THE NEW INVESTMENT REALITY

Lower-For-Longer Return Expectations Heighten Factor Investing Interest

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The year's first quarter provided ample evidence of the investment challenges we previewed in our Global Market Outlook for 2016.

China's rebalancing pains, oil price pressures and subdued earnings around the world deepened concerns over a global slowdown and touched off a roller coaster ride in markets that was far more frenetic than most had anticipated. For long-term investors, it is important not to overreact to the daily headlines and markets did recover somewhat. But the opening months of 2016 certainly suggested another year of lackluster market returns with deeper risks to the downside. Our forecast for developed world stocks on a one-year annualized basis stands at just 2.1% and global government bonds at 0.5%. The numbers for three- and five-year annualized returns across all asset classes barely breach the mid-single digits.

With lower-for-longer market returns and greater volatility forecast for the next few years, we think it will be more challenging for investors, at least in the intermediate term, to achieve their investment objectives. Muted market returns also mean that fees will have a greater impact on investment outcomes. As a result, we believe this new investment reality is likely to prompt more investors to rethink traditional investment models and consider their options. As we mentioned in our Global Market Outlook, some investors might consider doubling down on active risk to achieve their total return objectives. But that comes with a higher price tag both in terms of risk and fees.

Instead, we believe more investors might want to investigate factor-based approaches aimed at more capital efficient portfolios that target incremental returns and enhanced diversification in a highly fee-productive way. In this issue of the IQ we focus on the growing interest in factor investing as a way to construct more cost-efficient and risk-aware portfolios to address shifting objectives and constraints.

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We believe we are at a critical inflection point in investment management where the lines between active and passive are blurring and a new kind of active management is taking hold, as asset owners are compelled to focus more on the active decisions around their investment choices, with a strong emphasis on fee productivity. Fee productivity simply refers to a growing desire among investors to ensure that the fees they are paying are commensurate with the investment process and level of skill their managers are delivering.

Tactical/Strategic Asset Allocation Forecasts Annualized Returns (%)

Asset Class	1 Year	3 Years	5 Years
Emerging Markets Stocks	1.2	5.4	6.3
Emerging Markets Bonds	3.1	3.3	3.8
Hedge Funds (Market Neutral)	3.1	4.9	5.3
Global Real Estate (REITs)	0.7	3.9	4.5
Global Developed (World)	**2.1**	**5.0**	**5.6**
Global Government Bonds	**0.5**	**0.6**	**0.7**
Private Equity	3.9	5.9	6.4
Commodities	-1.9	3.3	4.4

Source: State Street Global Advisors (SSGA) Investment Solutions Group as of December 31, 2015. It is not possible to invest in an index. Past performance does not guarantee future results.

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Investment objectives are far more varied than the previous, singular focus on benchmark-relative performance. They encompass a broader range of goals such as liability management, absolute return, downside protection and even ESG impact. And while strategic asset allocation remains a key determinant of long-term performance, the new investment realities of shifting risks and opportunities require more tactical and dynamic components.

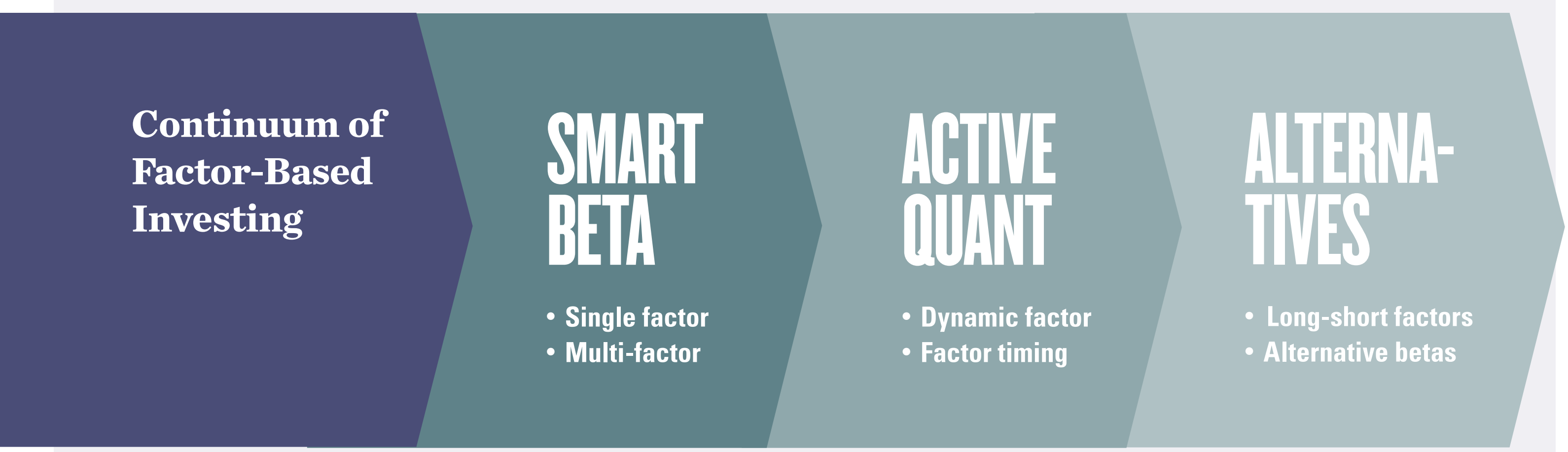
Factor investing helps investors achieve a better understanding of the drivers of risk and return in their portfolios across different macro environments. That in turn is raising the bar on traditional active managers to demonstrate their skill-based alpha, as distinct from risk exposures that can be replicated in a lower-cost, factor-based Smart Beta strategy.

