Allianz Global Investors

RiskMonitor

Asia-Pacific Edition
2017

Allianz
Global Investors

Understand. Act.

The AllianzGI RiskMonitor seeks to glean the impact the current market environment has had on the sentiment, attitudes and behavior of institutional investors. This report identifies investors' most pressing concerns and objectives for the year ahead, and analyzes their behavior in the face of a risk-return conundrum.

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Executive Summary

Institutional investors are turning their attention and concern to politics and equity market volatility as the forces most likely to impact their investment portfolios. These factors now eclipse more systemic concerns – including counterparty risk – as confidence in financial services continues to recover.

Balancing risk and return

Our research, based on interviews with 755 institutional investors globally, reveals that investors are concerned about the impact geopolitical events can have on their investments. As a result, they are focusing on risk management to protect their portfolios from potential downside risks. Three in five institutional investors in Asia Pacific (58%) say they have increased their focus on risk management in light of recent political events. Likewise, six in 10 (60%) are willing to sacrifice upside potential in return for tail-risk protection. This represents the conundrum investors face today – searching for higher returns while mitigating risk.

Furthermore, concern related to counterparties has decreased dramatically in the past two years – from one in five considering counterparty risk a considerable threat in 2015 to one in 20 in 2017 globally. This indicates investors' preoccupation with systemic risk is waning as regulation and other factors have helped restore a sense of strength and resilience. It has also led to investors shifting their focus to the geopolitical and market arena.

Globally, event risk now rivals equity market risk as the biggest perceived threat to portfolio performance. Although event risk also tops the list of threats in Asia Pacific, interest rate risk ranks higher than equity market risk. The threat of interest rate hikes has grown considerably in this region, when compared to last year. This shows the caution investors are taking amid the potential for rising interest rates after years of historically low rates.

To underscore these concerns, only 26% are ruling out a tail-risk event in the next 12 months. Forty-five percent of investors believe such an event is likely – a figure that has risen substantially in the past year (2016: 37%).

Active management and risk

In their quest to balance risk and return, active management comes to the fore as investors say they prefer an active approach to help them navigate the current market, despite challenges such as manager selection and cost efficiency. Half (53%) of Asia-Pacific investors say actively managed investments will play an important role in portfolios in the current market environment.

Investors in Asia Pacific and worldwide continue to rely on traditional risk management techniques: Diversification, whether by geography or asset class, remains the primary risk management strategy employed by institutions across the globe. The findings indicate the institutional world is in need of more sophisticated risk management strategies – the percentage of investors using more dynamic approaches is currently very low.

Moreover, despite the extensive use of diversification, many investors recognize that this approach provides limited protection. Investors globally say they need improved portfolio strategies to provide better downside protection and help improve the risk-return trade-off.

Those clamoring for better strategies have a lesson to learn from the Risk Leaders identified in this study.[1] Characterized by a more integrated and systematic approach to risk management, these investors globally are better prepared for investment risks (72% vs 57% of other investors) and are putting more money towards investment risk strategies (59% vs 41%).

[1] We define 'Risk Leaders' as those who responded 'Agree' or 'Strongly Agree' to the following questions: 'Risk management is as an integral part of our investment process and actively addressed on a systematic, ongoing basis', 'My organization has a strong risk management culture', and 'I am confident that our portfolio has appropriate downside protection for the next tail event.' Our research shows that this group differs across a number of areas, pointing the way for best-practice approaches to risk management. All 'Risk Leaders' data reported is global data.

Methodology

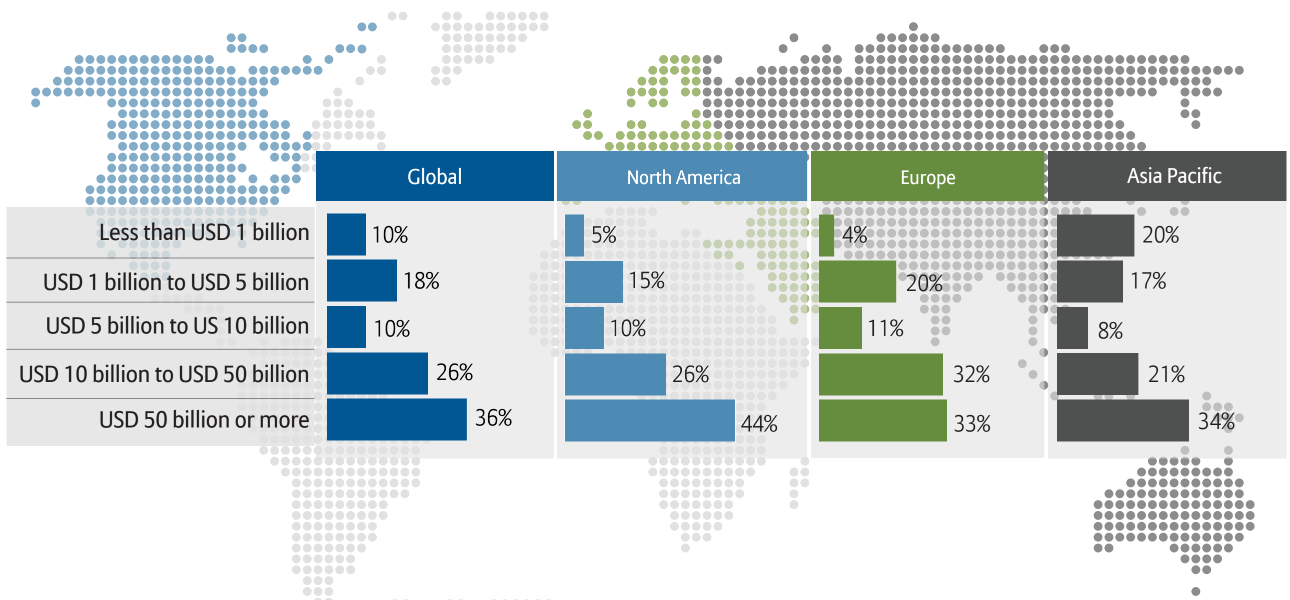
This report represents the fifth annual Allianz Global Investors RiskMonitor study. CoreData Research was commissioned by AllianzGI to conduct this study of institutional investors across North America, Europe and Asia Pacific to better understand attitudes towards risk, portfolio construction and asset allocation.

