Insights
ETF Model Portfolios

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Model Matters

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Exploring the current market landscape through the lens of State Street Global Advisors' investment process

What Are We Thinking?

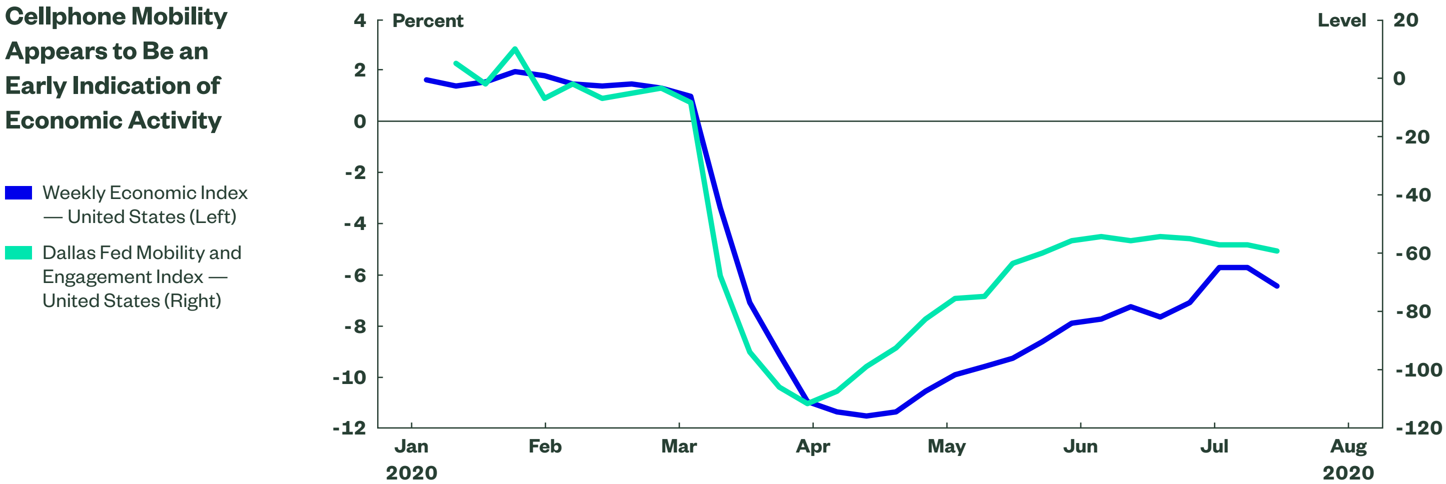
The Investment Solutions Group (ISG) still remains optimistic about the market outlook. Corporate earnings have shown improvement, PMIs continue to trend upwards, and positive economic surprises seem to be more common, but market participants are making adjustments and dampening the effects. The COVID-19 crisis also shows some signs of hope, as certain hotspots crested and then witnessed declines in community spread metrics. High-frequency mobility measures indicate that some have heeded social distancing measures — even though this might spell some short-term economic weakness, as evidenced by the high-frequency mobility data in Figure 1.

The Market Regime Indicator (MRI) now sits in a more comfortable, normal regime, as spread and equity-implied option indicators have reverted. However, some concerns remain, as the twitchier currency-implied indicators have been trending upwards. These indicators can presage new risks looming in the not-too-distant future. The indicator's track record is not perfect, but it still must be respected, as it accounts for about a third of MRI composite.

ISG's portfolio positioning has grown more nuanced. While exposure was added to large caps on the heels of better momentum, earnings and a more constructive MRI, equity exposure was reduced in Asia Pacific due its relative unattractiveness. Within fixed income, the high yield position was extended to take advantage of monetary support, attractive spreads and more benign volatility.

Figure 1
Cellphone Mobility Appears to Be an Early Indication of Economic Activity

US Cellphone Mobility vs. Weekly Economic Index



Source: Dallas Fed, New York Fed and FactSet, as of August 7, 2020.

