Insights
Active Quantitative Equity (AQE)

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Reconsidering Equity Risk

Risk across equity sectors is hard to isolate. A rigorous, systematic approach to assessing risk, therefore, is critical to unlocking excess return opportunities.

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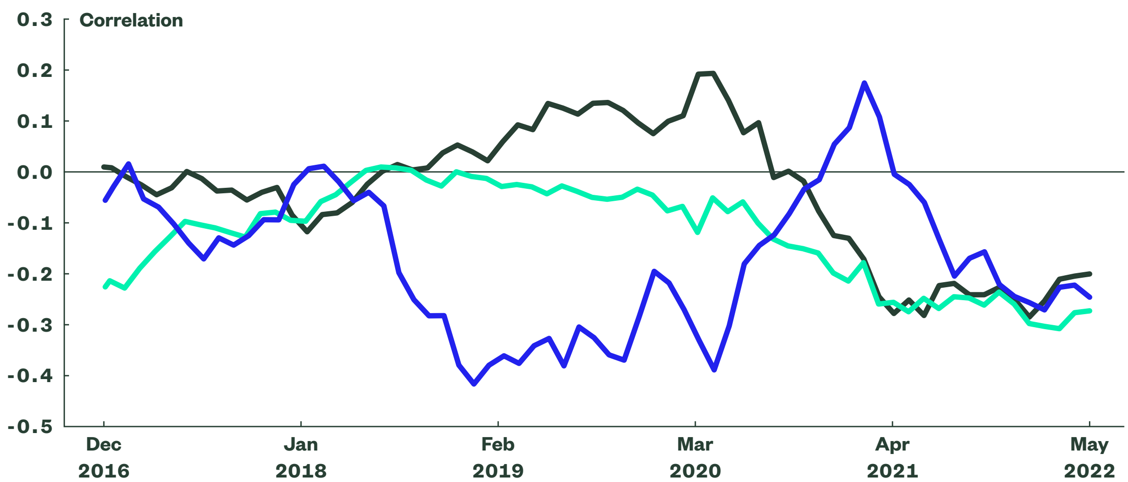
Active Quantitative Equity

By design, the Active Quantitative Equity (AQE) team's alpha model favors securities with high-quality balance sheets, reasonable growth expectations, improving market sentiment, and attractive valuations. Focusing on these themes can lead to differences over time in the riskiness[1] of our most preferred stocks.

Because of current market conditions, our most preferred stocks at the moment are, in total, quite a bit less risky than the average stock. In fact, each of the three main themes we focus on — Value, Quality, and Sentiment — are all pointing toward lower-risk names than has been typical for AQE over time (see Figure 1).

Figure 1
Correlation of Expected Returns with Risk

Value
Quality
Sentiment



Source: State Street Global Advisors as of May 31, 2022.

However, this does not mean we *only* like low-risk segments of the market. Our systematic, bottom-up approach currently favors some high-risk segments, while we have a negative outlook on some low-risk segments.

Energy

By some measures, the Energy sector is high risk; however, we hold a very positive view of that sector overall. How can this be? Let's take a closer look.

Due to the tremendous increase in both Sentiment and Quality metrics within the Energy sector over the last year, as well as the improving Valuation scores, our model sees the Energy sector — broadly one of the highest-risk segments of the market — as the most attractive of all sectors.

As of the end of May, the Energy sector on average, using our measure of risk, is the second most risky sector, only trailing Consumer Discretionary stocks, the riskiest sector, by a tight margin. While the Energy sector is up over 50% year to date, earnings-per-share (EPS) growth estimates are up over 60% this year, outpacing the index. We think the Energy sector is even more of a bargain than it was at the start of the year. This has led to a decline in the price-to-earnings ratio (P/E) of the sector broadly. As a result, we continue to find opportunities in the sector. A few segments of the Energy sector that we like are highlighted in Figure 2.

Figure 2
Segments of Interest in Energy Sector

	Expected Return	Value	Quality	Sentiment	Risk
Integrated Oil & Gas	High	Above Average	High	High	Below Average
Oil & Gas Exploration & Production	High	Above Average	Below Average	Extremely High	Average
Oil & Gas Refining & Marketing	High	Above Average	Extremely High	High	Low
Oil & Gas Storage & Transportation	High	Average	Above Average	High	Very Low

Source: State Street Global Advisors as of May 31, 2022.

Real Estate

Real Estate is another sector that shows how our process, although risk-aware, is not overly constrained by its influence. The Real Estate sector is one of the least risky; however, it ranks as one of the lowest categories from our total alpha perspective. This is largely driven by extremely poor valuation across the board, coupled with varying levels of Quality and relatively average Sentiment metrics. Real Estate has had a challenging year to date — down nearly 15% — while EPS estimates for the sector have been flat. We do not see this trend easing, particularly on the corporate Real Estate side, as companies move to more remote and hybrid return-to-work models for their workforces.

Although the sector has experienced a slight decline in multiples, we still view the sector as more expensive than other parts of the market. When combined with unappealing Quality and Sentiment scores, our outlook for the sector becomes poor (see Figure 3).

Figure 3
Real Estate Assessment Across Metrics

	Expected Return	Value	Quality	Sentiment	Risk
Residential REITs	Average	Extremely Low	Average	Above Average	Extremely Low
Office REITs	Average	Average	Above Average	Below Average	Extremely Low
Industrial REITs	Below Average	Extremely Low	Average	Above Average	Low
Real Estate Operating Companies	Below Average	Below Average	Average	Low	Low
Real Estate Services	Extremely Low	Low	Low	Extremely Low	Above Average

Source: State Street Global Advisors as of May 31, 2022.

The Bottom Line

Risk is often associated with a particular sector or segment of the market. In reality, however, risk usually does not appear in isolation. Instead, risk manifests within sectors, industries, regions, or countries (or combinations of these) simultaneously. In assessing risk and its complexities, the AQE team relies on a balanced, disciplined, and diversified bottom-up approach, which allows us to effectively target opportunities as they present themselves — even when views on risk within sectors diverge.

Endnote

1 AQE's definition of risk includes both absolute stock volatility and volatility relative to the overall market, as measured by beta.

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* Pensions & Investments Research Center, as of December 31, 2020.
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