GLENMEDE Investment Management

ANTICIPATING THE RETURN TO A MORE RATIONAL MARKET

The COVID-19 crisis may have ushered in what could be the most rapid market downturn that we experience in our lifetimes. Market concentration and a disregard for fundamentals, however, had already emerged as indicators of an unhealthy late stage bull market—before the pandemic triggered the selloff starting in mid-February. Investors continue to exhibit some of this seemingly irrational behavior today. Despite the rapid correction, we believe the market is overdue for a return to a mindset that rewards attractive fundamentals and valuations to allow broader participation in market rallies[1].

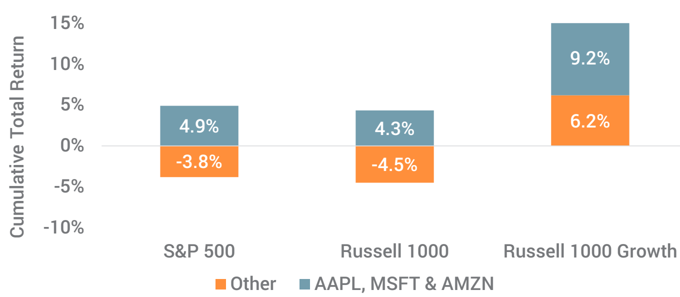
AN INCREASINGLY CONCENTRATED MARKET

In many ways, market dynamics until early February 2020 looked very much like conditions in 1999 before the start of the tech bubble downturn. Many thought the long-running bull market would never see such a significant fall again despite warning signs.

During the past several years, the capital markets have been dominated by macro issues which have driven investor behavior. Trends such as ongoing adoption of e-commerce; efficiencies and new business models enabled by cloud-based systems; and lower interest rates have created a gold-rush mentality among investors, who have rewarded mega stocks such as Amazon, Apple and Microsoft.

Since January 2018, although the average stock in the Russell 1000 Index fell more than 7 percent on an annualized basis, the largest technology and internet stocks had strong positive returns. Amazon, Apple and Microsoft all gained more than 20 percent on an annualized basis. Excluding these three stocks, the S&P 500 and Russell 1000 indexes would have had negative returns during this period, as shown in Exhibit 1. This narrow set of stocks has driven the rise of the major indexes in recent years.

EXHIBIT 1:
Benchmark Contributions of Microsoft, Apple and Amazon



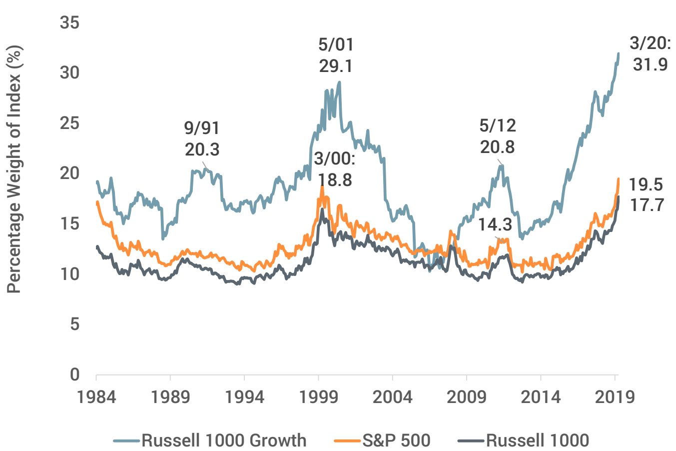
	Average Index Weight: S&P 500	Average Index Weight: Russell 1000	Average Index Weight: Russell 1000 Growth	Total return
Apple Inc.	3.9	3.7	7.2	55.2
Microsoft Corporation	3.8	3.4	6.5	90.9
Amazon.com, Inc.	3.0	2.7	5.2	66.7
Average Benchmark Weight (%)	10.8	9.8	19.0	
Weighted Average Return (%)	71.1	70.8	70.6	
Contributions to Benchmark Return (%)				
Top 3 Companies (AAPL, AMZN, MSFT)	4.9	4.3	9.2	
Other Stocks	-3.8	-4.5	6.2	
Total Benchmark Return	**1.1**	**-0.2**	**15.4**	

Source: FactSet *Data for the period from January 2018 to March 30, 2018*
Individual stock names are not included as recommendations.
Past performance is not indicative of future results.