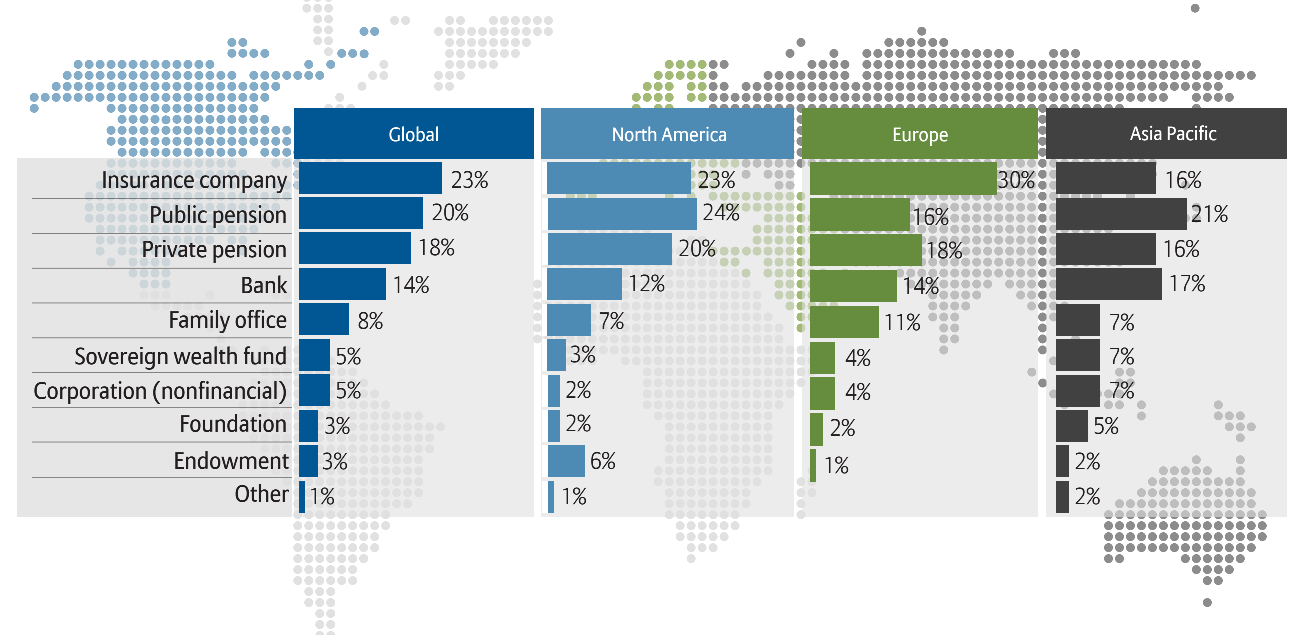
Respondents were drawn from a variety of 'asset owning' institutions: pension funds, foundations, endowments, sovereign wealth funds, family offices, banks and insurance companies.*

The research was carried out via an extensive global survey during April and May 2017. The 755 institutional respondents were split evenly by region: 250 from Europe**, 250 from North America and 255 from Asia Pacific.

*Bank and insurance respondents represent a broad mix with concentrations of professional buyers/gatekeepers, fund selectors, fund-of-funds (external manager appointments etc.), heads of research (influence in manager selection), portfolio specialists (those who build model portfolios using external managers). There is no retail participation in this study from financial advisors, or internally focused portfolio managers.

**Europe represents respondents in the Middle East as well, accounting for 4% of respondents in the region.





The changing face of risk

The geopolitical situation has risen rapidly up the risk agenda for institutional investors. A string of recent global events including the US presidential election, Brexit and tensions with North Korea have rattled investors. A general sense of disquiet surfaces repeatedly throughout this year's study.

