Insights
Active Quantitative Equity (AQE)

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Building Better Equity Portfolios for Investors

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State Street Global Advisors' Active Quantitative Equities team has created unique active equity solutions that put many investors' financial goals at the centre of portfolio construction. The State Street Australian Equity Fund and State Street Global Equity Fund aim to outperform its performance benchmark with lower volatility than the performance benchmark.

Investor's Primary Objectives

Individual investors often define their primary investment objective as "grow my assets with the highest return for the least amount of risk". Investors often think of "return" as capital growth over time and "risk" as capital loss or a large variability in capital value over time.

Many actively managed equity funds respond by seeking to manage "tracking error" or deviation from the benchmark. They construct portfolios so the portfolios' securities and sectors stay close to benchmark weights. As a result, the funds' performance also stays close to the benchmark. This means that risk and return stays close to benchmark outcomes, which can be beneficial during bull markets. However, it also can also leave investors vulnerable to major market movements.

Investor Objectives:

1. Grow My Assets
2. Guard My Assets

What is True Success?

While some may say that a benchmark-relative approach is the best way to select and assess active equity managers, we believe investor objectives, not benchmarks, belong at the centre of portfolio construction.

The State Street Global Advisors Active Quantitative Equity team defines true success as not only producing "alpha", but also managing total portfolio risk. We believe there is a better, more efficient way to deliver risk-adjusted returns and to reduce the impact of market losses.

Why the Traditional "Benchmark-Aware" Approach is Limited?

Market capitalisation-weighted indices, the most common benchmarks in equity investing, pose some risks that investors should be aware of. For example, there may be stock, sector and country concentration risk in market-cap-weighted indices and this is particularly true for the S&P/ASX 200 Index, which tracks Australia's largest 200 listed companies ranked by market capitalisation.

Active Equity portfolios constructed around a benchmark rest on a belief that the index offers the greatest return for a given level of risk. Anchoring stock selection and portfolio construction to the index minimises the risk of deviating too far from the market performance. These active managers try to limit the risk of making wrong decisions about which stocks to buy by evaluating a stock's return and risk relative to the benchmark rather than considering its absolute return and risk potential. These types of active portfolios generally limit stock, sector and country weights within predetermined ranges relative to the benchmark. Tracking error constrained active portfolio's may not offer investors the optimal balance of risk and return. As a result, it may be possible to manage an active equity portfolio to deliver returns with less risk than that of a portfolio tied to a benchmark.

Also, a portfolio that's not tied to a benchmark may avoid risks from "crowding" around a benchmark. The benchmark's largest stocks and sectors can experience volatility due to the movements of large, benchmark-constrained institutional investors. This concentrated exposure can limit a manager's ability to appropriately diversify, enhance returns and manage risk for market volatility and declines.

Does Your Success Hinge on Only 10 Stocks?

The top 10 stocks of the S&P/ASX 200 Index have an outsized impact. By market capitalisation, they make up 48.8% of this 200-stock index (Figure 1), making index returns vulnerable to their gyrations, even if other stocks in the index do well. Moreover, the top seven stocks are especially lopsided, representing 41% of the total market capitalisation and just under half of the Australian equity market's risk.[1] A benchmark-constrained active manager must hold these four banks, two miners and a health care company at significant weights even if the companies' fundamentals appear poor. This may contribute to portfolios holding higher sector weights than justified by fundamentals. Financials make up 28% of the total risk of the Australian market (based on the S&P/ASX 300 Index), while Materials — which are more cyclical and sensitive to commodity demand and supply factors, account for 36% of the total risk.[2]

Figure 1
Top 10 Stocks of the S&P/ASX 200 Index

Stock	(%)
BHP Group	11.6
CBA	8.3
CSL	6.3
NAB	4.5
Westpac	3.8
ANZ	3.4
Woodside Energy	3.2
Macquarie Group	3.0
Wesfarmers	2.5
Telstra	2.1
Top 10 Stocks:	**48.8**
Remaining 190 Stocks	51.2

Source: FactSet, Axioma, S&P as of 16 January 2022. Weights are as at the date indicated, are subject to change, and should not be relied upon as current thereafter. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

The Opportunity

Unhook Your Return Potential

State Street Global Advisors' Active Quantitative Equity Team believes that you don't have to take on extra risk for the sake of tracking a traditional benchmark. Nor should you sacrifice return opportunities to manage risk as defined by deviations from a benchmark.