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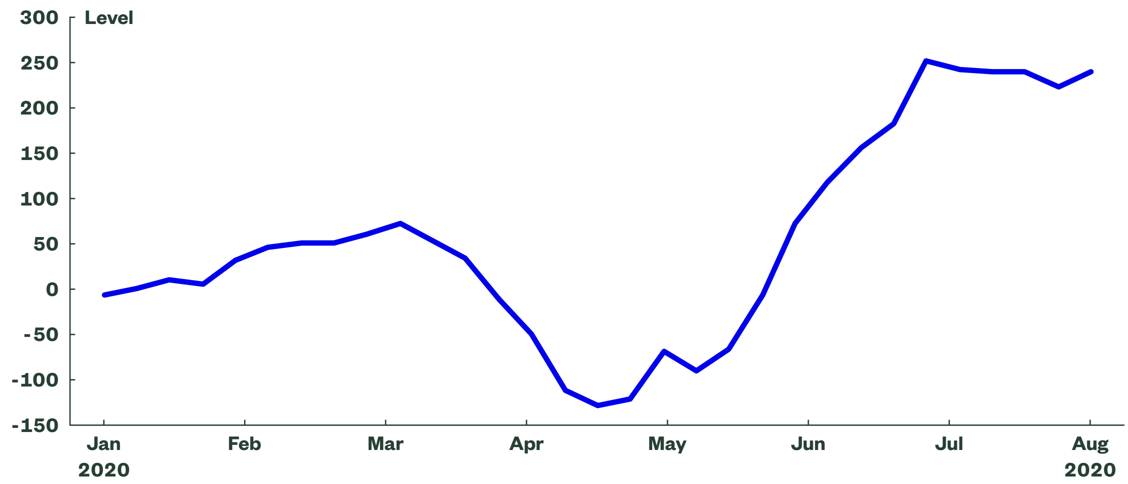
Figure 2
Surprises Seem to Be Getting More Muted, as More Market Participants May Be Anticipating Future Surprises

Citi Economic Surprise Index



Source: FactSet, as of August 14, 2020.

Package of Decisions

Managing a tactical global asset allocation portfolio is not as simple as forecasting expected returns and risks for underlying asset classes and running an optimizer to determine the best portfolio. Instead, each view and/or overweight/underweight should be regarded as a package of decisions.

Fundamentals ISG evaluates equities along five quantitative decision dimensions: momentum, quality, sentiment, value and macro. But, qualitatively, ISG makes additional decisions on the degree of refinement for these variables — sometimes directly and sometimes more ad hoc for the hard-to-quantify variables. The goal is to tap into each portfolio manager's global experience and to benefit from a diversity of views that can aid overall portfolio outcomes.

Directional and Relative Value The decision framework does not end there. Attractive assets do not automatically get a nod. Decisions have to be viewed through the lens of directional and relative value plays. The MRI, as has been discussed, and the Policy and Politics Committee are large determinants of the overall stock/bond/cash allocations and tracking error targets. ISG's general qualitative insights also serve to support the directional decision making.

Attractive assets are always evaluated in the context of other asset classes or their relative value. The team's ability to evaluate more than 125 asset classes is a huge benefit, as it provides the necessary optionality to exploit more finely tuned market opportunities. For example, ISG can invest in the Bloomberg Barclays Aggregate Bond Index, but they can also target specific aggregate bond exposures — including credit, mortgages and Treasuries — with the vast investment toolkit at its disposal. Moreover, the team targets different regional international exposures and has the means to exploit different size and style anomalies when the opportunities present themselves. Deciding how to target specific opportunities and when to favor them relative to the universe of securities that are available represents another layer of the decision framework.

Diversification ISG scales attractive assets by estimating standalone asset volatility and portfolio asset correlations. Prudent portfolio decision making involves aligning expected asset class returns with their contributions to risk. While deviations from this axiom occur regularly, they must be based on sound reasoning to justify a departure from theory. Perhaps correlations are estimated improperly, volatility is expected to increase, or the expected return prospects more than compensate investors for the added risk. These could all be worthy reasons for going against the finance gods.