Apprehension around these geopolitical tensions tops the list of concerns globally. These anxieties also surface at a regional level, with around two-fifths of investors across all regions saying these events could threaten their investment performance over the coming year. This also holds true in Asia Pacific where approximately half (47%) cite geopolitical tensions as the greatest risk to investment performance, followed by global economic slowdown (39%). Tensions between North Korea and the US could damage economic stability across the region, especially in South Korea, Japan and China.

The changing interest rate environment is also cause for concern. The US Federal Reserve has already increased key rates twice in 2017 and indicated that more rate hikes might be on the way. Global and Asia-Pacific investors believe a rise in interest rates is the third biggest risk to their investment performance (32% and 35%, respectively). Higher US interest rates have typically led to an increase in capital outflows from many Asia-Pacific countries.

Geopolitical events top list of worries

Global

Geopolitical tensions (e.g. - Syrian war, North Korea, etc.)	44%
Global economic slowdown	41%
Rise in interest rates	32%
US politics	31%
New asset bubbles	24%

Asia Pacific

Geopolitical tensions (e.g. - Syrian war, North Korea, etc.)	47%
Global economic slowdown	39%
Rise in interest rates	35%
US politics	31%
Currency swings (e.g. - stronger US dollar, Yuan devaluation)	30%

% Yes, Multiple answers allowed

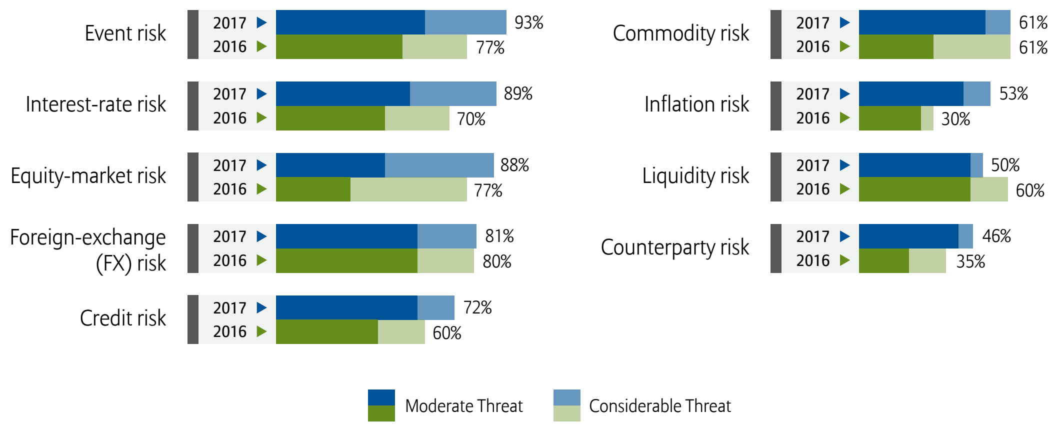
Almost half of Asia-Pacific investors say geopolitical tensions pose a risk to investment performance.

US politics is also a notable concern globally and in Asia Pacific (both 31%). US politics continue to weigh on investors' minds as they scrutinize the progress made by President Trump's administration on major issues such as trade and the impact this may have globally. Further, currency swings (30%) also makes it into the top five in this region.

Globally, event risk now sits alongside equity-market risk as one of the two biggest perceived threats to portfolio performance. In Asia Pacific, interest-rate risk surpasses equity-market risk as a threat. Concern around event risk saw an upsurge to 95% this year, compared to 77% last year, saying event risk is a threat to performance. While events so far have not had a significant impact on markets, aside from bouts of short-term volatility, investors may be less sanguine about the prospects ahead. In Europe, Brexit negotiations have just begun, and in the US there is still some uncertainty around President Trump's program and his ability to get major legislation passed.

Foreign exchange risk is viewed as a bigger threat in Asia Pacific (81%) than in North America (63%) and Europe (65%).

Equity market risk & event risk biggest threats to portfolio performance in Asia Pacific

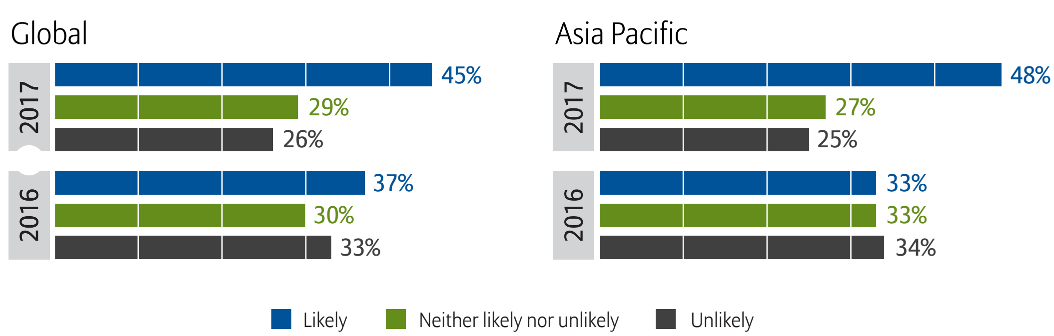


Asia-Pacific investors see event risk (93%) as the biggest threat to portfolio performance.

