Letters

Absolute Return Obsession

Thank you for your "Absolute Return Obsession" article (December 2009).

While absolute return (AR) strategies come in several forms, the common denominator seems to be that returns are uncorrelated with market factors. If the market is irrelevant to returns, then returns must stem from another source, most likely manager skill. Therefore, if an absolute return strategy promises an average annual return of 5%, with the current risk-free return at near zero, active management would need to generate the entire 5%. It is difficult to find any long-term track records where active management has generated anywhere near 5% excess returns.

When evaluating an AR strategy, it's important to examine how well it holds up in extreme markets. An AR approach containing nontraditional asset classes is probably vulnerable because these investments are thinly traded or illiquid. When fear is rampant, investors rush to cash and will sell any asset that is perceived as having risk. In 2008, even money market funds were considered unsafe. Also, does the AR strategy require trading when markets are chaotic? For example, "Portfolio Insurance" was touted in the 1980s as a way to protect investments if markets fell sharply, but failed miserably in the October '87 crash; trades could not be executed because traders simply did not pick up their phones. In another example, the unprecedented market volatility in 2008 caused a number of usually reliable derivative strategies to fail.

In my opinion, instead of rushing into strategies which are unhinged from the stock market, investment advisors should embrace the stock market, but at the same time, find better ways to manage market risk. The stock market has proved to be a marvelous investment vehicle; since 1926, stocks have produced positive returns in 60 out of 84 years (71%). The challenge is how to avoid severe losses in years like 2008.

I believe one answer is equity collars, which both limit the upside potential and downside risk of stocks. As described by Geoff Considine in his January 5, 2010, *Advisor Perspectives* article, "Risk Management Through Costless Collars," "The most attractive element of collar strategies is their ability to remove the impact of really bad events. … Particularly for retirement planning, the potential increase in happiness that a windfall could provide is far less significant than the potential for misery from a large loss."

Thomas J. Schwab
Chief Investment Officer
Summit Portfolio Advisors LLC
Denver, Colo.

Wagner Hits The Mark

Just as I finished your September issue, I found the "Mirror, Mirror …" piece.

This is a wonderful, articulate analysis of our unique position in the financial meltdown.

Thank you for asking Mr. Wagner to contribute and please pass on to him that this gives me hope for the industry not to be brain dead after all.

Jenny Fleming, CPA, CFP, PFS
Equistar Wealth Management LLC
Austin, Texas

Correction:

In the February issue of *Financial Advisor*, The name of Raymond James president Paul Reilly was mispelled. *Financial Advisor* regrets the error.