Since Putnam introduced its absolute return funds earlier this year, over 4,200 advisors and $650 million in assets have flocked to the new financial products. Putnam’s four funds seek to beat inflation by 100, 300, 500 and 700 basis points, and their performance over their first nine months (3.1%, 6.4%, 8.4% and 12.2%, respectively) was encouraging for their investors.

Impressive as those results may be, the question is whether they are sustainable. We cannot say whether these funds will achieve their objectives over longer time frames. We can, however, assess the skill required to meet or exceed the funds’ target objectives and the degree of risk implied by the strategies the fund managers use.

Consistently beating inflation by a margin as wide as 700 basis points would be an ideal outcome for any retirement-oriented investor, especially if it can be done with less volatility, as Putnam claims, than the traditional equity-centric portfolio. That is the tantalizing appeal of these funds – an appeal amplified by the experience of the recent bear market, which left many investors seeking more stable and secure investment options.

I took a close look at the more aggressive 500 and 700 funds, and spoke with Jeff Knight, the manager of those two portfolios.

I question the utility of the other two funds, especially the 100 fund. An investor whose goal is to beat inflation by 100 basis points can simply buy TIPS (individual bonds, not funds) and lock in such an outcome over the next six years (longer than Putnam’s target of three years) without any default or liquidity risk. In fairness, Putnam’s funds offer the opportunity to exceed the 100 basis point target but, as we will see, they do so by introducing risk.

Looking under the hood

Before exploring the mechanics of these funds, a word about their stated goals and performance benchmarks is in order. The funds seek to outperform inflation by a stated margin, but their performance benchmarks are Treasury bill rates.

Treasury bills have generally tracked inflation, but not always. After Treasury bills were deregulated in 1951, they closely tracked inflation until the early 1970s. As inflation rose in the 1970s, however, the relationship weakened and Treasury bill rates were
consistently below inflation. Since 1980, Treasury bills have outpaced inflation and generated a small, positive real return.

This is not a trivial concern, since investors may be disappointed if there is a repeat of 1970s-style inflation and Treasury bill rates lag behind inflation.

During the 83 years beginning in 1926, Treasury bills returned 3.7%, versus inflation of 3.0% and a nominal return on the S&P 500 of 9.6%. Over that period, equities have outpaced Treasury bills by 590 basis points so, over the long run, one could reasonably expect to achieve 700 basis points of outperformance by, for example, tilting the portfolio toward small cap or value stocks.

The Putnam funds, however, target outperformance over a three-year period with less volatility than equities, and therein lies the challenge.

To achieve that goal, Knight and his team can invest in any asset class (equities, fixed income, and commodities), market, or currency. They can also use derivatives or leverage, and they can sell short. Knight’s unconstrained mandate includes arbitrage-like strategies. For example, he is currently betting that the pattern of futures contracts in the crude oil market will change.

The 700 fund currently has 11% of its assets in US equities and 3% in non-US equities, while 30% of its holdings are in cash. Its biggest bets, according to Knight, are in high-quality, high-yield bonds and TIPS.

When strategy is constrained – as it is for a mid-cap growth fund, say, or a junk bond fund – investors can make forecasts about expected correlations and performance. With techniques such as Monte Carlo analysis, they can infer how the fund will do under a range of scenarios.

Such analysis is not possible with these funds, because of their unconstrained nature. Knight said that the closest proxy to his fund’s strategy would be a risk-parity strategy, which applies leverage to the lower-volatility fixed income portion of a portfolio, giving that portion risk on par with the equity portion’s. Leverage is a particularly attractive tactic today, since short-term rates are extremely low.

Knight uses leverage in the lower volatility portions of his portfolio, but risk-parity is just one of many strategies he employs, he said, and modeling based on it would not accurately forecast returns.
The Olympic high dive

Since we can't forecast the performance of Putnam's funds, let's look first at how many mutual funds achieved the fund's target benchmark over the three years ending September 30, 2009, during which the S&P 500 lost 5.49%:

<table>
<thead>
<tr>
<th>Basis point margin above CPI</th>
<th>100</th>
<th>300</th>
<th>500</th>
<th>700</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performance target</td>
<td>2.54</td>
<td>4.54</td>
<td>6.54</td>
<td>8.54</td>
</tr>
<tr>
<td># of funds beating margin</td>
<td>1,669</td>
<td>974</td>
<td>345</td>
<td>124</td>
</tr>
<tr>
<td>% of funds beating margin</td>
<td>28.7%</td>
<td>16.5%</td>
<td>5.8%</td>
<td>2.1%</td>
</tr>
</tbody>
</table>

These data were culled from Morningstar by Brigham Young University professor of finance Craig Israelsen. A note of caution: The numbers are skewed, because they do not take into account survivorship; many funds – notably poorly-performing ones – failed or were closed over this period. Thus, the percentages above overstate the likelihood of outperforming the benchmark.

