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P&I: What is Advanced Beta, and what are the advantages?

Lynn Blake: Since the scope of Advanced Beta strategies is so broad we define Advanced Beta in very general terms. At State Street Global Advisors, we define Advanced Beta as any objective, consistent and transparent investment strategy that may capture returns beyond those you see in the traditional market cap-weighted asset class. These exposures typically fall into four broad categories. The first is asset classes beyond traditional equity and fixed income, like commodities, gold, infrastructure, and currency carry. The second is alternatives asset class payoffs such as options over-writing, leveraged strategies, inverse strategies, or protection strategies. The third is rules-based or emulation strategies, like hedge fund beta and convertible arbitrage. The fourth is alternatives to market-cap weighting, which is what most investors think of when they consider Advanced Beta or smart beta. So broadly, it is weighting strategies by something other than market cap weights, usually around certain return-driven factors, like valuation, volatility, size, momentum, yield and quality. The advantage is the potential for higher absolute returns or risk adjusted returns relative to traditional cap-weighted indices. Empirical evidence suggests that tilting towards one or more of these factors can potentially deliver higher returns and/or less volatility. Advanced Beta strategies often retain many of the benefits associated with passive investing such as: transparency, objectivity, low cost, low turnover, good diversification and liquidity.

P&I: How does an Advanced Beta strategy fit into a portfolio, and how do investors take best advantage?

Blake: Advanced Beta strategies can be implemented in many different ways. Advanced Beta strategies are - for the most part - diversified strategies that emphasize equities with certain attributes -

Advancing Advanced Beta

A powerful evolution in passive investing that has generated a wide variety of alternatives to traditional cap-weighted index strategies, advanced beta broadens the toolkit available to investors yet maintains many of the benefits of index investing. Lynn Blake at State Street Global Advisors explains how.

low valuation, low volatility, high quality, smaller capitalization - that have been well-rewarded over long periods of time. The first hurdle for investors is buying into the underlying investment thesis and understanding the risks involved. Once investors have embraced the investment thesis associated with an Advanced Beta strategy, there are a number of ways Advanced Beta can fit into a portfolio. Some investors allocate a portion of core passive exposures to Advanced Beta strategies and see these as attractive complements to cap-weighted index strategies. Others view Advanced Beta strategies as healthy alternatives to traditional actively managed strategies. In either case our experience is that investors with conviction, patience and risk tolerance (and a strategic perspective on Advanced Beta strategies) have had the most long-term success with these strategies. In addition, we see investors recognizing the diversification benefits that can come from combining multiple Advanced Beta strategies (or factor exposures) in an overall portfolio. To date, most investors have utilized single-factor strategies, but there is also growing interest in multi-factor strategies.

P&I: What are some of the factors, criteria and other characteristics of an Advanced Beta strategy?

Blake: Advanced Beta strategies are the product of a long history of empirical evidence on the cross-section of equity returns. Theoretical explanations of the observed behavior of returns have been developed to explain this evidence. The main objective of Advanced Beta strategies is to consistently bias a portfolio toward securities with the desired attributes. There are only a handful of factors that drive relative returns, including low valuation, small size, low volatility, quality, momentum and perhaps yield to name a few. Sifting through the proliferation of Advanced Beta strategies can be challenging for an investor but we believe it is important that investors understand fully how their Advanced Beta strategy's capital allocation differs from that of the cap-weighting. We also believe the methodology for constructing Advanced Beta strategies should be transparent and objective, and the strategies should retain the diversification and cost savings benefits associated with passive investing.

P&I: Your recent research found that Advanced Beta could be a viable alternative to active management as well as passive. Could you elaborate on that?

Blake: Even though these have been termed "beta" strategies, they are a departure from the market's

allocation of capital and therefore represent an active decision with active risks. As such, Advanced Beta strategies can deliver very different returns. Some investors take the view that Advanced Beta strategies are a viable replacement for actively managed strategies, although even these investors typically appreciate that the underweight and overweight positions in an Advanced Beta strategy are relatively static and simplistic in comparison to many active strategies. Other clients believe that market cap-weighted indices are inherently flawed and inefficient because of their higher allocation to stocks with higher valuations or larger capitalization or, in the case of fixed income, high allocation to the most indebted companies or countries. However, very few investors are willing to give up the market cap-weighted index altogether, because it does represent the true reference, buy and hold, macro-consistent portfolio. Many investors view Advanced Beta strategies as a complement to core cap-weighted index holdings. Some investors have observed that the factors exposures associated with Advanced Beta strategies (low valuation, smaller capitalization, low volatility, and higher quality, for example) are the same factors that describe much of the variability in active manager returns. For those investors Advanced Beta strategies can provide a diversified and cost-effective way to capture those factor exposures embedded in active strategies.

P&I: Can you give an example of a custom application?

Blake: We have done customization work in the Advanced Beta space for a number of different clients. One example involved development of a series of Advanced Beta equity strategies for a financial services company that had a very well-articulated factor investment thesis (low valuation and small cap), they wanted to reflect in Advanced Beta strategies. The client wanted to offer competitive returns together with broad diversification at both a security and sector level - at a very competitive level of expenses. We did a significant amount of empirical work for the client and in an iterative way narrowed in on a strategy design that met the client's fairly aggressive need for expected return with effective risk control. The strategies represent a differentiated line of investment products that have been live for over five years and have generated a competitive track record for the client. Our experience with this client illustrates how Advanced Beta strategies can play an important role for financial intermediaries who are interested in positioning investment strategies somewhere between traditional active and passive products.

For more information please visit www.ssga.com/advancedbeta.

