APPLETON PARTNERS, INC.

# What's in Your Index?

Capital markets indices long ago became synonymous with "the market", and changes in value of the DJIA and the S&P 500, the two most prominent US equity benchmarks, have become a staple of the daily business horserace. Yet the nature of index construction and realignment is an arcane topic best understood by tracking error focused portfolio managers and the committees charged with creating and managing each index, not the wider investing public. Nonetheless, indices heavily influence perspectives on risk and return, and hence personal financial planning. With apologies to Otto von Bismarck, unlike laws and sausages, you ought to understand how indices are made.

## The Nature and Purpose of Indices

Passive investing has exploded in popularity and now accounts for roughly 45% of all US equity mutual fund assets, up from only 25% a decade ago.[1] What was once largely the domain of institutional investors seeking low cost, defined market exposure has also become a staple of the retail world. Indexing seeks to track representative benchmarks and, in doing so, can help minimize expenses and eliminate the perceived biases and uncertainties associated with active decision-making. This letter's purpose is not to debate active vs. passive investment approaches (we are active managers), but rather to deepen understanding of the private wealth mindset with which we approach investment decisions.

## Personalizing Risk

Indices offer a valuable frame of reference, acting as an asset class proxy and comparative performance assessment tool. Yet, at Appleton Partners we believe our clients' absolute asset levels are paramount, not relative returns. While we monitor benchmarks and should be held accountable for our long-term performance, the risk our clients assume is very personal - potential permanent loss of capital and/or failure to meet long-term financial goals and liability needs.

Let's look at a practical example. Index centric investors often consider an underweight position in a stock as a "bearish" or negative view of that name. For example, Apple represented 6.52% of the S&P 500 as of 10/7, yet to us, a 5% weight in Apple in a client's portfolio would reflect a *positive* view of the company's intrinsic value and growth prospects, not an indication of caution. If we put any of your assets in a stock, we believe in it. While we consider a stock's weight in the index as part of portfolio construction, it does not drive or supersede our fundamental conviction.

## Know What You Own

Committing to customized long-term investment plans ought to be based on an understanding what you own, and equity indices are not created equal. Most, such as the S&P 500, are capitalization weighted, meaning that the largest stocks account for a disproportionate percentage of assets. For example, the top 5 holdings in the S&P 500 - Apple, Microsoft, Amazon, Facebook and Alphabet – comprise nearly 23% of total index capitalization, almost twice the weight of a decade ago. Top heavy to say the least! These same stocks have produced a YTD return of 42%, compared with -3% for the remaining 495 S&P 500 constituents,[2] and thus are the primary reason the index is positive year to date. Capitalization weighted indices are inherently momentum driven, as index replication demands buying more of what is largest and going up in value the fastest. Casting aside the relative merits of these mega cap market leaders, index concentration can have a large, but not always readily apparent, impact on portfolio risk and return.

Other indices, such as the DJIA, are price weighted, indicating that nominal price per share drives the construction methodology. Again, this can introduce momentum characteristics. Corporate actions that have no bearing on actual value, such as stock splits, can also significantly alter the makeup of the underlying index. By contrast, equal weighted indices are just that, equally weighted among constituent names.

| S&P500 | | Dow Jones Industrial Average | |
|---|---|---|---|
| Apple Inc. | 6.52% | United Health Group Inc. | 7.51% |
| Microsoft Corp. | 5.60% | Home Depot Inc. | 6.57% |
| Amazon.com Inc. | 4.80% | Salesforce.com Inc. | 6.04% |
| Facebook Inc. Class A | 2.19% | Amgen Inc. | 5.99% |
| Alphabet Inc. Class A | 1.55% | McDonald's Corp. | 5.26% |

Source: SPDRS.COM as of 10/7/20

Fixed income indices introduce other risk related nuances, as most assign weights to components based on debt outstanding, thereby allocating greater capital to more indebted issuers. Because bonds are traded through dealers, not on an exchange, efficiently replicating desired exposures can be challenging given potentially limited secondary market bond availability. As with equities, we invest in bonds that our credit research and portfolio management teams believe offer good value, not based on index composition.

Index methodology can heavily influence an individual's exposures when investing in products that track a benchmark, and these distinctions are themselves active investment decisions. Whether these "bets" align well with an investor's unique needs and objectives is worth considering.

## Customized Goals Based on Individual Needs

Quite simply, we feel your primary benchmark should be your financial plan and that's what we manage towards. Institutional indices play an important role in the market landscape, yet funding your retirement, healthcare or educational needs is a function of capital accumulation, not outpacing index tracking managers. As active managers, we also seek to mitigate risk and preserve capital while targeting appropriate long-term risk adjusted returns.
We view relationships in personal terms and the investment strategies developed in consultation with our clients reflect that mindset. So, while we often speak about "the market", what matters most is how your portfolio works for you.

