The New Rules for Capturing Risk Premia

For sophisticated investors, advanced beta offers a new answer to an old question: “What is the optimal way to take and be compensated for risk?” Lying somewhere between active and index investing, advanced beta represents a new sweet spot for generating risk-adjusted returns. While active and traditional index strategies continue to have distinct roles to play in portfolio construction, we believe advanced beta strategies are changing the game in terms of how investors identify and take risks in their portfolios.

Simply defined, advanced beta is a rules-based approach to investing that seeks to capture specific risk premia in the marketplace, such as those historically associated with value, low volatility and small-cap stocks, or the issuer and credit risk of corporate or sovereign bonds. Advanced beta strategies combine the transparency, liquidity and flexibility of indexing with the ability to take an active view on which risk factors may outperform over time. As a result, advanced beta portfolios are able to capture specific risk/return characteristics in a more cost-efficient package than active management.

With the potential for generating attractive long-term risk-adjusted performance, advanced beta strategies may serve as an effective complement to both traditional active and index holdings. Whether investors are rebalancing away from active or index strategies, advanced beta offers the potential for improving Sharpe ratios without overpaying for performance.

From Theory to Practice

Discussions of active versus index investing are often highly focused on academic theories and market research, while ignoring the messy reality of investing for today’s pensions, endowments, foundations and corporations. Institutional investors frequently have a mix of active and index-based investments across and within different asset classes. Adding to this complexity, their views on individual asset classes may evolve over time as market conditions shift or their plan’s liabilities and investment needs change. As such, many institutional investors tend to fine-tune portfolios gradually. New ideas are tested by taking small positions and existing portfolios are rebalanced incrementally.

Starting in the 1970s, many researchers began to find that some of what people thought of as an active manager’s outperformance due to superior asset selection could actually be chalked up to distinct, identifiable market factors. Often more important than the performance of an individual stock, for example, was the general category of stocks that particular security belonged to, be it value, low volatility or momentum. This is not to say that manager skill doesn’t exist. The best active managers can add value through superior security selection, but selection alone, the data seemed to suggest, may not fully explain their performance. Part of the returns an active manager delivers may be derived from general risk premia that exist in the marketplace.
Still, it took the financial crisis of 2008 for the day-to-day investment community to start taking up these ideas. In the aftermath of the crisis, we have seen many investors re-examining the question of how to access the risk premia they seek to meet their investment needs. A big part of the appeal of indexing had always been the diversification it provides in terms of holding a large number of securities. Yet, during the low point in the crisis when the broader market was down by nearly 50%, even index strategies could only offer so much protection. At the other end of the spectrum, it was thought by many that the selective use of active management provided lower tail risk in addition to the potential for excess return over the market. The crisis highlighted the limitations of this view since the correction in the broad market universally affected all types of managers except for a handful of tail-risk funds. Naturally, this caused more investors to question whether the higher fees charged by active managers are always worth it, and whether factor exposures could be achieved in a more transparent and efficient manner.

Against this backdrop, advanced beta has emerged as a way to potentially solve for the sometimes-competing objectives of the post-crisis environment. The investors we speak with are realizing there are risk premia they can capture to potentially lower their susceptibility to the next tail-risk event, enhance returns or act on other convictions they may have about the general direction of the markets, without necessarily adding to the portfolio’s roster of active managers. To the extent that such factors are attributable to systemic risk premia—beta, in a word—investors can capture them with simple, transparent, rules-based beta strategies and cut out the middleman.

Factoring in Specific Objectives

Still, advanced beta is not a magic bullet. It’s a tool—a tool that puts a tremendous amount of power and precision directly in the hands of the investor. In order for investors to use advanced beta effectively, they need to have a fairly clear sense of what they are using it for and how they plan to implement it.

The first step is deciding what risk factors to capture. When considering an equity investment, for instance, looking at some common equity factors can provide a logical jumping-off point. Factors to consider may include:

- **Value** Low-valuation stocks have outperformed high-valuation stocks over time.
- **Low volatility/low beta** Low-volatility stocks have delivered better risk-adjusted performance than high-volatility stocks over time.
- **Small cap** Small-cap stocks have tended to outperform their large-cap peers over time.
- **Momentum** Stocks associated with higher momentum have outperformed stocks with lower momentum over time.
- **Quality** Stocks of higher-quality companies have delivered better risk-adjusted performance than stocks of lower-quality companies over time.

Investors can choose to access one factor or combine multiple risk factors within a single portfolio. One popular combination is value, quality and low volatility. This combination theoretically creates a portfolio with lower than average valuation and volatility, and higher than average quality (measured by metrics like profitability, earnings variability and leverage). A “three-factor” approach like this attempts to take advantage of the potential diversification that a combination of risk premia provides over time. With single-factor strategies, the cyclicality of an individual risk factor can present pricing challenges when timing your entry or exit from the investment. A three-factor portfolio helps to neutralize that cyclical variation.

