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Market dislocation opens up opportunities

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Maria Satizabal reflects on the current market environment and why the high level of uncertainty and market dislocation provide opportunities for absolute return strategies.

The investment proposition of absolute return strategies is to generate positive excess returns in all market conditions. Alpha generation in absolute return strategies is not about the level of yields, spreads, or prices. It is about generating returns by monetising movements up or down.

The market dislocation

The global return of inflation as the culmination of the strictest global lockdown in a hundred years has added to market uncertainty, with market participants unsure about the direction of several variables that were 'dormant' since the Great Financial Crisis in 2008. When central banks started to withdraw expansionary money supply support that governments, corporations, and individuals got accustomed to, an ocean of opportunities was created, which absolute return managers embraced with open arms.

Where to find opportunities?

Volatility in rates markets has risen dramatically as central banks started increasing rates to fight inflation. Consequently, returns from short-duration positions became very profitable as investors benefited from rising yields. While the market priced the path of interest rates into the future, investors took positions based on their expectations vis-a-vis the market.

Now that we might be witnessing the end of rate hikes around the world, savvy investors are not only taking long rate positions across markets but know how to position along yield curves to maximise profits. Investing in 'the range' is a skill which absolute return managers benefit.

In credit, research and analysis are paramount, playing an even more critical role now when the cost of capital is dearer. Before the rate hikes, when capital was 'cheap', even non-performing credits and corporations could survive. At the same time, growth and policy uncertainty creates volatility in top-down macro and bottom-up credit selection.

Benefits of absolute return strategies

The advantage of absolute return strategies is that they can avoid problems when investing in long-credit positions, as defaults tend to rise when the cost of capital becomes dearer. At the same time, these strategies can benefit from underperforming credits when looking to profit from a short position.

Capital preservation is paramount in a world where central banks tighten monetary conditions and decrease the money supply. Passive strategies are unable to protect capital in a falling market when their ability to neutralise beta is restricted. The current environment is well set for active managers, even more for absolute return strategies that can profit from rising and falling markets.

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