



# Syntax Direct A Direct-to-Index Solution Platform



Paul Kenney November 22, 2024

## Syntax Direct<sup>SM</sup>: a Direct-to-Index Solution

### Key takeaways:

- Syntax Direct<sup>SM</sup> provides RIA's the ability to create and manage boundless direct indexing solutions and rules-based portfolios in an instant, providing scale while meeting client needs in a fraction of the time.
- This paper provides an example of how Syntax Direct can be used to develop a customized solution for a client.

Many portfolios have benefitted from their passive exposure to the S&P 500, as have actively managed large cap growth-oriented equity funds. These strategies have performed very well in 2023 and through 2024 (year-to-date). The strong outperformance of these investments has created heavy exposure in many domestic equity portfolios towards technology-related stocks, which have had very strong performance and high valuations as a group. We have written about the risks this dynamic can cause on several occasions over the past year in our Stratified LargeCap Index quarterly reports. One way to address this bias could be to rebalance a portion of an investor's holdings to track an index strategy with a quality focus.

Investors have numerous options to implement an investment strategy designed to complement existing holdings. For example, an actively managed mutual fund is one

option, but this could raise concerns associated with tax considerations and fees. Investing in an ETF could address the tax concerns; however, finding an ETF that is the desired complement to an investor’s portfolio can be challenging. Alternatively, many investors find that a custom index featuring the desired market exposure and tax- and cost-efficiency can be an attractive option.

For illustrative purposes, we created a custom index, which we refer to as Potential Index Solution, that may serve to mitigate the concentration risk embedded in a tech heavy portfolio. The objectives of this model index are outlined below:

- Better balance: Reduce sector concentration risk, allocate more to underweight sectors.
- Downside protection: Likely to outperform the S&P 500 and growth equities in a downturn.
- Quality bias: Focus on profitable companies with stable earnings and low leverage.
- Dividend yield: Seek cash flow from dividends.

**Objectives of Potential Index Solution:**

<b>Potential Index Solution Model: Key Facts Summary</b>	
Strategy Type	Custom Large Cap Quality Index
Universe	Syntax US LargeCap 500
Target # Stocks	50
Factor Tilts	Quality, Low Leverage, Dividend Yield
Weighting Methodolgy	Modified Cap Weighted
Excluded Sectors	Information Technology
Excluded Stocks	None
Rebalance Frequency	Annual
Dividend Treatment	Reinvest In Portfolio

Source: Syntax Direct

The index model was constructed algorithmically from the universe of domestic large cap stocks in the Syntax US LargeCap Index, which has properties and characteristics

highly similar to the S&P 500. The index model targets holding 50 stocks to balance diversification, while also trying to limit the universe to the stocks that best fit the investment objectives. The investment objectives are expressed through factor tilts, which are the identified, desired traits and characteristics of the stocks to be held. For this index model, these include quality (profitability, earnings growth), low leverage (to mitigate financial statement risk), and an above market dividend yield. We also assume that the index model would be rebalanced annually and that dividends would be reinvested. All assumptions in the model can easily be modified.

# Top 10 Constituents

COST	<b>COSTCO WHOLESALE</b> Consumer Staples	6.15%
PLD	<b>PROLOGIS REIT</b> Real Estate	6.15%
JNJ	<b>JOHNSON &amp; JOHNSON</b> Healthcare	6.15%
MCD	<b>MCDONALDS</b> Consumer Discretionary	6.15%
MRK	<b>MERCK &amp; COMPANY</b> Healthcare	6.05%
CVX	<b>CHEVRON</b> Energy	5.63%
LOW	<b>LOWE'S COMPANIES</b> Consumer Discretionary	5.35%
VZ	<b>VERIZON COMMUNICATIONS</b> Communication Services	5.25%
	<b>BEIZER</b>	

The weighting methodology is referred to as modified cap weight, which weights constituents proportional to their size and then tilts the holdings in the portfolio to the companies with higher scores to the desired factors (higher quality, low leverage, dividends). This tilt is expressed through the conviction level that we targeted as “medium”; higher conviction leads to stronger tilts, while lower conviction would have a more moderate tilt. The graphic on the right shows the Top 10 Constituents of the index model, which represent about 55% of its total weight.

