

# HOW STATEPLUS *is* smoothing the ride WITH SMART BETA

By Dan Purves

Working with providers like *STATE STREET*, and its asset consultant *MERCER*, *STATEPLUS has enhanced its retirement income proposition* through the clever use of smart beta strategies.

STATEPLUS HAS NEARLY half of its equity portfolio deployed via smart beta strategies. The approach has been so successful in reducing volatility and protecting returns that the \$40 billion fund is now considering the use of smart beta in managing its fixed income portfolio.

Prioritising risk management over chasing returns helps the wealth management and advice business deliver reliable income streams to its retired clients.

Roughly 85 per cent of the industry fund's members have already stopped working full time and started drawing down on their superannuation.

In response to the needs of its older-than-industry-average client base, StatePlus, formerly State Super Financial Services, has emerged as one of the first super funds to truly specialise in retirement income.

The use of smart beta plays a big role in helping StatePlus to balance risk management with reliable returns. This is crucial so its roughly 60,000 clients can enjoy the best standard of living possible in retirement, which for some could be a period of 30 or 40 years.

"Our clients don't want us to shoot for the stars ... they want us to not lose their money," StatePlus head of research Richard Dinham said.

"A smoother ride through retirement really pays dividends as the compounding effect is powerful over time, even if it's often overlooked."

Dinham said the inclusion of a range of smart beta products in the portfolio allowed for the introduction of certain desirable characteristics, such as being able to reduce the risk to value premium, as well as lowering fees.

"Smart beta" describes an increasingly popular style of investment product that emulates the low costs of passive index investing, while still capturing some of the benefits of active selection.

In traditional index investing, indices are constructed with reference only to market capitalisation. Smart beta strategists use alternative index construction rules to create indices that are based on other benchmarks.

Factors commonly used as the basis for

constructing smart beta equity indices include price-to-earnings, price-to-book, and volatility ratios.

## 85%

of the industry fund's members have already stopped working full time and started drawing down on their superannuation

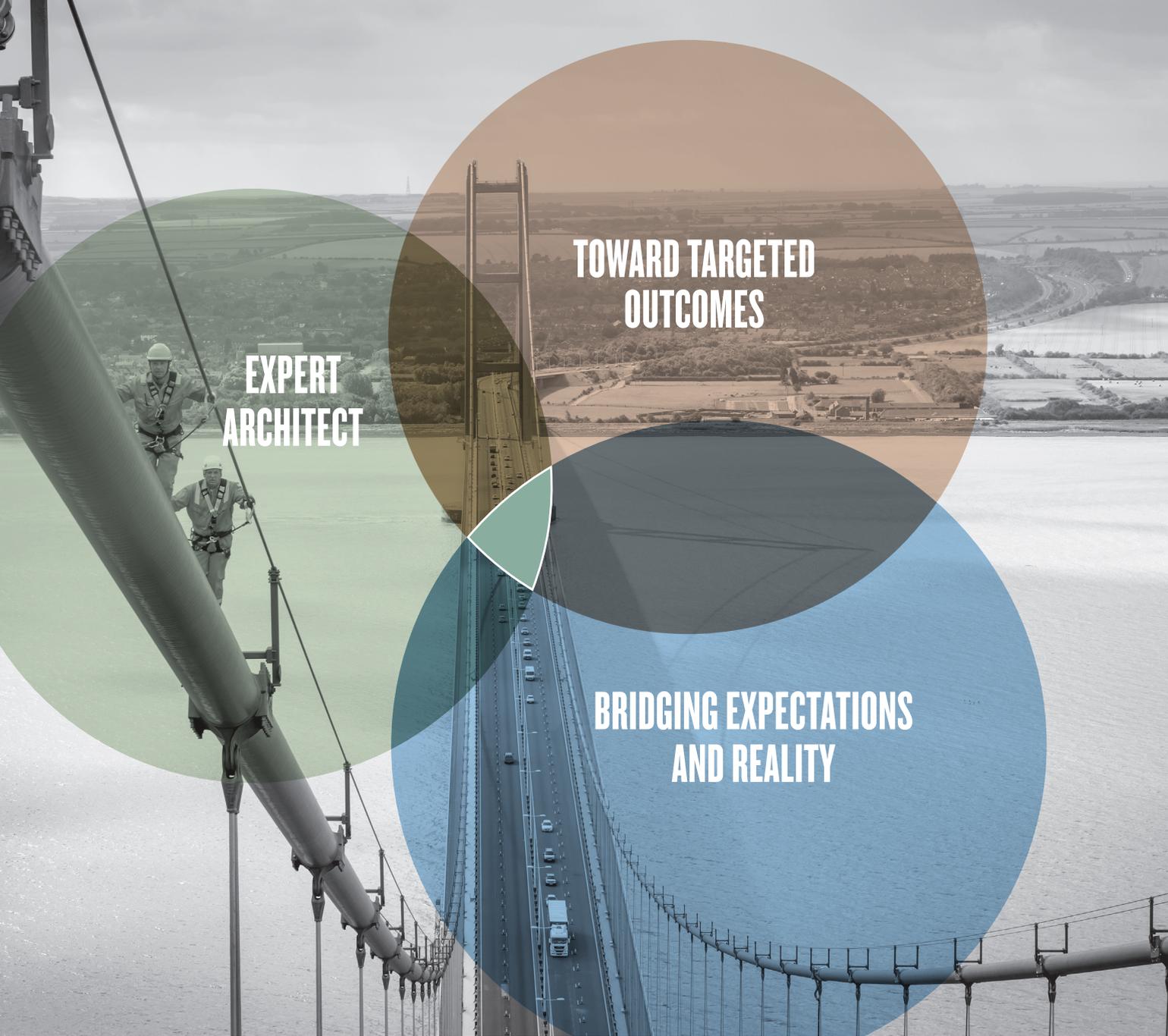
**ACHIEVING THE BEST RISK-WEIGHTED RETURN**

