

What to do when you don't know what to do: seek balance



Paul Kenney May 26, 2022

The Uncertain Road Ahead

The world is a complicated place right now, packed with uncertainty tied to a host of issues including Russia's invasion of Ukraine; inflation running at over eight percent per year, driven by food and energy price increases; continued supply chain challenges; and the lingering impacts of the Pandemic. Adding to this backdrop are questions surrounding Fed policy. How quickly and how high does the Fed need to raise interest rates to bring inflation down to its target? Can they engineer a soft landing given the consensus they are behind the curve?

In this environment, how does an investor position their portfolio? There are many options to consider, but the challenge is the investment advice of today can become stale or dated very quickly. Consider the changing economic and geopolitical landscape of the past six months.

The economic narrative for much of 2021 was the spike in inflation was transitory, and, as the supply chain pressures from COVID unwound, inflationary pressures would subside. However, the narrative for 2022 is moving towards inflation being sticky and more problematic, a situation further complicated by the lingering Russia-Ukraine conflict. With little on the horizon to alleviate either concern, the future remains far from predictable.

Investment Advice is Often a Moving Target

Investment advice typically incorporates numerous factors, which can include:

- Reviewing historical asset class performance to help understand risk premiums and to guide future expectations.

- Analysis of present valuations to assess attractiveness of an asset class relative to its history and other asset classes.
- Forward looking thoughts about how the future will unfold and how this will influence prospective returns.

This last point above is particularly challenging as thoughts on the future are recalibrated based on what has transpired. What you thought may have been a favorable asset allocation based on a view that inflation was transitory may not play out as expected given the changing global dynamics tied to the war in Ukraine (Exhibit 1). While recent months have been especially volatile, a quick review of the past 25 years shows unanticipated events appear relatively frequently. This ignominious list includes the collapse of the tech bubble, 9/11, the Great Financial Crisis, the European Debt Crisis, and the COVID-19 Pandemic.

Exhibit 1: Uncertainty is High, and the Impact of the Russia-Ukraine Situation is Unknown

Article Headline	Source & Date
Russia War Ends Era of Globalization That Kept Inflation Low	Associated Press, 3/30/22
The Risk That the War in Ukraine Escalates Past the Nuclear Threshold	The Economist, 3/19/2022
Ukraine Invasion Threatens Global Wheat Supply	New York Times, 3/23/2022

Source: Syntax Affinity™. Weights as of 3.31.2022. Largest two sector allocations for each index are highlighted.

Addressing Index Biases

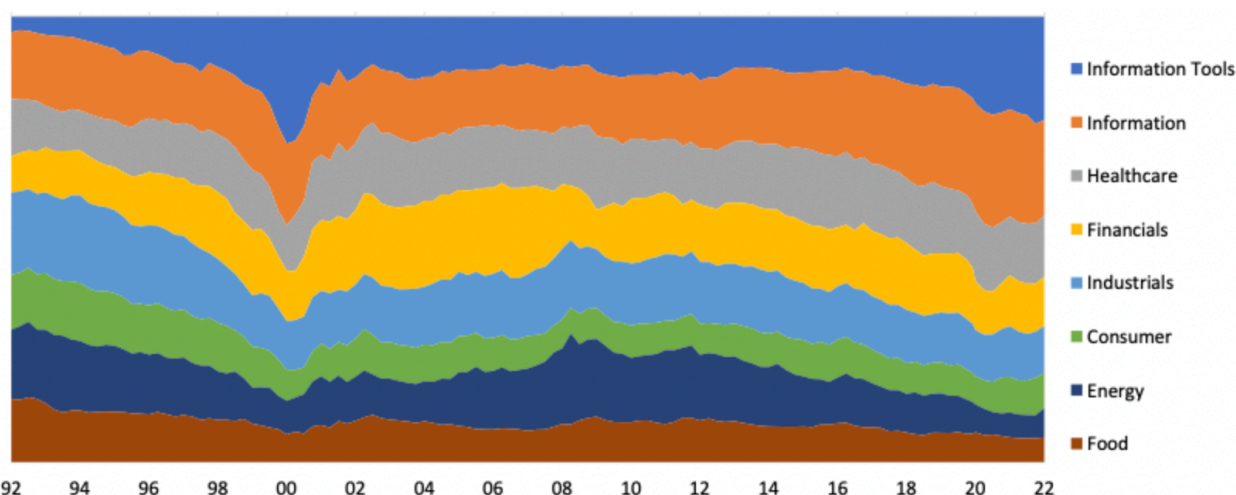
Exhibit 2 shows that the major public equity benchmarks contain significant sector concentrations and that these biases vary across the indices.

