Survey Findings
Global Active Equity

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The Power of Active Quantitative Strategies

STATE STREET GLOBAL ADVISORS

Institutional Investor

Contents

Executive Summary

As equity-market volatility returns to normal levels, institutional investors are considering how they will adapt their strategies to cope with the potential for muted market returns. As noted in “Seeking Opportunity at the Top of the Cycle,” investors are likely to embrace active equity strategies that span a broader universe of potential investments and more diverse sources of data.

Investors are unlikely to move reflexively into active equities. Instead, they will use active equity strategies when — and only when — such strategies are governed by well-informed investment hypotheses. At the same time, investors recognize the promise of more diverse data sources and a growing toolkit of sophisticated analytics, including those fueled by machine learning.

This follow-up report examines how investors view active quantitative strategies as a means to navigate an increasingly turbulent market, and the concerns — both internal and external — investors have about using new investment methods supported by expansive sources of information and the next generation of analytical technology.

Survey Data and Conversations with Investors Reveal Five Key Themes

In survey responses and interviews, investment decision makers at asset-owning institutions such as pensions, insurers, foundations and endowments in North America and Europe revealed what they expect from equity markets in the year ahead, and what they desire in strategies as a result. The following five key insights emerged from the research:

1 Investors anticipate lower returns and higher volatility in equity markets in the year ahead, driven by fundamental economic performance, continued trade tension, and monetary policy decisions.

2 In response, investors seek opportunity in a broader investment universe, including emerging markets.

3 One way investors plan on tackling upcoming challenges is by pivoting to active quantitative strategies that are based on sound investment hypotheses and supported by sophisticated analysis of diverse sources of information.

4 At their best, such active quant strategies deliver alpha by combining a larger and unbiased opportunity set with new sources of asset-pricing signals and highly disciplined portfolio construction.

5 Investors recognize the risk of forgone returns by having too many traditional active equity strategies. This overdiversification of active management can ultimately provide return akin to index strategies for active management fees, creating an imperative for investors to carefully consider the capital efficiency of their overall portfolios and to seek uncorrelated sources of alpha.

Higher Volatility, Lower Returns, and a Desire to Exploit Market Inefficiency

Institutional investors anticipate that equity markets will be substantially more volatile in the next year, according to a survey of 200 CIOs and other investment decision makers at public and private pensions, foundations and endowments, and insurance companies in North America and Europe.

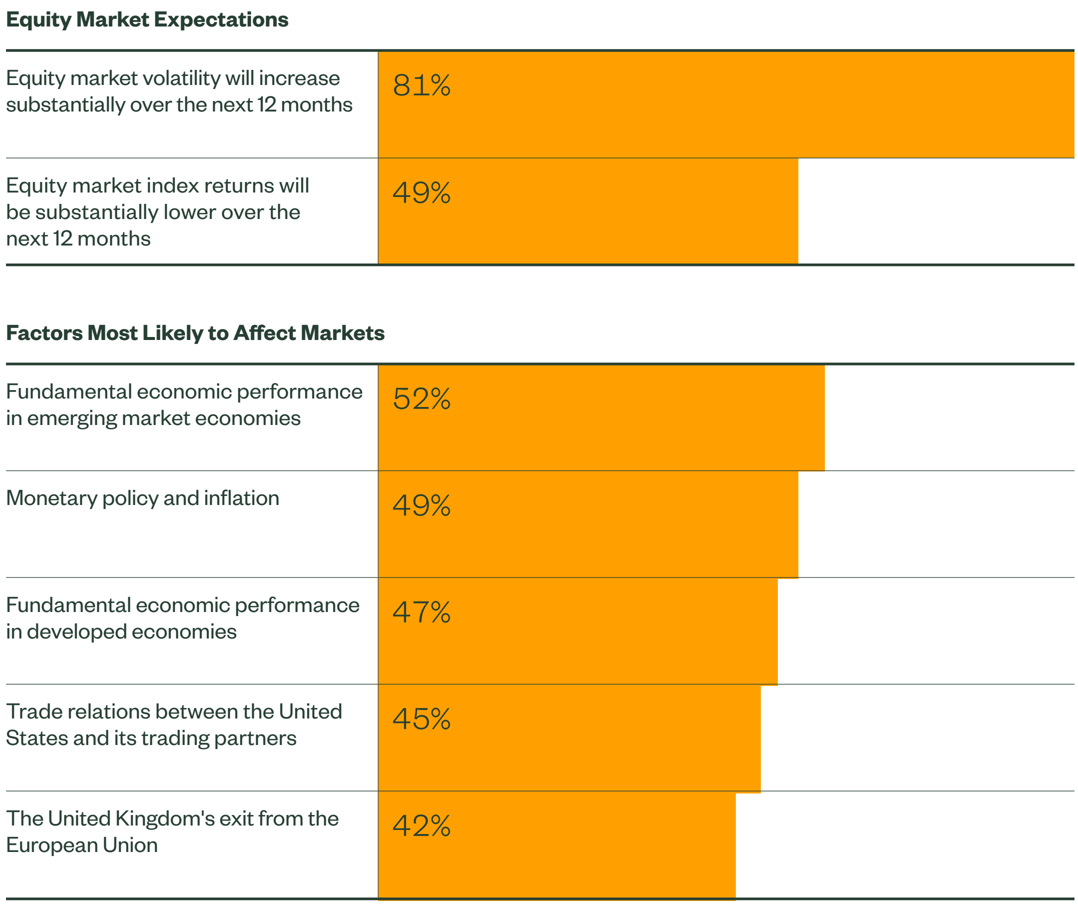
"We think the best part of the equity run is over. There's more volatility and a lack of the return we've seen over the past few years," says the head of equities at a large European pension. "Increased volatility is creeping in due to the late phase of the economic cycle we're in, high equity valuations, and rising interest rates in the United States."

