

Active is: Exploring new ideas

Allianz Global Investors Insights

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Global view

The unintended consequences of saving the world from the financial crisis

Key takeaways

- 10 years after the financial crisis, the global economy arguably solved a debt crisis with more debt, made affordable by low interest rates and quantitative easing
- Low yields have made safe returns hard to find – yet risk-aversion has left many investors unable to escape the effects of financial repression
- Fundamental and structural reforms remain elusive for many economies, as Japan has shown over the last 30 years
- Political uncertainty and populist politics could continue to rise as each economy comes under pressure to grow and deleverage simultaneously
- Inflation remains the enemy for investors: it is the “stealth default” solution for a world with too much debt

In 10 years, central banks changed the world

The global economy suffered a financial heart attack 10 years ago, when Lehman Brothers collapsed and a credit crunch roiled the financial markets. The economy was revived by aggressive intervention from major central banks, which reduced



Neil Dwane
Global Strategist

interest rates to low or sub-zero levels and created a wealth effect across equity, bond and property markets.

Yet this “rising tide” has not, in fact, helped the global economy fully recover. Instead, we solved a debt crisis by creating more debt – which made economic inequality worse, encouraged populist politics and strengthened anti-globalisation sentiment.

One decade after the financial crisis, perhaps it's too early to celebrate victory. Instead, it may be time to consider all the other ways in which the world was altered by the actions of central banks.

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Global view

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Ultra-loose monetary policy had a range of unintended consequences ...

...for savers

Post-financial crisis, central banks globally pursued a policy of financial repression – a series of actions designed to stimulate the economy and reduce debt while maintaining inflation. Yet with interest rates cut to ultra-low or even sub-zero levels, savers lost the ability to earn a return without taking risk while those who over-borrowed or over-spent escaped mostly unscathed. Older generations in or near retirement were particularly hurt.

...for investors

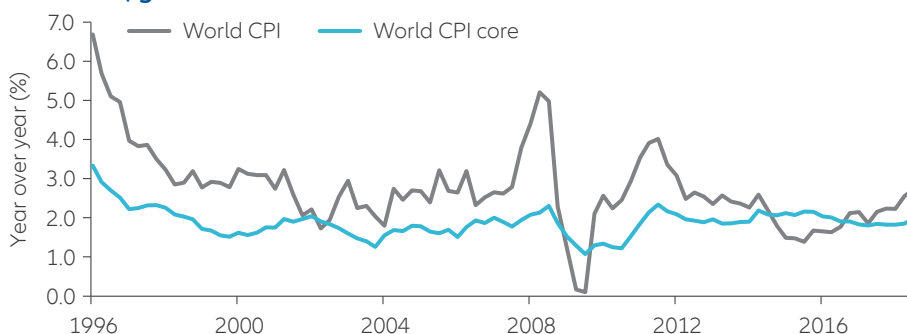
Quantitative easing and low rates have created a remorseless “hunt for income”. By driving bond yields ever lower, central banks interfered with the allocation of capital and encouraged the use of leverage. This has lowered financial-market volatility, but it has also encouraged procyclical flows into passive investments as investors stopped looking for value and instead focused on riding yesterday’s winners. As central bank liquidity flowed in and the wealth effect spread, equity and real estate valuations accelerated – and economic inequality has worsened.

Central banks managed to reduce volatility, but they also encouraged procyclical flows into passive investments

...for shareholders and corporations

With debt readily available from the credit markets, some corporations have created disruptive new business models that de-emphasised real profits and favoured boosting share prices. Low interest rates have prompted many companies to take on increasing levels of debt that they use to buy back shares – some estimates show US share buybacks reaching 3%-5% of GDP per year. Corporate board remuneration and executive pay have also ballooned at a time when wages for much of the rest of society stagnated, which can

Post-crisis, global consumer inflation has re-accelerated



Source: Allianz Global Investors Global Economics & Strategy, OECD, Bloomberg, Datastream, World Bank. Data as at 30 September 2018.

lead to less investment and more risky financial engineering.

Low rates prompted many companies to use increasing levels of debt to buy back shares

...for governments

Low interest rates have raised the cost of funding pensions and other long-term liabilities, and many pension funds and insurance companies have been forced by regulation to own unattractive sovereign bonds that are set to lose value as interest rates rise. Populations around the world are also ageing, placing a greater burden of care on governments that are already over-borrowing and making unaffordable welfare promises. These obligations will likely be met only through a combination of inflation, which destroys the value of those debts, and default, as some of these obligations are likely to be abrogated by future generations.

