White Paper
Equity

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Stop. Rethink Everything.

Why you need to reallocate your equity now

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There can be very few of the world's investors unaffected by the recent COVID19 crisis.

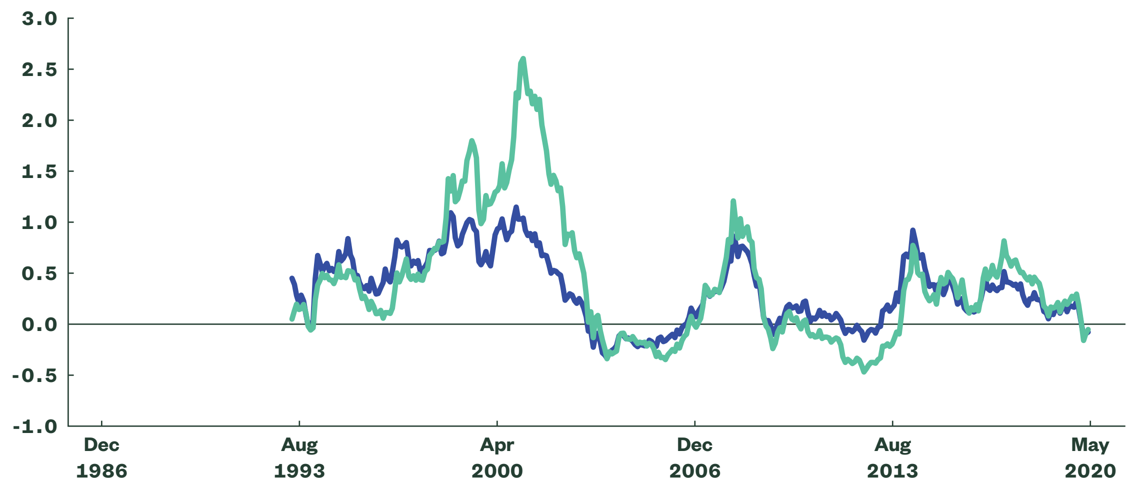
Facing an environment of increasing uncertainty[1] and complexity, we think now's the ideal time to stop and ask yourself: Do I still have the optimal portfolio for now? What could I be doing differently and how much difference could it make?

In this paper, we outline our thoughts on how investors can rebuild their equity portfolio to be fit for the future.

Why the Need to Reallocate?

Crisis-related drawdowns wiped out much of the last 5 year's of returns for many investors. Despite a subsequent stunning rebound in the US, the COVID19 crisis drawdown pulled trailing 5-year returns for UK and Eurozone equities firmly into the red.

Figure 1
Trailing Five-Year Returns

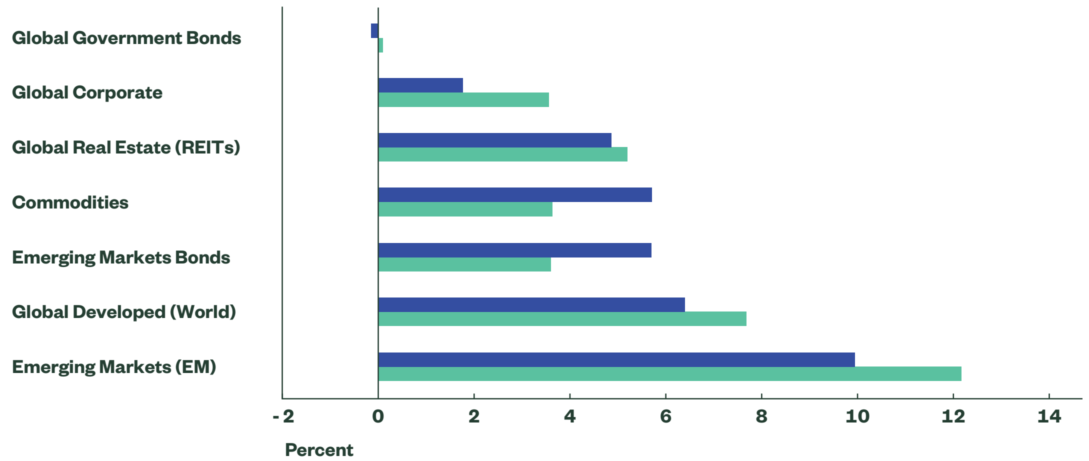


Source: Thomson Reuters Datastream, State Street Global calculations, Data as of 29 May 2020. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expenses associated with the fund or brokerage commissions associated with buying and selling a fund. Index performance is not meant to represent that of any particular fund.