Surveyed in the second half of 2018, more than eight in ten respondents say it's very or somewhat likely that equity markets will be more volatile over the next year. (See Figure 1.) In a separate question, investors identify performance in emerging markets, rising interest rates from central banks, US trade relations, and Brexit as the factors most likely to weigh heavily on equity markets.

From what may be the peak of equity markets, some investors see rising volatility and more dispersed returns as an inflection point at which active equity strategies become an especially powerful tool to generate returns. Says the head of investment strategy at a US university endowment, "In the very short term, we anticipate that volatility will increase. It has to, because it has been absurdly low. And dispersion should also eventually start to increase. Theoretically, this makes a case for a better environment for active management."

Equity market outlook for the next 12 months

Figure 1
Volatility rises, returns fall in response to monetary policy, economic performance, and trade



Regardless of market conditions and volatility level, index strategies and active strategies can each contribute to overall portfolio performance. As the head of equities at a US endowment says, “There’s a role for simple, pure beta, and there’s a role for active management in the form of discretionary stock-picking — there are firms that appear to have the skill to generate alpha. And there’s room for alpha on the systematic quant side [of active management].”

In the quest for outperformance, investors say they are likely to expand their investment universe to include new assets in less efficient markets. Doing so, however, will require mastery of a vast amount of information sourced from unfamiliar markets.

Seeking Alpha in Inefficient Markets

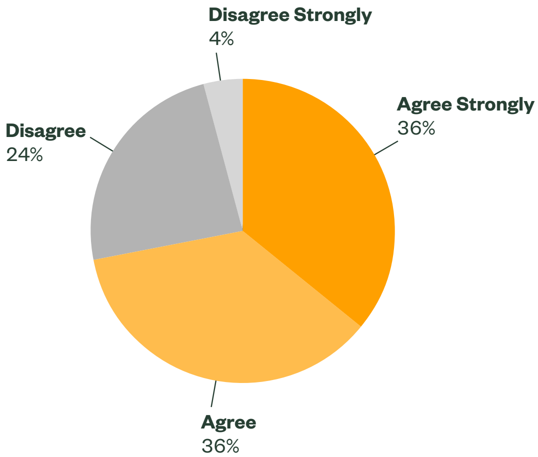
As equity markets become more closely connected, investment decision makers are likely to seek opportunity for excess returns in a broader global investment universe. They voice particular enthusiasm for active strategies in less efficient, less liquid emerging markets, wherein purely passive strategies may bring unwarranted risk.

