



Why is the
journey just as important
as the *destination*?

A guide to
absolute return

➤ A BNY MELLON COMPANYSM





More insight.
Not more of the same.

Introduction

Insight Investment is a specialist asset manager at the forefront of designing investment solutions to meet our clients' needs.

Launched in 2002, Insight is responsible for assets under management of £137.3 billion¹ across fixed income, liability driven investment, cash management, multi-asset, absolute return, income and specialist equity strategies.

We manage money for pension funds, sovereign wealth funds, insurance groups, local government, charities, private investors and other financial institutions.

¹As at 30 June 2011, represented by the value of physical securities and liability benchmarks.

Please note that the value of investments and any income from them will fluctuate (this may partly be due to exchange rate changes) and investors may not get back the amount invested.

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An introduction to absolute return



There are few investors who don't mind losing money.

Many, given the choice, would give strong consideration to an

investment that offers an above-average level of protection when markets fall, as well as providing participation in some of the upside when markets rise.

Until 2002, the types of products that offered this kind of solution were off limits to the vast majority of investors. However, the introduction of UCITS III allowed mainstream pooled funds to invest in a wider range of financial instruments, including derivatives, transforming the market. In the years since this legislation was passed, there has been an abundant supply of new products taking advantage of these new tools, many of which are designed and marketed as 'absolute return' funds.

An absolute return fund is a fund which aims to deliver positive returns with low volatility, irrespective of market direction. They therefore set out to provide some level of downside protection, given that preserving existing capital is an essential pre-requisite to delivering a positive return. Over the long term, an investor should expect less volatile performance compared to a fund run along more traditional lines, however they should remember that the value of investments and any income from them will fluctuate

(this may partly be due to exchange rate changes) and investors may not get back the amount invested.

In this guide, we explain how an absolute return approach to investing differs from more traditional strategies, the attributes which make this approach worth considering, as well as the risks that investors should be aware of.

UCITS

The Undertakings for Collective Investment in Transferable Securities (UCITS) are a set of EU directives that aim to allow collective investment schemes to operate freely throughout the EU on the basis of a single authorisation from one member state. The original UCITS Directive was adopted in 1985, and an update adopted in December 2001, known as UCITS III, widened the range of financial instruments allowed, the most notable of these being derivatives. The next stage of development, UCITS IV, was introduced in July 2011 and provides further opportunities to optimise the efficiency of UCITS funds. Throughout Europe, approximately €7.8 trillion is invested in collective investments, of which about 75% are authorised UCITS funds.

Source: (EFAMA, as at December 2010).

The benefits of absolute return funds

Positive returns

Absolute return funds potentially remove some of the uncertainty for investors, as they aim to produce positive returns regardless of market conditions. This contrasts with traditional funds, which can leave investors more exposed to fluctuations in the value of their capital, since they often aim to outperform a stockmarket benchmark that may result in both positive and negative returns.

Capital preservation

Having investments which aim to profit even when markets decline means that absolute return strategies can provide some protection in adverse market environments (and may compensate for losses in traditional investments), although this is not guaranteed.

Diversification

Absolute return strategies typically have a low correlation to other investments and assets. This can be particularly beneficial when markets or traditional securities are generating low or negative returns. However, the degree of diversification will depend on the type of strategy.

Directional or multi-asset absolute return funds, for example, will normally have a higher degree of correlation to other assets than market neutral funds, which aim to hedge out market risk altogether.

Stability

Market cycles can have a considerable impact on the value of the portfolio. For absolute return funds, the level of volatility will vary depending on the investment strategy but generally aims to create a smoother investment path than traditional funds and should potentially result in steadier growth. For the investor, smoother returns can help reduce the impact of market timing giving them more flexibility to move in and out of the funds, thus helping them to help mitigate consolidating losses.

Regulation

Absolute return funds that qualify for UCITS III and non-UCITS retail scheme (NURS) status provide the additional comfort of transparent regulation and liquidity to investors. The transparency provided by a regulated environment enables advisers and investors to understand key features of the funds and have confidence that there are no hidden charges in the fee structures.

