Syntax Index Insights: First Quarter 2020

Highlights

1. Market decline in Q1 2020 sees higher volatility than during the financial crisis.
2. Alternative Weight indices struggle to keep up with cap weight during flight to safety.
3. Market concentration is at the highest levels since 1978.
4. Previous recoveries have seen headwinds for momentum strategies, causing cap weight to underperform alternative weight products.

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Investor panic sends volatility above 2008 levels

The first quarter of 2020 saw a dramatic end to the bull market that reigned since the end of the global financial crisis. The widespread sell-off hit all risk assets as concerns over the impact of the coronavirus pandemic caused investor fear and panic selling. Equity volatility spiked and the VIX hit higher levels than those seen during the Global Financial Crisis. Macroeconomic data quickly followed suit as weekly jobless claims skyrocketed and US retail sales for March fell 8.7%, the largest decline since records began in 1992. The S&P 500 had its worst quarter since 2008, falling 19.6%. Alternative weight strategies also fared poorly, with the S&P 500 Equal Weight Index having its worst quarter since at least 1990 (-26.7%), while the Stratified LargeCap Index performed only marginally better (-25.5%).

Core Index Comparison: Cap, Equal and Stratified Weight

2020 Q1 Total Return	Stratified Weight	Equal Weight	Cap Weight
S&P 500	-25.5	-26.7	-19.6
S&P MidCap 400	-29.8	-32.5	-29.7
S&P SmallCap 600	-30.8	-36.4	-32.6
MSCI EAFE	-23.0	-24.6	-22.7

Source: Syntax, S&P Dow Jones Indices, MSCI. 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

Alternative Weight Strategies Struggle relative to Cap Weight

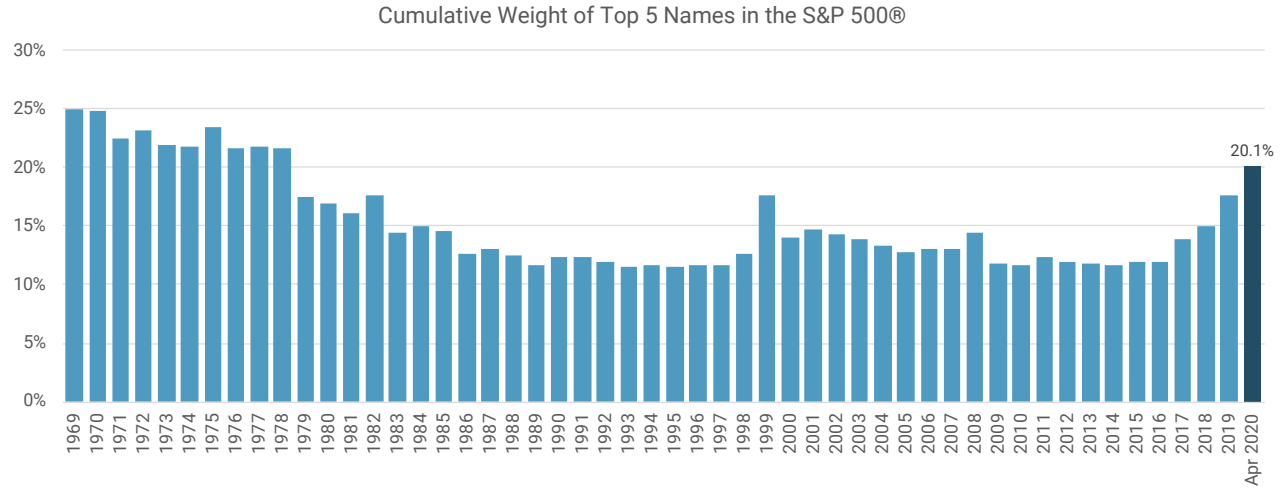
The flight to safety during the first quarter sell-off helped large cap and cash-rich companies to outperform. Market cap-weighted indices are strongly aligned to these investment factors which helped them to outperform their alternative weighted counterparts. Strong momentum effects in technology stocks also created a tough environment for alternative weight indices in 2019. As was the case in Q1 2020, the Syntax Stratified LargeCap Index performed favorably against other alternative weight indices in 2019.

	Q1 2020 Total Return (%)	2019 Total Return (%)
S&P 500 Index	-19.6%	31.5%
Syntax Stratified Large Cap Index	-25.5%	29.3%
S&P 500 Equal Weight Index	-26.7%	29.2%
S&P 500 Pure Growth Index	-20.7%	29.0%
FTSE RAFI US 1000 Index	-26.4%	28.0%
S&P 500 Pure Value Index	-41.8%	25.5%

Source: Syntax, S&P Dow Jones Indices, FTSE Russell. Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index.