Interest-rate risk also rose compared to last year (89% vs 70% in 2016) in Asia Pacific, perhaps in anticipation of the impact of US policy tightening.

This concern over external events impacting portfolio performance reaches its peak with only 26% thinking a tail event in the next 12 months is unlikely. This finding is consistent across the regions and sentiment in Asia Pacific is in line with the global average. The number of investors globally who think a tail-risk event is likely has risen substantially in the past year – up to 45% from 37% in 2016. Concern regarding a tail-risk event was much lower in Asia Pacific last year with just a third (33%) reporting it as likely versus almost half this year (48%).

Investors wary of growing chance of a tail-risk event



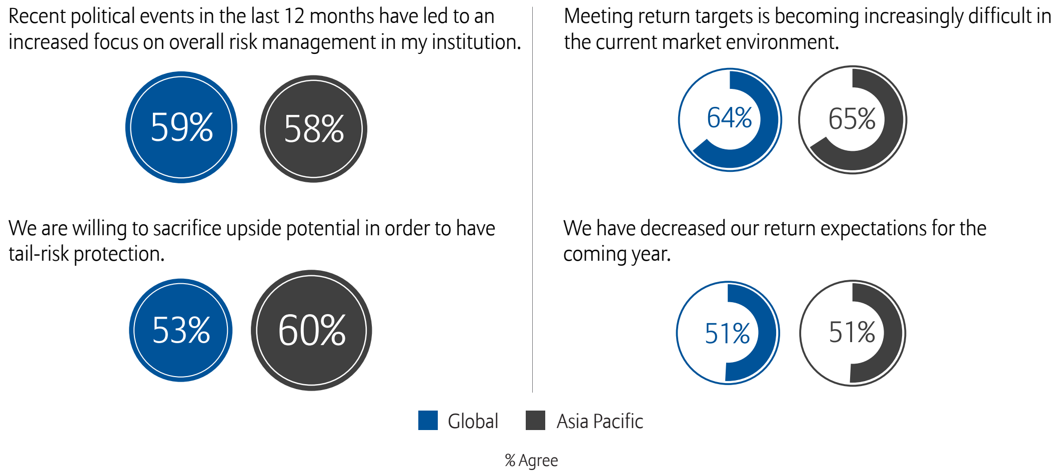
Approximately half (48%) of Asia-Pacific investors think a tail-risk event is likely in the next 12 months, compared to a third (33%) last year.

The results show institutional investors are more concerned about potential event-driven risks this year, with increased anxiety around the geopolitical outlook and a changing interest rate environment.

A ‘risk-return conundrum’

Against this backdrop, institutional investors face a ‘risk-return conundrum’. In an environment characterized by persistent low yields, potentially increased market volatility and greater geopolitical uncertainty, they face a conflict between managing the anticipated risks while also generating returns.

Investors split on growth versus protection



Three in five Asia-Pacific investors are willing to sacrifice upside potential in order to have tail-risk protection.

Three in five institutional investors in Asia Pacific (58%) say they have increased their focus on risk management in light of recent political events. But even with this additional reinforcement, six in 10 (60%) are willing to sacrifice upside potential in return for tail-risk protection. More than half (51%) say they have decreased their return expectations for the coming year and nearly two-thirds (65%) say it is increasingly difficult to meet return targets in the current market environment.

What we can learn from Risk Leaders

Our research identifies a group of ‘Risk Leaders’ who are leading the way in terms of risk management. Globally, they take a more systematic approach to risk and make risk management an integral part of their investment process. They have a strong risk culture and are confident their portfolio has appropriate downside protection for the next tail-risk event.

Importantly, Risk Leaders have more confidence in their ability to hit their return targets: Fewer Risk Leaders have lowered their return expectations for the coming year compared with other investors (47% vs 53% of others).

