

Syntax Index Insights: Third Quarter 2019

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Risk and Valuation: Red Flags for Cap Weight

Highlights

1. US Large Cap has strongest YTD since 1997
2. VIX and S&P 500 both rise in Q2 and Q3 – suggests more vol to come
3. Tech sector sees a renewed focus on valuation
4. Active Business Risk: Core products are heavily biased

US equities continued to rally in Q3 as economic data and earnings growth remained strong. However, the quarterly performance numbers mask a treacherous environment. As US equity markets rose, so too did the VIX (investors are becoming increasingly nervous). At the same time, both the IPO market and the public equity markets are hinting that valuation matters again and that momentum strategies may see further downside pressure. These themes make us worried about the heavy concentration cap-weighted indices have in high momentum, high valuation technology stocks.

Core Index Comparison: Cap Weight versus Stratified Weight

	2019 Q3 (total return %)		2019 YTD (total return %)	
	Stratified Weight	Cap Weight	Stratified Weight	Cap Weight
S&P 500	1.5	1.7	20.5	20.6
S&P 400	-0.5	-0.1	15.6	17.9
MSCI EAFE	-0.2	-1.0	11.2	13.4

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

Record bull market, but volatility on the rise

The S&P 500 rose 1.7% and the Stratified LargeCap index (which comprises the same stocks with different weights) performed in line (+1.5%). While political uncertainty and trade concerns still persist, the S&P 500 is in the longest bull market period in history, according to the Wall Street Journal¹ and through Q3 2019, the S&P 500 had risen 20.6%, its strongest YTD performance since 1997. Despite its more diversified weighting approach, the

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

Stratified LargeCap index performed in-line with its cap-weighted counterpart.

However, the picture is not as rosy under the surface. The US yield curve has inverted deep into its term structure and the IPO market is showing signs of weakness (especially for high valuation companies). Though the S&P 500 rose in Q2 and Q3, the VIX also rose, breaking its usual negative correlation.

Markets rise, but investors are hedging themselves

Volatility Index and S&P 500: Last four quarters

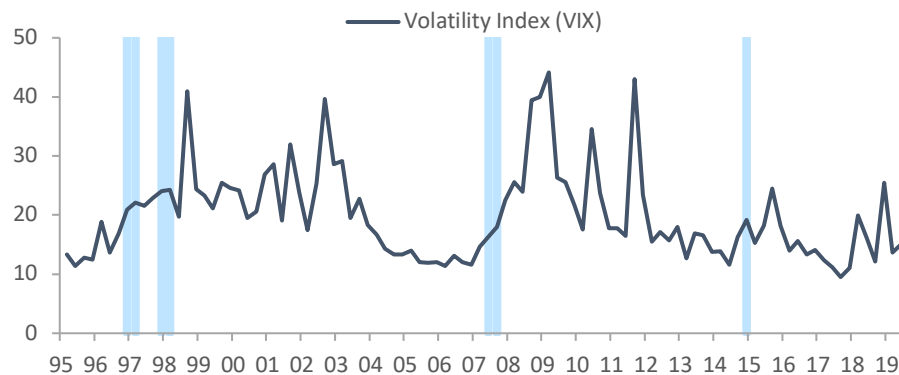
	S&P 500 Level	S&P 500 Return (%)	VIX Level	VIX Chg (%)
Q4 2018	2,506.85	-14.0	25.42	109.7
Q1 2019	2,834.40	13.1	13.71	-46.1
Q2 2019	2,941.76	3.8	15.08	10.0
Q3 2019	2,976.74	1.2	16.24	7.7

Source: Bloomberg, Syntax. S&P 500 and VIX price level and price return. Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index.

This is very unusual - the two indices have a negative 70% correlation and there are only 7 other instances in 25 years of both indices rising in consecutive quarters.

Rising volatility and positive market performance may be a sign of turbulence to come

Periods when S&P 500 and VIX both rose in consecutive quarters



Source: Bloomberg, Syntax. Shaded regions represent periods with positive increases in both the VIX and S&P 500 Indices for two or more consecutive quarters.

For the seven similar periods, shown as the blue bars on the chart above, the average level of the VIX was 20.7 - similar to its level at the time of writing (20.3 on 10/8/19). The following year, the VIX rose over 20% on average.

