Asset Allocation and Investment Ideas in uncertain markets

Carlos Kinsky | Saint Petersburg | May 2012

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Cross Asset Allocation

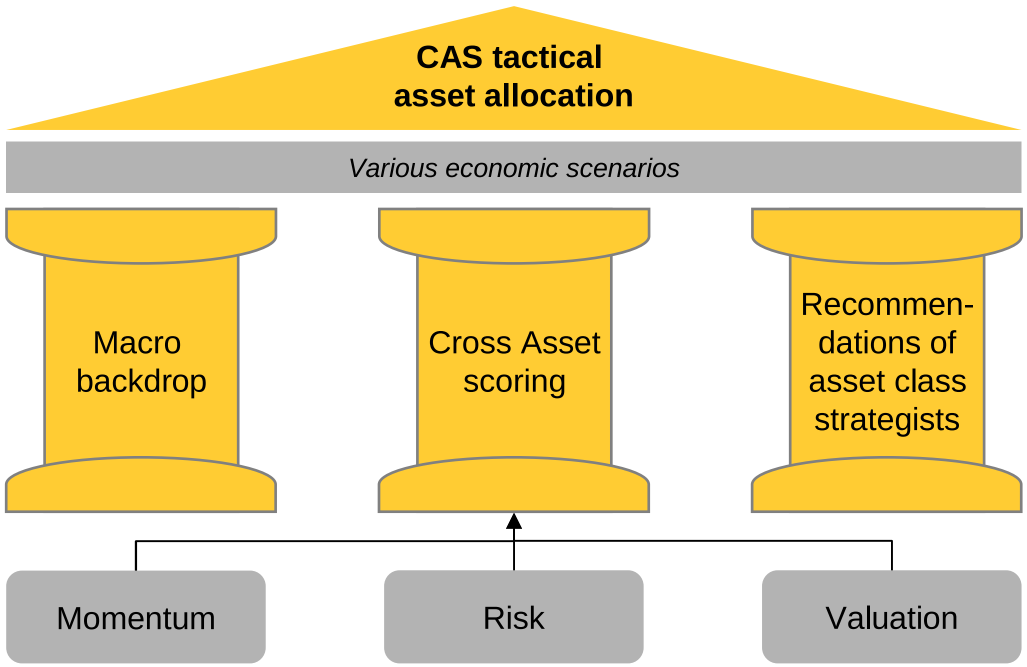
Commerzbank research

An overview

Introducing Commerzbank Cross Asset Strategy

An integrated approach to yield a consistent ‘house view’

- Using a multi-asset, multi-strategy approach, Commerzbank Cross Asset Strategy combines individually back-tested models in a transparent process to rank asset classes as well as equity regions and commodity sectors according to various momentum, valuation and risk criteria.
- Combining the **macro outlook** from our economists with the **recommendations** of the individual asset class strategists and the relative attractiveness of asset classes signalled by our **models**, we aim to create a consistent investable view on markets across asset classes (‘House View’).
- We arrive at tactical asset allocation calls, which are illustrated by an active positioning relative to a subjective benchmark.



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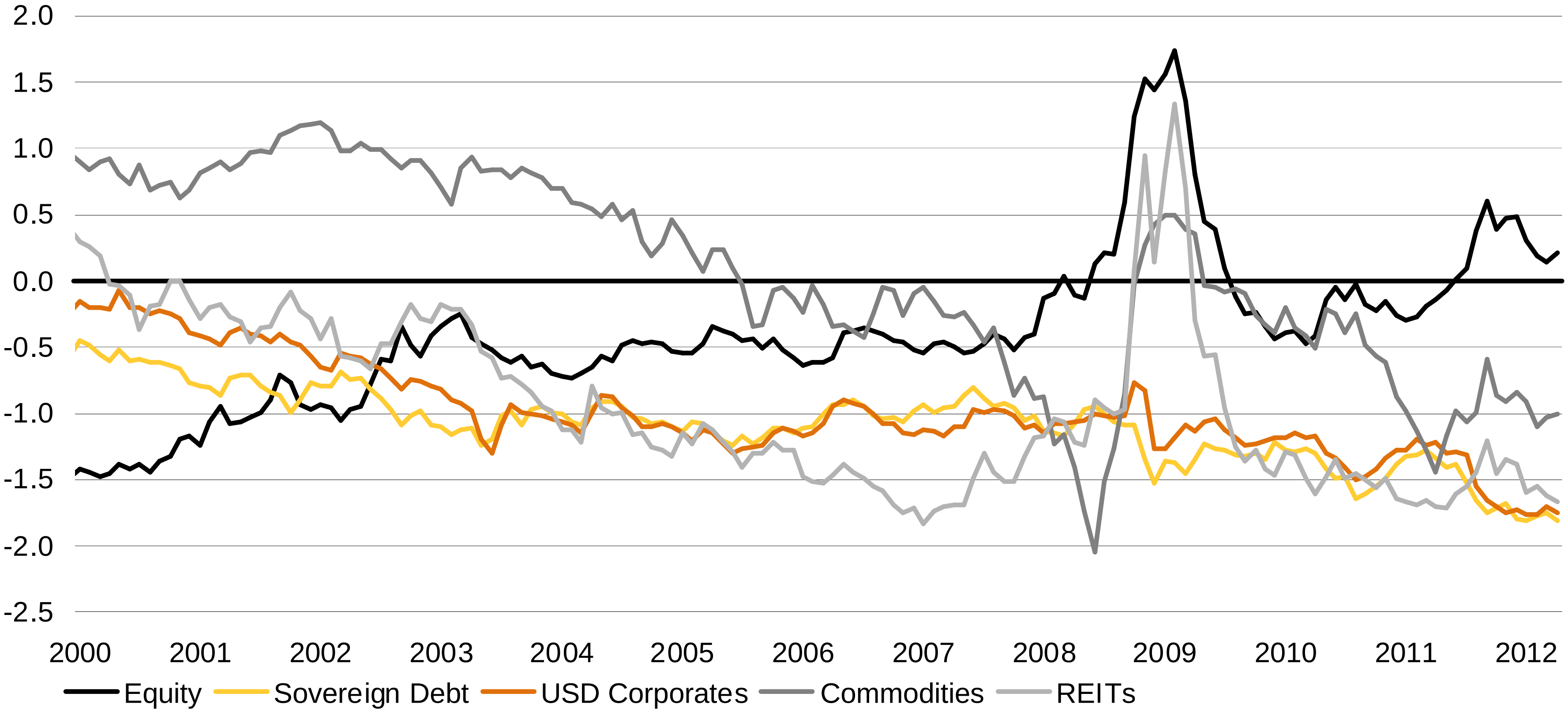
Relative valuation of asset classes

