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Model Matters

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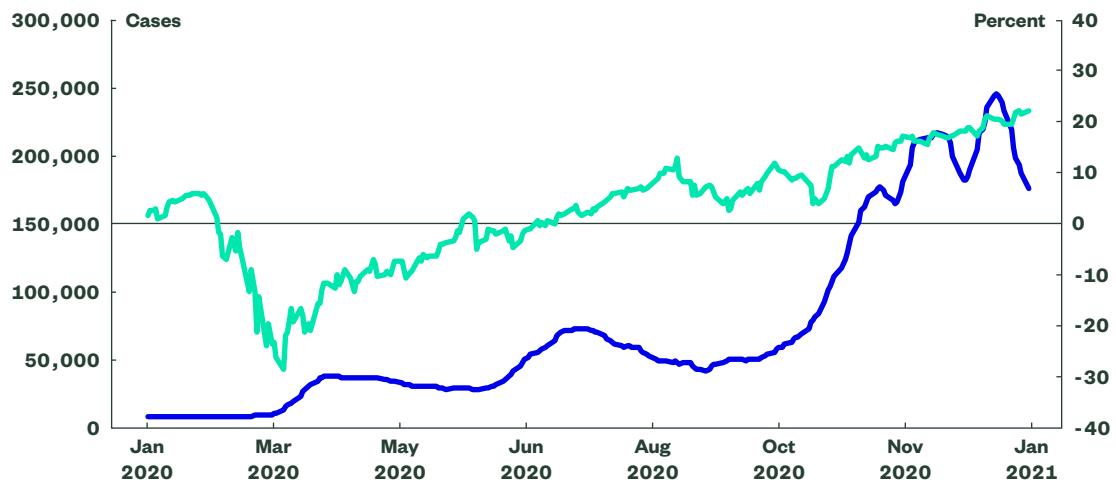
Exploring the current market landscape through the lens of State Street Global Advisors' investment process

What Are We Thinking?

Are we on the verge of reflation? The markets are seemingly awash with reasons to suggest that an upward climb is in the cards. Corporate balance sheets have improved, monetary and fiscal policy are accommodative, immunization trends are improving and risk appetites are less sated than before. The Investment Solutions Group (ISG) monitors these developments in real time and made notable moves in early January by redeploying some of its dry powder toward a healthy mélange of risk assets consisting of small caps, Pacific equities, emerging markets, high yield bonds and commodities. The team believes that a low risk regime reading on its proprietary Market Regime Indicator is further evidence that risk assets are poised for further gains as investors are less discriminate about taking on risk. But risks clearly remain — especially since the markets have gone on an almost unmitigated tear post-election. This should make investors pause and reflect on some of the short-term technical measures — such as relative strength indexes and 200-day moving averages — that are not overly positive about a continued climb. Moreover, picking an asset horse at this stage of the race can be a daunting task that requires factoring in asset attractiveness, conviction, standalone risks and diversification properties.

Figure 1
S&P 500 Cumulative Returns vs New & Probable COVID-19 Cases

- New and Probable COVID-19 Cases, 7-day Moving Average
- S&P 500 Index, Cumulative Returns



Source: FactSet, The COVID Tracking Project, as of January 25, 2021.

The Risk Process

ISG's comprehensive portfolio risk management process involves multiple stakeholders working in concert to achieve a common goal: risk excellence. These stakeholders include portfolio management, research, senior investment management, an investment committee, global compliance, the Investment Risk Team and operational risk management. As individual entities, each group has specific responsibilities and tasks that are integral to ensuring that risk is properly measured, reported and understood in aggregate. Moreover, the risk management effort attempts to achieve its goals by producing timely and insightful information relating to portfolio exposures and risk metrics while providing a highly refined process of consuming and interpreting this data through portfolio monitoring.

- **Exposure Analytics** When it comes to exposure analytics, ISG uses a bevy of metrics and systems to remain fully informed of its risk position. With a portfolio's risk parameters properly defined, the portfolio is managed against specific rules governing the relative benchmark risks taken, the assets classes used and the maximum exposures experienced. To help with this effort, the team leverages a trading/rebalancing system that is coded with trade rules, constraints, tolerances and guidelines.
- **Risk Analytics** Portfolio risk is forecasted on a daily basis using a combination of internal and external modeling tools. The results are thoroughly reviewed by portfolio managers and senior management to better inform portfolio decisions and to ensure that a portfolio is adhering to tracking error and volatility targets. These same modeling tools are also used for more customized analysis that may assess current portfolio sensitivity to specific factors or hypothetical portfolio performance in a specific or historical scenario. This generates deeper portfolio understanding and an improved calibration of portfolio exposures. Lastly, the team regularly reviews the deltas between forecasted and realized portfolio risks to help further improve portfolio outcomes in a feedback loop.
- **Portfolio Monitoring** A portfolio is monitored from several perspectives. On an ongoing basis, portfolio managers monitor performance, risk reports and characteristics. On a monthly basis, attribution reports are thoroughly reviewed to better understand the contributors and detractors, and a post-mortem analysis is performed to help improve portfolio outcomes. ISG management also reviews all positions and exposures to ensure that a portfolio is operating within its guidelines and constraints. In addition, they thoroughly evaluate all underlying strategies versus the benchmarks. Lastly, on a quarterly basis, ISG's CIO reports to State Street Global Advisors' Investment Committee, which serves as yet another level of oversight of the overall process and performance of portfolio strategies.

Risk-Aware Partnering

The average investor and advisor spend a disproportionate amount of time thinking about and evaluating the process for generating returns. However, it is important to also maintain a healthy appreciation of risk and how a risk-management process may lead to improved long-term outcomes. ISG exemplifies this in the institutional risk management process that it has forged for nearly 40 years. ISG believes that returns are closely linked to the risks taken and improved investment experiences are closely linked to the risk management practices applied. Aligning with an institutional manager who offers a multilayered risk management approach like ISG's can serve to bolster the risk excellence of your practice and hopefully improve your clients' portfolio outcomes by providing a carefully considered calibration of risk and return prospects.

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