Insights
ETF Model Portfolios

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Model Matters

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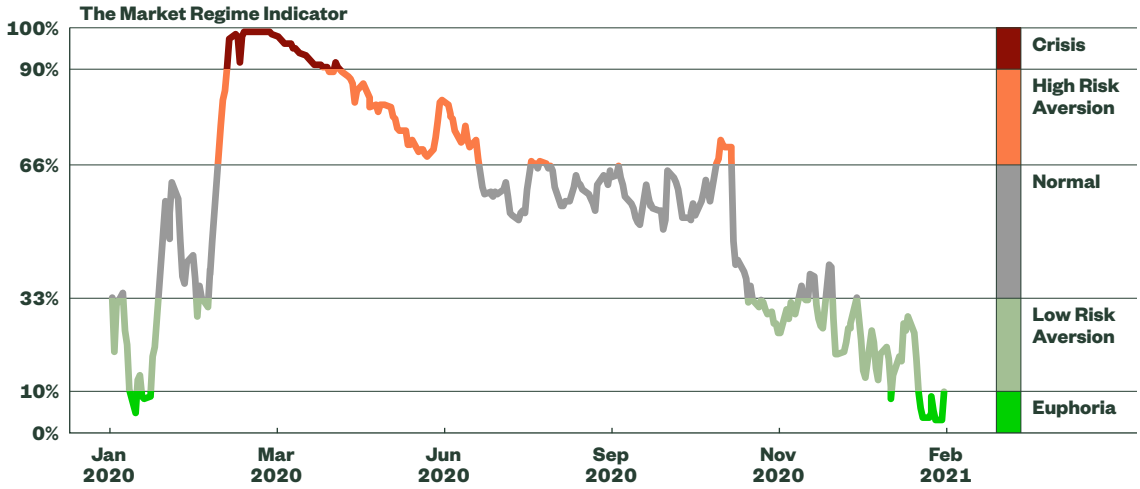
Exploring the current market landscape through the lens of State Street Global Advisors' investment process

What Are We Thinking?

The reflation trade is topic du jour in investment circles. But investors are doing more than talking and seem to have embraced the notion that the markets are poised to move higher, as evidenced by increasing equity flows and greater ambivalence towards risk. State Street Global Advisors' proprietary sentiment model, the Market Regime Indicator (MRI), paints a similar picture. It found that investors are less discriminate about market risk and it recently entered the model's most risk-averse market regime — Euphoria. It is in this regime that markets can underwhelm investors' short-term lofty expectations and risk management discipline might be more important for portfolio success. It is also be a period whereby "the trend is your friend" is no longer the perfect prescription and that contrarianism, in terms of having less risk assets invested, is often a preferred approach, especially if the markets are less prone to adequately reward the excessive risk taking that is characteristic of the regime.

Accordingly, the Investment Solutions Group (ISG) believes that a higher degree of risk aversion is currently warranted. To accomplish this, aggregate bond positions were increased while the consistent adds to risk assets over the past couple of months were interrupted by selling US large cap and developed equities.

Figure 1
The Implications of Euphoria Are Many



Source: State Street Global Advisors Investment Solutions Group, as of February 16, 2021. All data shown above does not represent the results of actual trading, and in fact, actual results could differ substantially, and there is the potential for loss as well as profit. The MRI is a quantitative framework that attempts to identify the current market risk environment based on forward-looking market indicators. We believe the factors used — equity-implied volatility, currency pairs implied-volatility and bond spreads — are good indicators of the current risk environment, as they are responsive to real-time market impacts and, in theory, should include all current and forward views of those markets. These factors are combined to create a single measure and used to identify one of five risk regimes: Euphoria, Low Risk, Normal, High Risk, and Crisis.

