STATE STREET GLOBAL ADVISORS

2018
Global Market Outlook

Step Forward, Look Both Ways

Investment Themes

Better Days for Active Management?

Lori Heinel, CFA
Deputy Global Chief
Investment Officer

Return of the Stock Picker?

Normalizing monetary policy and a decline in correlations suggest better days ahead for active.

When, Where and How to Go Active

Consider opportunities at the asset class, investment process and asset allocation levels.

Test for True Alpha

Ensure active managers in aggregate are providing more than naïve factor premia.

Amid all the hand-wringing of the last few years around the supposedly unstoppable rise of passive investing and demise of active, we have consistently taken a more measured view.

We acknowledge the good reasons for increased flows into index strategies and exchange traded funds (ETFs) and out of active strategies. Index investing and ETFs have democratized cost-efficient access to markets around the world for a broader base of investors. That is a positive development. It is also important to underscore that institutional investors are increasingly using ETFs to implement active investment views, so it is somewhat misleading to think of ETFs as a purely passive phenomenon.

At the same time, historically low interest rates and policy-driven liquidity since the global financial crisis have sent equity market indices ever higher and kept asset class correlations high and dispersion and volatility low, creating additional challenges for active managers to outperform. Because the market's gains have been widespread, with nearly all sectors participating, it has been difficult for active managers to exceed that performance, especially over long periods and net of fees.

At a time when investors are focused on value-for-fees like never before, it is not surprising that we have seen flows away from active managers who have underperformed, hugged a benchmark or provided little value beyond naïve factor exposures. Still, we believe that skilled managers can identify pockets of opportunity regardless of the prevailing macro environment.

We have also contextualized the flow data, highlighting that, globally, actively managed assets still dwarf passive nearly three to one, and that for every dollar flowing from active into passive, two and a half dollars flow between active managers.[1] We also note that, intuitively, the more assets flowing into index and ETF strategies, the likelier it is that market mispricings will arise for active managers to exploit. But most important, we have repeatedly argued that in a muted return environment, active versus passive is the wrong way to frame the investment challenge. Instead, investors need both active and passive approaches to achieve their goals.

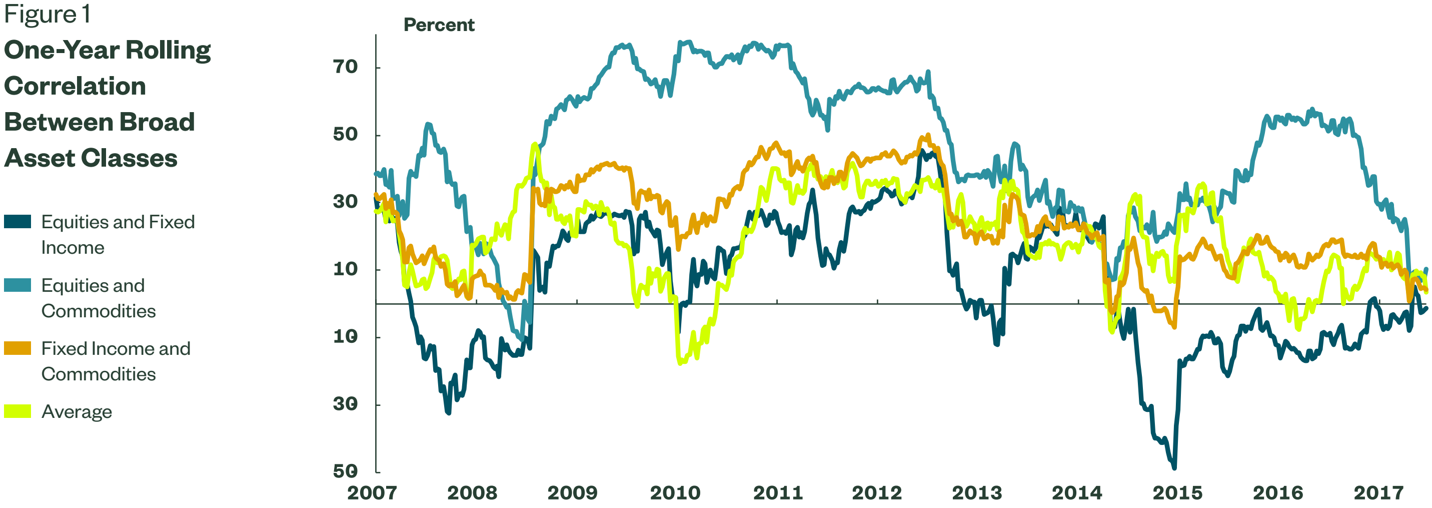
1 Source: Morgan Stanley Research, Oliver Wyman Bluepaper, "The World Turned Upside Down," March 2017.

When to Go Active?