Once investors have identified the factor or factors they may be most interested in capturing, they can begin to look at the specific realities of their current holdings to consider where and how advanced beta strategies may fit in. If investors need to lower the volatility of their funded status, they would likely seek out advanced beta strategies with a distinctly different (and lower-volatility) cast than the traditional beta holdings being swapped out. Or if they have determined that they are overpaying for some of their performance, they may be looking to mimic existing active strategies, but at a better price.

Putting Investors in the Driver’s Seat

Advanced beta strategies allow investors to take true ownership and control of their investment decisions. Rather than relying on asset selection for performance, though, advanced beta seeks to capture risk premia through a rules-based approach. Investors are actively identifying the risk premia they want, while enjoying an index-like implementation of the strategy. The result is the potential for active-like returns, in a rules-based, lower-cost vehicle.

For advanced beta investors, the ability to choose their own rules cuts both ways. Investors are reducing the cost of outperformance potential, but will also need the courage of their convictions when the factor or factors they’ve chosen may be out of favor. An active value manager, for example, is used to the ups and downs of the market cycle and comes with fortitude built in through perhaps decades of experience. Similarly, the institutional investor will need to resist the temptation to abandon a value advanced beta strategy when it’s experiencing short-term difficulties. By taking a long view, advanced beta investors are more likely to realize the rewards of the strategies they’ve chosen.
When investing in a single-factor strategy, investors may naturally want to consider making an initial investment when prices are low among securities representing that particular risk factor. When investing in a multi-factor strategy, timing and pricing may still be a consideration, but it may be easier to implement the strategy at a broader range of points in the market cycle. Working with an experienced advanced beta manager can help investors better understand and forecast market conditions impacting the factors they ultimately choose to pursue.

A Leader in Beta and Advanced Beta Strategies

With advanced beta strategies establishing a firmer foothold in institutional portfolios, investors have more ability than ever to choose the exact risk exposures they want. At State Street Global Advisors (SSGA), we draw upon decades of hands-on experience managing advanced beta portfolios to help clients make the most of these powerful tools. We are one of the largest providers of index and rules-based strategies in the world, with more than $1 trillion\(^3\) in traditional and advanced beta assets under management. Our advanced beta strategies alone represent more than $70 billion\(^1\) of assets, making us a valued partner for institutions pursuing rules-based investment opportunities related to specific investment characteristics.

As pioneers in the field of advanced beta, we continue to be on the front lines of bringing advanced beta solutions to market. Recognizing that advanced beta is often a complement to traditional active and passive strategies, we help clients take a holistic view of their existing holdings and objectives before implementing. We can help clients evaluate the effectiveness of single-factor versus multi-factor approaches, given current goals and constraints, and how best to incorporate an approach into the overall portfolio.

We believe advanced beta is potentially underused by many investors—particularly among those who have clear beliefs in the benefits of capturing individual or combined risk premia. The new rules of the game provide investors the opportunity to meet investment goals with greater precision while paying less for performance. All they need are the convictions, the right guidance and the willingness to do it.

For Institutional Use Only—Not to be Used with the Public

1 Several factors would eventually be discovered, including: low beta (Black, Jensen, and Scholes, 1972); size (Banz, 1981 and Reinganum, 1981); P/E (Basu, 1977); P/B (Fama / French 1993); quality (Haugen, 1979); and momentum (Jagadeesh, and Titman, 1993).

2 The data was reported by researchers in several different articles, including: The Capital Asset Pricing Model: Some Empirical Tests (Black, Jensen, and Scholes, 1972); The Relationship Between Return and Market Value of Common Stocks (Banz, 1981); A New Empirical Perspective on the CAPM (Reinganum, 1981); Investment Performance of Common Stocks in Relation to Their Price-Earning Ratios (Banz, 1977); Common Risk Factors in the Returns of Stocks and Bonds (Fama / French 1993); Do Common Stock Ratings Predict Risk? (Haugen, 1979); Returns to Buying Winners and Selling Losers (Jagadeesh, and Titman, 1993).

3 As of December 31, 2013

The Spectrum of Factor Investing

Investors can gain exposure to risk premia associated with different market factors across a broad spectrum of investment styles. Advanced beta represents an inflection point in the continuum — it is the last fully rules-based style of investing before the spectrum begins to tip into active management via active quant strategies. As a result, advanced beta can provide investors with active-like returns, while still maintaining many of the benefits that investors expect from traditional indexing, including low costs, transparency and liquidity.

