Active is:
Active Management

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Allianz Global Investors GmbH
Bockenheimer Landstr. 42 – 44
60323 Frankfurt am Main, Germany

Hans-Jörg Naumer (hjn), Stefan Scheurer (st)

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Active is: Active Management

The debate about the advantages and disadvantages of active and passive management has for years been one of the liveliest in the investment industry. Just what is the best approach to investment? "Active" or "passive"?

Globalisation, demographic trends, growth countries catching up, scarce resources and a new Information Age – megatrends are changing the world. As the world becomes increasingly interconnected, (capital market) risks arise more often. The following 10 aspects are intended to demonstrate why, in a changing world, active portfolio management seems to be the order of the day when investing.

1. Passive investments track the world of yesterday

Passive investment is backward-looking, i. e. it tracks the world of yesterday. This means that, as prices rise, the weighting of the sector in the portfolio increases. As a result passive management tends to be procyclical. The following example illustrates this: the financial sector element in the global equity market (Datastream Index) increased steadily in the years 2000 to the start of 2007, from around 10 % to 26 %. As the financial crisis unfolded, however, the financial sector lost weight, from 26 % in February 2007 to just under 16 % in March 2009. If, in this case, an investor had followed a passive management approach, he would have followed the market trend and would have held the highest proportion of financial stocks just as the financial crisis was about to erupt. This can be a disadvantage, especially in bear markets. An investor would have acted in a similar procyclical way with energy stocks during the oil crisis at the start of the 1980s or with technology shares during the "TMT[2]-bubble" at the start of the new millennium (see chart 1).

The question of active or passive management ultimately revolves around the following question: are markets efficient? The inefficiency of markets is evidenced by:

"I'd be a bum on the street with a tin cup if the markets were always efficient."[1]

(Warren Buffett)

[1] Quoted by Richard L. Peterson "Inside the Investor's Brain", 2007.
[2] Technology, Media, Telecommunications

Active vs. passive management

Active management is based on exploiting inefficiencies in capital markets in order to outperform an appropriate benchmark:

- On the strength of fundamental stock selection, active managers are already looking for tomorrow's winners whose growth potential is not yet adequately reflected in prices.
- They also usually have the flexibility required to move between attractive asset classes, regions, sectors and companies.
- Lastly, efficient risk management is also becoming more important in active management, since the world of tomorrow likely to see a greater number of extreme risks ("black swans") as global links become closer all the time.

The basic idea behind passive management is the assumption of "efficient markets". In efficient markets it is not possible to obtain any excess returns on a sustained basis since, theoretically, all information is known and priced in. As a result, the aim of most passively managed portfolios is to track the performance of an index.

There is no guarantee that actively managed investments will outperform the broader market.

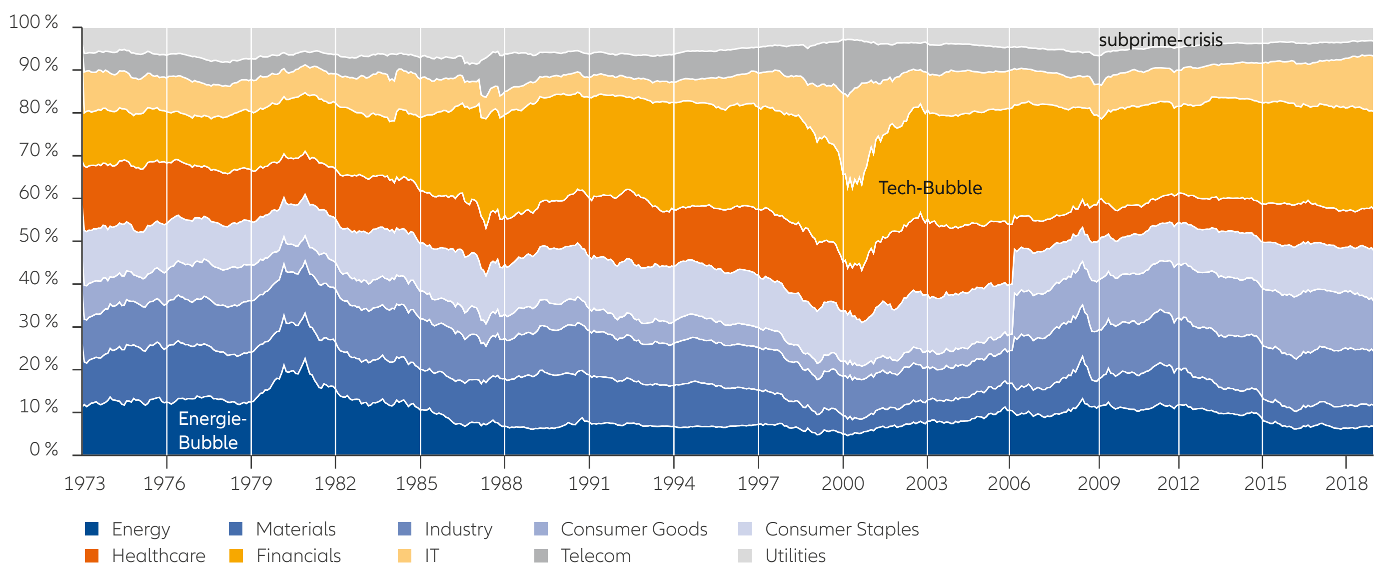
2. Behavioral Finance – saying goodbye to homo oeconomicus

Economic actors, and especially investors, act rationally. They try to maximise utility. That, at least, is the reigning paradigm of homo oeconomicus. One thing is certain. Rationality is one basis for human action, but not the only one. As a consequence it is not possible for the markets to be efficient.