Deciding when, where and how to go active is the real question, and will depend on a number of different criteria, beyond the current market environment, including an investor's time horizon and risk budget. So even as we believe that the move away from extraordinary monetary policy accommodation and lower cross-asset-class correlations are creating more conducive market conditions for active managers, we think investors need a more thoughtful and comprehensive framework for their active management decisions.

We consider the opportunities for active management from three distinct vantage points: 1) asset class; 2) investment process; and 3) asset allocation levels.

Figure 1
One-Year Rolling Correlation Between Broad Asset Classes



Sources: SSGA Investment Solutions Group (ISG) as of October 3, 2017. Past performance is not a guarantee of future results.

Asset Class: Active Opportunities in Inefficient and Less Liquid Markets

Because it is a zero-sum game, generating alpha is difficult under the best of circumstances. However, there are certain markets or asset classes that lend themselves more readily to active management because of their inherent inefficiencies, whether these derive from irrational investor behavior or market friction. For example, there might be informational inefficiencies associated with small-cap or emerging market companies that receive less coverage by analysts and thereby allow discerning managers to uncover less obvious opportunities. Inefficient markets also tend to be less liquid, with higher transaction costs, where trading is not as straightforward and mispricings are more common. This is especially true of less liquid sectors in the fixed income markets, such as high yield or more obscure regional sectors.

Investors can also focus on markets with greater performance dispersion between the best and worst performers. Another key attribute is the nature of a market's investor base. For example, the China A-share domestic stock market is heavily skewed to retail investors. As a result, inflows and outflows tend to be more volatile, providing inefficiencies and mispricings that active managers can seek to capture.

To demonstrate which markets lend themselves to active management, we looked at Morningstar's Active/Passive Barometer, an annual performance analysis of US active mutual funds versus their passive competitors. Figure 2 shows that more than 50% of active emerging markets equity, international equity and intermediate-term bond funds outperformed their respective indices over the five-year period ended December 2014.

Figure 2
Illiquid Market Segments Outperformed Their Benchmark by More than 50% in the Five-Year Period Ending December 2014

Active Funds Success Rate by Category (%)	**Success Rate**			
Category	**1-Year**	**3-Year**	**5-Year**	**10-Year**
US Large Blend	32.7	25.6	25.1	21.6
US Large Value	21.3	49.0	24.4	38.2
US Large Growth	42.3	26.0	12.2	16.9
US Mid Value	36.5	34.5	23.8	13.7
US Mid Value	20.9	34.8	13.5	54.4
US Mid Growth	48.0	37.0	31.1	26.8
US Small Blend	40.7	35.5	37.1	38.9
US Small Value	25.2	22.0	47.7	48.4
US Small Growth	51.4	40.8	30.2	24.4
Foreign Large Blend	47.0	44.8	52.8	40.2
Diversified Emerging Markets	58.2	70.4	85.8	36.6
Intermediate Term Bond	47.9	73.0	69.7	42.2

Source: Morningstar, as of December 31, 2014. For full details on these categories and what is included, see Morningstar, "Morningstar's Active/Passive Barometer: A new yardstick for an old debate," June 2015. Past performance is not a guarantee of future results.

Investment Process: High Conviction, Breadth and Risk Mitigation

Conviction. This is not to say that active managers cannot generate excess return in more efficient asset classes like US large caps. To the degree that managers believe they have an informational advantage about a company's future growth prospects, they can take a longer-term perspective and generate alpha over the long run.

Active managers have the potential to exploit mispricings in the market by extending their time horizon, especially given that markets tend to undervalue a company's ability to persist in its growth. This approach speaks to the high-conviction, high-active-share portfolios that active equity managers can build to incorporate growth and value opportunities they believe the market has overlooked.

As managers seek to identify companies that will outperform over the long run, this approach underscores the necessity of staying invested with a manager through a full cycle. Too often investors make the common mistake of investing with a manager when performance is strongest and is likely to begin to degrade. They then prematurely sell an underperforming manager, just before mean reversion suggests performance will soon improve.

Breadth. Active quantitative managers have the advantage of a systematic process with substantial breadth. Managers are able to sift through a broad universe of securities that display exactly those attributes that their models have identified as enhancing return and minimizing risk.

Risk Mitigation. An active investment process can be especially important in the later stages of an equity bull market, like the one we now find ourselves in. By definition, active managers can take a more selective approach and avoid securities or sectors that have reached lofty valuations and are primed for reverting to the mean. Active managers can more easily reduce risk in their portfolios by trimming allocations to highly volatile securities or by increasing exposure to more defensive kinds of securities.

Asset Allocation: Tactical Overlays, Factor Efficiencies

Finally, investors can choose to go active at the asset allocation level to enhance returns, better manage risk and improve the overall capital efficiency of their portfolios. Tactical overlays can target incremental return while meaningfully reducing drawdown risk. Applying a factor lens to an existing active manager program can help investors identify which managers are generating security-specific risk and which are providing in aggregate the kind of factor risk that can be accessed through less costly smart beta approaches.

