Syntax

Syntax Direct Case Study Creating a Defensive Equity Index to Balance Portfolio Risk

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Key takeaways:

- The recent weakness in the S&P 500 has raised concerns that the long running momentum-driven market is running out of steam.
- Given the S&P 500's concentration in tech stocks and the fact that the top-ten stocks comprise close to 40% of the index, investors may consider realizing some of their gains and allocating a portion of their portfolio to defensive equities.
- Syntax Direct℠ allows RIAs to create direct indexing solutions rapidly, including defensive-oriented indices that seek to provide greater levels of downside protection during market turbulence.

As we write this paper in March 2025, the S&P 500 is flirting with a correction. Uncertainty around the consequences of changes in trade policy, tariffs, and their impact on inflation, and general geopolitical instability has investors and advisors increasingly concerned over whether this long-running bull market has run its course. Of course, similar concerns have appeared in the not-too-distant past: in Q4 2018, the S&P 500 fell 13.5%, interestingly, in part due to trade and tariff concerns between the US and China during President Trump's first term. In 2022, anxiety over tech stock valuations led the S&P 500 down 18.1%, although these losses were recovered in 2023 as the S&P returned 26.3% for the year. The market built on these returns as the S&P 500 gained 25.0% in 2024. Investors have benefitted from these recoveries, but these rebounds have also lifted the market materially higher, increasing downside risk if the markets mean revert.

With defensive investing at the forefront of many advisors' minds, this paper provides an overview of how Syntax Direct can be used to create a Defensive Equity Index to help bring better balance to a client's domestic equity allocation.