An opportunity exists for investment managers to remove benchmark constraints, and construct a portfolio of shares based on their individual merits. This type of strategy should be benchmark unaware, be agile to market movements and explicitly manage risk in order to deliver a more balanced outcome of return and risk.

Why Risk Management Matters for Equity Portfolios

In traditional portfolio construction, equities have been assigned the "Grow My Assets" objective and defensive investments such as cash or fixed income have been given the "Guard My Assets" objective. But what if we could incorporate both of these objectives into our approach to managing the equities portfolio? In investment terms, this can be referred to as "maximising the Sharpe ratio", or "maximising total return while minimising total volatility".

An explicit focus on volatility management in equity portfolio construction may ease the effect of volatility and negative returns. Portfolios can suffer significant losses during crises that elevate volatility and deliver negative returns that aren't easy to make up. The percentage return required to recover from a loss is significantly bigger than the original percentage lost. For example, an investment portfolio that loses 10% of its value requires an 11.1% return to break even over a one-year period. A portfolio that loses 30% of its value requires a 42.9% return to recover over a one year period.

We believe a winning strategy "makes more by losing less".

An Alternative Way to Invest

The team has developed an alternative approach to managing equity portfolios. This approach seeks to capture value whilst explicitly managing total portfolio risk. A benchmark's exposure to stocks, sectors or countries has no relevance to our portfolio construction process. This means the portfolio management team has the flexibility to buy stocks in any sector at any time, so long as they are supported by strong fundamentals. In other words, **every stock in the portfolio has a purpose.**

Complement Your Equity Portfolio

The Funds are designed for investors seeking a diversified exposure to Australian or Global Equities. They may serve as a core equity holding, potentially providing upside participation in rising markets, with an explicit focus on managing total portfolio risk.

Given the benchmark unaware nature of the Funds, they may be complemented by index and benchmark-aware active funds, and direct share holdings. Their unconstrained investment approach materially differentiates their stock and sector positions from the index, and in turn, many actively managed investment strategies. In addition, the Funds' lower risk profile and competitive fees profile could free investors' fee and risk budgets for opportunistic allocations to higher risk or performance fee strategies such as hedge funds, concentrated equities or small/micro-cap equities.

The "Low Volatility" Phenomenon We have observed a long-term phenomenon of higher-volatility stocks underperforming lower volatility stocks over many different time periods across regions and asset classes. This is not a new phenomenon or a short-term play. Potential explanations come from behavioural finance which tries to determine why people make irrational financial decisions.

They point to:

- the effect of asset managers incentivised to generate high returns by taking on more risk
- the glamour effect of investing in stocks that attract the headlines
- the herding effect due to tracking error constrained managers, which encourages market-like portfolios

However, assessing volatility is only one part of aiming to deliver risk-adjusted returns as part of a diversified portfolio. It's also important to assess company-specific factors that contribute to potential returns, such as valuation, earnings, growth prospects and sentiment when constructing a diversified portfolio. Weighting up stocks' return potential with the accompanying risks, in a benchmark unaware manner, can offer powerful benefits.

Our Approach

Research — Explore the Market's Full Opportunity Set

Rigorous and ongoing research is the first step in our active investment process. Global research professionals, portfolio managers and strategists work collaboratively to generate new ideas that refine and develop our investment process for exploring all opportunities across the entire investment universe.

The team does not screen out any companies before forming a view. Through our sophisticated systems and access to vast amounts of company data, we monitor daily every stock in the investment universe on its return and risk characteristics. We form comprehensive views on thousands of stocks and seize opportunities in all sectors and countries.

Stock Selection

Effective active stock selection requires skill and technique, vigorous research and sound risk management. By monitoring the market each day, we assess every stock based on its return and risk characteristics. This active stock selection serves as the first layer of risk management.