Pursuit of excess returns requires market inefficiency — that is, assets must be priced incorrectly by an under-informed, imperfect market. Emerging markets are particularly fertile ground for these inefficiencies. The head of equities at a large US pension fund is committed to active strategies that consider “a broader and less efficient opportunity set” found in emerging markets. At the same time, in his view, the high trading volumes and robust reporting requirements of equity markets in developed economies such as North America, Western Europe, and Japan are often well suited to low-cost index strategies.

In their answers to a series of survey questions, a strong majority of investors say institutions similar to their own are likely to seek a broader opportunity set in emerging markets in the years ahead. More than 70% of respondents say institutions like theirs will seek alpha returns through a global rather than regional approach (see Figure 2). In an effort to take advantage of imperfect information and illiquidity, more than 80% say institutions are likely to seek alpha in emerging equity markets that are overlooked by sell-side analysts and active managers on the buy side (see Figure 3).

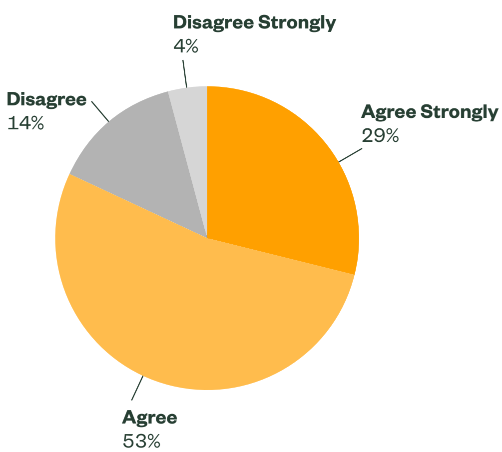
“Because world equity markets are increasingly connected, institutions like mine will increasingly pursue a global approach in active equities.”

Figure 2
Investors seek returns in a global investment universe



“Institutions like mine will increasingly need to seek alpha opportunities in emerging market segments with limited analyst coverage and few active managers.”

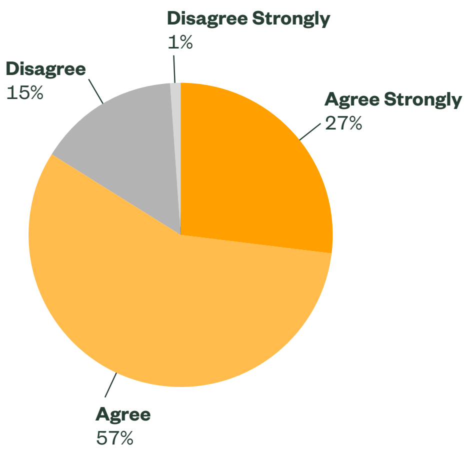
Figure 3
Opportunity lies in overlooked, inefficient markets



Nearly 85% of active equity investors surveyed agree that their institutions would benefit from greater exposure to emerging markets, and many investors interviewed for this study have already taken steps to increase such exposure (see Figure 4). "With dropping equity beta levels, it has been a long, slow process moving capital out of the US. We're moving assets to Europe, Japan, and emerging markets — especially emerging markets, with allocations coming out of the US and Europe," says the head of direct investments at a university endowment with nearly $20 billion in assets under management.

"My institution would benefit from greater exposure to emerging market equities."

Figure 4
Investors see opportunity in emerging markets



Others see strong potential in the relationship of emerging markets and US equities: "Emerging markets could present a good opportunity. The spread between US and emerging markets equities has widened compared to historic highs, but it's hard to predict. The spreads oscillate — they tend to diverge and converge, and this could go on for a while. US equities have always demanded a premium because the margins are much higher than the rest of the world, but that premium is pretty big right now," says a senior quantitative analyst at a $30 billion state retirement fund in the US.

