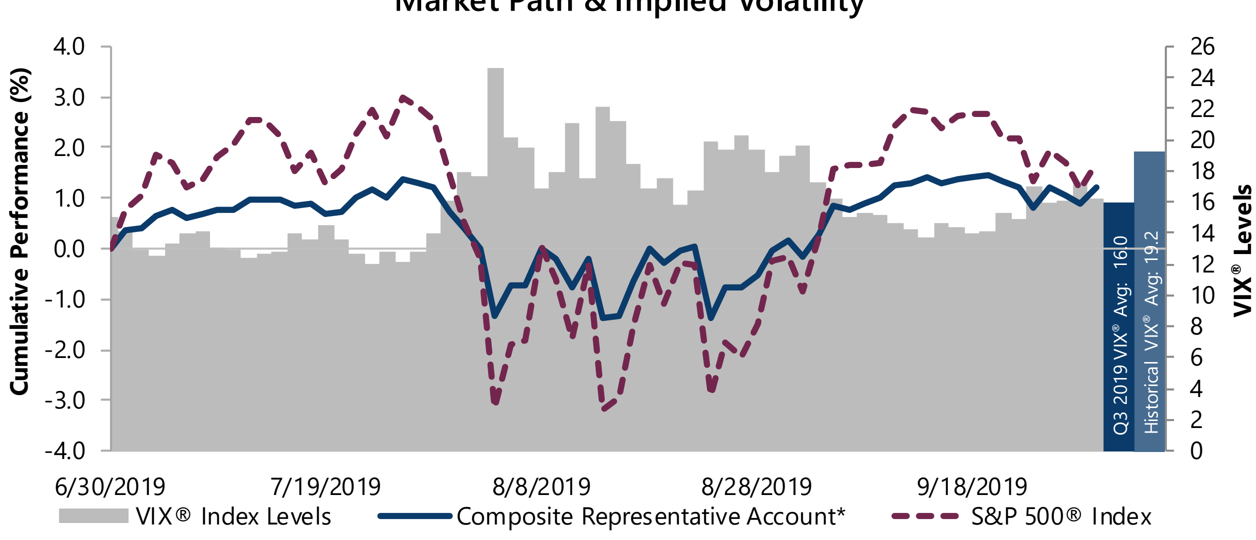
Index/RA Composite Commentary
Q3 2019

In Brief

- Gateway Index/RA Composite (the Composite) returned 1.26%, net of fees, in the third quarter of 2019 compared to the 1.70% return of the S&P 500® Index and the 2.27% return of the Bloomberg Barclays U.S. Aggregate Bond Index. (A GIPS® Composite Report is included with this Commentary.)
- The fluctuating tone of U.S. and China trade negotiations drove market choppiness mid-quarter as the S&P 500® Index declined 5.99% from its all-time high on July 26 through August 14 and had three separate one-day declines over 2.50%. Specifically, the S&P 500® Index dropped 2.97%, 2.90% and 2.59% on August 5, 14 and 23, respectively.
- Throughout the quarter, the Composite provided equity market participation and consistent downside protection with less risk relative to the S&P 500® Index. The Composite* declined 2.73% from July 26 through August 14 and declined 1.32%, 1.17% and 1.44% on August 5, 14, and 23, respectively. The annualized standard deviation of daily returns for the S&P 500® Index and the Composite* for the quarter were 14.84% and 6.60%, respectively.
- The Composite had positive returns in July and September but underperformed the S&P 500® Index both months, as expected when the market advances with below-average implied volatility.
- Implied volatility exceeded realized volatility with the Cboe® Volatility Exchange (the VIX®) averaging 15.96 for the quarter. The VIX® response to mid-quarter equity market declines was relatively muted as its high for the quarter was 24.59 on August 5 with an average of 18.98 for the month of August.
- The Federal Reserve (the Fed) made two key policy adjustments in September: 1) it resumed growing its balance sheet after a liquidity crunch in overnight lending reserves roiled markets and 2) it implemented its second consecutive cut in the Federal Funds rate. The Fed has evolved significantly this year on its use of both policy tools. Will it be able to continue evolving fast enough to satisfy a market that seems to evermore insist upon accommodation?