Investors Need to Reallocate to Get Back in the Game

To provide their end investors the returns they have been promised, investment managers now likely need to source returns in the region of 6–8%. Unfortunately — as our long-term asset class forecast below shows — the only way to reach these returns for most investors in public markets is equities.

Figure 2
Forecasted Long-Term Annualized Return

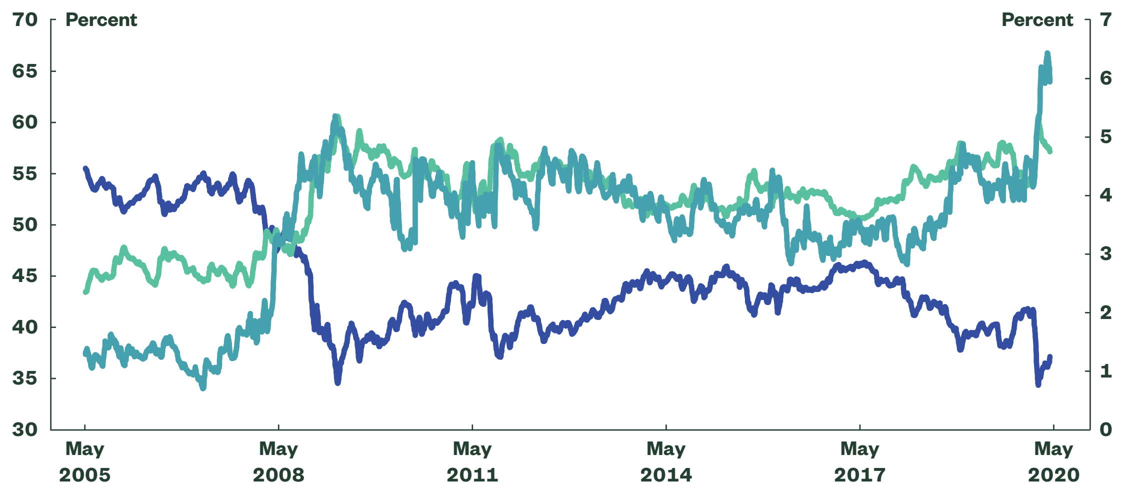


Source: State Street Global Advisors, Data as of 31 March 2020. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

Equities: The Only Game in Town

The catch is that currently, investors are underweight to equity, and our proprietary data shows that they had actually been reducing their allocations to equities since around Q3 2018. Many watched the 'most-hated' rally of 2019 from the sidelines, and so may have mostly missed out on the double-digit returns on offer then, even if that may have meant they swerved the swoon of COVID. In any case, we expect that as economic and financial conditions stabilize, we will see these cash holdings finally reduce *out of necessity*, and that allocation will *need* to move back into equities, the only remaining game in town.

Figure 3
Europe Asset Class Holdings

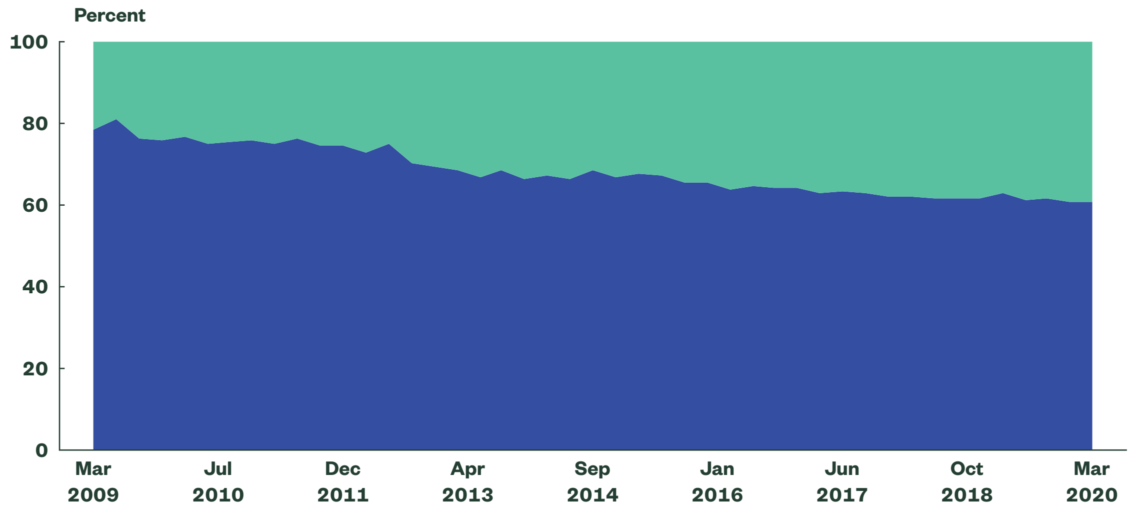


Source: eVestment Alliance, State Street Global Advisors calculations, Data as of 29 May 2020. Characteristics are as of date indicated and shouldn't be relied on thereafter.