Overly indebted governments are likely to meet their obligations only through a combination of inflation and default

...for economies

A decade of ultra-accommodative monetary policy has helped create a collection of “zombie” companies – generally older and weaker firms with interest expenses that exceed their operating profits. Japan has suffered from these zombies for 30 years, and the US and Europe seem to be heading down a similar path. Ideally, a market-based economy should seek to allocate

capital to opportunities most likely to generate a profitable return. But by not allowing economies to “clear”, central banks have invited all the consequent effects of low innovation and productivity. Moreover, perpetuating zombies both undermines good companies and creates the stagnancy that leads to social and political frictions.

The importance of learning from history

As we note the 100-year anniversary of the end of the first world war on 11 November, now is an appropriate time for sober reflection. History has shown us time and again that peace and prosperity must be earned, and a number of factors must all align to maintain this delicate equilibrium – from geopolitical accord and international cooperation to sustainable fiscal and monetary policies.

Ten years after the financial crisis, the consequences of our collective response to save the world from a second Great Depression are still working their way through the system. But there may be signs that the social and political “pact” that we have relied on for peace is beginning to fray. As the American philosopher Georges Santayana once said, “those who cannot remember the past are condemned to repeat it”. It is an important reminder for all of us to continue trying to learn from our successes – and our mistakes.

10 years after the financial crisis, the consequences of avoiding a second Great Depression are still working their way through the system

Why active?

Navigating markets with multi-asset strategies

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



Thomas Zimmerer, PhD
Co-Head of Multi Asset

portfolio, the risk attached to each underlying asset class has to be seen in the portfolio context, with the goal of managing the total risk across the portfolio. If the diversification benefit is optimised, the total portfolio risk is significantly less than the weighted sum of the single asset-class risks.

Delivering beyond diversification

While a basic balanced strategy can give investors an acceptable level of diversification, what sets some multi-asset strategies apart is that they can employ a solution-based approach that responds to investors' evolving needs.

What sets some multi-asset strategies apart is their solution-based approach

For example, actively managed multi-asset strategies will monitor and adjust asset allocation according to risk or opportunity. This helps investors navigate changing market conditions more dynamically, since professional managers can

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Multi-asset strategies are growing in popularity: our research shows that more than half of all European retail investments over the past 15 years were made into multi-asset funds. These inflows have been driven in large part by investors looking to maintain returns while protecting against downside risk. Now, multi-asset investors may find themselves well-positioned to take advantage of a market environment governed by increased volatility and heightened uncertainty.

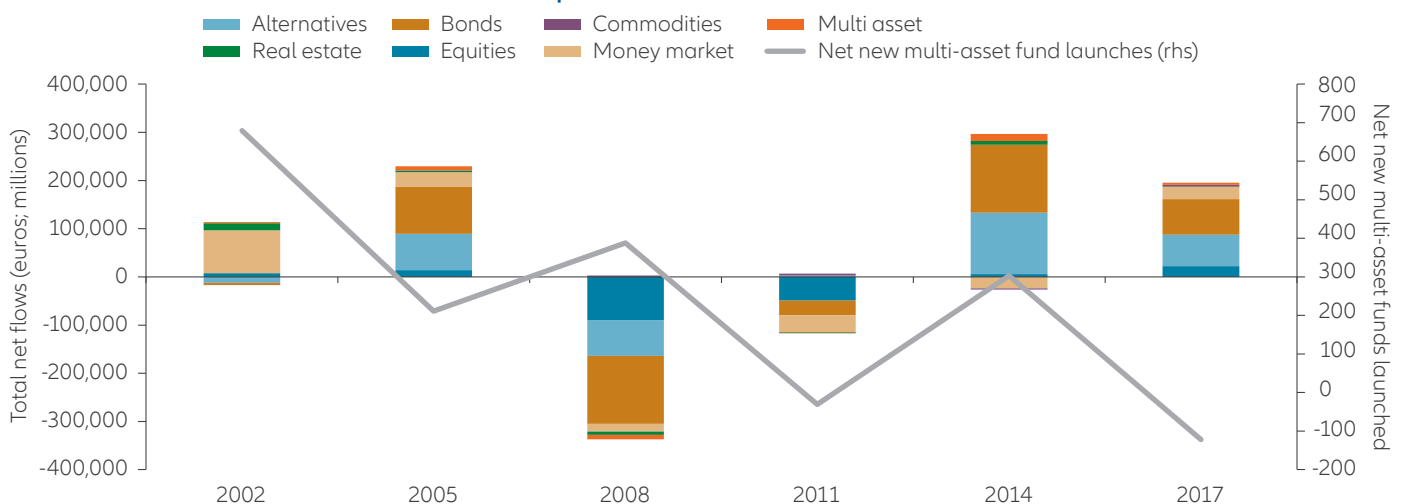
Our Risk Monitor survey highlighted that navigating the trade-off between upside potential and downside risk is a top challenge for investors, with more than 50% of survey respondents decreasing their return expectations. The good news is, as client demands and concerns have evolved, multi-asset

