Commentary
Markets

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Equity Reallocation Why? Where? When?

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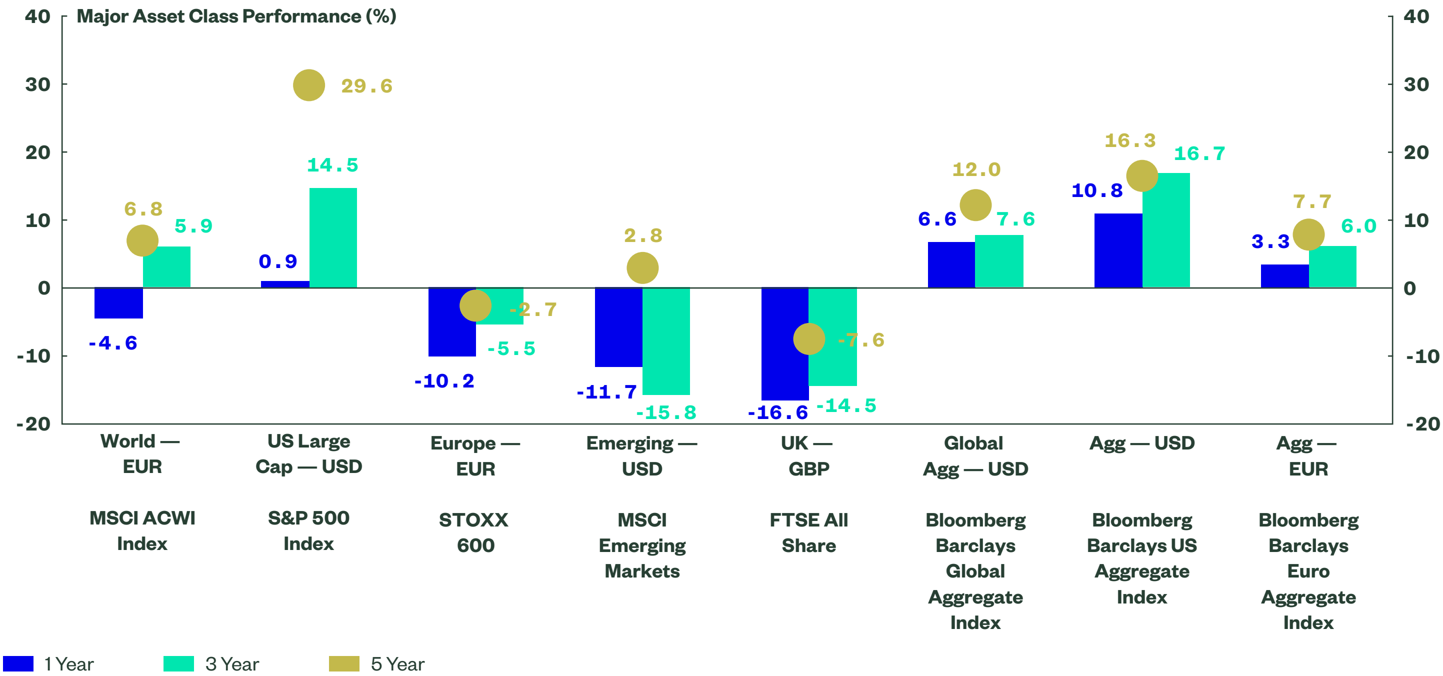
Unless you are a US investor focused solely on US assets, or a Fixed Income investor with very modest return targets, then the crisis has pretty much wiped out the last 5 years of your returns.

We consider the whys, where and when of where you should be reallocating to get back on track.