Among other things, the financial market crisis exposes a broad range of investors' behavioral patterns, so-called anomalies, which are described in "Behavioral Finance". These anomalies violate the basic assumption of rational behavior. The herd mentality is an example. This can lead to excess in either direction (upwards or downwards). In other words, investors do not act rationally, but emotionally, which also affects our investment decisions. Another anomaly is over-confidence, which makes us believe that we can control

Chart 1: Passive investments track the world of yesterday

Weighting of sectors in the global equity market (Datastream Index)



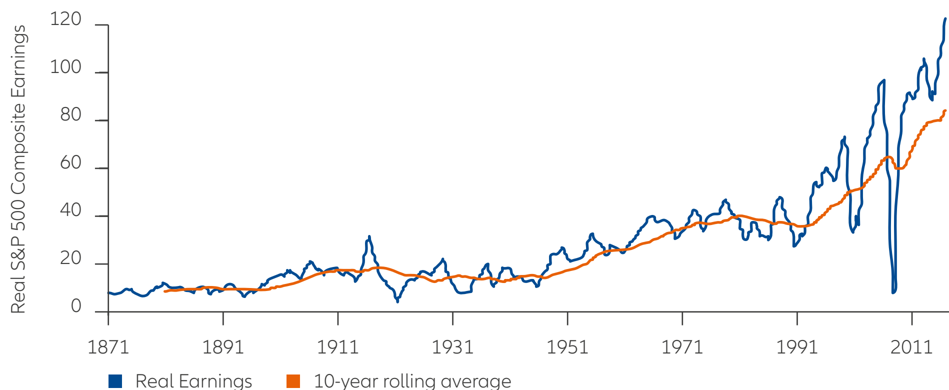
Source: Datastream (Sector Indices), Allianz Global Investors Capital Markets & Thematic Research, as of November 2018.

events that are beyond our control. Another example is hindsight bias, which is when we look back and think that we did indeed see the crisis coming. And finally, investors are usually risk averse and do not act rationally. Increasing losses are given more consideration than additional returns.

Since security prices additionally result from the supply and demand of many different market players, they are subject to just as many subjective factors and imperfections. The more pronounced these influences are, the greater the chance of identifying transient distortions through careful analysis of the fundamental factors over the long term and exploiting them to one's own advantage. This is precisely where active management is in demand, to help identify these anomalies with the support of analyses. If investors do not act on a purely rational basis – how can markets be efficient?

Chart 2a: "The good into the pot, the bad into the crop"

Earnings performance of the S&P 500 (in US Dollar, real) since 1871.



Past performance is not a reliable indicator of future results. If the currency in which the past performance is displayed differs from the currency of the country in which the investor resides, then the investor should be aware that due to the exchange rate fluctuations the performance shown may be higher or lower if converted into the investor's local currency.
Source: Yale University, R.J. Shiller; Datastream, Allianz Global Investors Capital Markets & Thematic Research, as of November 2018.

Chart 2b: Earnings per share (EPS) growth of global sector indices (in US Dollar, year-over-year in %)

