

Königsdisciplin

Stockholm (HedgeNordic) – It is more than ten years ago that Allianz Global Investors, the European Asset Management giant that today has in excess of 450 billion Euros under management, set out to do something different. With vast internal resources in research, trading and other areas, the ambition was to offer a product that would fit the more conservative DNA of the group and client base, but would be driven by equity Alpha. The challenge was to develop a new strategy whilst leveraging off the depth of the existing long only platform that would allow participation in both rising and falling markets. Harald Sporleder, who has managed this project since its paper trading days and is today the lead portfolio manager for Allianz Discovery Europe Strategy, provides his views on the art of running a true market neutral portfolio.

No pairs, no derivatives

Where many strategies rely on hedging out market risk with futures and options (typically being: short an index to protect a long book of single stocks), Harald has never used derivatives in the fund's eight-year track record. "We believe in hedging the portfolio by picking single stock names of good and bad companies."

Harald observes large parts of the industry relying on protecting downside risk with derivatives with some concern. "These products may not perform when markets come under stress, as the derivative will not always deliver the returns modelled out on an Excel sheet. When markets are in real trouble, correlations shift and protection fades away. The way you expected your portfolio to behave likely goes out the window."

Harald is not a believer in pair trading either but rather relies on deep, fundamental research. "Being long Daimler and short BMW or vice versa does not allow you to get the returns right to justify the fee structure." He does see some value in pair trading as implemented under some quantitative approaches. However, these strategies typically require entering into several hundred pair trades with the expectation of small returns on each position and a high turnover of the portfolio. Often these strategies need to take on leverage, which is limited in UCITS structures, and returns come from many different sources. "That is the complete opposite of what we do."

It may be less complicated and more arduous but we pick our investments as a result of research on individual stocks and thematic views on sectors and countries."

Active country or sector bets are a substantial part of portfolio construction, yet the fund remains strictly market neutral. Harald sees three core parameters that characterize a market neutral strategy: (1) The strategy must be Beta neutral (ideally with a Beta very close to zero); (2) the net equity exposure should be in a restricted range (in this case +/- 15%); and, (3) the volatility of the fund must remain low.

Picking your Shorts - The Königsdisciplin

"It is a daily challenge to build a portfolio which remains market neutral, capturing upside with the long positions whilst maintaining the necessary focus on the short positions. The biggest challenge – the Königsdisciplin – is to identify and manage these shorts. I spend 70% of my time generating and analysing short ideas," Harald says.

Due to the depth of research available within the group, Harald has the opportunity to challenge the

other investment teams' and analysts' understanding of a particular business model, and to leverage the global research platform to identify and understand the structural changes facing countries, industries, sectors and individual companies.

Structural changes within a sector can be very long lasting and may be triggered by a variety of factors including changes in regulation, legislation or by disruptive product innovation. Harald points to the utility space for an example; he believes that French and German energy providers whose revenues are based on nuclear power provision are structurally at risk and are therefore likely to fall out of favour. "I am always on the lookout for the long term losers. We do not come up with structural short ideas overnight. Our shorts undergo an extended research process often involving a number of parties across the groups business". Another internal tool

the team is utilizing is "Grassroots Research" - a global network of market researchers which has been in use since 1984. It employs investigative journalism, supply chain surveys and analytical techniques to identify stock and sector trends, and serves as a "fact check" on long / short ideas.

An advantage Harald also sees in the AllianzGI organisation is that all senior portfolio managers are located on the same floor. "Sometimes we get trading ideas from other teams, for example those who specialise in areas like small caps or growth stocks."

The portfolio's turnover is around 12-15 times a year. The turnover tends to be lower in directional markets and unsurprisingly, higher in volatile markets. Short-term trades, which make up about half of all trades, typically have a profit target or stop loss of 10% before positions are closed. For structural long ideas, those targets can be much wider. "These long term trades have a different return profile, there we try to identify a fixed catalyst prior to adding a position." Once this catalyst is reached the position is closed, or at least re-evaluated for other factors. Harald mentions he has three names in the portfolio that the team has held for at least six years. "These stocks have reached their catalyst and performance targets several times, but the companies' management teams always came up with new ways to enhance the earnings streams supporting our fundamental investment thesis."

To read the whole interview in the HedgeNordic Special Report on market neutral strategies, please [click here](#): Market Neutral Strategies