What We Look For:

Return We focus only on the best investment ideas, with stocks that exhibit:

- High quality
- Strong balance sheets
- Reasonable value
- Sustainable earnings and dividends
- Ability to generate internal growth
- Positive outlook

We also incorporate the impact of global investor behaviour and macroeconomic events into the stock selection model.

Risk Estimating the risk of stocks in the universe happens on three levels:

- Estimate the risk associated with a company's exposure to common characteristics such as its industry or fundamental themes like size, liquidity, value and leverage.
- Assess the stock-specific risk not explained by these common characteristics. The risks unique to an individual company could include management corruption or environmental disasters (e.g., a mine collapse or oil spill).
- Incorporate how the common characteristics move together. If groups of companies are uncorrelated, combining them can reduce overall portfolio risk

Portfolio Construction

When constructing the portfolio, we consider the return potential of a stock as well as expectations for its future volatility. We seek out stocks whose expected risk is appropriately compensated with expected return. Expected return being equal, we would typically favour a stock with a lower risk. But low historic volatility itself does not equal safety.

- **Fundamentals matter** If your historically low-risk investment exhibits, for example, poor quality of earnings, a deteriorating growth outlook or weak momentum, the past may not be a reliable guide to the future.
- **Valuations matter** If you overpay, it is unlikely you will reap a substantial return on your investment — no matter how safe the investment.
- **Risks matter** If your portfolio is diversified across sectors such as consumer discretionary, industrials, utilities, he — althcare and telecommunications, as well as financials and resources, it is more likely to successfully weather the ups and downs of the market.
- **Currencies matter** We manage currency risk using SSGA's Dynamic Strategic Hedging programme ("DSH"). Rather than choosing the Fund to be unhedged or fully hedged, we adjust the hedge ratio for each currency in the portfolio according to our medium to long term assessment of that currency's economic value relative to the Australian dollar.

Where the Fund's assets are invested in foreign securities, our approach of dynamic strategic hedging means there will not be a constant full hedge of currency risks. Currency movements relative to the Australian dollar can cause changes in the value of your investments. Currency losses are possible and, if this occurs, it will have a negative impact on the Fund's investment returns.

Investment Team and Resources

State Street Global Advisors is a global leader in asset management. Sophisticated investors worldwide rely on us for their investment needs. For more than three decades, we have contributed experience, depth of resources, strength and dedication toward a single goal: to achieve our clients' goals.

We currently manage in excess of US$21 billion[4] in a range of active quantitative global equity strategies across the risk spectrum. Our team is backed by a strong research foundation, and our core investment philosophy and process rests on practices developed over 30 years of experience. We continuously look to evolve our approach, as a result of ongoing change in both market structures and regulatory environments. Our global investment team shares insights and experience with one another so the nuances associated with different markets can be understood and exploited appropriately.

Meet the Team

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Endnotes

1 Source: FactSet, Axioma, S&P as of 16 January 2022.

2 Source: FactSet, Axioma, S&P as of 16 January 2022.

3 Sharpe ratio is calculated by dividing the funds excess return over the risk-free rate by its standard deviation. The higher a fund's Sharpe ratio, the better its returns have been relative to the amount of investment risk it has taken.

4 Source: SSGA, as at 31 December 2022.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 29 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $3.48 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as of December 31, 2022 and includes approximately $58.60 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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Investing involves risk including the risk of loss of principal. Equity securities may fluctuate in value and can decline significantly in response to the activities of individual companies and general market and economic conditions.

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

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Companies with large market capitalizations go in and out of favor based on market and economic conditions. Larger companies tend to be less volatile than companies with smaller market capitalizations. In exchange for this potentially lower risk, the value of the security may not rise as much as companies with smaller market capitalizations.

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.

Currency hedging involves taking offsetting positions intended to substantially offset currency losses on the hedged instrument. If the hedging position behaves differently than expected, the volatility of the strategy as a whole may increase and even exceed the volatility of the asset being hedged. There can be no assurance that the Funds' hedging strategies will be effective.

Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged

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