Allianz Global Investors Insights

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Global View

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Allianz Global Investors Investment Forum II

The Allianz Global Investors Investment Forum recently held in Hong Kong brought together CIOs, senior investment professionals and business leaders from Allianz Global Investors and outside speakers for a full day of in-depth debate. The conclusions of the Investment Forum inform individual strategies, affect the development of new investment strategies for our clients as well as help clients with their own asset allocation. In this second of a two-article series, we summarize our findings from the Investment Forum.

In the current environment, it is unlikely that any of the major central banks in the developed countries will pursue an exit strategy anytime soon. Interest rates on money markets will stay low for longer. (Long-term) bonds are likely overvalued in the current climate, and unless held to maturity and in portfolios that can avoid being marked to market, bondholders face the risk of valuation write-downs when the tide of repression ebbs.

With bondholders getting squeezed, you had better look for real returns–for example, in the form of commodities (including gold and silver), real estate and infrastructure investments, and companies with sustainable growth even in a low-growth, higher-inflation environment:

Small caps and companies with high pay-out ratios should be investors' first choice.

Dividends should be the main drivers of equity returns in times of moderate price-earnings ratios and low–not to say negative–real bond yields.

Equities will probably remain highly volatile. Be brave. History tells us that bounces in a financial-repression environment might be significant.

Currencies, primarily Asian ones, should be seen as a new favourable asset class. Asian currencies are, broadly speaking, undervalued, while the corresponding economies are catching up.

Asian bonds are worth a closer look, too. The Asian economies have moderate budget deficits and tax levels as well as strong current accounts and foreign currency reserves.

Remain prepared for the unexpected. There are a lot of historic shifts and changes happening right now–for example, a natural gas revolution in the US, which might help drive energy prices lower, spur consumption and shrink imbalances. But that is another story we just started to drill into at our latest Investment Forum.

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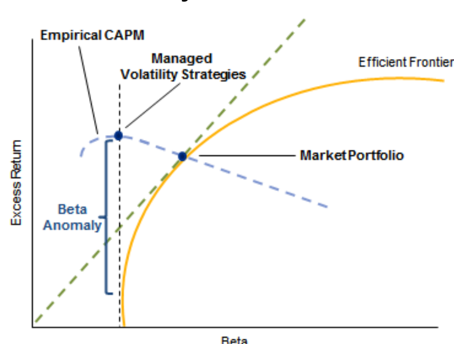
Understand. Act.

Winning by Not Losing–Managed Volatility Strategies

Viewpoint

Two equity bubbles in the past decade and increased market volatility have resulted in beta fatigue among investors. Managed volatility strategies allow investors to maintain equity exposure with significantly lower risk and potentially deliver superior investment returns, providing a compelling alternative to passive equity investing. We make a case that these strategies are a natural core equity allocation for any portfolio.

The Beta Anomaly



Source: Allianz Global Investors Capital
For illustrative purposes only. This does not represent the performance of any specific investment or strategy.

The Beta Anomaly The cornerstone of modern financial theory, the Capital Asset Pricing Model (CAPM), states that investors are compensated proportionate to the level of risk taken. However, empirical research on more than 40 years of equity market returns directly refutes CAPM's assertion of the relationship between risk and reward, demonstrating that lower-beta stocks have outperformed higher- beta stocks. This beta anomaly is the difference between the expected return according to CAPM and the empirical CAPM. Managed volatility strategies exploit this inefficiency by breaking the paradigm of managing relative to a capitalization-weighted benchmark. Instead, these strategies seek the portfolio with the lowest-feasible volatility. The root of the anomaly is linked to the human preference for "lottery-like payoffs" as proposed by Daniel Kahnemann in his Noble Prize-winning work.

Integral to the process of building a low volatility portfolio is the use of a sophisticated forecast risk model, which helps build the lowest-risk portfolio by considering low or negatively correlated stocks. Elements from behavioral finance also can enhance the risk forecast. In an effort to differentiate from competitors, an alpha model with return forecasts can be incorporated to build the final portfolio, resulting in a managed volatility portfolio of 50–80 stocks, which, in aggregate, offer low volatility and attractive fundamentals.

Where does a managed volatility strategy fit? Managed volatility strategies seem to be a perfect replacement for passive portfolios. Passive portfolios provide zero alpha but have all the underlying market volatility. Over an economic cycle, managed volatility strategies generally aim to exhibit only 60%–70% of the capitalization-weighted benchmark volatility. The lower volatility can result in more-attractive Sharpe ratios, which is ultimately how these strategies should be evaluated.

Managed volatility strategies may ultimately achieve greater returns than more-traditional approaches due in part to the effects of compounding. Potentially offering a significantly lower volatility than the market, these strategies are ideal for "return of capital". These strategies should tend to outperform in flat or down markets. However, in equity markets where beta becomes excessively rewarded (bubbles), managed volatility strategies may provide a positive total return but may lag the capitalization-weighted benchmark.

The focus on the lower total risk of the portfolio, coupled with a benchmark-agnostic approach to country, sector and security weights, is an approach that can help distinguish a managed volatility strategy from peers. A significant part of the managed volatility solutions offered are closely tied to the underlying capitalization-weighted or low-volatility indices. While investing in a low-volatility index may marginally improve Sharpe ratio, it too closely resembles the capitalization-weighted benchmark to take full advantage of the low-volatility anomaly.

