Managing Risk in Asian Equity Markets

Dr. Harold Kim, CEO of Neo Risk Investment Advisors, presented a Workshop at the Hubbis Asian Wealth Management Forum to share his insights on the recent performance of Asian equity markets and ways in which active risk management and diversified alpha exposure can improve investment returns. His detailed presentation not only informed but also engaged an audience eager to learn more about the theory and application of dynamic risk management.

KIM BEGAN WITH A DEFINITION OF INSANITY attributed to Albert Einstein: "Doing the same thing over and over again and expecting different results each time, which," Kim noted, "could also apply to investing and not learning the lessons from what have been a difficult twelve months in global equity markets."

Kim explained that he had founded Neo Risk several 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 mission 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's two pillars

Neo Risk has two core businesses. The first business is investment advisory, working with a range of investors, such as family offices, hedge funds, insurance companies, asset managers and other institutional investors. "We help our clients think about risk systematically in a variety of ways," Kim explained, "such as for strategic portfolio allocation and how to make risk more dynamic, or better ways to implement a long/short hedge strategy, including how to determine net exposure more quantitatively, or designing investment strategies to accomplish certain objectives."

Neo Risk's second business is managing the two-year-old REAP Asia Equity Fund, which uses a risk-focused investment strategy to deliver returns.

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Focusing on recent market conditions in Asia, Kim observed that the investment environment changed dramatically from 2017 to 2018, in particular, that risk had risen markedly over this period.

From low risk to much higher risk

He noted that realised risk of Asian equities for much of 2017 was in the range of just 8% to 10% volatility, reaching unprecedented historical lows. However, starting at the end of January 2018, risk rose dramatically with realised volatility surpassing 20% by the fourth quarter of 2018, representing a doubling of risk from 2017.

Kim pointed out that, unlike returns which are impossible to predict in the short run, volatility is very persistent, which means that 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 short-term predictability. 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.

Dynamism in our portfolios

"Dynamic portfolio allocation," he explained, "simply means changing portfolio allocations through time, in our case, as risk changes. I want to demonstrate to you what would have happened if you had used an approach like this over the last few years in Asian equities."

Kim explained that over the past two years there was a clear move in risk, starting from a low-risk regime during most of 2017, followed by a step up to a moderate risk regime in early 2018 and then a higher risk regime in October 2018. Kim then challenged the audience: "Did you change your portfolio allocation," he asked, "as equity risk doubled?"

Kim continued: "Dynamic risk management means reacting to changes in risk. It isn't enough to just measure and monitor risk; critically, you need to act. In short, when risk starts to change you must do something."

Take action

Kim recalled a meeting several years ago with a prominent Asian hedge fund manager. Kim discovered that while this fund manager was indeed measuring and monitoring risk, he was not acting on the basis of the information. "You have to manage risk, meaning if your measured risk is too high, you need to react by reducing net exposure, or shifting allocation to stocks that are less volatile," Kim advised the audience. "Action, making change, that is risk management. In our case, dynamic risk management means changing portfolio allocations to ensure our actual realised risk is controlled."

He further expounded on this advice by remarking that "What matters is your actual risk this quarter, next quarter, this year, next year; being practical, changing allocations to have realised risk that is within your tolerance as an investor."

Kim then gave delegates considerably greater detail in terms of estimating risk and determining portfolio allocations over the 2017-2018 period for Asian equities, supported by some excellent slides he had prepared for the Workshop. “There are many ways to implement dynamic risk management,” he commented, “but the key is to have some sense of what risk is in the market, how much risk is right for you and then as the risk in the market changes, changing your allocation accordingly. It could be as simple as moving between equity and cash, or reallocating among a basket of stocks to favour less risky stocks, or redistributing among a broader set of asset classes to allocations that are less risky.”

The result should be risk within the investor’s tolerance level.

Alpha portfolios

He then moved on to alpha diversification based on equity factor exposures. Factor indices, he reported, have been identified by both academic research and practitioner experience as consistent sources of alpha over the long term.

“Well-researched factor alphas include growth, value, momentum,” Kim elucidated, “and then more recently yield, low volatility, and quality. These are all characteristics that have been identified as sources of equity alpha over the long term.”

He explained further that this approach has been institutionalised in developed markets, in the sense that major index providers such as MSCI, Dow Jones S&P, and FTSE all provide factor indices. “But interestingly,” he reported, “the factor-based approach is still relatively new and not that well understood or widely used in Asia. I believe there is accordingly considerable opportunity for Asian investors to exploit this source of alpha.” He then went into more detail on this topic, again armed with a variety of detailed, insightful slides and examples.

Cut risk, boost returns

“By conducting dynamic portfolio allocation in a disciplined systematic way, you should reduce risk when market risk increases,” he summarised. “For global equities in particular, there is a strong negative correlation between risk and return. When risk goes up, returns tend to be weak, and vice versa.”

“Given this negative correlation, this allocation process should actually improve portfolio performance,” he added, “not just in managing overall risk, but also by improving returns. Adding the factor alpha overlay, which is also risk-based and provides countercyclical diversification, results in something that we’re all looking for as investors: smoother realised portfolio risk, outperformance in weak markets and better returns.” ■