

February 2015 » White paper

Absolute return strategies offer modern diversification

Key takeaways

- Absolute return differs from traditional stock and bond investing.
- Absolute return seeks to reduce market volatility for investors while achieving positive absolute returns in various market environments.
- Modern tools, investment flexibility, and management skill are keys to absolute return.
- Putnam offers a choice of absolute return funds to help diversify traditional portfolios.

Over the past 30 years, investors have embraced investing in stocks and bonds to pursue their financial goals. However, in recent years, investors have shown interest in new ways of thinking about portfolio diversification as a response to the relatively high market volatility since the 2008 recession.

Absolute return investing offers something different for investors who have followed traditional stock and bond strategies. Absolute return strategies, by definition, pursue returns independent of a traditional benchmark index like the S&P 500 Index or the Barclays U.S. Aggregate Bond Index. Absolute return investing is unconstrained and can “go anywhere” to achieve the most efficient risk-adjusted return for investors.

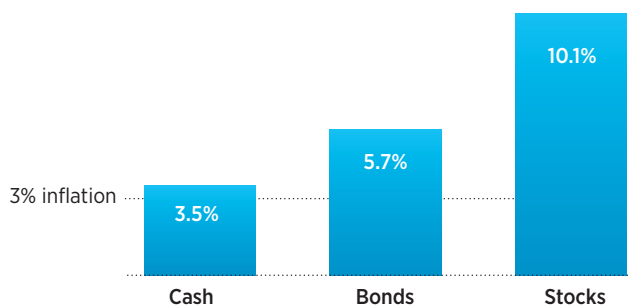
This paper explores the features of absolute return funds that differ from traditional stock or bond funds:

- A focus on providing positive, targeted returns over time with less volatility than more traditional funds
- Potential for positive returns in flat or declining markets
- Flexibility to pursue global investment opportunities
- Diversification across newer and alternative asset classes
- Progressive risk management with tools for hedging to choose what risk to take, and how much

Absolute return is a modern strategy that pursues target returns with lower volatility than traditional funds, to help diversify portfolios for all kinds of investors.

Figure 1. Relative return funds invest in traditional asset classes

Annualized returns (12/31/25–12/31/14)



Source: Morningstar, 2014. Stocks are represented by the Ibbotson U.S. Large Stock Total Return Index, bonds by the Ibbotson U.S. Long-Term Government Bond Total Return Index, cash by the Ibbotson U.S. 30-day Treasury Bill Total Return Index, and inflation by the Consumer Price Index. The indexes are unmanaged and measure broad sectors of the stock and bond markets. You cannot invest directly in an index. Past performance is not indicative of future results.

Traditional stock and bond funds follow benchmark indexes

Investors turn to stocks and bonds as a way to build long-term wealth because these asset classes have a historical track record of positive performance over the long term. While stocks and bonds have greater risks than short-term securities such as Treasury bills, history shows that, over the long haul, investors have been rewarded for taking these risks by earning higher rates of return (Figure 1).

Performance is measured against a market index

Most traditional mutual funds task the portfolio manager with outperforming a stock or bond benchmark such as the S&P 500 Index or Barclays U.S. Aggregate Bond Index. The manager is usually constrained to invest only in the domestic market or in a specific asset class. According to the Investment Company Institute 2013 Fact Book, 92% of mutual fund assets are in funds focused on a specific asset class — stocks, bonds, or money market securities. Hybrid funds are an exception. These traditional funds have greater flexibility to invest across global asset classes. However, only about 8% of industry assets are invested in hybrid funds. Furthermore, some traditional funds have even tighter constraints, such as bond funds that invest only in government bonds or high-yield bonds, and stock funds that invest only in small companies or growth

stocks. Such constraints benefit investors in that they discourage a money manager from taking a range of unintended risks, and they focus efforts on security selection.

Volatility is tied to market risk

At the same time, constraints carry a disadvantage as well. In a general market decline, when securities fall in price for systemic, rather than specific, reasons, there is little that a constrained manager can do to avoid a negative result. In fact, a manager may do what is considered a good job — by outperforming the market benchmark — yet, during a bear market, the fund might post a significant decline for shareholders.

