the holy grail of positive returns, risk control and low charges is understandably of interest to investors. So, having drawn attention to the shortcomings of Targeted Absolute Return funds, we want to highlight what we believe is a credible alternative: best-of-breed structured products.

There are various reasons why structured products may be better placed to deliver so called absolute returns than Targeted Absolute Return funds, and with notable differences.

Revisiting investor's fundamental interests and needs

Let's start by revisiting the question of what investors might design for themselves, if they were able to design their own investments. As we said at the beginning of the paper, the holy grail for most investors would be: positive returns; no downside risk / risk control; no / low charges.

We think investors would be unlikely to design anything that looks and feels much like a mutual fund.

**If investors
designed
their own
investments...**



**... they would
not design a
mutual fund**

However, many of the key interests for investors feel much like the key features and attributes of structured products:

- more likelihood of positive returns being generated, even in flat or falling market environments;
- less likelihood of capital losses being experienced as the result of market downside;
- charges that impact less on capital and returns generated;
- contractual legal obligations on providers to deliver what they promise.

Mutual funds, however, preceded structured products by about 60 years. M&G provided the first open-ended collective investment scheme in 1934, with structured products only entering the arena in the mid 1990's. As a result, mutual funds, whether that means actively managed or passive funds, are entrenched in the minds of professional advisers and investors.

We should also concede that over the 20 years of its existence, the UK retail structured products sector suffered two set-backs: issues that attracted high profile attention and unfortunately tarred all structured products with the same brush: precipice bonds (between 1999 - 2002) and the collapse of Lehman Brothers (in 2008). On this latter point however, it may surprise some readers to hear that the recovery rate for investors in structured products affected by the Lehman Brothers collapse has crept up to between 50-90%.

However, the UK structured products sector has come a long way in the last decade. Today, the sector operates with far fewer providers, almost exclusively through wealth managers and independent professional advisers, with acute focus on best practice governance, and stringent product design and development procedures (that preceded and helped create the blueprints of MiFID II and PROD).

'Best of breed'; structured products have a lot to offer wealth managers / professional advisers and investors, including various features and attributes that neither active nor passive funds can deliver.

Free your mind: it's time (and timely) to think differently and objectively about structured products ...

"I'm trying to free your mind, Neo. But I can only show you the door. You're the one that has to walk through it. You have to let it all go. Fear, doubt, and disbelief. Free your mind." Morpheus, The Matrix, 1999.

As we have already explained, active fund management is about aims and objectives: 'hopes', with no obligations on fund managers to actually deliver anything that they 'promise'. If fund managers fail to achieve their stated aims and objectives, they know that they can simply provide an explanation and suggest that investors just need to be patient.

For example, following poor performance in 2016, when the SLA Global Absolute Return Strategies, commonly known as 'GARS' and the biggest fund in the sector, lost 2.7%, at a time when the FTSE 100 rose by 22%, managers of the fund said, *"We have had periods of flat or underperformance before. It can take longer for some of the strategies to start performing. Our bet on American banks in the middle of 2016 was painful, for instance. There were also three significant shocks last year. The price of oil collapsed in February, the unexpected Brexit vote in June and the election of Donald Trump, with a clean sweep in the Senate, in November. Last year was disappointing but we're starting to see the returns our investors expect."* And more recently, in a trading update following the fund losing 4.4% over 3 years to the end of June 2018, the firm said, *"While GARS performance is behind benchmark over one and three years and behind its target over one, three and five years, it has continued to operate within the targeted volatility range"*.

The fact is that the risks of active fund management are borne by investors, not the fund managers. Notably, this includes the increased risks of more complex active fund management, such as absolute return investing.

This is fundamentally different from structured products.

Structured products are based on contractual legal obligations

As with Targeted Absolute Return funds, investors in structured products access marketing materials, for example a plan brochure, detailing what the product has been designed to provide, and the conditions and parameters for both returns and risks. However, structured products marketing creates contractual, legal obligations upon the investment bank standing behind the product, as the issuer / counterparty, to deliver what they stated.

Structured products are usually based upon securities issued by major investment banks. These securities are typically debt instruments, in other words bonds, such as medium-term notes. And the stated risk and return are black and white legal obligations on the issuer, who must deliver what they stated at the outset, throughout the investment term and at maturity, with no wriggle room or grey area.

