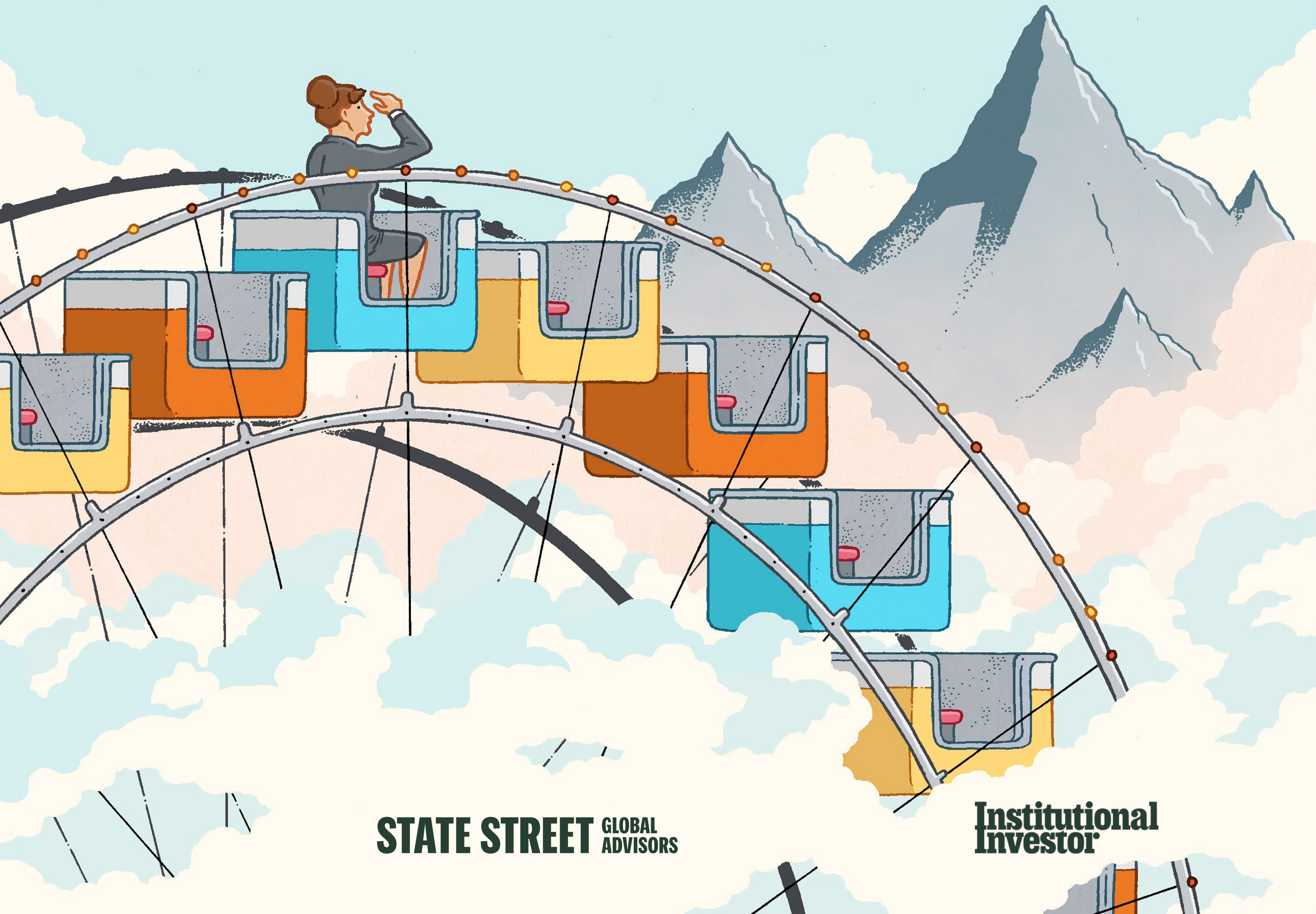
Survey Findings
Global Active Equity

March 2019

Seeking Opportunity at the Top of the Cycle



STATE STREET GLOBAL ADVISORS

Institutional Investor

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Executive Summary

This global survey of 200 senior institutional asset allocators assesses their views on equity markets over the next 12 months and offers insights into the strategy adjustments they might make as a result.