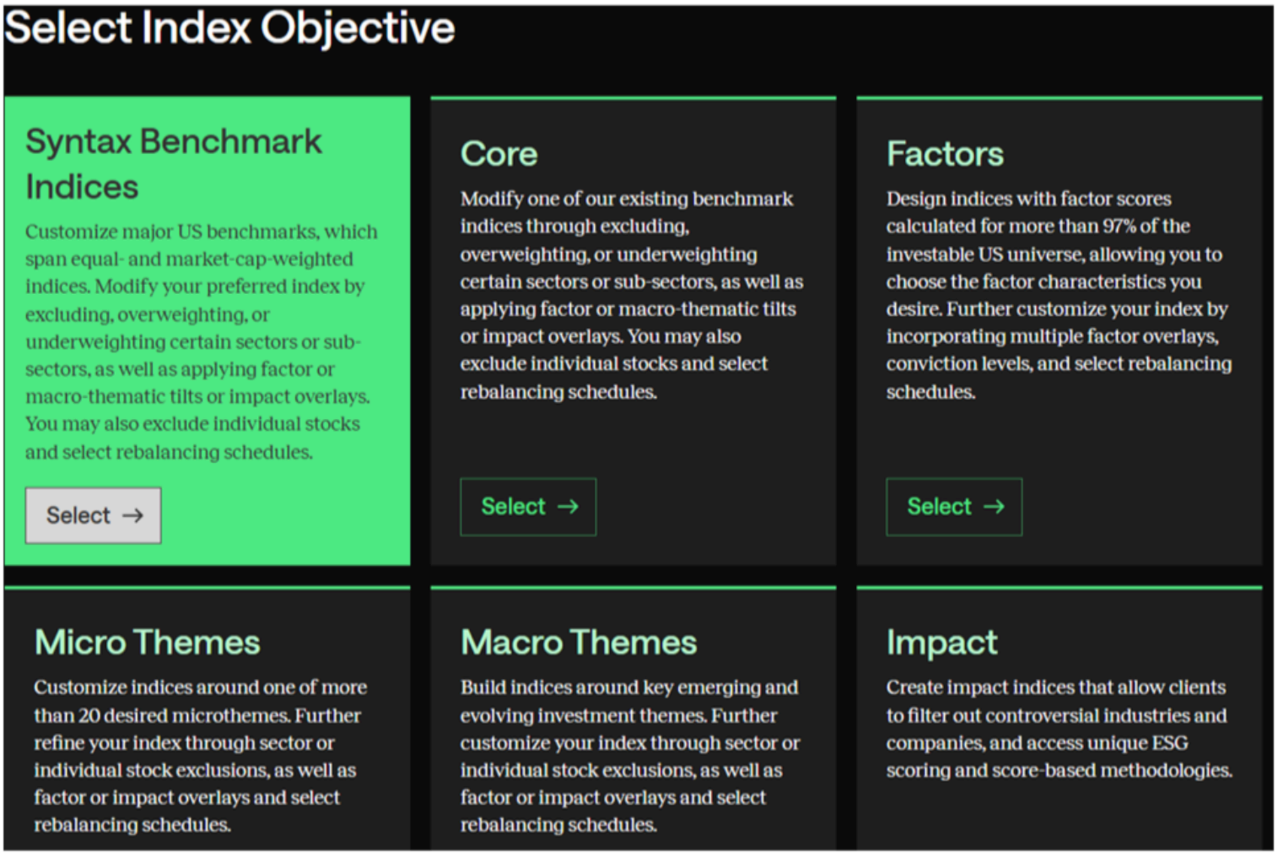
Evaluating Returns Versus Expectations

The S&P 500 has returned roughly 10% per year since 1926, an impressive feat. What's more impressive is that, over the past 15 years through the end of February 2025, it has returned 14.0% annualized. Thus, a $10,000 investment 15 years ago would be worth over $70,000 before fees and expenses, well above the roughly $42,000 if the index had returned its 10.0% historical average. Has the market's outperformance pulled returns from the future forward? Vanguard apparently thinks so, as their median forecast for U.S. equities is just 3.9% over the next decade.[1]

Given the present economic uncertainty and the extended exceptional performance of growth stocks, does it make sense for investors to take some of their winnings and rebalance their portfolios to include an allocation to stocks with defensive characteristics? This paper illustrates how an advisor can use Syntax Direct, our direct-to-index platform, to create a custom index that can form the basis of a cost-effective solution for a client's domestic equity portfolio. We provide details on the index's construction methodology, constituents, sector weights, and backtested performance, all of which are available to the users of the platform.

Syntax Direct allows users to model an index by selecting one of the six tiles shown in Exhibit 1. They begin by choosing an existing benchmark option (the Syntax Benchmark Indices and Core options below) or one of the four other options: Factors, Micro Themes, Macro Themes or Impact. Regardless of which option is selected, indices can be further customized to meet the client's desired needs. For this case study, we are going to create a Defensive Equity Index by selecting the Macro Themes option.[2]

Exhibit 1: Syntax Direct Index Objectives



Source: Syntax Direct

Exhibit 2 displays the characteristics of the Defensive Equity Index that we created within the Macro Themes tile.

Exhibit 2: Defensive Index Model Parameters

Potential Index Solution Model: Key Facts Summary	
Strategy Type	Defensive Equity Index
Universe	Syntax US LargeCap 500
Target # Stocks	50
Factor Tilts	None
Weighting Methodolgy	Modified Equal Weight
Excluded Sectors	None
Conviction Level	High
Excluded Stocks	None
Rebalance Frequency	Quarterly
Dividend Treatment	Reinvest In Portfolio

Source: Syntax Direct. Users can select these settings in Syntax Direct to construct the index presented in this paper, or can modify these settings to fit their individual needs.

The index model was constructed algorithmically from the universe of domestic large cap stocks in the Syntax US LargeCap 500 Index ("Syntax 500," "SY500"), which has properties and characteristics like the S&P 500. For each constituent in the Syntax 500 universe, we calculate a "defensive theme score" based on both the percentage and absolute dollars of revenue a company earns from defensive businesses, detailed below. Because we set the conviction level to "high," more emphasis is placed on companies that have a higher percentage of their revenue attributed to defensive industries, i.e. those that are more "pure play" in defensive businesses, rather than larger conglomerates which may earn large dollars of revenue from defensive activities but may be exposed to non-defensive revenues as well. The Defensive Index model then selects the top 50 companies by defensive theme score at each rebalance and weights them proportionally to their defensive theme score.

The Defensive Theme is focused on the following business segments: Consumer Staples and Necessities, Defensive Healthcare, Defensive Utilities, and other Defensive Businesses. Syntax's approach to classifying companies is tied to identifying revenues at the product line level, and allocating companies to multiple sectors and industries based on how much revenue they earn from them. With this level of granularity comes the ability to be more precise when constructing an index. For example, above we reference "Defensive Healthcare" and "Defensive Utilities." Securities found in the Healthcare and Utility sectors are often considered defensive. Based on our research, we believe this paints with too wide a brush. While large pharmaceutical companies with established product lines often exhibit defensive characteristics, smaller pharma and biotech firms with unproven medicines in clinical trials do not. Similarly, rate-regulated utilities typically have defensive characteristics while those operating in competitive markets have lower defensive qualities. The index model does not target specific sector and sub-sector weights; rather, these weights, which are shown in Exhibit 3, reflect the companies with the highest defensive equity scores.

