State Street Global Equity Fund

Understanding Value Amid The COVID-19 Crisis

- Many market participants are currently focusing on defensive and low-risk stocks to the exclusion of other investment themes.
- Value remains an important consideration in times of crisis, but assessing genuine value in these conditions requires close attention to quality considerations.
- Investors seeking glimmers of opportunity amid the crisis can gain a more complete assessment of expected returns by viewing value, quality and sentiment measures in context with one another.

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When markets go through extreme turmoil, a natural question for active equity investors is where we are seeing new opportunities emerge. As many market participants seem to focus on low risk to the exclusion of other investment themes, we believe that it's critical to maintain our investment discipline, which is based on our assessment of the risk and return characteristics of all the stocks in our universe, through the lens of three key investment themes: value, quality and sentiment. In this commentary, we'll discuss how we're working to identify opportunities that may present themselves in this crisis through that process.

Assessing Value in Context with Quality and Sentiment

When prices drop dramatically, it would be tempting to think that, from a valuation perspective, a glut of attractive companies would surely appear. The reality of assessing valuation in this environment is much more nuanced.
In general, the main way we assess value for companies is using price multiples to systematically compare company valuations within industries. Depending on the industry, different multiples or financial statement adjustments are relevant. In times of crisis, when prices are dropping hard and fast, book value, operating cash flow and other fundamentals take time to "catch up," because companies only report at most on a quarterly basis. Even the forward estimates of these items are slow to adjust. This means that many companies can appear on the surface to be attractive in terms of valuation — but a deeper examination is required to reveal genuine value.

To that end, viewing value in context with quality and sentiment themes can be very illuminating. Quality characteristics help us to distinguish good value from bad value — companies that are genuinely undervalued by the market versus companies that are cheap for a reason. Sentiment, the theme that helps us to time our entry into undervalued companies when the market is ready to realise that value, is the third core theme that binds our investment process together.

[1] CFA® is a trademark of the CFA Institute

Finding Opportunity at the Intersection of Value and Other Contributors to Expected Return

Looking first through the lens of valuation multiples, let's review some of the sectors that have changed the most over the first quarter of 2020. Of the segments that have cheapened the most, almost all have become less attractive overall for other reasons. Sentiment with respect to many segments has plummeted; their balance sheet liquidity profile is weak (a key measure of quality), and they're displaying increased volatility.

While these stocks have become meaningfully less expensive in aggregate versus other segments of the market, we favor only three of them from an expected-return standpoint: Diversified Financials, Pharmaceuticals, and Insurers. The others are indeed cheaper, but our analysis suggests they're cheap for a reason.

Figure 1: **Among Sectors that have Become much Cheaper in the Current Crisis, Only Diversified Financials, Pharmaceuticals, and Insurers have Improved from an Expected-return Perspective**

	Cheap	**Neutral**	**Expensive**
Preferred	Diversified Financials ↑ Pharmaceuticals ↑ Insurance ↑	–	–
Neutral	Energy ↓	–	–
Avoid	–	Aerospace & Defense ↔ Hotels, Restaurants & Leisure ↓ Textiles, Apparel & Luxury Goods ↓	Interactive Media ↓

Key
↑ Overall expected return has improved
↓ Overall expected return has declined
↔ Overall expected return has stayed the same

Source: State Street Global Advisors' proprietary valuation and expected return metrics, between January 1, 2020 and March 31, 2020.

Looking at the opposite end of the value spectrum, Figure 2 below shows the segments that have experienced the largest appreciation in their prices versus fundamentals and therefore have become more expensive from a valuation standpoint. These segments are among the lowest beta segments in the global equity market.

Figure 2: **Low-beta Stocks have Become More Expensive in the Current Crisis; Only the Wireless Telecoms Sector is Attractive in Terms of Expected Returns**

	Cheap	Neutral	Expensive
Preferred	Diversified Telecoms ↔	Wireless Telecoms ↑	_
Neutral	_	Food & Staples Retailing ↔	Electric Utilities ↔
Avoid	_	_	Household Products ↔ Road & Rail ↓ Personal Products ↓ Gas Utilities ↓ Food Products ↓

Key
↑ Overall expected return has improved
↓ Overall expected return has declined
↔ Overall expected return has stayed the same

Source: State Street Global Advisors' proprietary valuation and expected return metrics, between January 1, 2020 and March 31, 2020

Most of the segments that have become more expensive were already identified as unattractive before the crisis, and during the course of the crisis have simply become even more expensive. This appreciation versus other segments reflects the market's flight to safety. From an expected-returns standpoint, we like the Wireless Telecoms segment, which actually remains attractively valued despite this recent appreciation.

The Bottom Line

It may come as a surprise that this crisis environment hasn't brought about many new valuation opportunities for us. In fact, the largest changes in overall attractiveness in stocks have mainly been caused by changes in market sentiment. The obvious segments — airlines, transport infrastructure, hotels, restaurants, luxury goods and automobiles — have suffered the most, while the winners are beneficiaries of strong market sentiment — wireless telecoms, household products and internet retail.

At all times, but perhaps particularly in times of crisis, we believe it's crucial to view investment themes in context and to be conscious of the ways in which they interact to generate portfolio returns. The lag in availability of company financials (and their forecasts) during a rapidly escalating crisis can mean that a bet on value is akin to a bet that companies punished in the crisis will recover, while a bet on sentiment includes an implicit view that companies benefiting from the crisis will continue to do so. Positioning a portfolio to take advantage of the genuine opportunities that emerge in an unfolding recovery requires a nuanced assessment, at the individual stock level, of risk and return characteristics as uncertainty resolves and information becomes increasingly available.

Portfolio Positioning and Performance[2]

In March, COVID-19 fears saw global equity markets sell off sharply and bond yields collapse again. The VIX rose above Global Financial Crisis (GFC) peaks to the highest level since 1987. Among global developed market sectors, Energy, Financials and REITs underperformed, while Health Care, Consumer Staples and IT outperformed. The AUD also fell further to US$0.61, and touched US$0.55 at its weakest point in the month.

The State Street Global Equity Fund underperformed its benchmark by 1.24% net of fees (1.17% gross) during the month. While overall stock selection was positive, the single biggest cause of our underperformance was once again the effect of currency hedging. Our currency hedge detracted 3.1% from performance in March as the AUD fell to US$0.61 at month end, more than offsetting the downside protection provided via stock selection. The Australian dollar is now trading significantly below our fair value estimate and presents compelling long-term value. From a sector perspective, having a higher exposure to Health Care and a lower exposure to Energy added value during March, but was partially offset by our lower than benchmark weight in IT (not holding Microsoft and Apple) and negative stock selection within Discretionary.

Year to date, the fund (excluding the effects of currency hedging) generated a downside capture of ~84% on days the market delivered negative returns. While this is higher than our long-term target of 60%, it remains broadly within expectations given how fast and how indiscriminate the selling has been. For example, during the ongoing COVID-19 crisis the MSCI World Index returned -23.6% (USD) in just 34 days as of March 31, 2020. In comparison, during the Tech Bubble and GFC it took 162 and 226 days respectively to reach those levels. In terms of breadth, pandemic fears sparked a broad sell-off across all assets and sectors. Even oft-sought Defensive sectors were abandoned as investors ran for safety in cash.

[2]Bloomberg Finance, L.P. SSGA as at 31 March 2020. 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. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

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Tracking: 2912960.1.4.ANZ.RTL

Exp. Date: 30/04/2021