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*Olivia Engel*  
Deputy Chief Investment Officer,  
Active Quantitative Equities  
State Street Global Advisors

## Unlock the full potential of International Equities

### State Street Global Advisors

With political risks receding in Europe and the US economy on more stable fundamentals, a stronger global economic outlook could mean new opportunities for global equities. But when was the last time your clients looked under the hood of their global equity fund? What stocks are in there and how are those selected? With global markets appearing to be poised for an upturn, it may be time to talk about the impact of portfolio construction on their return potential.

Several active asset managers believe that an efficient way of investing in international equities is to construct a portfolio that does not deviate too far from a benchmark, reducing time and resources spent on stock selection and portfolio construction. This approach has its benefits, namely that the return and risk are limited around the benchmark outcomes.

But where does this leave the investor? An active strategy that mirrors the weights of a market-value weighted index means that investors end up holding the largest stocks in the market. But those may not necessarily be the kind of stocks they need to own in order to meet their investment objectives.

### The Whole Universe

Rather than building portfolios around the stock weights represented in the market-value weighted index, the State Street Global Equity Fund explores the market's full opportunity set. It seeks to construct a portfolio that balances between managing risk and growth opportunities.

This approach offers a well-diversified, flexible active equity strategy that aims to maximise potential returns while managing volatility. In other words, a strategy that addresses many investors needs.

"We believe that investors, in most cases, have two primary objectives. They want to grow their assets and they want to manage volatility. That's why we explicitly manage risk and return to align with investors' objectives," says Olivia Engel, Deputy Chief Investment Officer, Active Quantitative Equities at State Street Global Advisors. "To do so, we target companies with high expected returns. We look for companies that are reasonably valued, are high quality, have good profitability and improving earnings. We also manage total portfolio risk by estimating how volatile those companies would be and how they co-move with one another in order to build a well-diversified portfolio."

An active approach, without the limitations of a market-value weighted index, allows the Fund the



### The quote

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flexibility to buy stocks in any sector at any time, and to buy only those that are supported by strong fundamentals. As a result, the stock and sector positions are differentiated from benchmark weights and the Fund is able to capture a broader range of opportunities beyond the benchmark. (See Table 1)

Engel, who was named a 'star stock picker' in an article by James Frost, Smart Investor editor, which featured in the AFR on 19 August 2016, says investors benefit from both upside participation and downside reduction. "Upside/downside ratio is the participation of a Fund's captured performance in an up-market (return) or down-market (loss) relative to the market benchmark itself. Essentially, since its inception on 31 January 2014, if the market declined 100 points, the Fund had typically or on average only a decline of 56. If the market increased 100 points, the fund had typically or on average an increase 91 (as at 30 April 2017). Our upsides/downside participation rate is a standout in allowing us to smooth the return path for investors," she adds.

For investors with shorter investment horizons (like those in retirement), this approach aims to limit significant drawdowns, which they can't afford to have. Since inception, the Fund has returned on average 2.71% p.a. (net) more than the benchmark (MSCI World ex-Australia Index, as at 30 April 2017).

### Portfolio Construction Matters

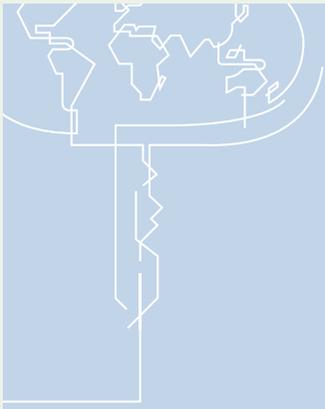
The ability to smooth the investment return path is important in volatile markets, when it's difficult to predict when markets have peaked or bottomed, or which sectors are in favour or out of favour.

For example, after the US election, financials and telecoms were the strongest sectors in the market, while consumer staples and utilities meaningfully lagged the broader market. Cheap stocks (many of which were financials) performed very strongly, and high quality, defensive stocks with low volatility underperformed. But in the first 100 days of the Trump presidency, that changed. US technology stocks advanced more than 12%, discretionary stocks continued to climb, healthcare stocks rallied, and utilities recovered. Energy stocks and telecoms experienced strong negative returns, and financials tapered off.

With a risk-aware strategy such as the State Street Global Equity Fund, led by Engel, the portfolio management team uses a systematic investment process, grounded on economic fundamentals, to carefully analyse stocks' return and risk characteristics — looking for reasonable valuation, growth capability, strong cash flows, and sustainable dividends.