Generally speaking, notwithstanding that the terms and conditions of a bond may allow for force majeure events, the only way that an investment bank cannot deliver precisely what they stated is to become insolvent i.e. to go bust. And, of course, investment banks are not keen on going bust, and neither are their shareholders, employees, depositors, creditors / bond holders; or their regulators, central bankers or governments. They are stringently regulated to try to ensure that they do not.

As a result, it is very rare that a major investment bank becomes insolvent. This risk, however, is known as the credit risk or counterparty risk of a structured product. It is a risk that should be carefully understood by professional advisers and investors.

But the benefit of accepting and embracing this risk, inherent in most structured products, is that doing so allows investors to abdicate from risks that active fund managers would normally expect them to bear, and to delegate the risks of achieving what is being promised to them back to the investment bank / counterparty behind the structured product, who are in turn legally obligated to deliver what they promised. It is hard to argue with the good sense in this.

Exchanging market risk for credit risk

This paper is a call to action: to think carefully about the Targeted Absolute Return funds sector; and to think objectively about 'best of breed' structured products.

Structured products exchange market risk for credit risk, by creating contractual legal obligations on the issuers to make a promised payment if predefined conditions are met. There is nothing wrong with credit risk. In fact, many investor portfolios might benefit from less market risk and more credit risk.

Through this approach, structured products can offer more absolute risk / return profiles than Targeted Absolute Return funds, with important advantages.

While Targeted Absolute Return funds are variable on return, risk, charges and time periods, in comparison, structured products can be described as:

- pre-defined / absolute on return, which they can sometimes deliver without any requirement for the market they are linked to rising, or even allow the market to fall;
- pre-defined / absolute on downside risk, which they can sometimes remove completely; and
- and they generally state returns after allowing for any implicit charges, meaning that no charges impact directly on investor's capital or returns.

In addition to understanding credit risk, there is a further major distinction between Targeted Absolute Return funds and structured products: structured products can predefine the parameters of returns and risk, but the variable that needs to be considered is 'timing'. Investors may need to accept that they will not know at the outset when their return will be delivered, although it will be within a specified period.

For example, with a 'kick-out' structured product strategy, investors will not know which anniversary within the investment term will see kick-out triggered. However, the kick-out coupons will accumulate for each year that the product runs, until the kick-out is triggered.

In what we believe is likely to be a more challenging investment environment in the decade ahead than the decade now behind us, we think many investors may be better served by and happier with variable timing, as opposed to variable return, risk and timing, as is the case with Targeted Absolute Return funds.

Best of breed structured product strategies

Let's look at some specific structured product examples, using plans from Tempo's current (October 2018) product suite.

Tempo offers 4 plans, with 7 investment options, providing kick-out plans, growth plans, and income plans. All of our plans are 'deliberately defensive', meaning that they are all designed so that they can generate some or all of their returns without requiring any rise in the market that they are linked to, in addition to including a defined level of protection should the market fall.

The Long Kick-Out Plan

Kick-out strategies are the most popular structured product strategy for professionally advised investors.

The Tempo **Long Kick-Out Plan** optimises the popular kick-out strategy, through the simple approach of combining a longer maximum investment term with defensive index conditions for kick-out.

The plan offers three options for investors. The potential annual returns and conditions for returns to be generated for each option are:

Option 1			Option 2			Option 3		
<p>If the FTSE 100 FDEW closes at or above 90% of the start level on one of the kick-out anniversary dates, or on the end date, the plan will generate a return of 7.40% for each year that the plan has run.</p> <p>The plan will automatically mature at this point and pay both the accumulated return and the money invested (less any agreed adviser fees and withdrawals).</p>			<p>If the FTSE 100 FDEW closes at or above a reducing percentage (reducing from 100% at Year 3 to 65% at Year 10) of the start level on one of the kick-out anniversary dates, or on the end date, the plan will generate a return of 6.85% for each year that the plan has run.</p> <p>The plan will automatically mature at this point and pay both the accumulated return and the money invested (less any agreed adviser fees and withdrawals).</p>			<p>If the FTSE 100 FDEW closes at or above 100% of the start level on one of the kick-out anniversary dates, or on the end date, the plan will generate a return of 11.10% for each year that the plan has run.</p> <p>The plan will automatically mature at this point and pay both the accumulated return and the money invested (less any agreed adviser fees and withdrawals).</p>		
Potential return			Potential return			Potential return		
KICK-OUT ANNIVERSARY	3rd	22.20%	KICK-OUT ANNIVERSARY	3rd	20.55%	KICK-OUT ANNIVERSARY	3rd	33.30%
	4th	29.60%		4th	27.40%		4th	44.40%
	5th	37.00%		5th	34.25%		5th	55.50%
	6th	44.40%		6th	41.10%		6th	66.60%
	7th	51.80%		7th	47.95%		7th	77.70%
	8th	59.20%		8th	54.80%		8th	88.80%
	9th	66.60%		9th	61.65%		9th	99.90%
	End date	74.00%		End date	68.50%		End date	111.00%