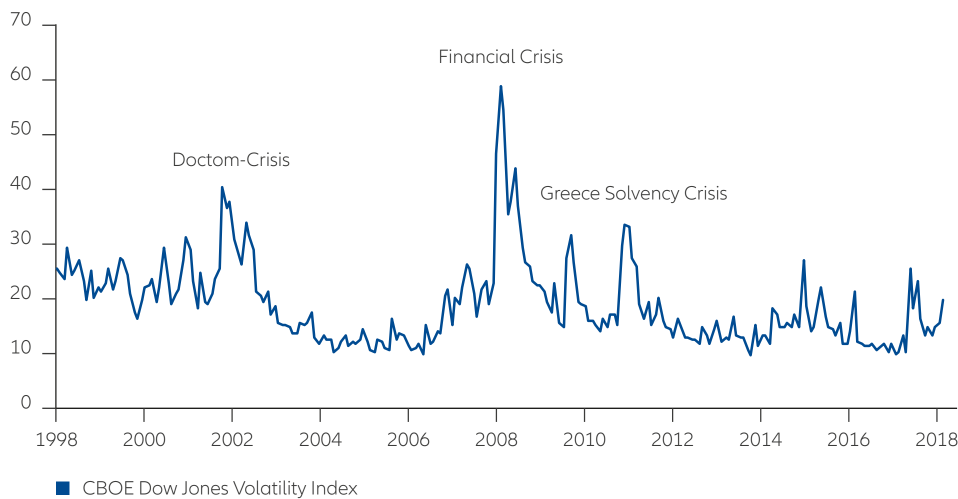
Rang	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1	30.84	283.17	75.74	78.55	37.19	20.48	16.49	9.88	93.02	28.14	9.10	16.42	10.16	7.27	10.51	99.50
2	12.17	45.34	47.87	41.30	23.18	18.54	6.50	5.75	79.93	26.80	5.83	8.18	5.29	4.30	4.65	38.58
3	9.62	25.89	36.62	32.83	22.10	15.95	6.46	4.57	50.71	14.28	4.81	6.46	4.29	3.32	2.48	21.14
4	8.55	21.26	29.75	24.24	18.94	15.00	–3.00	–3.52	45.85	9.95	3.83	3.87	1.84	1.48	2.24	14.01
5	6.24	18.19	27.57	12.73	18.30	14.64	–5.17	–12.99	34.88	7.90	1.09	1.53	0.26	–2.63	1.37	13.32
6	1.92	12.52	25.79	10.02	17.76	13.34	–5.76	–28.92	10.13	7.38	–0.08	0.13	–2.22	–3.57	0.51	11.26
7	–6.83	7.51	17.95	9.36	13.84	11.28	–6.35	–38.85	8.36	0.11	–1.83	–2.85	–4.21	–5.13	–1.33	8.63
8	–22.89	3.11	14.45	6.88	13.19	8.12	–27.77	–44.47	5.54	–1.98	–9.62	–7.97	–4.79	–24.71	–4.90	5.21
9	–57.70	2.10	12.01	5.70	13.01	3.63	–53.61	–50.90	0.09	–26.78	–28.80	–10.97	–7.83	–52.62	–46.54	4.23
Welt	**2.85**	**26.30**	**29.54**	**16.87**	**20.09**	**11.94**	**–16.88**	**–23.21**	**39.42**	**10.23**	**–0.96**	**2.72**	**1.56**	**–6.02**	**–2.77**	**18.39**

Energy · Materials · Industrials · Consumer Disc. · Consumer Staples · Healthcare · Financials · Telecom · Utilities

Calculation is based on the trailing 12-month earnings per share (EPS), MSCI World indices in US Dollar.
Source: Datastream, Allianz Global Investors Capital Markets & Thematic Research, as of November 2018.

Chart 3: Market memory

Development of Dow Jones implied volatility



Past performance is not a reliable indicator of future results
Source: Datastream; Allianz Global Investors Capital Markets & Thematic Research, as of November 2018.

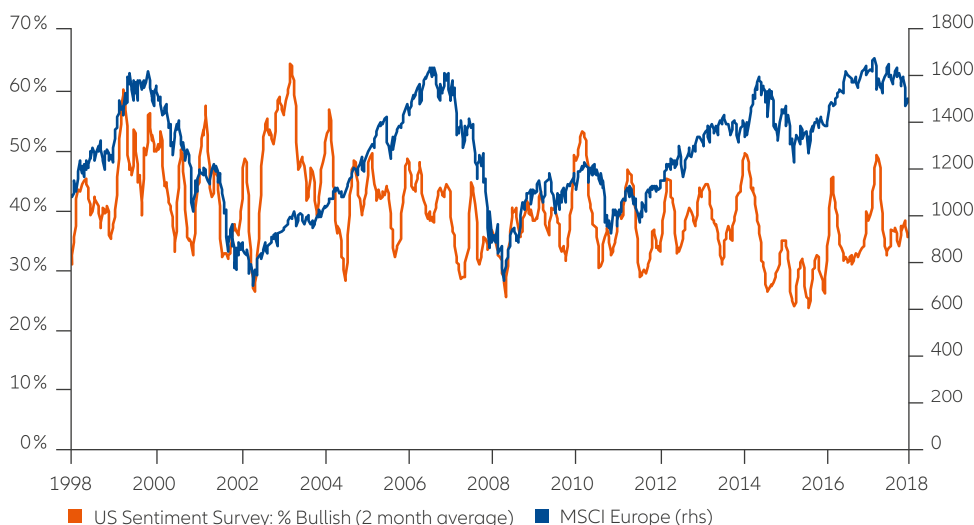
3. "The good into the pot, the bad into the crop"

Some market participants possess a certain lead in terms of information. This comes about because the data making up the information is located faster and analysed better by some investors than by others. As a result they can act faster before other investors become active. The earnings trend of companies in the key US index S&P 500 (Chart 2a) for the entire market, but also the earnings trend at sector level (Chart 2b), shows how strongly corporate earnings can fluctuate – also between individual sectors. – "The good into the pot, the bad into the crop".

So even in economic downturns or recessions companies perform differently. Active management can help provide the opportunity to identify companies that can sustain their high levels of earnings or emerge stronger from a recession. Fundamental forward-looking analysis is nevertheless the key to identifying the winners in a crisis.

