The Case for Enhanced Active Strategies

White Paper
May 2025

Marketing Communication

For institutional/professional investors use only

STATE STREET INVESTMENT MANAGEMENT

Contents

Introduction to Enhanced Active: Improving returns, but minimizing benchmark deviation

Over the past several decades, passive investments have become the default core holding for most long-term investors—particularly those investing in scale. Cost efficiency, liquidity and simplicity are just a few of the reasons why. And while these benefits do hold merit, it is worth considering alternative approaches that offer similar exposure, liquidity, and low-cost attributes, with the added benefit of potential incremental additional returns—such as Enhanced strategies.

Traditional binary definitions of 'Active' and 'Passive' no longer reflect the reality of today. Client needs and preferences are increasingly more complex as a result of the ever-changing global landscape. This warrants a greater variety of solutions and approaches along the spectrum.

An Enhanced strategy can offer a compelling alternative for investors seeking incremental returns above the benchmark, whilst taking on a tracking error that is 0.5%–2% lower than that of a traditional active strategy. This approach preserves the foundational benefits of passive investing while leveraging the strengths of systematic active methods, where each unit of risk must be efficiently rewarded.

The elegance of an Enhanced approach is that it's not a compromise between active and passive—it is a deliberate investment philosophy and approach: active in insight, modest in risk, and designed to deliver more from the core of your equity allocation.

Enhanced strategies versus active and systematic

> **In a world where excess return is scarce and the line between active and passive is faint, enhanced strategies represent a more risk controlled form of active investing, where process and outcome are tightly aligned, and where consistency and compounding matter.”**

Enhanced Active strategies—also known as low tracking error active, or enhanced indexing strategies—are often overlooked or misunderstood. They are not diluted active management strategies, or passive strategies with a twist. They are purpose-built strategies designed to deliver modest, but consistent outperformance through disciplined, risk-aware decision-making. By operating within a clearly defined tracking error range (often 1–2%), they balance consistency with scalability—an essential combination for institutional investors facing portfolio-level constraints.

Alpha is generated by harnessing small advantages through signals

These strategies differ from traditional active approaches in how they express conviction. What distinguishes enhanced strategies is not a lack of conviction, but the way that conviction is expressed: with tight risk controls, clarity, and consistency. Every step in their design, from factor definition to trading execution, is tailored to extract small advantages in a consistent and repeatable manner. Instead of relying on concentrated exposures, enhanced strategies use signals extracted from systematic data, i.e., empirically grounded factors such as Value, Quality, and Sentiment, in addition to other drivers of expected returns such as Catalyst. These signals are integrated through a portfolio construction process that is designed for precision: systematically controlling benchmark deviations, while focusing on efficient alpha transfer and cost management. They challenge the outdated notion that meaningful alpha requires large tracking errors.

