

Syntax Index Insights: Third Quarter 2020

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Rally continues in Q3, but September highlights need to diversify

Following the abrupt sell-off in Q1, the strong equity market recovery continued in the third quarter. The S&P 500 rose 8.9% in Q3, driven by strong performance in the IT, Consumer and Industrials sectors. The Stratified LargeCap Index delivered a 6.0% return, underperforming its cap weighted counterpart largely due to a lower weight in IT (12.6% versus 21.3%).

Other equity universes also performed strongly, though they did not keep up with the US large caps. The S&P MidCap 400 rose 4.8%, the S&P Small Cap 600 rose 3.2% and MSCI EAFE rose 4.9%. Stratified weight outperformed by 2.2% in small caps by diversifying business risk concentrations in poor performing Energy companies and by 0.4% for SEADM, due to the oversized weight that MSCI EAFE gave to the underperforming banking stocks (8.1%).

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

Exhibit 1. Core Index Comparison: Stratified, Cap, and Equal Weight

Index	Benchmark	Q3 2020			Year to date		
		Stratified	Benchmark	Rel.	Stratified	Benchmark	Rel.
Stratified LargeCap	S&P 500	6.0	8.9	-2.9	-4.7	5.6	-10.3
Stratified MidCap	S&P MidCap 400	3.9	4.8	-0.9	-6.7	-8.6	1.9
Stratified SmallCap	S&P SmallCap 600	5.4	3.2	2.2	-5.0	-15.2	10.2
SEADM*	MSCI EAFE	5.3	4.9	0.4	-5.7	-6.7	1.0
Stratified LargeCap	S&P 500 Eq. Wt.	6.0	6.7	-0.7	-4.7	-4.7	0.0

Source: Syntax, S&P Dow Jones Indices, MSCI. Total return performance does not reflect fees or implementation costs as an investor cannot directly invest in an index. Year-to-date covers period from 1.1.2020 to 9.30.2020. * Syntax Europe & Asia Developed Markets Index, based on the MSCI EAFE universe.

The strong quarterly performance masked a weak September as a rise in COVID-19 infections globally suggested that a second wave is likely and that the pandemic will persist longer than previously expected. Stratified Weight offered some protection from the weakness in September as the Stratified LargeCap index outperformed by 1.1% that month and the Stratified Small Cap and EAFE universes outperformed by 0.5% (Exhibit 2).

Exhibit 2. Stratified Weight offers some protection from September weakness

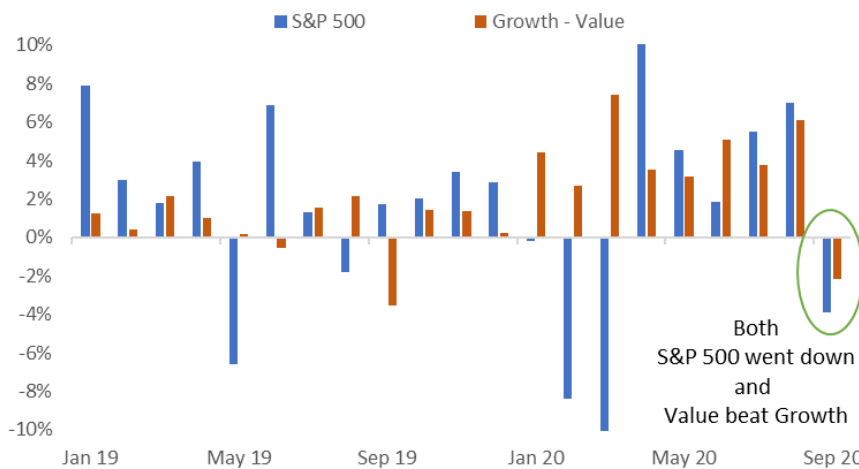
	S&P 500	Stratified LargeCap	S&P 600	Stratified SmallCap	MSCI EAFE	SEADM*
Jul 2020	5.6%	4.5%	4.1%	5.3%	2.4%	1.6%
Aug 2020	7.2%	4.5%	4.0%	4.4%	5.2%	5.9%
Sep 2020	-3.8%	-2.9%	-4.7%	-4.2%	-2.6%	-2.1%
Q3 2020	8.9%	6.0%	3.2%	5.4%	4.9%	5.3%

Source: Syntax, S&P Dow Jones Indices, MSCI. Total return performance does not reflect fees or implementation costs as an investor cannot directly invest in an index. Year-to-date covers period from 1.1.2020 to 9.30.2020.