Exhibit 3 Sector & Sub-Sector Weights

Sector (Sub-Sector)	% Index
Consumer Staples	**42.1**
Food	30.2
Personal and Homecare	8.0
Retailing	3.9
Healthcare	**20.3**
Services	6.1
Products	14.1
Utilities	**23.8**
Electric	21.9
Gas	1.9
Consumer Discretionary	**9.9**
Services	5.9
Automotive	4.0
Industrials	**3.9**
Commercial Services	4.0
Total	**100.0**

Source: Syntax Data

Exhibit 4: Top 10 Constituents

COR	CENCORA	Healthcare	2.08%
PEP	PEPSICO	Consumer Staples	2.08%
ABBV	ABBVIE	Healthcare	2.06%
MCK	MCKESSON	Healthcare	2.06%
TSN	TYSON FOODS 'A'	Consumer Staples	2.06%
KO	COCA COLA	Consumer Staples	2.06%
LLY	ELI LILLY	Healthcare	2.06%
PM	PHILIP MORRIS INTL.	Consumer Staples	2.05%
MDLZ	MONDELEZ INTERNATIONAL CL.A	Consumer Staples	2.05%
AMGN	AMGEN	Healthcare	2.05%

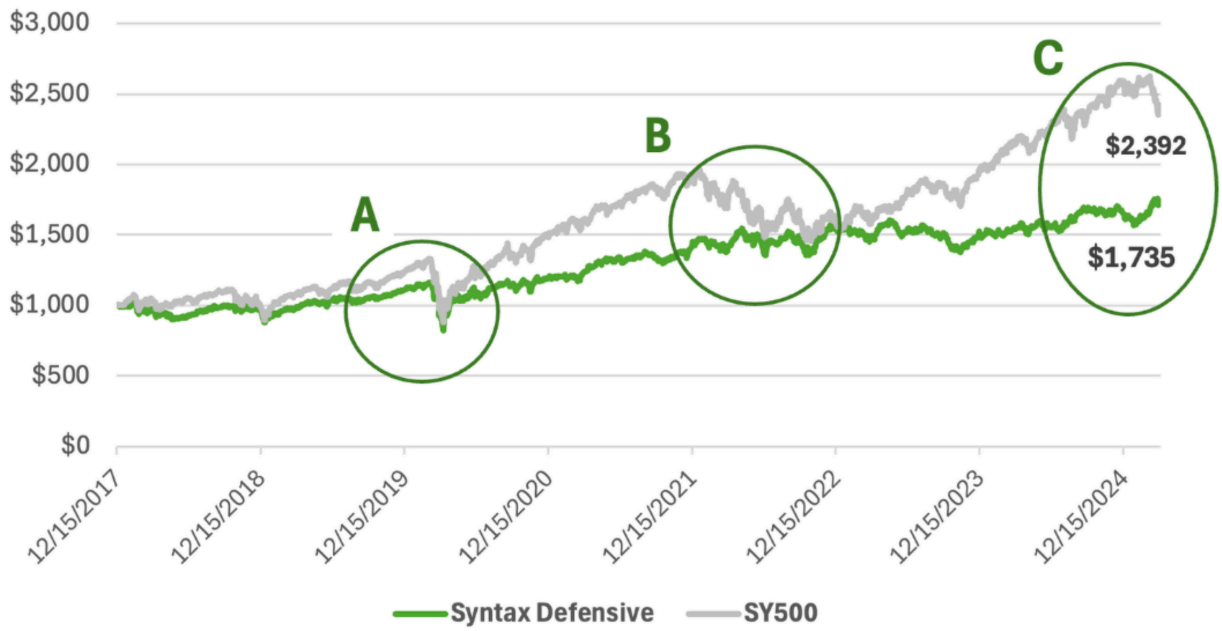
Source: Syntax Data

As modeled, the Defensive Equity Index has allocations to five sectors and ten sub-sectors. The index model is concentrated in three sectors (Consumer Staples, Healthcare and Utilities), which represent 86% of the index. Four sub-sectors make up just shy of 75% of the index, with Food being the largest (30.2%) followed by Electric Utilities (21.9%), Healthcare Products (14.1%), and Personal and Homecare Products (8.0%). When thinking about these weights from a portfolio construction perspective for a client, the tech-heavy S&P 500 has small allocations to these sectors and sub-sectors. The relatively concentrated Defensive Equity Index, with focused exposure to these sets of businesses, may provide diversification benefits in the broader portfolio context, helping to offset the sector biases found in the S&P 500. Using backtested data over the five years ending 2/28/2025, the Defensive Index model has a correlation to the SY500 of 0.74, and a beta of 0.58.