Figure 1
Selloff has flattened longer-term returns for equity investments outside the US



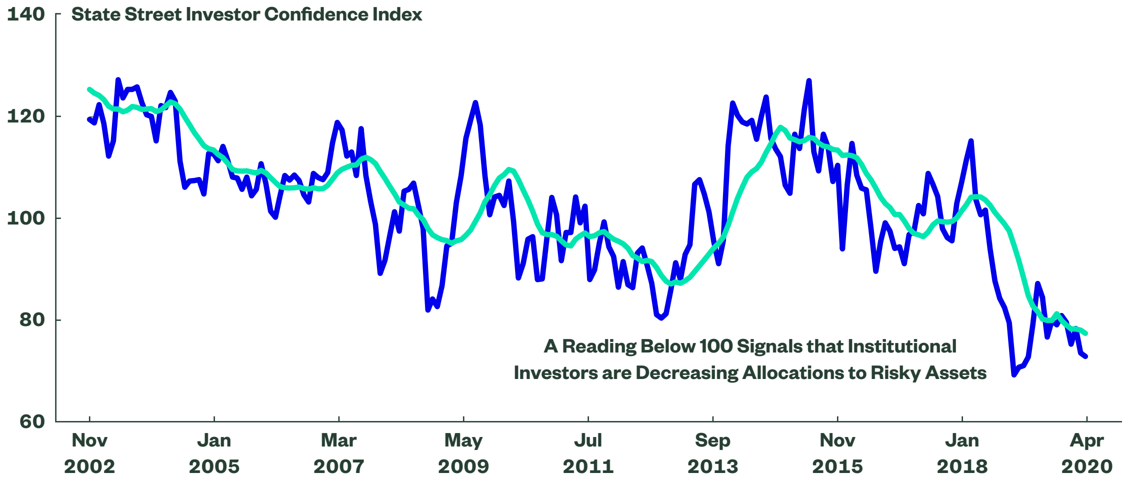
Source: Bloomberg Finance, L.P. As of 30 April 2020. Past performance is not a guarantee of future results. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income. Performance returns for periods of less than one year are not annualised.

Investor Confidence is Near All-Time Lows...

Not surprisingly, recent events have taken their toll on investor confidence, driving it down to near all-time lows. Perhaps more surprisingly confidence has been on a downtrend since late 2018 — a reason many investors didn't participate in last years' rally as much as they might have liked. While this does mean that they may have been more protected from the downturn, the corollary is that they need returns.

Figure 2

Historic Decline in Investor Confidence



Source: Bloomberg Finance, L.P. As of 30 April 2020. The results shown represent current results generated by State Street Investor Confidence Index. The results shown were achieved by means of a mathematical formula in addition to transactional market data, and are not indicative of actual future results which could differ substantially.

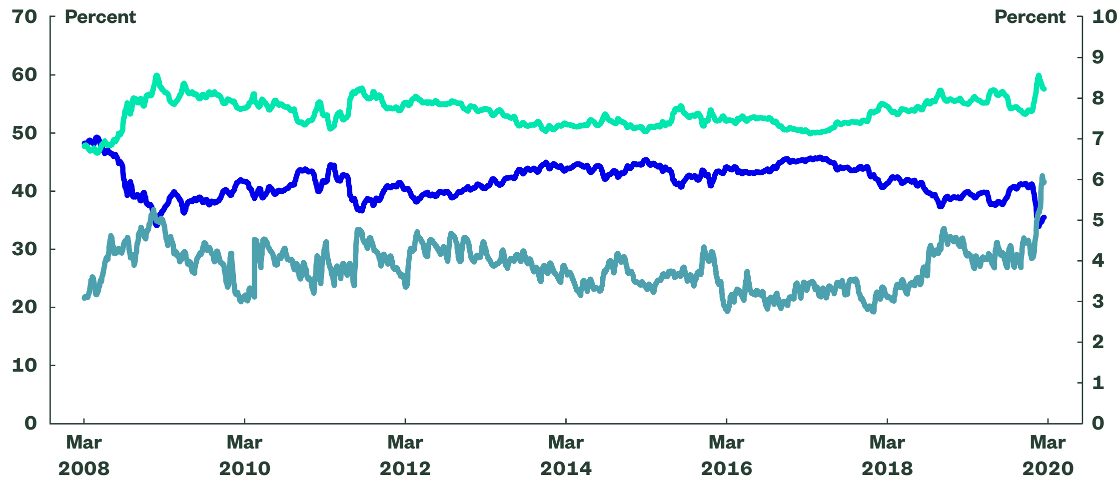
While Equities are Extremely Underweighted

Implied equity allocations suggest significant underweight to equities. Our past experience suggests that significant equity inflows are likely in the course of 2020.