Source: Bloomberg, L.P. *The portfolio performance and annualized standard deviation reflected for the Composite are those measured by a representative account. This information represents supplemental information to the GIPS-compliant presentation. This representative account was selected as it is the largest account in the Composite.

Market Recap

After a very strong first half of 2019, the S&P 500® Index hit a relatively choppy plateau in the third quarter. Though the S&P 500® Index advanced 1.70% for the quarter, its path was not steady as monthly returns came in at 1.44%, -1.58%, and 1.87% in July, August, and September, respectively. The year-to-date return of the S&P 500® Index at the end of the third quarter was 20.55%. The middle of the quarter was particularly volatile as the S&P 500® Index experienced a 5.99% peak-to-trough decline from its all-time high on July 26 through August 14 and had three separate one-day declines of over 2.50% in August. The last time a month included three one-day declines of that magnitude was September 2011 when the equity market was reeling from the credit rating downgrade of U.S. government debt.

Third quarter choppiness was largely driven by the fluctuating tone of U.S. and China trade negotiations. August brought a flurry of exchange over the level and products affected by proposed tariffs from both sides. This back-and-forth contributed to uncertainty in the equity markets and led to daily declines of 2.97%, 2.90%, and 2.59% on August 5, 14, and 23, respectively.

Trade tensions also impacted monetary policy in the third quarter, compelling the Fed to lower its benchmark overnight lending rate a quarter point at its meeting at the end of July and again in mid-September. Uncertainty over trade policy was cited as a key risk to continued economic expansion and the rate cuts were characterized as a "mid-cycle policy adjustment" and "insurance" against economic retrenchment. The Fed also adjusted its policy on the size of its balance sheet in September. After more than a year of allowing its balance sheet to shrink as bonds it owned matured, the Fed restarted asset purchases to address a lack of liquidity in the overnight lending market. The Fed had not engaged in such an operation since the depths of the financial crisis more than a decade ago. The Fed's action helped calm markets that had been unnerved by a spike in overnight lending rates.

Despite the uptick in uncertainty and volatility, U.S. economic and corporate earnings data were generally positive. The third estimate of Gross Domestic Product growth for the second quarter of 2019 was 2.0%, near the upper range of consensus expectations. Corporate earnings decelerated a bit but remained positive as aggregate operating earnings for S&P 500® Index companies grew nearly 1% in the second quarter and more than 10% year-over-year. More than 82% of these companies reported second quarter earnings that met or exceeded analyst estimates. The employment situation held steady throughout the third quarter with the unemployment rate at 3.7% as reported for August. The August Consumer Price Index, released on September 12, showed a 1.7% year-over-year increase, in line with expectations.

Implied volatility, as measured by the VIX®, averaged 15.96 for the quarter, exceeding S&P 500® Index realized volatility of 14.84%, as measured by its annualized standard deviation of daily returns in the quarter. The VIX® began the quarter on a downtrend and bottomed at 12.07 on July 24. As U.S. – China trade tensions ratcheted higher and the equity market sold off, the VIX® rose to its third quarter peak of 24.59 on August 5. Despite a sizeable peak-to-trough decline that included multiple days of large losses, the VIX® response to mid-quarter equity market price volatility was relatively subdued compared to periods with similar declines. The VIX® averaged just 18.98 for the month of August and ended the third quarter at 16.24.

The Bloomberg Barclays U.S. Aggregate Bond Index increased 2.27% in the third quarter, bringing its year-to-date return to 8.52%. The yield on the 10-year U.S. Treasury Note started the quarter at 2.02%, reached a high of 2.14% in July, then drifted lower to end the quarter at 1.67%. The lowest point of the quarter came in early September when yields reached 1.46%, more than 178 bps below its recent peak of 3.24% on November 8, 2018. The 10-year yield also fell below the yield of the 2-year U.S. Treasury Note during the quarter, an inversion of the yield curve that in the past has preceded recessionary periods.