Investors Will Move Deeper into Equities

In fact, we envision a major inflow to index equities, similar to that which happened after the GFC. However, at the end of the GFC we saw a brief burst of inflows into Active equity before the now seemingly relentless shift from Active to Index took hold. That trend has by now seen the Index proportion of institutional equity 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.

Figure 4
Indexing Share of Equity AUM Doubled to 40%



Source: eVestment Alliance, State Street Global Advisors calculations, Data as of 29 May 2020.

Active Has Changed

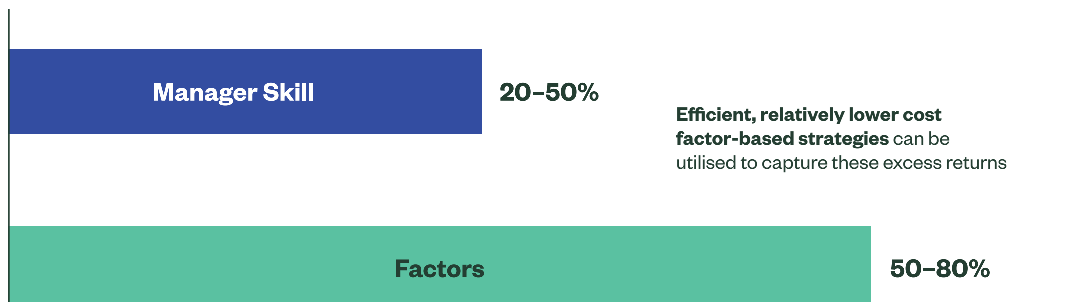
Active today is not the same binary proposition as Active in 2009. Today, investors can choose from a spectrum of Active. There are many more choices in terms of investment style (eg factor or smart beta strategies or different ESG approaches) and vehicle (from broad index funds through focused ETF's to highly concentrated active managers), and the differences between these choices are now much better understood.

Look Also to Smart Beta

In particular, the awareness and availability of vehicles for factor investing has expanded over the last 10 years, with low volatility products leading the first wave given their solid performance through and after the Global Financial Crisis. We believe these low volatility strategies will continue to prove their worth in the aftermath of the COVID crisis, as the background level of volatility remains materially higher than we have seen over the last 5 years, and the efficacy of 'buying the dip' evaporates as central banks reach the limits of their stimuli.

Given better awareness of the spectrum of investment products, and of factor investing in particular, we see investors correctly being more choosy — avoiding Index Huggers and converting Factor Huggers to cheaper and more reliable Smart Beta, and adding these to both pure indexing and concentrated stock-pickers.

Figure 5
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.

Don't Overdo the Active

Empirical data shows that the average active manager has underperformed their benchmark Index net of fees across a broad range of asset classes and geographies, over the short- (through the COVID crisis) to long-term (15 years). This does not mean that all active managers have underperformed, nor will they going forward, and there will always be a number whose innate investment skill means they can excel and provide Alpha, however difficult the environment.

Even though finding such skilled managers can be difficult, and proving persistent outperformance even more challenging, such managers should find a home in many investment portfolios where fee and risk budgets, as well as capacity constraints, allow, given the high net of fee excess return they can provide, in an otherwise heavily constrained environment.

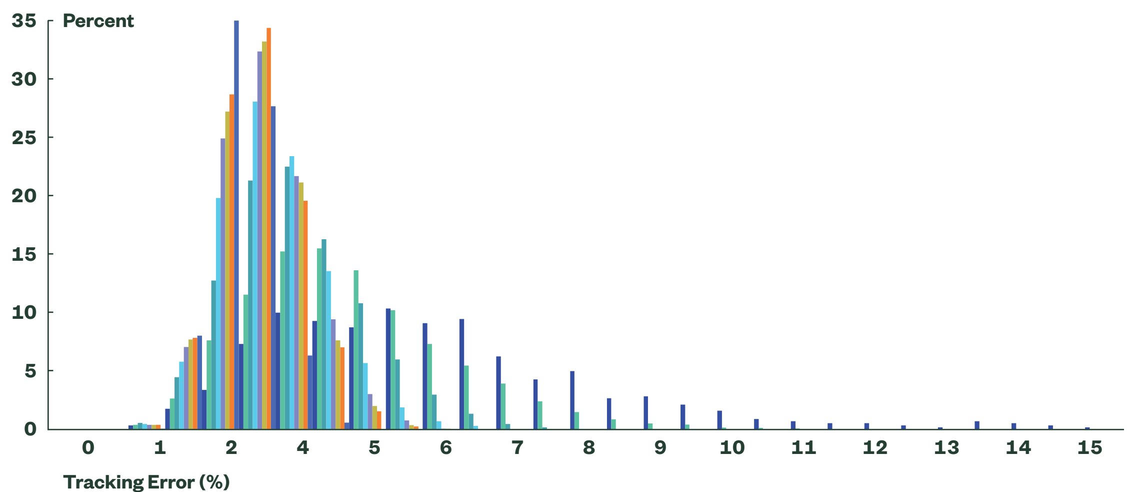
In particular, in the environment we see currently and expect to persist going forward of concentrated benchmark indices, a concentrated discretionary approach can prove particularly effective.