Exhibit 2: Sector Exposure by Index

	S&P 500	R2000	MSCI EAFE	MSCI EM
Information	25.6%	9.4%	11.6%	17.8%
Information Tools	19.7%	10.8%	6.1%	16.3%
Healthcare	13.4%	16.6%	13.0%	4.3%
Industrials	11.2%	18.7%	20.9%	16.3%
Financials	9.2%	22.1%	19.4%	23.8%
Consumer	8.2%	7.6%	12.3%	8.6%
Energy	7.1%	9.9%	8.0%	7.4%
Food	5.6%	4.9%	8.7%	5.5%
Totals	100%	100%	100%	100%
Largest Two Sectors	45.3%	40.8%	40.3%	41.6%

The bias of the S&P 500 to tech stocks, proxied here by the allocations to Information and Information Tools sectors, has been well documented, and has been a major driver of the disparate performance of the S&P 500 to different indices over the last two decades. Exhibit 3 below highlights the sector exposure of the S&P 500 from 1992 to year end 2021.

Exhibit 3: Historical S&P 500 Sector Exposure: 1992-2021



Source: Affinity, S&P Dow Jones Indices.

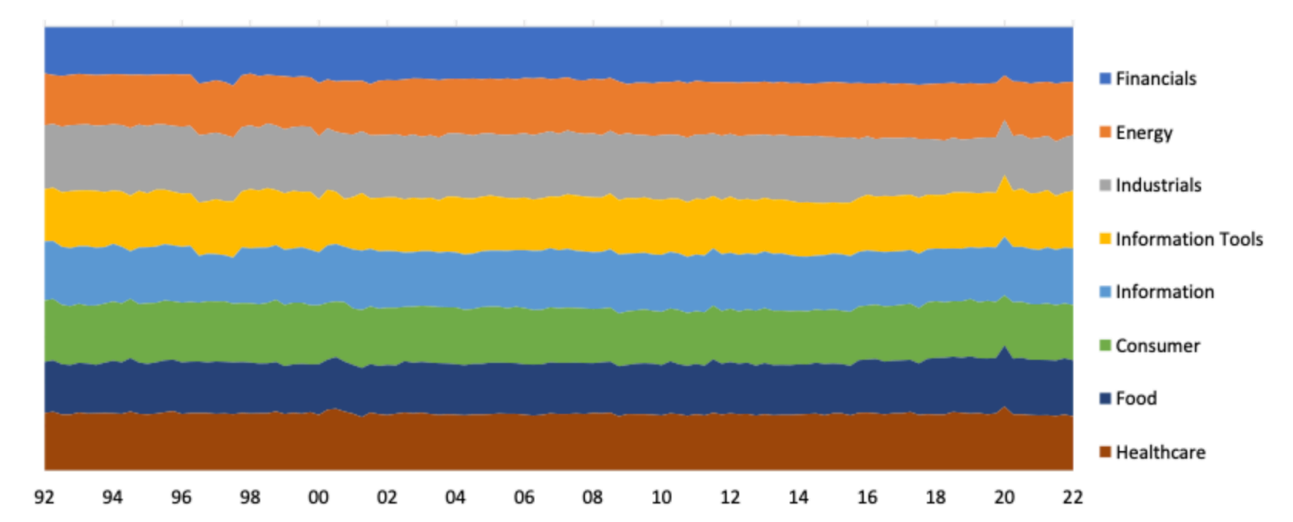
The period from 1/1/2000 to 12/31/2009 was a “lost decade” where the S&P 500 returned just 0.45% annualized. With inflation averaging 2.7% over this period, the S&P 500

annualized real return was negative. Compounded over the course of the decade, investors lost 20.4% cumulatively on an inflation-adjusted basis. The period from 1/1/2010 to 12/31/2019 was a mirror image: the S&P 500 returned 16.1% annualized, producing a nominal cumulative return of 345%. With inflation averaging 2.4% per year for the decade, the S&P produced an impressive annualized real return of 14.4%.