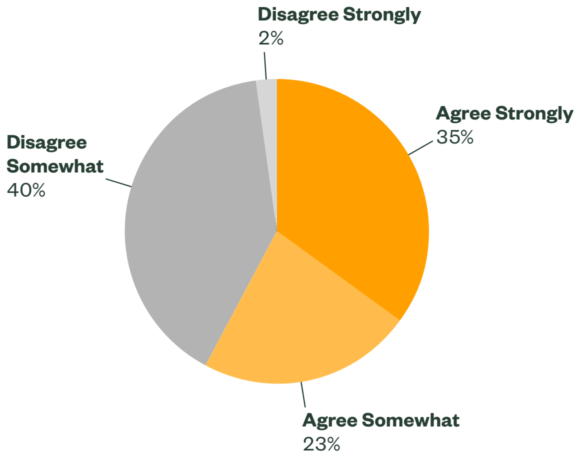
Emerging markets have long been stigmatized by the perception that some companies in these markets are poorly managed and performance data is reported unevenly or inaccurately. The view also holds that even companies with acceptable corporate governance and reporting practices are operating in a loose regulatory environment in emerging markets. That perception lingers, but well over half of investors surveyed believe the situation is improving, with 58% indicating that corporate governance issues and the quality and availability of performance are less of a roadblock to emerging market investments than they were five years ago (see Figure 5).

Be that as it may, emerging markets still warrant especially close scrutiny for outside investors, say decision makers interviewed for this report. In arguing for an active rather than passive strategy in emerging markets, the head of equities at a US pension says “too many unknowns” keep him from considering a low-cost index strategy: “Having the ability to look at non-financial factors and how they affect valuation is important. In many emerging market countries, companies don’t get in trouble for not filing their taxes for 10 years. To try to catch an index — those risks would be foolish.”

“Compared to five years ago, corporate governance issues and the quality of performance information in emerging markets are less formidable barriers to investment.”

Figure 5

Corporate governance and performance information less of a barrier to emerging markets



Harvesting Diverse Signals in Active Quant

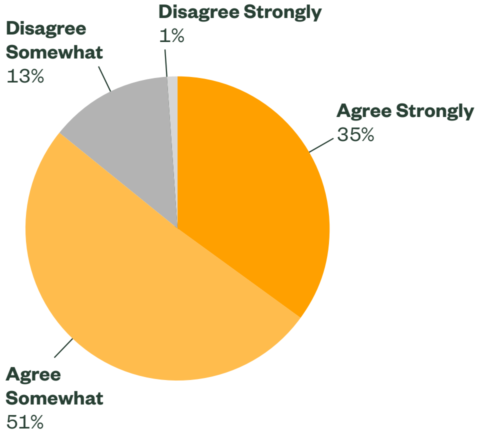
In "Seeking Opportunity at the Top of the Cycle," the first report in this series, survey results revealed that, across the population, investors see particular potential for active quantitative strategies to deliver risk-adjusted equity returns, compared to smart beta, fundamental, long/short hedge funds, and high-conviction active strategies. In interviews for this follow-on report, investors delved into why they find active quant strategies attractive in what they anticipate will be an environment defined by lower returns and higher volatility.

Rigorous portfolio construction and trading practices are one important benefit of active quant strategies, according to investors. "There is much clearer buy and sell discipline with active quant — much more control, with tight stops — than what I've experienced with fundamental strategies," says the portfolio manager for a pension plan with nearly $3 billion in assets under management.

Another reason active quant strategies have investors' attention is that they are seen as an effective way to incorporate diverse return and risk signals based on a wide range of nonfinancial data sets. One example cited often by investors participating in this study are signals based on environmental, social, and governance (ESG) practices, which currently lack universally accepted definition, standards and measurement. Making better use of ESG-related information is of particular importance to investors; indeed, 86% of investors surveyed think that ESG data is increasingly important in establishing an information advantage that can drive outperformance (see Figure 6).

“ESG considerations increasingly provide a valuable information advantage to investors seeking to outperform the market.”

Figure 6
ESG data provides a valuable information advantage



“There are a lot of entities trying to get into the ESG ratings and research space to make it more efficient,” says the pension-plan portfolio manager. “The fact that it's still inefficient creates an opportunity for generating alpha.”