1. See Wall Street Journal, "U.S. Stocks Poised to Enter Longest-Ever Bull Market." Aug 21 2019

Tech sector sees a renewed focus on valuation

The anti-trust investigations into big tech (see Q2 Insights), coupled with a softening in the IPO market has given investors a renewed focus on valuation for technology related companies. In Q3, the FAANG stocks with above market P/E multiples underperformed the market, whereas those with lower multiples outperformed. Four of the five FAANG stocks are in the Information sector and oversized exposure in many market cap-weighted indices has led to a bias in that sector. In contrast, by spreading weight more evenly, the Stratified LargeCap Index allocated only 0.8% to the FAANG stocks in Q3.

FAANG stocks: Valuation and performance in Q3

	P/E*	Q3 Performance	S&P 500 Weight	Stratified Weight
Netflix	65.4	-27.1%	0.7%	0.1%
Amazon	48.2	-8.3%	3.2%	0.1%
Facebook	19.3	-7.7%	1.9%	0.1%
S&P 500	17.7	1.2%		
Google	17.3	12.8%	2.7%	0.1%
Apple	16.1	13.6%	3.5%	0.3%
FAANGs			12.0%	0.8%

FAANG performance correlated strongly with valuation in Q3

Source: Bloomberg. 12m forward P/E ratio on 6/30/19

Core equity products remain heavily biased

The Syntax Active Business Risk Score enables us to more accurately measure the amount of sector and industry bias in a portfolio or index. It is a measure of industry weightings relative to a neutral (equal) business risk exposure (see “Active Business Risk” by Rory Riggs).

Active Business Risk, a measure of the sector and industry bias in a portfolio, flashes warning signs

We find that key equity indices continue to take large positions in specific business areas and have above average Active Business Risk scores. For example the S&P 500 has a score consistent with that seen in Q4 1999.

Historically, when markets become over concentrated, economic shocks carry an exaggerated impact on overall performance and hence the portfolio underperforms its potential. We caution taking a cap-weighted approach to capture the equity risk premium at these Active Business Risk levels.

Sector Exposure and Bias (from neutral business risk)

FIS Sector	S&P 500		S&P MidCap		MSCI EAFE	
	wgt	bias	wgt	bias	wgt	bias
Financials	13.0		24.4		23.4	
Energy	8.1		8.2		9.0	
Industrials	12.1		24.2		18.0	
Info. Tools	16.1		8.4		4.5	
Information	23.3		11.2		10.9	
Consumer	7.0		8.7		14.3	
Food	6.7		4.1		9.3	
Healthcare	13.7		10.8		10.6	

Source: Syntax. "Wgt" represent the weight of each sector as of 9.30.2019; "bias" represent deviation from neutral business risk exposure, as defined using Syntax's FIS classification system; blue bars indicate overexposure to the sector, while red bars indicate underexposure.

Active Business Risk in the S&P 500


Source: Syntax. Active business risk of the S&P 500 index from 12/31/1991 to 9/30/2019. Active business risk is the average of the sum of the absolute deviation between index weight and neutral business risk exposure for each level in the Syntax business risk taxonomy, as defined using Syntax's FIS classification system.

Sector and Composite Performance

US LargeCap (S&P 500 universe)

	2019 Q3 (total return %)		2019 YTD (total return %)	
	Stratified LargeCap	S&P 500	Stratified LargeCap	S&P 500
Total	1.5	1.7	20.5	20.6
Financials	2.5	2.6	24.0	20.7
Energy	0.6	0.0	13.6	13.7
Industrials	0.1	0.3	23.8	21.6
Info. Tools	1.9	4.5	30.5	31.7
Information	0.1	0.5	21.2	23.4
Consumer	0.7	6.9	19.9	27.1
Food	6.5	4.7	25.5	23.3
Healthcare	-0.5	-1.9	8.8	4.9

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 Q3 (total return %)		2019 YTD (total return %)	
	SEADM	MSCI EAFE	SEADM	MSCI EAFE
Total	-0.2	-1.4	11.3	12.5
Financials	-1.3	-2.7	9.1	8.6
Energy	-2.3	-2.5	7.1	7.5
Industrials	-2.3	-3.8	11.6	12.9
Info. Tools	3.6	0.1	25.6	22.9
Information	0.7	-0.6	16.9	14.0
Consumer	1.2	-1.4	10.4	12.9
Food	1.2	2.5	8.3	18.3
Healthcare	0.6	2.1	9.8	14.6

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 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

Past performance is no guarantee of future results. Charts and graphs are provided for illustrative purposes only.

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