While the end of 2018 may well have signaled the end of the long-running bull market, this research program reveals how institutional investors will adapt their strategies amid attenuated market returns and higher volatility.

Investors are likely to embrace active equity strategies that span both a broader universe of potential investments and more diverse sources of data to inform investment decisions. At the same time, investors are unlikely to move reflexively into active equities. Instead, they are likely to use active equities when — and only when — they are governed by well-informed investment hypotheses.

Survey Data and Conversations with Investors Reveal Four Key Themes

1

Lower market returns as signs accumulate that equity markets are approaching a transition

Nearly one-half of respondents say it's likely that market returns will be substantially lower in the year ahead. "We expect a positive market return over the next 12 months, but we also see increased volatility," says the portfolio manager at an €11 billion Nordic pension.

2

Increasing volatility and uncertainty

The positive expectations for equity markets are tempered by caution as investors note an increase in volatility, and nearly all expect the market to reach an inflection point in the next year. "We're seeing the repricing of risk, and the theme for the next 12 months will be volatility and dispersion by asset class and by region," says the head of equities at a Dutch pension with more than $400 billion under management.

3

Expanding the universe of equity opportunities

In preparation for a market shift, investors are broadening their universe of potential equity strategies, including an increased appetite for emerging markets. Instead of regional and sector approaches, for example, some are starting with strategies themselves. "We are taking a holdings-based approach, and considering the best geography or sector for each strategy. We don't necessarily manage by sector or to targets, unless they're within the strategies themselves," says the CIO of a $153 billion US state teachers' pension.

4

Openness to compelling alpha opportunities

Asset owners remain committed to active equity strategies. They are especially supportive of active quantitative strategies that draw on sophisticated analytics, highly diverse sources of valuation signals, and factor-based smart beta strategies. "We have an active quant equity portfolio, which we use to reduce volatility and generate returns," says a head of equities in Europe with $200 billion under management.

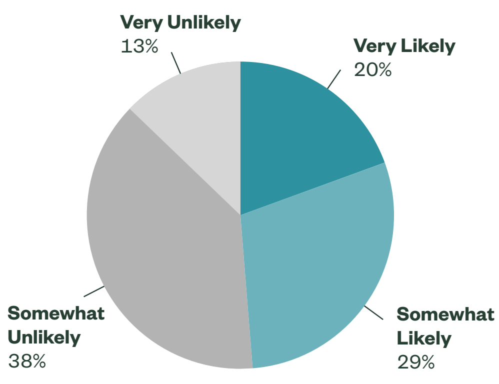
A Positive (But Not Exuberant) Outlook for Equities

While investors may feel positive about the outlook for equities, they are far from exuberant. Optimism is tempered, while pessimism is accompanied by hope. About one-half of survey respondents say that equity market index returns are likely or very likely to be substantially lower over the next 12 months than in the past five years.

"We're still positive, and we expect a positive market returns over the next 12 months. We are forecasting a single-digit annual return, but we also see increased volatility going forward. From a return perspective, equities is still the asset class we favor the most," says a portfolio manager at an €11 billion Nordic pension.

"Over the next 12 months, it is ___________ that equity market index returns will be substantially lower than in the past five years."

Figure 1
Confidence in Index Returns Erodes



Enthusiasm regarding potential equity market index returns varies slightly along geographic lines. Less than 15% of North American respondents believe returns are very likely to be substantially lower, compared to 21% of their European counterparts.

"We are far along in the cycle, but the market remains supported by corporate results. Realized earnings per share remain quite impressive, especially in the US," says the CIO at a €37 billion European pension. "We're seeing some contraction in pricing, and forward price/earnings ratios are average. We're seeing more volatility, too, but we don't think this is the big correction that everyone is waiting for. However, that could change."