A Cross Asset Strategy valuation model as an example

Equities more attractive on valuation grounds than sovereign fixed income

Yields (respectively real prices) in standard deviations relative to 38-year average

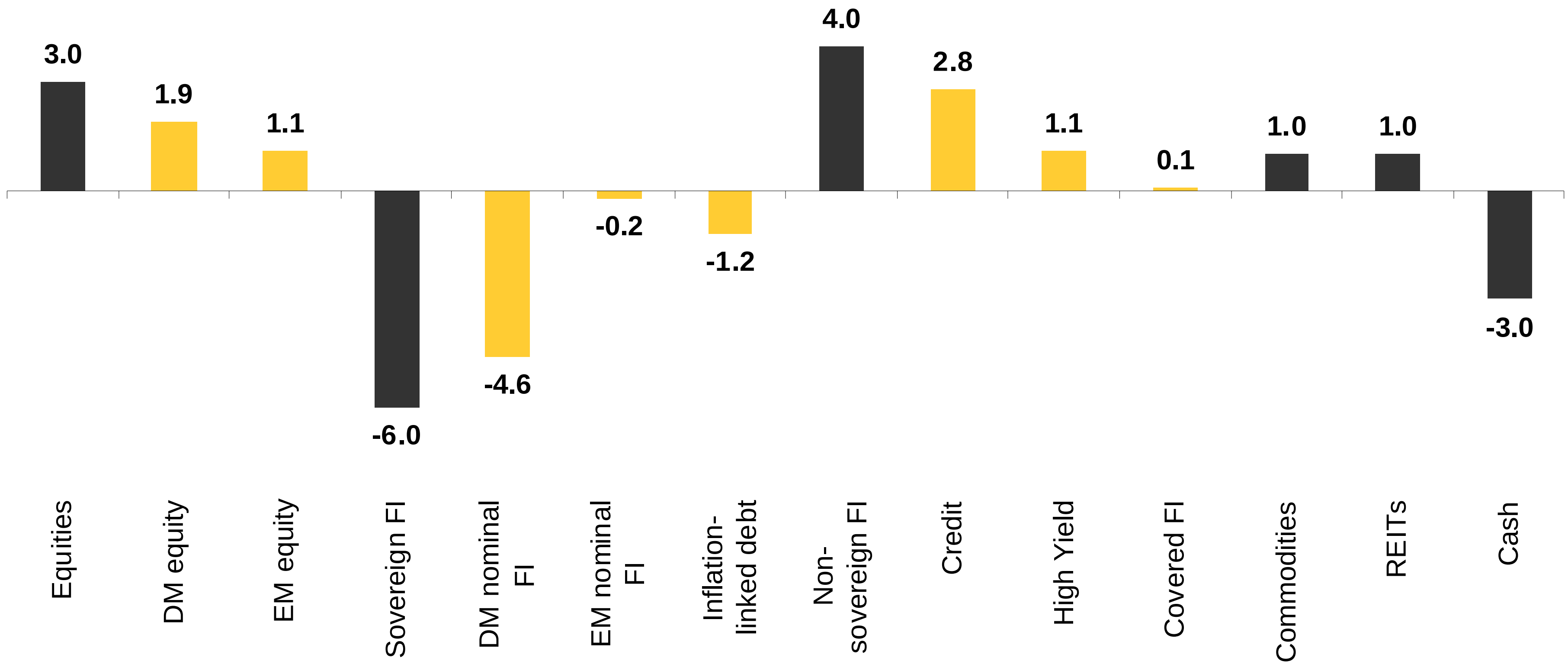


Source: Bloomberg, Commerzbank Corporates & Markets

Current Cross Asset positioning

Prefering risk assets and – due to a positive carry – investments in non-sovereign fixed income

Active asset class weights relative to subjective benchmark (in percentage points)



Note: Orange bars show a more detailed distribution of the active weight within the asset class

Systematic Strategies

Systematic Strategies as an investment

Systematic Strategy Indices are seen as a core investment by institutional investment committees and retail investors. Indexed portfolios account for an estimated 40% of institutional assets and up to 15% – 20% of retail.

The Indices and Strategies team at Commerzbank Corporates and Markets delivers off-the-peg and bespoke indices and strategies, fulfilling individual client needs in terms of risk/reward capture, preferred underlyings, currency and wrapper requirements.

Drawing on the long-standing structuring expertise within Commerzbank, the Indices and Strategies team is skilled in devising transparent rules-based beta strategies that systematically capture market returns, while limiting downside risk.

Equally, the team can deliver state-of-the art alpha strategies that use proprietary technology and algorithms to identify market direction, to deliver absolute returns under different market regimes and hedge fund- like performance.