Option 1 offers 7.4% p.a., which is payable at the first anniversary, from year 3 onwards, at which the index, an equal weight version of the FTSE 100, is at or above 90% of its starting level. In other words, the index can fall by 10%, but so long as it is above 90% of its start level at one of the anniversaries in the next decade, the plan will generate a return of 7.4% for each year that the plan has run.

Option 2 is more defensive and offers 6.85% p.a. if the index is at or above a percentage of its start level that reduces by 5% each year, between year 3 and year 10, to 65% at the end date. In other words, the index could fall by more than a third, and the plan would still generate a return of 68.5% at year 10.

Option 3 is more 'bullish', but still doesn't require the index to rise at any anniversary over the next decade in order to generate positive returns for investors. This option offers 11.1% if the index is at or above its start level at any anniversary between year 3 and year 10. At year 10, if the index is at above its start level, from a decade earlier, the plan will generate a return of 111%.

Combining a longer maximum term with a defensive index condition is a very simple but compelling approach. In fact, if this strategy is back tested, to January 1984, based on the FTSE 100 (noting that the Tempo product is linked to a new version of the FTSE 100, that is equally weighted and uses a total return / fixed dividend approach, developed by FTSE Russell), it can be seen that it would never failed to generate a positive return, in over 6,000 possible investment terms (i.e. every investment term possible, on a rolling day basis, since the inception of the FTSE 100).

Further, the backtesting shows that it would never have needed to run to the end of the maximum 10 year investment term, as it would have generated positive returns in every investment term possible before year 8. The back testing is shown in Figure 13:

Figure 13: Back-testing a 90% kick-out condition and a 10 year maximum investment term

Using the FTSE 100: back-tested to FTSE 100 inception date: 03 Jan 1984

Outcome	% of periods in back-test	Return
Kick-out at year 3	80% of all periods tested	3 X annual coupon
Kick-out at year 4	7% of all periods tested	4 X annual coupon
Kick-out at year 5	3.5% of all periods tested	5 X annual coupon
Kick-out at year 6	4.3% of all periods tested	6 X annual coupon
Kick-out at year 7	4.6% of all periods tested	7 X annual coupon
Kick-out at year 8	0.6% of all periods tested	8 X annual coupon
Kick-out at year 9	0% Never	N/A
Maturity at year 10	0% Never	N/A
Return of capital only	0% Never	N/A
Capital loss	0% Never	N/A

Source: Tempo Structured Products. To 29 June 2018: 6,389 periods tested, based on all possible business day start dates for FTSE 100 since 03 Jan 1984.

Professional advisers are, of course, aware of the regulator's stringent guidance that past performance is not a guide to future performance. However, structured products are based on contracts, that define the conditions for and parameters of risks and returns, and structured product back-testing uses actual index data and actual product terms.

The Long Growth Accelerator Plan

Tempo's Long Growth Accelerator Plan is the only product of its kind in the market, combining kick-out with a defensive 'supertracker' in a '2 in 1' strategy plan, offering exceptional compound annual growth potential.