All Eyes on Volatility at the "Top of a Cycle"

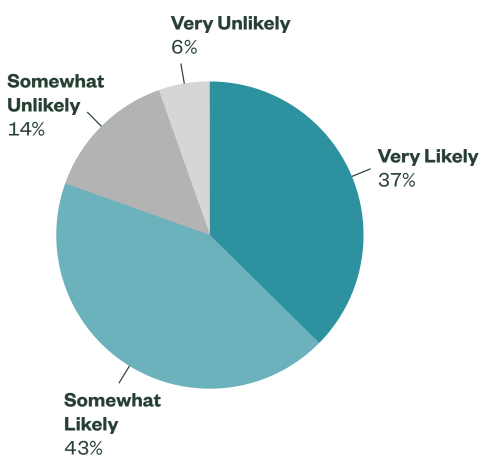
Regardless of their split outlook for equity index returns in the coming year, nearly all respondents expect a more volatile market environment. There are ample macroeconomic and geopolitical reasons to anticipate more volatility, but investors seem focused on market fundamentals, central bank monetary policy, and trade tensions as the main drivers.

"Volatility tends to rise when markets are mis-valued. In our view, the market is typically 10% – 15% overvalued or undervalued, and we believe the market is now overvalued. And when discount rates are low, as they are now, stock and bond volatility is potentially higher, because of longer duration — the importance of future cash flows, at low interest rates, is increased and there's higher sensitivity," says the CIO of $15 billion US state fund.

"No one really knows where the market is heading, although everyone has an opinion. We've had a pretty good run in terms of returns, and that could continue for a time. But we're at the top of a cycle, and it's getting hard for companies to beat the last big margin, and we expect returns to diminish. Comparing this year to previous years, it seems like it's trying to go up, but there have been a couple of spikes in volatility, which we expect will continue," says a senior analyst at a $32 billion US state pension fund.

"Over the next 12 months, it is ___________ that equity market volatility will increase substantially."

Figure 2
Equity Market Volatility Is Expected to Rise



Some investors believe that volatility is already on a significant uptick. "You can point to many causes of volatility that are happening right now. The big ones are China, Italy, and other geopolitical issues, and fiscal policy in the US. Global yields are also going up. Things are starting to shake a little bit. When we look at our own metrics, we're now at the higher end of normal volatility, so at some point one would expect it to revert, but we'll see what that looks like in the months ahead," says the CIO of a US state teachers' pension fund.

Investors with long time horizons, a category that includes most institutional investors, may see the chance to be opportunistic as volatility rises. "In developed markets, we are in the process of repricing based on fundamentals. We are long-term investors, so we are taking advantage of the volatility. Trading will be closer to fundamentals — this will be the defining factor," says the head of equities at a €480 billion European pension.