Exposures are tilted based on signal data

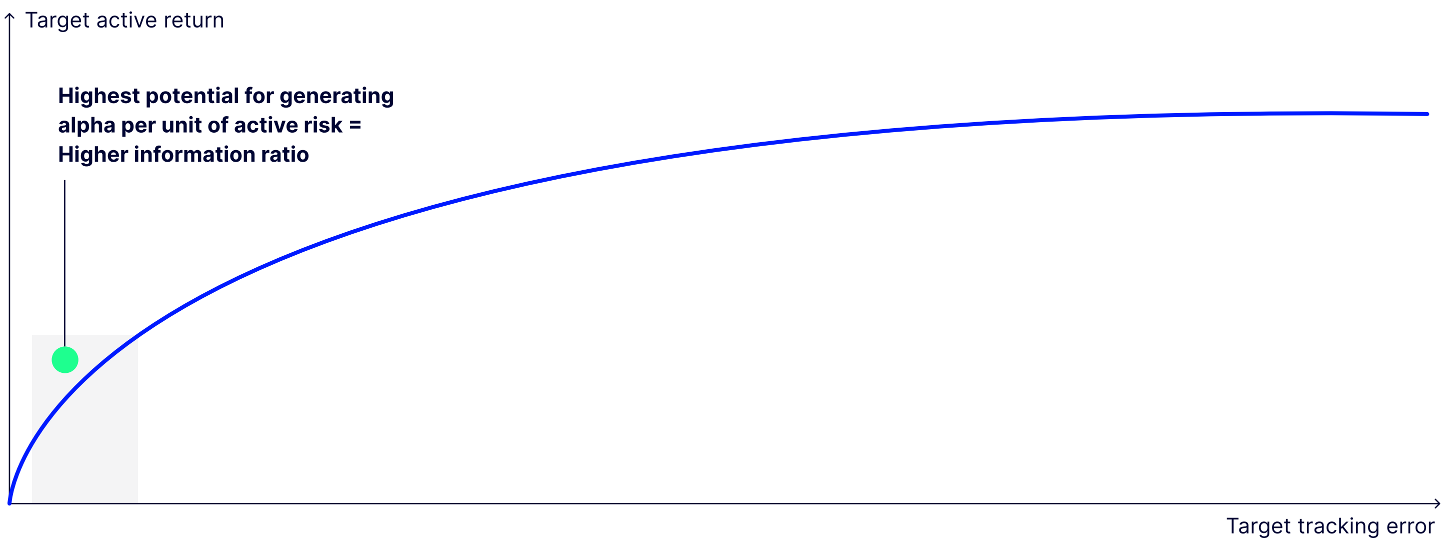
Enhanced Active strategies use systematic models to ascertain whether stocks are attractive or unattractive based on forward-looking alpha signals, and apply portfolio construction and optimization tools to modestly tilt exposures while adhering to fairly tight benchmark-relative constraints. These tilts are not arbitrary; they are designed to capture small inefficiencies across many positions, and are executed within narrow sector, country, and risk factor bounds. This produces a portfolio that remains close to the benchmark but is better informed.

Is the higher tracking error in active strategies justified?

For investors concerned about the prospect that future returns on their core portfolio assets will be lower than in the past, the potential for additional alpha from their equity allocation may be particularly welcome. At the same time, the need for portfolios to maximize return and be rewarded for each incremental unit of additional risk exposure has assumed greater prominence in the wake of the Global Financial Crisis. As risk budgets tighten further, the search for returns and yields must be more finely balanced than ever.

Figure 1 shows a hypothetical tracking error/active return efficiency frontier. As illustrated in Figure 1, the largest increase in the information ratio (IR)[1] is seen in the initial zone, within a range of tracking error typically associated with enhanced strategies. As the level of tracking error increases, the increase in active return is not commensurate. In other words, investors face a diminishing trade-off between risk and reward.

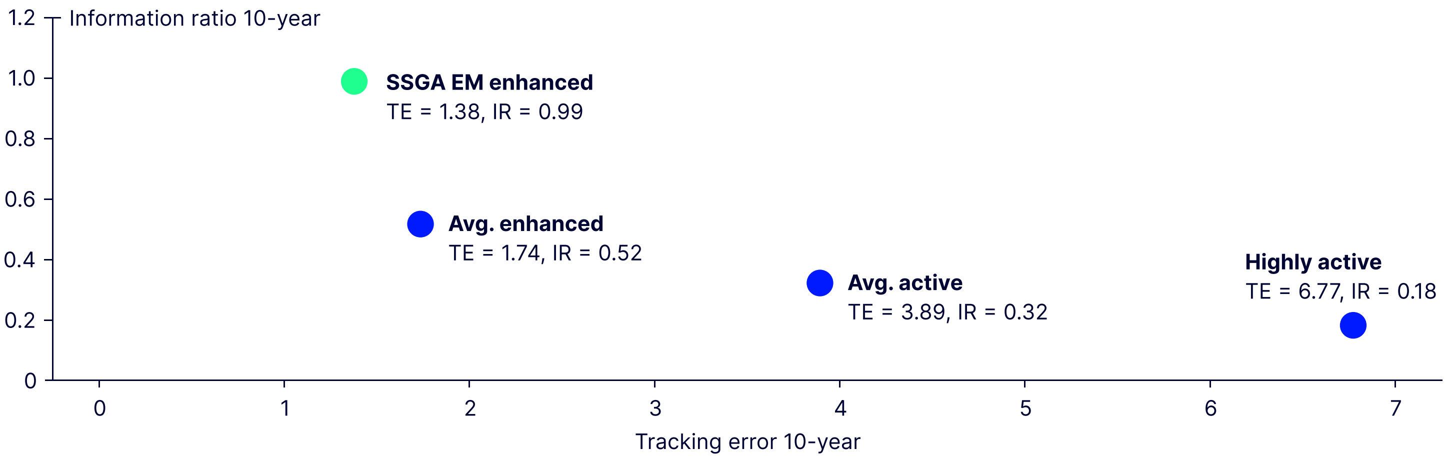
Figure 1: The Information Ratio increases most per unit of risk at a lower target tracking error range



For illustrative purposes only.

