10

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Allianz Global Investors Insights

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Global View

Generating ACTive Returns with Alpha, Conviction and Tenacity

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Our investment experts recently gathered in Frankfurt for our second Investment Forum of 2016. Over a day of discussions, we took the pulse of the global economy and made only slight adjustments to our house view, given that our financial repression thesis is holding steady with no end in sight. At the same time, other themes – including rising political risks, the "Japanification" of Europe and the painful effects of negative rates – are set to affect investors for some time to come.

The state of the global economy

Economic growth and inflation have remained weak this year and real bond yields have continued to fall due to negative interest-rate policies (NIRP) in Europe and Japan. As we predicted in previous Forums, volatility has increased in asset classes such as global equities, oil and bonds. On the bright side, India and Indonesia have offered resilient returns and renewed hope from their new governments. In addition, China's renminbi has remained stable despite depreciation fears, while oil has stayed in a distinct trading range.

Growth and inflation are weak, bond yields have fallen and volatility has increased. On the bright side, India and Indonesia offer resilient returns.

Political risks go global

Politics has grown into an increasingly important risk factor for investors – especially with Brexit, troubles in Italy and Spain, and the US presidential election causing uncertainty and sideways movement in many markets. Sadly, one undeniably upward-moving trend can be found in the growing number of violent conflicts around the world, which are fuelling massive refugee movements and terrorist activity. Some estimates put the business cost of this political violence at more than USD 13 trillion.

Conflicts such as these are also fuelling populist and nationalist movements in the US and Europe, which could roll back the growth-friendly globalization, free trade and deregulation policies that have been in place since the 1980s.

This populism appears to have its roots in income inequality and the growing number of people left behind by globalization, and it may hurt large multinational companies if governments continue to interfere in tax issues and M&A executions.

Populist and nationalist movements could roll back the growth-friendly globalization, free trade and deregulation policies in place since the 1980s

A clear example of populism's rise can be seen in the US presidential campaign: Donald Trump is strongly protectionist and keen to reform the tax code, while Hillary

(Continued on page 4)

2 Perspective on the US
Risk Assets Boosted by the Hunt for Income and Total Return

2 Soundbites from Research
Negative Rates Are Forcing Insurers to Adapt

3 Viewpoint
Factor-Based Investing Is on the Upswing

Allianz Global Investors

Perspective on the US

Risk Assets Boosted by the Hunt for Income and Total Return

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For some time, many investors have been gravitating toward riskier assets to take advantage of attractive valuations and compelling total-return profiles – and some of the greatest beneficiaries of this shift have been high-yield bonds, convertibles and equities. Indeed, after a volatile start to 2016, risk assets such as these have turned dramatically higher, despite experiencing a brief Brexit-related setback in June. For example, on a year-to-date basis through August, US large-cap growth stocks moved up by 5.6 per cent, US convertible bonds returned 7.0 per cent and US high-yield bonds climbed 14.6 per cent.

After a volatile start to 2016, risk assets such as high-yield bonds, convertibles and equities have turned dramatically higher

One of the biggest factors boosting the performance of these asset classes has been investors' search for income. Yields are depressed globally and have even turned negative for government bonds in Japan and developed countries throughout Europe; in comparison, the US high-yield market in particular offers a compelling yield advantage.

Investors have been searching for income: Yields are depressed and some have even turned negative

An improved fundamental backdrop has also been a driver of this performance. Second-quarter earnings were generally better than expected, and outlooks for the remainder of the year are largely positive, as the headwinds experienced in 2015 from the energy sector and from the stronger US dollar have begun to diminish. Companies should continue to benefit from stable and accelerating revenues, cost controls, and earnings growth and stability.

Another benefit to high-yield and convertibles is the modest forecast for defaults: While defaults are expected to continue to increase slightly, they should remain at a low percentage level for 2016.

All told, while the path for high-yield bonds, convertibles and equities may be choppy, and may at times require strong conviction, these asset classes still offer compelling yields and attractive total-return potential in a low-yield world. In our view, investors would be wise to add to their positions by taking advantage of lower prices when they present themselves.

While the path for high-yield bonds, convertibles and equities may be choppy, they offer compelling yields and attractive total-return potential in a low-yield world

Soundbites from Research

Negative Rates Are Forcing Insurers to Adapt

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Legendary investor Warren Buffett has time and again sung the praises of the "float" in the insurance companies he owns. As many investors know, the float is the amount that can be invested after insurance premiums are collected but before claims payments are made – and it is a concept that lies at the very heart of his celebrated business model's success.

But today, Buffett's insurance companies and many other financial institutions are navigating a strange new environment: a world of ultra-low yields and NIRP. In this landscape, risk-free interest rates are negative and spreads are artificially kept low – and assets like the float are becoming the new liabilities for many insurers.

