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Real Returns Versus Absolute Returns

Chris Budd examines methods for smoothing investment returns.

There are, broadly speaking, two types of investors. The investor looking for 'relative returns' will compare his or her performance against a benchmark. Over some time periods their money may go up, and over other periods it may go down, but as long as they are beating the index, they will be ahead of the game.

In contrast, the investor looking for 'absolute returns' will have no interest in market cycles, and will instead be purely concerned with always producing a positive result. This will mean that, when markets go down, they are well ahead of the game, when markets go up, they might be behind. Nevertheless, they will bask in the knowledge that their money is going up.

Which type of investor are you? I would hazard a guess that the bulk of people reading this article would consider themselves, at the moment, to be a relative investor. In other words, if, over the last year or two, they have looked at their money and seen it go up, they will immediately want to know how everybody else did.

In rising markets, most people want to beat the markets. In falling markets, however, everyone suddenly turns into an absolute investor, and simply wants positive returns.

Is it possible to have it both ways? Well, not really. The principles of each approach are very different. A relative investor can generally try to add value and therefore perform above sector average in two ways.

Firstly, asset allocation. This is the technique whereby an investment portfolio is split into different asset classes (stocks and shares, property, gilts, cash etc), and then within each asset class further (e.g. stocks and shares being spread across the world's markets). Being overweight in the area that goes up, and underweight in the one that goes down, will result in beating the average.

The second method is fund or stock picking. Choosing the latest star fund, or picking a share which performs exceptionally well, will also ensure out performance.

So how does one generate absolute returns? The key here is by investing in assets which produce income. A share which is paying high levels of dividend will ensure a positive

inflow of cash, even if the price fluctuates. Likewise, property (or property funds) which hold actual property, will always have rent coming in, even if the capital values fall.

In this way, an absolute portfolio should always have income, and always therefore have a positive cash position. The value of the portfolio will then have to fall by more than the income being received for there to be a negative shift.

In this article I have, of course, omitted the single most common type of investor – the one that doesn't have any process at all! All investments should be reviewed frequently (at least annually), and a good quality advisor (preferably one that is fee based) can be of huge benefit in helping to define, and then apply, a suitable plan.

This article is for general information only and you should seek professional advice in respect of your own circumstances.

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