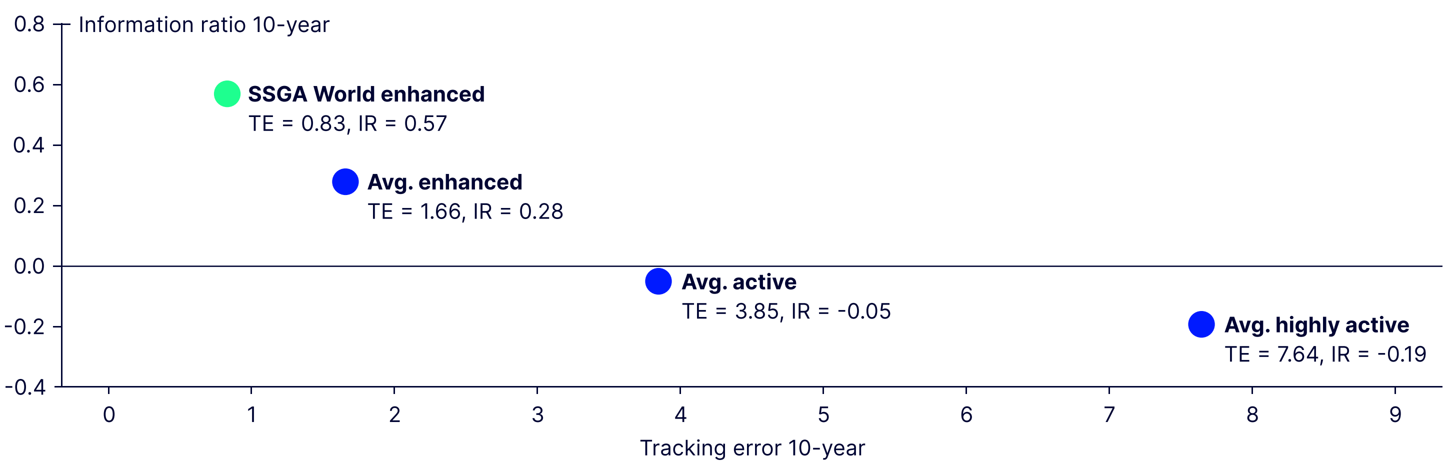
Figures 2 and 3 show the real-world impact on risk-adjusted returns given a manager's active risk levels. Figure 2 compares the IRs of the universe of emerging market (EM) active equity funds grouped by their annualized tracking error, over the past 10 years. Strategies belonging to the Enhanced group—i.e., those with tracking errors with tracking error below 2.5%—have delivered a smoother active-return profile and smaller relative drawdowns, compared with higher-alpha strategies with higher tracking error targets (strategies with tracking error between 2.5 and 5%). The highest tracking error active group, i.e, those with tracking error above 5%, only had a 0.18 IR. To analyze whether this is a phenomena specific to EM, we also evaluated the MSCI World universe in Figure 3.

Figure 2: Rolling 12-month excess return trajectory—EM enhanced versus active strategies



Source: State Street Investment Management, eVestment, as of September 30, 2025. Strategies were screened based on MSCI EM-ND or MSCI EM-GD as the benchmark for EM Enhanced. The numbers shown are trailing 10-year figures. Enhanced category represents strategies that have tracking error between 0–2.5%, Active category represents strategies that have tracking error between 2.5–5%, Highly Active category represents strategies that have tracking error greater than 5%. The numbers displayed in the chart are gross of fees. Past performance does not guarantee future results. TE stands for Tracking Error. IR stands for Information Ratio.