Sector biases move with the ebb and flow of the markets. Exhibit 3 shows how the Information Tools sector was negligible back in 1992 and grew to over 25% by the end of the 1990's before being reduced roughly in half by 2002. Today, Information Tools has grown back to roughly 20%, and when combined with the Information sector comprises 45.3% of the index. The index is increasingly tech focused, sectors like Food (5%), Energy (5%) and Consumer Products (8%) are relatively small components on a market cap basis despite being important parts of the economy.

To seek balance, Syntax's approach is to take a public equity benchmark, such as the S&P 500, and reweight the holdings in the benchmark to maximize business risk diversification (Exhibit 4).

Exhibit 4: Historical Syntax Stratified LargeCap Index Sector Exposure: 1992-2021



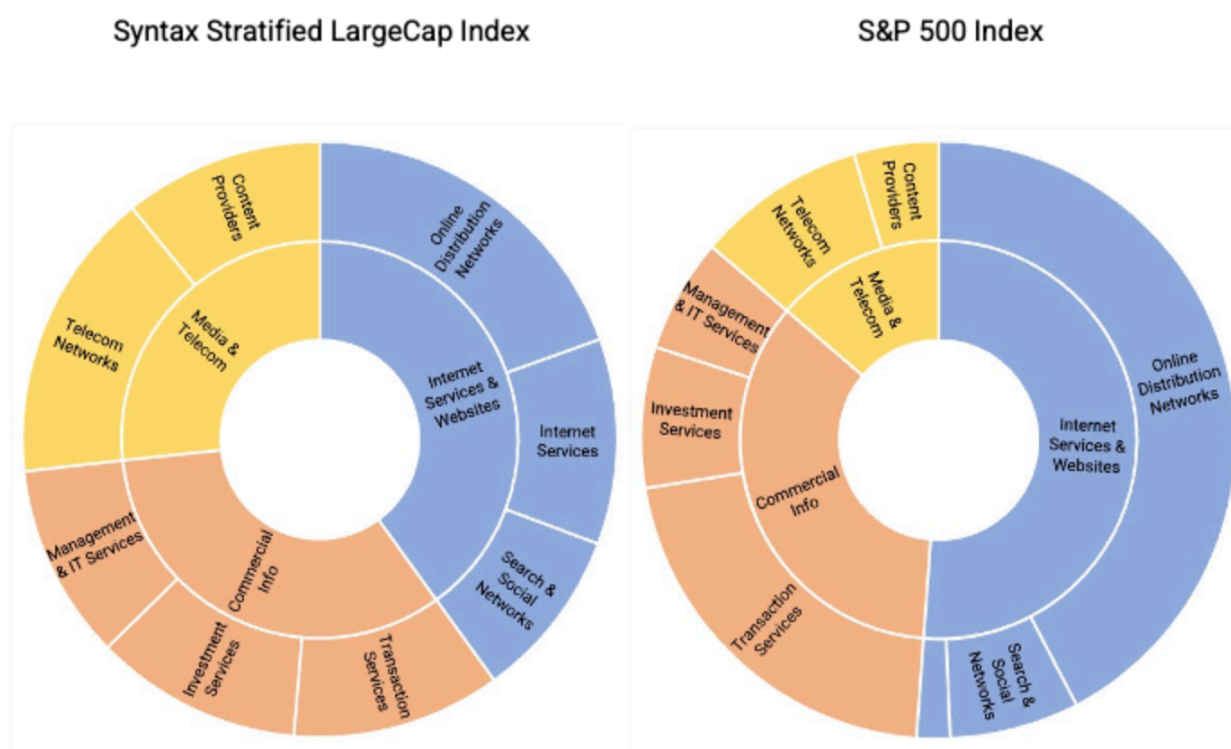
Source: Syntax. Please see important disclaimers regarding backtested data prior to inception.