Bear markets can be devastating

There have been 13 bear markets in stocks since World War II, with prices declining 21% over 14 months, on average. Bear markets pose substantial risks. For younger investors, a downturn interrupts the compounding of returns, and this delays wealth accumulation. For investors who have already built up savings and may be relying on them to generate income, the impact of a bear market can be devastating. For safety, such investors typically favor more conservative investments, which, with lower rates of return, require a number of years to recover from a downturn (Figure 2). Since their time horizon is shorter, older investors cannot reallocate enough money to stocks to potentially benefit from a recovery in prices and restore their wealth.

Retired investors are vulnerable

For retired investors, a bear market poses special risks. Withdrawing money during declines locks in the low stock prices and leaves investors with a smaller position for when the market recovers. In short, retirees are particularly vulnerable to bear markets, which can shrink savings and reduce the potential for generating a future income stream, because retirees are unable to add to their portfolios from occupational income.

To understand the heightened bear market risk for retired investors, consider the example of the stock market decline of 2000–2002. Figure 3 compares two investors, one who retired in late 1999, at the start of a bear market, and one who retired in late 2002, near the beginning of a recovery. The first investor's portfolio declined during the bear market and remained well below its original value even

after the market recovered, leaving the investor with less financial security. The other investor benefited from market performance, and the portfolio even appreciated for several years. The difference highlights the damaging impact of a bear market. For more information on the importance of stable returns in retirement, visit theretirementsavingschallenge.com

Absolute return strategies are less constrained

An absolute return objective removes many constraints on managers and allows them to implement more strategies for addressing market volatility. More traditional strategies can have some flexibility, but are generally more constrained. For example, a traditional bond fund

manager may be allowed to invest in all sectors, but is likely to be influenced by the sector weightings of the benchmark index because diverging from them can cause greater performance variance. This generally compels traditional funds to take on market exposure. By contrast, pursuing absolute returns means that managers do not have to take the risk of full market exposure.

Absolute return strategies are independent of traditional benchmarks

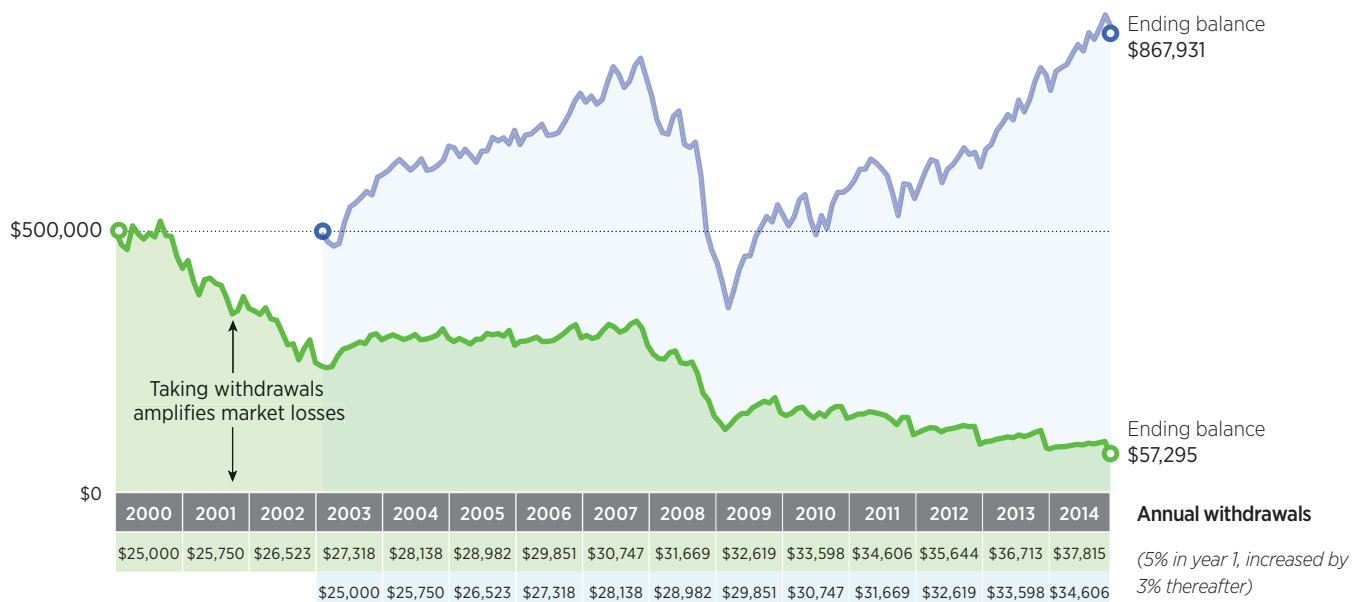
Unlike traditional funds, absolute return funds are not measured against traditional market indexes. Instead, they are measured against their return goals. This also helps to remove many constraints on investment