The list is composed of well-known companies with leadership positions within their respective industries. The largest constituents have a weight of roughly 6.0%. The weight of these ten securities can be adjusted up or down by changing the conviction level.

## Sector Allocation

	POTENTIAL INDEX	SY500
Communication Services	9.64%	8.89%
Consumer Discretionary	22.24%	9.94%
Consumer Staples	10.11%	5.73%
Energy	10.14%	3.32%
Financials	7.91%	11.34%
Healthcare	22.50%	12.55%
Industrials	6.04%	8.27%
Information Technology	0.00%	31.74%
Materials	0.91%	1.90%
Real Estate	6.15%	2.08%
Utilities	4.36%	2.44%

Given the objective of reducing the exposure to technology stocks, we excluded stocks in the Information Technology sector from this index model, which you can see

reflected in the 0% weight to this sector in the table to the right.

Note: the Syntax 500 Index (like the S&P 500) has a weight of nearly 32% to the Information Technology sector, which is dominated by large tech stocks like Microsoft, NVIDIA, Apple and Alphabet. The Potential Index Solution, therefore, has larger allocations to the Consumer Discretionary, Consumer Staples, Healthcare, Energy, and Real Estate sectors relative to the benchmark index. These overweights help provide more balance to our hypothetical portfolio. For example, Energy has a weight of 10.1% in the custom index model, compared to just 3.6% of the benchmark. This allocation can be viewed favorably from a diversification perspective given the economic importance of the Energy sector. There is also the ability to exclude stocks involved in certain segments of the Energy sector, like coal or fossil fuels, if desired.

When an index is created in Syntax Direct, a backtest is automatically generated. Below you can see the backtested performance of the Potential Index Solution relative to the Syntax 500. This backtest is based on the methodology described above, implementing those rules at each historical rebalance date from December 15, 2017 to the present. Please see important disclaimers for information regarding backtested index data.

The following page shows the growth of a hypothetical \$1,000 investment tracking this index model, gross of fees and implementation costs, as an investor cannot directly invest in an index model. The custom index model shows strong performance, with the initial hypothetical investment of \$1,000 increasing to roughly \$1,923.

The Potential Index Solution trailed the Syntax 500 benchmark, which is unsurprising as the index model has reduced exposure to the Magnificent Seven stocks that have driven the large cap market's performance. Over the same period, \$1,000 hypothetically invested to track the Syntax 500 Index would have grown to \$2,433, gross of fees and implementation costs.

# Index Performance

PAKE-ULVTK-7674 Potential Index Solution 1 SY500 Syntax US LargeCap 500 Index



Total Return, 12/15/2017 to 9/30/2024. Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index. Please see important disclaimers regarding backtested index model data.

As part of our backtest, we calculated both calendar- and trailing-year returns for the custom index model and the benchmark. The annual returns are shown below. The results for 2022 and 2023 are particularly noteworthy.

## Annual Return

As of 9/30/2024

	POTENTIAL INDEX SOLUTION	SY500
YTD	14.52%	22.25%
2023	8.34%	27.11%
2022	-3.37%	-19.59%
2021	27.30%	27.17%
2020	8.14%	21.39%
2019	20.94%	31.63%
2018	-1.34%	-4.15%

Total Return, 12/31/2017 to 9/30/2024. Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index. Please see important disclaimers regarding backtested index model data.

In 2022, the custom index model returned -3.37%, substantially outperforming the -19.59% loss for the benchmark. The lack of tech stocks in the index model would have provided better downside protection in this market environment.

Conversely, as tech stocks rebounded in 2023, the custom index model would have underperformed, returning 8.34% vs. 27.11% for the benchmark. During this two-year period, the hypothetical index model would have provided better balance and downside protection when held with an S&P 500 index.

The annualized returns (depicted below) highlight the solid returns provided by the custom index model, despite underperforming the benchmark.

## Annualized Return

As of 9/30/2024

	POTENTIAL INDEX SOLUTION	SY500
1-Year	22.92%	36.81%
3-Year	10.05%	11.25%
5-Year	12.05%	16.05%

Total Return, 9/30/2019 to 9/30/2024. Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index. Please see important disclaimers regarding backtested index model data.