The Risk of Overdiversifying Active Managers

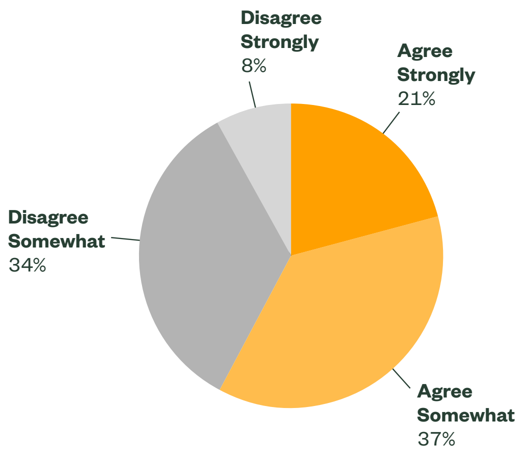
Active quantitative and active fundamental strategies can each play a powerful role in institutional portfolios. At the same time, the investors who participated in this study acknowledge that, when a single institution engages many active managers, the risk of overdiversified holdings is ever present.

In interviews for this report, a trend emerged that can be summed up as follows: the diversification that results from working with multiple active asset managers can choke off the potential for outperformance. This means that asset allocators can find themselves in the position of paying active management fees for what, in essence, are index returns that could have been achieved far more cost-effectively (see Figure 7).

Survey respondents are more likely to be concerned about the risk of forgone returns than misspending management fees, although in each case a majority of respondents voice some concern for the potential impact of overdiversification (see Figure 8).

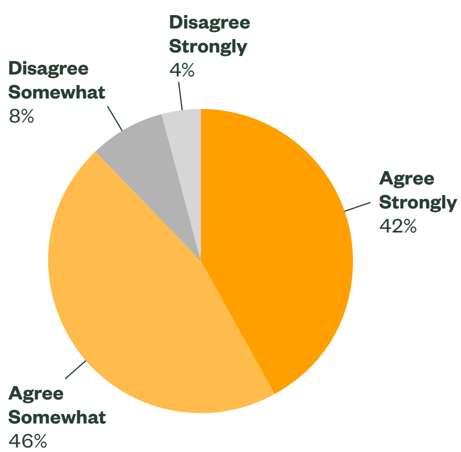
“Institutions with many asset managers and mandates risk misspending management fees due to overdiversification.”

Figure 7
The risk of over-paying for under-performance



“Institutions with many asset managers and mandates risk forgoing returns due to overdiversification.”

Figure 8
Overdiversified portfolios forgo investment returns



As one investor explains, allocating to relatively few managers with a dual focus on seeking returns while managing risk can lead to better overall outcomes. “If you find a manager you like, that’s managing risk well, and getting you the returns you want, you don’t need a massive roster of active managers. When you take on more managers you take on more risk of forgone returns. It’s very difficult to beat the market — that’s a fact — so you can end up in the position of being a de facto index fund with high fees.”

Closing Thoughts

Investors surveyed and interviewed for this report expect equity-market returns to be lower and volatility higher over the next two years, and will look to identify and exploit market inefficiencies to meet their risk-adjusted return objectives. To find those inefficiencies, they will look beyond established markets to emerging markets, and they will seek managers that draw on increasingly diverse sources of information and analysis. Many investors recognize that active quantitative strategies are well-suited for extracting investment insight from a wide and growing range of data sources, and have particular strengths when applied across a broad universe of stocks to achieve a dual risk and return mandate.

About This Research

Institutional Investor's Custom Research Lab composed a questionnaire with SSGA to examine investors' views on active quantitative equity strategies. The questionnaire was fielded in the summer of 2018 and includes responses from 200 investment decision makers at pensions, foundations, endowments, and insurance companies in North American and Europe. To supplement the survey findings, we interview more than 10 investment decision makers at asset allocators in North America and Europe. The demographic highlights of the research program are below.

25%

survey respondents from North America

75%

survey respondents from Europe

What type of institution do you work for?		What are your institution's assets under management?	
Insurance company	18%	> $50 billion*	16%
Private pension	18%	$10 billion – $50 billion	12%
Public pension	16%	$5 billion – $10 billion	10%
Multi-employer/Taft-Hartley plan	14%	$1 billion – $5 billion	21%
Foundation	13%	$500 million – $1 billion	41%
Financial advisory firm focused on institutional investors	11%	< $500 million	0%
Endowment	10%		

* US dollars

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Start with Rigor
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Invest as Stewards
We help our portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. As fiduciaries, we believe good stewardship is good investing.

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