The extent to which investors have been on the sidelines is clear in the graph below. The Blue line of equities has dropped below even the lows of the GFC, and interestingly the Green line of Fixed Income has bounced off its highs, but that reduction has added to cash (the Teal line), not equities. In other words, investors have been selling equities and reduced their maximum overweights to Fixed Income but the proceeds have gone into Cash.

Figure 3

Europe Asset Class Holdings



Source: State Street Global Markets as of 30 March 2020.

Lower for Longer Challenges Return Expectations for Global Investors

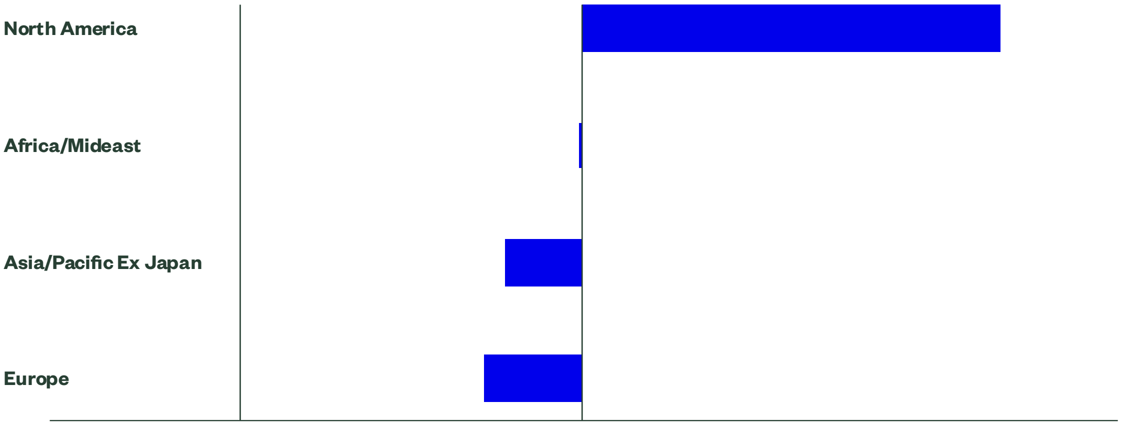
Since the GFC, accommodative monetary policy, both conventional (policy rates) and unconventional (QE), has driven government rates lower and yield curves flatter. Major central banks across developed markets are aligned in pursuit of strong policy responses (rate cuts, QE and liquidity programs) to the COVID19 pandemic.

This collective action in conjunction with the supply/demand shocks stemming from the pandemic suggests that rates are likely to be at/below zero and yield curves flat for the foreseeable future (and at the very least going into 2021). This will have profound implications for investments.

...Benefits Defensives

Low-rate environments benefit defensives, consequently, since we forecast lower yields for longer, we are biased towards defensives. There will be clear sector winners, but the Defensives nature and scale of its equity market tends to see the US as being superior.

Figure 6
Quality by Region (MSCI World Quality vs. MSCI World)

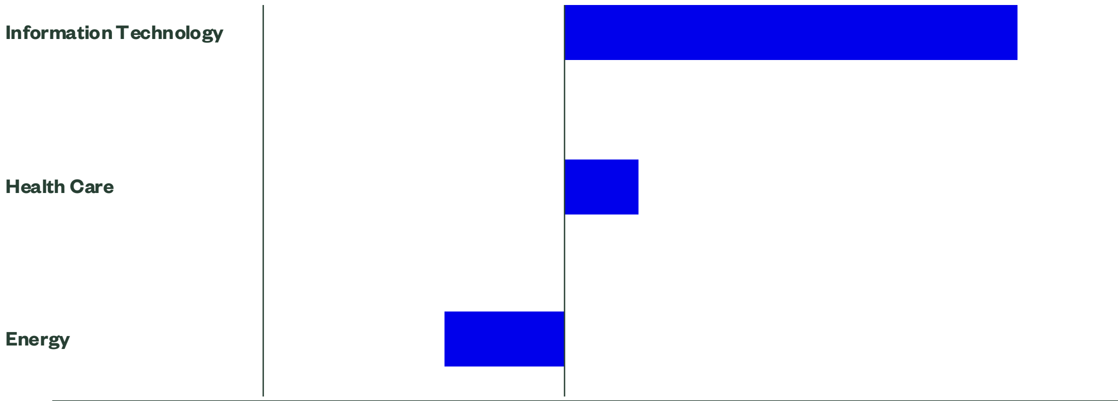


Source: FactSet, as of 31 March 2020. Past performance is not a guarantee of future results. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income. Performance returns for periods of less than one year are not annualised.