Be Wary of Overdiversification

But, be careful, we've shown that it makes sense to be discerning when allocating to active to in order to avoid overdiversification.[2]

Institutional investors often allocate to active managers in order to meet their return objective but hiring too many managers significantly reduces active risk, leaving the investor with high fees and limited ability to outperform the benchmark. In other words, it pays to be judicious in the number of active managers engaged.

Figure 6
The Active Risk Opportunity Set from 1 to 20 Equally Weighted Funds



Source: What Free Lunch? The Costs of Overdiversification — Shawn McKay, CFA, Robert Shapiro, CFA, and Ric Thomas, CFA: Financial Analysts' Journal Q1 2018.

The Correct Way to Rebuild

Given that investors will need to allocate to equities to achieve their return targets, and that there is now a wide array of well-differentiated equity offerings available, it makes sense for investors to use a combination of the products available to realise their objectives.

Indeed, our quantitative analysis of combining Index, Enhanced, Smart Beta and Active strategies within an equity portfolio makes the case very clearly that investors should and can allocate across all these strategies.

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.

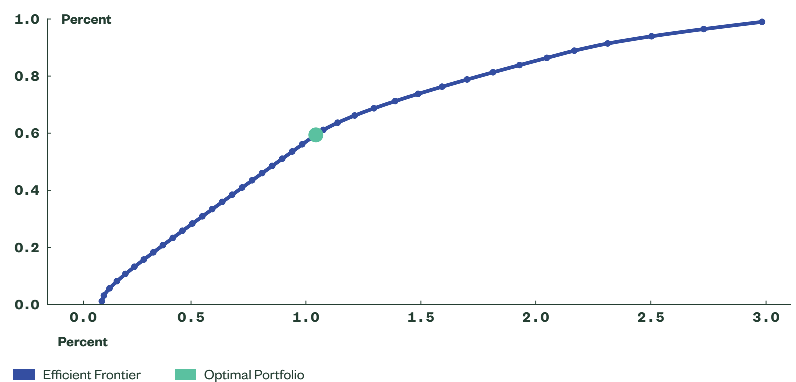
The optimal portfolio has weighted average fee of 15 bps. Constraining the fee to 10 bps implies a shift from enhanced/active into smart beta. Increasing tracking error shifts from index/enhanced into smart beta/active.

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 7
Finding the Optimal Portfolio for Equity Strategies

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.



75% + **25%**

Index + Enhanced

Active + Smart Beta

Capturing the Premium The equity return premium continues to be the most important return driver for many diversified plans, so, building a robust equity program across market-capitalisation indexing, enhanced indexation, smart beta and judicious use of active management (both fundamental and quantitative) is key to the overall success of an investment plan.

1 See, for example, https://hbr.org/resources/images/article_assets/hbr/1401/F1401C_A_LG.gif.
2 What Free Lunch? The Costs of Overdiversification — Shawn McKay, CFA, Robert Shapiro, CFA, and Ric Thomas, CFA: Financial Analysts' Journal Q1 2018.

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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 Rigour 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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These investments may have difficulty in liquidating an investment position without taking a significant discount from current market value, which can be a significant problem with certain lightly traded securities.

The returns on a portfolio of securities which exclude companies that do not meet the portfolio's specified ESG criteria may trail the returns on a portfolio of securities which include such companies. A portfolio's ESG criteria may result in the portfolio investing in industry sectors or securities which underperform the market as a whole.

A Smart Beta strategy does not seek to replicate the performance of a specified cap-weighted index and as such may underperform such an index. The factors to which a Smart Beta strategy seeks to deliver exposure may themselves undergo cyclical performance. As such, a Smart Beta strategy may underperform the market or other Smart Beta strategies exposed to similar or other targeted factors. In fact, we believe that factor premia accrue over the long term (5-10 years), and investors must keep that long time horizon in mind when investing.

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