Chart 4: Sentiment as counter-indicator

MSCI Europe vs. Sentiment of the American Association for Individual Investors (AAII).



Past performance is not a reliable indicator of future results
Source: Datastream; Allianz Global Investors Capital Markets & Thematic Research, as of November 2018.

Definition of the efficiency of capital markets

The equity market's ability to process information rapidly has long been the subject of debate. Information efficiency is commonly classified into three categories in the technical literature:

Weak efficiency assumes that all historical information (e.g. price performance, liquidity) has already been priced in. The conclusion would be that technical analysis does not work. In medium-strong efficiency it is assumed that not only historical data but also all publicly accessible information (macroeconomic data, business reports, etc.) is included in current prices. The strongest form of efficiency hypothesis, strong efficiency, is based on the assumption that "insider information" is also priced in.

4. Market memory

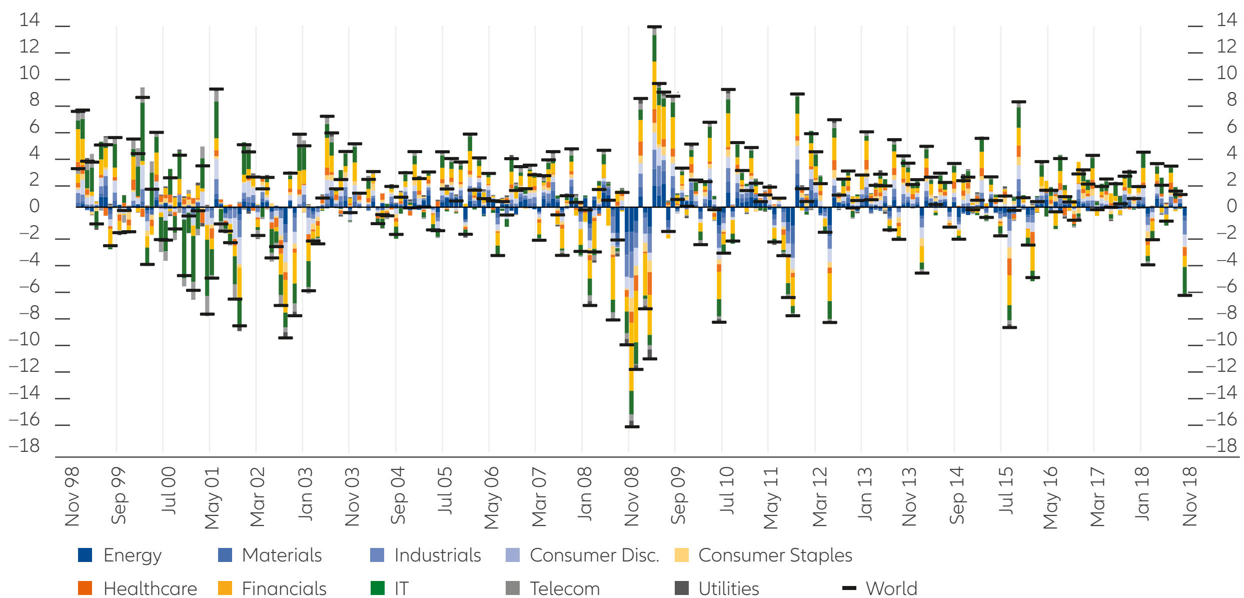
Inefficiencies (anomalies) may arise, particularly in a market environment in which volatility is high. Anomalies do not necessarily have to possess negative connotations. They may indeed even open up investment opportunities that an active manager can also actively use. This includes stock-picking, for example, i. e. selecting particular stocks.

Rising volatility, as can be clearly seen in the fluctuation during the global economic crisis at the start of the 1930s or the financial market crisis in 2008/2009, leads to greater variation of returns (see chart 3). In such times of crisis, selling mostly involves securities that are less liquid, i. e. less easily tradable.

These inflows and outflows of investor cash consequently would have a larger effect on the prices of small capitalization companies. As a result, stock picking, we believe, is gaining importance. In years of very low volatility another indicator is that investors do not pay much attention to stock-picking using fundamental research. Although equities are regarded as an asset class, we find hardly any distinction is made between each of the individual companies during these phases, e. g. in terms of future prospects or earnings growth.

Chart 5: Sector rotation

Performance contribution of sectors in MSCI World (in percentage points)



Source: Datastream; Allianz Global Investors Capital Markets & Thematic Research, as of November 2018.

5. Sector rotation

Another aspect that is just as important is sector rotation. Besides the influence of real-economic performance, it is also necessary to look at sector level, to see how each of the sectors behaves with regard to the overall equity market (see chart 5). We beleive the following is a good rule of thumb: During economic upturns and boom phases, cyclical sectors (cyclical consumer goods, industry, basic materials, IT) should be overweighted, since they are likely to be winners in the upturn. In contrast, non-cyclical sectors (utilities, healthcare and non-cyclical consumer goods) could set the tone in the portfolio during phases of economic downturn or recession. This demonstrates an approach for active management that seeks to generate excess returns by overweighting or underweighting particular sectors in the course of the economic cycle.