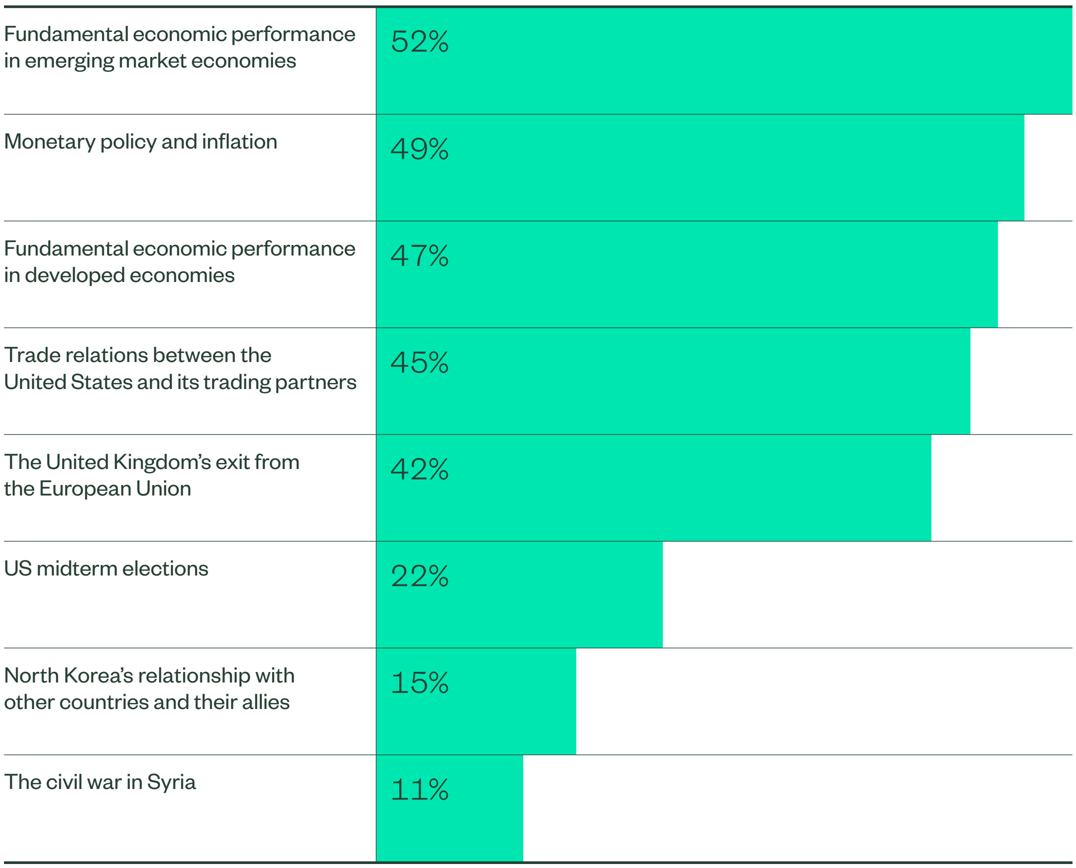
Listening for Fundamental Signals Amid the Noise

Monetary policy and fundamental economic performance in both developed and emerging markets are likely to determine equity performance in the coming year, say investors. More than half of respondents say that fundamental economic performance in emerging market economies will have the greatest effect on equity markets in the next 12 months. Trade relations between the US and its trading partners — notably, with China — is likely to affect equity market performance as well.

"Monetary policy is definitely the main driver of the markets. Geopolitics is usually just noise," says the head of equities at a €480 billion European pension. "With quantitative easing unwinding in Europe, central banks are still in expansion mode. The tipping point will be in early 2019, when we believe they will be taking money away." The CIO of a US state investment fund concurs, saying, "From our perspective, central bank liquidity provisioning is affecting the markets the most — that's what is most responsible for the booms and the busts around fair value."

Which of the following political and macroeconomic developments do you believe will have the greatest impact on equity markets over the next twelve months?

Figure 3
Economic Fundamentals Are Most Likely to Affect Equity Markets



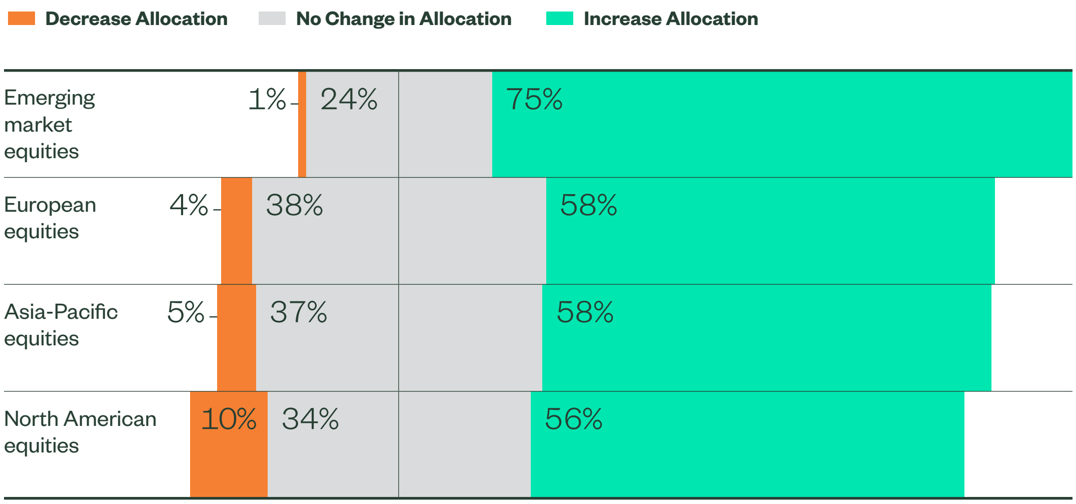
Keen interest in emerging market economic fundamentals is likely related to the fact that 98% of respondents who currently have invested in emerging markets anticipate their institutions will either increase or make no changes to their allocations to them over the next two years. Only 1% say they plan to decrease them.