Our European Financials research team has been keeping a close eye on the challenges insurance companies are facing from NIRP, and we have noted several new trends.

Insurance companies and other financial institutions are navigating a strange new environment of ultra-low yields and NIRP

NIRP is redirecting life insurers toward new products

For life insurers that sell products carrying return guarantees that are hard to fulfill with new investments, NIRP can cause problems if the durations of assets and liabilities are not matched. Life insurers in Japan, Taiwan and Korea have already experienced the long-lasting effects of

(Continued on page 5)

Viewpoint

Factor-Based Investing Is on the Upswing

A growing number of investors are realizing just how important investment "factors" such as value and momentum are to portfolio performance. This is leading to a wholesale change in how they invest, with many taking back control over their implicit factor exposures by explicitly allocating to those factors.

This shift happened on the heels of several decades worth of highly regarded academic research that repeatedly proved the existence of investment factors – research that hit the mainstream in 2013, when Eugene Fama received the Nobel Prize in Economics for his explanation of the empirical outperformance of value and small caps as risk premiums.

Decades worth of highly regarded academic research have repeatedly proved the existence of investment factors

Yet despite this long history of academic research, it took an institutional investor's investigation of the role of factors in their aggregate portfolio's performance to permanently change many investors' minds.

The case of the Norwegian Pension Fund

During the Great Financial Crisis of 2008, the Norwegian Pension Fund – one of the largest sovereign wealth funds in the world – hit a significant and sudden period of underperformance versus its benchmarks. The ensuing public pressure triggered a careful analysis of what had gone wrong.

Part of this analysis came in a 2009 report by renowned finance professors Andrew Ang, William Goetzmann and Stephen Schaefer, who found that despite the fund's commitment to active investing for its individual mandates, its return behavior was not driven by stock picking; its different investment weights tended to cancel each other out at the aggregate portfolio level. Moreover, the professors proved that about two-thirds of the fund's excess return could be explained by including well-known factors and style risk premiums – in particular value, size, momentum and volatility. Given the size of the fund, this situation was unavoidable: The role of factor exposures will always be much greater than the role of stock picking.

A 2009 report found that about 2/3 of the Norwegian Pension Fund's excess return could be explained by factors and risk premiums

As a result, the Norwegian Pension Fund decided to change central parts of its investment policy. Although the fund did not move to a completely factor-based approach, it did include key tenets of factor investing in its official "Investment Beliefs".

The birth of "smart beta"

This report not only changed the Norwegian Pension Fund's core policy, but it was a seminal moment for the industry and triggered a great deal of interest in factor investing. In response, index providers launched a plethora of "smart-beta" indices, factor indices and style indices. Although these terms largely overlap, they all essentially refer to the same thing: capturing the risk premiums associated with different investment factors.

This report changed the NPF's core policy and led to a plethora of new "smart-beta" indices, factor indices and style indices

The issue with passively investing in factors

While we are encouraged by the widespread acknowledgement of the benefits of factor investing, serious issues have arisen as investors moved into passive factor-based products. Imagine, for example, that you are an investor in a basket of prefabricated smart-beta ETFs and you observe that there is a high overlap between your indexes, or that they are all biased towards low-beta stocks or another macro risk. What can you do about it? Not much, unfortunately. Whichever way you weight these indexes in your basket, you will always end up with a high overlap of the investment styles, and hence find yourself stuck with macro biases. This can create a serious risk-management challenge.

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Serious risk-management issues have arisen as investors moved into passive factor-based products

The benefits of actively harvesting risk premiums

Active portfolio managers, however, have several options for changing the composition of their portfolios as they seek to capture risk premiums in an efficient, diversified way:

- Active managers can buy stocks with different factors to get the desired exposures to the right investment styles, but at the same time ensure that the

(Continued on page 4)

(Continued from page 1)

Global View

Clinton wishes to impose more regulation and enact some tax reform – but is less isolationist. Investors looking to place sector bets should note that Trump favours "old energy" and defence, while Clinton seems to favour "new energy"; both candidates want more infrastructure spending to stimulate economic growth.

Both Clinton and Trump want more infrastructure spending to stimulate economic growth

Will Europe fall into the same trap as Japan?

It has become clear that many promises from politicians, such as healthcare and welfare, may be unaffordable unless governments enact significant structural reforms. This is not happening in Japan and much of Europe, which are already suffering from systemic demographic challenges and could stagnate further. Indeed, there is hard evidence that Europe's shrinking economic growth could push it into the same economic blind alley that Japan entered in the 1990s. On a more positive note, it is the world as a whole – not just Europe – that has been hurt by weak demographics and labour productivity. Moreover, Europe's GDP per capita is much stronger than Japan's, it is substantially less leveraged and it does not have an overvalued property sector to deal with.