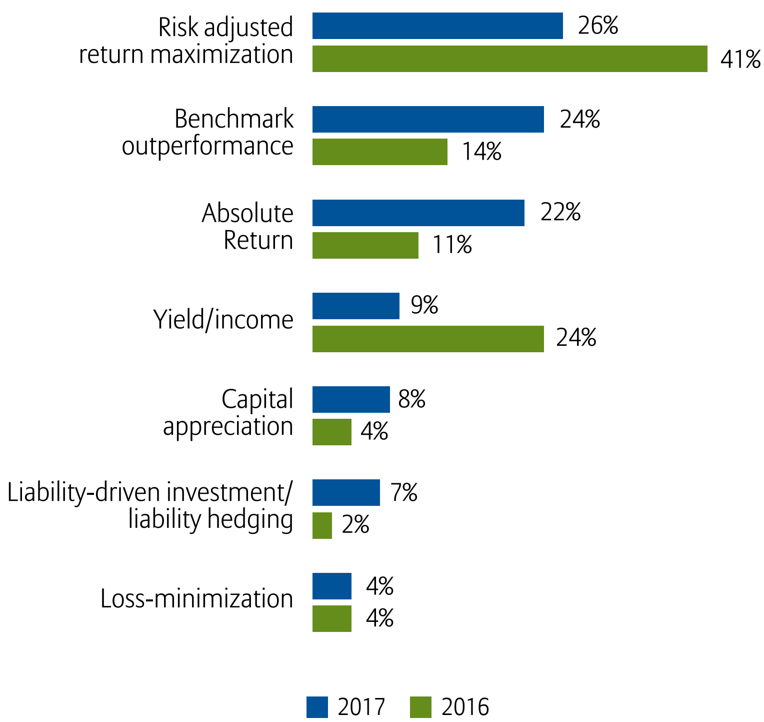
This represents the conundrum that investors face today – how to move efficiently along the risk-return spectrum, finding a balance of upside potential and downside protection that is most effectively calibrated to their risk profile.

Asia-Pacific investors echo the global need to achieve the highest possible returns. One in four (26%) say risk-adjusted return maximization is their main investment goal for the coming year.

The importance of achieving the highest possible risk adjusted return has decreased compared to last year among institutional investors in Asia Pacific (26% vs 41%). This year, 10% more investors cite benchmark outperformance (24% vs 14% in 2016) as their primary investment goal for 2017. Further, absolute return (22% vs 11% in 2016) has also grown in importance to Asia-Pacific investors.

The rising importance of outperformance and absolute return among Asia-Pacific investors is indicative of the dire need for yield these investors are experiencing.

Investment goals for 2017



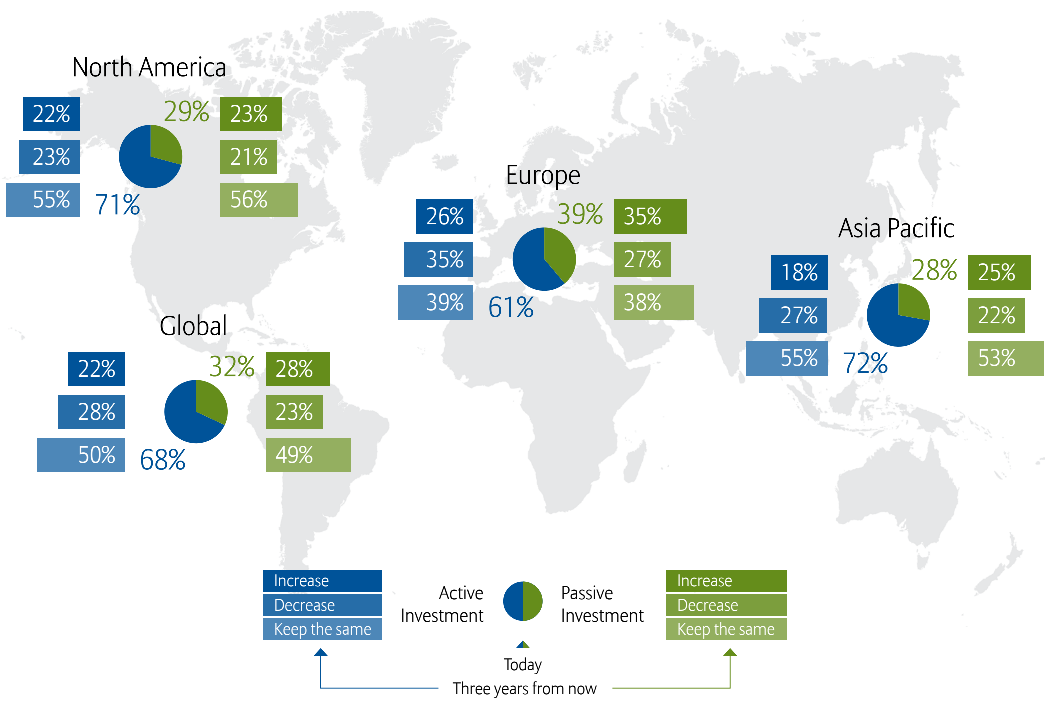
Fewer Asia-Pacific investors say risk-adjusted return maximization is their primary investment goal this year compared to last year (26% vs 41% in 2016).

Active favored to perform in current market

Passive investing has attracted assets during a prolonged bull market, but the uncertainty and potential market volatility may indicate renewed opportunities for active investing. Passive funds, while riding the highs of a bull market, may also assume full market risk in the event of a meaningful downward correction. Our research shows investors recognize the value of active investing to navigate the current market, despite challenges related to manager selection and cost efficiency in the active space. More than half (53%) of Asia-Pacific investors say actively managed investments will play an important role in portfolios in the current market environment.

