Friday Night ´Lights

08th December 2017

For Professional Investors and Institutional Clients only

FORTEM CAPITAL

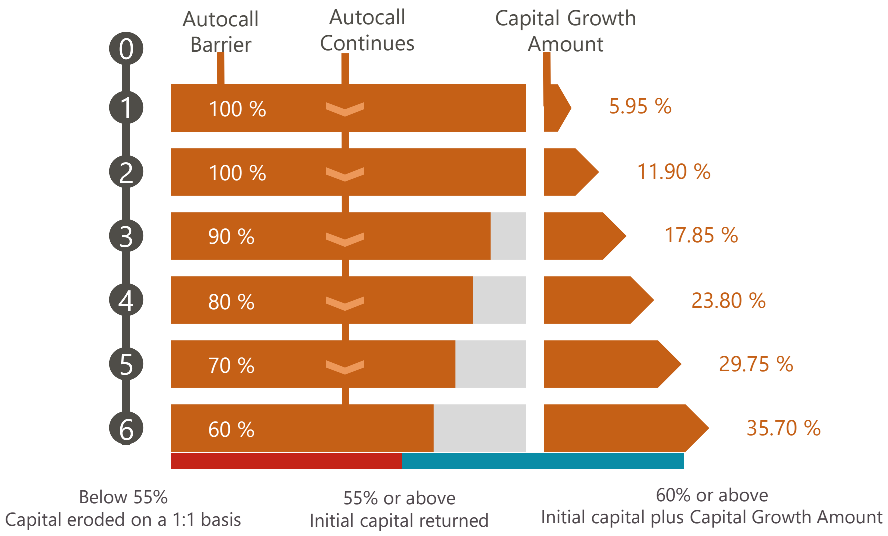
Help! Absolute Return can't buy me love…

2017 – A *Magical Mystery Tour* for Absolute Return

A consistent theme this year has been the varied performance of absolute return vehicles. Many of our clients have been speaking about their frustrations at a lack of consistency in the space over the last two to three years. After mass outflows in 2016 and early 2017, the sector has made a bit of a *Kum Back*, however there is a large difference in performance between the top funds and those that have had a tough few months – a gap of some 58% YTD as at 31st November[1]. This highlights the importance of picking the right fund at the right time, and how absolute return is not always "absolute". Definitions vary – some funds aim to return a steady profit over a 3 year timeframe, others state they look to make returns each year, regardless of markets. *I don't wanna spoil the party* but, of the 117 funds listed by the Investment Association as being eligible to be classed as absolute return, many have failed to produce positive annual returns, observed over a rolling one year period. In fact, the sector average for negative annual returns is around 34%[2].

With many of our clients looking to diversify away from pure equities and bonds, and with inconsistent performance in the "TAR" space, there is certainly a case to be made for clients to look towards the defined return space for lower beta alternatives. And Fortem are here *Eight Days a Week* to keep you up to date. This week's FNL is going to look into the various options investors have to lower their exposure to direct equities and bonds by using defined return investments. Using traditional Autocalls with a delta of 70-80% is a good first step – but how better to create more diversified, defensive investments? Perhaps even looking towards uncorrelated investments with similar return profiles.

Firstly, let's start with the ever so popular Autocall. A traditional stepdown FTSE/Eurostoxx Autocall, with a knock-in put at 60% of strike will have a delta of ~75%. Say we want to diversify away from the FTSE and make this sort of product more defensive. Well, the product below was traded this week to do just that and uses S&P/Eurostoxx as the underlying indices. By adjusting the barriers, and lowering your knock-in level to 55% you can bring this delta right down to ~55%. This does impact returns (5.95% p.a. vs 8.88%), but on a historical backtest, the results speak for themselves. With the more defensive product, 95% of the time you have received your snowballing returns (vs only 45% for the traditional auto), and your capital barrier has historically never been breached (vs 3.5% in the other example)[3]. *Baby, you're a rich man…*



***All You Need Is Love*, and an able fund manager…**

Moving further down the risk curve naturally comes with a lowering of returns. One way to avoid this is by utilising a fund vehicle. Recently, as many of you will be aware Fortem launched a fund which aims to provide positive returns along with reduced equity beta over the medium to longer term, even if global equity markets have been range bound. It will invest in a core portfolio comprised of defined return equity strategies that aim to provide capital growth over the medium to longer term, in all but extreme negative market scenarios. The Fund will make a smaller allocation to diversifier type investments that meet strict capital preservation and investment return criteria whilst…

Markets this week:

Rates (bps)	Current	Change*
GBP 1yr	68.70	0.2
GBP 3yr	97.00	2.2
GBP 5yr	113.60	4.5

Equity Indices (%)	Current	Change*
FTSE 100	7,329.33	0.40%
S&P 500	2,636.98	-0.20%
Nikkei 225	22,811.08	-0.03%
Eurostoxx 50	3,603.33	2.15%