6. Anomalies: the "style" and "size effect"

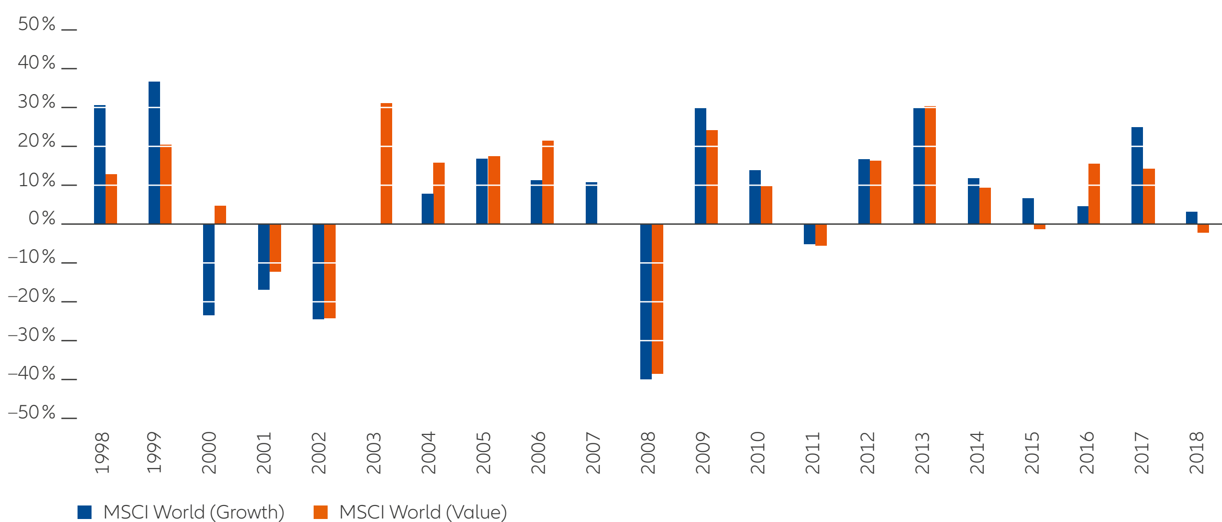
It is not only within individual sectors that inefficiencies could be exploited. Investment styles (e.g. "small vs. large capitalization stocks", "value vs. growth") may offer opportunities in certain market phases that can be actively used ("style effect") (see chart 6).

In a growth-oriented investment style ("growth" style) the future comes more to the fore: the appeal of a particular stock is not determined by the valuation obtainable now, but by the hope of above-average growth in sales and earnings in the future. A "value" manager on the other hand focuses primarily on companies with a low valuation and stable prospects for earnings and growth. The Value investor's hypothesis: "Sooner or later the market should detect the undervaluation – so the share price should rise." This is where an active manager invests in order to benefit from future prospects and this undervaluation at an early stage.

Nonetheless, opportunities may not only arise within the Growth and Value investment styles, but also in relation to the size of the company ("size effect"). While many analysts and professional investors are interested in Large Caps, much less attention is paid to Small Caps. Since the information efficiency is lower, price-related information tends to be distributed less quickly. Anyone who is well informed, however, should obtain additional benefits from the information. For this reason a good analytical process we believe offers advantages, especially in the case of Small Caps, since one could exploit the lower information efficiency while seeking to separate the wheat from the chaff (see chart 7).

Chart 6: Anomalies – the "style effect"

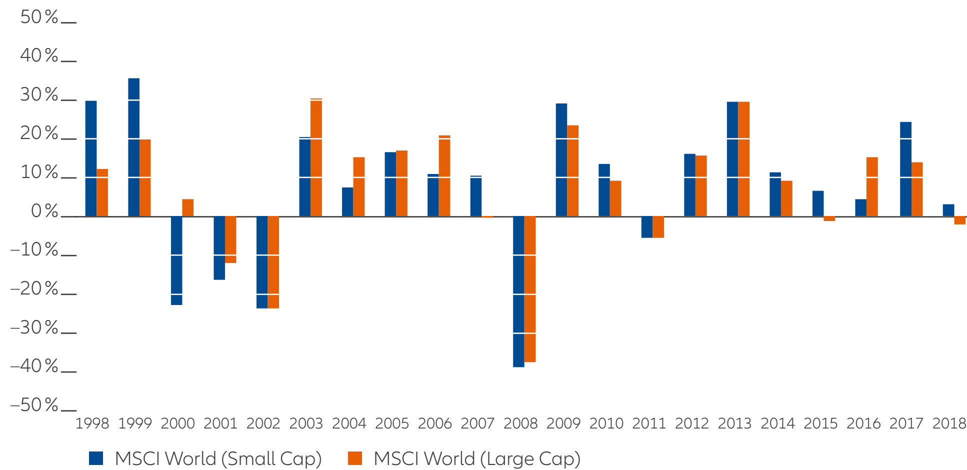
Performance of value and growth since 1988 (in %)



Past performance is not a reliable indicator of future results
Source: Datastream, Index: MSCI World (value, growth) Total Return, Allianz Global Investors Capital Markets & Thematic Research, as of November 2018.