One of the case studies we feature in this issue describes an institutional investor who was able to realize significant savings in active management fees by replacing a number of active equity managers with a Smart Beta approach. While the managers provided active security selection risk individually, in aggregate they canceled each other out and provided more factor risk. Increasingly, tools that were once the domain of sophisticated quant investors are available to a broader group of investors who are developing a better understanding of the underlying components of returns and challenging traditional assumptions about active and alternative investing.

Active fundamental and quantitative managers will continue to be central to achieving investors' total return objectives in this lower-for-longer environment, but they will need to identify and capture truly idiosyncratic return streams to justify their fee structures. One could argue that factor investing will be a powerful driver of innovation in active management, as managers seek to leverage big data and new analytic tools to push the boundaries of alpha generation.

Although Smart Beta has become a marketing term of convenience for a subset of factor investing, we regard it as simply the starting point on a much broader continuum of approaches and techniques. Smart beta is based on the research-driven principle that there are systematic factors such as size, valuation or momentum that deliver a durable premium over the long term versus a market-cap weighted benchmark.

We define Smart Beta as a rules-based, transparent way for investors to capture those well-documented factor premia.



For investors new to factor investing, tilting to one or more of these Smart Beta factors in their core passive exposures is an attractive way to target incremental returns over the long term in a cost-efficient manner. In our recent survey of over 400 global institutional investors, which we highlight in this issue, we found that three-quarters of the respondents who had implemented Smart Beta said they found moderate to significant improvement in their ability to meet their long-term objectives.

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But beyond Smart Beta there is an entire spectrum of more sophisticated methodologies that active quantitative managers are using. They are specifying factors in more nuanced ways and managing them through time on both the long and short side. New data sets and tools as well as temporary anomalies arising from regulatory-driven or other dislocations in the market provide a fertile ground for these managers to capture differentiated sources of return. Moreover, a new generation of alternative risk premia strategies are evolving that we believe will be able to deliver excess returns rivaling those of hedge funds, only for lower fees.

Our investment roundtable on the factor revolution explores many of these themes and discusses the shift away from traditional investment models toward factor-based approaches at both the asset class and total portfolio levels. In addition to our in-house factor investing experts, we hear from one of Europe's pioneering investors at Denmark's PKA on how the pension fund has navigated the factor investing spectrum over the last 15 years, moving from equities and fixed income into currencies and commodities — ultimately factorizing their entire portfolio and moving into alternative risk premia. We also provide a consultant's perspective on some of the education and governance challenges associated with factor investing that investment boards need to surmount before embracing this approach on a wider scale. As with any new methodology, investors need to understand how these factors behave across different market environments and when they are likely to outperform or underperform.

As market turbulence spreads, we also revisit the range of volatility management strategies investors can consider, depending on their objectives and risk tolerance. In our survey of institutional investors, downside protection was one of the three most important objectives cited, in addition to capital growth and generating income.

More striking, the survey illustrated what we consider to be wildly optimistic return expectations on the part of the respondents. The mean long-term return expectations across every major asset class save commodities and bonds were in the double digits. Regardless of the robust returns generated during the initial recovery phase following the global financial crisis, we think the new investment reality requires that investors make meaningful adjustments to their return expectations.

The survey also confirmed some well-known barriers to adopting new investment models like factor investing, including a reluctance to be a first mover and a lack of in-house expertise. Still, an overwhelming majority of respondents expected substantial changes to investment approaches and portfolio structures for institutional investors over the next five years, even if they indicated only moderate changes expected within their own organizations.

Our view is that traditional investment approaches based on static, asset-class-only allocations and benchmark-relative performance are unlikely to achieve investors' desired outcomes in a more complex market environment. As a number of cyclical and secular forces complicate the investment backdrop — everything from regulation to technology to changing demographics and geopolitical and policy risks — we think investors need to take a more systematic and risk-aware approach to building diversified portfolios tailored to their long-term objectives. We believe factor investing provides a powerful lens for understanding shifting risks and opportunities and has the potential for revolutionizing the next generation of active management and the tools required to achieve investors' specific outcomes.

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