Alternative asset allocation: Risk Allotment Strategy

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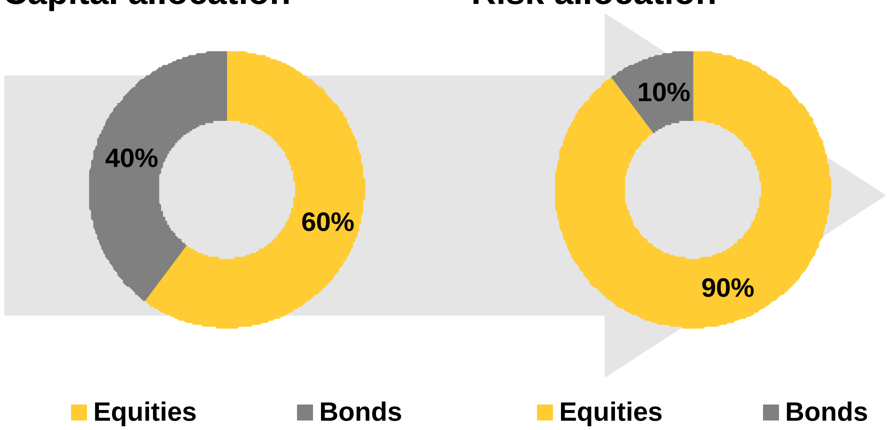
Risk parity / Balanced Risk concept

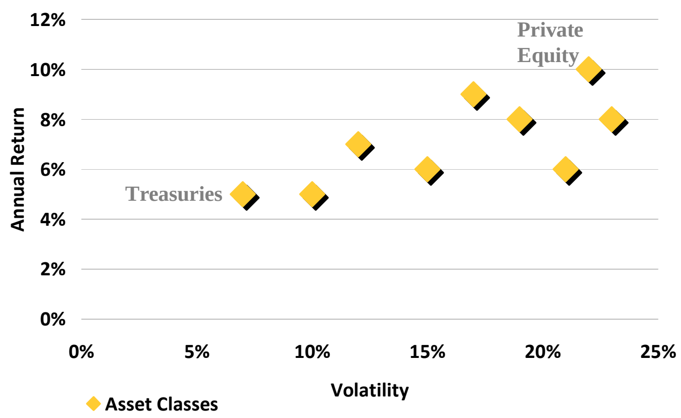
Strategy background

- Risk parity or equally-weighted risk contribution is an alternative approach to portfolio allocation. Rather than focusing on capital allocation, risk parity allocations are risk driven.
- The risk parity concept addresses the issue that capital driven allocation results in counterintuitive risk allocation. For example, the traditional portfolio (60% Equities/ 40% Bonds) is overexposed to equity risk.
- The principle of risk parity is to leverage low risk assets and deleverage high risk assets such that the risk contribution from each asset/asset class is the same.

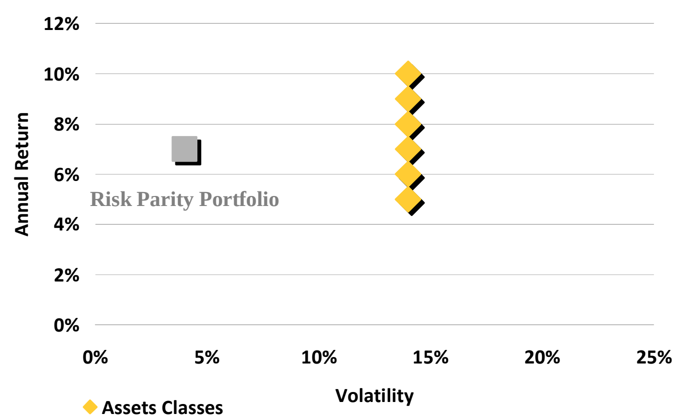
Capital allocation **Risk allocation**



Underlying universe



Risk parity portfolio



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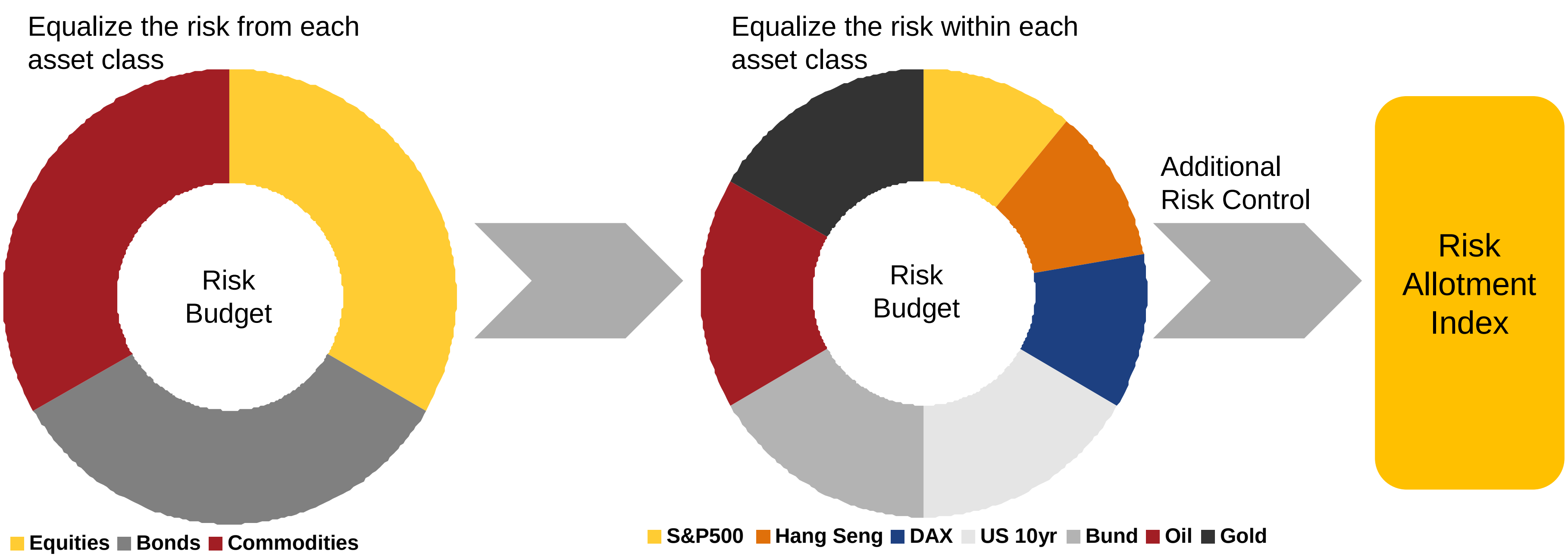
Risk Allotment mechanism

- The Risk Allotment mechanism is a completely transparent and systematic process.
- The strategy is long only and the maximum exposure is 100%.
- The aim is to equalize the risk from the top down.
  1. The strategy equalizes the risk from each asset class.
  2. The strategy equalizes the risk within each asset class.
- An additional risk control mechanism is applied on top of the strategy.