Figure 2. Older investors cannot take the risk of a bear market because it can take years to recover

Rate of return	Size of bear market downturn				
	-10%	-20%	-30%	-40%	-50%
2%	5.25 years	11.25 years	17.75 years	25.50 years	34.75 years
4%	2.75 years	5.50 years	9.00 years	12.75 years	17.25 years
6%	1.75 years	3.75 years	6.00 years	8.50 years	11.50 years
8%	1.25 years	2.75 years	4.50 years	6.50 years	8.75 years
10%	1.00 year	2.25 years	3.50 years	5.25 years	7.00 years

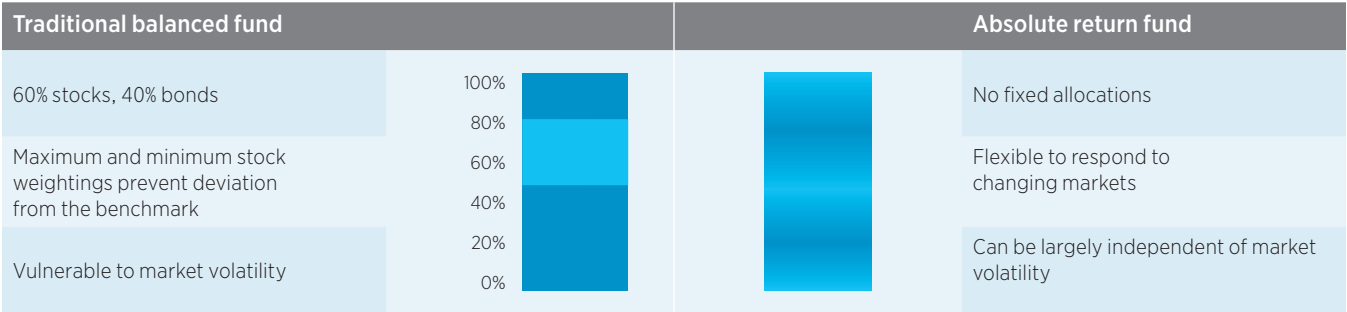
This hypothetical illustration is based on mathematical principles and assumes monthly compounding. It is not meant as a forecast of future events or as a statement that prior markets may be duplicated. Recovery periods are rounded to the nearest quarter of a year.

Figure 3. Reducing losses early in retirement is a key to success



This illustration depicts two hypothetical \$500,000 investments in stocks, as represented by the S&P 500 Index. One investor starts on 12/31/99, withdraws 5% in year one, and increases that amount by 3% each year to adjust for inflation. Another investor takes the same approach, but starts three years later, thereby missing the market decline of 2000–2002. Past performance is not indicative of future results.

Figure 4. Absolute return portfolios can adjust with changing market conditions



managers. There is no incentive for an absolute return manager to make a fund look similar to any securities index. Instead, there is greater incentive to avoid the risk of negative returns.

Return targets provide diversification advantages

An absolute return objective focuses money managers on the elementary concerns of an investor — achieving a positive real return, one that enhances purchasing power. This objective is valuable to investors because of the long-term persistence of inflation. It has averaged 2.7% annually over the past 30 years (1985–2014), according to the Bureau of Labor Statistics. Inflation undercuts the returns of all traditional asset classes, including cash, stocks, and bonds, and many traditional funds have no mandate to outperform inflation. The role of T-bills in their performance target gives absolute return strategies attributes for addressing inflation risk. The rates on T-bills usually rise when inflation increases. The goal of outperforming T-bills by specific margins makes absolute return strategies a tool for diversifying a portfolio that has no other strategy for the risk of inflation.

Seeking to keep market risk low

Traditional funds compete on the basis of relative returns rather than risk. Although investors have paid greater attention to risk over the years, managing risk in a portfolio depends on asset allocation strategies. Absolute return strategies employ asset allocation as a starting point. However, absolute return managers generally have greater latitude to invest in a wider universe of securities, and without the fixed asset weightings of traditional asset allocation approaches (Figure 4).