Exhibit 4 shows the Syntax Stratified LargeCap Index, which equally weights eight primary sectors, targeting a 12.5% weight to each at each quarterly rebalance. This approach has the benefit of avoiding concentration risk to a specific sector and balancing economic exposure across the portfolio. We believe this captures the

broadest, unbiased equity market risk premium.

Stratified Weight Indices also diversify risk concentrations within each sector. Exhibit 5 shows a snapshot of the exposure to the Information Sector within the Stratified LargeCap Index. There are three sub sectors to Information, highlighted by the different colors in the chart. The Internet Services and Websites sub segment (in blue) has three components (Online Distribution and Networks, Internet Services, and Search and Social Networks), each weighted equally. The Commercial Information sub segment (in orange) has three components (Management and IT Services, Investment Services, and Transaction Services), also equally weighted. The same methodology applies to the Media and Telecommunication sub segment (yellow) which is equally divided into Content providers and Telecommunication networks. The same cannot be said about S&P 500 index, which concentrates in the Internet Services and Websites sub segment (blue) and avoids Media and Telecommunication (yellow).

Exhibit 5: Diversification Within Sectors: Information Sector Example



Source: Syntax, Affinity™, S&P Dow Jones Indices. Weight data as of 3.31.2022

Exhibit 6 below compares the performance of the Stratified LargeCap Index to the S&P 500 Index (cap-weighted). The results highlight how this balancing of business risk led to more consistent long-term performance.

Exhibit 6: Stratified LargeCap Index vs. S&P 500 Index

	First Decade 2000-2010	Second Decade 2010-2020	Whole Period 2000-2020
Stratified LargeCap	9.6%	16.1%	12.8%
S&P 500 Cap Weighted	0.5%	16.8%	8.3%
Difference	9.1%	-0.7%	4.5%

Source: Syntax, S&P Dow Jones Indices. Total return performance does not reflect fees or implementation costs as an investor cannot directly invest in an index. Please see important disclaimers regarding backtested data prior to inception.

Conclusion

The world is filled with uncertainty, which creates challenges for investors in positioning their portfolios. The success of a portfolio is in large part determined by how well it is positioned relative to a set of events that are not knowable today. Indices such as the S&P 500 concentrate in particular sectors and industries, leading to biases that can be diversified. We believe by balancing exposure to business risk by reweighting the holdings within various public equity benchmarks, we can construct indices that are more likely to mitigate the risks associated with future unanticipated events.

About Syntax

Syntax LLC is a financial data and technology company that codifies business models into a relational system we call Affinity Data™. Syntax operates through three segments: Affinity Data™, Syntax Direct™, and Syntax Indices™. Using its patented FIS® technology inspired by systems sciences, the Affinity Data™ segment offers the most comprehensive, granular, and accurate product line revenue data available on the market. The Syntax Direct™ segment then uses this abundance of data to facilitate the near instantaneous creation and ongoing management of boundless direct indexing solutions and rules-based equity portfolios through a fully automated platform. The Syntax Indices™ segment offers customized and proprietary indices, including core global benchmarks and micro- and macro-thematic, smart beta, defined outcome, and target volatility indices. These indices are foundational for a range of financial products, such as ETFs, UITs, and structured products.

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Index performance does not represent actual fund or portfolio performance and such performance does not reflect the actual investment experience of any investor. An investor cannot invest directly in an index. In addition, the results actual investors might have achieved would have differed from those shown because of differences in the timing, amounts of their investments, and fees and expenses associated with an investment in a portfolio invested in accordance with an index. None of the Syntax Indices or the benchmark indices portrayed herein charge management fees or incur brokerage expenses, and no such fees or expenses were deducted from the performance shown; provided, however that the returns of any investment portfolio invested in accordance with such indices would be net of such fees and expenses. Additionally, none of such indices lend securities, and no revenues from securities lending were added to the performance shown.

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