5yr Credit Spreads (bps)	Current	Change*
Citigroup	42.91	-1.83
Credit Suisse	54.13	2.34
Deutsche	75.23	2.13
GS	59.26	0.92
HSBC	21.40	0.14
JPM	43.48	2.79
Soc Gen	23.05	-1.61
Sant UK	42.19	-2.42
MS	54.65	1.17

Commodities & Currencies (%)	Current	Change*
Gold	1,247.46	-2.65%
Oil (CLA)	56.85	-2.54%
GBPUSD	1.3477	0.00%
GBPEUR	1.1475	1.31%
GBPJPY	152.935	1.23%

5yr Implied (vol pts)	Current	Change*
FTSE 100	16.58%	-0.16%
S&P 500	18.63%	-0.03%
Nikkei 225	18.28%	-0.27%
Eurostoxx 50	17.72%	-0.39%

**Source Fortem / Partner Banks*
Weekly changes for Data as at
08th December 09.00am

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"You don't need anybody to tell you who you are or what you are. You are what you are!"
– John Lennon stressing the insignificance of labels

...providing diversification and reduced equity market beta in short term drawdowns. Moreover, the fund is currently 100% Gilt Backed, and looks to mitigate against material single index exposure. This construction will enable (alongside a hedging overlay) the fund in the current environment, to have a beta below 50% and target a return of 6-7% per annum. For more details on the fund, feel free to contact us or read the latest monthly document.

Time to *Twist and Shout* about *Something New*

Though the ideas above do diversify your equity market holdings, whilst lowering your overall exposure, there is naturally an element of equity risk in-built. Therefore, the final suggestion is to move away from equity linked defined returns, and back towards the absolute return space, but with some tweaks to hopefully enhance returns. The first suggestion on this front is a note we launched back in August (we know, just *Let It Be*), that tracks a systematic strategy with a 5yr live track record and historical returns of close to 4% p.a. It aims to generate returns by taking advantage of the buying and selling pressures caused by money tracking benchmark commodity indices. It is low volatility, with minimal correlation to both bond and equity markets and is importantly not a directional play on commodities. The note was 100% capital protected with 150% leverage and is performing well. Since launch, the strategy has returned ~1.90% (~5.7% annualised), which including the leverage, would have an intrinsic value of 8.55% for the year. Given the IA TAR sector's cumulative performance over 3yrs is just 6.7%[4], this makes for a potentially viable alternative. Please see the document here for more product details.

That is not to say however, that all funds in this sector have sunk like a *Yellow Submarine**. Indeed, many have had strong periods of performance, followed by a degree of stagnation. Our client base are well aware of the culprits, though these funds are not without their merits, and in a time where there could be somewhat of a market drawdown, there is certainly a role for these types of holding. The question therefore is how to smooth performance (and mitigate any downside risk), whilst still producing consistent returns. Perhaps the solution is to create a capital protected note exposed to the Total Return of a bespoke selection of these funds, whilst also (like the above note) applying a degree of leverage. *Hello Goodbye!* This is something we have been working on for some time at Fortem with our partner banks and the following is just one brief example of our offering:

- 5yr Tenor
- 100% Capital Protected
- ~120% participation in a basket of three absolute return funds that blended equally together have a 5yr track of 5.78% per annum

This type of product can be fully customised (including being actively managed to allow for changes to asset allocation) and the funds in question are well known, large absolute return vehicles, that many of our client base already own. Moreover, they are also able to be written on many large Fixed Income Funds. The capital protection element, alongside the gearing, make this potentially quite intriguing and we'd love to *Come Together* to discuss it further. *Yoko Ono* live once...

*Edward has requested credit for this pun. The ghost writer was happy to let him have it.

Please see below for our most recent launches:

Description	Barriers	Sedol	Offer Price
CIBC 6yr WO S&P/Eurostoxx Auotcall EIS – 5.95%	100/100/90/80/70/60 55% KI	BFB3VQ5	100.14%
Morgan Stanley 6yr WO FTSE/Eurostoxx Autocall EIS – 8.88%	100/95/90/85/80/75 60% KI	BZVQY43	101.07%
Santander UK 6yr WO S&P/Eurostoxx Autocall EIS - 7.80%	100/95/90/85/80/75 65% KI	BD1QTX3	100.44%
Soc Gen 6yr WO FTSE/Eurostoxx Autocall EIS - 8.82%	100/95/90/85/80/75 60% KI	BF6XDV9	101.25%
Citigroup 6yr WO FTSE/Eurostoxx Autocall EIS 8.10%	100/95/90/85/80/65 65% KI	BD97CH3	101.01%
CIBC 6yr WO FTSE/Russell Autocall EIS - 8.10%	105/105/95/90/85/65 65% KI	BDDVJM5	98.53%

Footnotes
1. https://www.theinvestmentassociation.org/fund-sectors/targeted-absolute-return-tool.html
2. https://www.theinvestmentassociation.org/assets/files/sectors/20171115-TARmonitoringdata.pdf
3. Backtest carried out from January 1990 to September 2017. Please click here and here for more details.
4. https://www2.trustnet.com/Investments/SectorProfile.aspx?code=O:IMAABR&univ=O

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