Even within advanced beta, investors can choose from a range of options for accessing the specific market factors they seek. Depending on their objectives, some investors may choose advanced beta strategies based on a single market factor such as value stocks. Others may choose an advanced beta strategy combining multiple factors such as value, quality and low volatility for a more diversified and potentially less cyclical strategy. At State Street Global Advisors, our solutions group can also help investors deconstruct their entire portfolios through a factor lens. They help investors identify precisely where their factor exposures currently exist. They then help them determine which can be accessed most efficiently via indexing, where a true active approach is required, and where advanced beta is the best solution given investors’ total return objectives, their preferences for managing risks and expenses, and their views on the market.
Advanced Beta Series  |  How Advanced Beta is Changing the Game

For More Information on Advanced Beta
In the United States, please visit ssga.com/advancedbeta
In Europe, please visit ssgainsight.com

State Street Global Advisors Worldwide Entities

Australia: State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services Licence (AFSL Number 238278). Registered Office: Level 17, 420 George Street, Sydney, NSW 2000, Australia. T: +612 9240-7600. F: +612 9240-7611. Belgium: State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: +32 2 663 2038, F: +32 2 672 2077. SSGA Belgium is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. Canada: State Street Global Advisors, 770 Sherbrooke Street West, Suite 1200 Montreal, Québec, H3A 1G1, 514-282-2400 and 36 Adelaide Street East Suite 500, Toronto, Ontario M5C 3G6. T: 647-775-5900. Dubai: State Street Bank and Trust Company (Representative Office), Boulevard Plaza 1, 17th Floor, Office 1703 Near Dubai Mall & Burj Khalifa, PO Box 28838, Dubai, United Arab Emirates. T: +971 (0)4-3372800. F: +971 (0)4-3372818. France: State Street Global Advisors France. Authorised and regulated by the Autorité des Marchés Financiers. Registered with the Register of Commerce and Companies of Nanterre under the number: 412 052 680. Registered Office: Immeuble Défense Plaza, 23-25 rue Delavierre-Lefouillou, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00. F: (+33) 1 44 45 41 92. Germany: State Street Global Advisors GmbH, Briener Strasse 59, D-80333 Munich. T: +49 (0)89-55878-100. F: +49 (0)89-55878-440. Hong Kong: State Street Global Advisors Asia Limited, 6/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200. Ireland: State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Incorporated and registered in Ireland at Two Park Place, Upper Hatch Street, Dublin 2. Registered Number: 145221. Member of the Irish Association of Investment Managers. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. Italy: State Street Global Advisors Italy, Sede Secondaria di Milano, Via dei Boschi, 4 20121 Milan, Italy. T: +39 02 32086 100. F: +39 02 32086 155. State Street Global Advisors Italy is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. Japan: State Street Global Advisors (Japan) Co., Ltd., 9-7-1 Akasaka, Minato-ku, Tokyo 107-6239. T: +813 4530 7380. Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345). Japan Investment Advisers Association, Investment Trusts Association Japan, Japan Securities Dealers Association. Netherlands: State Street Global Advisors Netherlands, Adam Smith Building, Thomas Malthusstraat 1-3, 1066 JR Amsterdam, Netherlands. T: +31 (0)20 7191701. State Street Global Advisors Netherlands is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. Singapore: State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Registered Number: 200000219D). T: +65 6826-7500. F: +65 6826-7501. Switzerland: State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 18. United Kingdom: State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered Number: 2509289. VAT Number: 5778591. Registered Office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: +44 3395 6000. F: +44 3395 6350. United States: State Street Global Advisors, One Lincoln Street, Boston, MA 02111-2900. T: (817) 664-7727. SSGA generally delegates commodities management for separately managed accounts to SSGA FM, a wholly owned subsidiary of State Street and an affiliate of SSGA. SSGA FM is registered as a commodity trading advisor (“CTA”) with the Commodity Futures Trading Commission and National Futures Association. This communication is not specifically directed to investors of separately managed accounts (SMA) utilizing futures, options on futures or swaps. SSGA FM CTA clients should contact SSGA Relationship Management for important CTA materials. The views expressed in this article are the views of Rick Lacaile, Lynn Blake, Ric Thomas, Scott Conlon, Ana Harris, Dan Farley and Jennifer Bender through the period ended August 8, 2014 and are subject to change based on market and other conditions. The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor’s particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor. All material has been obtained from sources believed to be reliable. There is no representation or warranty as to the accuracy of the information and State Street shall have no liability for decisions based on such information. The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without SSGA’s express written consent. Investing involves risk including the risk of loss of principal. Companies with large market capitalizations go in and out of favor based on market and economic conditions. Larger companies tend to be less volatile than companies with smaller market capitalizations. In exchange for this potentially lower risk, the value of the security may not rise as much as companies with smaller market capitalizations. Investments in small / mid-sized companies may involve greater risks than in those of larger, better known companies, but may be less volatile than investments in smaller companies. Risk associated with equity investing include stock values which may fluctuate in response to the activities of individual companies and general market and economic conditions. Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations. Source: MSCI. The MSCI data is comprised of a custom index calculated by MSCI for, and as requested by, SSGA. The MSCI data is for internal use only and may not be redistributed or used in connection with creating or offering any securities, financial products or indices. Neither MSCI nor any other third party involved in or related to compiling, computing or creating the MSCI data (the “MSCI Parties”) makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and the MSCI Parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to such data. Without limiting any of the foregoing, in no event shall any of the MSCI Parties have any liability for any indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages. For use with SSGA Clients only. The Advanced Beta solution is a concept for discussion purposes only. The information provided herein does not constitute investment advice and is not a solicitation. It does not take into account any investor’s particular investment objectives, risk tolerance, or financial and tax status.