1. B of A/Merrill Lynch, March 2019
2. Goldman Sachs, as of Sept. 11, 2020

## MARKET OBSERVATIONS & IMPLICATIONS

### Tax-Exempt Investment Grade Municipals

- The story of Q3 was a continued rebound in the municipal markets following March's COVID-19 meltdown. At the tail end of the quarter the Fed reaffirmed that yields are expected to remain near zero for some time, namely until the job market has fully recovered and inflation has reached or moderately exceeds 2% for a sustained period.
- Strong fund flows continued throughout Q3, driving the bid side for municipals. For all but the last week of September, fund flows were positive, bringing in $26.4B over the quarter and raising YTD net flows to $20.2B (as per Lipper).
- The curve continued to steepen over Q3 as the front end remains anchored by Fed Funds in a 0-25 bps range. The spread between 2-yr AAA munis and 10-yr AAA munis steepened by 11 bps to 74 bps.  We continue to see relative value in the 6 to 9-year maturity range.

| | 6/30/20 | 9/30/20 | QTD change |
|---|---|---|---|
| 2-yr AAA Muni | 0.27% | 0.13% | -14 bps |
| 10-yr AAA Muni | 0.90% | 0.87% | -3 bps |
| 30-yr AAA Muni | 1.63% | 1.62% | -1 bp |

- SIFMA, the weekly VRDN benchmark, started Q3 at 9 bps only to finish 2 bps higher at 11 bps.
- Q3 issuance continued a strong uptrend driven by 4 months of $40B+ issuance from June – September. YTD issuance is 22% ahead vs. 2019, a trend that should continue absent materially higher rates or a sharp downturn in investor confidence.
- Taxable offerings – up 203% vs. 2019 – have driven overall issuance with low yields fueling taxable refunding. Supply should stay high unless we see an uptick in yields or a change in the limitation on tax-exempt refinancing.
- Tax-exempt issuance spiked in Q3 and is now roughly even YoY.  Factoring in average long-term Q4 issuance levels, year-end totals should exceed earlier 2020 projections and could climb to $440-$450B. This would add sought after tax-exempt supply.
- Strong demand for municipals and largely flat UST yields drove AAA Muni/UST ratios down somewhat during Q3. The 10-year ratio fell modestly but remains at a still elevated 126.09% as of 9/30, as compared to a post-1990 average of 86.8%.
- We maintain a UST trading range of 0.60 – 1.20% but are mindful of the rate implications of rapidly growing federal deficits and the Fed's bloated balance sheet.
- Our intermediate municipal duration target remains at 4.65-4.75 years.

### Investment Grade Corporates & Treasuries

- IG credit issuance has been incredibly robust as issuers take advantage of low interest rates and very high demand for high-quality bonds. September brought $164B of new IG debt, the largest September and 7th largest month on record.
- YTD issuance of $1.542 Trillion is 67% higher than the same period of 2019, although we expect issuance to slow as the election approaches and economic sluggishness persists.
- Since March's breakout, IG credit spreads have rapidly normalized. The OAS on the Bloomberg Barclays US Investment Grade Corporate Index began Q3 at a high of 149 bps before falling to 124 bp and ultimately ending the quarter at 132 bp.
- An elongated range bound movement in spreads has set a positive tone for IG credit and investors are taking notice.  We anticipate modest volatility in Q4 but feel that a positive tone will persist through year-end.

### Equities

- Stocks extended their rally over Q3 with the S&P 500 and Nasdaq hitting all-time highs in early September before losing some momentum to close the quarter. The S&P 500 returned 8.9% and posted its best back-to-back quarterly gains since 2009.
- The supportive narrative of massive monetary and fiscal policy support, a recovering economy, corporate earnings inflecting higher, and vaccine hopes provided a tailwind for stocks.
- Credit spreads remained subdued during late September's downturn. That, coupled with slightly higher bond yields and a steeper yield curve, was a signal that the short late quarter equity market correction was more a function of overbought conditions than fundamental economic weakness.
- Megacap technology stocks have had a profound performance impact both positively (July/Aug.) and negatively (Sept.). S&P 500 Growth (+11.4%) once again outperformed S&P 500 Value (+3.9%), and LC Growth remains an emphasis in our portfolios.
- Wall Street analysts are predicting a Q3 drop of -21% in S&P 500 earnings. However, it is a good sign that estimates have recently been adjusted higher for Q3, FY '20 and FY '21. We are closely monitoring earnings as growth will ultimately be necessary to justify higher than average valuation levels.

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