Understanding the risks



The prospect of attractive, positive returns in excess of cash for a moderate level of risk is a compelling proposition. But as with any investment, it is important to understand the risks involved:

- Individual absolute return funds differ in their objectives. Those with higher targets may need to assume a higher level of risk in order to achieve them. Investors should look carefully at what level of risk funds can or are prepared to accept in order to meet their objectives.
 - Absolute return funds can still lose money, particularly in the short-term and are not guaranteed. The time frame over which they aim to achieve their target can indicate the minimum recommended period of investment. Although investments in the main should be considered for a minimum of five years.
 - Absolute return funds vary in the degree of exposure they have to market risk (beta). The higher the fund's beta, the greater its sensitivity to market movements.
 - Absolute return funds are unlikely to keep pace with traditional equity funds during a market rally, as their short and hedging positions will act as a drag on performance.
- However, this acts as the counterbalance in a declining market.
- Absolute return funds depend largely on fund manager skill and timing. There are no guarantees that fund managers will make the right decisions, and they will not be able to hide behind market performance. Fund managers need to have sufficient experience and knowledge to understand this aspect of the market. This is why when choosing the appropriate fund you should be comfortable with key factors such as: fund process, fund manager and team skill, robust risk and research capabilities.
 - Derivatives will be used for investment purposes. When implemented in a portfolio there is a possibility that the unit price of a fund may be more volatile than would otherwise be the case. The effect of the derivative strategies employed could be to amplify or dampen market movements, or to cause the net asset value of the Fund to move in an opposite direction to that of the market. In such cases, its behaviour could be counter-intuitive to that expected by investors who are used to investment in traditional long-only funds.

How do absolute return funds differ from traditional funds?



Absolute return funds are often referred to as an asset class, such as equities and bonds, and are grouped together under the heading of 'alternative investments'. This is not strictly accurate because the pursuit of absolute returns is an investment strategy. The funds falling within the absolute return spectrum can invest in all the traditional asset classes, including: equities; bonds; currencies and commodities.

Although absolute return funds will be managed in many different ways, they will broadly fall into two main categories (as discussed on pages 10 and 11). In addition, they all differ from traditional funds in three main ways: their overall objectives; flexibility; and the investment techniques employed.

Different objectives

Whereas traditional funds aim to outperform the benchmark index that most closely encapsulates their investment universe, such as the FTSE All-Share index, the objective of an absolute return fund is to achieve a defined return, typically outperforming cash (LIBOR or LIBID).

The traditional approach means investors may experience either positive or negative returns, but this is largely dependent on the direction of the markets. While outperforming the market can deliver strong returns when equities are rising, outperforming in a falling market may seem a fairly meaningless measure of success for an investor facing a substantial loss and an erosion of their original capital.

Greater flexibility

Traditional funds that aim to outperform a particular market index will usually be restricted in terms of where they can invest according to the weighting of particular companies, countries or sectors within the reference index.

Absolute return managers, on the other hand, can focus on the areas of the market where they feel the best opportunities lie.

This provides managers of absolute return funds with much greater freedom to switch between stocks and sectors and achieve the optimal blend for different market conditions.

Investment techniques

Absolute return managers use a wide range of investment techniques, which they hope will enable them to potentially benefit from market declines and market volatility and to exploit potential areas of inefficiency. Following changes to regulations, most of these techniques can be used in UCITS regulated funds, both absolute return and relative (traditional), although they are not yet widely used by the latter.

Absolute return funds are sometimes seen as one and the same as hedge funds. However, hedge funds are just one sub-set of the absolute return universe, which encompasses a broad range of product types.

An ideal absolute return product seeks to combine the most attractive characteristics of both hedge and relative funds, as illustrated below.

	Traditional long-only funds	Regulated absolute return funds	Hedge funds
Investor protection			
Regulation	Yes	Yes	No
Transparency	Yes	Yes	No
Business failure risk	Low	Low	High
Daily pricing	Yes	Yes	Variable
Capital preservation			
Asset volatility	High	Low	Variable
Alpha ²	Variable	Variable	Variable
Use of derivatives	Low	High	High
Use of short selling	Low	High³	High
Other			
Management costs	Low	Low	High
High leverage	No	No	Yes
Lock-up period	No	No	Yes

See Appendix 1 for an explanation of hedge funds, Appendix 2 for an explanation of derivatives and Appendix 3 for examples of how derivatives are used in practice.

² Level of outperformance generated by manager skill.

³ Direct shorting is not permitted under UCITS regulations, however short exposure can be replicated through the use of derivatives (see Appendix 2 for more details).