[1] The approach throughout the paper is to use the maximum amount of data possible for analysis. As a result, starting dates for various exhibits may differ due to availability of data from a particular source. For example, monthly returns for Fama French factors begin in July 1926 while FactSet's pricing database starts in 1984.

As stock market performance became increasingly concentrated in this small number of the largest technology and internet-related names, the benchmark indexes have become increasingly top heavy. Five companies (Alphabet, Amazon, Apple, Facebook, and Microsoft) account for approximately 20 percent of the overall weighting in the S&P 500 Index, and the concentration has reached similar levels in the Russell 1000 Index, as shown in Exhibit 2. The same five companies in the Russell 1000 Growth Index are even more concentrated at nearly 32 percent.

EXHIBIT 2: Benchmark Index Concentrations
Total Weightings of FIve Largest Constituents



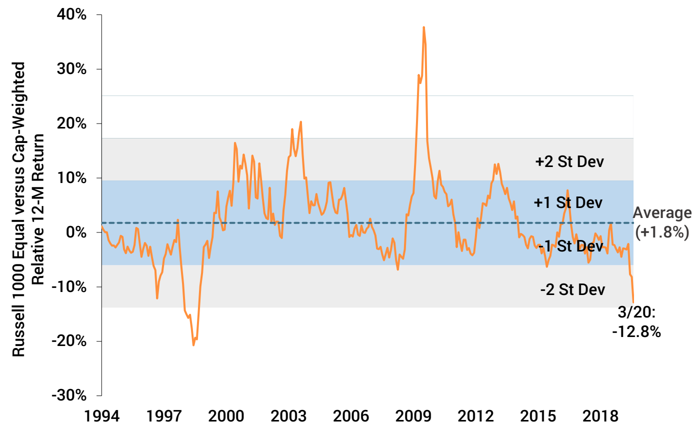
Source: FactSet *Data as of March 31, 2020*
Past performance is not indicative of future results.

A DIFFICULT SEARCH FOR ALPHA

This context has been challenging for equal weighted portfolios and stock selection strategies.

For the 12 months ending March 31, 2020, the average stock in the Russell 1000 Index had a total return of approximately -20.9 percent and underperformed the cap-weighted index by about -12.8 percent, as the chart in Exhibit 3 illustrates. This result is the most negative relative performance since the 12-months ending April 1999.

EXHIBIT 3: Russell 1000 Index - Equal vs. Market Cap Weighted
Rolling 12-month Spread Since 1994



Sources: Glenmede Investment Management LP, FactSet *Data as of March 31, 2020*
Past performance is not indicative of future results.

Over the past 27 months, the average stock (equal-weighted) in the Russell 1000 Index has underperformed the cap-weighted index by about 7.4 percent. Where only a small percentage of stocks beat the index, an equal weighted portfolio would not be likely to outperform. It has been difficult for many stock selection strategies to outperform during the past two to three years as less than one-third of large cap stocks have outperformed the Russell 1000 Index, as shown in Exhibit 4.

EXHIBIT 4: Percentage of Stocks Outperforming Russell 1000
Rolling 36-month periods

Sources: Glenmede Investment Management LP, FactSet *Data as of March 31, 2020*
Past performance is not indicative of future results.

IS A RETURN TO AN "OLD NORMAL" ON THE HORIZON?

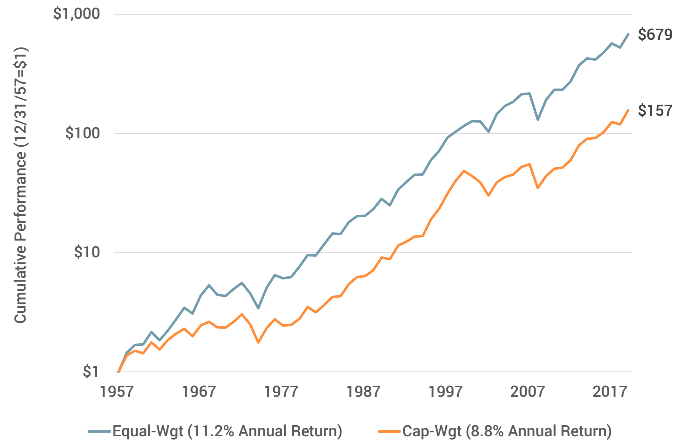
There are a number of factors that give us confidence that performance trends will reverse and ultimately gravity will prevail. Typically, the largest stocks that have outperformed are subject to diminishing future returns due to size and increased regulatory scrutiny. These shifts can be seen when considering the rate of turnover of the top ten largest constituents in the S&P 500 Index, which has been approximately 17 percent versus about 6 percent for the overall index (since 1993).

