INSIDE THE STOCK INDEX

Market Review **SEPTEMBER 2020**

Monthly returns in the total world stock index slid for the first time since the recovery began in April. Even with returns slipping in September, the total world stock index hangs on to slim gains to finish out the first three-quarters of the year. Returns in the total world stock index have been moved higher on the robust activity in the US large-cap segment of the index. Current demand for US large-caps has turned the landscape of investing into a less diverse and more asymmetric place for taking on risk in the total world stock index.

Growing concentration in the US large-cap index has happened over the course of many years as demand for ownership continues to pull investors into these types of securities. Currently, over a quarter of the US large-cap index's market cap is held in the ten biggest company names that reside in the index. Even the popularized group that goes by the FAANGM expression now accounts for a fifth or more of total market cap in the same index. With better returns coming out of the large-cap index for such a sustained period of time, a rather large performance gap has grown between the returns of large-cap and small-cap indexes. Some liken this to 1999 when the market cap representing the broad small-cap market slimmed to tiny proportions relative to the total world stock index.

Without a doubt, earnings growth has fared better in US large companies compared to US small-cap companies, which has led to the performance divide. In the long-run, however, earnings growth is meant to be better in the small-cap index allowing for a small-cap premium to be made by investors. This is necessary to compensate investors for the increased risk of small companies. Naturally, small-caps grow into larger companies as their average earnings growth compounds at a larger rate. But that long-term phenomenon, known as the small-cap premium, has gone missing now for some 15 years. As long as money keeps pouring into the large-cap index at current rates, the small-cap premium will continue to fade further into the background.

In the low rate environment that exists today, prices paid for large-cap earnings have expanded at a much faster rate compared to the same measure for uncertain earnings in small-caps. Today's elevated demand for ownership in large-cap earnings has been more than enough to overcompensate for the losses due to declining earnings in large-cap companies. As a result, large-caps in aggregate stand with a net positive gain for the year while small-caps still sits in a net loss position.

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In 2020, earnings declined in small-caps at a rate that doubled the decline for large-cap earnings.

Return volatility in stock indexes is still above average over the recent past. Volatility will definitely challenge the future of investment returns as new money is committed in stocks at today's levels. Now that the US election season is underway, volatility is likely to remain for some time before complacency can come back into the stock indexes. The political divide in the US has widened with the debate turning towards plans for vaccinations, social order, and how government assistance should be used in an effort to end the current recession.

Stocks were at least helped out by softening changes in interest rate markets in the third quarter of the year. Interest rates stayed latched on to their historic lows coming into the quarter and remained at that level. Many investors looking to invest new money are concluding that there is not much left for bond returns. The next best alternative for return is then the earnings of stocks, which may explain why investors are more willing to pay higher prices for earnings relative to other times in history.

Investors are being pulled into stocks, which is good and can help retool the economy. This allows companies to access cheap capital through equity markets and make investments in labor and assets. Companies being able to invest on public demand for equity is one solution for pulling this economy out of a crisis.

Asset Categories	US STOCKS	FOREIGN STOCKS	US BONDS	FOREIGN BONDS	HARD ASSETS	HYBRIDS
Monthly	-3.21%	-1.47%	-0.23%	-1.15%	-5.88%	-1.40%
Year to Date	-6.01%	-4.26%	3.22%	1.05%	-9.05%	8.10%

*DATA USED IS SOURCED FROM MORNINGSTAR®, DATE ENDING SEPTEMBER 30, 2020.

US STOCKS

US Stocks posted monthly losses across all market caps. The average total return outcome in the month of September was -3.2%, nearly matching the decline in large-cap stocks. Small-cap losses in the month were a bit deeper at -3.8%. Mid-cap stocks held greatest relative strength with total losses dipping to -2.7%. For the year, large-caps hold gains of 2.3% while mid- and small-cap returns remain negative.

FOREIGN STOCKS

Foreign Stocks experienced more relative strength in their total return losses for the month when compared to domestic stocks. The average loss among category averages was -1.5% in the month of September. The month's loss for developed country large-caps was -2.0% and -1.5% for emerging-market stocks. Emerging-stock returns provide the greatest contribution in slimming down the year-to-date losses in foreign stocks. This year's losses in emerging-market stocks stand at a mere -1.4%.

US BONDS

US Bond returns were relatively flat as interest rate changes remained more stable in the month of September. Those category averages experiencing losses hit the credit markets and inflation protected markets. Credit markets eased in September as investors saw a need to raise the risk premium on default-risk securities. The 3.2% year-to-date average return among category averages is still being propped up by the returns in investment-grade securities.

FOREIGN BONDS

Foreign Bond returns retracted in September as the return premium asked on these securities rose. The emerging market bond category weighed on the average total return of -0.2% for the categories in the prior month. Last month's return in emerging market bonds was -1.7%. The same category holds a -1.6% return representing the cumulative change for 2020. The cumulative return for the total world bond category remains positive for the year at 3.7%.

HARD ASSETS

Hard Assets had a disappointing month bringing in an average return of -5.9% into the diversified portfolio. Energy-related assets and precious metals realized the biggest declines in the month. Energy lost -10.5% and precious metals fell -7.5%. Monthly losses in real estate categories were much slimer averaging about -2.8%. Recent experience in most hard asset categories has produced a cumulative return drag in the diversified portfolio return.

HYBRIDS

Hybrids, on the other hand, is where the diversified portfolio experienced the most benefit as of late. The year-to-date losses in preferred stock of -2.3% have been more than offset by the same period's gains of 18.5% for convertible securities. Recent momentum in hybrids, however, slowed in September along with the declines in equity market securities. The convertible category has largely tracked the growth return in growth-oriented equities throughout the year, making it one of the best performing asset classes.

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