How do absolute return funds work?



Absolute return managers are able to exploit a broad range of investment tools, techniques and strategies that have not been widely used by traditional fund managers in the past. Most of these approaches involve the use of derivatives. These are some of the most common:

Tools

Synthetic short selling: Short selling involves borrowing and selling an asset with the intention of buying it in the future, in the expectation that the price will decline in the interim. Effectively, the fund manager is seeking to make a return from a security he believes may fall but not by the amount that the security is trading at. The ability to sell short doubles the opportunity set for investors, as it enables them to profit from market downturns as well as rises, and to exploit individual cases of company or security overvaluation. UCITS regulated funds are not permitted to employ short selling but can still achieve a short position 'synthetically' by selling derivatives such as a Contract for Difference (CFD), in order to achieve the same effect.

Derivatives: Derivatives allow investors to gain exposure to the performance of an asset at a much lower cost than

buying the real asset. These instruments are highly flexible and enable managers to implement their views with a high degree of precision. They derive their value from underlying assets, such as equities, bonds, properties, commodities, currency or an index. More details can be found in Appendix 2.

Leverage and gearing: This is the use of borrowing to increase the amount invested. This can be done by borrowing cash directly or as a consequence of using derivatives which enable the fund manager to access more exposure to the asset than buying the asset directly.

Whilst leverage or gearing enable managers to increase the potential returns, it can also magnify losses and investors should be mindful of this.

Techniques

Hedging positions: This technique is often used by absolute return funds, as it focuses on inefficiencies in relative valuation between securities without taking on market risk. The fund manager can achieve this by matching a long position (i.e. the traditional method of buying an asset in anticipation of a rise in price) in one security, sector or index with a short sale in another.

Strategies

Market neutral investing: The concept of this strategy is to combine long positions with short positions in order to remove market exposure as much as possible from a portfolio. The reason for doing this is to produce a return that derives primarily from security selection (alpha) decisions and as little as possible from overall market movement (beta). Market neutrality can be achieved through various techniques, such as a long-short approach or paired trading, but the objective is the same: a market neutral manager should be indifferent as to whether the overall market moves up or down in a given period.



See Appendix 2 for an explanation of derivatives and Appendix 3 for examples of how derivatives are used in practice.

Directional strategies: A directional strategy involves taking a net long or short position in a market, reflecting the fund manager's view on which direction that market will move. A net long position (whereby the fund manager holds bigger long positions than short positions overall) should benefit from a market rise, while a net short position (where bigger short positions are held than long) should benefit from a decline.

Volatility strategies: The pricing of financial options and other securities with embedded options (e.g. convertible and callable bonds) depends on expectations of future market volatility. Funds that can take both long and short volatility positions may be able to benefit from market trends.

What are the product options?



Absolute return funds typically have an investment objective to generate positive returns in all market conditions.

Depending on the strategies used to construct the fund, the time horizon over which this objective is delivered can vary. In the purest form, such as a market neutral fund, the time horizon can be very short. Whereas a fund with more exposure to market direction will have a longer time horizon to deliver its return objective, such as over a market cycle. For inclusion in the Absolute Return sector run by the Investment Management Association (IMA), funds should deliver returns of more than zero on a 12 month basis.

Although absolute return strategies seem like a relatively new concept, they have existed outside of the regulated environment of UCITS for many years.

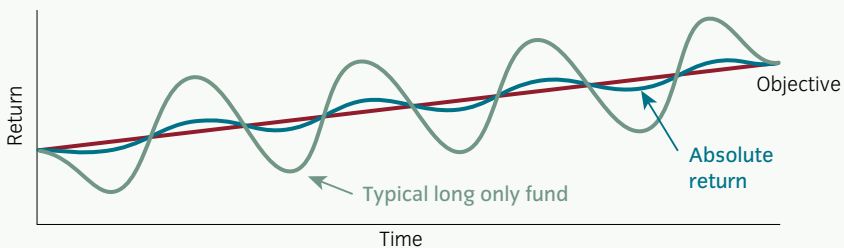
Hedge funds with absolute return objectives have been around for decades but the key differentiating factor is that hedge fund vehicles are not regulated and therefore are only suitable for certain investors. We compare the key characteristics of hedge funds with traditional and absolute return funds in the table on page 7.