Kunal Ghosh
Portfolio Manager
Global Emerging

Brandon Michael
Product Specialist

Why consider investing in managed volatility strategies now? Managed volatility strategies help to dampen equity volatility and potentially provide superior returns over time. Linking the anomaly to the basic human behavioral bias of greed (lottery-like preference) helps ensure its persistence. Additionally, trillions of dollars allocated to passive investments may further propagate and enhance this anomaly, as capitalization-weighted benchmarks–by definition–invest disproportionately in stocks that have historically performed well and hence have a higher beta. Managed volatility strategies should not be considered a tactical investment decision only during high volatility periods. Instead, managed volatility strategies should be a strategic core equity allocation and can be considered as a potential substitute for passive portfolios, seeking to provide above-market returns with substantially lower risk.

Investing in Asia–Theme 2: The Gaming Industry in Asia

Perspective on Asia

The gaming industry in Asia has grown dramatically in the past few years, reaching about USD49 billion of gaming revenue in aggregate in 2011 across the region. Macau is by far the biggest gaming market in Asia, with USD 34 billion in gaming revenue, and has been growing the fastest, at 36% Compound Annual Growth Rate (CAGR) for 2006–2011. Singapore is the second-largest market in Asia, with USD 6 billion in gaming revenue, followed by Australia with USD 4 billion, South Korea with USD 2 billion, and Malaysia and the Philippines, with less than USD 2 billion each.

Demand in the gaming sector is driven by strong economic growth and increasing urban household incomes in the region, and has been outpacing average GDP growth. Due to the development of integrated resorts and their positioning as a tourist destination, the sector is able to take advantage of the rising consumer discretionary spending trend and the rapid growth of Chinese high-end wealth demographics. The VIP segment is of particular importance, as it contributes 75% to the Macau market and 52% to the Singaporean market. The recent macroeconomic issues have negatively affected VIP market growth, however, mass-market growth was sustained on the back of an underpenetrated middle-class segment in China. Overall, demand growth is estimated to be 10%–15% annually in the medium term.

Casino gaming supply is highly regulated by local governments; hence, there is a high certainty of numbers of operators and the development pipeline. In the legalized jurisdictions, Macau and the Philippines are seeing supply increases with seven large-scale properties under development. There is also continued traction towards further proliferation of gaming in new jurisdictions due to strong economic benefits, such as job creation and tax revenue. Japan and South Korea seem to be the two most important investment opportunities in the next several years.

Raymond Chan
Chief Investment Officer, Asia Pacific

The gaming sector remains an attractive investment area on the back of strong income growth in the region and the upcoming infrastructure buildup. The massive Asian population, growing affluence, and the cultural affinity to gambling are all key factors supporting growth of the gaming industry. We believe the sector represents an attractive way of playing the consumption theme in the region.

Central Counterparty Clearing and OTC Regulation

Heard at Allianz Global Investors

It is astounding how undiscovered in vast parts of the world the probably biggest global reform in the history of financial markets is taking place. In the aftermath of the subprime crises, a year after Lehman Brothers declared bankruptcy, the G20 in its 2009 summit in Pittsburgh decided to regulate the, at this time, mainly self-regulated market of Over-the-counter (OTC) derivatives.

According to Bank of International Settlements (BIS) statistics, this market for interest rate, credit, equity and Foreign Exchange (FX) derivatives has an outstanding notional volume of USD648 trillion. With an ambitious time frame targeting the end of 2012, this market is supposed to be centrally cleared and traded on organized platforms.

At the core of this endeavor stands the idea to move the incredibly complex system of bilateral contracts between individual institutions to a market that circles around central clearing houses. These are supposed to remove the old form of counterparty risk. Trade repositories should increase transparency of outstanding exposures, and regulated trade platforms should offer more-competitive and more-transparent execution of trades.

The impact of this cannot be underestimated: Bilateral credit exposure will be replaced by standardized margins. In a world of scarce collateral, this will change the cost of holding positions for some counterparties significantly. Transparent

Eric Boess
Global Head of Derivatives

open interest numbers will give regulators and central banks a better view of the plumbing of the financial system than they have ever had. Trading in swaps, Credit Default Swaps (CDS) and other OTC products will move to far more competitive

Heard at Allianz Global Investors

Central Counterparty Clearing and OTC

levels and reconciliation of contracts will take place intraday, removing settlement risk from days to hours. And all of this is the equivalent to an open-heart surgery, since all these markets combined trade several billion per day.

Such transformations are never without risk, and one might argue that this changes a system of complex, interconnected risk models to a centralized risk hub, which in itself bears a new and clustered type of risk: the clearinghouse itself.

Unfortunately, this new ecosystem of institutions is growing slower than legislators had wished. The number of existing and operational clearinghouses is still very limited (LCH, ICE, EUREX among others), and the product range covered is lagging, too. To make things worse, the agencies charged with the detailed implementation of the Dodd Frank Act (DFA) and the European Markets Infrastructure Regulation (EMIR) are behind their own timetable, and the chance of different national rulings that might lead to regulatory arbitrage prevail. Still, this reform has the potential to make global markets a systematically much more stable place.

Source: Allianz Global Investors Insights, Volume 4, Issue 8

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