Syntax Index Insights: Fourth Quarter 2019

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Markets climb the wall of worry without a harness

Highlights

1. 30 for 30: S&P 500 up over 30% - 4th best annual return in 30 years
2. Active Business Risk: Most concentrated market since June 1999
3. Alternative Weight indices struggle to keep up with Cap Weight
4. Small Cap resurgence in Q4
5. Brexit and trade war news eases uncertainty internationally
6. Sectors: Healthcare and Financials outperform in Q4 after lagging

US Large Cap – 30 for 30

Following a volatile third quarter, equity markets climbed the wall of worry in Q4 (S&P 500 +9.2%). This stands in sharp contrast to the dreadful fourth quarter in 2018 (-13.5%), largely due to a dramatically more dovish Federal Reserve. The S&P 500 celebrated the new year with an annual total return of over 30%, its fourth strongest annual performance in 30 years.

All major indices rose – large, small, value and growth. However, the rally masked the structural bias that prevails in most cap weighted benchmarks, i.e. concentrated exposure to specific business risks. In 2019, concentration in technology propelled the S&P 500 to new highs, as the "big 5" megacap tech stocks (Microsoft, Apple, Alphabet, Amazon and Facebook) rose 51% on average. These five stocks ended the year comprising 16.8% of the cap weight index, more than the smallest 295 stocks combined (16.2%). The Syntax Stratified LargeCap Index (SYLC) broadly kept up, returning 29.3% for the year while maintaining its diversified exposure (only 1.5% weight in the big 5).

Core Index Comparison: Cap Weight versus Stratified Weight

	2019 Q4 (total return %)		2019 (total return %)	
	Stratified Weight	Cap Weight	Stratified Weight	Cap Weight
S&P 500	7.3	9.1	29.3	31.5
S&P 400	7.1	7.1	23.8	26.2
MSCI EAFE	8.7	8.2	20.9	22.7

Source: Syntax. Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index.

Syntax, LLC is an index provider and financial analytics company based in New York. Syntax offers a suite of Stratified Benchmark Indices which reweight the most widely used benchmarks

Active Business Risk: Most concentrated market since June 1999

As we have written in recent quarters, the current S&P 500 (cap weighted) index exposures are troubling because of their narrow focus in the IT and Information sectors. Such related business risks can amplify the effect of macro and micro shocks on the broad index return.

Active Business Risk continues to rise

Active Business Risk, our measure of aggregate index bias toward sectors and industries has risen to 24.9, a level last seen in June 1999. Furthermore, at 19.8x, the 12m forward P/E ratio for the S&P 500 is near its post DotCom bubble peak of 20x (December 2017). Expensive valuations and concentrated markets is a recipe for future volatility.

Active Business Risk for S&P 500

Source: Syntax

Alternative Weight indices struggle to keep up with Cap Weight

Both S&P Pure Value and S&P Pure Growth underperformed the cap weighted index

In the S&P 500, the largest ten companies contributed 9.2 percentage points of total return (almost one third of the overall index's 31.5% performance for the year). Both the S&P 500 Pure Value and the S&P 500 Pure Growth underperformed the vanilla index – a phenomenon that has never before happened in a year where all three indices went up (going back to the inception of the pure factor indices in 1996).

Strong momentum effects in the largest stocks created a tough environment for alternative weight indices to outperform their cap weighted counterparts. The Syntax Stratified LargeCap Index performed favorably against other strategies.