Risk Allotment

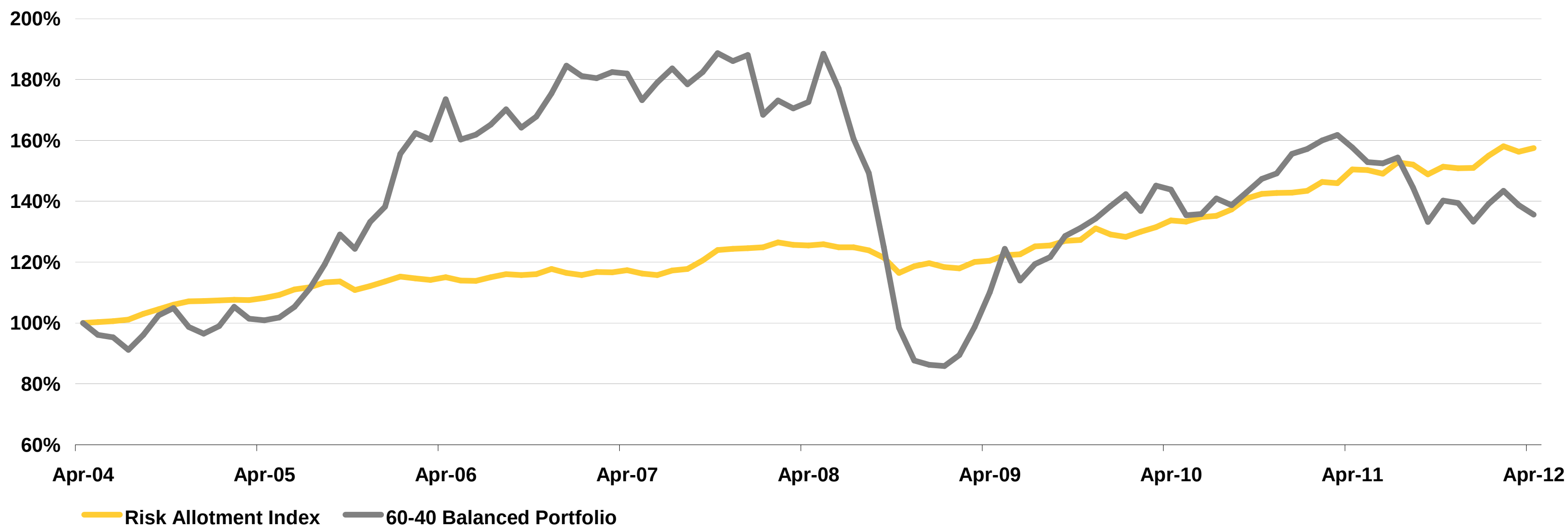
Key backtest performance data*

In backtest, the Risk Allotment strategy shows:

- Consistent performance in different market regimes.
- Low correlation with a Balanced Portfolio (Equities and Bonds).
- Maximum drawdown of 8%, recovering within 11 months.

	Risk Allotment	Balanced Portfolio
Annualized Return	5.8%	3.9%
Annualized Volatility	4.3%	19.6%
Max Drawdown	8.0%	54.5%
Time to Recover	11 Months	38 Months SIR**
Correlation	-	0.49

**SIR = Still in Recovery



* Please note that Risk Allotment performance is based on Backtest data. Source: Commerzbank, Bloomberg. Period: 2004 – 2012

Risk Allotment

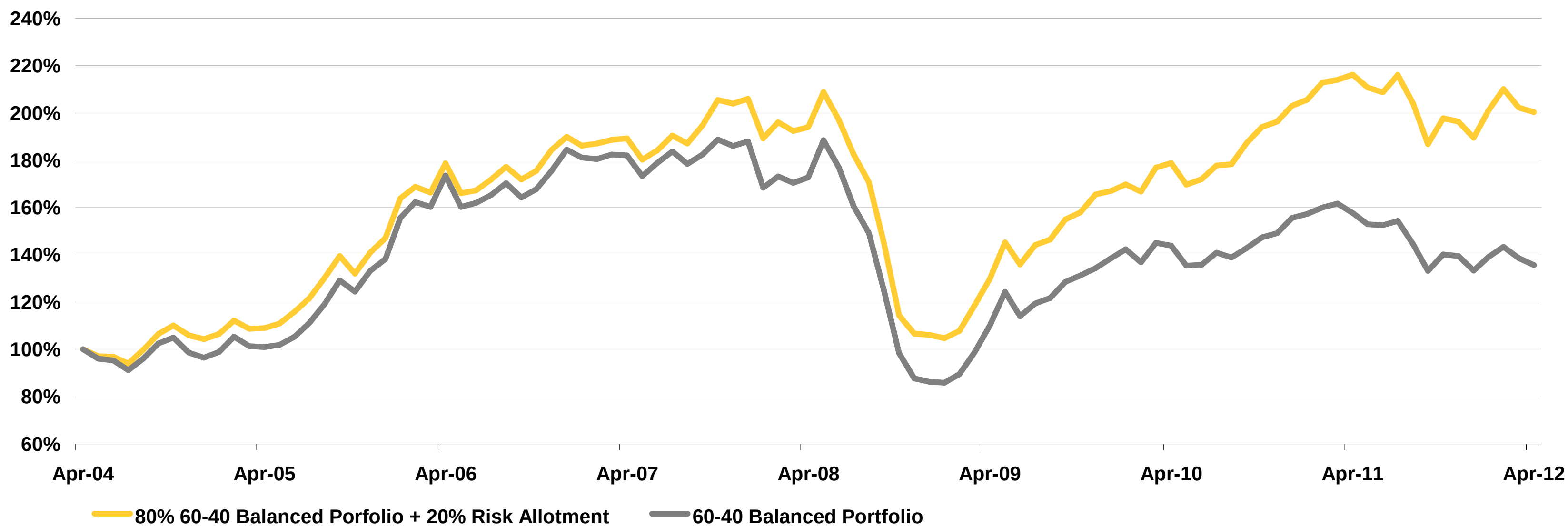
Adding some Risk Allotment to your existing portfolio