Option 1	Option 2
On the 5th anniversary if the FTSE 100 FDEW closes at or above 100% of the start level	On the 5th anniversary if the FTSE 100 FDEW closes at or above 110% of the start level
the plan will generate a return of 52.5%	the plan will generate a return of 86.25%
and mature early automatically	and mature early automatically
If the plan does not mature at the 5th anniversary it will continue to run until the 10th anniversary.	If the plan does not mature at the 5th anniversary it will continue to run until the 10th anniversary.
On the end date option 1 will generate a return of 4 times the amount that the FTSE 100 FDEW	On the end date option 2 will generate a return of 6 times the amount that the FTSE 100 FDEW
closes above 70% of the start level	closes above 90% of the start level
with a maximum potential return of 120%	with a maximum potential return of 180%

Option 1 offers a potential kick-out return of 52.5% at the 5th anniversary, if the index is at or above its start level. This is equivalent to 10.5% p.a. simple or 8.81% compound. The index does not need to rise for this return to be triggered. If kick-out is not triggered at year 5, the plan continues to year 10, when it offers four times any amount that the index is above 70% of its start level, with a maximum return of 120%. This is equivalent to 12% p.a. simple or 8.20% compound. The maximum return will be achieved if the index is simply at or above its start level. The index does not need to rise for the maximum return to be generated, for option 1.

Option 2 offers a potential kick-out return of 86.5% at year 5, if the index is at or above 110% of its start level. This is equivalent to 17.25% p.a. simple or 13.2% compound. The index needs to rise by 10% over 5 years for this return to be triggered. If kick-out is not triggered at year 5 the plan continues to year 10 when it offers six times any amount that the index is above 90% of its start level, with a maximum return of 180%. This is equivalent to 18% p.a. simple or 10.84% compound. The maximum return will be achieved if the index is at or above 120% its start level, i.e. the index has risen by 20%.

In order for the index to have risen by 10% over 5 years, for option 2, it must rise by 1.84% p.a. compound. If it does, the plan will deliver a 13.2% p.a. compound return for investors.

In order for the index to have risen by 20% over 10 years, for option 2, it must rise by 1.92% p.a. compound. If it does, the plan will deliver a 10.84% return to investors.

We would suggest that this type of structured product return can be thought of as 'alpha by contract', with pre-defined conditions and contractual, legal obligations on the issuer. The strategy offers the potential for material outperformance of the index, without the unreliability and inconsistency of trying to access alpha through active fund management. In a more challenging investment environment, reducing exposure to risks, particularly unnecessary risks and / or risks that can be mitigated or avoided, including mitigating the risk of active fund management not working, can only be seen as prudent.

Longer term time horizons

The current investment environment of low interest rates, some inflation, low bond yields and fairly if not fully valued equity markets, presents a challenging backdrop within which professional advisers and investors must construct portfolios.

Equity-market investing is based on the principle that markets can be expected to rise over time, and that market risk can be mitigated over that period. Consequently, the longer the time horizon of an investment, the greater the likelihood of both positive returns being realised and of market risk being mitigated.

We feel that adjusting investor expectations to consider longer-term time horizons is sensible. In our opinion, 'long' investment strategies can optimise risk and return, by focussing on the importance and potential benefits of 'time'. We therefore include long strategy options, which focus on the importance and benefits of time, in our product suite.

Not forgetting the risks ...

Of course, as with all forms of investment there are risks involved in structured products.

Structured products do not guarantee to repay the money invested. The potential returns of products and repaying the money invested are linked to the level of the stock market and also depend on the financial stability of the structured products issuer / counterparty bank.

All of the risks of our products are carefully detailed and explained, in plain English, in our product literature.

In addition, we provide exceptional support for professional advisers, including our ground-breaking and bar-raising Tempo Issuer & Counterparty Scorecards ('TICS') and our Professional Adviser Academy.

Conclusion

It is not hard to see why the holy grail of positive returns in all market conditions, with controlled risk and low charges, appeals to investors.

It is, however, harder to see that the Targeted Absolute Returns funds sector is delivering the holy grail solution to investors, despite the sector marketing its ability to do so.

Our analysis supports our hypothesis that half the funds in the sector are failing to deliver what they are promising, more than half of the time – the typical Targeted Absolute Return fund does not work very well more than half the time: producing positive returns in less than 50% of one-year rolling periods over the last five years; exceeding their own objectives in c. 49% of periods; and their own benchmarks in c. 41% of periods.

Despite the sector broadly purporting to offer positive return in all market conditions; 30% of the funds in the sector have delivered negative returns over the last three years; 15% have delivered negative returns over the last five years; all the funds in the sector have suffered negative maximum loss / drawdown; and the variance of both returns and risks is higher than may be recognised and understood.

We find it hard not to draw a conclusion that the Targeted Absolute Return sector, in the round, exhibits little value, versus long-only counterparts.