The team then estimates the volatility of each company. The investment process estimates stock-specific risk and risk associated with a

# International Equities



*The State Street Global Equity Fund was recently upgraded to “Recommended” by both Lonsec\* (Apr 2017) & Zenith\*\* (Nov 2016).*

company’s exposure to different characteristics such as what industry they are in or fundamental risk factors such as size, liquidity, volatility, value, leverage and market sensitivity.

In constructing the portfolio, we consider the return potential of a stock as well as expectations of future volatility to make an informed investment decision. We seek out those stocks whose expected risk is appropriately compensated with expected return. Everything being equal, we would favour a stock with lower risk.

The third pillar of portfolio construction is currency risk management. Currency fluctuations may impact the overall return of the portfolio. Instead of leaving this responsibility to investors to regularly manage the hedged/unhedged ratio of their global equity investment, the State Street Global Equity Fund manages currency risk on behalf of the investor through our Dynamic Strategic Hedging programme (DSH).

“Rather than choosing the Fund to be unhedged or fully hedged, we adjust the hedge ratio for each currency in the portfolio according to our medium to long term assessment of that currency’s economic value relative to the Australian dollar,” says Engel.

Of all the domiciles within the Fund, the average hedge is 33% (SSGA, as at 30 April 2017).

## Get as Core, or to Access Small Caps

As a long-only, benchmark-unaware equity strategy that focuses on delivering strong returns while managing total risk, the State Street Global Equity Fund may be suitable to serve as a core position in a broader equity strategy. At the same time, being structurally underweight large caps, the fund can also serve as a gateway to access global small caps, which may not be easily accessible without adding significant risk or fees to one’s portfolio.

“Global small caps are a big part of our portfolio, and many advisers are replacing their global small caps allocation with the Fund,” says Engel.

The Top 100 stocks globally account for 42% of the MSCI World ex Australia Index. In the State Street Global Equity Fund, the same 100 holdings represent only 14.75%. This equates to holding only two stocks in the Top 10 and 13 stocks in the Top 100 of MSCI World Ex Australia (as at 30 April 2017).

## The Takeaway

Put simply, investors want to grow their assets and don’t want to lose money. So why let benchmark dictate your clients’ investment outcomes? Pick an active strategy that explores the entire investment universe and puts their investment objectives at the core of portfolio construction — aiming for stronger returns with less total risk. With the global economic outlook appearing to be set for an upturn, it’s time to check if your clients’ global equity fund is up to the job. **FS**



### The quote

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**Table 1: Stock and Sector Holdings Comparison, Fund vs Benchmark**

## Top 10 Fund Holdings

As of 30 April 2017

Holding	Fund (%)	Benchmark (%)
PEUGEOT SA	1.61	0.03
BOLIDEN AB	1.59	0.02
AGILENT TECHNOLOGIES INC	1.57	0.05
CR BARD INC	1.55	0.06
JPMORGAN CHASE & CO	1.51	0.89
MICHELIN (CGDE)	1.49	0.07
ACS ACTIVIDADES CONS Y SERV	1.47	0.02
SOUTHWEST AIRLINES CO	1.44	0.02
HOLOGIC INC	1.43	0.03
ALTRIA GROUP INC	1.41	0.40

## Sector Allocations

As of 30 April 2017

Sector	Fund (%)	Benchmark (%)
Health Care	20.08	12.42
Financials	13.98	16.83
Utilities	12.70	3.18
Industrials	12.66	11.58
Consumer Staples	11.70	9.87
Information Technology	7.81	16.03
Consumer Discretionary	6.27	12.81
Telecommunication	6.04	3.07
Materials	5.96	4.76
Real Estate	2.44	3.06
Energy	0.36	6.38
Total	100.00	100.00

Holdings and sector country allocations shown are as of the date indicated and are subject to change. 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. The holdings are taken from the accounting records of SSGA which may differ from the official books and records of the custodian. Excludes cash, cash equivalents and accruals. Source: SSGA

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Investing involves risk including the risk of loss of principal. Risk associated with equity investing includes stock values which may fluctuate in response to the activities of individual companies and general market and economic conditions.