managers have responded by bringing new products – underpinned by new strategies – to market.

For instance, many multi-asset strategies have diversified, embracing a broader range of assets and opportunities for investors. Their blend of equities and bonds can cover a range of geographies and sectors, and many strategies further bolster diversification with the addition of non-traditional asset classes, such as real estate and infrastructure.

While diversification cannot guarantee positive returns or protection against loss, it provides an additional layer of risk management. An investor could only otherwise achieve this by building a portfolio themselves, with additional cost and effort. In a risk-managed multi-asset

Multi-asset funds accounted for half of all European retail investments since 2002



Source: Broadridge, LuminAM, AllianzGI Global Capital Markets & Thematic Research. Data as at May 2017.

Why active?

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rebalance the portfolio whenever needed, informed by in-depth knowledge and analysis of the underlying assets.

In addition, some multi-asset strategies are not tethered to a benchmark index. This gives them more freedom to make adjustments according to market conditions, diversify risk and produce a return stream uncorrelated with general market performance.

These multiple benefits are increasingly central to the appeal of multi-asset strategies, particularly in a market environment where yields are likely to be subdued for some years and geopolitical and other risks are high on investors' watch lists.

The embodiment of active management

At Allianz Global Investors, we strive to take multi-asset investing a step further. We have a large global team with expertise across asset classes and geographies. Close to 100 investment professionals from Asia, the US and Europe come together monthly to discuss major events in global capital markets.

At Allianz Global Investors, our large, global team strives to take multi-asset investing a step further

This collective approach helps to eliminate the "framing bias", where a specialist focus on one specific area can come at the expense of opportunities elsewhere.

We think the multi-asset approach is the embodiment of active

management: it requires active managers with diverse skill sets, who use their global expertise to access a range of global opportunities and reposition our strategies for whatever the environment brings.

Economic inequality

Enabling access to markets can help reduce inequality

Key takeaways

- The top 1% of the population owns 34% of the total wealth in the US and 24% in Europe
- The wealthier are more willing (and able) to take equity-market risk – and the performance of financial markets shows that over time, it has paid to take risk
- Enabling participation in the financial markets could help arrest the widening inequality gap

Economic inequality isn't a new phenomenon, but in recent years some important shifts have been taking place under the surface.

As automation has taken away more middle-income jobs, the global economy has swelled the ranks of higher- and lower-income earners, which has widened the inequality gap. Meanwhile, the affluent have invested in the capital markets, taken risks and earned a "risk premium" – and this has helped them increase their wealth even more.

This is becoming a serious issue for society at large: in addition to taking a human toll, economic inequality suppresses economic growth, stretches governments' capabilities and destabilises social systems. Addressing this situation will require action on many fronts, but we believe the answer lies at least partially in encouraging participation in the financial markets.

Inequality not only takes a human toll – it suppresses growth, stretches governments' capabilities and destabilises social systems



Hans-Jörg Naumer
Global Head of Global Capital Markets & Thematic Research

Capital income is rising while labour income is falling

In the field of economics, there are two primary components of overall income: capital income, or money that is earned from investing, and labour income, or money that is earned by working.

Since the 1970s, labour income's share of overall income has decreased around the world, while capital income's share has increased. That means growth in investment earnings is outpacing growth in earnings from wages. According to Branko Milanovic, a visiting presidential professor at the University of New York, a shift such as this one contributes to rising inequality when the following three

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Economic inequality

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conditions are met – as they are in all rich economies today:

1. The rate of return for capital outstrips income's growth rate.
2. Income from capital is concentrated among the wealthy.
3. The income source that is less equally distributed is correlated with overall income.