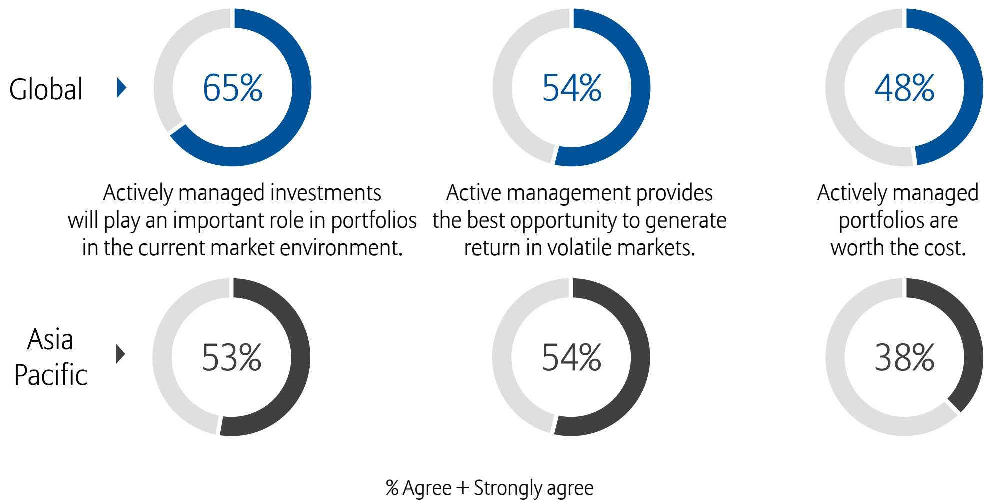
Among our survey respondents, the average Asia-Pacific institutional investor portfolio is made up of 72% active investments (68% globally) and 28% in passive (32% globally). Half expect to keep their active (55%) and passive (53%) allocations similar over the next three years, while one in five would increase their holdings to active (18%) and one in four to passive (25%) respectively.

Active remains preferred choice to tackle difficult markets



Active investments make up a majority of institutional investors' portfolios.

Attitudes towards active management

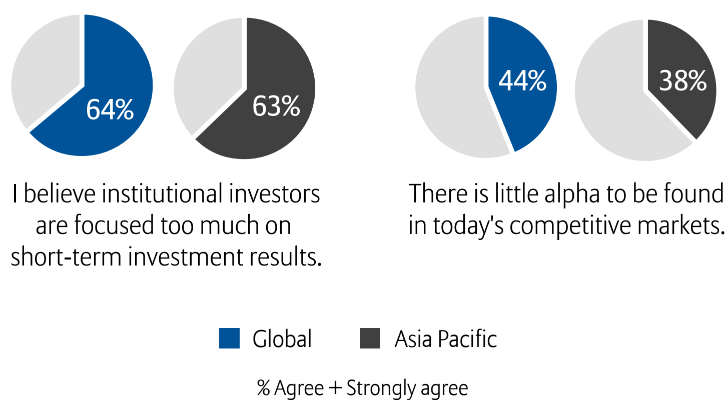


Fewer Asia-Pacific investors think actively managed portfolios are worth the cost (38%) compared to their global counterparts (48%).

More than half of (54%) Asia-Pacific institutional investors agree active management is the appropriate option to generate return in volatile markets. Bull markets tend to be accompanied by low volatility, as we have seen in the past few years. The low dispersion in these periods can make it difficult to generate alpha. But with interest rate hikes and greater levels of uncertainty and potential volatility, higher valuation dispersions may emerge that provide opportunities for skilful active managers.

When it comes to the cost of active management, four in 10 Asia-Pacific investors (38%) are convinced that actively managed portfolios are worth the cost – a figure which is lower than the 48% of investors globally who agree.

Challenges with active management



Two-thirds of investors globally and in Asia-Pacific believe institutional investors are too focused on short-term investment results.

However, headwinds remain for active management in the form of manager selection and the ability to generate alpha, with two in five (38%) Asia-Pacific investors saying that alpha is difficult to generate in today's market.

What we can learn from Risk Leaders

Globally, Risk Leaders think active portfolios are worth the cost (56% of Risk Leaders vs 46% of other investors). They have a strong conviction that there is alpha out there to be realized: Only 37% of Risk Leaders, compared to 45% of others, believe there is little alpha to be found in today's markets.

Managing risks

With a risk-return conundrum on their hands, institutional investors need to optimize risk management in a way that avoids compromising on returns. But despite the challenges of this task, investors continue to use traditional approaches to risk management. There is a need for more modern and sophisticated strategies, including hedging and risk overlays that may support a more efficient trade-off between risk and return.

Risk management: A systematic and ongoing process

Three in five institutional investors in Asia Pacific (61%) say they actively consider risk management on a systematic and ongoing basis. As event risk increases and the threat of tail risks loom large, it is important to get ahead of the challenge rather than waiting to deal with the aftermath. Prevention is, according to the old adage, better than cure.

Risk management culture

Over half of Asia-Pacific investors say their organization has a strong risk management culture.