Chart 7: Anomalies – the "size effect"

Performance of Large Caps and Small Caps since 1998 (in %)



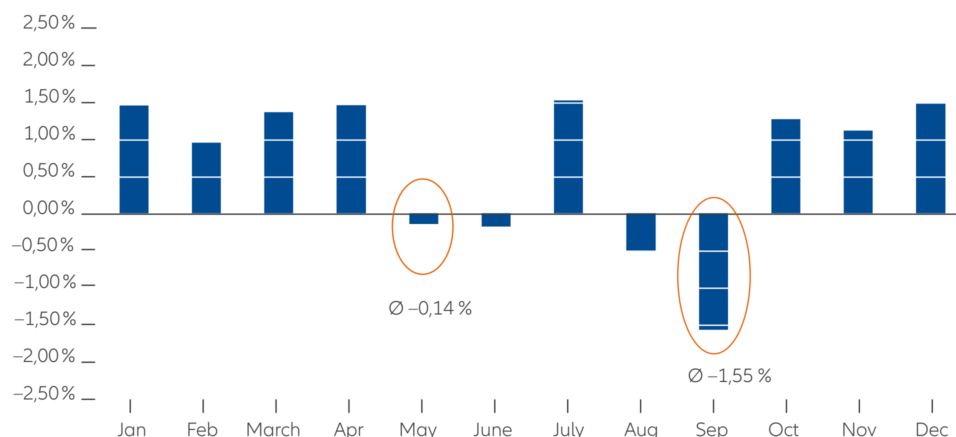
Past performance is not a reliable indicator of future results
Source: Datastream, Index: MSCI World (Large, Small Cap) Total Return, Allianz Global Investors Capital Markets & Thematic Research, as of November 2018.

7. Stock market rules as a sign of inefficient markets

The old stock market rule "Sell in May and go away" is based on the finding that equity indices have so far usually underperformed in the summer months compared to the winter months. It is indeed the case that the month of May on the DAX has produced a slightly negative return on average since 1965. Traditionally, however, it tends to be August and September that are the low months on the stock markets – the average returns for the month of September from 1965 onwards was roughly –1,6 %, although the figure varied by year (see chart 8). In this case, too, there are exceptions to the rule and these can be used by active management. In 2009, for example, September was a very strong month. Conversely, this would mean that, if the markets really were efficient, they would already have factored in this (negative) trend in the previous months. Consequently stock market rules would be completely unfounded.

Chart 8: Seasonal anomalies: Sell in May and go away?

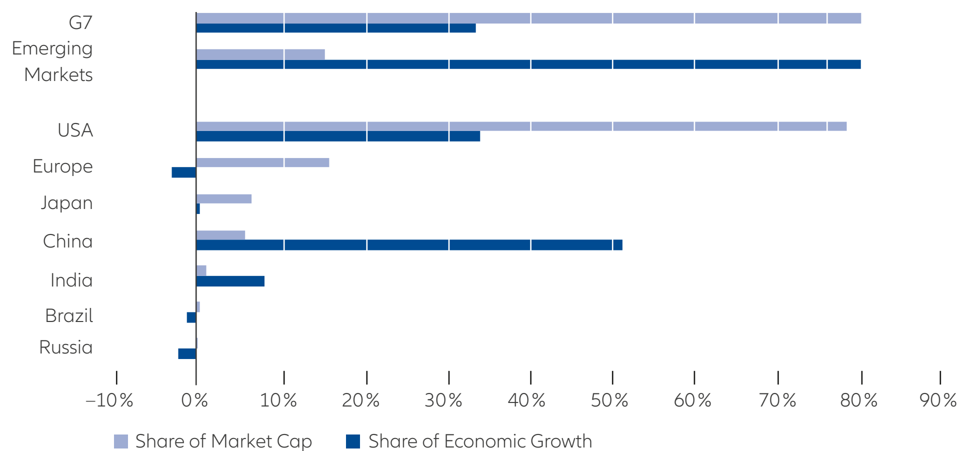
Average monthly return of the DAX index since 1965 (in %)



Past performance is not a reliable indicator of future results
Source: Datastream; Allianz Global Investors Capital Markets & Thematic Research, as of November 2018.

Chart 9: Invest in tomorrow's winners

Share of MSCI World market cap (All countries, USD) and share of global gross domestic product (GDP, USD) of the last 10 years (2008 – 2018).