In the capital markets, taking risk has paid off over time

For those who are willing to take a risk, capital income can be earned in the financial markets via the "risk premium" – a return on riskier investments that can be higher than that of safer investments. Consider the risk premium offered by the "risky" S&P 500 vs the returns offered by "safe" US Treasuries: as the accompanying chart shows, since 1801, it has paid to take risk.

Clearly, when one factors in the existence of the risk premium with the growing number of wealthy individuals who are earning more capital income, one can conclude that the rich are growing richer at least in part because they are willing – and able – to take more risk.

Embracing the risk premium can help address inequality

Of course, capital-market participation is not the only factor contributing

to rising economic inequality: globalisation, taxation, deregulation and automation all play a part. But society would be well-served by enabling more middle- and lower-income individuals to embrace the risks associated with capital markets in order to pursue the rewards of the risk premium.

Society would benefit by enabling more middle- and lower-income people to embrace the risks associated with capital markets

We estimated how this could work in the real world by performing a study of a hypothetical equity savings plan in Europe. We imagined that between 1992 and 2015, every gainfully employed person in Germany, Italy, Spain, France and the UK participated in their local equity markets by investing EUR 50 each month between 1992 and the end of 2017.

The result was impressive: if this savings and investment plan had been put in place more than 25 years ago, gainfully employed people in these five countries would nowadays own around 53% of the market capitalization of the MSCI Europe (equivalent to some EUR 4 trillion) and would have earned an average return of more than 10% a year on their savings. And all this would have happened in spite of the crises that occurred during this period, such as the burst of the dot-com bubble, the 2007-2008 financial crisis and the European debt crisis.

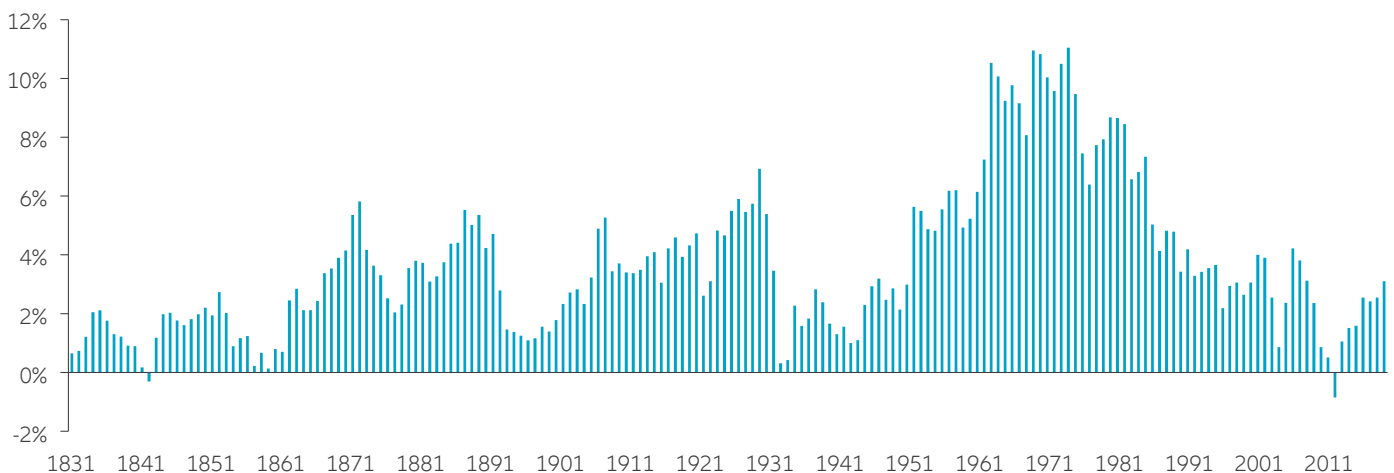
Granted, this was only one hypothetical study, and past performance does not guarantee future results. Moreover, getting everyone to participate in the financial markets is far easier said than done; many low-income people simply do not have the extra money to invest.

Nevertheless, we believe this study illustrates the potential for more people to embrace the risk premium and earn an appreciable return on their investments – and in doing so, to help address the worsening problems created by rising economic inequality.

Source for hypothetical study of equity investment in Europe: OECD, Allianz Global Investors Global Capital Markets & Thematic Research. MSCI Europe was the benchmark index used. Past performance is not indicative of future results. The savings plan is an illustration derived from historical data. Data as at 30 November 2015.

Over time, taking risk has consistently paid a premium

Risk premium on US stocks vs US Treasuries (rolling 30-year yields)



Source: Jeremy Siegel database (1801-1900); Elroy Dimson, Paul Marsh and Mike Staunton (1900 – 2009); Datastream; Allianz Global Investors Capital Markets & Thematic Research. Data as at 31 December 2017.