"We have already seen a 20% correction in emerging markets, which we believe is closer to their true value, and there are good opportunities," says the head of EMEA equities of a European pension.

More than 75% of respondents anticipate their institutions will increase or make no changes to their allocations to North American equities over the next two years, with similar plans indicated regarding European and Asia-Pacific equities.

How do you anticipate your institution will alter its allocations to the following categories of equities over the next two years?

Figure 4
Strong Support for Equities, Especially in Emerging Markets*

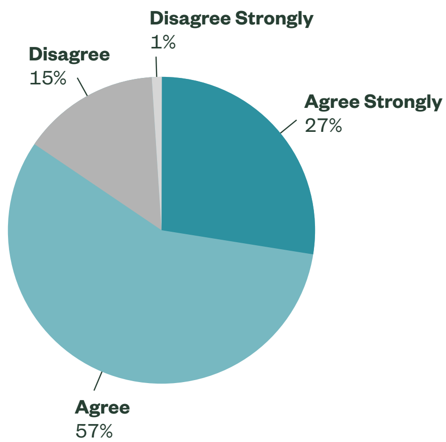


* Respondents who selected "Non-applicable" were excluded.

Enthusiasm for emerging market equities is tied to its comparative upside potential, say sources interviewed for this study. "We think about emerging markets in relative terms," says the CIO of a large US public retirement plan. "US equities are negative for the year, so where else are we going to put our funds? Emerging market equities are cheap on a relative basis — We believe there is room for growth, and we can't afford not to be in emerging markets." Similarly, says the CFO of an €11 billion European pension, emerging markets are "an important component to a diversified portfolio, and countercyclical to US markets, so we're always looking for opportunities." Queried directly on the potential for emerging markets, more than 80% of survey respondents agree or agree strongly that their institutions would benefit from greater exposure to this asset class.

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

Figure 5
Investors Call for Greater Emerging Market Exposure



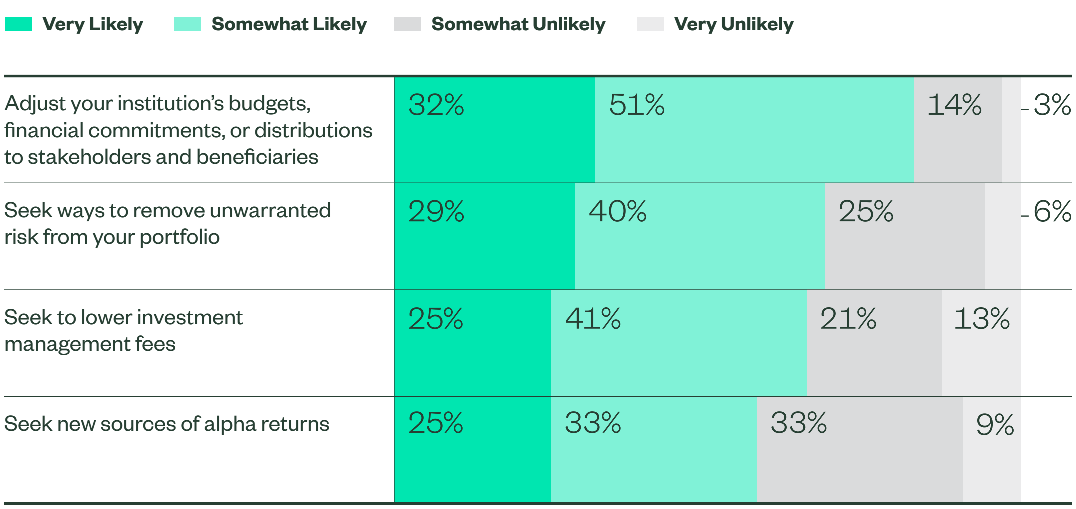
Beyond monetary policy and economic fundamentals, it is feared the US trade spat with China will have knock-on effects globally. “With the US trade policy, China has to devalue the yuan, which makes its exports less expensive for the US, and the US Treasury takes the tariffs. In Europe, exports are more complicated — Europe is the victim here. European economic figures are falling. US rates are a concern, too. But in the ’90s, the markets were doing well and rates were much higher, so it’s all relative. The market will figure it out,” says the chief investment officer of a European insurance company with more than $1 trillion under management.