...And Flatter Benefits Growth Over Value

In a similar fashion, a flat yield curve tends to benefit Growth versus Value strategies. Growth currently has a large overweight to Technology, overweight to Healthcare, and underweights to Energy and Financials. We believe these sector views have a sound fundamental backing.

Figure 7
Growth by Sector (MSCI World Growth vs. MSCI World)



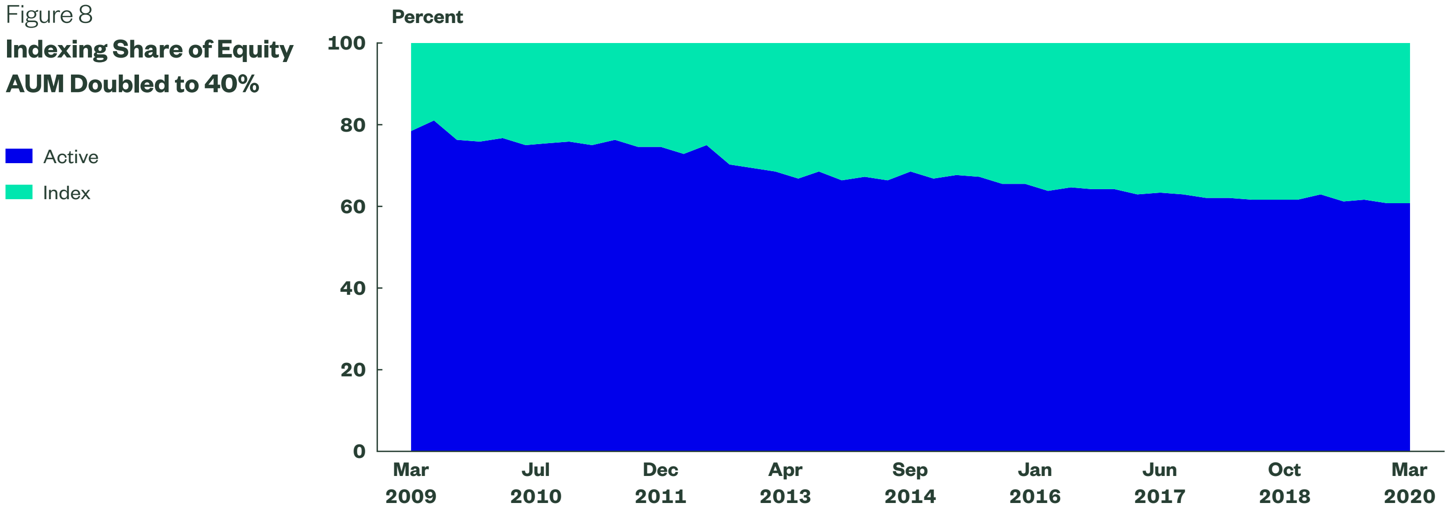
Source: Bloomberg, State Street Global Advisors calculations, Data as of 30 April 2020.

Accelerated Moves to Indexing, More Selective Active

At the end of the GFC we saw a constant shift of equity assets from Active to Index, with the index proportion doubling from 20% to 40% in around 10 years.

We expect this trend to accelerate post-pandemic as rates stay low and fees are even more challenged. At the same time, investors will need to make up their lost returns, but will be more discerning when allocating to active to avoid overdiversification (again given the tight fee budget they need maximal bang for the buck) so will opt for a few carefully selected active managers.

