Newsletter
Fundamental Growth and Core Equity

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Investing in Sustainable Growth

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Contents

Sourcing Long-Term Winners in a Transforming Economy: An Interview with Esther Baroudy

Esther Baroudy, CFA,
Portfolio Manager

The Global Equity Select strategy, co-managed by Esther Baroudy and John Flynn, takes a high-conviction active approach to global investing. Supported by our 25-member research team, the focus is on identifying high quality companies that can deliver sustainable growth over the long term.

As the third quarter came to an end, we took the opportunity to quiz Esther on recent thinking within the team. Esther shared her views on the transformative impact of advances in Artificial Intelligence (AI) and Big Data, recent US-China tensions, the importance of ESG, and why she's not worried about market rotations.

Esther, your team has an investment approach that is forward-looking and long term. Looking toward the investment horizon, what trends do you see that will impact equity investing over the coming years?

One secular trend that is rapidly gaining momentum is sophisticated high tech such as AI and Big Data. This is beginning to propagate across both economies and corporates, which will in turn help to accelerate productivity. We believe this has the potential to create almost unlimited opportunity in equity investment going forward. The winners will be those companies that adopt new technologies intelligently.

The IT sector has been very strong in recent years, led by the so-called FAANGS[1] which have invested huge amounts in AI and Big Data. Do you see a continuation of this pattern of a narrow segment of technology stocks leading the market?

We believe all sectors are going to benefit. In the near term, healthcare, the financial sector and many consumer-related firms will likely be beneficiaries alongside traditional technology firms. In healthcare, machine learning is already ubiquitous in clinical trials and diagnostics. This has ESG implications as well. For instance, Novartis has partnered with Microsoft in certain developing countries where leprosy is found. Patients photograph their lesions and these are then coded by Microsoft using machine learning, aiding more effective treatment. In healthcare, these technology advances promise to be transformative.

The shift towards AI is certainly in focus, but vast spending in this space has sometimes delivered uninspiring commercial returns. How sustainable is AI-based investment?

We are still in the early stages when it comes to using these new tools. However, we can see from the companies we invest in that these developments are starting to make a significant operational impact.

Is investment in these technologies concentrated in certain countries or is it more global in nature?

The United States and China are the largest spenders on IT. US investment in software exceeded $400 billion in the first half of 2019, which was a new record. In terms of adoption, the US and UK lead the way in the developed markets, while Japan is a leader in the manufacture of high precision equipment for the industry. Among developing nations, China and Brazil are really making up ground in terms of use. However, European countries, and Germany in particular, have tended to lag behind when it comes to adopting new technologies.

China's efforts to catch up, either through investment or adoption and importation of technology, have contributed to inflamed US-China tensions. Do you see longer-term repercussions?

The US Administration has stated that China has been using unfair practices to achieve its "Made in China 2025" objectives. One of those goals is to achieve number one status in AI and other high-tech applications. The US has signaled its determination to pressure China to change its behavior in this regard. The timeline for genuine agreement is uncertain and that doubt is driving a redesign of the global trading system. This may in turn prove costly for certain companies. Another impact that we may see is an increase in foreign direct investment (FDI) to the United States as the country has become more competitive in terms of corporate tax rates and regulatory reform.

Have these developments impacted on allocation within the Global Equity Select strategy?

We take a bottom-up approach to equity investing. We look for high-quality companies that will deliver sustainable growth over the long term and where we feel the valuation relative to growth is reasonable. Where companies have their regional exposures piques our interest more than where the benchmark classifies them. However, as US-China trade tensions began to escalate in the summer of 2018, we did take the decision to reduce our direct exposure to China.

You referenced ESG in the context of developments in technology. Is ESG an important part of your broader investment approach?

We are keen to ensure the companies we invest in have a strong corporate governance model and take a responsible approach to their customers, employees and the environment they operate in. Our analysts also perform rigorous ESG screening when they are assessing new ideas. This includes the use of State Street Global Advisors' R-factor, which is a sophisticated ESG screening tool.