Asset Owners Play Defense, and Active Strategies Provide Room to Maneuver

Investors are taking proactive measures in anticipation of lower equity returns and rising volatility over the next two years. Most institutions will play a bit of defense by re-examining budget allocations and looking to shed some risk from their portfolios.

How likely is your institution to take the following steps over the next two years in response to the equity market outlook?

Figure 6
Investors Revisit Internal Commitments and Lessen Risk Exposure



"The markets today are overvalued, in our view," says the CIO of a US state investment fund. "We have a trigger, which signals us to go to our minimum risk position, that was tripped last year, and we're part way through our de-risking process. We don't have any short-term return expectations. We estimate the fair value of all assets on an ongoing basis and observe whether prices at any moment in time are below or ahead of that."

“We’re not making attempts to time the cycle. We take a defensive stance anyway. In a downturn, our relative performance would be good. We’re positioned that way already,” says the head of equities of a €220 billion European pension.

Other investors respond to volatility aggressively and see opportunity in turbulent markets. “We are long-term investors, so we’re able to weather short-term volatility. Pullbacks can be good entry points. We’re also well diversified — especially in real assets like real estate and infrastructure. We think down the line and ignore the noise,” says the head of EMEA equities of a European pension.

Active Allocations Play Key Role in Sophisticated Strategies

Interviews conducted for this report reveal that many investors think active allocations are a key component of the sophisticated overall strategy they will rely on as they confront a lower return, higher volatility landscape. The majority of investors interviewed indicate it’s not a matter of whether they will allocate assets to active management, but rather that active management is vital to getting the most out of a particular investment hypothesis. A phrase that appears consistently throughout the interviews supports this trend — “it depends.”

“We have both actively and passively managed allocations. It depends on the strategy,” says a senior analyst at a $32 billion US public retirement fund. “For example, we have some US large-cap managed passively to give us the benchmark return over time, but most is managed actively to generate some outperformance. We use passive management for equities that are hard to manage actively, like emerging markets. 80% of our total AUM is managed in house. Only a small portion is managed externally,” says this senior analyst.

“If we think we it will give us an edge, we might manage a strategy actively and in-house — it depends on our level of conviction and whether we can deliver it effectively. If not, we’ll look for an external manager who can,” says the head of EMEA equity at a European pension.

“Of the 20 billion Danish Krone that we manage, about 75% is actively managed. Some long-term equity strategies are handled by external managers, and some we do internally. It depends on the investment views, strategies, and expertise. Ordinary fixed income, the overlay of duration risk, and listed US large-cap equities are passively managed,” says the CFO of a European pension.

To Maximize Risk-Adjusted Returns Investors Look to Active Quant

With a goal to maximize risk-adjusted returns in what they anticipate will be a period of weaker equity market returns and increased volatility, 24% of investors believe active quant strategies could be the answer. In what represents the leading most effective/least effective assessment in the survey, only 15% of respondents say that active quant strategies would be least effective in maximizing risk-adjusted returns. However, fundamental bottom-up strategies are considered the most effective by 24% of investors, but a nearly equal proportion find them least effective.

24%

of investors believe active quant is the most effective strategy for the next two years

14%

of investors see high conviction, concentrated strategies as most effective

Commenting on their preference for active quant strategies, survey respondents cited the breadth of investment opportunities and indications of nascent market trends as important sources of quant strategies' value. Active quant strategies make "different markets and geographies more easily accessible," according to the COO of a European insurer. In the US, the CIO of an insurance company says, "Quant strategies enable us to gather a lot of data and hence different markets, countries, and companies become accessible to us." A managing director at a European endowment says, "Information obtained from quantitative strategies using analytics serves our purpose of recognizing market trends and makes our decision making simpler."

