

Investment in Innovation: Opportunities for Potential Outperformance across the Market- Cap Spectrum

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It is of no surprise to anyone following the markets of late that the returns of larger companies have generally fared better than their smaller brethren during the pandemic. The extent of this dynamic was brought into sharp relief when looking at YTD total returns through May 29, 2020: the large-cap [S&P 500[®]](#) returned -4.97%; the [S&P MidCap 400[®]](#) returned -13.86%; and the [S&P SmallCap 600[®]](#) returned -20.81%. In the small-cap segment, the Russell 2000 reflected the same story over this period with a return of -15.95%.

Meanwhile, the equivalent market-cap segments of the [S&P Kensho New Economies Composite Index](#), which seeks to capture the industries and innovation of the Fourth Industrial Revolution, have significantly outperformed their broad market peers by 3.96%, 9.35%, and a substantial 16.49%, respectively, over this same time period (see Exhibit 1).

Exhibit 1: S&P Kensho New Economies Composite Index Outperformance by Market Cap Segment

MARKET CAP SEGMENT	BENCHMARK	2020 YTD OUTPERFORMANCE (%)
Large-Cap Holdings (>USD 10 Billion)	S&P 500	3.96
Mid-Cap Holdings (>USD 2 Billion, <=USD 10 Billion)	S&P MidCap 400	9.35
Small-Cap Holdings (<=USD 2 Billion)	S&P SmallCap 600	16.49
	Russell 2000	11.62

Source: S&P Dow Jones Indices LLC, FactSet. Data from Jan. 2, 2020, to May 29, 2020. Index performance based on total return in USD. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

This persistent outperformance across market-cap segments may illustrate the positive impact of the security selection effect and underscores the potential benefits of a robust, disciplined, and transparent framework when investing in innovation and growth.

This commentary will discuss our approach to capturing the New Economies and explore how persistent this pattern has been over

different time periods and weighting strategies. Let's start out with some context setting.

Each market-cap segment of the S&P Kensho New Economies Composite Index outperformed its broad market peer YTD.

Before our lives were completely upended by the COVID-19 pandemic, the way we live and work was already being transformed by the power of artificial intelligence, robotics, exponential processing power, and ubiquitous connectivity—the catalysts of the so-called Fourth Industrial Revolution. This industrial revolution, unprecedented in its breadth, depth, and rate of change, will see established industries across the global economy transformed and new industries emerge. In many ways, the pandemic has served to accelerate aspects of this transformation: the remote working, Zoom culture, the dominance of e-commerce over brick-and-mortar retail, and even the migration to clean renewable energy sources.

Before our lives were upended by the COVID-19 pandemic, the way we live and work was already being transformed by the Fourth Industrial Revolution.

The S&P Kensho New Economy Indices seek to capture the industries and innovation of the Fourth Industrial Revolution. Objective, rules-based, and adaptive, these indices seek to identify the companies at the forefront of innovation, the ones whose products and services are transforming the way we live our lives, and represent 25 distinct areas of exponential innovation, everything from Autonomous Vehicles, 3D Printing, and Genetic Engineering all the way to the commercialization of Space.

Innovations patterns for the Fourth Industrial Revolution are: Autonomy, Hyperconnectivity, Adaptability, On-demand, and Renewability.

Security selection is central to the efficacy of any innovation-related strategy, and our approach to this is comprehensive, disciplined, and differentiated. The foundation of our security selection is an adaptive classification framework¹ that allows us to identify areas of exponential innovation in a transparent and disciplined way. Innovations patterns² consistent with the Fourth Industrial Revolution are overlaid onto essential economic activity to identify the areas of the New Economy being disrupted, each a subsector in our taxonomy. With these in hand, we then build a comprehensive industry model for the identified areas of exponential innovation or subsectors. This involves a combination of machine-driven insights through advanced topic modeling and industry expert curation. The innovative companies driving the disruption in each of these areas of the New Economy are subsequently identified from their regulatory filings using our sophisticated natural language processing platform. The approach is forward-looking in that we are seeking to identify the companies putting their strategic chips on the areas of exponential

¹ ["Innovation Patterns: Upgrading Sectoral Classification for the Fourth Industrial Revolution."](#) May 2017.

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innovation (i.e., those companies skating to where the puck is going, rather than where it has been). It also allows us to identify the full ecosystem of companies involved in a given area, not just the pure play names but also the supply chain companies and service providers essential to understanding the full economic footprint. A modified equal-weighting strategy is used in which core, or pure-play, companies are overweighted versus non-core, or ecosystem, companies; however, within each category, companies are equal weighted.

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With this context in mind, let's review the approach for constructing the S&P Kensho New Economies Composite Index using the building blocks described above. As the name implies, the index is an aggregation of all qualifying areas of exponential innovation, or subsectors in our parlance. However, in recognizing that each of these areas are moving at different speeds and are at different points in their evolution (Virtual Reality is still in its early days, but Space is already a USD 400 billion industry), the contributing subsectors are weighted according to where they are in their gestation relative to all the other subsectors, providing investors with a broad exposure to the Fourth Industrial Revolution without having to gauge the ebbs and flows of a given industry. The net result is a highly diversified, dynamic instrument consisting of 388 companies with a fairly equal distribution across the market-cap structure (145 companies in the large-cap segment, 112 in mid caps, and 131 in small caps) as of the last rebalance.³ While biased toward Information Technology (35%), the index is also diversified across other traditional GICS® sectors, including Industrials (20%), Health Care (14%), and Consumer Discretionary (11%).

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...however, recognizing that each area is moving at a different speed, it weights the subsectors according to where they are in their gestation.