Meanwhile, the risks tied to individual securities are mitigated through a modified equal weighting approach where each security has a weight relatively close to 2%. Exhibit 4 shows the weights to the top 10 constituents, which include well-known, blue-chip companies.

Syntax Direct calculates backtests for indices modeled on the platform beginning on December 15, 2017. Exhibit 5 shows the results of this backtest through March 18, 2025. The SY500, with its market cap-weighted exposure to the Magnificent Seven, has exhibited very strong modeled performance: a hypothetical $1,000 investment grew to $2,392 before fees and expenses, an annualized return of 12.3%.

Exhibit 5: Modeled Performance: Syntax Defensive Equity Index vs. Syntax Large Cap Index

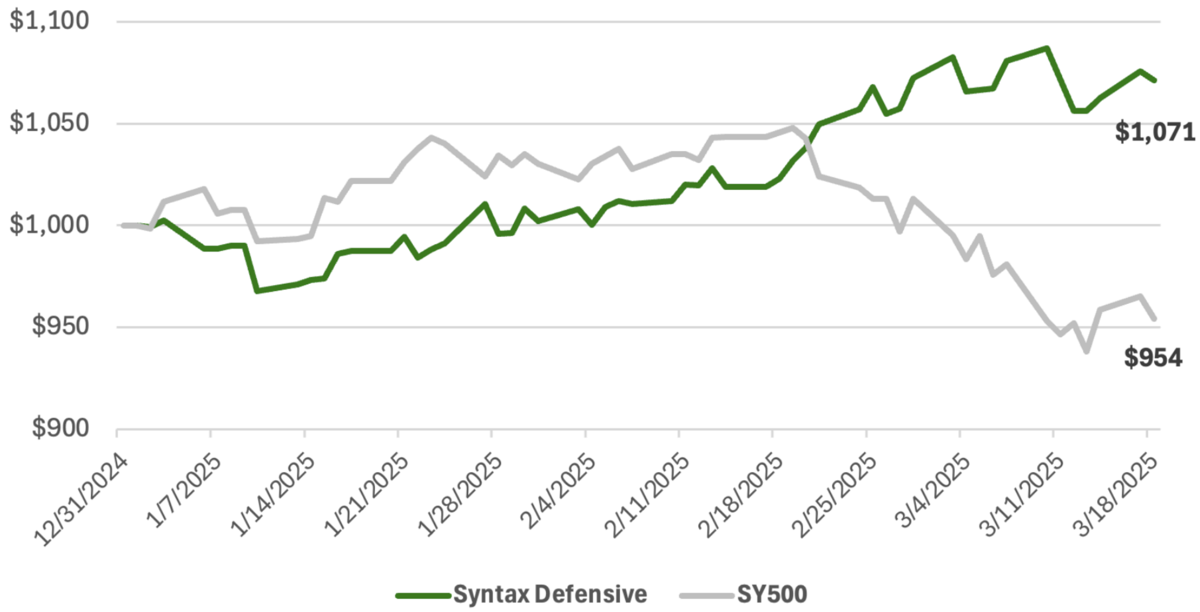


Modeled total return 12.15.2017 – 3.18.2025. Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index. Please see important disclaimers regarding backtested index model data. Source: Syntax Direct.

The Syntax Defensive Index model grew the same hypothetical $1,000 investment to $1,735, a modeled annualized return of 7.6%. Not surprisingly, the defensive-oriented index underperformed during this growth-heavy period. However, the pattern of returns exhibited by these two indices during market downturns, annotated as periods A, B, and C in Exhibit 5, tells a very different story.

Points A and B represent time periods where the SY500 had begun to outpace the Syntax Defensive Index model, only to then see the lines converge. Point C shows the most recent trend where the SY500 has produced losses, while the Defensive Index exhibited positive performance. This is shown in greater detail in Exhibit 6.

Exhibit 6: Syntax Defensive Equity Index vs. Syntax Large Cap Index



Modeled total return 12.31.2024 – 3.18.2025. 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. Source: Syntax Direct.