Market Concentration Highest Since 1970s

The recent strong momentum in the largest companies has further driven up their weight in broad market indices. The weight of the largest five stocks in the S&P 500 surged over 20%, a level not seen since the 1970s, according to S&P Dow Jones Indices. Though this concentration helped cap-weighted indices during the sell-off, it will likely create a strong headwind during the recovery period, as we saw in 2009.



Source: S&P Dow Jones Indices. Data as of 4.15.2020.

Lessons from the 2008 Sell-off and Recovery

The root cause of the recent market sell-off was markedly different from anything we've seen before. However, the broad risk aversion, disorderly markets and divergence of sector performance has many of the hallmarks of the 2008 Global Financial Crisis.

As we wrote in our recent white paper "Sell-offs, Reversals and Business Risk", there were two regimes in 2008 and 2009: (i) a sharp sell-off, which picked up steam when Lehman Brothers collapsed on September 15th, 2008 until almost six months later on March 9th, 2009 and (ii) a sharp recovery when confidence returned. The sell-off regime sees the share prices of distressed businesses significantly underperform the safer regions of the market. In 2008, the most distressed sector was Financials, while the safest businesses were low-cost restaurants and other consumer staples. This time around, consumer groups such as cruise ships, airlines, retailers and auto companies were the hardest hit, while tech-related businesses such as business software, telecoms and healthcare have seen lower drawdowns.

As was the case in March 2009, the recovery regime often sees a complete reversal in industry performance (see "Sell-offs, Reversals and Business Risk" for more detail). Therefore, in a robust recovery, investors buy the most beaten down stocks and sectors causing them to outperform.

This reversal effect was clearly seen immediately following the market trough on March 24th. The market rose 9.4% that day, led by Consumer, Financials and Energy and there was a 95% negative correlation between the sector performance on the 24th March and the performance during the sell-off period (February 21st through March 23rd). We saw a similar pattern on April 17th, when reversals in Financials, Energy, Industrials, and Consumer led the rally.

Performance	Sell-off Period	Mar 24	Apr 17
S&P 500	**-37.3%**	**9.7%**	**3.5%**
Financials	-47.8%	12.5%	5.0%
Energy	-46.7%	12.0%	6.1%
Consumer	-43.9%	12.0%	4.0%
Industrials	-40.4%	10.8%	4.1%
Information Tools	-36.5%	9.8%	3.1%
Information	-32.8%	9.7%	1.8%
Healthcare	-31.3%	7.2%	2.7%
Food	-26.8%	6.1%	2.1%
Correlation with sell-off period		**-0.96**	**-0.91**

Source: Syntax. S&P 500 Sector Total Return in sell-off period (2.21.2020 – 3.23.2020) and on two prominent reversal days (3.24.2020, 4.17.2020). Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index.

As was the case in 2009, a sustained recovery is likely to be led by the sectors that declined the most during the sell-off. As cap-weight is currently underweight these sectors versus Stratified Weight which will likely create a headwind for cap weight versus alternative weighted indices.

We reiterate that the Stratified Weight approach is a long-term strategy designed to capture the broad equity risk premium for a given universe and should not be biased by any business risk drivers over any others. It is not designed to be a low beta strategy and will hence carry roughly equal exposure to distressed sectors as it will to the safer sectors at any point in time.

Distressed Sectors: Consumer, Financials and Energy

On its rebalance date, the Stratified LargeCap index will hold 37.5% weight to these sectors combined.

The national stay-at-home order has and will continue to have a devastating effect on the earnings of most cyclical (recession sensitive) companies. Transportation companies and brick and mortar retailers, together with many restaurant chains, saw their businesses shut down and smaller stocks within the Consumer sector were among the hardest hit (S&P 600 Consumer sector fell 48.8%). In the S&P 500 consumer sector, transportation companies were hit the hardest, with airlines losing just over half their value (-50.3%), automobile components manufacturers down 46.8%, and automobile manufacturers down 44.8% in Q1. Home and office retailers outperformed (down 19.0%), while household products manufacturers performed the best, falling 6.3%.

Financial companies (S&P 500 Financials -33.7%) suffered liquidity concerns and calls to cut their dividend programs, which weighed heavily on their share prices. In the S&P 500 universe, this was most notable in smaller consumer banks (-54.4%); while larger capital markets banks like Goldman Sachs (-32.4%) and Morgan Stanley (-33.1%) fared relatively better. In the Real Estate group, drawdowns were dominated by losses in the Cruise Ships group (-76.2%) but were offset by relatively stronger performance from Residential REITs (-19.9%), Industrial REITs (-11.0%), and Telecom REITs (-0.3%).

