AEGON Asset Management

Monthly outlook – October

Ádám Halóka – Practical asset management: do it yourself, or entrust it to a pro

Last month was the best September in the history of the US stock market since 1939, as the S&P500 index rose by 8.9% after an August that had, by contrast, turned out to be the worst period in 30 years. The share-price movements point to a high degree of high volatility; however, the US index remained within the previously established band until the end of the month, when it managed an upward surge, giving an impetus to those of the emerging market equities that were already breaking their earlier records, of which India (11%) and Turkey (10%) stood out the most this time.

The other emerging markets, however, were only characterised by restrained optimism, as Europe (+1.5%) continues to be held back by the economic problems of the PIGS group of countries, while in Japan (+3.1%) it was only the central bank's currency-market intervention to curb the strengthening of the yen that gave any reason to be optimistic. (All yields are stated in their respective currencies. Due to the 5-10% strengthening of the forint, the yields expressed in the Hungarian currency do not fully reflect the increases that took place in the stock markets.)

On the macro front the outlook remains mixed, to say the least; the European Commission is expecting a greater economic upturn in the eurozone than its previously published prediction, and the Swiss central bank is counting on 2.5% growth in the Alpine country this year. Meanwhile the European Central Bank had to intervene in the Irish government securities market after the yield on Irish long-term bonds exceeded that of its German counterpart by 390 points, and the CDS level soared to an all-time high. In more worrying news for investors, the Irish Republic's finance minister has said that this year's budget deficit could amount to more than 30% of GDP.

In the second half of the month the Japanese central bank commenced measures aimed at weakening its domestic currency, in an attempt to stem the long-established upward trend in the value of the yen, in order to boost the profitability of exporters, which are so important to the economy.

So how should we invest in an environment where the various countries, competing with each other by devaluing their own currencies, attempt to increase the quantity of money in circulation, and where the average yields on bonds no longer represents the “acceptable” return to which savers had previously been accustomed?

I would like to help out small investors by offering a few practical tips, and outline a cost-effective and rational solution for those who would like to entrust almost all of their investment decisions to an asset manager.

Many small investors take an active interest in the question of how to grow their savings. They are constantly seeking opportunities to achieve substantial asset growth at a low risk. I have some bad news for them, however: there are no such solutions.

As soon as investors give up their search for the “Holy Grail” and start to take a realistic view of the opportunities available, the real process of creating value can begin. The following, practical steps are intended for those small investors who would like to know how a substantial proportion of private banking portfolio recommendations and reviews are made.

It is important that instead of setting targets along the lines of “I would like to achieve a 70-80% return”, investors should ask themselves a few questions which, although they may seem almost self-evident, often go unanswered, such as:

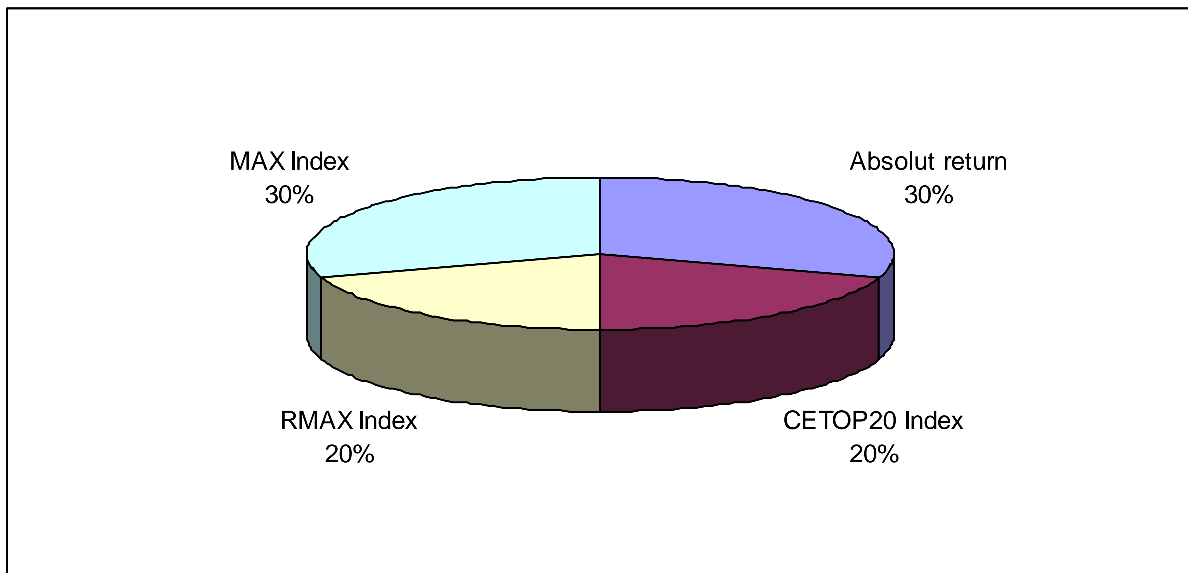
1. How much money would I like to invest, over what time period and in which currency, so that my solvency is not endangered over the given investment horizon?
2. How much of a risk am I prepared to take?
3. Do I need to retain the option of immediately liquidating my investment at any time, or am I prepared to maintain my position until the end of the investment horizon?
4. Am I an experienced investor, and do I have the time to constantly monitor the markets and make properly researched decisions?