Figure 3: Rolling 12-month excess return trajectory—world enhanced versus active strategies



Source: State Street Investment Management, eVestment, as of September 30, 2025. Strategies were screened based on MSCI World-ND or MSCI World-GD as the benchmark for World Enhanced. The numbers shown are trailing 10-year figures. Enhanced category represents strategies that have tracking error between 0–2.5%, Active category represents strategies that have tracking error between 2.5–5%, Highly Active category represents strategies that have tracking error greater than 5%. The numbers displayed in the chart are gross of fees. Past performance does not guarantee future results. TE stands for Tracking Error. IR stands for Information Ratio.

Key benefits of Enhanced Active strategies

Enhanced Equity Strategies fall between index and higher alpha active strategies, and offer several advantages for investors:

- Target more risk-efficient alpha, up to 2% annually
- Provide the potential for an incremental addition to returns
- Tightly manage risk constraints, helping deliver a portfolio with the look and feel of the index.
- Provide a smoother return trajectory over a full market cycle compared with higher active strategies.

State Street Investment Management Enhanced Active investment process

Value, Quality, Sentiment, and Catalyst factors drive alpha generation

The core components of our multi-factor stock selection model comprise innovative and thoroughly tested alpha factors, which we believe collectively help forecast potential future excess returns within our investable universe. Each factor is grounded in a robust and clear economic rationale, and validated through a rigorous empirical testing process (see Understanding the Factor Families section below). Factors with similar rationales and correlation structures are grouped into ‘sub-themes,’ such as the ‘Sector/Industry Value’ sub-theme. The relative weights of these sub-themes are systematically determined by considering both temporal and cross-sectional variations in their effectiveness and orthogonality. These are then further consolidated into four overarching ‘themes’: Value, Quality, Sentiment, and Catalyst.

We engineered our multi-factor model with these factors, and combine them in an optimal way to assess stocks in a holistic fashion, allowing the model to generate excess returns in a variety of environments. The complementary nature of Value, Quality, Sentiment and Catalyst factors enables our model to identify attractively valued, high quality companies with strong earnings and balance sheets that are benefiting from improving investor sentiment. Using these signals, we aim to gain both an analytical and behavioral advantage over other market participants in order to capture sources of return premium.

Our stock selection model also incorporates a dynamic component (or dynamic factor), which allows us to slightly vary the exposure of Value, Sentiment and Risk attributes depending on the broader macro backdrop and the level of risk aversion in the market.

Understanding the factor families

Value

In general, we believe that firms can be valued in two fairly distinct ways. First, we consider broad-based relative valuation approaches using multiples. Some examples of these are the commonly used valuation-based metrics such as Book Value, Earnings, Enterprise Value and Sales, scaled by the denominator (i.e., Price). In the case of our Value factor family, we consider earnings measures, cash flow measures, and metrics that make adjustments to balance sheet items where applicable. The rationale for using cash flow-based measures is to guard against the possibilities of firms engaging in earnings manipulation or other forms of financial engineering.

Second, we look at sector/industry-specific valuation measures such that firms with similar business models are compared intelligently with the right framework in place. Certain metrics are more appropriate for specific industries. For example, we use different measures to evaluate a bank (where we might look at Net Interest Margin), than we use to evaluate a technology company or a real estate company. Such nuances help us rank thousands of stocks against their peers so we can reliably target higher expected returns.

Quality

Similar to Value factors, we assess company Quality in two distinct ways. One is through the lens of 'broad' Quality (factors that are applicable to all firms), and the other is through sector/industry-specific measures of quality. Within broad measures of Quality, factors can be further categorized into asset quality/financial health measures (e.g. strong balance sheet, profitability etc), sustainability measures and several others.

Within sector/industry-specific measures of Quality, we use a wide range of signals that are only applicable to companies within a specific industry group—such as airlines or mining. These signals can range from those that assess intangible assets (like R&D for Health Care and Tech stocks), or those that capture nuanced operational growth for certain types of companies (such as same store sales growth for Retailers).

Together, Quality metrics also complement the Value factor to help us identify underpriced companies that are resilient, profitable and well-managed, and to avoid buying into Value traps.

