State Street Australian Equity Fund

Has low volatility become risky?

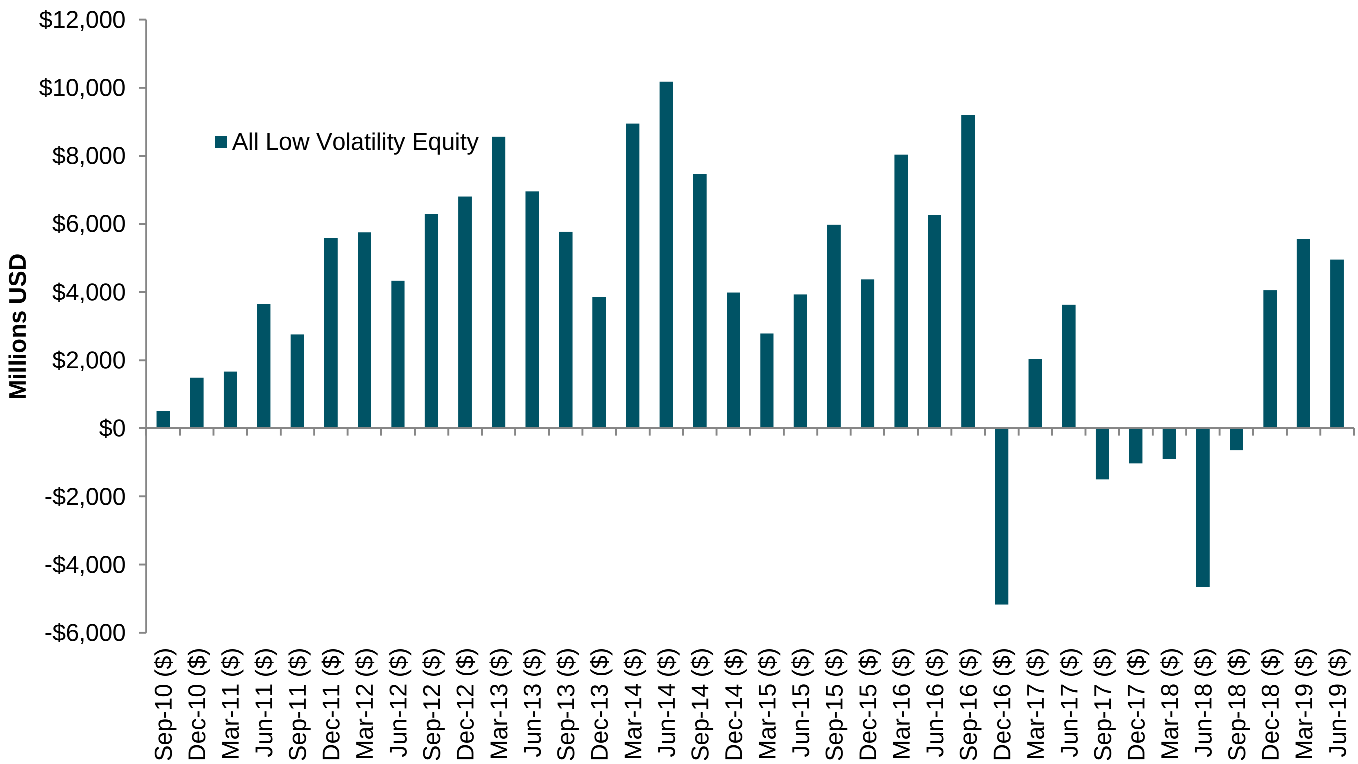
- Increasing popularity for lower volatility investing
- Lower volatility stocks are becoming more expensive
- Look for more than just low volatility in a company

Bruce Apted
Head of Portfolio Management – Australia
Active Quantitative Equities

Popularity of low volatility investing increases

The Global Financial Crisis (GFC) had many impacts on investors and investor behaviour. The size of the equity market losses during the GFC caused many to reassess their equity allocations and approaches to equity investing more generally. In the wake of the GFC the idea of investing in companies with lower volatility gained in popularity. Companies that have historically had less price volatility are typically more stable businesses with more earnings certainty and have also tended to outperform during more volatile market conditions. Figure 1 highlights the increasing popularity of lower volatility strategies post the GFC. The popularity paused for about two years from the end of September 2016 to the end of September 2018 before coming back into popularity in the wake of the Q4 2018 correction.