The flexible investment approach of absolute return funds allows fund managers to deliver positive investment returns, even when markets are falling. At the same time, by investing in a wide range of assets, these returns are created with lower levels of risk.

Absolute return funds can broadly be broken down into two sub-categories; total or target return funds and pure alpha funds.

See Appendix 1 for an explanation of hedge funds.

A smoother path to achieve objectives



For illustrative purposes only.

1. Total and target return funds

Total return funds typically have unconstrained investment strategies, meaning that managers have the freedom to move between asset classes to achieve the optimal blend of investments for different market conditions. Fund managers depend on a combination of market returns, asset allocation, management skill and timing to achieve their objective. These funds often have a predominantly long exposure, meaning that they are exposed to the direction of the underlying markets.

Total return funds may seek to meet their objective by investing in a broad range of assets. In addition to traditional asset classes, such as equities, bonds and cash, these products, depending on their regulatory structure may gain exposure to commodities, property, currencies, structured products and funds managed by third parties. Investment risk may be further diversified through investment across a number of regions and investment styles.


Target return funds are able to employ the same flexible, multi-strategy, multi-asset approach and are effectively a sub-set of total return funds. The main difference is that they target a specific level of return, usually in relation to cash, over the long-term.

These targets are usually defined in recognition of a particular risk budget. An example might be cash plus 4% over a market cycle (typically five to seven years although this can vary), which is broadly the same return as that produced by equities over the long-term.

2. 'Pure alpha' / market neutral absolute return funds

Pure alpha absolute return funds use various derivative based strategies to hedge unwanted market risk and target the risks they wish to assume. This enables them to isolate 'alpha' (essentially the outperformance generated by the manager's skill in a traditional long only fund) as opposed to the return generated by market movements.

Pure alpha absolute return funds may invest in a range of assets, including equities, fixed income and currencies. For example, equity market neutral funds contain a broadly equal weighting of long and short positions and are largely independent of the equity market's performance.



ppendices

Appendix 1: What are hedge funds?

Hedge funds are highly diverse in nature, differing widely in the assets in which they invest, in the strategies and techniques they employ, and in the level of risk they assume to achieve their targets.

Despite their diversity, the following characteristics are common to most hedge funds:



- Higher fees
- High leverage (borrowing)
- The hedge fund vehicle is unregulated and therefore usually available through discretionary management and not to retail investors, although the Financial Services Authority (FSA) regulates UK hedge fund managers
- Liquidity constraints – may restrict access by closing the hedge fund to new investors and they often have restrictions on when and how quickly investors can redeem
- Low degree of transparency over investment strategies
- High minimum investment requirements

Appendix 2: Derivatives explained

What are derivatives?



As their name suggests, derivatives are financial instruments that derive their value from an underlying asset, such as an equity, bond, property, commodity or currency. Instead of having to buy or sell a particular asset, a fund manager can buy or sell a derivative linked to that asset and still take advantage of movements in the underlying asset's value. Derivatives are not only linked to single assets, but may also provide exposure to a market or sector.

Reasons for using derivatives

1. Effective risk management

Derivatives can be used to gain large market exposure with a relatively small outlay, making them effective tools for managing portfolio risk.

2. Cost

Derivatives typically provide exposure to an asset at a fraction of the cost of physically owning the underlying asset.

3. Flexibility

Derivatives enable fund managers to implement asset allocation changes or tactical positions quickly and cost-effectively, without substantially changing the underlying assets in their portfolios.

However, when derivatives strategies are used in a portfolio there is a possibility that the unit price of a fund may be more volatile than would otherwise be the case.

Derivatives also have the potential to magnify losses as well as smooth returns. As such, they need to be used in combination with tight risk controls, particularly in the management of counterparty risk when dealing with over-the-counter derivatives.

Types of derivative

Many types of derivative instruments are used in absolute return strategies.

1. Futures and forwards

A buyer agrees with a seller to purchase an asset at a specified date in the future, at a price agreed upon today. Futures are standardised products, traded on an exchange. Forwards are negotiated directly between the counterparties.

2. Options

A type of derivative that gives the buyer the right, but not the obligation, to buy (a 'call' option) or sell (a 'put' option) an underlying asset at an agreed price on a specified future date.