Sentiment

We include a third family, Sentiment, to allow portfolios to benefit from improving outlooks and trends in the market. The Sentiment factor family is complementary to the Value and Quality signals and is somewhat faster moving in nature. Sentiment signals are good predictors of future earnings growth, and also tend to act as diversifiers for Value signals. We assess Sentiment through the following lenses:

- Investor under-reaction based sentiment measures
- Analyst-based sentiment measures
- Hedge fund positioning-based measures to assess supply and demand imbalances in the shorting market
- Inter-company linkages and relationships, using comprehensive global supplier customer relationships for over 10,000 companies globally

Catalyst

Catalyst represents a newer group of signals that do not fall within the other three factor families. This factor family typically leverages machine learning, alternative data and natural language processing techniques to quantify signals derived from management communication, conference call transcripts and financial reports—linking language with stock returns. Catalyst contains several underlying signals that use machine learning and Large Language Models (LLMs) to assess different aspects of language such as complexity, context, tone, as well as other machine-learned signals that link language with stock returns.

Top-down views are incorporated

Additionally, we have quantitative country and sector allocation views, which incorporate top-down, macroeconomic and bottom-up (valuation, sentiment etc.) criteria to assess the relative return expectations at the country and sector level. We combine country and sector views alongside dynamic components, with the core drivers of Value, Quality, Sentiment and Catalyst for the final insights used to deliver systematic alpha.

In selecting a particular driver, we focus on what drives a company's price away from fundamentals. To best capture this, our research process starts with strong economic rationale as to why mis-pricings may occur and we scientifically test data to support or reject our hypothesis. We seek longer-term, reliable drivers based on economic and investment intuition, which allow us to minimize signal turnover in our model. Robustness of metrics are also scrutinized to maximize our confidence in factors and guard against data mining. All metrics are examined to ensure that they are not overly sensitive to definition, eligible universe, data source, market cycle or sample period.

Sustainability integration

Sustainability can mean different things to different investors. For us, as it relates to our active capabilities in the Enhanced range. We treat Sustainability explicitly in the portfolio construction process via constraints. For example, we allow bespoke tailoring along the following dimensions: arctic drilling, oil sands, thermal coal, brown revenues, carbon intensity, fossil fuel reserves and green revenues, among many others.

Sustainability is also an important factor that is fully incorporated in our investment process, and we have classified it as part of Quality Theme. Even though sustainability is a part of our Quality factor family, its correlation is very low with Quality, and therefore it adds even more diversification.

We also treat Sustainability research no differently from any other alpha research. Therefore, the principles are exactly the same. We start with an economic rationale as to why that particular branch of sustainability research has the potential for generating excess returns in the universe it is applied to. We must go through all the necessary steps of rigorous empirical in-sample and out-of-sample analysis before it is admitted in to our alpha models.

In one such example, we used a proprietary dataset to establish the innovation and adaptation that companies are undertaking along a specific climate dimension. For example, investments in "green technologies" would help us identify favorable firms in this domain. We also leveraged proprietary parent classification schemes to generate insights that are specific to green technology investments.

Our Enhanced Active capabilities

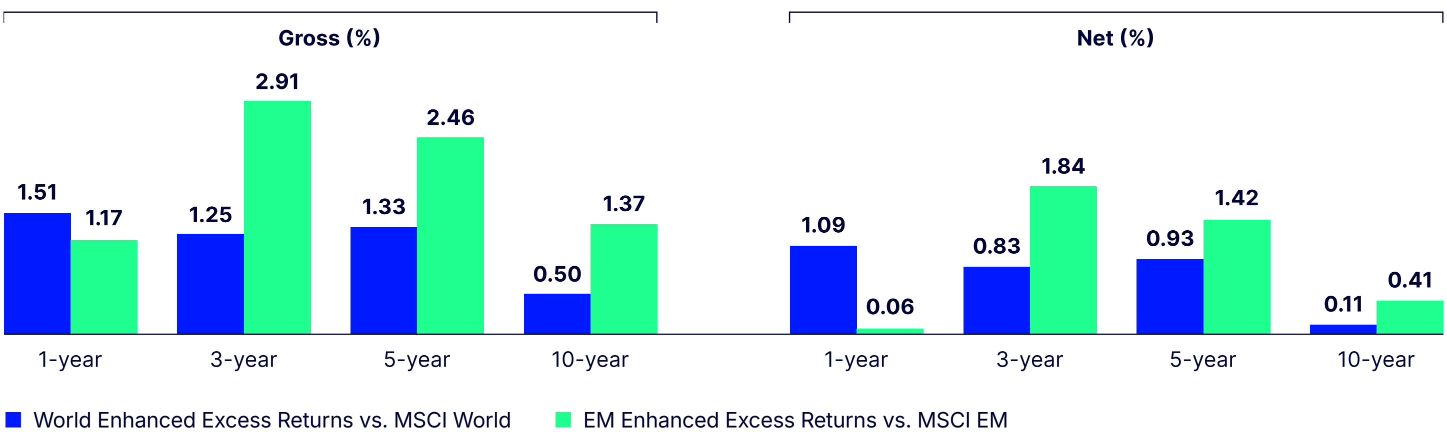
Our Enhanced Active strategies have shown solid risk-adjusted results, distinguishing themselves in the emerging market (EM) and developed market (DM) universes. The State Street Enhanced Equity Strategies aim to provide a modest amount of excess return, before expenses, while closely adhering to benchmark characteristics.