Figure 8
Indexing Share of Equity AUM Doubled to 40%

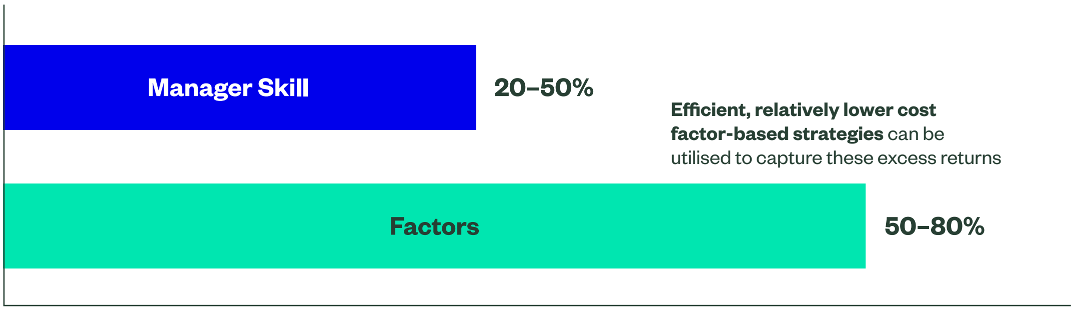


Source: State Street Global Markets as of March 30, 2020.

Socially Distancing the Huggers

Given better awareness of the spectrum of investment products, we see investors being more choosy — avoiding Index Huggers and converting Factor Huggers to cheaper and more reliable Smart Beta, and using both pure indexing and concentrated stock pickers.

Figure 9
A Significant Portion of Active Returns Result from Exposure to Common Factors

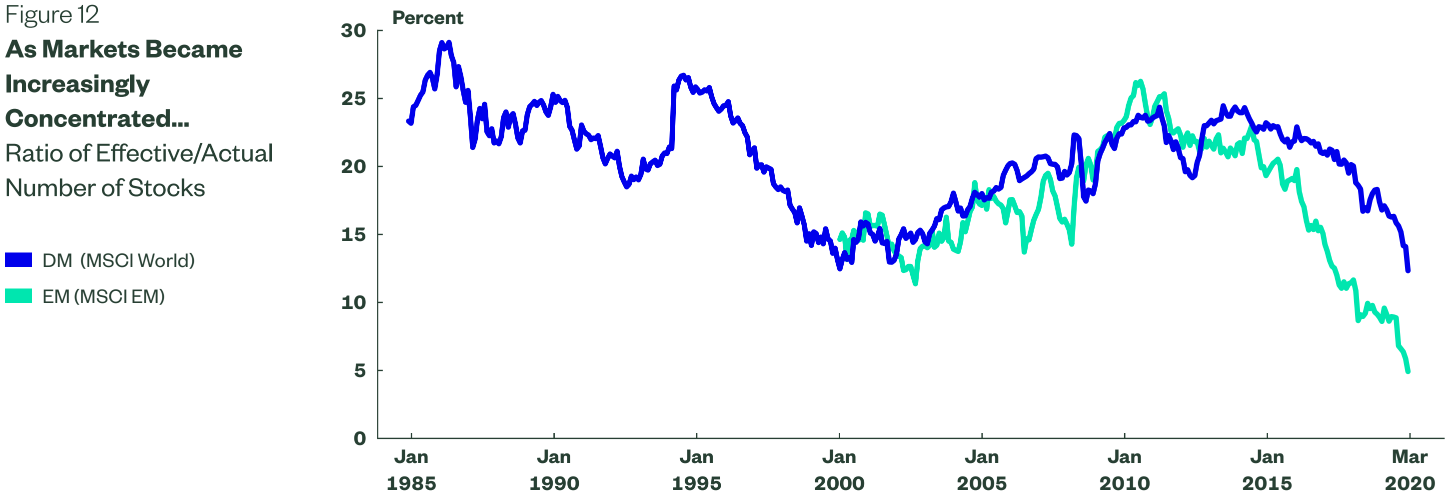


Source: Mok, William, Jennifer Bender, and P. Brett Hammond (2013), "Can Alpha Be Captured by Risk Premia?" Journal of Portfolio Management, Vol. 40, No.2: pp. 18–29.

High Conviction is Necessary in Concentrated Markets

We believe concentrated active will be a favoured allocation as markets are becoming more concentrated — a phenomenon which is here to stay for a while and which favours managers who operate concentrated rather than diversified portfolios.