The strong results of the Syntax 500 Index are reflected in this index's fundamentals, as shown below. The Syntax 500 Index has a price/earnings ratio of 24.3, relative to 18.9 for the custom index model. Stated alternatively, the Syntax 500 price/earnings valuation is roughly 29% higher than the custom index model.

## Fundamentals

	POTENTIAL INDEX As of 12/06/2023	SY500 As of 12/06/2023
Indicated Dividend Yield	2.61%	1.49%
Price/Earnings Ratio	18.87	24.29
Price/Book Ratio	4.23	4.36
Max Mkt Cap (\$B)	\$1,424.08	\$2,811.64
Min Mkt Cap (\$B)	\$40.76	\$10.48
Wtd. Avg Mkt Cap (\$B)	\$240.32	\$663.48

Please see important disclaimers regarding backtested index model data.

The custom index model, by design, has a higher dividend yield at 2.6%, compared to 1.5% for the Syntax 500. The average market cap of the stocks in the custom index model is \$240 billion, well below the average market cap of \$663 billion in the Syntax 500 Index, which is driven higher by the market caps of the mega-tech stocks excluded from the custom index model.



In addition to Syntax Direct's ability to create personalized index solutions, the system supports your regulatory needs by providing immediate access to factsheets for every index created, accompanied by an index rulebook, a compliance-ready document that details the key assumptions used to create an index. To learn more, please visit [www.syntaxdata.com](http://www.syntaxdata.com)

#### Disclaimers

Past performance is no guarantee of future results. The Potential Index Solution Index Model ("the Index Model") is a hypothetical index model. All performance, holdings, and fundamentals information provided on the Index Model is backtested. Backtested performance is not actual performance but is hypothetical and is suitable only for institutional audiences. Backtested performance may not be predictive of actual or future performance. Backtested data may reflect the application of the index methodology with the benefit of hindsight, and the historic calculations of an index may change from month-to-month based on revisions to the underlying economic and/or financial data used in the calculation of the index. Charts and graphs are provided for illustrative purposes only. Syntax® is a registered trademark of Syntax, LLC and/or its affiliates.

Index and index model 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 or index model. 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 or index model. Neither the Index Model nor the benchmark indices portrayed herein charge management fees directly to end investors 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 these indices lend securities, and no revenues from securities lending were added to the performance shown. Performance shown is unaudited and subject to revision.

Weighted Average Stock Price-to-Earnings Ratio (P/E Ratio) is the harmonic weighted average of the ratio of each stock's share price to its trailing 12-month earnings per share. Weighted Average Stock Price-to-Book-Value Ratio (P/B Ratio) is the harmonic weighted average of the ratio of each stock's market price to its net asset value. Indicated Dividend Yield is the arithmetic weighted average of the ratio of each stock's annual dividend per share to its market price. Price-to-Earnings, Price-to-Book and Dividend Yield are calculated as of the labeled period-end. P/E, P/B, Dividend Yield, and Turnover are calculated by Syntax using data from Refinitiv. Top holdings and security classifications used in calculating allocation tables are based on ending weight as of the labeled period end.

This sample letter is for informational purposes only and is not intended to be, nor should it be construed or used as an offer to sell, or a solicitation of any offer to buy, any security or investment vehicle, nor should it be redistributed. Additionally, the information herein is not intended to provide, and should not be relied upon for, legal advice, tax advice, financial advice, or investment advice. You should make an independent investigation of the matters described herein, including consulting your own advisors on the matters discussed herein. In addition, certain information contained in this sample letter has been obtained from published and non-published sources prepared by other parties, which in certain cases have not been updated through the date hereof. While such information is believed to be reliable for the purpose used in this sample letter, such information has not been independently verified by Syntax and Syntax does not assume any responsibility for the accuracy or completeness of such information. Syntax LLC, its affiliates and their independent providers are not liable for any informational or technical errors, incompleteness, or delays, or for any actions taken in reliance on information contained herein. Distribution of Syntax data and the use of Syntax indices, data, software, or technology to create financial products require a license with Syntax and/or its licensors. Investments are not FDIC insured, may lose value and have no bank guarantee.