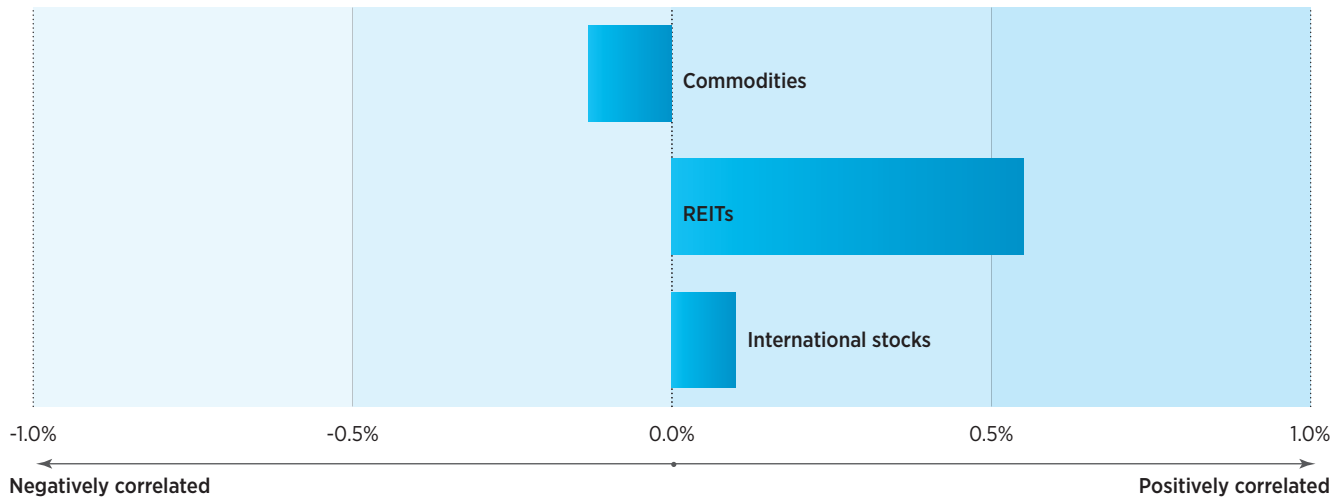
Tools for protection during bear markets

Flexibility to use modern investment tools allows managers to go beyond traditional methods of obtaining exposure to markets and to seek alpha opportunities. Alpha refers to returns beyond those generated by market movements. Active use of tools that can capture alpha can help investment performance when markets are flat or negative. Here, as well, many traditional funds employ similar tools, but in most cases they are less integral to a strategy when a fund does not have a specific return goal, like an absolute return target.

Giving a money manager flexibility to invest globally, across a variety of sectors and with modern tools, allows a skilled professional to pursue more consistent positive returns. Money managers with hands-on experience in a variety of markets can decide which areas are likely to appreciate and which are not. In a strategy without asset class constraints, a manager can move money out of stocks and into bonds, or out of both stocks and bonds and into cash and alternative investments. An absolute return manager is free to take risk only with investments considered likely to generate positive returns and tries to avoid weaker investments.

Figure 5. Several asset classes offer lower negative correlation with bonds

Three-year correlation with the Barclays U.S. Aggregate Bond Index as of 12/31/14.



Source: Putnam. Correlation is a measure of how similar the historical performances of two different asset classes have been. The maximum correlation is 1.0, and the minimum is -1.0. A positive correlation close to 1.0 indicates that the historical returns of the two asset classes being compared have been very similar. A negative correlation close to -1.0 indicates that the historical returns of the two asset classes being compared have been opposite each other: For example, when one gained 5%, the other declined 5%. Correlations near zero indicate that there has been little discernible relationship between the two asset classes being compared.

Commodities are represented by the S&P GSCI Index. REITs are represented by the MSCI REIT Index (GD). International stocks are represented by the MSCI EAFE Index (ND).

Diversifying across sectors and asset classes

One of the more distinctive tools available to absolute return strategies is the freedom to own a range of investments and to go to any sector or asset class that offers attractive opportunities. In an absolute return strategy, this flexibility is greater than in most traditional asset allocation strategies, and it takes advantage of the increasing diversification of financial markets in recent years. Combining investments in securities that have low or negative performance correlation can reduce portfolio volatility relative to returns (Figure 5).

Alternative asset classes — commodities, real estate, and foreign currencies

Another dimension of absolute return investing involves alternative asset classes, a general category that includes investments beyond stocks and bonds. Examples include commodities, real estate, and foreign currencies.

