

When choosing funds, make sure to prioritize these two things

KEVIN FOLEY

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In a market that feels both expensive and fragile, investors face a vexing question: how to stay invested with confidence when the usual signals are muddled by economic, political, and geopolitical uncertainty?

Valuations in many asset classes are stretched, central banks are torn, and political headlines add fresh volatility. Yet abandoning markets altogether is rarely the right choice. The challenge is to invest smarter now, by prioritizing funds that can both beat the market (alpha) and deliver steady positive returns (absolute return) across cycles.

It's a demanding standard. But in today's environment, it may be the most thoughtful way to protect capital and compound wealth with any sort of confidence.

Alpha: Skill Beyond the Benchmark

For decades, alpha has been the gold standard of active management. Defined as returns above a benchmark after adjusting for risk, alpha demonstrates genuine investment skill. A fund that generates alpha is doing something more than simply riding the market tide, it is selecting securities, timing, or structuring portfolios in ways that consistently add value.

In [Yale's endowment report](#), David Swensen, the late chief investment officer of the fund, writes that its "single most important function is to develop investment partnerships with extraordinary investors," and that "nothing matters more than finding and working with high-quality partners." Swensen's insight suggested that finding managers with the ability to generate alpha was more valuable than endlessly debating the right mix of stocks and bonds. These skilled managers can tilt the odds in your favour.

But alpha alone does not guarantee peace of mind. The ability to generate alpha can be an illusion over a short period of time or a trending market. The coveted alpha-generating fund managers produce it consistently without sacrificing capital when the tide turns.

Absolute Return: The Discipline of Preservation

Absolute return investing takes a different lens. Instead of focusing on alpha's outperformance relative to a benchmark, it asks a simpler, more primal question: did the fund make money? And did it do so with consistency, in both calm and stormy markets?

Here, Warren Buffett's near-cliche reminder comes to mind: "Rule No. 1: Never lose money. Rule No. 2: Never forget Rule No. 1." While Buffett was speaking about investing broadly, the principle is central to absolute return thinking. Compounding only works if capital is preserved; avoiding deep drawdowns is as important as capturing upside, while nobody would be surprised by a surprise in today's market.

Absolute return strategies are usually not beholden to replicating a benchmark – a benchmark that indeed turns negative at times. They are more than one trick ponies – by design. They diversify and hedge risks, equipped with the tools and flexibility to actively change tacks as required. Their strength lies in protecting capital when markets stumble, where the best ones have both de-risked and identified opportunities by layering data analysis into their processes.

The Power of Combining Both

Funds that can do both: generate alpha and deliver consistent absolute returns - are rare. They represent a kind of "holy grail" for investors, replacing historical returns as the simple filter, especially now.

These managers show not only the skill to beat benchmarks but also the discipline to protect capital and produce steady gains.

Howard Marks, co-founder of Oaktree Capital, captured the spirit of this dual capability with: "You can't predict. You can prepare." A fund capable of producing both alpha and absolute return prepares you for a wide range of futures - whether markets roar, drift, or stumble - allowing you to stay invested with confidence.

This duality is particularly powerful now. When valuations are stretched, relying on market beta alone is risky. When economics, politics and geopolitics inject volatility, investors should prioritize invaluable managers who can both outperform and defend.

How to Select Funds That Deliver Both

The theory is compelling, so investors identifying funds that demonstrate both of these coveted qualities should be less about guesswork and more about discipline:

- **Check for consistent alpha:** Look at a fund's record relative to its benchmark over three, five, and even ten years. True alpha shows up not in one good year, but across multiple cycles.

- **Look at downside protection:** Review the fund's maximum drawdowns and the percentage of time it produced positive returns. Consistency matters more than occasional brilliance.
- **Demand proof of skill, not luck:** Metrics like the information ratio (alpha per unit of risk) and Sharpe ratio (aka risk-adjusted return or return per unit of volatility) can help separate sustainable skill from chance. Many purport to be active managers, while the data betrays the closet-indexers.
- **Examine manager behavior:** Low correlation is a hint that a manager does not simply replicate the benchmark. A focus on higher quality assets lends itself to capital preservation. Smaller funds and funds labelled alternative are more likely to offer both of these traits together. Has the manager proven to stay-on-style, promoting the likelihood that they will in the future too? Is the manager invested in their fund?
- **After-fee returns:** Don't get hijacked by passive funds that typically reproduce benchmarks, sometimes with lower fees. Successful portfolios rely on after-fee total returns.

In short, the best candidates demonstrate outperformance relative to benchmarks and resilience in absolute terms. Investors should seek evidence of both before committing.

These aren't hidden tools - most investors have access to return histories, drawdown data, and risk measures. The edge lies in actually using them as the priority screen, not the fine print.

Why Now Is the Time to Prioritize Both

In easier times, when valuations are cheap, interest rates low and steady, and growth predictable - investors could afford to focus on returns alone, ideally benefitting from at least some alpha, while tolerating drawdowns in exchange for long-term outperformance. Conversely, in crisis periods, absolute return alone might feel sufficient, preserving capital until the skies clear.

But today's environment combines both challenges: markets that look expensive, yet also highly uncertain. This is precisely the moment when insisting on managers who can demonstrate both alpha and absolute return is more than prudent, it's holy grail.

It is not about seeking perfection. No fund wins in every quarter. But by prioritizing these twin qualities, investors give themselves the best chance of staying invested with confidence: continuing to capture upside without being derailed by downside.

Kevin Foley is managing director, Institutional Accounts, at Canadian asset manager YTM Capital. He was previously a fixed income executive at a major Canadian bank and serves on several Canadian foundation boards and investment committees. He can be reached at Kevin.Foley@YTMCapital.com