Figure 1. **Increasing flows into low volatility strategies**

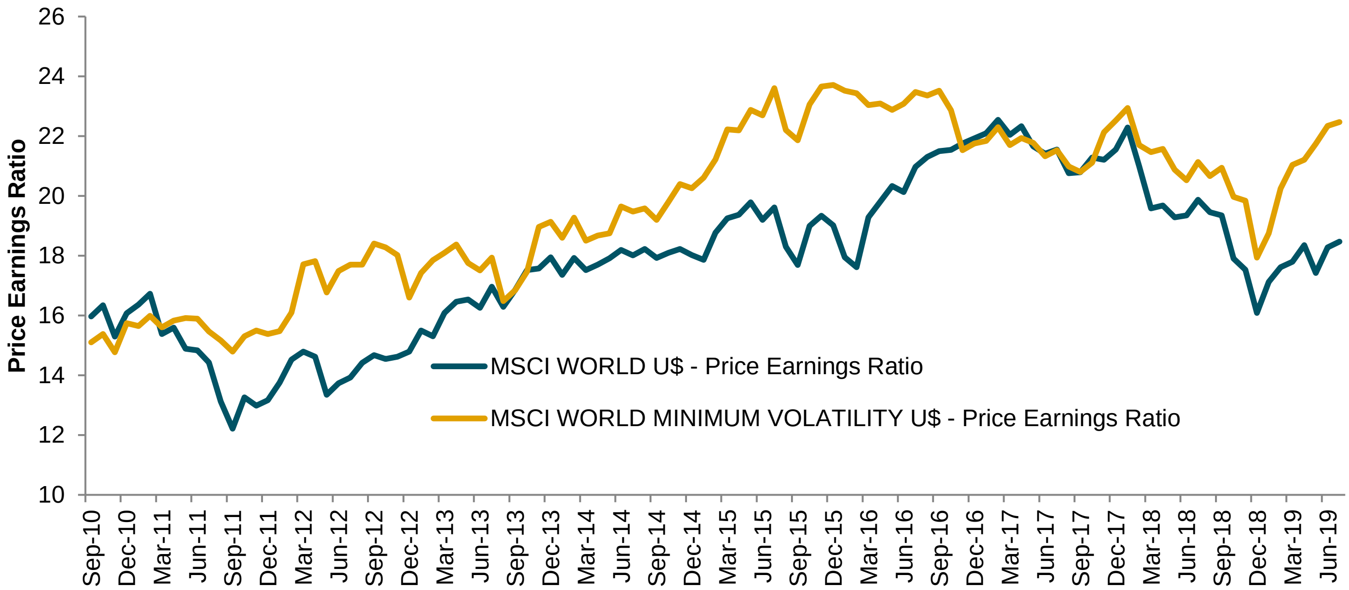


Source: eVestment Alliance, LLC and its affiliated entities (collectively, “eVestment”), SSGA as at 31 July 2019. Past performance is not a reliable indicator of future performance.