Despite recent market turmoil, equities have achieved significant gains for the year to date, leading some to argue that valuations are at extremes, especially in the growth segment. Do you worry about a market reversal or rotation?

Sector and regional rotations will always take place in equity markets. We believe that high-quality companies will deliver sustainable growth and this will be recognized in share price performance and relative rating. Long-term winners will have qualities and drivers that enable success and we use our Confidence Quotient (CQ) tool to identify these. Amongst those are strong market positions, robust balance sheets and capable management strategies.

Accepting that technological advances such as AI and Big Data will drive massive changes across all sectors of the economy, does this create the risk that today's exceptional companies may not have a sustainable competitive advantage? How do you find companies that can remain ahead of the technology curve?

As technological change accelerates and drives rapid changes in consumer and corporate behavior, the onus is on us to stay ahead of the curve. This is a constant challenge. Our analyst team keeps a close watch on developments in the sectors they specialize in. The proliferation of information on the internet is also yielding dividends: from better and greater data availability from public sector sources, podcasts by heavy-weight think tanks and renowned scientists, to a vast improvement in information from and regarding our companies, particularly in the US and Europe. This all helps to identify and assess up and coming trends.

In Depth: Fintech — A Disruptor or Enabler in US Banking?

Eric Greenshields, CFA,
Research Analyst

Fintech might not put the banking industry out of business, but strides in technology will continue to transform the landscape in which banks operate. This will drive opportunities for investors, Fintech firms, the banks and their customers.

As a US financial sector analyst, one question I hear on a regular basis is "Who goes to a bank branch anymore?" It's a reasonable question, given that banking technology has made branch visits less relevant, if not entirely unnecessary. The evolution has been gradual, starting with telephone banking, ATMs, and credit cards. Online banking took things to another level, while the development of contactless technology means you can now pay for your coffee with a mobile phone. Now you can even apply for a mortgage with the same device. A catchy name has even been coined for this particular branch of technology: Fintech.

As the impact of Fintech on the industry has become more dramatic, the question about branches might seem too limited. So the question I get asked more and more often today is "Will Fintech put banks out of business?" The answer is "Probably not." It's more likely that Fintech will be less of a "disruptor" and more an "enabler," just as it has been for the past few decades. However, the Fintech dynamic will certainly drive change in the industry and create interesting investment opportunities along the way.

Understanding Fintech

Fintech is a broad category. For the purposes of this discussion, the following are the major innovations occurring within the banking space right now:

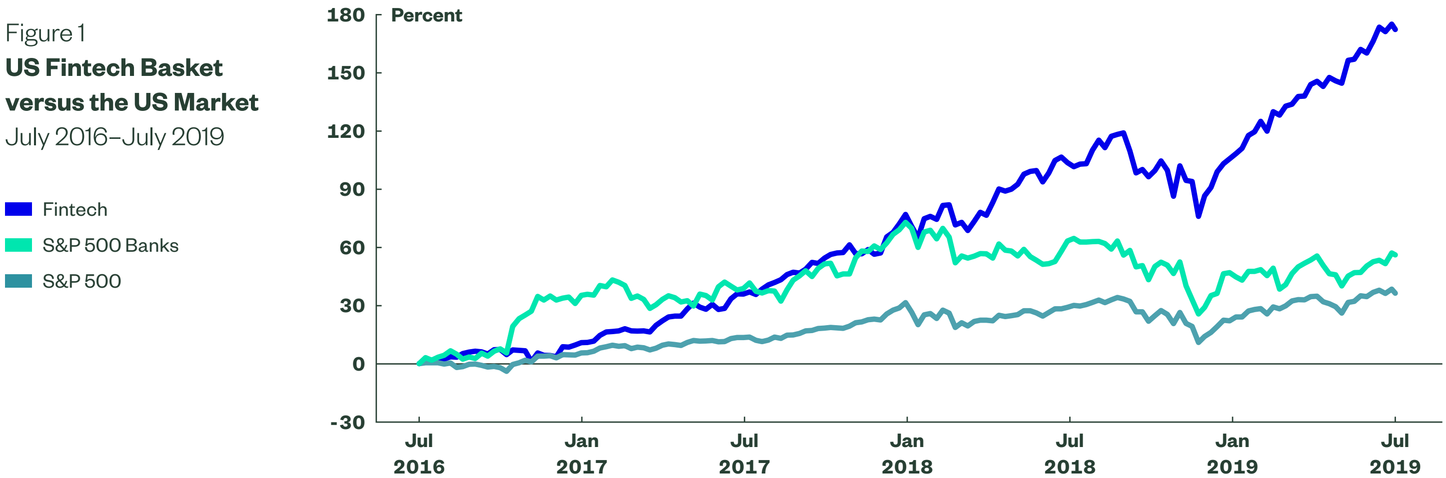
Online and mobile banking Replicating the functions of the bank branch remotely — including accessing accounts, making lending decisions, and getting help with questions.