We believe this is because active fund management is fundamentally not capable of delivering these promises, due to straightforward investment fundamentals.

As we said previously, if Hans Christian Anderson were alive today, he might find the sector a perfect demonstration of 'The Emperor's New Clothes'.

However, the fact remains that the concept of positive returns in all market conditions, with controlled risk and low charges, obviously appeals to investors.

We believe that the years ahead may present a more challenging investment environment, which will see professional advisers and investors needing to consider different types of investments for portfolio diversification, not just asset class and geography.

We are asserting that best of breed structured products present compelling portfolio options, that can add value alongside passive, smart beta and active funds, for professional advisers and their clients.

There are some things that passive and active fund management just cannot do, and that the Targeted Absolute Return funds sector, on the evidence, cannot do either.

Structured products can help fill that gap, offering the potential for positive returns in range bound, possibly flat and / or falling markets, in addition to reducing and controlling exposure to downside market risk.

It is time (and timely) to think carefully and differently about targeted Absolute Return funds; and to think differently and objectively about best of breed structured products.

About Tempo Structured Products

Tempo Structured Products is a new division of international co-investing asset management group Alpha Real Capital, operating in conjunction with group subsidiaries Alternative Real Capital and TIME Investments.

Tempo Structured Products has four areas of business focus: i) Retail: the primary focus is simple, defensive retail structured products, for distribution through TIME Investments to UK Professional Advisers (IFAs) and wealth managers; ii) Institutions / Pension Funds: the second area is working with Alternative Real Capital and institutions / pension funds consultants to develop structured products that fuse the best attributes of structured products, passive and smart beta strategies; iii) HNW / UHNW / Family Offices: thirdly, designing bespoke structured product solutions for HNW / UHNW Individuals and Family Offices; iv) Strategic partnerships: and lastly offering structured products expertise to 3rd party institutions, to develop structured product offerings for their clients / customers.

The team behind Tempo are deeply experienced, having been at the forefront of the structured products sector since its earliest days in the UK, and also having broad asset management backgrounds, including in active and passive fund management.

Tempo is founded upon a commitment to straightforward, lower risk products, underpinned by operational strength and a focus on robust governance, presented with transparency and integrity, and exceptional support and service for professional advisers and their clients.

Tempo's aim is to help redefine structured products for professional advisers and their clients, showing how structured products could be done and should be done. Tempo's core mantra is 'doing the right things - and doing simple well'.

The entire emphasis for Tempo is on working closely with professional advisers to advance and enhance the value that can be gained from structured products, for the benefit of their clients, providing professional advisers and their clients with a high calibre structured product provider, a carefully considered approach to structured products and a level of support and service that they can be genuinely confident in.

Tempo provides important resources and tools to support professional advisers using its products. Tempo feel strongly that a well-resourced, operationally strong structured product provider, committed to straightforward, lower risk products and 'doing the right things and doing simple well', should be able to take the benefits of structured products to a wider audience of professional advisers.

About Chris Taylor



Chris is Global Head of Structured Products for Tempo Structured Products. His financial services career dates back to 1987, initially as a private client adviser. He has been actively involved with the structured product industry since its earliest days in the UK, in the mid 1990's – playing a significant role in its creation and in many of its turning points over the years, through various senior roles: Managing Director at Incapital Europe, Chief Executive of Blue Sky Asset Management; Managing Director of the Structured Product Division of Dawnay Day Quantum; Director of UK Structured Products Distribution, HSBC Asset Management.

Chris is a well-known and highly regarded 'go to' expert in the structured product industry.

About gbi2

Since “Graham Bentley Investment Intelligence Ltd” is a bit of a mouthful, the investment consultancy eponymously named after its 40-year City veteran goes by the rather more succinct “gbi2”.

gbi2 is a specialist consultancy helping asset managers, intermediaries and distributors create investment propositions that customers want to buy, delivered in a language they understand. Graham believes there is a too-healthy industry involved in the marketing of meta-information, i.e. gathering freely available data and reframing it as new (and expensive) research, which is then recycled several times over. This can encourage lazy, copycat ‘groupthink’, and the persistence of erroneous opinion.

Graham believes businesses benefit from an external, non-aligned viewpoint, in order to generate innovative propositions, solutions and supporting material that are easy to use, make the investor feel valued, and most importantly give them peace of mind.

