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Viewpoints

Allianz Global Investors Structured Return Strategy:

An alternative school of thought

A Q&A with Greg Tournant

Greg Tournant, Managing Director, Portfolio Manager.

Lead portfolio manager of AllianzGI Structured Return Fund, explains why he believes equity-index options are a smart way to fine-tune portfolios, boost diversification and guard against market crashes.

Liquid alternative investments have gone mainstream in recent years. What's driving demand?

The appetite for liquid alternatives stems from institutional investors' need for portfolio returns that are uncorrelated to stocks. Investors also want returns that are not dependent on the direction or level of interest rates. They are posing the question, "What can we do to help you achieve greater diversification with less risk?" Even though the stock market has been climbing for more than five years now, it has disappointed a lot of people over the past 10 or 15 years. Bonds are also cause for concern because record-low interest rates are expected to rise. As a result, we've seen a wave of alternative strategies UCITS funds come to market.

Alternative investments mean different things to different people. Is there a simple way to define the universe?

To us, an alternative strategy is unique in that it offers the potential to generate positive returns, irrespective of the market environment. It is also one that has an asymmetrical risk-return profile, low exposure to market beta and a higher Sharpe ratio than traditional asset classes. An alternative strategy should be able to bring diversification benefits to a portfolio with additional returns.

Alternatives have come into focus with the rise of the endowment model made popular by Yale's David Swensen. What diversification benefits do they offer?

Their risk-reward profile is more attractive—the return an investor can get per unit of risk is higher. But it's not just about delivering something different; it's about delivering something better. Investors have to ask themselves if they're comfortable with their equity allocation, given stocks' potential for extreme volatility, or with their fixed- income allocation, given that interest rates are likely to rise. Even if you expect the stock market to perform well over the next 10 to 15 years, a 40% decline at any time during that stretch can wreak havoc on your portfolio. An allocation to the proper alternatives strategy has the potential to soften the blow.

Post-2008, investors are now more risk-averse. How can options help protect investors from catastrophic events or tail risks?

We can't predict the next crisis, but we have to be prepared for it, so we spend a lot of time on what-if scenarios. Options are like Legos—you use them to construct something one piece at a time. And you can add and remove those pieces, in this case to increase or decrease risk, as you go.

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What's your team's experience in the options market and with managing money?

We're battle tested, for sure. At $7.8 billion as of December 2016, the AllianzGI Structured Alpha platform is one of the largest pure-play option strategies in the marketplace, and we've been able to consistently deliver on our return target since the platform's launch in 2005.[1] Our team has been together a long time, and I was personally involved in the Funds' research and development for several years before it was launched. There's a lot of research and a lot of math behind it, and it has paid off. We've been able to navigate the extraordinary range of environments and market shocks of the past 11 years, all while delivering consistent returns.

What do you look for before buying or selling options?

First, we look at the path of the underlying equity index. Many option strategies focus on the price of an option, for example, whether it is overvalue or undervalued. We're more focused on what kind of risk control or profit potential an option offers assuming we hold it to expiration, which we always aim to do. So we place much more of our research emphasis on the path of the underlying index—how much is the equity index likely to move up or down prior to expiration, how can we benefit from this insight, and what protections can we put in place if the unexpected occurs.

Investors have some hang-ups about alternative strategies. Why might they be more advantahes than they think?

Our strategies are not race cars looking to speed their way to high returns. They're four-wheel-drive vehicles designed to tackle tough terrain. We use simple, liquid instruments to pursue returns based on the path of the S&P 500 Index. These are plain-vanilla, transparent, exchange-traded options. It's not the ingredients that are complex, but how they are mixed together. In our case we are able to generate consistant and uncorrelated returns by implementing our strategy on option markets.

How does this AllianzGI Structured Return strategy differ from its peers in the category?

We consider volatility its own asset class; that's our niche. Compared with many other options-based mutual funds and strategy in the market-neutral category, our ability to combine simple instruments in a more sophisticated and risk-managed way—and with no financial leverage —gives us the potential to deliver more consistent performance.

Faced with a combination of contemporary market challenges, can you describe how the strategy's unique investment process provides an advantage?

By combining passive, long equity exposure with an overlay primarily consisting of short, in-the-money call options, the strategy is able to offer investors a distinct risk-return profile while pursuing absolute returns. The goal is to provide an attractive market-neutral return profile for investors (see exhibit 1).

Exhibit 1:

Using options to Transform Equity into Absolute Return

For illustrative purposes only.

Where does this strategy fit in an overall asset allocation strategy?

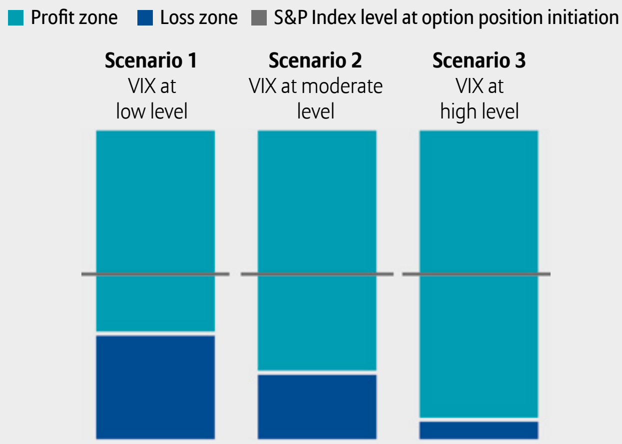
Absolute-return strategies have a place in any asset allocation. A strategy that can generate returns in an uncorrelated way makes the total portfolio better. This idea is widely recognized and is now being implemented more broadly. From our perspective, AllianzGI Structured Return strategy provides the opportunity to reduce your equity or fixed-income risk, but also provides the potential for your assets to grow.

In focus: How an options based strategy has the potential to profit in a wide range of market environments

Expected portfolio behaviour

Market Conditions	Expected Outcome
Normal	• Portfolio designed to deliver steady, consistent returns
Volatile	• Potential for higher returns
Rapid change from low to high	• Has the potential to underperform for a few weeks • Higher volatility levels may enable better risk adjusted returns thereafter
Rapid change from high to low volatility	• Higher return potential over a few weeks • Lower volatility levels should bring return potential back to normal

Our strategy profits in high volatility environments



For illustrative purposes only. This is not a indication of past performance or a guarantee of future performance.

How much does central bank intervention, specifically financial repression, impact the ability to deliver absolute returns?

We aim to deliver returns regardless of the environment. That said, if we had our choice, we would pick a higher-volatility environment. So the fact that the Federal Reserve ("Fed") has been providing a lot of liquidity that is muting volatility is of no benefit to us. But rest assured, there are enough structural imbalances and disruptions in capital markets that another wave of volatility could occur at any time. And volatility is our friend.

Alternatives like 130/30 funds had a lot of cachet back in 2005. Many of those funds have either underperformed or since disappeared. What will separate the winners from the losers in today's alts space?

Consistency of returns. It's true that a meaningful percentage of hedge funds and hedge-like strategies have disappeared. That was one way to take out the managers that didn't have the skill or the financial wherewithal to compete. Ultimately, the market will take care of itself. There's enough appetite for alternatives that if you have a good track record, transparency and liquidity, then you should do well. We are well positioned to profit from high volatility levels when the markets decide to give us some!

For more information

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[1] A performance of the strategy is not guaranteed and losses remain possible.

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