As discussed above, individual constituent weighting in the S&P Kensho New Economies Composite Index is principally determined by three things: the number of qualifying subsectors the company is part of, how the company is categorized in each of those subsectors, and the relative weighting given to those subsectors in the index. To ensure this is truly an apples-to-apples comparison, we created two additional hypothetical time series to more closely align with the weighting strategies of the broad market index benchmarks. In this analysis, the constituents of each market-cap segment of the S&P Kensho New Economies Composite Index was weighted in three ways: 1) scaled, modified equal weight reflecting the contributing

³ The last rebalance was Dec. 20, 2019.

factors described above; 2) equal weighted at each rebalance; and 3) weighted by their float-adjusted market capitalization at each rebalance.

Interestingly, each S&P Kensho New Economies Composite Index market-cap segment, regardless of weighting configuration, significantly outperformed its broad market peer over the period from Jan. 1, 2020, to May 29, 2020 (see Exhibit 2).

Regardless of weighting configuration, each S&P Kensho New Economies Composite Index market-cap segment outperformed its benchmark YTD.

Exhibit 2: S&P Kensho New Economies Composite Index 2020 YTD Outperformance by Weighting Configuration		
WEIGHTING*	BENCHMARK	2020 YTD OUTPERFORMANCE (%)
LARGE CAP		
Modified Equal Weight	S&P 500	3.96
Equal Weight	S&P 500 Equal Weight Index	10.15
Market Cap	S&P 500	5.97
MID CAP		
Modified Equal Weight	S&P MidCap 400	9.35
Equal Weight	S&P MidCap 400 Equal Weight Index	11.48
Market Cap	S&P MidCap 400	9.99
SMALL CAP		
Modified Equal Weight	S&P SmallCap 600	16.49
Equal Weight	S&P SmallCap 600 Equal Weight Index	16.30
Market Cap	S&P SmallCap 600	14.23
	Russell 2000	9.37

* Modified Equal Weight reflects the standard weighting approach in the S&P New Economies Composite Index.

Source: S&P Dow Jones Indices LLC, FactSet. Data from Jan. 2, 2020, to May 29, 2020. Index performance based on total return in USD. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

The question now turns to whether or not this outperformance has persisted over different time periods.

The question now turns to whether or not this outperformance has persisted over different time periods. The equity markets generally had a banner year in 2019 and the S&P Kensho New Economies Composite Index was no exception, posting 37.3% on a total return basis. As seen in Exhibit 3, the outperformance has indeed persisted over a variety of different time horizons, and in some cases by considerable amounts.

Exhibit 3: S&P Kensho New Economies Composite Index's Persistent Outperformance by Weighting Configuration

WEIGHTING*	BENCHMARK	OUTPERFORMANCE BY PERIOD (ANNUALIZED, %)				
		CALENDAR YEAR 2019	1 YEAR	3 YEAR	5 YEAR	SINCE INCEPTION (JAN. 2, 2014)
LARGE CAP						
Modified Equal Weight	S&P 500	7.29	7.11	3.25	2.72	1.45
Equal Weight	S&P 500 Equal Weight Index	6.70	13.82	7.12	5.72	3.77
Market Cap	S&P 500	8.10	10.46	6.19	3.93	2.12
MID CAP						
Modified Equal Weight	S&P MidCap 400	11.79	13.63	8.14	6.25	8.06
Equal Weight	S&P MidCap 400 Equal Weight Index	8.23	14.50	10.57	5.97	6.37
Market Cap	S&P MidCap 400	8.43	13.36	9.73	6.08	5.99
SMALL CAP						
Modified Equal Weight	S&P SmallCap 600	11.71	20.40	9.77	3.50	2.53
Equal Weight	S&P SmallCap 600 Equal Weight Index	10.39	16.34	11.47	3.81	2.38
Market Cap	S&P SmallCap 600	8.94	13.06	9.71	2.15	2.04
	Russell 2000	6.19	7.88	8.07	2.20	2.22

* Modified Equal Weight reflects the standard weighting approach in the S&P New Economies Composite Index.

Source: S&P Dow Jones Indices LLC, FactSet. Data as of May 29, 2020. Index performance based on total return in USD. Past performance is no guarantee of future results. Table is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

The outperformance has indeed persisted over a variety of different time horizons, and in some cases by considerable amounts.

While many factors may have influenced returns, security selection has been paramount for innovation-oriented strategies.

While there are many factors that may influence returns, security selection and the methods employed to accomplish it effectively have been paramount for innovation-oriented strategies, such as the S&P Kensho New Economy Indices. The persistent outperformance over the period examined ably demonstrates the efficacy of our comprehensive approach.

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The S&P Kensho New Economies Composite Index was launched February 6, 2017. All information presented prior to an index's Launch Date is hypothetical (back-tested), not actual performance. The back-test calculations are based on the same methodology that was in effect on the index Launch Date. However, when creating back-tested history for periods of market anomalies or other periods that do not reflect the general current market environment, index methodology rules may be relaxed to capture a large enough universe of securities to simulate the target market the index is designed to measure or strategy the index is designed to capture. For example, market capitalization and liquidity thresholds may be reduced. Complete index methodology details are available at www.spdji.com. Past performance of the Index is not an indication of future results. Prospective application of the methodology used to construct the Index may not result in performance commensurate with the back-test returns shown.

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The back-test period does not necessarily correspond to the entire available history of the Index. Please refer to the methodology paper for the Index, available at www.spdji.com for more details about the index, including the manner in which it is rebalanced, the timing of such rebalancing, criteria for additions and deletions, as well as all index calculations.

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