# Building a Core with a Conscience

*(Partner Content by  State Street Global Advisors)* – Our investment landscape is changing. We believe it is changing for the better. We can show you how investors' options are broadening and how we may be able to achieve better returns while being aware of the world around us.

**Where are We Now?**

When we look back and see how investors have changed their investment strategies, Smart Beta is an innovation that stands out. These relatively new strategies have definitely earned their place in investors' portfolios. Reasons put forward for their adoption are linked to both improved return and risk expectations.

In the most recent Smart Beta survey from FTSE Russell,1asset owners' allocation to Smart Beta had risen to 46% from 36% in a year. This increased familiarity and subsequent allocation is echoed at the more individual level — in an equivalent survey for Financial Advisors,[2] just over half of the surveyed advisors reported the use of Smart Beta strategies.

From an asset owner perspective, Smart Beta use is growing in both DC and DB schemes. Over the last few years, we have seen it increasingly become a standard component of many glide paths, with DC Smart Beta assets expected to grow at 42% per year between now and 2025. [3]

So what is Smart Beta, and what is it trying to achieve? Smart Beta is a set of strategies that look to capture well-known and well-researched factors. These factors have been shown to deliver a premium above a market capitalisation weighted portfolio. It is possible to capture them through systematic processes that follow a well-defined set of rules and will do so consistently over time.

These strategies can be wrapped in an index which allows investors to gain more control of their portfolio risk and return drivers while aiming for specific outcomes. In a recent PLSA publication, it categorised Smart Beta indices into alternatively weighted, factor and thematic indices.[4] These indices will further help the understanding and adoption of these approaches.

Now that investors are increasingly more comfortable with the evidence and investment rationale behind Smart Beta, they are looking for further innovations, especially when it comes to combining several factors within a single portfolio and creating multi-factor approaches. This will help them benefit from diversification and, potentially, remove some of the performance cyclicality associated with single factor investors. In the FTSE Russell survey,[1] the adoption of multi-factor solutions has gone from 20% in 2015 to 64% in 2017.

### Equity Factors

Factors, or exposures, are equity attributes that have been found to explain equity returns over the long term. These factors have proved to be persistent, even if not always present. There is cyclicality in their performance relative to cap-weighted indices but there is an expectation they will outperform over the long term.

There should be a strong investment intuition behind each factor and how it is defined. As such, qualitative research considers not only the reasons for why the factor should persist, but also how that factor should be best captured. In general, the persistence of factors can be due to behavioural reasons, a reward for risk or both. After having established a robust investment intuition, it is necessary researchers use extensive quantitative analysis to verify the existence and persistence of each factor.

We believe there are five factors that explain equity returns over the long term:

**Value** Lower valuation stocks outperform higher valuation stocks.

**Size** Smaller capitalisation stocks outperform larger capitalisation stocks.

**Volatility** Lower volatility (or lower risk) stocks outperform higher volatility stocks.

**Momentum** Higher momentum stocks outperform lower momentum stocks.

**Quality** Higher quality stocks outperform lower quality stocks.

**Where Next?**

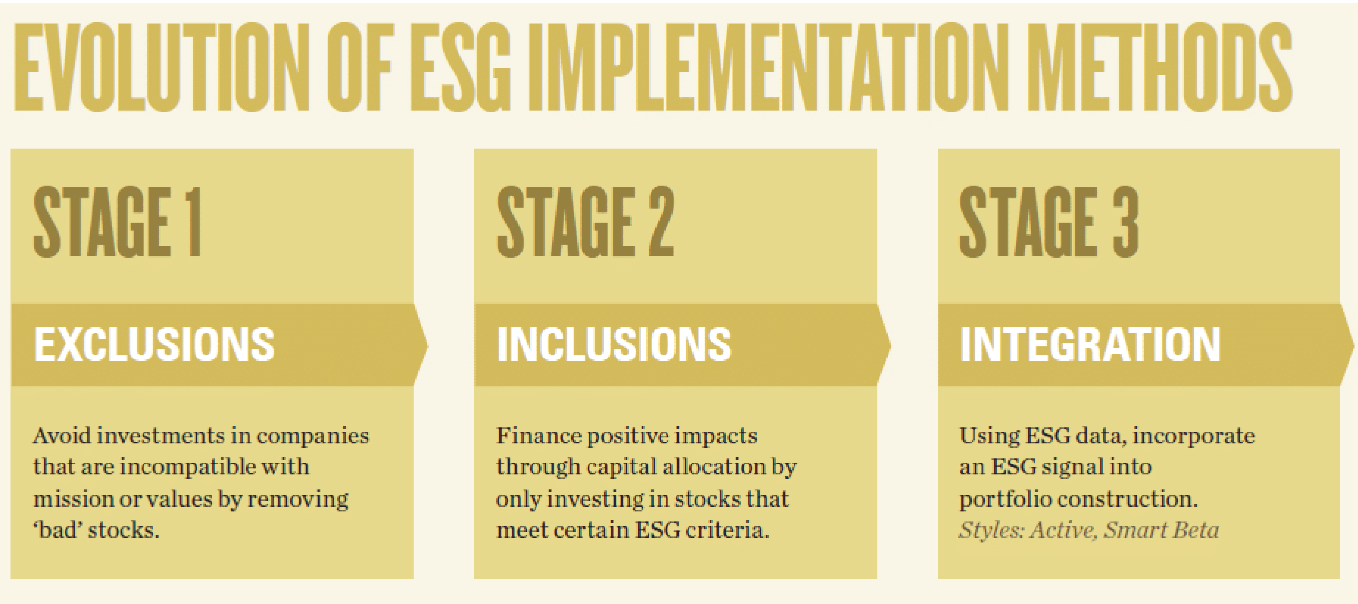
Another trend that is gaining further traction is the inclusion of environmental, social and governance (ESG) issues in investors' portfolios. There is a multitude of studies that explores the potential impact of positive (or negative) ESG characteristics in the context of company and stock performance.

A 2015 Oxford University paper,[5]which covered over 200 differentiated sources, showed a positive relationship between diligent sustainability business practices and economic performance, measured in different ways. Some more recent research from MSCI6 went beyond correlations, demonstrating how positive ESG characteristics can lead to financially significant effects by examining how that ESG information finds its way to the equity market.

In the UK, the Pensions Regulator back in 2016 issued guidance on trustees' responsibility to take into account ESG factors if they deem it to be financially significant. This follows regulation and guidance from other regulators and supervisory authorities, like in the Netherlands and France.

From an implementation perspective, ESG views and considerations can be brought into a portfolio in a variety of ways. Within State Street Global Advisors, we developed a terminology[7] to improve communication between asset owners and their providers and to help address some of the practical steps involved in ESG investing.

On one end we have a screening approach which is based purely on exclusions, which can be seen as a first generation approach. As data and solutions have evolved, we are now building more integrated approaches which will incorporate ESG as a criteria for the selection and weighting of investments.




**The Best of Both Worlds? Smart Beta and ESG Combined**

Investors are now more convinced of the benefits of both Smart Beta and ESG and are looking for ways to bring both into their portfolio. However, desired factor characteristics like Low Valuation are not always aligned with good ESG characteristics, as some of our recent research has shown.8 This means investors will need a thoughtful approach that will incorporate the implementation challenges of sometimes conflicting objectives. A paper from our research team illustrates the promise and the potential of ESG integration into equity strategies, from indexing to Smart Beta.[9]

We can see how a combined approach can help both DB and DC schemes target a multitude of objectives and not only returns. It is time to be mindful of our impact on the world around us and how we best protect future returns by investing responsibly today.

*1 FTSE Russell, "Smart beta: 2017 global survey findings from asset owners", May/2017.*

*2 FTSE Russell, "Smart beta: 2018 survey findings from US, Canadian, and UK financial advisors".*

*3 UK DC Annual Report 2016, Spence Johnson.*

*4 PLSA, "Indices and Benchmarks — Made Simple Guide", March/2017.*

*5 Oxford University, Arabesque "From the stockholder to the stakeholders", March/2015.*

*6 MSCI, "Foundations of ESG Investing. Part 1", November/2017.*

*7 SSGA, "Understanding & Comparing ESG Terminology", September/2017.*

*8 SSGA, Jennifer Bender, Xialoe Sun, "Aligning Factor and ESG Views", March/2017.*

*9 SSGA, Jennifer Bender, Todd Bridges, Chen He, Anna Lester, Xiaole Sun "A Blueprint for integrating ESG into Equity Portfolios", JOIM 2018.*

***State Street Global Advisors***

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