These three decision areas allow investors to be more intentional about building a well-diversified portfolio of core beta exposures as well as active approaches that blend more efficiently in the aim of achieving their objectives. Importantly, these are portfolio choices investors can make regardless of the prevailing market environment.

In short, the focus becomes less about "Better Days for Active Management?" and more about "Better Ways for Active Management."

Glossary

Active Investing
An investment approach that involves a manager choosing securities to build, say, a fixed-income portfolio rather than replicating the securities of a fixed income index.

Bull Market
A market environment in which the value of securities is rising, or expected to rise.

Passive Investing
Involves managing a portfolio so that it tracks an index such as the Bloomberg Barclays US Aggregate Index.

Smart Beta
A set of investment strategies that use alternative index construction rules to achieve outperformance over first generation market capitalization based indices. Smart beta indices isolate six particular "factors"—small size, value, high yield, low volatility, quality and momentum—and are designed to deliver better risk-adjusted returns than cap-weighted indices.

State Street Global Advisors Worldwide Entities

ssga.com

Australia
State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services Licence (AFSL Number 238276). Registered office: Level 17, 420 George Street, Sydney, NSW 2000, Australia.
T: +612 9240-7600

Belgium
State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036, 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, Ltd., 770 Sherbrooke Street West, Suite 1200 Montreal, Quebec, H3A 1G1,
T: +514 282 2400 and 30 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, P.O Box 26838, Dubai, United Arab Emirates.
T: +971 (0)4-4372800,

France
State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00.

Germany
State Street Global Advisors GmbH, Brienner Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381.
T: +49 (0)89-55878-400.

Hong Kong
State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong.
T: +852 2103-0288

Japan
State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan,
T: +81-3-4530-7380 Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association

Ireland
State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered number 145221.
T: +353 (0)1 776 3000.

Italy
State Street Global Advisors Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), with a capital of GBP 62,350,000, and whose registered office is at 20 Churchill Place, London E14 5HJ. State Street Global Advisors Limited, Milan Branch (Sede Secondaria di Milano), is registered in Italy with company number 06353340968 - R.E.A. 1887090 and VAT number 06353340968 and whose office is at Via dei Bossi, 4 - 20121 Milano, Italy
T: 39 02 32066 100

Netherlands
State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands.
T:: 31 20 7181701. SSGA 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 Reg. No: 200002719D, regulated by the Monetary Authority of Singapore)
T: +65 6826-7555

Switzerland
State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00.

United Kingdom
State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ.
T: 020 3395 6000.

United States
State Street Global Advisors, One Lincoln Street, Boston, MA 02111-2900

Disclosure

For use in Australia Issued by State Street Global Advisors, Australia, Limited (AFSL Number 238276, ABN 42 003 914 225) ("SSGA Australia"). Registered office: Level 17, 420 George Street, Sydney, NSW 2000, Australia T: +612 9240 7600 Web: ssga.com. 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. You should consult your tax and financial advisor. There is no representation or warranty as to the current accuracy of, nor liability for, decisions based on such information. This communication is directed at institutional and wholesale clients only. The products and services to which this communication relates are only available to such persons and persons of any other description (including retail clients) are not entitled to rely on this communication.

For use in EMEA The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the European Communities (Markets in Financial Instruments) Regulations 2007. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information provided does not constitute investment advice as such term is defined under the Markets in Financial Instruments Directive (2004/39/EC) and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell any investment. It does not take into account any investor's or potential investor's particular investment objectives, strategies, tax status, risk appetite or investment horizon. This communication is directed at professional clients (this includes eligible counterparties) who are deemed both knowledgeable and experienced in matters relating to investments. The products and services to which this communication relates are only available to such persons and persons of any other description (including retail clients) should not rely on this communication.

For use in Switzerland The information provided does not constitute investment advice as such term is defined under applicable Swiss regulation and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell any investment. It does not take into account any investor's or potential investor's particular investment objectives, strategies, tax status, risk appetite or investment horizon. If you require investment advice you should consult your tax and financial or other professional 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. This communication is directed at qualified investors (as defined by FINMA) who are deemed both knowledgeable and experienced in matters relating to investments. The products and services to which this communication relates are only available to such persons and persons of any other description (including retail clients) should not rely on this communication.
Investing involves risk including the risk of loss of principal.

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.

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 views expressed in this material are the views of Lori Heinel noted as of 15 November 2017 and are subject to change based on market and other conditions.

This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

Equity securities are volatile and can decline significantly in response to broad market and economic conditions.

Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates raise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Diversification does not ensure a profit or guarantee against loss.

The trademarks and service marks referenced herein are the property of their respective owners. Third party data providers make no warranties or representations of any kind relating to the accuracy, completeness or timeliness of the data and have no liability for damages of any kind relating to the use of such data.

CFA® is a trademark of the CFA Institute.

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.

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.

Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.

INST-8172 Exp. Date: 11/30/2018