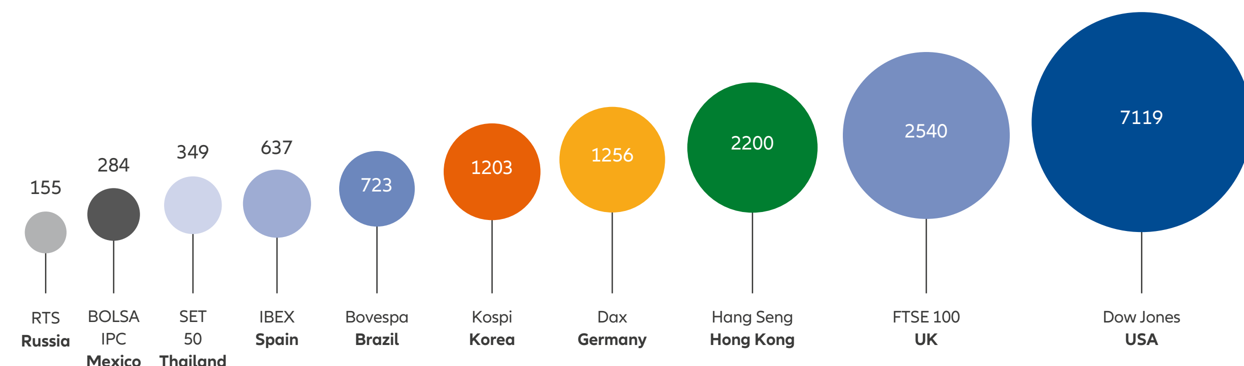


Source: Datastream; Allianz Global Investors Capital Markets & Thematic Research, as of November 2018.

8. Invest in tomorrow's potential winners

Today more than ever, stock-picking depends on the stability of cash-flows, companies' credit ratings and avoiding insolvency risks. But simply tracking the index would mean following the past. An index reflects yesterday's successes. Companies, sectors or whole regions that were favoured by investors over a long period have gained in market capitalisation and consequently are weighted more heavily in the index. Yesterday's successes nevertheless do not guarantee future performance. The disadvantages of a backward-looking approach are evidenced very well by the "TMT bubble" at the end of the second millennium, in which Technology, Media and Telecom stocks rose sharply. Another example is the crisis on financial markets, which resulted in a growing proportion of banks in the indexes. Even the MSCI World benchmark tracks the world of yesterday, since the G7 (the US, Japan and

Chart 10: Market capitalization of individual indices (US Dollar bn)



Source: Bloomberg; Allianz Global Investors Capital Markets & Thematic Research, as of November 2018

European industrialised nations amongst others) make up the majority of the market capitalisation. The gains made by Emerging Markets, for example, as shown by their share of global economic growth, are testimony to how short-sighted this is (see chart 9).

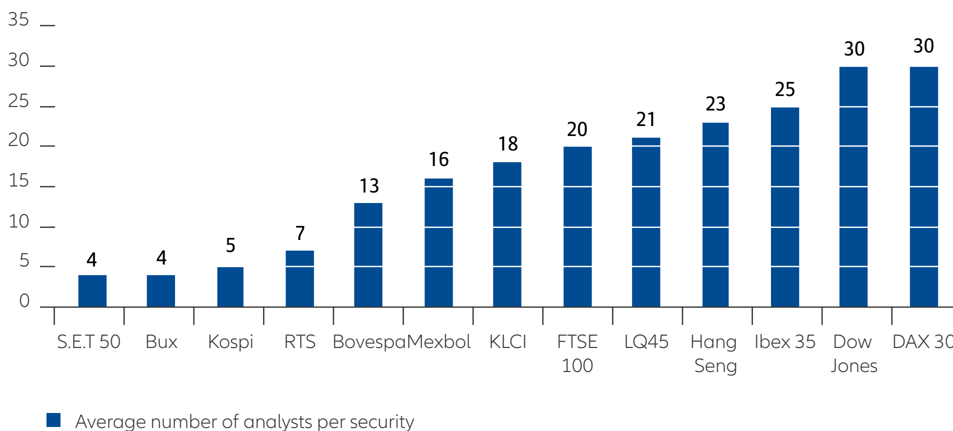
In contrast, active managers can invest now in tomorrow's potential winners based on the strength of fundamental stock selection. Currently this means that they have the chance to invest more in what they believe will be winners emerging from the crisis, and less in those who caused it in the first place.

9. Market conditions

Although active management of security portfolios does not provide any guarantee of long-term above-average investment returns, it does open up additional opportunities. In this respect it is possible to use anomalies in certain segments of the capital market in which liquidity and transparency are relatively low (see chart 10), with exceptional knowledge and analysis being required for successful participation in the market. This applies in particular if markets or market segments are hardly monitored by market players or analysts. Example: Every single company in the German equity index (DAX) is observed on a regular basis by an average of about 30 analysts, who also comment on them. There are also 30 analysts per company on the US Dow Jones Index, while there are just 5 analysts for companies on the Korean equity market (see chart 11). The fewer the analysts who analyse the capital market or its companies, the higher the information inefficiency potential that can be actively used. Even in highly liquid and transparent segments, however, we find there are repeatedly opportunities for active positioning. Examples include short-term exploitation of price excess in either direction (upwards or downwards), leading to the expectation of attractive returns over the long term.