Standard deviation is a historical measure of the degree to which a fund’s returns varied over a certain period of time. The higher the standard deviation, the greater the likelihood (and risk) that a fund’s performance will fluctuate and have greater potential for volatility; a lower standard deviation indicates past returns have been less volatile.

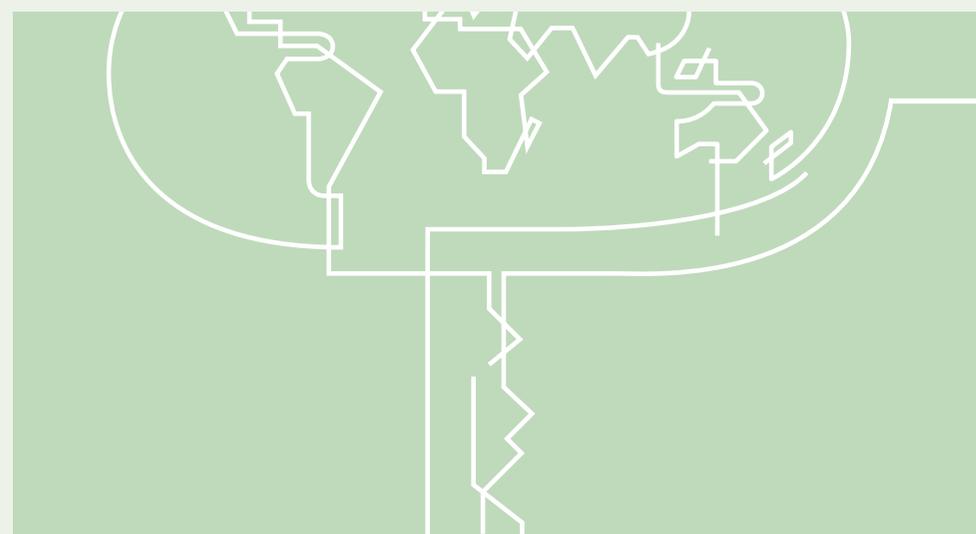
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# Global Equities Fund



## Putting it into practice

**Director of Fortunity, Shaun O'Farrell, discusses the value of including a global equities fund in model portfolios.**

### What are your key frustrations with the global equity products available in the market?

Our main frustration is the choice of currency exposure. It's very difficult to pick currency markets and almost impossible to be nimble enough to implement quick changes across our client base. i.e. switch all clients from unhedged to hedged products.

### Can you comment on how currency risk has impacted investor appetite for global equities in the past?

Investors can usually see the merit of investing globally due to the large number of investment opportunities. Global equities provide the

opportunity for diversification and clients understand this however understanding currency movements and the effects it can have on performance is more complex. Investors often feel our local markets follow the direction of the global markets anyway so therefore investing locally without the risk of currency is often deemed the safer or preferred option.

### Most Fund managers in our industry typically focus on alpha alone. In your view, how important is downside risk management?

Generally clients don't really understand alpha, however, they do understand downside risk. Any effort to manage downside risk is viewed as prudent from the client's perspective. Alpha is great but our experience with clients tells us they are more concerned about losing capital than achieving alpha.



#### The quote

*Global equity provides the opportunity for diversification and they understand this but understanding currency movements and the effects it can have on performance is more complex.*

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### What should an investor look for when choosing a global equity fund?

- Risk management
- Currency management
- Benchmark unaware (don't follow the herd when global markets provide so many opportunities)
- Fees – it's the one thing we can control
- Risk adjusted returns

### How do you use State Street's "benchmark unaware" Global Equity Fund in your portfolios?

We look to the State Street Global Equity Fund to provide good risk adjusted returns with active currency management. It provides clients with a detailed and repeatable investment process at a reasonable fee. When you also include the focus on downside protection our expectation is that clients will remain invested for the long term which gives them the best chance of success. We blend the fund with other benchmark unaware active managers. **FS**

## Unlock the Whole Universe: State Street Global Equity Fund

### Investing beyond the big brands

The MSCI World ex Australia Index has almost 1600 stocks in its universe.

But out of 112 holdings the State Street Global Equity Fund only holds:<sup>1</sup>

**2** TOP 10 STOCKS + **13** TOP 100 STOCKS

### Targets smoother return path

**18%** LESS VOLATILITY than the Index<sup>2</sup>

**2.71%** p.a. net outperformance of the index since inception<sup>3</sup>

### Purposeful currency management

We adjust the hedge ratio for each currency in the Fund, optimised for AUD investors<sup>4</sup>.