Low volatility securities become more expensive

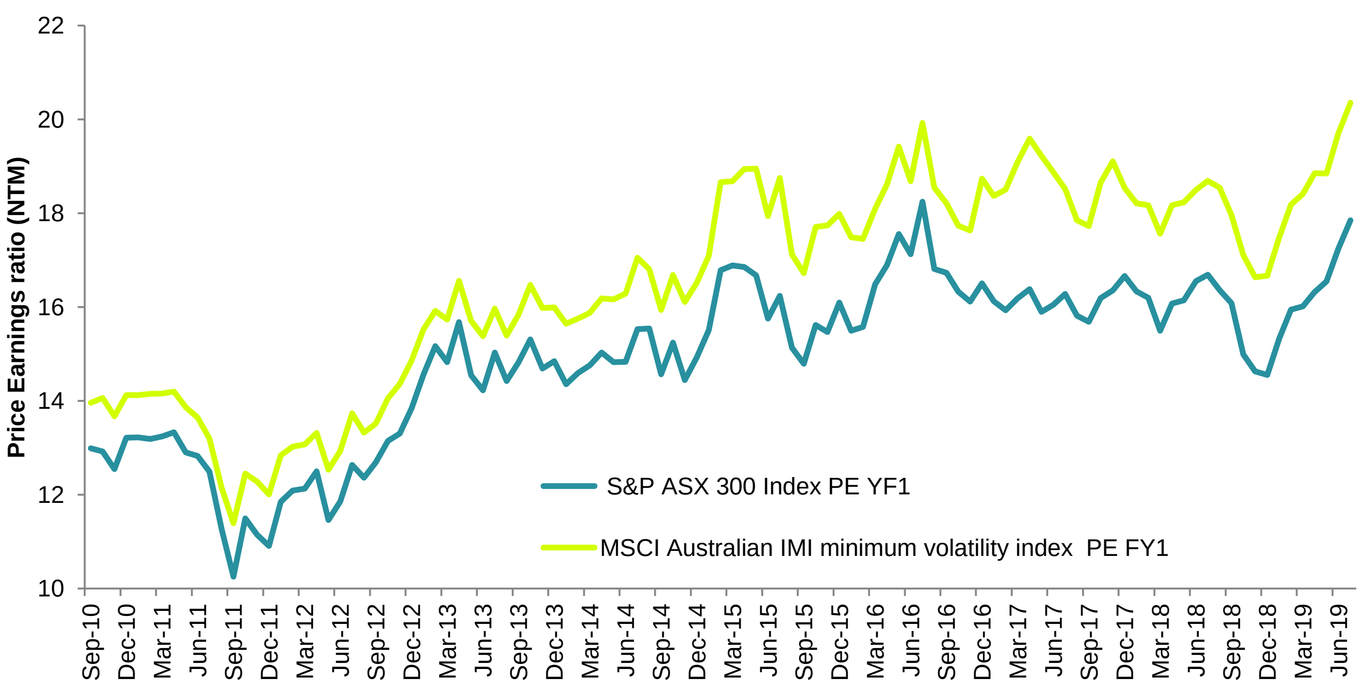
Recently we have seen the valuations of low volatility strategies become more expensive. Figure 2 below illustrates the price earnings multiple for the MSCI World minimum volatility index compared to the price earnings multiple for the MSCI world index. The gap between the two is towards its historical highs and has widened since December 2018. Lower volatility companies often have less earnings variability and can be more defensive businesses. In addition they may have a greater sensitivity to long term interest rates, benefitting from a greater valuation uplift when interest rates decline. The recent decline in longer term interest rates has likely contributed to the increase in valuations. Within the Australian equity market (Figure 3) we have seen the Australian minimum volatility index become more expensive in absolute terms and also relative to the S&P ASX 300 index. The increase in valuation adds additional risk for these securities.

Figure 2. **World low volatility strategies are now trading at higher valuations**



Source: Thomson Reuters, Datastream, SSGA as at 31 July 2019. Past performance is not a reliable indicator of future performance.