An 80% exposure to a balanced portfolio + 20% invested in a capital protected note on Risk Allotment RUB* may be expected to offer improved performance and a shorter time to recover.

*Assumes a notional capital protected note on Risk Allotment RUB ER Index offering 500% participation and 100% capital protection.

	Balanced Portfolio	Modified Balanced Portfolio
Annualized Return	3.9%	9.1%
Annualized Volatility	19.6%	18.2%
Max Drawdown	54.5%	49.9%
Time to Recover	38 Months SIR**	25 Months

**SIR = Still in Recovery



* Please note that Risk Allotment performance is based on Backtest data. Source: Commerzbank, Bloomberg. Period: 2004 – 2012

Alpha in Equity and Commodity Markets: Fast Momentum Strategy

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Fast Momentum 7% Index

A simple and systematic solution

› Commerzbank Fast Momentum 7% Index invests long or short in one underlying out of a diversified basket based on its absolute return.

› The aim of the strategy is to capitalize on current market trends by identifying the one underlying with the highest absolute return (positive or negative).

Key Features

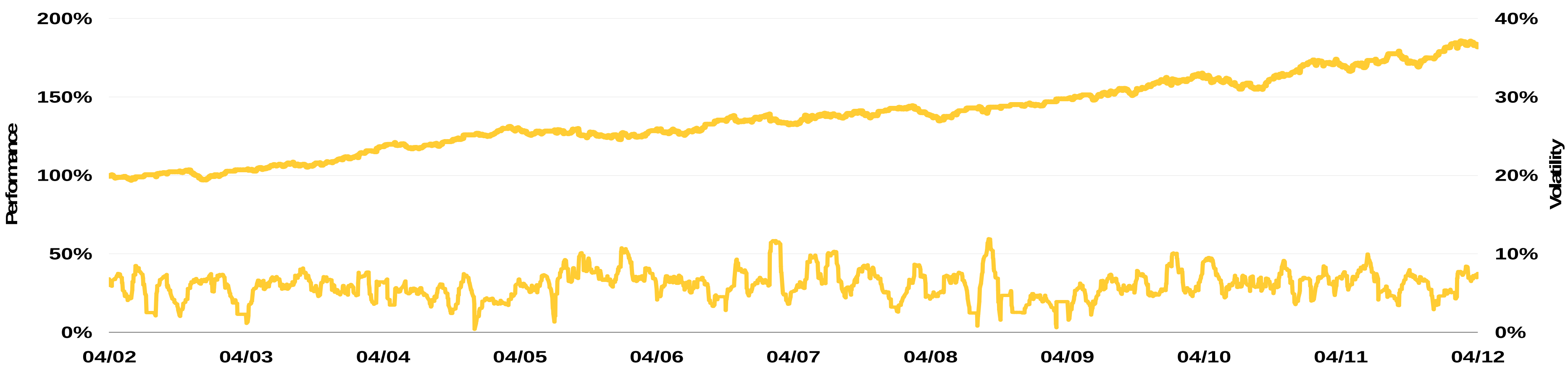
- The index is rebalanced **monthly**.
- The index invests in the underlying asset with the **highest <u>absolute</u> return last month** (negative or positive).
- When the return for the selected asset was **positive** during the last observation period then a **long** position is taken in the relevant futures.
- When the return for the selected asset was **negative** during the last observation period then a **short** position is taken in the relevant futures.
- The index has a **volatility control** mechanism that reduces market risk.
- The index has an **optimal exit function** which closes positions which have exceeded their expected return.

Assets	Market Exposure
EURO STOXX 50	European Equity
DAX	German Equity
S&P500	American Equity
Hang Seng	Asian Equity
Basket of Brent Crude and Gold	Commodity

Fast Momentum Excess Return Indices – Historical Analysis

	Commodity Basket	EURO STOXX 50	DAX	S&P500	Hang Seng	Fast Momentum Excess Return
Annualised Return	9.5%	-1.5%	3.0%	0.8%	5.7%	**6.2%**
Volatility*	27.2%	20.2%	23.2%	15.2%	20.2%	**5.1%**
Sharpe Ratio*	0.27	-0.18	0.03	-0.09	0.18	**1.20**
Max Drawdown*	47%	54%	52%	47%	52%	**5%**

* The frequency for measuring statistics is monthly.