Our EM and DM track records demonstrate a beneficial mix of robust and consistent alpha, alongside thoughtful risk controlled processes. The annualized returns have been stronger in EM with an annualized gross return since inception of 1.2% whereas in the developed markets, it is 0.5% since inception. The 1-,3-, and 5-year annualized returns have been strong for both EM and DM, with EM performing well amid varied market backdrops (Figure 4).

Investment options

Our Enhanced Equity Strategies are benchmark-relative risk-controlled strategies, and are available for both Emerging and Developed markets, as collective funds, or as specialized mandates (Figure 5).

Figure 4: State Street Global Markets Emerging Markets Enhanced and World Enhanced Strategies have outperformed the benchmark



Source: State Street Investment Management, as of June 30, 2025.

Figure 5: Our enhanced capabilities

	World Enhanced	Emerging Markets Enhanced	Socially Responsible Investing	US Large Cap	Europe
Investment Universe	MSCI World	MSCI Emerging Markets	MSCI Emerging Markets	S&P 500	MSCI Europe
Inception	February 2002	July 2007	December 2012	March 1993	February 2002
Excess Return Target	0.75–1.00%	0.75–1.00%	0.75–1.00%	0.5–1.00 %	0.75–1.00%
Tracking Error Target	Up to 1.75%	Up to 1.75%	Up to 1.75%	Up to 2.0%	Up to 1.75%

Source: State Street Investment Management.

The bottom line

Enhanced Active can allow investors to receive higher returns, but with lower tracking error versus the benchmark. By incorporating data-driven fundamental signals and top-down views, Enhanced Active can provide small incremental improvements over the benchmark—without deviating sharpy from the benchmark risk profile.

At State Street Investment Management, our Enhanced Active investment team has an established track record of enhanced strategies, with strong performance relative to the benchmark and to peers. Our Enhanced Active strategies use a linear multi factor model with dynamic overlay, and our experience as a manager with about $3 trillion in indexed equity AUM[2] allows us to have the trading and systems expertise to integrate factors efficiently.

On the active side, we use our longstanding stringent research processes to help identify the signals—80 in the current model—that are most impactful to portfolio alpha. Any changes to the signals are subject to rigorous review. For clients with sustainable investing goals, we can implement customizations such as exclusion lists, climate criteria constraints, or region-specific weights.

To learn more about the Enhanced Active, email the **Systematic Equity Client Portfolio Management Team** at SE_ClientPM_Active@ssga.com.

Endnotes

1 Actively-managed equity portfolios are often evaluated by assessing the amount of active return they generate relative to a benchmark per unit of tracking error or active risk taken—a measurement known as the "information ratio." Investors typically prefer portfolios that exhibit a higher information ratio, as this implies a greater probability of positive excess returns for a given level of active risk over an investment horizon.

2 Source: State Street Global Advisors, as of March 31, 2025.

About State Street Investment Management

At State Street Investment Management, we draw from our global scale and market-tested expertise to help create original solutions and better outcomes for our clients and the world's investors.

statestreet.com/investment-management