Electronic and mobile payments Typically facilitating electronic and mobile payments between customers and merchants, but this technology is also expanding to include person-to-person, business-to-business, and international transfers.

Artificial Intelligence / Machine Learning / Big Data Using machine "intelligence" to replicate functions done by humans, from routine customer service to innovative ways to use data for targeted marketing, automated advising ("robo-advising"), credit approval, fraud prevention, security, automated trading, and beyond.

Blockchain / Smart contract Database technology that makes reconciliation of transactions and record-keeping more automated and efficient, especially ones that involve multiple parties or complex contracts.

Figure 1
US Fintech Basket versus the US Market
July 2016–July 2019



Representative U.S. FinTech basket = Visa, Mastercard, Paypal, Q2 Holdings, Shopify, Square, MarketAxess, Envestnet, LendingClub , On Deck Capital Market cap weighted, Price change only, Normalized to 7/29/2016.
Source: State Street Global Advisors, Bloomberg Finance LP. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Past performance is not a reliable indicator of future performance.

Why Fintech Won't Disrupt Banks

In the early stages of the Fintech boom, 'putting banks out of business' was part of the stated strategy of many start-up companies. Such ambitions have since been reined in, and we are now seeing a much more collaborative environment as many discovered that they need the banks to grow past a certain point. Partnering with a bank can be the fastest way to access a broader set of customers, and some need the banks' access to deposit funding, liquidity, or large technology budgets. Perhaps most importantly, banks tend to have huge pools of historical transactions and customer data that are like gold for a data-driven technology company seeking to test theories or develop new artificial intelligence (AI) algorithms.

For their part, the banks have learned that they can use start-ups as a form of research and development. Instead of trying to build everything in-house, banks can benefit from partnering with, or buying, smaller companies. There are hundreds of small operations that are funded by venture capitalists rather than the banks. The banks can wait until the technology is proven and then pick and choose from the winners without any cost to the bank for the ones that fail. It seems reasonable that paying a premium for the proven winners could ultimately lead to less total costs (and better technology) for the banks than funding a plethora of failed attempts in-house to get to the same place. Especially since ever more private capital looking for places to invest is driving an ever bigger pool of innovative companies from which the banks can fish. Plus, it is much easier and faster to start up a Fintech company as an unregulated entity rather than attempting to launch within a heavily-regulated bank.

US Banks Adopting Fintech

Large financial institutions have been fast followers of Fintech. It didn't take long for most banks to replicate and spin-up their own versions of online banking sites, mobile banking apps, and mobile check depositing shortly after these services were pioneered.

- Goldman Sachs developed and launched "Marcus" for online lending and deposit-gathering after seeing other start-ups come to market.
- US banks collaborated to develop Zelle, a person-to-person payments app, when Venmo became popular.
- Incumbent Charles Schwab Co. quickly developed one of the industry's largest robo-advisors to sit alongside its traditional offerings in response to start-up competition.
- The large money-center banks in the US are all involved in some form of developing blockchain technology, showing they are not afraid to jump on board with new technology.