Figure 3. **Australian low volatility is also trading at higher valuations**

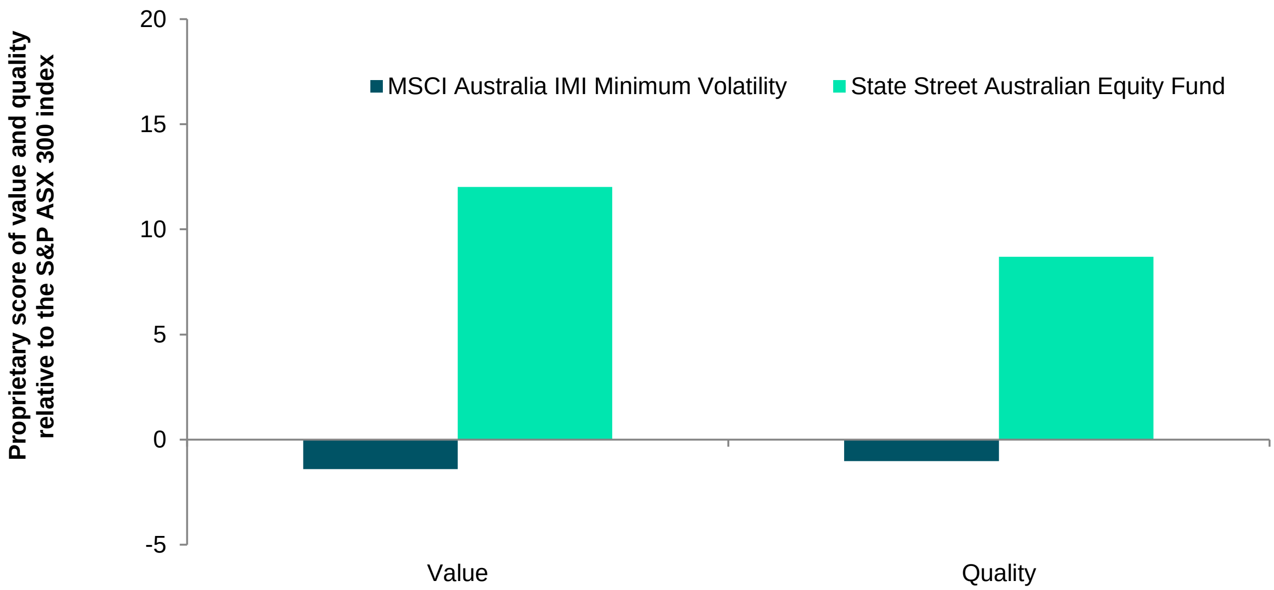


Source: Thomson Reuters, Datastream, as at 31 July 2019. Past performance is not a reliable indicator of future performance.

Low volatility currently has less exposure to Value and Quality

As investors in the State Street Australian Equity Fund would be aware we assess companies across the key dimension of Quality, Value, Sentiment and expected Risk. It is the combination of these elements that we expect will provide the best opportunity for return and lower volatility. Importantly volatility is only one part of this assessment. If less volatile companies becoming more expensive or lower quality then we will look to invest in better opportunities. Currently the price earnings multiple for the State Street Australian Equity Fund stands at 16.8 times compared to the MSCI Australian IMI minimum volatility index of 22.1 times. In Figure 4 below we compare the exposures of our proprietary measures of Quality and Value. The MSCI Australian IMI minimum volatility index has less exposure to the Value and less exposure to Quality compared to the State Street Australian Equity Portfolio.

Figure 4. **Exposures to Quality and Value**



Source: Thomson Reuters, Datastream, SSGA as at 31 July 2019. Past performance is not a reliable indicator of future performance.

The bottom line

Lower volatility is often a marker of a more defensive company but it is not in of itself sufficient. The single minded pursuit of low volatility stocks can lead to undesirable outcomes. In the current market environment when lower volatility has become more expensive and lower quality it introduces an additional risk for investors. Within the State Street Australian Equity Fund we believe a balanced approach that focuses on those companies that offer the best combination of quality, value, and improving outlook for the acceptable level of expected volatility can provide investors with opportunity for return with acceptable levels of volatility.

Portfolio positioning and performance[1]

The Australian equity market recorded a positive month in July, reaching its pre-GFC high. Consumer Staples and Health Care dominated the Australian boards during the month. This was the second month in a row where defensive sectors led the market. On the economic front, the RBA cut the cash rate again by 0.25bp to 1.0%, marking the first back-to-back cuts since mid-2012. In a speech on July 25, RBA Governor Lowe noted "the Board is prepared to provide additional support by easing monetary policy further… it is reasonable to expect an extended period of low interest rates".