Source: Commerzbank Corporates & Markets Data for the period 04.2002 – 04.2012. All performances are in EUR (backtested data)

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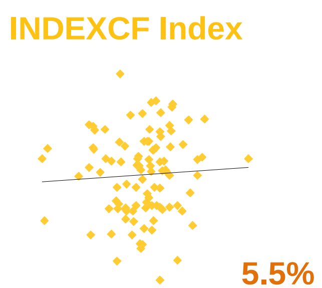
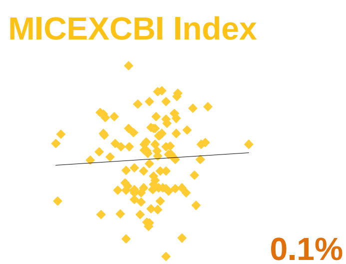
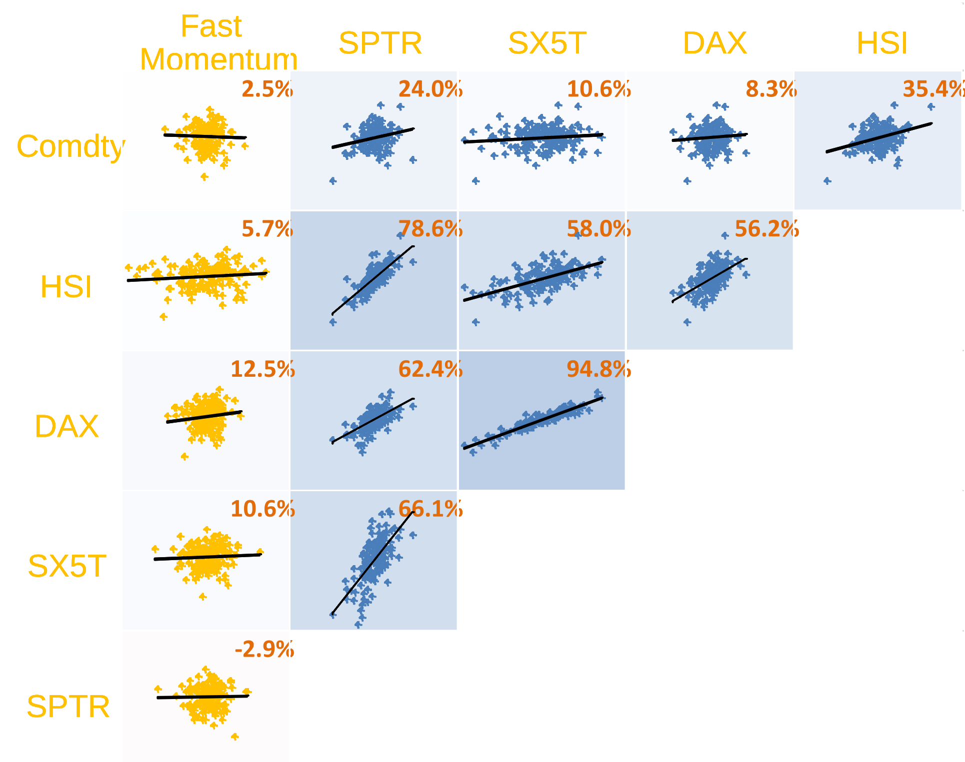
Fast Momentum Excess Return Indices – Correlation Matrix

› Fast Momentum has a low correlation with its underlyings and also with Russian equities and bonds.

› Therefore, the strategy acts as a good diversifier in an existing portfolio.







•The frequency for measuring statistics is monthly.

Source: Commerzbank AG. Data for the period 04.1999 – 04.2012. All performances are in EUR (backtested data)

Protection against inflation: Fast Commodity Momentum

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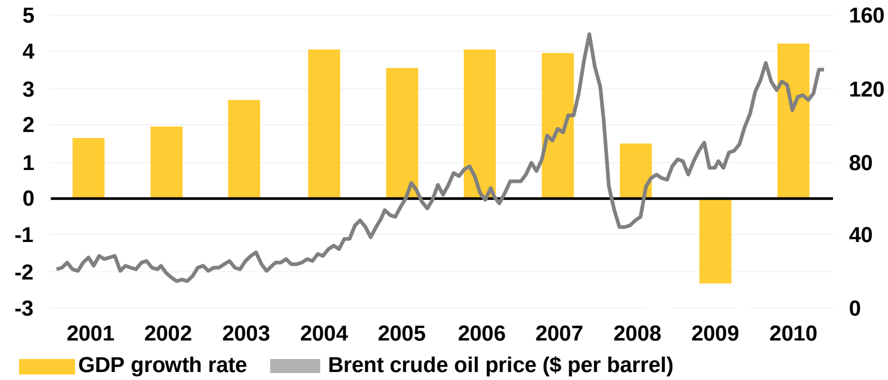
Oil and Gold relationship

Oil as an economic indicator[1]

- Oil prices reflect the health of the global economy. If the economy is growing, high demand pushes oil prices up
- However, in times of uncertainty, people tend to consume less thus resulting in decreasing demand for oil



Source: Bloomberg, World Bank, Commerzbank

Gold as a “safe haven” asset

Gold as a commodity tends to increase in value in times of uncertainty and is mainly seen as a “safe haven” asset

During crises, investors tend to flee stocks and buy gold massively

Rationale behind the ratio

- The Oil-Gold ratio can be seen as a bellwether of the global economy
- The ratio tends to increase in times of growing economic activity and decrease during times of uncertainty

Note: (1) F. Ravazzolo, P. Rothman, 2011, Oil and US GDP: A Real-Time Out-of-Sample Examination
L. Ghalayini, 2011, The Interaction between Oil Price and Economic Growth

Fast Commodity Momentum – Economic Signal

1.