Figure 12
As Markets Became Increasingly Concentrated...
Ratio of Effective/Actual Number of Stocks



Source: MSCI, FactSet, State Street Global Advisors calculations, Data as of 31 March 2020.

This is mirrored by the flows we see. Money is coming out of diversified fundamental in large amounts, and moving back into concentrated active, low volatility and proprietary smart beta in smaller amounts.

The Takeaway?

An Optimal Equity Portfolio Blends Index, Enhanced, Smart beta and Active

Our analysis of combining Index, Enhanced, Smart Beta and Active makes very clearly that investors should and can allocate across all our strategies in their equity portfolios.

Given the assumptions listed in the table below, we find that an optimal portfolio would have a core of 75% in Index + Enhanced and 25% in a satellite of Active + Smart Beta.

The optimal portfolio has weighted average fee of 15 bps. Constraining the fee to 10 bps implies a shift from enhanced/active into smart beta. Increasing tracking error shifts from index/enhanced into smart beta/active.

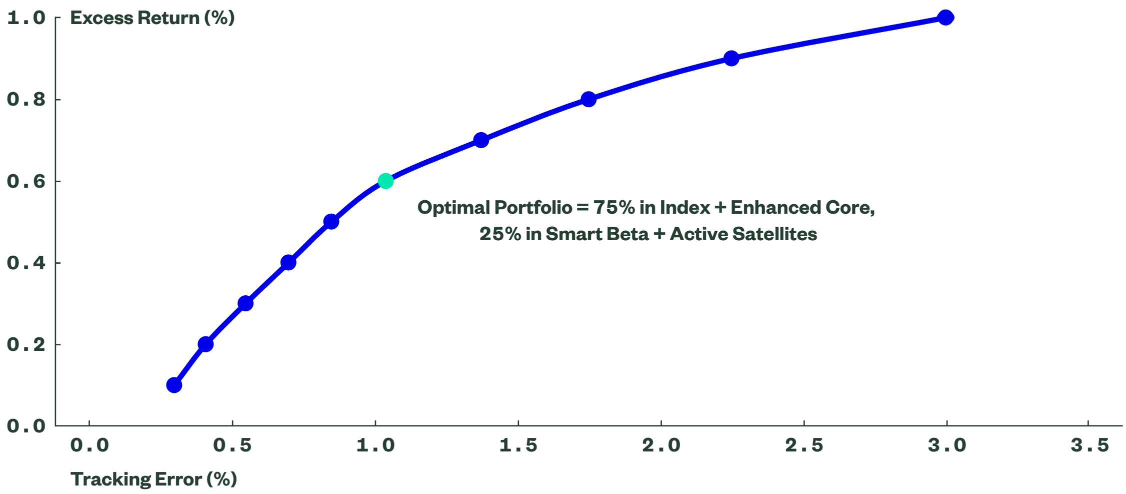
Investors needing to take more risk to gain extra returns would put more into smart beta and active from the core, and those looking to pay lower fees would have to shift some of their enhanced and active to smart beta.

Figure 14
Optimiser Assumptions for Equity Strategies to Generate Efficient Frontier

Strategy	Expected Excess Return (%)	Active Risk (%)	Fees (%)
Indexing	0.00	0.10	0.03
Enhanced Indexing	0.50	1.00	0.15
Smart Beta	0.75	2.50	0.05
Active	1.00	3.00	0.30

Source: MSCI, State Street. The above estimates are based on certain assumptions and analysis. There is no guarantee that the estimates will be achieved.

Figure 15
75% Low Tracking Error Core with Index + Enhanced 25% Smart Beta + Active Satellite



Source: State Street Global Advisors Calculations. For illustrative purposes only.

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Start with Rigor We take a highly disciplined and risk-aware approach built on exhaustive research, careful analysis and market-tested experience to meet client needs. Rigor is behind every decision we make.

Build from Breadth Today's investment problems demand a breadth of capabilities. We build from a universe of active and index strategies to create cost-effective solutions.

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

Invent the Future We created the first ETF in the US and are pioneers in index, active, and ESG investing. Using data, insights and investment skill, we are always inventing new ways to invest.

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 27 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $2.69 trillion* under our care.

* AUM reflects approximately $50.01 billion USD (as of March 31, 2020), 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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