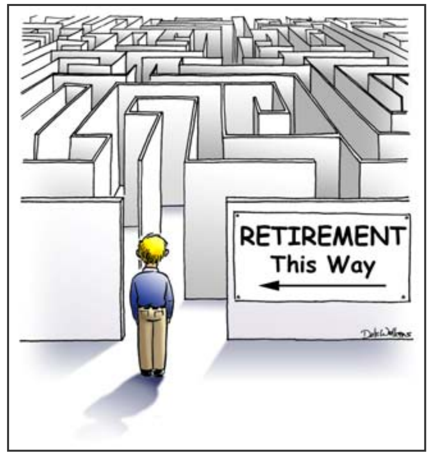
Reprinted from the
Lexington
Minuteman

COROMANDEL WEALTH MANAGEMENT

July 2011

Absolute Return Funds: Absolutely Misleading

Navigating the Retirement Maze



Leave it to the financial industry to promote yet another product that plays to fears of investors. After the S&P 500 Index dropped by half during 2008-09, many investors became gun-shy about owning stocks. Allianz Life Insurance recently published the results of a study in which they found that by nearly a 4-to-1 margin, baby boomers were more interested in guaranteed income than potentially higher returns with market risk.

Enter the absolute return fund. The name derives from the funds' aim to achieve gains independent of the direction of the stock market. The companies promoting absolute return funds use descriptive phrases like: *"The funds seek a positive return, over a three year period and regardless of market conditions…"* Positive returns regardless of market conditions? Investing Nirvana.

An Absolute Explosion of Offerings

Not willing to miss a good sales opportunity, the mutual fund industry has tripled the number of "absolute return" funds within the past three years. There are now over forty funds bearing the absolute return label, and likely more to come.

So what's the problem with funds whose stated aim is to provide positive returns independent of stock market movements? Well, several things. First, there is no guarantee that these funds won't lose money. During the market downturn in 2008, eight out of ten absolute return funds showed losses. True, they were less than that of the overall market, but the funds also didn't gain back nearly as much as the S&P 500 did over the next two years.

There are a few other concerns that I have with these funds:

- Short track records – With so many new funds, few have been in existence more than a few years, making it difficult to judge how they perform in both up and down markets.
- High fees – For the privilege of owning a fund that "seeks" a positive return, be prepared to pay from 1% to 3% per year, which is considerably higher than the average mutual fund.
- No uniformity among funds – Bond funds hold bonds; stock funds hold stocks. So what do absolute return funds hold? Well, it depends. There is no standard definition of the types of securities in absolute return fund portfolios. And that's the problem.

Looking Under the Hood

I'm a firm believer in: *"If you don't understand it, then don't buy it."* Thus, I advise investors to look at what is held in any fund in which they are considering investing. So what does one find in a "typical" absolute return fund? Consider these phrases taken from actual fund prospectuses (italics are mine):

- "The fund expects to achieve certain exposures primarily through (but not limited to) *foreign exchange forward contracts*, *futures* on securities, indices, *currencies*, *commodities* … *options*… and *credit default swaps*, which may create *leverage* in the fund."
- "Additional risks may be associated with *emerging-market securities*, including *illiquidity* and *volatility*."
- "We may engage in a variety of transactions involving *derivatives*, such as *futures*, *options*, *warrants* and *swap contracts*."

Derivatives? Leverage? Swaps? This doesn't sound like your average mutual fund, because it isn't. Absolute return fund managers are typically given the leeway to engage in a broad range of investment strategies, depending upon what is stated in the fund's prospectus. You may or may not be comfortable with these types of investments. But you should at least know what you're getting into before investing.

Better Choices for the Risk-Averse Investor

Esoteric strategies aside, the main concerns that I have with absolute return funds – other than the obviously misleading moniker – is the high fees and the absence of significant fund histories. Also, these funds tend to trade a lot and thus have high turnover ratios, which means that the actual fund expense can be double the listed management fee, dragging down performance.

Want something that doesn't lose any value? It's called a bond. Want some protection from inflation? Buy TIPS (Treasury Inflation-Protected Securities) bonds. Want less stomach-churning price volatility but some upside in a rising stock market? Check out balanced funds – blends of stocks and bonds. The bonds help smooth out the volatility, and the stocks keep you in the game with market returns. Many balanced funds have long track records, charge low fees, have low turnover, and are suitable for either taxable or tax-deferred accounts. Several that are rated 5-Stars by Morningstar include Vanguard Wellington, Oakmark Equity & Income, and Mairs & Powers Balanced.

Albert Einstein once said: *"Make everything as simple as possible, but not simpler."* He probably would have avoided absolute return funds for this reason alone.

As a financial planner with Coromandel Wealth Management in Lexington, George Gagliardi helps clients develop and implement retirement strategies. He is affiliated with Trust Advisory Group, Ltd., a Registered Investment Advisor, and can be reached at (781) 728-9001 or george@coromandelwm.com. *This article is intended for general information purposes only, and may not be appropriate for your specific circumstances. Investment advice is particular to each individual, and should only be given after an individual situation has been reviewed.*

Coromandel Wealth Management
15 Muzzey Street
Lexington, MA 02421

Phone: 781.728.9001
info@CoromandelWealthMgmt.com
www.CoromandelWealthMgmt.com