MRI Properties

The MRI identifies five distinct regimes based on the aggregate level of three broad factors: equity implied volatility, currency implied volatility and spreads on risky debt. By design, the factors capture risk sentiment across global assets in one convenient composite number that informs portfolio management and investors on the state of priced risk. Moreover, the model has several other properties that are worth noting. The MRI:

- provides a general recommendation on the composition of risky assets
- implies specific risk and return outcomes based on current regime and
- challenges contrarian portfolio manager views

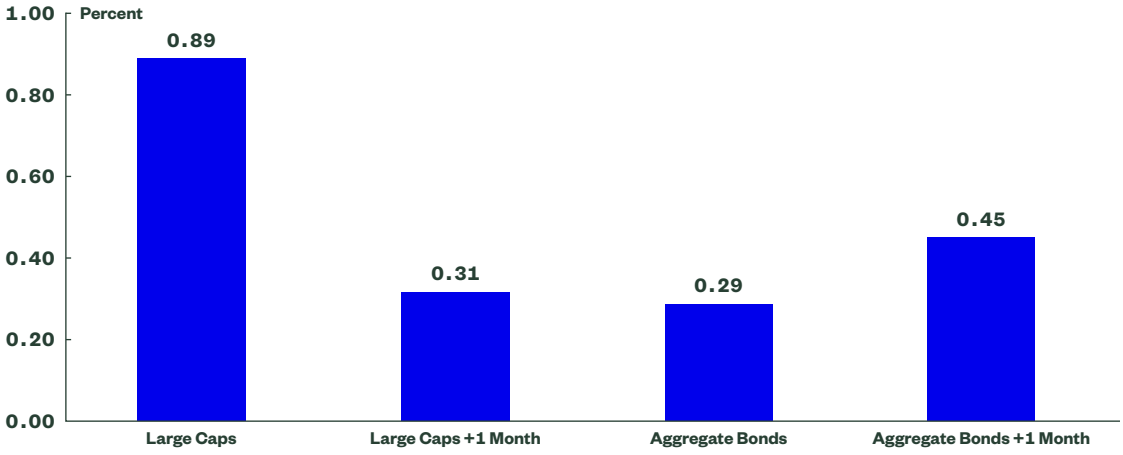
The MRI is a powerful signal that produces actionable recommendations based on extensive quantitative analysis and research. The model's rigor establishes credibility and provides some comfort when relying on its prescription. So it's not surprising that ISG tends to increase risk allocations in lower risk environments and decrease risk allocations in higher risk environments, as history and theory have demonstrated the efficacy of the approach.[1] But like all models, the MRI is not always right, although its track record is difficult to deny. The portfolio managers with contrarian model views often have the burden of formulating more persuasive arguments by supplying information that the MRI does not capture. But, this is a welcome burden as it leads to a more informed process that is capable of producing better outcomes.

Navigating the Extreme Regime

The MRI currently resides in a euphoric state, which typically only occurs around 10% of the time. But market extremes are often ripe places for understanding market dynamics or exploiting market opportunities. Historically, the investment returns are highest in the Low Risk regime and, characteristically, investors are feeling good about market prospects. There is often a reduction in investment risk and an economic stimulus through fiscal and monetary policies. But left unchecked, investors can become overly exuberant. Their risk assessments can become less rigorous and what determines a good investment can be more correlated to assets that increased in value as opposed to valuation and analyst sentiment. This is Euphoria by definition and is quantitatively determined by the MRI. Concurrently, euphoric regimes display positive performance outcomes, but it is the future which can be more concerning. As investors bid up assets with less regard for fundamentals, they can influence fundamental asset mispricings that are capable of reverting over short periods. Due to these elevated risks, it is not uncommon to see ISG buck the trend and seek refuge in lower allocations to risk assets. However, this reduction of risk may be short-lived. As the markets re-calibrate risk sentiment, the Low Risk regime could be revisited and risk asset positioning could be re-established to model highs. Such a scenario could still be hypothetical if the reflation trade forecast remains valid and partially offset by overzealous market participants anxious to reach their destination in a day.

Figure 2

History Tells Us That It Could Be Prudent to Decrease Risk Assets When Entering Euphoria



Source: Investment Solutions Group, SPDR Model Strategy, FactSet, as of January 1, 2001–January 31, 2021. Monthly regimes are determined by the daily intra-month regime score.

Experts in Reading Market Dynamics

For many advisors, while the decision to use a static or dynamic allocation can be difficult, deciding when to change allocations can be an even greater dilemma. ISG has explored this issue in depth and has nearly 40 years of experience grappling with these issues. The MRI is one of many tools employed to read the market tea leaves and to inform portfolio positioning. When these tools work in tandem with the portfolio management team's discretionary insights, it creates synergies that the team believes may improve portfolio outcomes.

Endnote

1 "Noise Trader Risk in Financial Markets," De Long et al, *The Journal of Political Economy,* Vol. 98, No. 4, (1990).

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