When it comes to managing retirement income portfolios, one of the most important factors to consider is how much risk capital is exposed to in the pursuit of returns.

State Street Global Advisors (SSGA) is one

of the providers that Sydney-based StatePlus has smart beta mandates with, specifically designed to help achieve the best risk-weighted return.

SSGA's deputy head of research global equity beta solutions Taie Wang said smart beta strategies had an important role to play in helping



**EXPERT  
ARCHITECT**

**TOWARD TARGETED  
OUTCOMES**

**BRIDGING EXPECTATIONS  
AND REALITY**

## **SMART BETA – BRIDGING AMBITIOUS TARGETS AND MARKET REALITIES**

Looking to rise above the current world of low returns? That's where State Street Global Advisors (SSGA) can help. Our smart beta strategies aim to hone in on key return drivers across global asset classes to pinpoint the source of returns – to keep investors on track for growth. Our expertly crafted tools combined with our analytical insight may help you achieve increased control of your investment outcomes.

**Make smart beta work for you. Visit [ssga.com/smartbeta/aus](http://ssga.com/smartbeta/aus)**

**STATE STREET  
GLOBAL ADVISORS**

There's opportunity  
in complexity

Issued by State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) ("SSGA Australia") the holder of an Australian Financial Services Licence (AFSL Number 238276). Registered office: Level 17, 420 George Street, Sydney, NSW 2000, Australia · Telephone: +612 9240-7600 · Facsimile: +612 9240-7611 · Web: [www.ssga.com](http://www.ssga.com). The information provided does not constitute investment advice and it should not be relied on as such. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor. There is no representation or warranty as to the accuracy of the information and State Street shall have no liability for decisions based on such information. The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without SSGA's express written consent. Investing involves risk including the risk of loss of principal. © 2016 State Street Corporation. All Rights Reserved. AUSMKT-2712. Expiry date: 31 Dec 2016.



Our clients don't want us to shoot for the stars ...  
they want us to not lose their money.

A smoother ride through retirement really pays  
dividends as the compounding effect is powerful  
over time, even if it's often overlooked.

super funds manage risk on behalf of members in and approaching retirement.

"An important concept to these smart beta strategies is 'exposure per unit of active risk,'" Wang said.