Adding a range of different investments to more conventional investments can diversify the sources of return that improve performance relative to risk, producing a more efficient overall portfolio. Freedom to choose among these investments, when given to an experienced, professional money manager, can help

investment performance in any market environment. For example, the manager can determine the periods when it might be beneficial to have broad diversification across a range of asset classes, and at other times, selectively focus on a handful of areas while dialing down exposure to others. A number of traditional funds can invest in alternative asset classes, but these are typically specialized funds designed to provide exposure to the asset class. By contrast, alternative asset classes are employed opportunistically in an absolute return strategy as a means to achieve its positive return goal, and may be excluded when negative returns are expected.

Among the more prominent alternative asset classes are commodities and REITs. Commodities can include a range of products such as gold and other precious metals, natural resources such as paper and timber, industrial metals, and agricultural products, to name a few. This asset class can provide protection from inflation because commodity prices are strongly linked to supply and demand pressures. During periods of economic expansion, demand increases for commodities, which pushes up prices and rewards investors.

Conversely, when economies slow or recede, demand for commodities usually falls, and prices decline as well.

Real estate can protect investors from inflation for similar reasons. Demand for real estate usually increases when the economy is strong and inflationary pressures are rising. The utilization of real estate properties typically increases during expansions, which lifts the cash flow of REITs, and if real estate supply is constrained, rental rates can also increase.

Currencies also represent a type of alternative asset class. Unlike most other assets, currencies have no intrinsic value, but they can nevertheless generate a return or loss because of fluctuations in exchange rates. These fluctuations are caused by a host of factors, but for investors who turn to currencies as a source of diversification, the key benefit is that exchange-rate fluctuations are generally not correlated with the performance of other asset classes.

Investing in global opportunities

Absolute return strategies are not constrained by geography. They can invest in the United States and in overseas markets to draw from a wide range of opportunities. While the United States is the single-largest market, international stock markets represent a majority of the world's securities, as measured by the market capitalization weightings of the MSCI World Index. Fixed-income markets outside the United States feature a wide range of issuers, including foreign governments and corporations, with different profiles of risk and return that allow flexibility for managers constructing portfolios.

With global flexibility, absolute return strategies can pursue the most attractive investments anywhere in the world and move money out of the least attractive. By contrast, traditional global funds generally do not move money with the same degree of flexibility. A traditional global strategy invests in both the U.S. and international markets at all times, while a traditional international strategy is constrained to invest only outside the United States. An absolute return strategy can move money without constraint among global markets at any time in pursuit of its return goal.

Adapting flexibly to changing markets

As markets evolve, absolute return strategies can adapt with them. The goal is to make the strategies more resilient and more versatile in changing markets. This flexibility can help absolute return strategies as they seek to overcome the short-term volatility risks that have posed problems for traditional strategies.

Hedging risk with modern investment tools

Another type of flexibility usually associated with absolute return strategies is the ability to use modern investment tools such as derivatives, including forwards, futures, and option contracts. A trained, professional money manager can use these tools to gain exposure to specific markets, to fine-tune portfolio strategies, and to mitigate unwanted market risks.

Many traditional investment strategies are permitted to employ hedging techniques, but their use of these tools is not guided by an absolute return goal. In other words, in a traditional strategy hedging might be a blunt instrument to protect performance in a broad market decline. An absolute return strategy implements hedging as one of many approaches to achieve a focused goal.

Employing futures, forwards, and options

Broadly speaking, a derivative is any type of investment whose value is linked to the performance of another security. Futures, forwards, options, and swaps are among the most commonly used derivatives. Futures and forward contracts are similar — they are agreements to buy or to sell something in a specified quantity and for a specified price at a future time. These contracts provide an indication of where investors think prices are headed, and they are typically used for either speculative or hedging purposes. Futures or forward contracts may be used to obtain exposure to an investment, and profit if the price moves as expected. In hedging strategies, almost the exact opposite occurs — the contract is used to lock in a certain price in the future, and thereby remove the uncertainty involved in the price movement. Forward contracts are also heavily used to establish positions in currencies, while futures contracts are common tools for gaining exposure to stock indexes and bonds, such as Treasuries.

Figure 6. Putnam Absolute Return Funds for all kinds of investors

	Putnam Absolute Return 100 Fund®	Putnam Absolute Return 300 Fund®	Putnam Absolute Return 500 Fund®	Putnam Absolute Return 700 Fund®
Return target	1% above T-bills	3% above T-bills	5% above T-bills	7% above T-bills
Holdings	Global bonds	Global bonds	Global bonds, stocks, and alternative asset classes	Global bonds, stocks, and alternative asset classes
Alternative to	Short-term securities	Bond fund	Balanced fund	Stock fund

Each fund seeks to outperform Treasury bills by targeted amounts. While Treasury bills are backed by the U.S. government, investments in mutual funds are not.