Alternatives

The key to infrastructure equity is hands-on, active management



Armin Sandhoevel, PhD
CIO Infrastructure Equity

Key takeaways

- New global political agreements mean more infrastructure projects are coming online, and institutional investors are increasingly supplying capital in place of governments and banks
- In the energy infrastructure space, privately negotiated electricity consumption agreements are on the rise, forcing investors to learn how to act as energy suppliers
- Partnering with the right active manager – one who has the infrastructure expertise to manage the project itself – is critical to pursuing attractive returns and managing risk

Infrastructure equity has become a major investment theme for the institutional investment community – particularly “green” infrastructure. In fact, according to Preqin, half of all institutional investors plan to increase their infrastructure allocations, preferably through energy infrastructure investments.

New global political agreements mean more infrastructure projects are coming online – including in the fields of renewable energy, water infrastructure for supply and sanitation, green buildings and sustainable transport. In Europe in particular, there is enormous demand:

- The European Commission has been canvassing for a so-called Energy Union, which would be financed by EUR 315 billion in guarantees granted by the European Investment Bank and from capital released from the European Structural Funds.
- In 2020 alone, roughly EUR 1.1 trillion will be needed within the European Union for investments in energy grids, generation and storage.

At the same time, these projects cannot be paid for out of government budgets alone. Moreover, faced with higher capital requirements, banks are exercising greater restraint when financing investments. This has encouraged institutional investors to

play a significant role as lenders in an asset class that can feel unfamiliar.

Why use active management in infrastructure equity?

As more investors move into this multi-trillion-dollar space, the energy industry is changing dramatically. While energy infrastructure investments were once the preserve of large energy suppliers, new opportunities are being opened up by increased decentralization and disintermediation. One only needs to note the latest “buzz phrases” in today’s industry – the rise of storage

facilities, direct marketing of electricity, the decentralisation of the electricity market, etc – to realize that many new changes are taking place.

Energy infrastructure investments were once the preserve of large energy suppliers, but new opportunities are being opened up

As a result, privately negotiated electricity consumption agreements are on the rise, and financial investors must not only find ways to put their money to work, but also learn how to act as energy suppliers. It is here where partnering with the right active manager – one who has the expertise to manage the project itself – is critical to pursuing attractive returns and managing risk.

What to look for in an active infrastructure manager

To help add value in the energy infrastructure space, the right active asset manager can bring broad knowledge and extensive experience to the table, including:

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Two examples of the benefits of active management

First, in the past, infrastructure investors frequently acted within fixed feed-in tariffs structures to limit the return for electricity generated from renewable energy sources, both upward and downward. Today, however, prices can be optimised through individual, well-negotiated contracts between generators and large industrial consumers – which an active asset manager can help facilitate. Of course, if poorly negotiated, these contracts can be detrimental.

Second, due to the interrelation of different individual energy generation types – including renewable, fossil or nuclear resources and how they interfere in the electricity grid – the electricity market has become highly complex. Analysing the nature of the market and understanding where revenue flows come from is crucial for success. For specific markets, market electricity prices can be highly volatile, but exposure can be limited via individually negotiated power purchasing agreements that offer cash flow stability and visibility – and it is here where experienced active managers can again add value. “To invest and to forget” using a passive investment strategy can be a disadvantage in today’s complex energy infrastructure markets.

Alternatives

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- The ability to understand the supply and demand patterns of energy markets, source the right assets, and extract commercial and technical efficiencies.
- In-house technical and commercial expertise to help improve projects.
- Deep knowledge in the commercial and technical aspects of energy-generation plants, storage technologies, energy grids and energy-efficient technologies.
- A time-tested track record of establishing partnerships with energy companies and developers.
- Extensive portfolio management and asset management capabilities to help create an attractive risk-return profile.
- Experience in the structuring and regulation of alternative investment funds – and demonstrated insurance know-how to complete the picture.

In our view, these are essential capabilities for helping to execute both long-term buy-and-hold and mid-term buy-and-sell strategies in

this space. If infrastructure-equity managers make the right investment decisions and actively manage their clients' assets, they can hope to achieve an attractive risk-return profile, smooth out volatility and seek stable cash flows while retaining value over the lifetime of their clients' portfolios.

The right active manager can help execute successful buy-and-hold and buy-and-sell strategies in this space

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