* Syntax Europe & Asia Developed Markets Index, based on the MSCI EAFE universe.

September decline coincides with Value outperforming Growth

Value stocks outperformed Growth in the S&P 500 last month. This is unusual for two reasons. Firstly, since January 2019 there have been only three months where this has happened and secondly, Value outperformed even as the market declined.

Exhibit 3. S&P 500 and Growth – Value Return Differential


September 2020 saw the first time a market decline coincided with Value outperforming Growth in the S&P 500 since 2018

Source: Syntax, S&P Dow Jones Indices. "Growth – Value" is the total return differential of the S&P 500 Growth Index and S&P 500 Value Index.

In September, the S&P 500 Growth index declined 4.6% as investors questioned the inflated valuations of technology stocks. Even though the broad market fell 3.8%, the Information sector (which has been viewed as defensive during the pandemic) lost 6.6% as investors exited a crowded trade.

Value companies, which have been derated relative to growth, fared better, falling only 2.5% in September. The relative performance of Value versus Growth was echoed by the ETF flows during Q3 2020 which saw \$4.8bn leave the largest S&P 500 Growth ETFs (IWF and VUG) and \$1.7bn flow into S&P 500 Value ETFs (IWD and VTV). This was the strongest relative quarterly flow differential of Value versus Growth ever.

International indices overexposed to Banking Risks

The Financial sector represents one of the more homogeneous set of business risks across the eight broad economic sectors in the Functional Information System (FIS). International indices often carry a large exposure to Financials and especially banking companies, as most countries have at least one listed banking institution. Of the 21 countries in MSCI EAFE, 18 have at least one major banking institution (we note that Bank of Ireland left the MSCI large cap universe in May 2020 as its market cap dropped below the minimum threshold).

In MSCI EAFE there are 67 banking stocks which comprised 8.1% of the overall index. This overexposure was a headwind for the MSCI EAFE index as banking stocks lost 4.3% in Q3 2020. In contrast the SEADM banking group made up 6.2% of the index and returned 0.4%.

The large weight that MSCI EAFE allocated to Financials was balanced by a small weight in IT (5.5%) and highlights the business risk biases which exist due to the sheer number of companies in certain segments relative to others. For example, there are 50 Japanese Financials companies in MSCI EAFE, more than the number of companies in the entire IT sector (43). This concentration bias lead to a further drag on performance as IT was one of the best performing sectors in the MSCI EAFE universe this quarter.

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Energy risks weigh on performance, especially for Small Caps

The Energy sector continued to underperform this quarter. Year-to-date it was the worst performing sector in all broad US universes (S&P 500, 400 and 600). In EAFE, it was the second-worst (see Appendix for sector breakdown).

Weak global demand for travel amidst the pandemic has put pressure on the oil price and hurt the income statements and cash flows of many oil extraction and services companies. This is especially problematic for the smaller drillers which are highly leveraged and whose profits and cashflows are directly linked to the oil price. The increased default risk was most evident in the S&P 600 where 40 oil stocks lost 62% YTD on average (Exhibit 4).

