As an industry, we now have a better understanding of the underlying drivers of risk and return and have an array of strategies aimed at capturing the equity risk premium. Our clients often ask for guidance on how to combine the various ways to gain equity exposure across traditional capitalization-weighted indexing, single- or multifactor smart beta, enhanced and higher alpha active strategies. While there is no one-size-fits-all answer, we believe there are some guidelines that can help institutions arrive at an optimal structure for their risk and return objectives.

**Tools of the Trade**

Having helped global institutional investors of all sizes and objectives for more than 40 years to build efficient portfolios, we believe there are a few principles that will help investors think about the appropriate choices. Our research-driven, systematic approach to investing informs how we think about the potential implementation methods for equities.

We begin with our belief that certain structural factors (technology, demography, globalization) are likely to keep equity returns lower for the next 25 years than they have been for the last 25 years. That means that many asset owners will be unable to achieve their long-term return targets through traditional equity beta or index-based strategies alone. At the other end of the equity spectrum, very large asset owners like sovereign wealth funds or multi-billion dollar pension plans will find it hard to find the necessary scale by relying solely on concentrated active equity strategies.

**The Over-diversification Dilemma**

Moreover, our Investment Solutions Group has found that many active equity management programs are over-diversified. In other words, our analysis has shown that asset owners who have hired multiple active equity managers (usually around 10 or more) are often deriving limited idiosyncratic alpha and quite a bit of factor premia they could capture in a more cost-efficient way. They are in effect paying high active fees for limited value-add.

**Equity Core and Satellite Framework**

Most investors will need some thoughtful combination of equity beta and alpha to achieve their objectives. We suggest asset owners focus on building a strong, capital-efficient equity core with a complementary set of alpha drivers (the satellites). The role of the core is to deliver equity beta with all of the attributes that it provides in a broader portfolio context — risk, return, correlation, etc. The satellite strategies are meant to deliver incremental alpha over a predetermined time frame (typically a market cycle) with a high degree of confidence.
When Every Bip Counts: Building a Capital-Efficient Equity Program

While there is no hard and fast rule about how much of the equity portfolio should be dedicated to the core versus the satellites, we believe a reasonable starting point would be 50/50. This combination may be calibrated based on the size of the overall equity allocation, the asset owner’s confidence level in alpha opportunities, fee constraints, short-term risk and tracking-error considerations as well as other constraints and objectives.

Start with a Strong Core

The core part of the portfolio needs to deliver the desired beta exposure, which means that it should generate market-like returns, risk and correlation to other asset classes. There are several ways to build the core allocation with one or more of the following approaches:

- Traditional capitalization-weighted indexing.
- Enhanced indexing, which retains the appropriate level of risk control to mirror the attributes of a standard index but also provides exposure to targeted factor premia.
- Multifactor smart beta, which can also be managed tightly to the desired index exposure.
- A multi-manager portfolio of complementary active managers might also form the core, but there is limited ability to ensure that this approach will deliver the appropriate risk control and benchmark beta over time.

We believe that the best starting point for a core portfolio is an enhanced indexing approach, given the outlook for modest equity returns, the desire for appropriate beta exposure and risk control, as well as the sensitivities around high active management fees. Given the quantitative nature of enhanced indexing, it is especially appropriate for larger plans that need to scale their core equity exposure.

For asset owners with greater fee sensitivity, who are still interested in generating excess return, a multifactor smart beta approach might also be a good core allocation. This approach has the benefit of transparency regarding the factor drivers of excess return and may be particularly attractive to investors who accept the academic underpinnings of such strategies.