Options contracts are also focused on future prices, but instead of creating an obligation, these contracts give the buyer or seller the right to purchase or sell securities at a certain price within a specified period of time. A put option is the right to sell a security, while a call option is the right to purchase a security.

Reducing market risk

For the purpose of an absolute return strategy, an attractive feature of forwards, futures, and options is the ability to reduce risk by hedging against market declines. In particular, by using put options on market indexes, an investor can build in a buffer against market declines. That is because a put option becomes more valuable when the underlying security or index approaches or falls below the put price.

Derivatives can be used to help funds perform more independently of overall market direction. They also allow investment managers to implement their views about which securities, sectors, or markets are likely to appreciate or depreciate. With this tool, investment managers can more comprehensively capture their overall investment view in a portfolio, and not be limited to long exposures only.

Focusing on prudent hedging

While derivatives can be a very valuable tool, it is important to remember that they are not a cure-all that eliminates the risk of market declines. First of all, using derivatives effectively requires analytical and forecasting skills similar to those used in selecting securities. As such, not every decision made with derivatives will help a strategy. Second, because derivatives give investors a great deal of leeway, they can also have an outsized impact on performance, and when the decisions are wrong, they represent a risk to performance.

Third, trading derivatives involves investment costs that can reduce performance. While highly specialized and aggressive strategies rely on widespread use of derivatives, for most investors, a prudent, judicious approach to derivatives is most effective.

Putnam's approach to absolute return

Putnam Investments offers absolute return funds for retail investors (Figure 6). Previously, Putnam's absolute return strategies were available primarily to institutional investors, but they can now serve important roles in individual portfolios as well.

Putnam Absolute Return Funds pursue positive returns above the returns of Treasury bills, over market cycles of at least three years, with lower volatility than markets and more traditional funds. The funds are designed to serve investors by using a wide range of investment tools. Putnam's funds can use strategies that add performance potential and seek to reduce market risk. If successful, the strategies can be expected to outperform general securities markets during periods of flat or negative market performance, although they may lag during market rallies.

Putnam Absolute Return Funds offer a complement to funds constrained by traditional benchmarks. Putnam's strategies mix traditional and alternative investments, as well as traditional security selection, with more advanced active strategies involving derivatives. Putnam's funds can use derivatives to obtain or enhance exposure to sectors and markets, and to mitigate risks. The funds will not borrow money in order to establish leverage, but some of them can use derivatives to gain leveraged exposures.

With these attributes, Putnam Absolute Return Funds can be valuable additions to portfolios constructed with traditional investments.

The hallmarks of Putnam's approach to absolute return

- A focus on positive returns with less volatility over time than more traditional funds
- Potential for outperformance during a flat or negative market environment
- A wide range of investments
- Progressive risk management with modern tools
- Flexibility to invest without constraints
- Portfolio managers experienced in absolute return strategies over many years

Putnam's experience and capabilities

Putnam's Fixed Income group has managed absolute return strategies for institutional investors since 1999, and are backed by more than 70 fixed-income experts in all sectors. Putnam's Global Asset Allocation group has managed a multi-asset strategy for institutions since 2006, applying strategies that reflect the skills that this 14-member group has developed over 22 years of managing asset allocation funds.

Consider these risks before you invest: Asset allocation decisions may not always be correct and may adversely affect fund performance. The use of leverage through derivatives may magnify this risk. Leverage and derivatives carry other risks that may result in losses, including the effects of unexpected market shifts and/or the potential illiquidity of certain derivatives. International investments carry risks of volatile currencies, economies, and governments, and emerging-market securities can be illiquid. Bonds are affected by changes in interest rates, credit conditions, and inflation. As interest rates rise, prices of bonds fall. Long-term bonds are more sensitive to interest-rate risk than short-term bonds, while lower-rated bonds may offer higher yields in return for more risk. Unlike bonds, funds that invest in bonds have ongoing fees and expenses. Stocks of small and/or midsize companies increase the risk of greater price fluctuations. REITs involve the risks of real estate investing, including declining property values. Commodities involve the risks of changes in market, political, regulatory, and natural conditions. Additional risks are listed in the funds' prospectus.

Request a prospectus, or a summary prospectus if available, from your financial representative or by calling Putnam at 1-800-225-1581. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.