Absolute Return Strategies: An Alternative Approach

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An investment strategy focused on absolute returns can complement one's overall portfolio while also reducing risk through style diversification, especially with a portfolio heavily geared toward buy-and-hold investing.

Absolute return strategies offer the following advantages: they are systematically tested prior to being implemented, they provide a rule book on how to implement and adhere to the strategy and they allow for the automation of the strategy. As we shall see, these advantages serve to help the absolute return investor avoid many of the costly missteps common with other investment approaches.

The goal of an absolute return strategy is to produce positive returns, irrespective of market conditions. This differs from relative return strategies, such as traditional buy-and-hold strategies, that measure success based on performance against a specified index. With a relative return approach, an investment is deemed to have performed well if it matches or outperforms the index against which it is being compared — even if the investor loses money. For instance, if the DJIA loses 10% of its value in a given time period, and an investment portfolio loses only 8% of its value, this would be seen as a positive outcome for investors pursuing a relative return strategy.

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Inukshuk Capital Management (ICM) believes that positive returns should be an investor's goal in all types of markets, regardless of how a certain index is behaving. To achieve returns in both bull and bear markets, ICM uses a quantitative investment strategy. Specifically, ICM's absolute return strategy uses a technique known as systematic trend following, which aims to earn positive returns on prolonged directional price movements — both up and down. And it's that ability to earn profits in bear markets as well as in bull markets that makes ICM's strategy an excellent replacement for, or complement to, traditional buy-and-hold strategies. An important additional benefit is risk reduction: by being able to profit from both positive and negative market movements, absolute return strategies are indifferent to the direction of the market whereas other approaches such as long-only strategies rely on positive market trends, a condition that is not always present.

Quantitative investing is simply "the systematic implementation of trading strategies that human beings create through rigorous research.

In this context, systematic is defined as a disciplined, methodical, and automated approach."[1] Quantitative investors can be contrasted with discretionary investors in that quantitative investors are typically more disciplined in following the rules of their strategy than are discretionary investors. Discretionary investors usually make use of some general rules or guidelines for deciding which financial instruments to buy and sell but, unlike quantitative investors, they do not adhere to them in a manner that makes automated execution of their strategy a possibility.

It is important to stress that the basic ideas that form the foundation of the strategies of both discretionary and quantitative investors are often the same. For example, trend following and mean reversion strategies are used by discretionary and quantitative traders alike. However, the difference is that quantitative traders believe that there is great benefit in rigorously testing one's strategy in a scientific manner — something the discretionary investor cannot do — as well as strictly adhering to the rules developed during the research and testing process. Historical testing, if done properly, can provide the quantitative trader with knowledge not only of how one's strategy performed in the past, but also provide them with an idea of whether the strategy will also work in the future.

In addition to the advantages that arise from being able to historically test one's strategy, quantitative traders also benefit from the ability to automate buying and selling decisions. This allows them to avoid one of the most problematic issues that confront discretionary traders: the manner in which emotions distort one's ability to make sound investment decisions. Emotions such as fear and greed can, and often do, hinder the performance of traders by leading them to make decisions that are driven by emotion, not by a clear analysis of the situation. For example, it has long been accepted that one should ride their winning trades, and quickly cut their losing ones. Quantitative traders can easily implement automated rules that will ensure they will follow this advice. Discretionary investors, on the other hand, often fail to heed this advice because of the intense emotions that can arise from making time-dependent decisions that involve large amounts of money. Instead, many discretionary investors cut their winners short and ride their losers. This well-studied behaviour is known as the disposition effect, and is something that quantitative investors are able to avoid.

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The impact of emotions can be especially dangerous during times of geopolitical uncertainty. Geopolitical events can result in fast-moving markets and sharp price declines — which can lead to devastating losses for long-only investors. Even discretionary investors who are willing to take short positions are often ill-prepared for volatile times, when heightened emotions can lead to poor investment decisions. The nature of ICM's systematic strategy allows it to objectively manage the volatility associated with geopolitical risks. By entering both long and short positions, ICM's strategy can potentially profit when geopolitical instability leads to downward price movement. And the quantitative, rule-based nature of the strategy allows ICM to avoid the harmful impact that emotions can have on investment decisions during times of volatility and geopolitical uncertainty.

During times of uncertainty as well as stability, the advantages of quantitative investing — rigorous testing, methodical implementation and automation — underlie ICM's application of disciplined absolute return strategies and enable it to pursue profits in markets that are moving are up, down or sideways.

To discuss further, or for more information, please contact Christopher Keeley, CFA, lead portfolio manager at ICM, at 647-748-4651.

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End note

[1] Narang, R. (2013). Inside the black box: A simple guide to quantitative and high-frequency trading (Second ed., p. xiv).