

# Seeing the positive

Allianz Global Investors' David Tan gives his take on investing in Asian fixed income assets



PHOTO: ALLIANZGLOBALINVESTORS

*FIXED income assets have been rewarding over the past years, and Asian investors have been particularly keen on Asian fixed income. We ask David Tan, Allianz Global Investors chief investment officer, Asia Pacific, to share his views.*

**Q. What do you see as the major themes or underpinnings (structural or cyclical) that would benefit Asian fixed income in the short to medium term (one to two-year view)?**

We believe the current economic backdrop is conducive to Asian fixed income over the next one to two years. Global economic growth and inflation remain weak as financial repression continues. While the US Federal Reserve may normalise interest rates in the coming months, it is by no means tightening monetary conditions. This means a “lower for longer” global interest rate environment will remain. Today, around US\$10 trillion of debt outstanding globally suffers from negative yields. Asian fixed income is an asset class that still offers positive yields in both US dollar denominated bonds and local currency denominated bonds.

Another theme is the growing impact of political risk and geopolitics in financial market volatility. So with a backdrop of low yields and rising volatility becoming the norm, we have a situation where investors' returns will be increasingly driven by their tolerance for volatility and risk.

In other words, investors will need to reduce their return expectations or they will need to take more risk to generate the same level of yield/returns that they have been used to in the past. There are two key takeaways from this:

i) Investors need to focus more on risk-adjusted return potential. Asia as a region continues to have the best fundamentals among its emerging market peers. The 10 largest Asian economies have investment grade ratings from Moody's and Fitch. Asian corporate bonds currently have the lowest default rate expectation among the broader Emerging Market universe. Hence, we continue to believe that Asian fixed income offers good long-term risk-adjusted return potential.

ii) With beta returns expected to be lower than before, investors will also need to be more active and agile. This makes it important to find an active manager that is focused on both generating alpha and minimising downside risks.

**Q. What segments of the Asian fixed income asset class are you most positive about, and which segments do you least favour and why?**

We believe Asian credit can continue to generate positive returns in 2017 for an actively managed portfolio; however, returns are likely to be lower than this year. Carry will be the key driver of beta returns so it is important to select an active manager that can identify alpha opportunities through credit selection. In the China high yield space, we are seeing new issuers in industries such as energy, utilities and infrastructure. We like these types of opportunities which are in line with the government's long-term growth objectives. We are careful of sectors that have become expensive such as selective property credits.

For Asian local currency bonds, we favour Indonesia and India where five-year government bond yields are in excess of 6 per cent. We believe the macro situation in both countries has stabilised and ongoing reforms will improve the long-term poten-

tial of these countries. For local currency bonds, we are cognisant that market volatility will typically result in a US dollar bias and we would actively hedge currency exposures in our portfolios if necessary.

**Q. Please share with us your investment discipline: How do you select the credits to include in your portfolios; what would drive buy or sell decisions?**

Our approach to credit selection is fundamentally driven. We look for issuers that have good business models, are competitive in their industry, exhibit prudence in financial management, and possess strong management capability in the execution of their business plan to ensure operational success.

We incorporate our top-down macro analysis to identify any specific country or industry concerns that may cause an underweight or avoidance of a specific country or industry from a macro point of view. We then assess whether an individual issuer's fundamentals are commensurate with their credit rating and peer group to determine whether their valuation is attractive.

While yield is important, we focus on the total return potential of the credits that we invest in, which incorporates not only yield, but also the potential for credit spread tightening due to undervaluation or expected improvement in fundamentals and/or technicals.

We would look to sell a credit if it becomes expensive, if we find better relative opportunities to switch into or if we expect deterioration in credit fundamentals.

**Q. Individual investors remain very hungry for yield and may take more risk than they are prepared for, particularly in the high yield space. What advice can you offer investors in terms of return/risk expectations, and how to size up whether they are adequately compensated for the risk they take?**

The reality is that we are in a “lower for longer” yield environment. Because of this, investors need to adjust their yield and return expectations to ensure that they remain in line with their risk tolerance level. They should first determine their risk tolerance and then look for products that meet the level of risk that they are prepared to take.

In the high yield space, credit analysis and selection is paramount to avoid default risk. Rather than invest directly in individual high yield bonds, investors could benefit by investing in a mutual fund managed by an experienced active manager. One of the advantages of a mutual fund is the ability to achieve diversification of holdings to minimise exposure to individual credit risks.

At Allianz Global Investors, we offer three different Asian Fixed Income products designed for different levels of risk appetite. The investment grade strategy is designed for more risk-averse investors who still want to achieve some yield pick-up, but prefer to stay within investment grade bonds that have historically experienced lower default risk.

At the other end of the spectrum, our high yield fund offers higher yield and return potential for investors that can withstand higher levels of volatility and risk. In the middle, we offer the Flexi Asia Bond fund that provides broad-based exposure to Asian fixed income markets for income and long-term capital appreciation potential. This product can invest in high yield bonds, but it targets an investment grade average portfolio credit quality. **W**