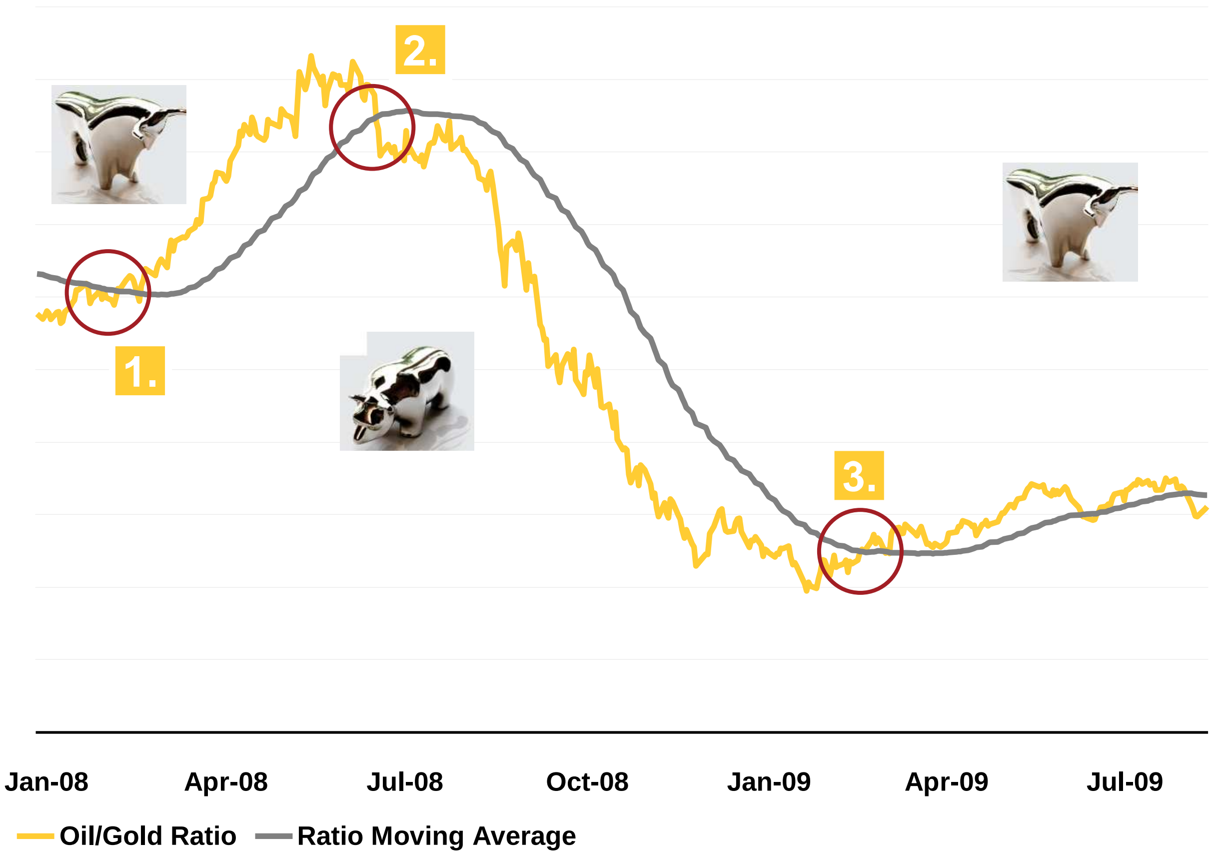
- The ratio is above its moving average. It is associated with a bullish trend.
- Invest in Oil, Oil is outperforming Gold

2.

- The ratio goes below its moving average, it is associated with a bearish trend
- Invest in Gold, Gold is outperforming Oil

3.

- The ratio goes again above its moving average, this is a new bullish trend.
- Invest in Oil, Oil is outperforming Gold



Source: Bloomberg, Commerzbank

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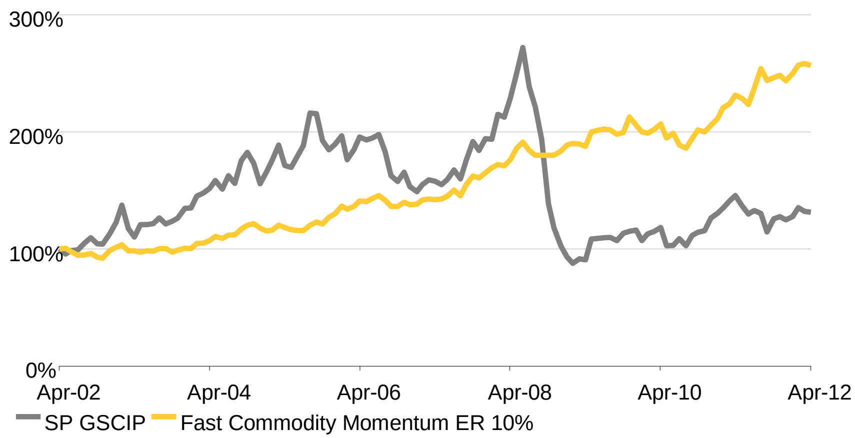
Fast Commodity Momentum – Summary

- Strategy:
  - The Index is rebalanced **weekly**
  - The Index is based on a **long-only** strategy
  - The investment is allocated to the single asset satisfying the “**economic criterion”**
  - A **momentum** filter allows the strategy to preserve capital by exiting the market if the upside is limited. The strategy waits until there is a high probability of positive returns before making an investment
  - The investment is **risk controlled** via a volatility cap mechanism
  - The currency is **USD**



Fast Commodity Momentum	
IRR 9.88%	Vol 9.51%

SP GSCIP Index	
IRR 2.76%	Vol 24.79%

All the indices are expressed in **USD** and are **excess return**. The values are based on the backtested performance on **10 years** from Apr-2002 to Apr-2012. Computations from Monthly data.

Source: Bloomberg, Commerzbank, Apr 2012

Fast Commodity Momentum – How to hedge Inflation Risk?

- An obvious way to protect your portfolio against inflation risk are linkers (aka inflation linked bonds). However, they present low returns.
- Inflation consists in general of increases in the prices of goods and services. So an alternative and intuitive way to obtain exposure to inflation is to invest in commodities directly.
- During periods of high inflation / negative real interest rates, Equities and Bonds tend to perform poorly while Commodities and other hard assets tend to appreciate in value as they generally show a higher correlation with inflation (see table below over 5 years from 2007 to 2012).
- Rising inflation is one of the macro environments where **stocks and bonds are negatively correlated**. It is hard for investors to time the purchase of inflation protection. By the time the inflation threat is imminent, protection could be too expensive and investors may hesitate to pull the trigger. So implementing inflation protection should be part of a strategic asset allocation decision – with tactical shifts made only at the margin.
- Usually, investors hedge against inflation risk by increasing exposure to commodities. Commodities volatility tends to discourage large exposures to this particular asset class.