3. Swaps

A contractual agreement where two parties agree to exchange (swap) either single payments or a series of payments in the future. The following types of swap are widely used:

- **Interest rate swaps:** Counterparties exchange two future streams of interest payments. In its most common form, a fixed rate of interest is exchanged for a floating or variable rate of interest, usually measured by an index such as LIBOR.

- **Index swaps:** This type of swap involves the exchange of one index return for another index return or for a floating interest rate. The buyer pays the return on a money market deposit in exchange for the total return on an index, such as the FTSE 100.
 - **Currency swaps:** Counterparties exchange a pre-agreed amount of foreign currency now and re-exchange them at a certain specified date in the future.
 - **Credit default swaps (CDS):** A type of swap whereby one party buys protection ('insurance') from another against the default of a third party, usually a corporate bond issuer.
- ### 4. Contract for Difference (CFD):
- This is a contract between two parties, whereby the seller agrees to pay the buyer the difference between the value of an asset now and its value at the contract expiry. This enables fund managers to benefit from changes in the price of an asset without actually owning it.

Appendix 3: Using derivatives in practice

Using long and short strategies

Long position = retailer X,
short position = retail sector swap Y

Scenario: The retail environment is tough and consumer confidence is low. However, retailer X is undervalued relative to peers and staging a recovery under new management.

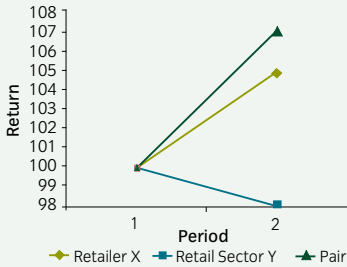
Strategy: The fund manager decides to take a long position in retailer X totalling 2% of the portfolio, hedging it with a 2% weighted retail sector swap Y. By doing this the fund manager seeks to generate returns from holding the undervalued stock and at the same time trades sector swap Y to minimise risk in the market.



Four scenarios

Scenario 1

Retailer X rises 5%,
retail sector falls 2%



Profit from both elements of trade
= 14 basis points (bps) gain.

Long position: $2\% \times 5\% = +10\text{bps}$

Short position: $2\% \times 2\% = +4\text{bps}$

Scenario 2

Retailer X rises 5%,
retail sector rises 2%



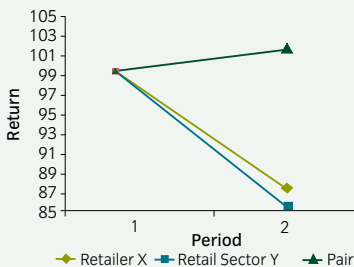
Profit as Retailer X rises more than the
sector = 6bps gain.

Long position: $2\% \times 5\% = +10\text{bps}$

Short position: $2\% \times 2\% = -4\text{bps}$

Scenario 3

Retailer X falls 13%,
retail sector falls 15%



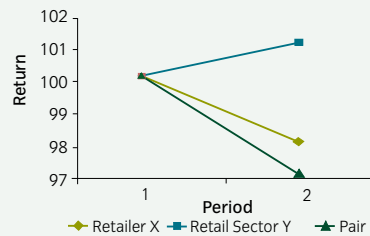
Profit as Retailer X falls by less than the
sector = 4bps gain. This example shows
that it is still possible to profit even when
both the sector and the stock are falling.

Long position: $2\% \times -13\% = -26\text{bps}$

Short position: $2\% \times -15\% = +30\text{bps}$

Scenario 4

Retailer X falls 2%,
retail sector rises 1%



Make loss on both elements of the
trade = -6bps.

Long position: $2\% \times -2\% = -4\text{bps}$

Short position: $2\% \times -1\% = -2\text{bps}$

Source: Insight Investment.

For illustrative purposes only.

Appendix 3: Using derivatives in practice

Using options to protect against falling markets

Scenario: Following a sustained rally in equities, the fund manager decides to hedge against a sharp fall in the market by buying a put option on the most relevant benchmark to the portfolio holdings, for example, the FTSE 100 index.

A put option gives the holder the right to sell the index at a fixed price by, or at, a set expiry date. Buying a put option to hedge risk is similar to taking out insurance. For example, for a reasonably small premium you can insure expensive assets, such as a house.