A scant 2.1% of funds achieved the target set for the 700 fund, and almost all that did were positioned in high-performing, narrowly defined segments, such as China, Latin America, or Gold.

Morningstar assigns the 500 and 700 funds to its World Allocation Fund category. Within that category, 3 of 35 (8.6%) funds returned 8.54% or greater over three years ending 9/30/09, with an average return of 0.24%. Morningstar, however, assigns many total return-oriented funds to its Long-Short, Moderate Allocation, and World Bond funds. Across all four fund categories, 17 of 388 (5.0%) funds returned 8.54% or greater, and those funds on average lost 0.50% over the last three years.

We can also turn to Ron Surz' PODS universe to assess the likelihood of Putnam hitting its benchmarks. Surz simulated all possible US large cap portfolios, assuming a "market-neutral" strategy that could go long or short any individual holding. Over the three-year period, a fund returning 8.54% would be among the top 2% or 3% of possible funds. Surz' analysis does not include leverage or asset classes other than equities, but it confirms that an exceptionally high degree of skill is required to beat inflation by 700 basis points if one’s universe is restricted to US equities.

The data looks slightly better among hedge funds. According to Chicago-based Hedge Fund Research, Inc., the percentage of funds outperforming the above benchmarks over the three years ending 9/30/09 were 65.5%, 56.6%, 45.8% and 37.0%.

Survivorship bias, however, plays an even greater role in the hedge fund industry, which has contracted significantly over the last several years. The probability of any given hedge fund outperforming the benchmarks above is significantly lower than these
figures suggest. Hedge funds also have a significant advantage over mutual funds like Putnam's for a number of reasons, including the fact that they are not subject to daily redemptions.

Given the recent extreme bear market, Knight said that this three-year period is not necessarily the appropriate time period for evaluation, and that his shareholders would have been extremely happy with his results had his fund been operating over the entire interval. Nonetheless, it is precisely during difficult periods – including extreme bear markets – that these strategies must demonstrate their value; it is far easier to achieve a fund’s benchmarks during a bull market.

None of the above performance comparisons are perfect. Taken as a group, however, they lead to the unavoidable conclusion that it is extremely difficult to achieve the performance targets for Putnam's funds. If this were an Olympic high-diving competition, the degree-of-difficulty would be the highest possible. Moreover, the diver will need to execute a flawless dive, with impeccable form and a splash-less entry, scoring a perfect ten from all the judges, month after month to achieve the desired target over successive 36-month periods.

**Manager incentives**

Putnam deserves credit for including a performance-based fee as part of the fee structure for these funds. For class Y shares the 700 fund, the base expense ratio is a hefty 1.40%, but this can vary from 1.12% to 1.68%, depending on fund performance.

The performance incentive does not include high-water mark and clawback provisions that are common among hedge fund and some mutual fund incentive structures. With a high-water mark, managers do not earn performance incentives until and unless the fund’s value surpasses its value at the time of the investor’s purchase. Clawback provisions ensure that the manager must give back performance fees if the fund’s value declines beyond a certain level.

In addition to incentive fees, investor and management incentives are aligned because Knight has more that $500,000 of his own money invested in the 500 and 700 funds.

Investors in these funds must acknowledge that success depends on a lot of variables – equity market performance, interest rates, currencies, and the commodity markets. Add leverage – abetted by today’s low interest rate environment – and short selling to the mix, and the inescapable conclusion is that remarkable manager skill will be required to achieve the funds' targets over the long term.
In an article about the relationship between risk and return we will publish next week, Adam Apt discusses what he calls “knife-juggling risk.” Apt is referring to managers who “trade in and out of entire asset classes and subclasses … to avoid gross volatility of their own returns by constantly buying cheap and selling dear.” To quote Apt:

So they try not to be exposed to the vagaries of any one asset class or subclass for very long. They might, say, try to buy gold at the trough and sell at the crest. This is dandy as long as they’re clever enough to keep all the knives in the air. But timing is critical, and if they drop one, the result can be disastrous. They — and their clients — are bearing the huge risk that their skills or their luck will at some point fail.

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