Alternative Weight Index Performance in 2019

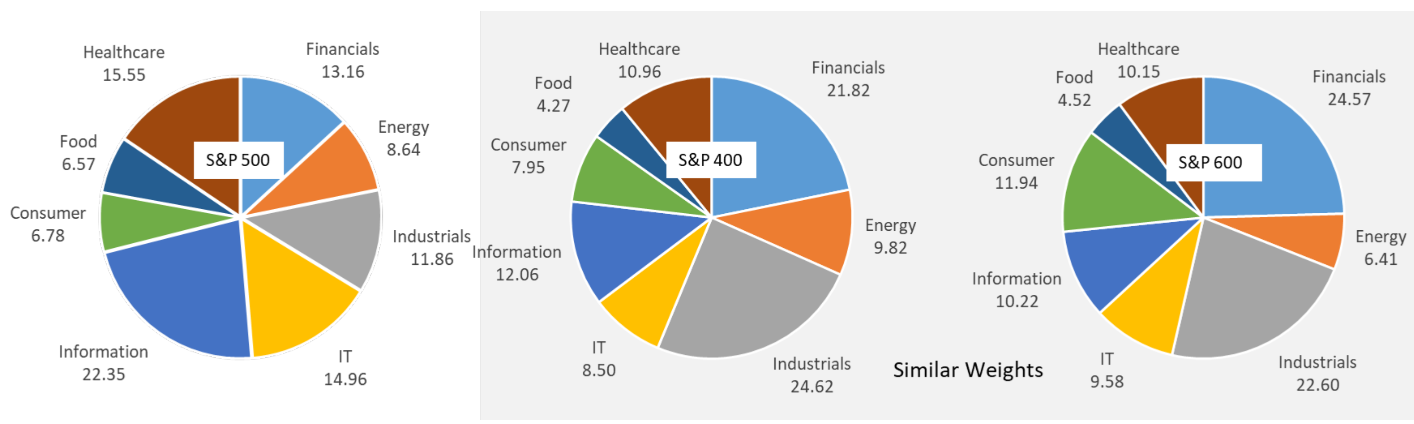
	2019 Total Return (%)
S&P 500 Index	31.5%
Syntax Stratified Large Cap Index	29.3%
S&P 500 Equal Weight Index	29.2%
S&P 500 Pure Growth Index	29.0%
FTSE RAFI US 1000 Index	28.0%
S&P 500 Pure Value Index	25.5%

Source: Syntax, FactSet

Small Cap & Mid Cap Offer Different Biases to LargeCap Indices

When branching out from the S&P 500 into the small (S&P 600) or mid cap (S&P 400) universes, investors are exposing themselves to different types of business risks. Almost half of the S&P 400 and S&P 600 indices are made up of just two sectors, Financials and Industrials, while less than 10% of their weight is allocated to the IT sector. Interestingly, the broad sector weights of the S&P 400 and S&P 600 are similar to one another.

Sector Weights for S&P 500 (LargeCap), S&P MidCap 400 and S&P SmallCap 600



Source: Syntax, FactSet

This underweight in tech led to underperformance of both SmallCap and MidCap indices versus the large caps, given that IT was the best performing sector in all three universes. Unlike the Stratified LargeCap index, the Stratified SmallCap and Stratified MidCap indices have a larger exposure to technology than their cap weighted versions. Addressing this bias led the Stratified SmallCap Index to rise 23.9% in 2019, versus 22.8% for the S&P 600. The Syntax Stratified MidCap index performed in-line with the Stratified SmallCap index (23.8%), underperforming the S&P 400 (26.2%) for the year. The majority of the S&P 400 outperformance was due to the largest two cap-weighted sectors, namely the Industrials and Financials, where the concentrated sector exposures benefited from strong relative performance.

Brexit and trade war news eases uncertainty internationally

Q4 2019 gave some much-needed forward momentum to the ongoing Brexit and the US-China Trade War sagas, helping MSCI EAFE to rise 8.2% for the quarter. The "risk on" trade that played out in the US markets was reflected by an 80% correlation in the pattern of EAFE vs S&P 500 sector returns. Similar to the US LargeCap universe, the Stratified Europe & Asia Developed Markets (SEADM) index underperformed its cap weighted benchmark for the full year (20.9% vs 22.7%).

The announcement of the "phase one trade deal" between the US and China is certainly a step in the right direction, but some of the most contentious details remain unresolved and will likely lead to continued uncertainty and volatility in 2020.