Strategy: The FTSE 100 passed through the 6000 mark and the fund manager decides to buy a put option giving him the right to sell the index at 6000. The amount he wishes to hedge is £60m at a cost of £600,000 for expiry in 90 days (i.e. it costs 1% of the portfolio for the given time period).



Possible scenarios for illustrative purposes

FTSE 100 continues rising

Result = net gain. Profits continue to accrue from the long position held in the FTSE 100 index. The fund manager does not exercise his option to sell the index and the loss is limited to the cost of the premium for buying the put option.

FTSE 100 falls sharply

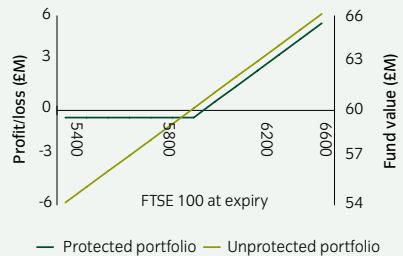
Result = small loss (£600,000). Losses from the long element of the portfolio are offset by gains from the put option. The fund has to bear the cost of the option premium.

FTSE 100 remains flat

Result = small loss (£600,000). The fund manager exercises his option to sell the index. The fund has to bear the cost of the option premium.

In this kind of hedging strategy, the put option is not aimed at generating profits for the fund. Its central function is to offset any fall in the market. This type of strategy can also effectively reduce volatility in a portfolio.

Using options to protect against market falls



Source: Insight Investment.
For illustrative purposes only.

A large, light green, stylized letter 'G' serves as a background graphic, occupying most of the page. It has a thick, rounded stroke and a circular cutout at the bottom right.

Glossary

A

Absolute return

A change in value of an investment measured in absolute, not relative, terms.

Absolute return funds

An absolute return fund seeks to generate positive returns in all market conditions. In contrast, performance of a relative return fund is measured against a given benchmark.

Absolute return funds

(IMA definition as at July 2009)

Funds managed with the aim of delivering absolute (i.e. more than zero) returns in any market conditions. Typically, funds in this sector would normally expect to deliver absolute (more than zero) returns on a 12 month basis.

Alpha

The additional return generated by manager skill as opposed to general market movements. Historical alpha measures the outperformance achieved by active management over time.

Alternative investments

Investments that do not fit into traditional categories of equities, bonds and cash, examples are private equity, venture capital, hedge funds, absolute return funds and property.

Arbitrage

Profiting from differences in price when the same security, currency or commodity is traded on two or more markets. By taking advantage of monetary disparities in prices between markets, arbitrageurs perform the economic function of making these markets trade more efficiently.

B

Beta

Statistical measure of the sensitivity of a security or portfolio to movements in the relevant market, usually calculated by regression analysis. A security with a beta of 1 is expected to move in line with the market; high beta stocks or portfolios (beta greater than 1) are expected to outperform in rising markets and underperform in falling markets; low beta stocks (beta less than 1) are considered to be defensive stocks. Strategies that contain both beta and alpha are exposed to market risk as well as active risk.

C

Call option

The purchaser of a call option has the right, but not the obligation, to buy an asset at a specified price on or before an agreed date. See also 'put option'.

Correlation

The degree to which the movements of two variables are associated.

Correlation is positive when two variables move in the same direction, and negative (or inverse) when they move in the opposite direction.

The degree of correlation is measured by a correlation coefficient, which varies from -1.0 to +1.0. A correlation coefficient of -1.0 indicates perfect negative correlation while +1.0 indicates perfect positive correlation.

D

Derivative

A financial contract whose value is derived from a stock, commodity, interest rate, currency or market index. A stock option, for example, is a derivative security whose value depends on the price of the underlying stock. Derivatives can be used by investors as a speculative tool, or to protect assets against changes in value. See also forward contract, futures contract, call option, put option and swap.

Drawdown

A drawdown refers to any peak-to-valley decline a fund has suffered and is usually quoted as the percentage decline from the peak to the trough.

E

Equity market-neutral

Fund managers employing this strategy operate portfolios with minimal market exposure by having a broadly equal long and short exposure.

Ex-ante

An ex-ante value will therefore refer to a predicted value. See **ex-post**.

Ex-post

Latin for 'after the event'. An **ex-post** value will therefore refer to an actual or realised value. See also **ex-ante**.

