

Asian investors adjust to changing risks

Market conditions have led to a levelling of portfolios and a need for greater ambition



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International institutions investing in Asia had experienced less differentiation between their Asian specialist managers before this year than previously.

This convergence or 'bunching' among actively managed Asian invested portfolios was in part a function of the prevailing market conditions. Reduced market volatility had a direct impact on specialist managers' ability to generate enough active risk to demonstrate performance and risk differences from their competitors. As a result, managers needed to increase their active risk exposure to stay competitive.

Increasing portfolio concentration, either in terms of the overall number of stocks or in respect of sector, market or capitalisation preference, was a typical response. In doing so, managers and clients became accustomed to portfolios built to meet their objectives in a specific market environment characterised by low volatility.

This year market volatility has been increasing across the Asian region. In the past week or so this increase has been pronounced. The likely

consequence is that there is now a greater dispersion of performance among specialist Asian invested portfolios and fund managers are likely to be reconsidering their strategies as markets transition to a more volatile period.

Although Asia's retail investors are less likely to be concerned about their funds' relative risk profile, an increase in the absolute level of market volatility will impact upon sentiment. Personal investors across the region have been regaining confidence in equity funds since the middle of last year.

Since the beginning of this year there has been a tidal wave of allocation to riskier strategies. Whereas conservative and yield-based funds were dominant in 2004, fund flows this year have been in favour of emerging markets, particularly those in Asia where individuals have historically been most familiar.

As the guaranteed funds launched earlier in the decade have reached maturity, these pools of monies have been recycled in to riskier asset classes. In some markets this has coincided with greater appetite for internally invested funds – Korea being a good example.

Market liberalisation and an increasing awareness of internationally invested fund opportunities, coincident with a growing wealth management segment, has



Personal investors across the region have been regaining confidence

laid the foundation for international fund management companies.

Analysts and professional investors alike are not certain whether the latest pull back in equity and commodity markets is a prelude to a more generalised correction or more optimistically a short-term consolidation caused by profit-taking. There seems little doubt though that the low interest rate and low volatility conditions are now drawing to a close.

The other factor sustaining sentiment through this bull market run has been low inflation. It remains to be seen whether or not this will be maintained. So far retail investors in Asia have taken the opportunity to

increase their allocation to the region having slowed their appetite at the start of the second quarter. If this continues it may prove too early for international investors to be running for the exit. Unlike the situation in previous bouts of enthusiasm for Asian investing – 1997 and 1993 being prime examples – domestic liquidity has played a big part this time around and could support prices despite worsening global sentiment.

Investing in China is likely to continue to attract attention regardless. New initiatives to make it easier and more convenient for international investors to participate in the domestic A-share market are widely expected. The current structure is difficult to implement for open-ended funds and the conditions are off-putting for longer-term institutional investors. Restrictions have sought to limit the participation of short-term speculators looking to take advantage of possible Chinese renminbi appreciation. It is moot whether or not these restrictions have met their objectives. Meanwhile, the work-out of the untradeable share problem on the mainland is expected to be completed through the summer and some mutual funds are already looking to take advantage of the likely improved status of the A-share market. Minimum holding periods and other restrictions will limit the

exposure of any open-ended fund to A-shares. However, further liberalisation will result in A-shares being held far more widely and internally – this would be a positive development.

A significant factor contributing to the latest equity market consolidation has been the tightening of liquidity in Japan. This follows the announcement earlier in the year that the Bank of Japan was ending its quantitative easing policy and wide expectation that interest rates will rise during the third quarter. Total reserves within the banking system have been reduced and commercial banks are now less likely to expand their balance sheets.

Easy monetary conditions in Japan have supported equity prices globally and specifically across Asia's emerging markets. Mutual fund flows to pan-Pacific funds have been buoyed by the strong performance of the Japanese equity market. It is unlikely that most of Asia's retail investors understand fully the possible impact of changing monetary conditions in Japan on their mutual fund investments. However, further Bank of Japan tightening will test the hypothesis of whether Asian markets can overcome their dependence on global fund flows.

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