Meanwhile, the reduced demand for oil was amplified by OPEC+'s failure to agree to supply curbs on March 5th resulting in a bitter price war resembling the sell-off in late 2014, which hit the US shale producers and explains the relatively poor performance of the SmallCap Energy sector (-49.4%) versus the Large Cap sector (-34.4%). LargeCap Upstream Energy producers (-60.8%) were hit harder than their Downstream peers (-44.7%), while

Competitive Electric Utilities (-12.3%) and Rate-Regulated Electric Utilities (-15.4%) fared even better.

Safer Sectors: Information Tools, Health Care & Food

On its rebalance date, the Stratified LargeCap index will hold 37.5% weight to these sectors combined.

Information Tools was the best performing LargeCap sector this quarter (-9.6%). The sector is well positioned to benefit from virtual working leading to increased demand for data centers, higher network traffic, or software subscriptions. However, it is difficult to separate out the business risk story from the traditional factors: the cap weight returns of the sector are dominated by cash-rich Apple and Microsoft, and momentum, growth, and quality were the best performing factors through this turbulent quarter. Within the S&P 500 Information Tools Sector, Semiconductor Manufacturers (-14.0%) saw the greatest drawdown, while Software producers (-2.35%), especially Security Software (+7.0%) and Cloud Access Software (+28.0%), helped ease the pain.

As was the case in 2008, the more defensive Food (-15.0%) and Health Care (-13.4%) sectors also benefited in relative terms. Food Distributors (-8.1%) performed the best in the S&P 500 Food Sector, while Agricultural producers (-23.5%) and Meat and Dairy companies (-23.3%) saw heavier falls driven by reduced demand from restaurants and other commercial food buyers. As healthcare providers have suspended elective procedures, Acute Care Facilities (-37.1%) and Outpatient Facilities (-30.9%) have suffered, and concerns over the viability of senior homes led that group to fall 52.2% in Q1. Meanwhile, Pharmaceutical manufacturers (-8.2%) saw healthier performance.

Sector and Composite Performance

US LargeCap (S&P 500 universe)

	2020 Q1 Total Return		
	Stratified LargeCap	**S&P 500 Equal Wgt**	**S&P 500**
Total	**-25.5**	**-26.7**	**-19.6**
Financials	-35.4	-37.0	-33.7
Energy	-39.5	-37.2	-34.4
Industrials	-25.5	-25.9	-25.8
Info. Tools	-15.7	-15.2	-9.6
Information	-20.5	-21.8	-14.6
Consumer	-33.4	-37.1	-23.8
Food	-17.9	-16.9	-15.0
Healthcare	-16.1	-16.0	-13.4

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

US MidCap (S&P 400 universe)

	2020 Q1 Total Return		
	Stratified MidCap	**S&P 400 Equal Wgt**	**S&P 400**
Total	-29.8	-32.5	-29.7
Financials	-34.0	-38.0	-38.1
Energy	-41.3	-42.9	-36.0
Industrials	-30.7	-31.0	-28.6
Info. Tools	-22.0	-22.5	-19.9
Information	-28.6	-29.5	-27.6
Consumer	-39.3	-42.0	-38.8
Food	-20.3	-21.7	-18.0
Healthcare	-21.9	-20.8	-16.7

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

US SmallCap (S&P 600 universe)

2020 Q1 Total Return

	Stratified SmallCap	S&P 600 Equal Wgt	S&P 600
Total	-30.8	-36.4	-32.6
Financials	-30.5	-36.7	-35.9
Energy	-34.5	-61.4	-49.4
Industrials	-33.3	-34.3	-29.5
Info. Tools	-26.2	-26.6	-24.4
Information	-23.5	-26.2	-21.0
Consumer	-48.7	-50.2	-48.4
Food	-29.9	-32.3	-29.8
Healthcare	-19.4	-22.2	-21.2

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

International (MSCI EAFE universe)

2020 Q1 Total Return

	SEADM	MSCI EAFE Equal Wgt	MSCI EAFE
Total	-23.0	-24.6	-22.7
Financials	-31.4	-31.6	-31.2
Energy	-26.1	-23.4	-25.7
Industrials	-27.0	-26.3	-25.3
Info. Tools	-21.3	-21.1	-16.8
Information	-21.1	-20.6	-16.2
Consumer	-24.3	-26.9	-22.7
Food	-15.6	-15.1	-17.9
Healthcare	-13.5	-11.1	-9.0

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
Syntax Stratified 1000	SY1KTR	Russell 1000
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

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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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