The implementation of active quant strategies reflects the "lower aggregate return, higher volatility" view investors have of the next two years. "On the equities side, we're one-third active. We have some active impact investing strategies in the portfolio, and we have an active quant equity portfolio as well, which we use to reduce volatility and generate returns," says the head of equities at a €220 billion European pension.

Which of the following strategies is likely to be most effective in delivering risk-adjusted returns for your institution's equity allocation over the next two years? Which is likely to be least effective?

Figure 7

Quantitative Strategies Prevail as Most Effective Source of Risk-Adjusted Return Over the Next Two Years

	Least Effective	Most Effective
Active quantitative strategies that draw on sophisticated analytics and highly diverse sources of information	15%	24%
Smart Beta strategies that rely on well-known, transparent quantitative factors	21%	23%
Fundamental, bottom-up active equity strategies	23%	24%
Long/short hedge funds	22%	17%
High-conviction, concentrated active equity strategies	21%	14%

While quant strategies may not be universally embraced, in part due to governance constraints ("We don't use quantitative strategies — not because we think they don't work, but because they require your board and others to believe in them and to stick to them," says one CIO), many investors find they complement other strategies in the effort to boost risk-adjusted returns.

"From a quant perspective, we're not heavy traders, but we do use a quant-driven process to create customized portfolios to pick up beta in certain markets, and we find metrics and do the qualitative work to back it up," says the head of direct investments at an $18 billion US university endowment. "None of our passive allocations are traditional. For example, we don't buy ETFs, or we might take an emerging markets index of 800 companies and invest in 200 of them, excluding government entities and companies in certain sectors. There is always a tilt, but it's still passive, and it's a larger, diverse portfolio that has less tracking error than a concentrated or long-short strategy. As we make the selections, we go out and make visits and talk to senior management to make sure what the quant models tell us is really true."

The willingness to go an extra mile, whether making in-person visits to company leadership or undertaking a detailed and unflinching review of an investment process, can reveal the potential for quant strategies to outperform.

“Two years ago, we started a comprehensive review of our investment process and made decisions to cut areas where we don’t believe there’s an alpha story, and to growing areas where we believe there is an alpha story. We believe there’s an alpha story in quantitative strategies,” says the CIO of a US teachers’ pension fund that manages most of its quant strategies internally. “Ten years ago, most of them were managed externally, and about five years ago, we started an internal paper portfolio with our staff who had learned from our external managers. They’re multifactor strategies that we’ve scaled up, and they’ve grown. We’re fortunate to have a network of external managers and investment funds that we work with — they’ll never tell us their secrets, but at least developing our staff by working with them and learning from them has been one way to capture what we think is generous alpha.”

Closing Thoughts

Institutional investors in North America and Europe expect equity market returns will be lower and price volatility will be higher than in recent years. In response, say the investment decision makers contributing to this study, they'll increasingly look to a broader universe of prospective investments and active strategies to meet their risk/return requirements.

No single strategy is suitable for all institutions. Nonetheless, active quantitative strategies emerge as a top choice among study participants. Some sources see active quant strategies as an innovative way to take advantage of nascent market trends revealed through rigorous analysis of vast data sets that span an unconstrained (or less constrained) investment universe.

For complete discussion of how investors think about extracting value from a broader, more volatile market, see the companion to this report, "The Power of Active Quantitative Strategies." 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.

About This Research

Institutional Investor's Custom Research Lab composed a questionnaire with State Street Global Advisors 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 America and Europe. To supplement the survey findings, we interviewed more than 10 investment decision makers at asset allocators in North America and Europe. The demographic highlights of the research program are below.

200

survey respondents from North America and Europe

$3.4 Trillion

in assets under management by survey respondents

Figure 8
Broad Representation Across Institution Types and Sizes

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	

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

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 sustainable 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 $2.5 trillion*under our care.

*AUM reflects approximately $32.4 billion (as of December 31, 2018), 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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