Going forward, as the world manages through the COVID-19 pandemic and investors reassess the role of fundamentals, we expect a normalization of economic growth and the capital markets. Three historical trends inform our perspective:

1 The average stock tends to outperform cap-weighed indexes over time.

Since 1958, the average stock (equal-weighted) in the S&P 500 Index has outperformed the cap-weighted index by an annualized 2.4 percent, creating an environment for equal-weighted portfolio construction to add to performance. On a cumulative basis, a dollar invested in an equal-weighted portfolio of S&P 500 constituents on January 1, 1958, would have grown by December 31, 2019 to $679 versus $157 for the cap-weighted index, as shown in Exhibit 5.

EXHIBIT 5: S&P 500 Equal and Cap-Weighted Indexes
Cumulative Performance
Annual Returns 1958 through 2019



Sources: Glenmede Investment Management LP, FactSet (1990-2019), Leuthold Research (S&P 500:1972-1989, S&P 425:1958-1971) Data as of March 31, 2020
Past performance is not indicative of future results.

2 Today's leaders tend to become tomorrow's laggards.

Since 1984 through March 31, 2020, when S&P 500 Index concentration in five companies reached more than 14 percent, those top five companies went on to underperform the index on average by more than 5 percent annualized in the subsequent 3 years. See Exhibit 6.

EXHIBIT 6: Performance Relative to S&P 500

	Post One-Year Return		Post Three-Year Return	
Top Five Weight	Average (%)	Negative Frequency (%)	Average (%)	Negative Frequency (%)
> 14%	5.2	71.6	-5.3	100.0
12.5% - 14%	-0.5	57.2	-2.6	73.0
11% - 12.5%	1.1	49.7	0.2	53.6
< 11%	2.0	39.8	1.1	33.0
All Periods	**-0.9**	**54.4**	**-1.6**	**62.8**

Sources: Glenmede Investment Management LP, FactSet
Data from 1984 to March 31, 2020
Negative frequency is the percentage of time that the average return for the 5 largest companies was below the S&P 500. Past performance is not indicative of future results.

3 Equal weighted and inexpensive stocks have typically outperformed following a bear market bottom.

The results from analyzing Fama French data since July 1926 in Exhibit 7 show that U.S. stocks (NYSE, AMEX and NASDAQ) achieved on average nearly 37 percent returns in the 12 months after the bottom of a bear market has been reached. During those post-drawdown periods, incrementally, stocks biased towards value and small size factors outperformed by approximately 11 percent and 10 percent, respectively. The value and size excess returns in Exhibit 7 are based on the annualized average spread between the performance of the top and bottom quintiles for all U.S. listed equities on a market-cap weighted basis.

EXHIBIT 7: Fama French Factors Excess Return vs Market

	Market Return	Value Factor Excess Return	Small Size Factor Excess Return
Total Time Period*	11.2	2.3	4.1
Year After Bear Market Bottom**	36.8	11.0	9.9

Source: FactSet, Haver Analytics and https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html
Data as of March 31, 2020. Past performance is not indicative of future results.
**Overall time period reflects average monthly returns from July 1926 until February 2020.*
***Bear market bottoms include: June 1932, March 1938, November 1946, June 1962, June 1970, September 1974, November 1987, September 2002, and February 2009. Returns are for the following 12 months.*

ANTICIPATING REVIVAL OF RATIONALITY

The intensifying market concentration in recent years has made the search for alpha in the large cap market significantly more difficult. Certain macro trends have eclipsed business fundamentals as drivers of investment decisions, and a small set of the largest stocks have primarily driven index performance as a result. We believe a return to more historic norms for performance drivers is on the horizon given the patterns we have seen in the data from past decades. As investors re-evaluate their investment strategies in today's uncertain world, a more rational consideration of business fundamentals and value factors to inform decision making should prevail.

INSIGHTS is a Glenmede Investment Management LP research paper. This issue was written by:

Vladimir de Vassal, CFA ®
Portfolio Manager, Quantitative Equity

1650 Market Street, Suite 1200 Philadelphia, PA 19103-7391
215-419-6662 | gimclientsupport@glenmede.com
glenmedeim.com