The methods used so far have aimed primarily at generating "Alpha" (α), i. e. the pursuit of an excess return over the average for the market. Another method of active management could involve aiming at "Beta" (ß), i. e. market risks. This also includes strategic and tactical asset allocation, which is combined with diversification.

Chart 11: Average number of analysts per security



Source: Bloomberg; Allianz Global Investors Capital Markets & Thematic Research, as of November 2018.

Chart 12: Diversification can reduce risk (in %)

Rank	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Q3 '18 (ytd)
1	37.10	16.88	55.04	22.36	26.07	17.79	73.44	38.33	14.78	30.07	26.88	29.09	12.86	14.95	21.00	23.97
2	30.02	12.65	44.88	20.18	22.60	8.45	32.55	27.48	12.09	18.09	26.68	20.17	12.76	14.94	12.87	11.01
3	15.76	9.12	34.81	18.60	19.76	1.55	24.19	23.47	10.81	16.81	20.51	17.46	9.97	14.71	10.88	1.77
4	7.42	8.26	27.59	10.74	18.86	–3.55	23.18	19.82	7.96	16.71	3.65	14.64	8.78	13.49	7.08	1.31
5	4.54	3.69	27.36	3.16	3.17	–6.31	23.16	16.91	5.40	14.35	–4.22	11.85	8.48	12.22	5.70	0.74
6	1.13	2.74	26.68	1.03	1.83	–33.88	22.61	15.76	3.75	9.36	–4.49	11.81	7.19	7.39	–1.08	–0.50
7	0.43	2.18	21.83	–1.71	–0.06	–42.67	15.46	13.82	1.87	3.95	–6.49	7.40	4.17	6.59	–3.97	–1.33
8	–1.45	1.49	11.76	–4.14	–3.23	–43.29	9.52	13.37	–7.51	3.67	–8.62	4.48	–0.25	4.90	–4.04	–2.97
9	–4.74	–0.99	7.71	–5.23	–4.15	–44.78	1.14	11.75	–14.69	–0.26	–10.62	2.76	–4.87	4.61	–6.16	–3.52
10	–4.79	–2.56	0.42	–24.69	–4.37	–50.76	–1.27	1.80	–15.44	–1.68	–30.48	–24.65	–26.10	3.22	–7.33	n/a
Average	**8.54**	**5.34**	**25.81**	**4.03**	**8.05**	**–19.74**	**22.40**	**18.25**	**1.90**	**11.11**	**1.28**	**9.50**	**3.30**	**9.63**	**3.49**	**3.39**

- Equities Germany
- Equities USA
- Equities Emerging Markets
- Equities Europe
- Gold
- Bonds Emerging Markets
- Corporate Bonds
- Bonds Advanced Economies
- Commodities (ex. precious metals)
- Real Estate

Past performance is not a reliable indicator of future results.; Source: Datastream as of. 30.09.2018, Allianz Global Investors Capital Market Analysis, Benchmarks used: Germany: MSCI Germany TR, USA: MSCI USA TR, Emerging Markets Equities: MSCI Emerging Markets Total Return, Bonds of Industrialised Countries: JPM Global Govt. Bond Index TR, Emerging Market Bonds: JPMorgan Emerging Markets Bond Index Compiste Total Return, Corporate Bonds: BofA ML Broad Corp. Index TR, Real Estate: Real Estate Price Index Germany Bulwien, Commodities (ex Precious Metals): S&P GSCI Non Precious Metals TR, Gold: EUR/Troy Ounce, Hedge Funds: Credit Swiss/Tremont Hedge Fund Index NAV, Hedge Fund – Market Neutral: CS/Tremont Market Neutral Hedge Index NAV; all indices adjusted for currency differences in EUR (TR = Total Return Index, NAV = Net Asset Value), Datastream Index, S&P 500, MSCI World Index, DAX.

10. Combining active management with diversification

In order to help maximise the market risk premiums of different asset classes, investors should consider distributing their money equally across multiple baskets. Over time, asset classes turn in varying performances. The best example is 2008, when the financial market crisis was peaking. That year prices of government bonds in the industrialised nations rose by an average of 18 %, and gold by 8 %, while equities fell 40 %, their weakest year since the global economic crisis of 1931 (see chart 12). The market recovery in 2009 also favoured certain asset classes, with emerging markets equities up 73 %, easily outpacing other investments.

However, diversification does not have to be static. Active management can flexibly combine diversification with strategic and tactical reallocations. Diversification is thus the first and simplest form of risk management. To take active asset allocation further, various risk management strategies may also be implemented. These strategies also endeavour to reduce the market risk through active management.

Although our world does not rotate any faster, it is changing dramatically. Since this "changing world" has become our constant companion in relation to (capital market) risks, active management should offer investors added value over the long term.

Stefan Scheurer

Diversification does not ensure a profit or protect against a loss.

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Allianz Global Investors GmbH
Bockenheimer Landstraße 42 – 44
60323 Frankfurt am Main, Germany

Phone +49 (0) 69 24431-4141
Fax +49 (0) 69 24431-4186

info@allianzgi.de
https://de.allianzgi.com

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