Read, print, and email this Q&A
to a colleague at...

www.pionline.com/InvestmentInsights_SSGA

Advancing Advanced Beta

P&I: What benchmarks do you use to measure performance?

Blake: That can be a challenging question for investors. From State Street Global Advisors' perspective we normally have a benchmark that can help clients evaluate how good a job we are doing at capturing the investment returns we have been hired to deliver. The tracking error measures we use to gauge our effectiveness in capturing traditional index strategies are also used by clients in measuring our effectiveness in managing Advanced Beta strategies. However, clients also are normally measured in a broader sense against the performance of cap-weighted benchmarks, which for most investors are the ultimate performance benchmark. Over longer horizons Advanced Beta strategies are expected to outperform cap-weighted benchmarks in either absolute return or risk-adjusted return space. The benchmarking issue can be more complicated for things like low volatility strategies, where risk reduction is a primary objective, but even there some version of a cap-weighted benchmark is normally used to benchmark performance. Most of our clients appreciate that benchmarks in the Advanced Beta arena play the dual role of measuring manager performance and the underlying decision to pursue an Advanced Beta strategy that is different from the market portfolio.

P&I: Tell us about your education efforts.

Blake: We spend a significant amount of energy and time helping investors understand Advanced Beta strategies. There are many claims made by proponents of Advanced Beta strategies, but at the end of the day, we believe that Advanced Beta strategies are relatively straightforward techniques for tilting or biasing a portfolio toward attributes or factors that have been well-rewarded in the past. We therefore try to demystify the strategies and make it clear to investors how they differ from cap-weighted indexes, which in our view are the appropriate reference portfolio. Only then can investors understand the underlying investment thesis and assess whether they have the conviction and patience necessary to be successful with Advanced Beta strategies.

P&I: Tell us about your team and resources at State Street Global Advisors.

Blake: Within the equity beta team at State Street Global Advisors, we have roughly 60 portfolio managers around the world that are responsible for the \$1.3T passive equity business across almost 1,500 portfolios. This includes traditional cap-weighted strategies, as well as Advanced Beta strategies. Within the beta team, we have a dedicated Research team which consists of 5 senior research professionals that focus predominantly on Advanced Beta research topics. The research team leads Advanced Beta efforts on education, thought-leadership, and custom research and analysis, while portfolio managers have developed expertise in handling the implementation nuances associated with Advanced Beta strategies. So at State Street Global Advisors we have experience and expertise with both the research and implementation aspects of Advanced Beta strategies. We are well-positioned for what we expect to be continued growth in use of Advanced Beta strategies.

STATE STREET GLOBAL ADVISORS®

\$2,345B total AUM

\$72B in advanced beta strategies*

*Advanced Beta Strategies in asset classes ranging from equities to fixed income to REITs and commodities.

Please indicate the extent to which you agree or disagree with the following statements.

- A. Smart beta strategies are a viable alternative to traditional index strategies
- B. Smart beta is here to stay as an evolution in indexing
- C. Smart beta is a viable alternative to active management

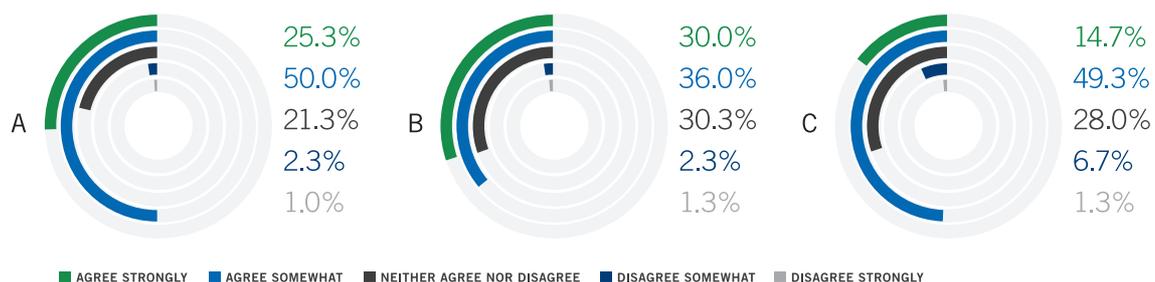


Figure Source: Longitude Research

Do you agree that combining several targeted market exposures as part of a Smart/Advanced Beta offering makes for a more refined product?

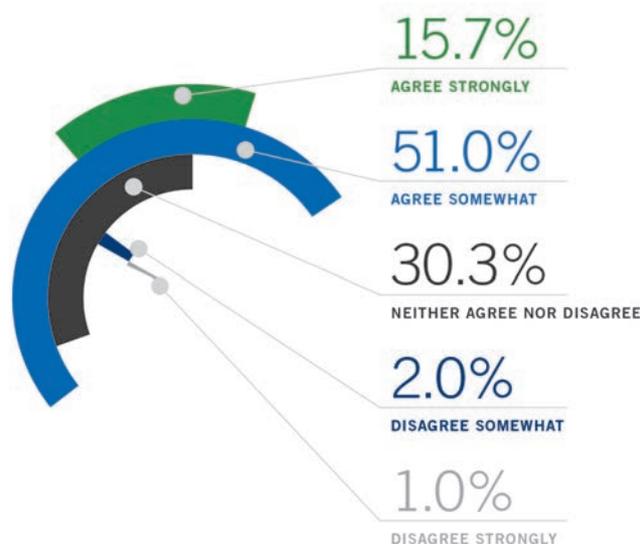


Figure Source: Longitude Research



Scan to visit State Street Global Advisors Advanced Beta page to download the full report: *Beyond Active and Passive: Advanced Beta Comes of Age*.

As of December 31, 2013

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