Half of investors (53% vs 59% globally) say they have a strong risk management culture. Three in five (62%) say that the senior management at their institution is dedicated to ensuring and supporting sound risk management practices.

What we can learn from Risk Leaders

Globally, Risk Leaders say they are more prepared for investment risks (72% vs 57% of others) and are putting more money towards investment risk strategies (59% vs 41%). Seven out of 10 conduct independent risk analysis of their portfolios (others: 55%). Their experience shows the importance of the right 'tone from the top': Nearly nine in 10 Risk Leaders (88%) say the senior management at their organization are dedicated to ensuring and supporting sound risk management practices (others: 62%).

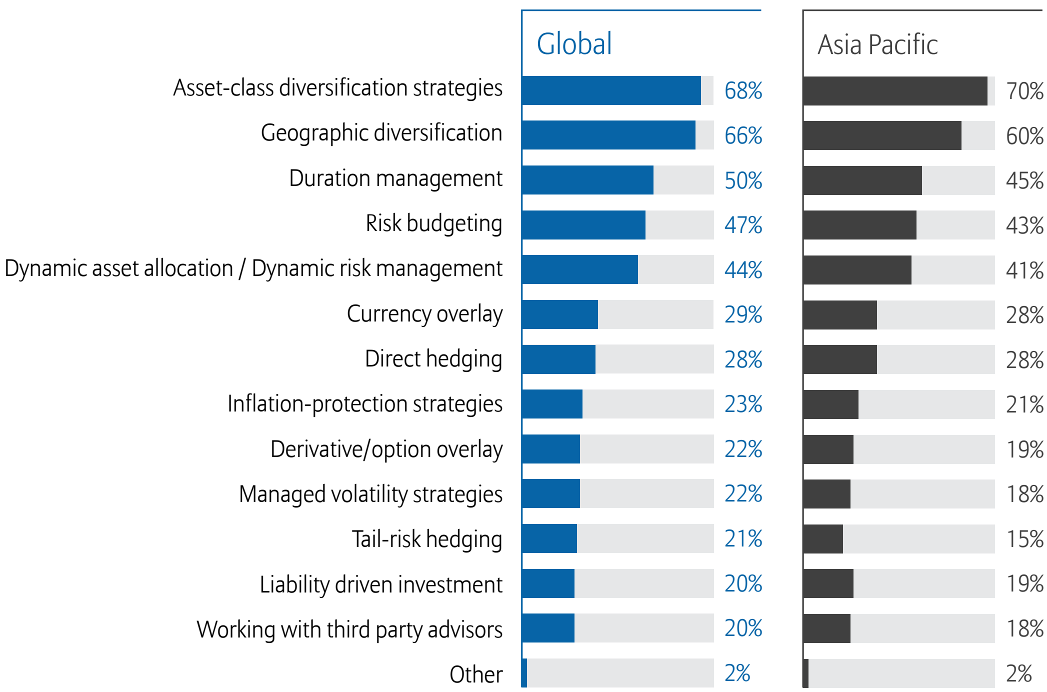
Diversification still top risk management strategy

Institutional investors in Asia Pacific and worldwide are still relying on traditional risk management techniques. Diversification, whether by geography or asset class, continues to be the main risk management strategy employed by institutions across the globe.

This type of approach remains crucial: Diversifying across a range of asset classes and geography can help to insulate the portfolio from specific risks, either in certain markets or asset classes, and may reduce portfolio volatility. The most prevalent risk management strategies are uncomplicated: Only a small proportion of investors invest in strategies such as direct hedging (28%), currency overlay (28%) or tail-risk hedging (15%). This may indicate a need – on the part of both the industry and investors – to develop and adopt more sophisticated approaches to risk management.

Less than half in Asia Pacific (45%) use duration management, which may be an important tool in the current low-yield environment. Risk budgeting (43%) and dynamic asset allocation (41%) are used by only two in five respondents. The risk management strategies used currently point to a need for more sophisticated strategies. Asia-Pacific institutional investors appear to be slightly less likely to use other risk management strategies compared to their global counterparts.

Risk management strategies



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Diversifying across asset classes and geography are the leading risk management strategies.

Investors recognize the importance of diversification as the most prevalent form of risk management but many understand that it provides only so much protection – only 46% agree diversification across traditional asset classes would provide effective protection from tail risk events. A growing number acknowledge the power of alternative assets as important diversifiers.

Investors globally continue to clamor for strategies that can better support them in providing downside protection (62%). They also seek ways of improving the risk-return trade-off (58%). Investors in Asia Pacific echo these sentiments, with 62% and 56% agreeing, respectively.

Demand for newer portfolio strategies

	Global	Asia Pacific
There is a greater need for new portfolio strategies that will provide greater downside protection in volatile markets.	62%	62%
There is a need for new portfolio strategies that balance risk-return trade-off.	58%	56%
Diversification across traditional asset classes is an effective protection from tail-risk events.	47%	46%

% Agree

Investors think there is a greater need for new portfolio strategies that will provide better downside protection in volatile markets.