About Graham Bentley



Graham entered the investment industry in 1977, forging his reputation at Henderson in the 1980s by guiding advisers through the nascent regulatory regime born out of the 1986 Financial Services Act. In an era where most unit trust investing was practiced by stockbrokers, he was in the vanguard introducing unit trust investment to the wider community of financial advisers.

Among his many achievements, in the 1990s, Graham built the proposition and adviser education programme for the UK’s first Corporate Bond fund, with Theo Zemek at M&G. He subsequently created the first ‘critical yield’ risk-assessment process. He was on the original Old Mutual team that launched the first on-line, straight-through processing investment platform, Selestia in 2001, ultimately becoming Head of Proposition for the Life and platform businesses when OM bought Skandia in 2006. At Selestia he created the first, and now ubiquitous end-to-end risk assessment and asset allocation process, and in 2008 designed its spin-off - the first volatility-targeted fund range, Spectrum.

Graham is expert in Behavioural Finance and the psychology of investing. A former economics and stock Markets “guru” at Virginmoney.com, he is frequent contributor in Investment press, and TV. He is an entertaining speaker, known for his ability to present complex subjects in an easy manner, yet with a refreshing touch of irreverence.

Important information

Professional Advisers should not invest in, or advise and recommend their clients invest in, any investment product unless they and their clients understand them, in particular the relevant risks.

It should always be understood that:

- structured products are not suitable for everyone
- past performance is not a reliable indicator of or guide to future performance and should not be relied upon, particularly in isolation
- the value of investments and the income from them can go down as well as up
- the value of structured products may be affected by the price of their underlying investments
- capital is at risk and investors could lose some or all of their capital

Professional Advisers should access and read the relevant plan documents relating to any structured product plan of interest, in particular: the plan brochure; plan application pack, including, the terms and conditions of the plan; and the Issuer's key information document ('KID'), securities prospectus and securities final terms sheet, before making a recommendation to their clients.

The 'Important risks' section of the Tempo website highlights the key and other risks of our structured product plans, in addition to explaining important information for Professional Advisers who wish to access the current products area of our website and who may use our structured product plans with their clients. To see our full 'Important risks', please see: [www.tempo-sp.com / home / important-risks](http://www.tempo-sp.com/home/important-risks).

We also provide important resources and collateral support for Professional Advisers, including access to our Tempo Issuer & Counterparty Scorecards ('TICS') and CPD accredited Professional Adviser Academy.

Below is a brief summary of some of the main risks associated with investments in our plans:

Market risk to potential returns

Whether or not the plan or plan options chosen generate the potential returns for investors depends on the closing level of the relevant index that the plan is linked to, on the relevant dates for the plan, i.e. the kick-out and end dates for kick-out products; the early maturity dates and end dates for growth products; and the income dates, early maturity dates (if applicable) and end dates for income products. If the relevant index for the plan closes below the level needed, for the plan or plan options chosen, on all of the relevant dates, the plan or plan options will not generate a return.

Market risk to repayment of money invested

If the closing level of the relevant index that the plan is linked to closes below the level needed on all of the kick-out dates (if applicable), early maturity dates (if applicable) and end dates, repaying the money invested at maturity will depend on the closing level of the relevant index on the end date. All of our products are 'Deliberately Defensive' and use single indexes and end of term only barriers. If on the end date the relevant index for the plan or plan options chosen closes at or above 60% of the start level, money invested will be repaid in full (less any agreed adviser fees and withdrawals). However, if on the end date the relevant index for the plan or plan options chosen closes below 60% of the start level, the amount of money repaid (less any agreed adviser fees and withdrawals) will be reduced by the amount that the index has fallen. For example, if the index has fallen by 45%, the repayment of money invested will be reduced by 45% (meaning that investors will get 55% of their investment back).

Issuer and Counterparty Bank risk

Both the potential returns and repaying the money invested, depend on the financial stability of the Issuer and Counterparty Bank, for all of our plans. If the Issuer and Counterparty Bank become insolvent, or similar, or fail to be able to meet their obligations, it is likely that investors will receive back less than they invested.

Financial Services Compensation Scheme ('FSCS') protection

It is not usually possible to claim under the Financial Services compensation Scheme if the Issuer and Counterparty Bank fail to meet their obligations or if the stock market index that a plan links to falls.

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