Exhibit 4. Related Business Risk: S&P 600 has 40 oilfield and extraction companies

Oilfield Services and Equipment	YTD*	Chap. 11	Oil and Gas Extraction	YTD*	Chap. 11
Valaris PLC Class A	-98.7%	*	Denbury Resources Inc.	-97.9%	*
Noble Corporation plc	-98.2%	*	Whiting Petroleum Corporation	-92.3%	*
Diamond Offshore Drilling, Inc.	-96.9%	*	Oasis Petroleum Inc.	-91.4%	*
McDermott International, Inc.	-89.4%	*	Callon Petroleum Company	-90.0%	
KLX Energy Services Holdings, Inc.	-87.1%		HighPoint Resources Corp.	-86.4%	
Oil States International, Inc.	-83.3%		SM Energy Company	-85.8%	
Newpark Resources, Inc.	-83.3%		Laredo Petroleum, Inc.	-82.9%	
Nabors Industries Ltd.	-82.6%		Gulfport Energy Corporation	-82.7%	
Oceaneering International, Inc.	-76.4%		QEP Resources, Inc.	-79.7%	
Helix Energy Solutions Group, Inc.	-75.0%		Talos Energy, Inc.	-78.6%	
TETRA Technologies, Inc.	-73.9%		Ring Energy, Inc.	-74.2%	
ProPetro Holding Corp.	-63.9%		Penn Virginia Corporation	-67.5%	
Matrix Service Company	-63.5%		PDC Energy, Inc.	-52.6%	
Geospace Technologies Corporation	-63.1%		Bristow Group Inc	-30.4%	
U.S. Silica Holdings, Inc.	-50.5%		Bonanza Creek Energy Inc	-19.5%	
RPC, Inc.	-49.6%		Jagged Peak Energy, Inc.	-3.1%	
Dril-Quip, Inc.	-47.2%		SRC Energy Inc	-2.9%	
Exterran Corp.	-46.9%		Southwestern Energy Company	-2.9%	
Archrock Inc.	-42.5%		Range Resources Corporation	36.5%	
Aegion Corporation	-36.8%				
MYR Group Inc.	14.1%				

Source: Syntax, S&P Dow Jones Indices. * Year-to-date (YTD) total returns from 12.31.2019 to 09.30.2020.

In fact, seven out of the 40 oil-related companies in the S&P 600 have already entered into Chapter 11 this year. Such a concentration of companies which are tied to the same business risk highlights the importance of stratification.

At the start of the year, the 40 oil stocks in Exhibit 4 represented 6.7% of the S&P 600 on an equal weighted basis and 3.8% of the cap weighted index. By contrast, the Stratified SmallCap index allocated only 2.3% to the them.

Economic Breadth Indicator points to modest gains in Q4 2020

Last quarter we introduced our Economic Business Breadth Indicator, a measure of the degree that the market return was driven by a single or a broad range of business risks.

We view Business Breadth as a confirmation of positive demand for an equity index. When Business Breadth is high, S&P 500 Equal Weight index returns have historically been positive the following quarter. Since 1992, there have been 26 quarters when breadth was above 80% (i.e. 80% or more business risk groupings delivered positive returns over the quarter) and the index rose the following month 85% of the time.

Very low levels of Business Breadth (0-20%) have historically been a contrarian signal that markets are overly pessimistic, as was the case in Q1 2020.

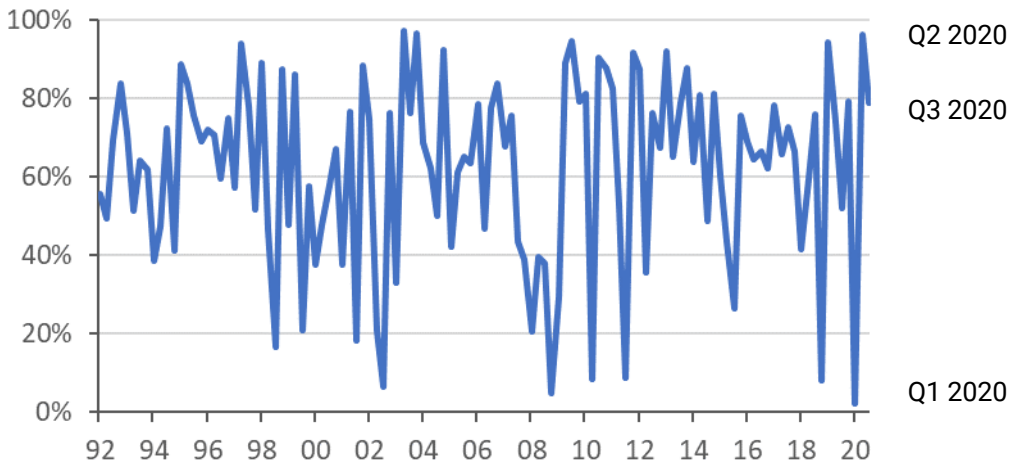
Exhibit 5. S&P 500 Equal Weight Returns by Business Breadth Quintile