Alternatives for diversification and return

With uncertainty around geopolitical events and the urgent search for yield, institutional investors are looking at new sources of return and stability. Alternative assets can be a useful tool in providing diversification within a portfolio, with the potential also to generate differentiated sources of return. Importantly, our research shows that investors would embrace alternatives even more wholeheartedly if they understood the risks better.

Diversification continues to be the main driver of institutional allocation to alternatives with one in four (26%) citing it as the main reason for investing in these asset classes. One in five (22%) state low correlation to other investment strategies/asset classes as a driver.

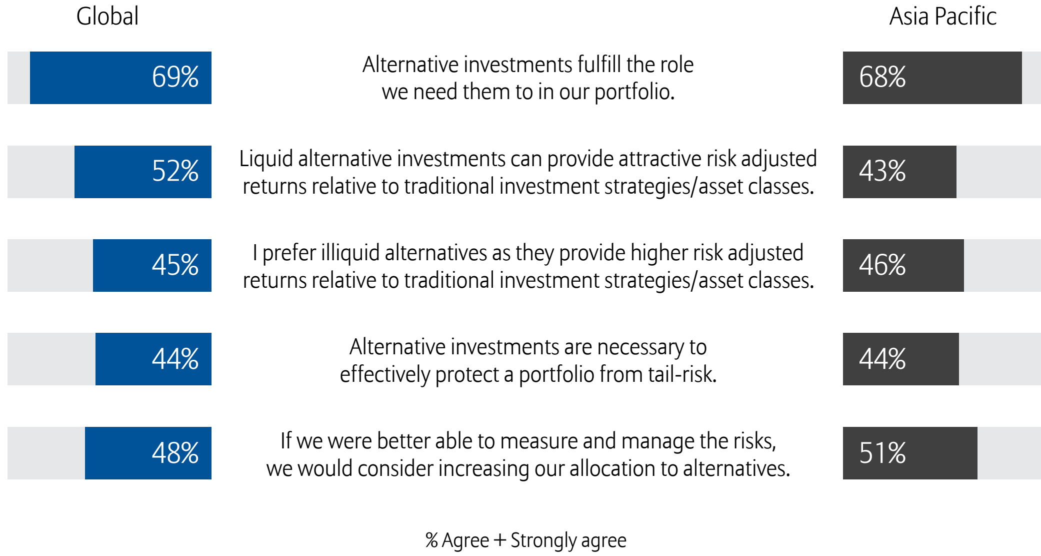
Top reasons to use alternatives (Asia-Pacific investors)

Diversification	26%
Low correlation to other investment strategies/asset classes	22%
Higher returns than conventional debt or equity investments	13%
Reliable income stream	10%
Reduce overall portfolio volatility	9%

Diversification is the top reason why institutional investors use alternatives.

Over two in five (43%) Asia-Pacific investors believe liquid alternatives can provide attractive risk-adjusted returns relative to traditional investment strategies. Seven in 10 (68%) Asia-Pacific investors (vs 69% globally) say alternative investments fulfill their role in a portfolio effectively.

Role of alternatives



Half (51%) of Asia-Pacific investors would increase their allocation to alternatives if they were able to better measure and manage risks.

While investors are in agreement on the value of alternative assets in driving diversification, nearly half (51% in Asia-Pacific and 48% globally) would make greater commitments to alternatives if they felt more confident in their ability to manage and measure the associated risks. This finding represents a major opportunity for the industry to build understanding and confidence in alternative assets and drive increased flows.

What we can learn from Risk Leaders

Globally, Risk Leaders are more confident than other investors in their understanding of alternative assets (72% vs 64% of other investors) and a much higher proportion invest in alternatives for diversification (43% vs 28% of others).

Conclusion

Institutional investors' risk agenda is changing. Geopolitical tensions, following the events of the past year, are now at the top of the list of investor concerns. Investors are also worried about a global economic slowdown. Meanwhile, event risk now is the biggest perceived threat to portfolio performance globally, rivalling interest-rate risk in Asia Pacific. While potential equity-market risk is also causing investor anxiety in the region.

Amid this geopolitical tumult, our research shows that investors face a battle to juggle their objectives. They have to strike a careful balance between taking adequate levels of risk to generate return in a low-yield environment while also protecting their assets. Many see the value of active management in helping to navigate these challenges.

As part of their approach to risk management, investors continue to rely heavily on diversification, both by geography and asset class. While they express a need for new portfolio strategies to balance the risk-return trade-off, the good news is that many say they have a strong risk management culture.

Within this paper we identified a group of Risk Leaders – those investors who have a more integrated and systematic approach to risk management. Their approach brings multiple additional benefits. We will analyse their views and experiences in more detail in a forthcoming report focusing specifically on this group of investors.

As noted in this report, alternative asset classes are an increasingly critical part of investors' diversification strategy. We will further investigate attitudes and sentiment towards alternatives in the third report in our RiskMonitor 2017 series.

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