State Street Global Equity Fund

STATE STREET GLOBAL ADVISORS

When Expensive Stocks are Worth the Price

- Caring about valuation doesn't mean everything in a portfolio must be cheap.
- If your goal is to generate strong, risk-adjusted total returns, it's important to have balanced exposures in your equity portfolio, especially in times of great uncertainty.

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Active Quantitative Equity

When working to maximise risk-adjusted returns in a highly uncertain investment landscape like the current one, it's important to consider how balanced exposures within an equity portfolio will perform in different market environments. If we in Active Quantitative Equity (AQE) were to choose stocks today for our defensive equity portfolios based only on valuation, for example, we would end up with a portfolio comprising banks, autos, insurers, and some cyclical industrials — i.e., stocks that are cheap but which may be undervalued for some very good reasons.

That's why there's a lot more to investing than just valuation, and why AQE's investment approach includes additional exposures that can help generate strong, risk-adjusted returns. In fact, we currently like some segments of the market that look quite extended based on valuation ratios alone; we like them for other reasons.

Although we believe it's important not to overpay for stocks, it's perfectly acceptable — indeed, it can be desirable — to hold a stock that looks expensive based on valuation ratios alone if that stock provides other benefits. The ability to balance out macro exposures could be one such benefit. The stock could exhibit very strong quality characteristics that are worth paying up for; it could have some wind beneath its wings (e.g., having captured the attention of informed investors, leading to positive price trends); or it could simply help to diversify the overall portfolio.

The portion of our own global defensive portfolio that is currently invested in the most expensive third of the market includes companies with positive growth and strong sentiment, some high quality attributes that make a valuation justified, and either low volatility or diversification from a risk perspective. Our choices include some household products, basic retail, food retail, restaurants, food and beverage, and residential REITs. Many of these holdings have consistent and stable earnings — a characteristic that is highly sought-after during times of economic uncertainty. We wouldn't want to dedicate an entire portfolio to these sectors and these investment themes, but gaining a balance is key.

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

It may be impossible in this market environment to find a diversified collection of stocks that each tick all of the boxes, but what's important is to build a portfolio that balances cheap valuation, positive sentiment, high quality, and low risk. Across the developed world, we see some expensive stocks that are worth holding across North America and Europe. The segments that these stocks fall within are listed below, according to the dimensions on which we find them attractive (see table). In sum, caring about valuation doesn't mean everything in the a portfolio must be cheap; rather, we believe that everything in a portfolio must help to achieve a clear goal.

Figure 1: **Expensive Stocks that are Worth Holding (North America and Europe)**

	High Quality	**Neutral Quality**
Good Sentiment	US Food Danish Medical Products Dutch Comm Services Swiss Food French Medical Products	US Restaurant US Household Products US Reits Swiss Materials Finnish Capital Goods US Electric Utilities
Neutral Sentiment	Danish Materials Swiss Capital Goods Spanish Utilities	

Source: State Street Global Advisors analysis, as of 31 May 2020. Valuation is determined using State Street Active Quantitative Equity's proprietary valuation metrics; all sectors that appear are in the most expensive third of companies in our stock-selection universe, which in this case consists of companies in the MSCI World Index.

Portfolio Attribution and Performance[2]

Rising confidence in government stimulus and a continued easing of lockdown measures saw global markets rally again in May. All global developed market sectors rose, with the IT, Material and Industrial sectors outperforming the most, while Energy, REITs and Consumer Staples underperformed the most. On the economic front, US economic data was generally negative due to COVID-19, European data was weak but largely better than expected while China economic data was mixed.

The State Street Global Equity Fund underperformed its benchmark during the month. From a sector perspective, good stock picking within Utilities and the lower than benchmark exposure to Financials were the key contributors towards relative performance. This, however, was more than offset by negative stock selection within Health Care, Communication Services and IT. Currency hedging added +0.5% towards relative performance in May as the AUD appreciated slightly against the USD, ending the month at $0.67USD (up from $0.65USD at the beginning of May).

[2] Source: Factset, SSGA as at 29 May 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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