**Figure 1: Enhanced Index vs Multifactor Smart Beta Guidelines**

<table>
<thead>
<tr>
<th>Client Consideration</th>
<th>Enhanced Index</th>
<th>Multifactor Smart Beta</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risk Tolerance</strong></td>
<td>Low tolerance for risk</td>
<td>Higher tolerance for risk</td>
</tr>
<tr>
<td></td>
<td>• Client does not want to deviate meaningfully from the benchmark</td>
<td>• Benchmark is considered but not tightly tracked</td>
</tr>
<tr>
<td></td>
<td>• Investment process is tightly risk controlled</td>
<td>• Client is comfortable with higher tracking risk: 3% to 6%</td>
</tr>
<tr>
<td></td>
<td>• Low tracking risk: 0.25% to 1.25%</td>
<td></td>
</tr>
<tr>
<td><strong>Outperformance Driver</strong></td>
<td>Proprietary alpha</td>
<td>Non-proprietary alpha</td>
</tr>
<tr>
<td></td>
<td>• Outperformance driven by manager skill</td>
<td>• Outperformance driven by factor exposures</td>
</tr>
<tr>
<td></td>
<td>• Clients value manager skill and are willing to pay higher fees for it</td>
<td>• Factor exposures are not proprietary. Because of this, fees are generally lower</td>
</tr>
<tr>
<td><strong>Time Horizon</strong></td>
<td>Shorter horizon for performance</td>
<td>Longer horizon for performance</td>
</tr>
<tr>
<td></td>
<td>• Lower tracking risk leads to more consistent alpha pattern</td>
<td>• Factors outperform over the long term, but in the short term can be cyclical</td>
</tr>
<tr>
<td></td>
<td>• Appropriate for clients who have less tolerance for short-term underperformance</td>
<td>• Clients should have a higher tolerance for short-term alpha volatility</td>
</tr>
<tr>
<td><strong>Transparency</strong></td>
<td>Non-transparent</td>
<td>Transparent</td>
</tr>
<tr>
<td></td>
<td>• A proprietary research process drives alpha</td>
<td>• Follows a transparent, rules-based process</td>
</tr>
<tr>
<td></td>
<td>• Managers do not provide full transparency into the portfolio construction process</td>
<td>• Because the process is not proprietary, portfolio construction can be disclosed</td>
</tr>
</tbody>
</table>

Source: SSGA
Building the Satellites

As the satellites are meant to deliver excess return, there is a higher tolerance for risk, whether in terms of tracking error, style, concentration, etc. Asset owners will also be expected to pay higher fees to achieve the higher return.

Once again, several approaches can act as effective satellite strategies:

• Traditional active management, either fundamental or quantitative.
• Multifactor or single factor smart beta.
• Enhanced indexing.
• Other alpha strategies, such as tactical asset allocation, long/short equity, and private equity.

As noted, it is important that asset owners analyze their active managers to ensure they are generating true idiosyncratic returns beyond factor premia only. Where multiple active managers in aggregate provide more factor risk than stock-specific risk, we believe asset owners are better served by allocating to a factor-based strategy, whether smart beta or an enhanced strategy. Both of those approaches will provide a more capital-efficient solution to harvesting factor premia rather than paying higher active management fees.

The benefit of using smart beta to replace multiple active managers is that it is highly customizable. Smart beta approaches can involve a single factor or multiple factors, the tracking risk can be calibrated up or down to manage the risk and return characteristics and the smart beta exposures themselves can be managed over time, depending on the asset owner’s view of the market opportunity.

Active management of all types (systematic or fundamental) may be used in the satellite depending on the investor’s confidence in the strategy’s alpha opportunity, the alpha target, fee considerations and risk parameters.

While every asset owner will have unique specifications, we believe equity investors today have a far more versatile toolkit at their disposal for building equity programs that enable a much more efficient deployment of risk and fee budgets.

At a time when every bip counts, asset owners should carefully assess the kinds of equity approaches they want to use to target their risk and return objectives with fees that are properly and transparently aligned to the value added to their portfolios.
When Every Bip Counts: Building a Capital-Efficient Equity Program


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A Smart Beta strategy does not seek to replicate the performance of a specified capital-weighted index and as such may underperform such an index. The factors to which a Smart Beta strategy seeks to deliver exposure may themselves undergo cyclical performance. As such, a Smart Beta strategy may underperform the market or other Smart Beta strategies exposed to similar or other targeted factors. In fact, we believe that factor premia accrue over the long term (5-10 years), and investors must keep that long time horizon in mind when investing.

While diversification does not ensure a profit or guarantee against loss, investors in Smart Beta may diversify across a mix of factors to address cyclical changes in factor performance. However, factors may have high or increasing correlation to each other.

Investments in mid-sized companies may involve greater risks than in those of larger, better known companies, but may be less volatile than investments in smaller companies. Investments in small-sized companies may involve greater risks than in those of larger, better known companies.

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