Index and Quant Investing in Asian Market for Asia's Wealth Management Community

Harold Kim, Founder and Chief Executive Officer of Neo Risk Investment Advisors, offered a fascinating Workshop at the Investment Solutions Forum to explain how factor/smart beta investing and dynamic risk management works. These investment approaches are widely used in developed markets, but their adoption in Asia has been lagging. Using passive investments, smart beta and dynamic risk management can significantly improve investment performance while reducing risk in Asian equity markets.

"IF I HAD SIMPLY TITLED THIS TALK 'INDEX AND QUANT INVESTING IN ASIAN MARKETS', NOBODY WOULD HAVE SHOWN UP!" Kim quipped on opening his Workshop. "So, my subtitle is 'Why you should care about factors, smart beta and dynamic risk management'. Hopefully this subtitle has grabbed your attention."

Kim started with an historical perspective on the development of the fund management industry, both active and passive, before zooming in to explain more about factors, smart beta and dynamic risk management.

Factors and smart beta

A factor is "an attribute of an asset, stock or bond, that both explains and produces extra returns," according to Morningstar, or from BlackRock's viewpoint, "broad persistent drivers of returns". "For example, equities and bonds that are exposed to growth, rates, inflation, credit, and other factors may provide excess returns as a result of these exposures," he noted.

Smart beta, he then clarified, is an implementation of a factor exposure. "Factor is an attribute," he said, "while smart beta is a product that is trying to capture that factor. As it is often difficult to capture pure factors, most industry participants seek

HAROLD KIM
Neo Risk Investment Advisors

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to capture tilts to the factors in smart beta index form. Examples include value, momentum, and low beta indexes."

Dynamic risk management

Dynamic risk management relies first on the fact that volatility tends to be persistent—if volatility is high today, then volatility will most likely be high tomorrow; similarly, if volatility is low today, then most likely it will be low tomorrow. Persistence implies predictability (unlike in the case of returns, which are impossible to predict in the short run). The key to dynamic risk management, then, is to recognise when markets are in a state of high volatility or low volatility and to position the portfolio allocation accordingly, and to be reactive when markets are transitioning from one risk state to the other.

"Dynamic portfolio allocation," he explained, "simply means changing portfolio allocations through time in response to changes in the investing environment; in our case, as risk changes. Dynamic risk management means reacting to changes in risk. It isn't enough to just measure and monitor risk; critically, you need to act. When risk starts to change you must do something. The result should be outperformance and realised portfolio risk within the investor's tolerance level."

In addition to persistence, the second driver of outperformance is negative correlation between volatility and returns, particularly in equity and credit. If high risk is systematically associated with low returns, then dynamic risk management can deliver added value.

Kim noted that the dynamic risk approach is widely used in developed markets and has

been institutionalised, with major index providers such as S&P Dow Jones, MSCI and FTSE Russell calculating dynamic risk management versions of their benchmark indexes.

Passive beats active

But why should investors care about this? Kim cited S&P Dow Jones research that finds that, for the five years to December 2018, 82% of US large-cap funds underperformed the S&P500, meaning that the majority of investors would have done better by simply buying a passive S&P500 ETF. Kim also mentioned data from Morningstar that found only 35% of active funds across various asset classes beat their relevant indexes in 2018.

"Little surprise then," Kim concluded, "that in a recent article the Wall Street Journal highlighted that more US equity assets are now managed passively than by active managers. For investors, the spread of passive investment vehicles like index funds and ETFs is a good development, since investors now have access to solid investments across a variety of asset classes with low fees and with real transparency."

Adding factors and smart beta

When we add factors and smart beta into the equation, the hurdle for active managers becomes even higher. Kim quoted academic research that showed that excess returns previously

attributable as active manager alpha were actually systematic, factor-related excess returns that could be captured in a low-cost way by smart beta ETFs such as those based on quality, value and momentum, driving the growth in popularity in these products.

"For active managers, this is troublesome," he stated, "because it was hard enough to beat the benchmark before, and now beating the benchmark plus is even more difficult."

What is risk?

The role of risk in the investment process is often neglected. "Investing is a trade-off between risk and return, so as you think about the investment equation, risk should be just as important as return."

Furthermore, what makes risk interesting is that risk is persistent and therefore predictable.

"What do I mean by persistent?" he asked, rhetorically. "If market risk is low today, market risk tomorrow will most likely be low. If market risk is high today, then most probably market risk will be high tomorrow. That is persistence. Contrast that with returns. If returns are positive today, does that mean returns will be positive tomorrow? Most likely the answer is that we do not know—the chance is 50-50 that markets will be up."

If you have two important inputs to an investing model, one of which is unpredictable and of one of which is predictable, which input should you focus on? Of course, you should focus on the predictable input. That input is risk.

Application to Asian markets

The investment environment in Asia changed dramatically from 2017 to today. After strong equity market performance in 2017, everyone expected things to continue in 2018. Instead, what happened? Asia turned around and went right back down again, falling almost 15% in 2018. It is very hard to predict return!

At the same time, risk, which was very benign in 2017, more-than-doubled during the course of 2018 as markets fell. Kim explained that if investors had reacted by adjusting their portfolios as risk changed, then they would have been managing risk dynamically, and they should have done better than if they had taken no action.

Take action, be dynamic

For example, in October 2018, Asian equity markets fell by over 10%; therefore, an investor with a full allocation to equity would have lost the same amount. However, an investor who lowered their equity allocation as risk jumped through 2018 would have lost less.

Neo Risk Investment Advisers: A Snapshot

Kim founded Neo Risk nearly five years ago with two colleagues after leaving a 20-year career at Citibank, where he had been responsible for the investor derivatives business in Asia.

The premise behind the creation of Neo Risk was his observation that Asian investors lag in terms of understanding advances in quantitative finance that can be used to improve investment performance, including derivatives, factor investing, dynamic risk management and asset allocation.

Kim's focus is to apply these skills and approaches in Neo Risk's advisory business and within the fund that Neo Risk manages on behalf of the firm's clients.

Neo Risk has two core businesses. The first business is investment advisory, working with a range of investors, such as family offices, hedge funds, asset managers and other institutional investors.

"We help our clients think about risk systematically in a variety of ways," Kim explained, "including strategic portfolio allocation and how to make risk more dynamic, better ways to implement a long/short hedge strategy and designing investment strategies to accomplish defined objectives."

Neo Risk's second business is managing the REAP Asia Equity Fund, which uses a risk-focused investment strategy focused on Asian exposure. The Fund was nominated as best new fund of the year by AsiaHedge (2017) and EurekaHedge (2018).

Kim explained that the dynamic risk management approach really differentiated itself in 2018. "Asia lost almost 15% with 16% realised risk, but a dynamic risk management approach achieved 4% outperformance with one-third less risk."

Inaction (that is, keeping a static portfolio allocation) during 2017 and 2018 meant missed opportunities. Either you did not capture returns in 2017 or you lost more money than you should have in 2018. "When risk doubles, triples, quadruples, you must respond dynamically. Doing nothing is not optimal. Adding smart beta exposure that outperforms most active managers further enhances returns. The combination allows investors in Asia to invest smarter and do better." ■

Neo Risk Investment Advisors Limited is a Hong Kong SFC-registered investment advisor and fund manager.

We take an innovative approach to investing that focuses on risk management to deliver superior investment results. Our approach enables us to construct investment portfolios that are resilient in volatile markets; our aim is to control risk and limit losses when markets are weak.

We use a variety of tools that are grounded in academic research but have been tested in the real world to measure, monitor and manage risk actively, including quantitative risk modeling, advanced asset allocation and derivatives.