The State Street Australian Equity Fund outperformed its benchmark during July. Our lower exposure to Financials (not holding big 4 banks) and good stock picking within Discretionary (Wesfarmers) were the key contributors towards relative performance. On the other hand, negative stock selection within Energy (Woodside) and Materials ex Metals & Mining (Amcor) were key detractors. Our July portfolio rebalance involved some minor tweaks across the board; as we took profit in Metals & Mining (Fortescue Metals) to redeploy in Discretionary, Health Care and Utilities.

[1] Bloomberg Finance, L.P. SSGA. As at 30 June 2019. Past performance is not a reliable indicator of future performance. This information should not be considered a recommendation to buy or sell any security or sector shown. It is not known whether the securities or sectors shown will be profitable in the future. Characteristics are as of the date indicated, subject to change, and should not be relied upon as current thereafter.

Disclosure

ssga.com

Issued by State Street Global Advisors, Australia Services Limited (AFSL Number 274900, ABN 16 108 671 441) ("SSGA, ASL"). Registered office: Level 17, 420 George Street, Sydney, NSW 2000, Australia. T: 612 9240-7600. State Street Global Advisors, Australia, Limited (AFSL Number 238276, ABN 42 003 914 225) ("SSGA Australia") is the Investment Manager. References to the State Street Australian Equity Fund ("the Fund") in this communication are references to the managed investment scheme domiciled in Australia, promoted by SSGA Australia, in respect of which SSGA, ASL is the Responsible Entity.

Investors should read and consider the relevant Product Disclosure Statement (PDS) for a Fund carefully before making an investment decision. A copy of SSGA's Managed Fund PDSs are available at www.ssga.com.au

This general information has been prepared without taking into account your individual objectives, financial situation or needs and you should consider whether it is appropriate for you. You should seek professional advice and consider the product disclosure document, available at ssga.com, before deciding whether to acquire or continue to hold units in the Funds.

The views expressed in this material are the views of the SSGA Australian Active Quantitative Equity Team through the period ended 31 July 2019 and are subject to change based on market and other conditions. The information provided does not constitute investment advice and it should not be relied on as such. All material has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

Volatility management techniques may result in periods of loss and underperformance, may limit the Fund's ability to participate in rising markets and may increase transaction costs.

Standard & Poor's and S&P are registered trademarks of Standard & Poor's Financial Services LLC ("S&P") and Dow Jones is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones") and have been licensed for use by S&P Dow Jones Indices LLC and sublicensed by SSGA. The S&P/ASX 300 Index is a product of S&P Dow Jones Indices LLC, and has been licensed by SSGA. SSGA's Funds are not sponsored, endorsed, sold or promoted by S&P Dow Jones Indices LLC, Dow Jones, S&P, their respective affiliates, and none of S&P Dow Jones Indices LLC, Dow Jones, S&P, nor their respective affiliates make any representation regarding the advisability of investing in such product(s).

MSCI indices are the exclusive property of MSCI Inc. ("MSCI"). MSCI and the MSCI index names are service mark(s) of MSCI or its affiliates and have been licensed for use for certain purposes by State Street Global Advisors ("SSGA"). The financial securities referred to herein are not sponsored, endorsed, or promoted by MSCI, and MSCI bears no liability with respect to any such financial securities. No purchaser, seller or holder of this product, or any other person or entity, should use or refer to any MSCI trade name, trademark or service mark to sponsor, endorse, market or promote this product without first contacting MSCI to determine whether MSCI's permission is required. Under no circumstances may any person or entity claim any affiliation with MSCI without the prior written permission of MSCI.

Investing involves risk including the risk of loss of principal. Risk associated with equity investing includes stock values which may fluctuate in response to the activities of individual companies and general market and economic conditions. This material should not be considered a solicitation to apply for interests in the Funds and investors should obtain independent financial and other professional advice before making investment decisions. There is no representation or warranty as to the currency or accuracy of, nor liability for, decisions based on such information.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without SSGA Australia's express written consent.

2387196.1.10.ANZ.RTL | Exp. Date: 31/08/2020