F

Forwards

A contract whereby a buyer agrees with a seller to purchase an asset at a specified date in the future, at a price agreed upon today. They are similar to futures contracts, but are customisable and traded 'over-the counter' i.e. through private agreements rather than via an exchange.

Futures

A contract whereby a buyer agrees with a seller to purchase an asset at a specified date in the future, at a price agreed upon today.

Futures are standardised products, traded on an exchange. They are used for either speculation or risk reduction.

G

Gearing

See **leverage**.

Gross exposure

The total of a fund's long and short positions in relation to the assets of the fund. For example, if the fund is 80% long and 50% short, then the fund is 130% gross invested.

H

Hedge fund

A general term for a fund which seeks to generate investment returns by using unconstrained and non-traditional investment strategies and tools such as short selling, leverage, programme trading swaps, arbitrage and derivatives. Their returns tend to be uncorrelated with standard market indices. They target positive returns in all market conditions.

Hedging

Action taken to protect the value of a portfolio against a change in market movements. It is normally used to reduce, minimise or eliminate risk, although similar techniques can also be used to speculate in a market.

L

Leverage

In terms of a portfolio of assets, using leverage in the portfolio means borrowing **cash** to purchase more of the required assets so that the exposure to this is greater than the value of the original portfolio. Instead of borrowing, **futures contracts** are often used for gearing a portfolio. Use of borrowed money to increase returns.

Long position

A long position is established when an investor buys an asset, such as a stock, commodity or currency, or gains equivalent exposure by using derivatives. For example, an owner of 1,000 shares in a particular company is said to be 'long the stock'. Long positions are generally taken in the expectation that the asset will rise in value.

London inter-bank bid rate (LIBID)

The interest rate paid by a bank on currency deposits. It is the rate at which a bank can borrow from other banks.

London inter-bank offered rate (LIBOR)

The rate received by a bank on currency deposits. It is the rate at which banks are willing to lend to one another. LIBOR is the standard floating rate reference in interest rate swap transactions.

Long exposure

The percentage of a fund's assets invested in long positions.

M

Market-neutral

A long/short fund with no net exposure to the underlying market.

N

Net exposure

The percentage of a fund that is currently net invested in the market. It is calculated as the difference between the long and the short positions. For example, if a fund is 100% long and 25% short, then the fund is 75% net long.

O

Option

The right, but not the obligation, to buy or sell an asset at an agreed price within an agreed time period. The right to buy a security is known as a call option, the right to sell a security is known as a put option.

P

Paired trade

Matching a long position with a short position in two closely related assets in order to achieve market neutrality. The resulting position is a relative view between the two components: a lead position and hedge to cancel out the unwanted risk.

Portable alpha

The return from a portfolio with zero beta.

Put option

The purchaser of a put option has the right, but not the obligation, to sell an asset at an agreed price within an agreed time limit. See also 'call option'.

S

Sharpe ratio

Measure of the total risk-reward trade-off calculated as the excess return divided by the variability of the return.

Short exposure

The percentage of a fund's assets that are invested in short positions.

Short selling

Borrowing a security and selling it with the expectation of being able to repurchase it at a later date at a lower price, thereby making a profit.

Sortino ratio

The sortino ratio is a measure of return per unit of downside risk. Whereas the sharpe ratio focuses on all volatility (upward and downward), the sortino ratio uses the downside standard deviation to highlight only the downward volatility, which tends to be of greatest concern to investors.

Swap

A contractual agreement to exchange a stream of periodic payments between counterparties. See page 17 for more details.

Total return

The overall return on a stock or portfolio taking into account changes in capital values and income earned.

T

Tracking error

A measure of the variability of investment returns relative to a benchmark or index. It is calculated as the standard deviation of the monthly or quarterly relative returns.

Treynor ratio

The treynor ratio calculates the excess return of a portfolio for every unit of market risk (beta). This differs from the sharpe ratio because it focuses on beta, rather than standard deviation.

V

Value-at-risk (VaR)

Measures the maximum expected loss at a given confidence interval over a specified period of time. For example, if a portfolio's 95% one-year VaR is £1m, there is a 5% probability that, within a one-year period, the portfolio's value will be more than £1m below its current level. VaR measures depend on the assumptions made about market returns, and so retain an element of subjectivity.

Volatility

A measure of risk, that encompasses the variation in an investment's return or price over a set time period versus the expected return or price, as represented by the mean.

Find out more

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