Exposure per unit of active risk is a way of measuring how much risk an investor is taking on to achieve more exposure to the factor they want in an equity portfolio, she said.

"This can also be applied to other asset classes, such as fixed income, as long as the objective is a factor exposure."

However, there is nuance to that, depending on whether the strategy is benchmark-aware or not.

"Most smart beta strategies are constructed in a benchmark-aware way," Wang said.

"So it is appropriate to use an *active* exposure per unit of *active* risk, which can otherwise be described as the tracking error."

To illustrate her point, Wang describes a scenario where an institutional investor is looking to invest into a value strategy, such as underpriced stocks in the World Developed Market.

In this scenario, Product A is a very concentrated portfolio that holds only 50 low valuation stocks, while Product B is a broad portfolio that holds all 1600 stocks in the universe and tilts the stock weights mildly away from cap-weight towards lower valuation stocks.

#### **MORE EFFICIENT, LESS RISKY, SMART BETA OPTION**

"Product A might give you a higher exposure to valuation due to its high concentration into value stocks, while Product B may only give you mild

exposure to value," Wang said.

"However, Product A may at the same time give you a very high tracking error – deviating far from the cap-weighted benchmark – while Product B's tracking error is much smaller."

Comparing the products in terms of active exposure per unit of tracking error, Product B is shown to be a more efficient, less risky, smart beta option that still provides exposure to valuation upside, she said.

However, some strategies (especially in the low volatility space) are built in a benchmark-agnostic way, meaning the pricing differential is not a constraint. This means the portfolio could deviate significantly away from the cap-weighted benchmark.

"In this case, an approach based on total exposure per unit of total risk might be more suitable," Wang said.

Dinham said the thinking behind why StatePlus had underpinned its portfolio with smart beta strategies was that if the market falls 5 per cent, they might limit their losses to 2 per cent, leaving less ground to make up when the market turned.

"That's the type of pattern of returns we're trying to achieve. Still taking risk, but minimising that downside where we can, so we have a smooth outcome from compounding over time," he said.

"It's amazing how that plays out over time in terms of better outcomes for clients."

Dinham said the heavy falls and spiking volatility in the aftermath of the Brexit vote was a real test that showed how a heavy tilt to smart

beta strategies is paying off for StatePlus.

"Both our value and low volatility strategies outperformed through Brexit."

Mercer director of strategic research Hendrie Koster also sees good reasons to use smart beta in a retirement income portfolio.

Smart beta strategies targeting low volatility can be effective tools to help mitigate sequencing risk at a time when super fund members have relatively large saving pots and need a way to reduce the impact of market volatility, Koster said.

#### **SHIFT FROM SAVINGS TO RETIREMENT INCOME**

It is an approach more superannuation funds will have to consider in the coming years. For the first two-and-a-half decades of compulsory super, most funds have been almost solely focused on helping members accumulate savings during their working lives. Now the industry is being forced to turn its attention to how convert the nation's \$2.1 trillion and growing super pool into retirement income.

The government plans to mandate that all super funds must offer retiring members a comprehensive income product for retirement (CIPR), as an alternative to a lump sum payout.

Koster predicted the incoming CIPR rules could lead to more funds turning to smart beta strategies to enable them to deliver low-cost default pension accounts.

"Similar to the impact of MySuper, we could see a number of funds launch low-cost CIPRs, as an alternative to those relying on more expensive actively-managed approaches," he said.

SSGA's Wang said the ultra-low interest rate environment meant the impact of fees on net investment income was amplified.

Dinham agreed, although he remains worried about how markets might react if the US Federal Reserve raises rates more quickly than expected.

"Everyone is looking for the magic pudding for retirement incomes, and we don't even know all the details about what CIPRs will have to look like yet," he said.

It is expected that most CIPRs will include some form of annuity to help manage longevity risk – the risk that people will outlive their savings. It remains to be seen if the inclusion of annuities as a component of CIPRs will be mandated.

Smart beta products, while no panacea to all the challenges involved in CIPR design, likely have an important role to play as a building block in the solutions many funds develop. ✕