The Benefits for Fintech

Banks have proven to be pretty good partners too. Standalone online lenders have struggled to thrive in some instances, while partnerships with banks have prospered due to banks' stable source of funding.

- PayPal's management has acknowledged that its recent success is due in part to a strategic shift toward being a partner to all players in the payments space, rather than attempting to disrupt the incumbent payment networks.
- Square might superficially look like a disruptor in the payments space, but Visa is one of its original investors.
- Behind the scenes, there are a number of start-ups whose technology helps banks pre-fill data on mortgage applications; electronically replace paper forms; get credit applications processed faster; and otherwise help banks operate more efficiently.

Sourcing Investment Opportunities

Ultimately, a successful approach to Fintech from a bank's perspective will be a good balance of partnership, acquisition, and then building in-house where necessary. For Fintech, even if it isn't playing the role of disruptor per se, it still offers a slew of good investment opportunities in either the public markets or private markets.

For investors in the US public equity markets, we have identified a range of companies that are good opportunities within the Fintech theme. We focus on high-quality companies with sustainable growth and use a proprietary Confidence Quotient (CQ) process, where we evaluate and score the qualitative aspects of companies across five categories in addition to developing detailed earnings models:

Figure 2
Confidence Quotient: Looking for Drivers of Sustainable Growth

Market Position	**Management**	**Financial Condition**	**Fundamental Momentum**	**Transparency**

This helps us identify companies for our portfolios that can potentially sustain their business models and growth rates, increasing our confidence in their long-term investment case. For example, we identified JP Morgan as a bank with a strong Market Position and Management score in part because it is ahead of other banks in partnering and investing in Fintech and using this as a competitive moat. Visa and Mastercard are 'high CQ' companies within the Fintech theme due to their dominant positioning in the electronic and mobile payments space, partnership with other Fintech start-ups, and strong secular growth opportunities as cash continues to be replaced by electronic forms of payments around the world. Finally, Tradeweb is a newly-public Fintech opportunity that rates highly in our CQ scores as it has been a pioneer in electronic trading in the fixed income markets for over 20 years with a tenured management team and enviable market position.

Embracing Change for Growth

There are certainly areas of the Fintech landscape that could be disruptive for US banks, but we believe this is greatly outweighed by the opportunities for collaboration and partnership. Banks that embrace this can win by acting as aggregators of new technologies which will improve their customers' experience and make their operations more efficient.

Overall, developments in Fintech should be a net positive for the banking industry. Some companies will inevitably get left behind, but those that can adapt, execute, and leverage their market position — in other words, those that score highly in our CQ framework — will most likely benefit from Fintech rather than be disrupted by it.

Stock Study: Walt Disney

Sandra O'Keefe, CFA,
Research Analyst

Walt Disney has been at the heart of the US entertainment industry for a century. It is now embarking on a strategy that will see it challenge those streaming companies that have sought to corner the on-demand market.

In seeking out stocks to include in our equity portfolios, we take a long-term perspective with an approach that looks for high-quality companies that can deliver sustainable growth at reasonable valuations. We have an established investment process that helps our assessment of quality. We measure something called Confidence Quotient (CQ), which scores the qualitative aspects of a company that we think will lead to sustainable growth. Disney has a top brand and an excellent management team with an established track-record of investing to maintain its market position. In our framework, this gives Disney a high CQ, which increases our conviction in its ability to deliver sustainable growth. We take a closer look at what Disney has to offer the long-term investor.

Challenging the Challengers

If Walt were with us today, even he would be surprised by the tremendous change occurring in the video entertainment industry. His namesake company has embarked on a bold new video strategy that will significantly change the company's business model as it moves to challenge Netflix's dominance of the on-demand TV market. Netflix has been a major disruptive force to traditional television, changing the model from "linear TV" to "on demand TV."