NIRP's implications for financial stability and economic growth

Of course, the euro-zone's banks are echoing the traumas that are affecting Japan's banks. A close analysis suggests that the ECB may have overstepped with NIRP: This modest success has forestalled any incentive to deepen structural reforms – particularly given that the ECB has no ability to punish under-reformers. In Japan, meanwhile, sustained zero and negative interest-rate policies have affected the returns and solvency of all banks and insurers. This may be the future that beckons in Europe.

The central banks' journey into NIRP has been a long one. Unlike how monetary policy was employed before the Great Financial Crisis, it is now being used to sustain economic growth. Meanwhile, ZIRP and NIRP have driven investors into ever-riskier assets in search of return, which will make today's monetary policies that much harder to exit from.

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Actions for investors

While it may have been better for central banks to have avoided QE and its distortions, we are nevertheless in a "lower for longer" environment; in fact, financial repression may persist for another 20 years. As such, global economic growth will remain slow and low, and investors' returns will be driven by their appetite for accepting volatility and risk.

With the stage set for volatility stemming from so many political, economic and monetary uncertainties, investors must be active, disciplined and tenacious in harnessing returns. Attractive opportunities can be found in equities, and good income potential can be found in fixed-income securities in emerging markets, Asia and the US. Of course, it is especially important to actively pursue alpha in these areas, since beta returns are set to be low and volatile, which could undermine cheap index investments. Active engagement with corporations as part of a broader environmental, social and governance (ESG) focus can also play a key role in driving performance. In addition, investors should take a close look at the risk-mitigation and diversification benefits that alternatives provide. Above all, investors need to realize that they must take some risk to achieve their returns.

(Continued from page 3)

Viewpoint

overlap of these investment styles does not become too big.

- Active managers can buy low-beta and high-beta names. In this way, they can establish the exposure to the desired risk factors, while at the same time spreading out the portfolio in many more risk dimensions to make it more stable than a basket of smart-beta indexes.

Unlike passive approaches, active portfolio managers can change their portfolios as they seek to capture risk premiums in an efficient, diversified way

Our view

Investors have become increasingly aware of risk premiums in the equity markets – a view supported by decades of research from leading academics. And although some investors may disagree about the number or causes of risk premiums, certain economically significant and persistent investment factors have been identified as reliable sources of risk-adjusted excess returns. At the same time, capitalizing on multiple factors in a portfolio is a difficult task, which is why turning to commoditized smart-beta exposure using ETFs may lead to insufficient risk management. Unfortunately, many ETFs get used naïvely in portfolios, which can invite a range of unintended consequences in terms of macro-economic exposures. An active approach that diversifies those risks may be much more helpful.

This article was adapted from a new white paper, "Factor Investing: A Reliable Source of Excess Returns?". from www.allianzgi.com.

(Continued from page 2)

Soundbites from Research

such a mismatch. That is why today, life insurance companies have been trying to steer their sales more toward risk products centred around mortality or morbidity risk. These products carry fewer assets, and thus their smaller float reduces the asset-side risk substantially.

Life insurance companies are steering sales toward risk products centred around mortality or morbidity risk

There have been other new NIRP-related product developments, including new savings products that carry minimal or no guarantees, which make them less capital-intensive. But because of the long durations of this book of business, it will take time before these new products begin to add to these companies' bottom lines.

P&C insurers seem better positioned to navigate NIRP

While property and casualty insurers are also facing headwinds from NIRP, they are typically able to reprice their businesses on an annual basis – a product advantage that enables them to reflect the latest interest-rate environments in their pricing assumptions. P&C firms also tend to rely less on the float for their profits; instead, they make the lion's share from the technical profit gained from underwriting risks such as natural catastrophes or accidents. These underwriting profits also bring an additional benefit to P&C companies: They nicely diversify portfolios against the ups and downs of the economic cycle.

P&C insurers face NIRP headwinds, but they can also reprice their businesses on an annual basis – a product advantage over life companies

Finding the sweet spot among P&C and life companies

In this NIRP environment, Allianz Global Investors has a preference for short-duration P&C and life insurance companies with risk business models that also offer good asset and liability matching. Both types of business are rather capital-light and can be found within reinsurance or selective composite insurers. Not only do we believe firms like these are among those best-positioned to succeed in today's challenging interest-rate environment, but with sustainable dividend yields that can surpass five per cent, they can also offer investors attractive income potential at a time when other yield sources are woefully insufficient.

We look for short-duration P&C and life companies with risk business models that also offer good asset and liability matching

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