Healthcare and Financials Outperform in Q4 after Lagging

The Healthcare sector was the worst performing sector through the third quarter, despite the announcement of two of the year's largest mergers (Bristol-Myers Squibb's $92bn acquisition of Celgene and AbbVie's $87bn acquisition of Allergan). Through the end of Q3, the Stratified Healthcare index underperformed SYLC by 12.1%, while cap weighted Healthcare underperformed the S&P 500 by 15.7%. However, the S&P 500 Healthcare sector reversed in Q4, outperforming the broad index by 4.8%. Volatility to both the upside and the downside in the Healthcare sector saw the stratified weight index outperform the cap weighted version, highlighting the importance of a diversified approach.

Healthcare sector bounces back after three quarters of underperformance.

The stratified weight Financials lagged its cap weight counterpart because of strong returns by capital markets banks after robust earnings announcements. This group returned 15.2% in the S&P 500 and had almost three times the stratified weight exposure (CW: 5.7%, Strat: 2.1%).

Sector and Composite Performance

US LargeCap (S&P 500 universe)

	2019 Q4 (total return %)		2019 (total return %)	
	Stratified LargeCap	**S&P 500**	**Stratified LargeCap**	**S&P 500**
Total	**7.3**	**9.1**	**29.3**	**31.5**
Financials	7.3	9.1	31.7	31.8
Energy	6.2	9.2	18.8	17.7
Industrials	7.5	5.9	32.2	28.7
Info. Tools	14.5	17.2	49.4	54.4
Information	6.5	7.7	28.9	33.0
Consumer	6.1	3.3	27.2	31.4
Food	3.6	2.8	30.0	26.7
Healthcare	11.3	13.9	21.1	19.4

Source: Syntax. Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index.

Europe & Asia Developed Markets (MSCI EAFE universe)

	2019 Q4 (total return %)		2019 (total return %)	
	SEADM	**MSCI EAFE**	**SEADM**	**MSCI EAFE**
Total	**8.7**	**8.2**	**20.9**	**22.7**
Financials	8.5	7.7	18.3	17.0
Energy	7.6	7.0	15.2	12.3
Industrials	11.0	10.9	23.9	25.2
Info. Tools	10.8	12.7	39.3	38.6
Information	8.4	7.4	26.7	22.5
Consumer	7.4	7.8	18.4	21.6
Food	5.4	1.2	14.1	19.7
Healthcare	12.9	12.6	24.0	29.1

Source: Syntax. Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index.

Syntax Core Index Suite

Index	Ticker (TR)	Base Universe
Stratified Benchmark Indices™		
Syntax Stratified LargeCap	SYLCTR	S&P 500
Syntax Stratified MidCap	SYMIDTR	S&P MidCap 400
Syntax Stratified SmallCap	SYSCTR	S&P SmallCap 600
Syntax Stratified Core	SYCORETR	S&P 900
Stratified Sector Indices™		
Syntax Stratified Financials	SYFINTR	S&P 900
Syntax Stratified Energy	SYENYTR	S&P 900
Syntax Stratified Industrials	SYINDTR	S&P 900
Syntax Stratified Info. Tools	SYITTR	S&P 900
Syntax Stratified Information	SYINFOTR	S&P 900
Syntax Stratified Consumer	SYCPSTR	S&P 900
Syntax Stratified Food	SYFOODTR	S&P 900
Syntax Stratified Healthcare	SYHLTHTR	S&P 900
Stratified Thematic Indices™		
Syntax US Social Core Tier 1	SOCIAL1TR	Custom US Large & Mid Cap
Syntax US Social Core Tier 2	SOCIAL2TR	Custom US Large & Mid Cap

Important Disclaimers

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The S&P 500® Index is an unmanaged index considered representative of the US mid- and large-cap stock market. The MSCI EAFE Index is an unmanaged index considered representative of the European, Australian, and East Asian large-cap stock market. Benchmark data for the S&P 500, S&P MidCap 400, and S&P SmallCap 600 Indices are provided by S&P Dow Jones through FactSet®. Benchmark data for the MSCI EAFE index is provided by MSCI through FactSet.

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