> **In this volatile business of ours, we can ill afford to rest on our laurels, even to pause in retrospect. Times and conditions change so rapidly that we must keep our aim constantly focused on the future.**
>
> — Walt Disney

Disney — The Blue Chip of Media

Disney has always stood out as the blue chip amongst its media peers, driven by a longstanding tradition of excellence in storytelling. This manifests in the quality of their creative output, physical assets, intellectual property (enhanced by the acquisitions of Pixar, Marvel, Lucas Films and Fox) and ultimately their unparalleled brand.

Historically, three operating units — Media Networks, Studio Entertainment and Parks — have contributed the majority of profits for the company. The rate of secular growth of the media networks and studio entertainment divisions had become an area of concern for investors over the last several years as the new distribution method of on-demand streaming video has become a substitute for traditional viewing for a small but growing segment of consumers. The Parks unit, while not immune to cyclical forces, has produced strong performance over the last decade. It is continuing to expand geographically while adding new attractions and enhancing operations at existing parks, including employing technology to improve asset utilization and customer satisfaction/loyalty.

The media networks business continues to produce solid financial results while secular pressures around linear television viewership limit growth. Evolving technologies have enabled media content to be delivered directly to consumers (DTC) on demand across multiple devices, providing alternatives to traditional 'appointment viewing'. The magnitude and pace of viewership declines has been relatively modest and consistent over the last few years but recent results suggest these trends may be accelerating.

Technologically-savvy companies outside of the traditional media content and distribution industries were first to market with these products. Providing a wide array of content, including some exclusive content, anytime, anywhere coupled with the ability to choose a commercial-free format addressed an unmet consumer preference. Combined with an attractive price point relative to the traditional video bundle, this has driven adoption of these new products.

Adopting an Active Approach to Streaming

The traditional media companies, including Disney, were initially passive to the market's evolution. They benefitted from 'renting' their content to these start-ups at high incremental margins and provided a key ingredient to the success of the new products in the process.

Having seen the consumer adoption of the new services and the attrition of subscribers in the traditional video distribution channels, Disney and most other traditional content companies have launched or have plans to launch their own DTC products. Disney's flagship DTC product, Disney Plus, will launch on November 12th in the US and a few international markets, with a full international roll-out to follow.

Pricing Disney will offer the new service commercial free at a modest monthly subscription price of $6.99/mo. or as part of a package along with ad-supported ESPN Plus and Hulu for $12.99/mo. We expect the product will be a success in terms of consumer uptake and pricing power, as well as a hedge on changing consumer video consumption habits including a further acceleration in traditional video subscriber declines.

Exclusivity Disney has decided to cease renting its content to other DTC services going forward. Other traditional media companies have plans to follow a similar path, both launching their own DTC platform and pulling back content from third-party DTC services. As such, a significant amount of content from incumbent media companies will no longer be available to consumers on third-party DTC platforms.

The Trade-off: Near-term Earnings for Investment in the Long Term

Now that the strategy has been laid out for Disney to offer product to both traditional linear television subscribers and streaming DTC subscribers, with the content available on Disney Plus being separate and distinct, Disney has largely hedged the risk of an acceleration of traditional video subscriber losses with an alternative product, Disney Plus and a bundle of Disney Plus, ESPN Plus and Hulu. As a result of these strategic moves, we trade off near-term earnings visibility that was dependent on a secularly challenged video distribution model for a period of investment in a longer-term strategy to better serve both existing and evolving consumer video consumption preferences.

As noted at the outset, we take a long-term perspective when investing. We look to identify high quality companies that can deliver sustainable growth at reasonable valuations. Disney's high Confidence Quotient hardens our conviction that it can deliver sustainable growth. As it has done many times since its founding in 1923, we believe Disney will successfully adapt to the changed market environment.

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Endnotes

1 FAANG: Facebook, Apple, Amazon, Netflix, Google.

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For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's third-largest asset manager with US $2.9 trillion* under our care.

* AUM reflects approximately $36 billion (as of June 30, 2019), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated

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