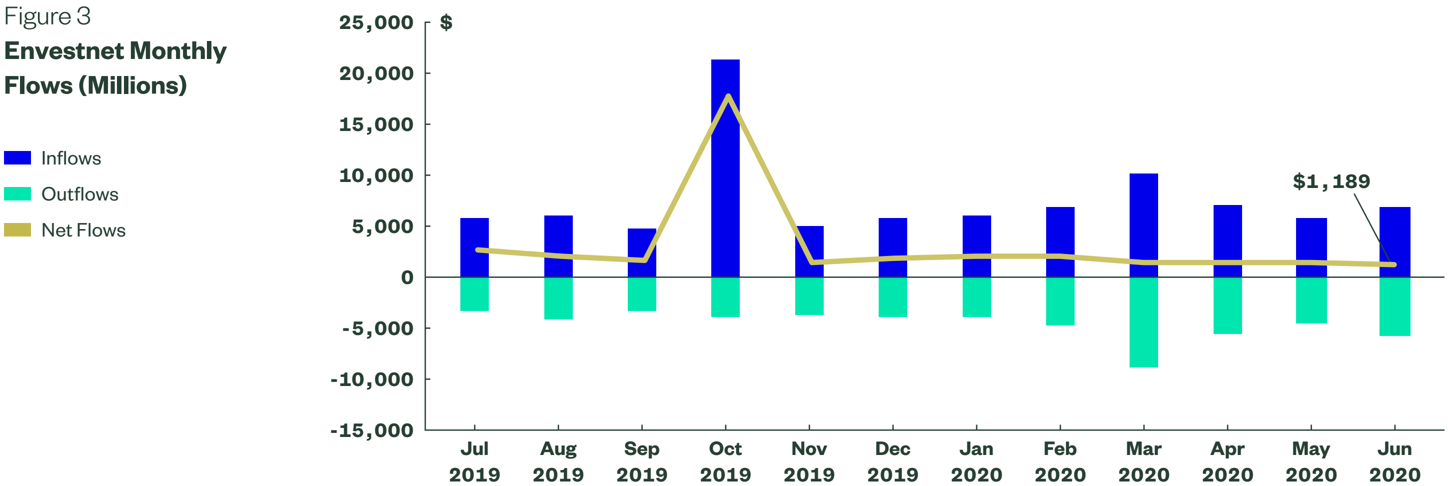
Benefiting from Decision Making

Global tactical asset allocation models are transparent and easy-to-follow portfolios that rely on a sophisticated framework of decision making to produce portfolios capable of satisfying various risk and return objectives. ISG's process, which has been refined over the past 35 years, provides the rigor needed for portfolio managers to thoughtfully arrive at the multitude of decisions required to formulate the sophisticated views that the team expects will lead to the mandated expectations being realized. Investors using model portfolios stand to benefit from the rigorous decision framework that produces asset class views that the ISG anticipates will add value over time.

Model Asset Trends

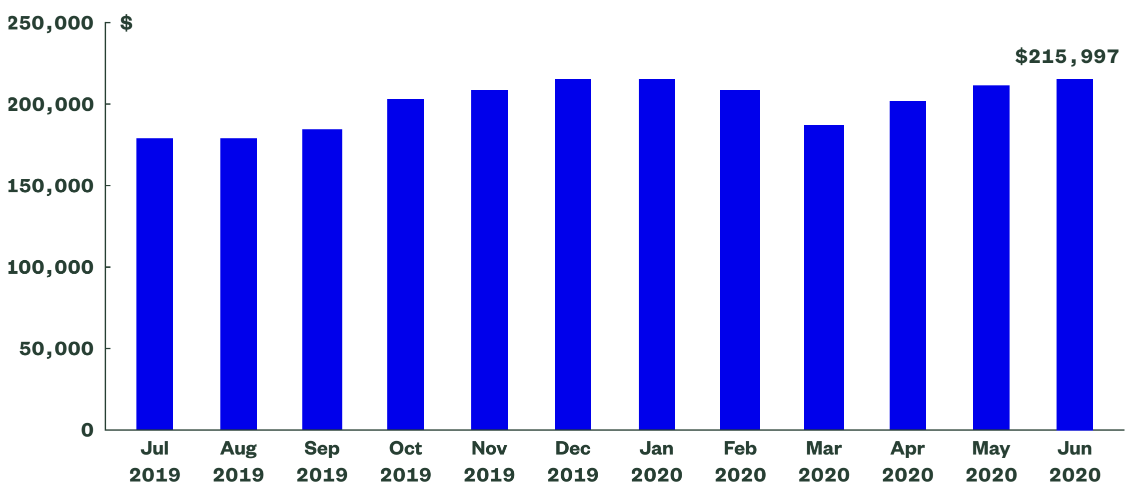
Despite a tumultuous first quarter, model flows and AUM seemed undeterred and marched higher in the second quarter.

Figure 3
Envestnet Monthly Flows (Millions)



Source: Envestnet Intelligence, as of June 30, 2020.

Figure 4
Envestnet AUM (Millions)



Source: Envestnet Intelligence, as of June 30, 2020.

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Citi Surprise Index An index that tracks the difference between consensus expectations and realized outcomes of various economic releases.

Dallas Fed Mobility and Engagement Index An index comprised of several mobility measures based on cell phone usage that provides economic insights into personal consumption patterns and trends.

Weekly Economic Index An index that provides information about the state of the economy by using several high frequency data series.

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