For the year-to-date performance through March 18, the Syntax Defensive Index model's hypothetical $1,000 investment grew to $1,071 before fees and expenses, a return of 7.1%, whereas the SY500 declined to $954, a loss of 4.6%. The divergence was especially noteworthy since late February, when market volatility notably increased: exactly the sort of performance investors should hope to see from defensive strategies.

Exhibit 7 highlights the modeled returns and standard deviations of the Defensive Index and the SY500. The returns for the Defensive Index model exceed the benchmark by 11.7 percentage points for the year-to-date through March 18th. The index model has also outperformed the benchmark in the trailing year ending 3/18/24 by 1.3%. However, in longer horizons that include strong growth markets, the Defensive Index model has underperformed the benchmark, losing by 2.7% in the trailing 3 years and by 7.0%

annually in the trailing 5 years.

Exhibit 7: Modeled Syntax Defensive Equity Index and Syntax Large Cap Index Annualized Returns

Annual Returns			
	Syntax Defensive	SY500	Difference
YTD	7.12%	-4.56%	11.68%
1-Year	12.21%	10.91%	1.30%
3-Year	6.58%	9.27%	-2.69%
5-Year	12.79%	19.75%	-6.96%
Full History	7.61%	12.31%	-4.70%

Modeled total return, 12.15.2017 – 3.18.2025. calculated using daily values; periods greater than one year have been annualized. 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. Source: Syntax Direct.

Exhibit 8: Modeled Syntax Defensive Equity Index and Syntax Large Cap Index Standard Deviations

Annualized Standard Deviation			
	Syntax Defensive	SY500	Difference
1-Year	12.00%	10.82%	1.19%
3-Year	13.00%	17.09%	-4.09%
5-Year	14.14%	17.95%	-3.81%
Full History	13.45%	17.16%	-3.71%

Annualized standard deviations, 12.31.2017-2.28.2025, calculated using monthly 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 index model data. Source: Syntax Direct.

Looking at the annualized standard deviation in Exhibit 8, the Defensive Index model was more volatile over the past year than the benchmark at 12.0% vs. 10.8%, respectively. Over the past three and five years, the Defensive Index model was substantially less volatile at 13.0% and 14.1% compared to the benchmark at 17.1% and 18.0%, respectively.

Exhibit 9 compares index fundamentals for the Defensive Index vs. the SY500 benchmark. Given the strong modeled performance of the benchmark over the past five years, it's not surprising that the Defensive Index model is relatively more attractive from a valuation perspective.

Exhibit 9: Modeled Index Fundamentals: Syntax Defensive Equity Index and Syntax Large Cap Index

Index Fundamentals		
	Syntax Defensive	SY500
Indicated Dividend Yield	2.57%	1.15%
Price/Earnings Ratio	26.22	30.42
Price/Book Ratio	4.16	5.57
Max Mkt Cap ($B)	$634.77	$3,725.90
Min Mkt Cap ($B)	$13.10	$12.41
Wtd. Avg Mkt Cap ($B)	$88.99	$1,095.16

Results and data based on the previous index model rebalance basket on 12/11/2024. Source: Syntax Direct

The Defensive Index's dividend yield at 2.57% is more than twice that of the benchmark. Its price / earnings ratio at 26.2 is 14% lower than the benchmark, while its price / book ratio of 4.16 is 25% lower. Also, the average market cap of $89 billion is well below the $1.1 trillion market cap of the benchmark, which is skewed by the concentration in tech companies.

In this paper, we highlight how an advisor can use Syntax Direct to create a custom index solution for a client. We demonstrate the steps taken to create the custom Defensive Index and illustrate the information that is readily available in Syntax Direct to support our sample case study. And, for advisors who do not believe the current bearish environment will last, Syntax Direct can be used to design countless indices with wide-ranging objectives.

In addition to this enabling the creation of personalized index solutions, the system supports the regulatory needs of advisors by providing immediate access to factsheets for every index created, accompanied by an index rulebook, which is a compliance-ready document that details the key assumptions used to create an index. To learn more, please visit www.syntaxdata.com or email sgreico@syntaxdata.com.

1. Vanguard Capital Markets Model forecasts -- setting realistic expectations.

2. Other Macro Themes include Commodities, Inflation, Infrastructure, Retail, Transport and Logistics.

Disclaimers

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, and Dividend Yield 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.