Breadth	N	Return next Qtr	Return / Risk	Hit-rate
0%-20%	8	48.4	2.58	87.5%
20%-40%	13	2.1	0.07	46.2%
40%-60%	23	13.1	0.80	73.9%
60%-80%	44	5.7	0.38	70.5%
80%-100%	26	15.5	1.16	76.9%

Source: Syntax. Breadth is defined as the percent of FIS sub-industries with positive returns for the quarter.

When economic breadth is low (20-40%), the market has historically struggled to perform the following quarter.

In Q3 2020, 79% business risks (130/165) delivered positive returns. Though this is a relatively high level of market breadth, it is lower than we saw in Q2 and consistent with only modest market returns in Q4 2020.

Exhibit 6. Business Breadth for the S&P 500 Equal Weight Index


Source: Syntax. Breadth is defined as the percent of FIS sub-industries with positive returns for the quarter.

Sector and Composite Performance

US LargeCap (S&P 500 universe)

	2020 Q3 Total Return		
	Stratified LargeCap	S&P 500 Equal Wgt	S&P 500
Total	6.0	6.7	8.9
Financials	5.2	3.6	4.3
Energy	-8.8	-7.2	-6.2
Industrials	13.4	13.9	13.0
Info. Tools	6.9	6.8	13.3
Information	5.9	5.5	8.8
Consumer	13.1	13.9	14.9
Food	11.1	9.3	11.4
Healthcare	2.4	5.8	5.7

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

US MidCap (S&P MidCap 400 universe)

	2020 Q3 Total Return		
	Stratified MidCap	S&P 400 Equal Wgt	S&P 400
Total	3.9	3.7	4.8
Financials	3.9	0.3	1.2
Energy	-6.4	-3.4	0.2
Industrials	8.2	8.2	10.8
Info. Tools	4.0	6.4	1.7
Information	-2.0	-2.8	-1.6
Consumer	9.1	9.2	9.7
Food	13.4	8.1	11.8
Healthcare	0.9	2.9	3.5

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

US SmallCap (S&P SmallCap 600 universe)

	2020 Q3 Total Return		
	Stratified SmallCap	S&P 600 Equal Wgt	S&P 600
Total	5.4	3.2	3.2
Financials	1.0	-3.2	-1.1
Energy	10.3	-16.3	-7.4
Industrials	4.8	3.8	4.6
Info. Tools	1.1	-0.7	-1.1
Information	6.1	7.7	1.6
Consumer	15.0	14.8	8.8
Food	9.5	14.1	10.0
Healthcare	5.6	6.5	9.7

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

International Developed (MSCI EAFE universe)

	2020 Q3 Total Return		
	SEADM	MSCI EAFE Equal Wgt	MSCI EAFE
Total	5.3	5.8	4.9
Financials	2.5	1.6	-0.6
Energy	-4.5	-2.1	-2.5
Industrials	10.7	10.8	12.3
Info. Tools	7.8	6.6	7.2
Information	7.7	7.0	6.8
Consumer	8.5	7.8	7.7
Food	5.5	4.4	4.2
Healthcare	5.9	6.6	2.6

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 SmallCap	YSCTR	S&P SmallCap 600
Syntax Stratified Core	SYCORETR	S&P 900
Syntax Stratified 1000	SY1KTR	Russell 1000
Syntax Europe & Asia Developed Markets	SEADMTR	MSCI EAFE
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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