	Equities (MICEX Index)	Bonds (MICEX Corp Bond Index)	Commodities (SP GSCIP)	Fast Commodity Momentum
Correlation with inflation	-7.4%	8.7%	41.5%	**77.2%**

Computations from Annual data from Jan 2002 to Jan 2012

Source: Bloomberg, Commerzbank

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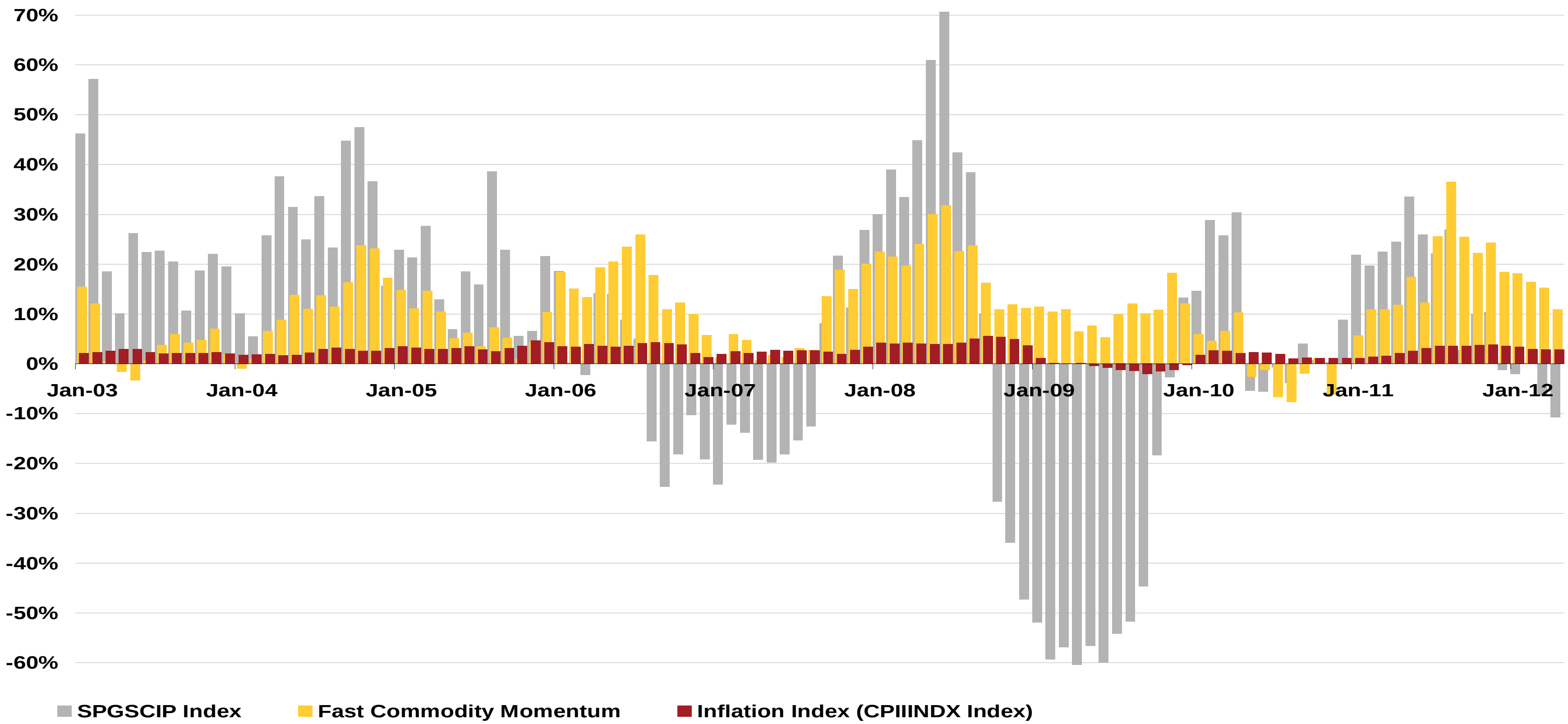
1 year rolling performance vs Inflation & Commodity Benchmark



- Fast Commodity Momentum exceeds inflation on a 1 year rolling window much more often than commodities
- The strategy avoids large drawdowns of traditional commodity investments (2007 & 2009)

Source: Bloomberg, Commerzbank, Backtested data for the period 01.2002 – 04.2012 (since launch).

Capital Guaranteed Notes Offers

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Capital Guaranteed Notes Offers

Commerzbank is able to price a wide range of exotics on its indices (Asian tail, periodic coupons, etc.)

Below are some examples for a 4 year note in RUB with 100% capital guarantee.

Therefore at maturity the payoff is:

Payoff = 100% + Participation * Max(0, Performance-Strike)

	Risk Allotment	Fast Momentum	Fast Commodity Momentum
10 y Backtested IRR*	6.1%	6.2%	9.9%
Reoffer Price	97.5%	97.5%	97.5%
Capital Guaranteed	100%	100%	100%
Participation**	**500%**	**350%**	**175%**

Source: Commerzbank AG. *Backtested data for the period: Apr 2002 – Apr 2012. **Indicative offers on the 14/05/2012.

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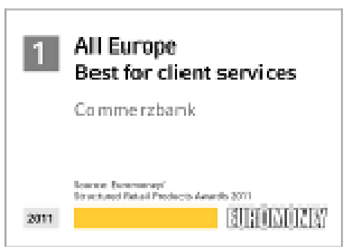

Спасибо за внимание!
Thank you for your attention

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Volatility Target Mechanism

- A volatility control mechanism targets a consistent level of risk, aiming to reduce losses from short term counter-trends
- The strategy targets a relatively low volatility, decreasing exposure as volatility increases beyond this target
- A conservative volatility target results in low option prices:
  - Products can be structured to offer >100% capital protection or >100% participation in the strategy performance