Embracing opportunities in volatility

04/10/2018

Summary

The expected return to market volatility could unsettle some investors, who have grown used to the steadily rising markets of the past decade. While markets will likely continue to offer opportunities, investors will need to navigate the overall environment more carefully, and active asset management can play a critical role.

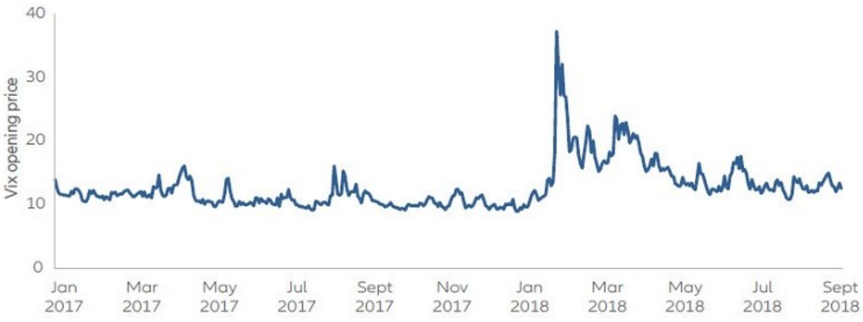
Key takeaways

- After a decade or so of steady growth, increasing global market uncertainty is driving an expectation of a return to volatility
- Volatile markets will still offer opportunities for those prepared to find them, particularly as correlations break down
- While index-linked investments benefited from the bull market, they will follow any downturn too

The spike in volatility in early 2018 was a reminder that investors can no longer rely on the smoothly rising stock market that has been a staple feature of the past decade. The CBOE Volatility Index (VIX) more than doubled in a matter of days, after a year characterised by historic lows. This spike in what is informally known as "the fear index" was attributed to investors growing increasingly concerned about high valuations and rising interest rates – and the resulting risk of market corrections.

Several macroeconomic factors continue to fuel these fears. The global economic recovery is increasingly fragmented, Brexit and rising populism are driving uncertainty in Europe, and the threat of trade wars and sanctions has unsettled global markets. Investors are also anxiously awaiting the impact of the Federal Reserve's reversal of its quantitative easing (QE) policy, which has dominated the post-financial crisis period, particularly given the strong economic performance of the US. The European Central Bank and the Bank of England are also starting to bring their own QE policies to an end, potentially leading to higher capital costs. Markets are much less certain now over interest rate decisions, something which is likely to foster increased market volatility.

The VIX's February 2018 spike followed a year of relative calm
Daily opening level of CBOE Volatility Index (Vix) since start of 2017



Source: Chicago Board Options Exchange. Data as at September 2018.

Volatility creates opportunities for the brave

Increasing volatility may create opportunities for those investors who can navigate the new environment, even if potential returns overall become harder to find. Against this backdrop, assets are more likely to be over or underpriced and active managers can focus on companies, sectors and geographies with stronger overall outlooks in these conditions. Without volatility, opportunities like these are scarcer.

In addition, as investors emerge from this sustained period of steady growth, the high correlations between stocks that were such a feature of this period will start to break down. Stock market correlations nearly doubled after the financial crisis, but by the end of 2017, they had already fallen to one of their lowest ever levels. 1

Maintaining momentum during times of volatility

Investors have enjoyed following the bull market of recent years, but a return to volatility would mean an active approach is essential to navigating opportunities while mitigating external risks.

Return to reality

Despite the talk of a return to volatility – and the resulting fears – in reality, markets are simply set to return to more normal conditions. Investors may have become used to easy returns, and many will have employed passive instruments to capitalise on smooth market conditions. However, those investors could soon find that, while index-linked investments ride the rising tide of a bull market, they also follow the market when it falls.

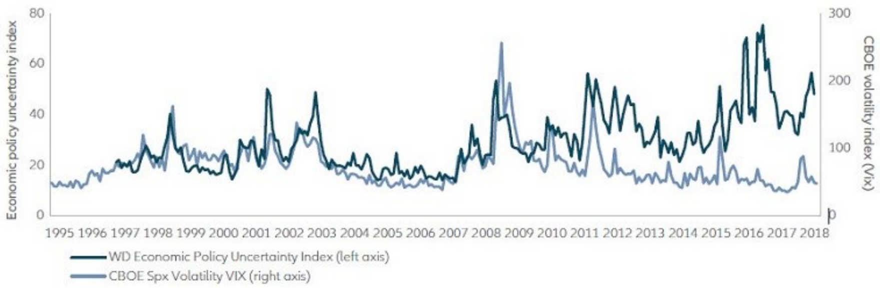
In fact, research has shown that passive products can actually underperform their benchmarks in volatile conditions. In times of stress, the tracking error of passive vehicles tends to increase – a trend that can be more pronounced if the underlying index is illiquid.

Avoiding bad debt

Volatility isn't just an issue for equity markets. The expected increase in long-term volatility will likely involve greater deviation across asset classes. In the fixed-income market, debt levels have increased substantially over the past decade, particularly in the corporate space. This is where an actively managed approach may be particularly helpful. Instead of adhering to one index, active managers will aim to identify which fixed-income securities – from corporate to government to emerging market bonds – offer the most reliable source of return potential.

As the largest issuers tend also to be the largest borrowers, a passive approach – where your exposure reflects the index weightings –potentially leaves investors exposed to corporates with the weakest credit fundamentals.

Historically, high political uncertainty means higher volatility
CBOE Volatility Index versus Economic Policy Uncertainty Index 1990-2018



Source: Chicago Board Options Exchange. Data as at September 2018.

Performing in all environments

Active management should differentiate itself irrespective of prevailing market conditions: any shift in the market environment is not in itself enough to prove the case for an active approach. At Allianz Global Investors, our goal is to come to a common understanding with clients of where and how we add value.

Whatever the level of underlying volatility, an active manager's role is to pursue return and risk objectives within a framework agreed with their client. They can even take a short position on volatility, which provides the potential to generate outperformance in an otherwise flat market.

Ultimately investors may have to take on more risk in order to earn a reasonable return, but they will also have to be selective about the risks that they take. They will also need to manage that risk in the best possible way, taking a more active, fundamental and research-based approach.

If they do, there are still opportunities to be found, regardless of what happens in the future. Indeed, the active manager's entire philosophy is predicated on playing whatever hand they are dealt to meet investors' objectives.

1 Credit Suisse found that in December 2017, three-month correlations between S&P 500 sectors fell below 20%, close to their lowest-ever level.

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Navigating markets with multi-asset strategies

07/11/2018

Summary

Multi-asset strategies have grown to dominate European retail investment over the past decade, and new product innovation should ensure this trend continues. Indeed, testing market conditions can provide a platform for multi-asset portfolios to stand out: their diversified approach can give investors more flexibility to hunt down opportunities.

Key takeaways

- Despite their relatively recent arrival, multi-asset strategies have grown to dominate European retail investment
- In-built diversification enables investors to benefit from a wide portfolio within a single investment
- Managers' ability to adjust portfolio positions across markets and asset types, without restriction of a benchmark, helps to maximise flexibility and manage risk