Answering the above questions can sometimes be simple, but at other times can cause serious consternation. I think that deciding on the investment horizon is a simple matter; however, investors don't devote enough time to assessing their appetite for risk. A simple game can help with this. Let’s say there’s a prize draw in which there are two possible outcomes, each with a 50% likelihood of occurring. The competitor will either win HUF 5 million, or will not win anything. How much money would you be prepared to pay to enter the competition? Obviously, the size of the prize should be matched to your particular asset situation, since it is only possible to measure risk tolerance by setting the appropriate stakes and loss threshold. The fair value of the competition is 0.5*5 million, which amounts to HUF 2.5 million. An investor who is only prepared to pay much less than this in order to participate can most probably be categorised as risk-averse. On the other hand, an investor who is prepared to pay more would be rated as having greater-than-average appetite for risk.

Similarly to the professional managers of investment funds, it is advisable to take a purposeful approach to your portfolio investments, selecting a reference index that suits your risk and investment horizon preferences, and following a predetermined set of rules, in order to minimise the chances of making emotionally-based decisions. This is where the simple game above shows its true benefit: risk-averse investors are best advised to overweight bonds heavily and to select a low proportion of shares and other risky assets for the benchmark, while the risk-tolerant tend to prefer a higher equity and lower fixed-income exposure. Since the majority of savers are not professional asset managers, saving through investment funds could represent the most obvious solution for them.

Let’s assume that a moderately risk-tolerant investor with no financial qualifications wishes to invest his forint savings through investment funds over a 5-year horizon, in the following breakdown: 20% RMAX Index (Hungarian short bond index, high liquidity), 30% MAX Index (Hungarian bonds with a maturity of more than one year), 30% absolute yield instruments, 20% CETOP20 Index (Central European share index).

Sample portfolio:



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As the next step, it is worth taking a look at the options available in the domestic investment fund management market and purchasing collective instruments with a similar benchmark, taking into

consideration the ratios that you have determined for yourself, and also bearing in mind that the distributor's initial commission could be a factor that detracts – possibly substantially – from the performance achieved by the fund. From the perspective of risk management it is advisable to set up “stop-loss” rules for the various asset classes, a good example of this being the liquidation and reinvestment of shares in the event of a 10% drop in value.

Throughout the term of the investment it is sensible to regularly review the portfolio, for which I can recommend two simple methods. When reviewing small investors’ portfolios, to fine-tune the weights of the reference indices we use either the constant-weight or the portfolio insurance method. The holding of constant-weighted assets simply means that you restore the original portfolio weights at each regular review of the investments; in other words you realise any profits, and in the case of assets that have lost weight, you treat the fall in price as an opportunity to buy. The advantage of this method is that it enables the simple, regular realisation of profit, and prompts the investor to buy assets that have come under seller pressure.

Portfolio insurance works in precisely the opposite way, as it involves increasing, in a predetermined extent (e.g. 2%) the weight of those asset classes that are rising in price, while gradually reducing the weight of the bad performers in the portfolio, at the same rate. Portfolio insurance is a trend-following strategy, and as such it works best in markets that display a clear tendency in one direction or another.

The good news for those who would also like to entrust the steps described above to a professional asset manager is that AEGON Fund Management’s product range includes an investment fund with moderate risk characteristics (AEGON Smart Money Investment Fund of Funds), one the best features of which is that it performs the necessary reinvestments on at least a monthly basis, in the light of the given market changes and events. In other words, in times of an unfavourable equities market, it prefers absolute-yield instruments, while in a bull market it increases the weight of shares and, selecting the most promising regions, makes it possible to achieve a higher yield. It does this by switching between investment funds, while maintaining a high level of diversification and cost efficiency.

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