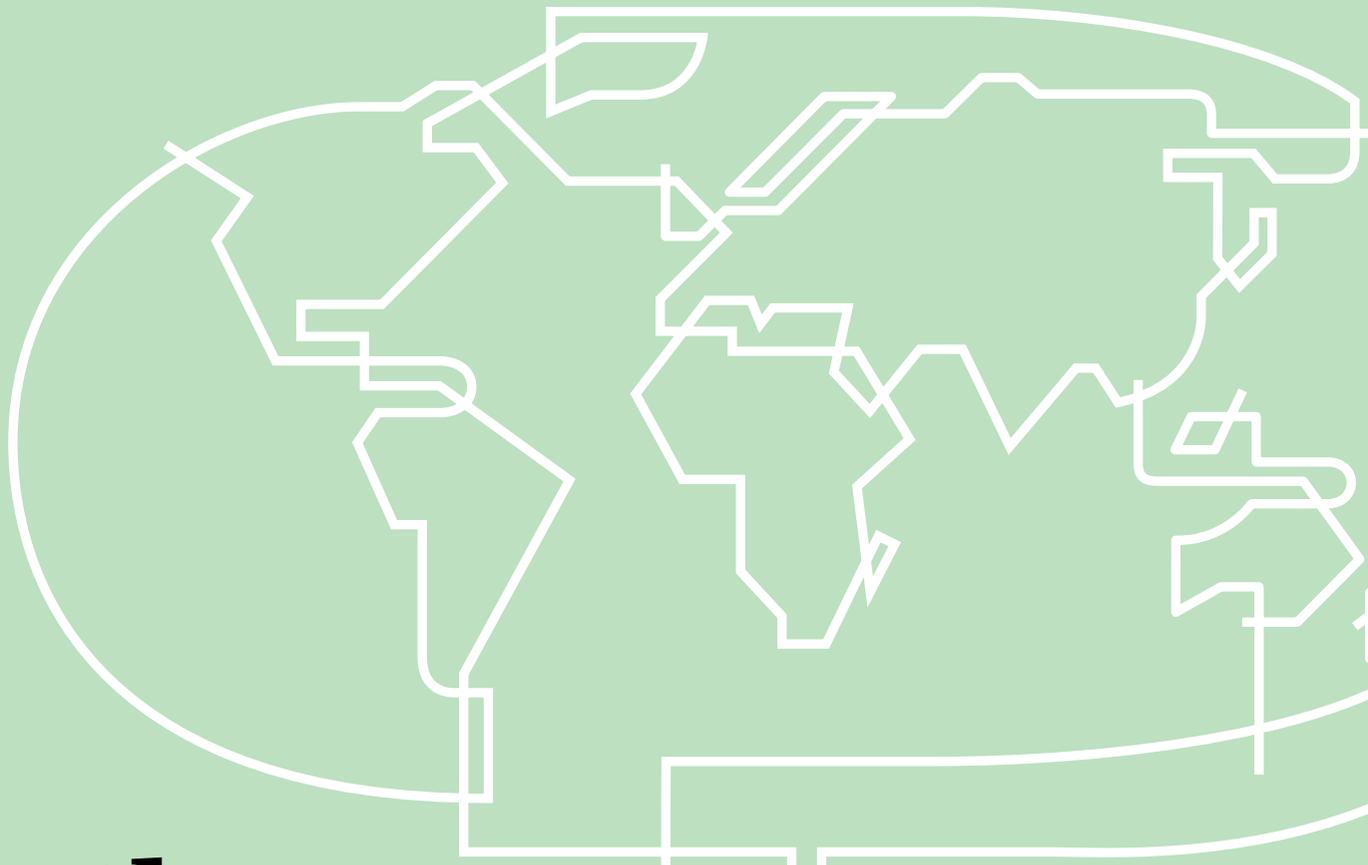


**AVG. HEDGE RATIO** of all the currencies within the Fund<sup>1</sup>.

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# Unlock the whole universe. Get active.

**The State Street Global Equity Fund explores every stock in the investment universe. The active strategy explores the market's full opportunity set\*, looking beyond the constraints of benchmark weights and constructing a portfolio that focuses on maximising return and managing total portfolio risk.**

**Learn more at [ssga.com/active](https://www.ssga.com/active)**

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