Gateway IndexRA Composite Performance

The Composite returned 1.26%, net of fees, in the third quarter, underperforming the S&P 500® Index by 43 basis points (bps), and bringing its year-to-date net return to 7.38%. Throughout the quarter, the Composite provided equity market participation and consistent downside protection with monthly returns of 0.72%, -0.56% and 1.10% for July, August and September, respectively.

The portfolio performance, contributions, annualized standard deviation and portfolio statistics quoted for the Composite in the following paragraphs are those measured by a representative account.[1]

Despite a muted response from the VIX® to the mid-quarter market decline, the Composite mitigated more than half the loss of the S&P 500® Index with a return of -2.73% from July 26 through August 14. The Composite's downside protection during August did not make up for its lagging performance in July and September, which was expected due to the equity market advance combined with below-average implied volatility levels.

The Composite's underlying equity portfolio returned 1.75% for the quarter, outperforming the S&P 500® Index by five bps. The Composite's written index call option positions detracted from returns during the equity market advance in July and September. However, index call option writing generated risk-reducing cash flow throughout the quarter and gains on written index call option positions contributed to downside protection during August's equity market decline. Similarly, gains from index put option positions provided downside protection in August, but losses from index put options during the equity market advances of July and September resulted in an overall net quarterly loss. The Composite's annualized standard deviation of daily returns for the quarter was 6.60% as compared to 14.84% for the S&P 500® Index. The Composite exhibited a beta to the S&P 500® Index of 0.43 for the quarter.

Gateway's investment team was active in their response to changes in market conditions and direction throughout the quarter. In periods when the equity market advanced, the team focused on exchanging index call options well in advance of their expiration dates for ones with later expiration dates and higher strike prices. This was in an effort to maintain a typical amount of equity market exposure and protect the Composite from the potentially adverse impact of a sharp reversal in market direction. As markets turned south during the middle of the quarter, the investment team took advantage of the relatively elevated volatility levels by making several index call option trades that increased potential cash flow while maintaining a typical risk profile.

The Composite maintained full put coverage throughout most of the third quarter. While managing the Composite's index put option

1: Represents supplemental information to the GIPS-compliant presentation. This representative account was selected as it is the largest account in the Composite.

portfolio during periods when the equity market advanced, the investment team focused on managing the cost of downside protection by trading select contracts well in advance of their expiration while extending weighted-average time to expiration. During the intra-quarter drawdown, as equity market volatility increased, the investment team realized profits in select index put option contracts and purchased new index put contracts with lower strike prices and later expiration dates. On August 5, the investment team closed one index put option position in an effort to preserve the time value of out-of-the-money index put option contracts, which brought put coverage into a range of 80% to 95%. On August 9, the investment team restored put coverage to greater than 95% when index put options became more reasonably priced as the VIX® declined from the relatively elevated levels witnessed on August 5.

At the end of the quarter, index call options were sold against over 95% of the equity portfolio's value and had a weighted average strike price between 1.5% in-the-money and 1.5% out-of-the-money, 32 days to expiration and annualized premium to earn between 10.0% and 15.0%. Index put options covered more than 95% of the portfolio and had a weighted average strike price between 7.5% and 10.0% out-of-the-money, 56 days to expiration and an annualized cost between 2.5% and 5.0%. Relative to the beginning of the quarter, this positioning represented slightly higher potential net cash flow and market exposure.

Market Perspective

Are the July and September Federal Fund rate cuts and renewed expansion of the Fed balance sheet signs that the policies led by Chairman Powell are falling into place? Or, are these adjustments a sign that it is falling behind?

At his final press conference in 2018, despite having just implemented the fourth rate hike of the year, Fed Chairman Powell noted fourth quarter market volatility was part of a backdrop, which included tighter financial conditions, which were less supportive of growth going forward. In that context, he stated that "Many [Federal Open Market Committee] FOMC participants had expected that economic conditions would likely call for about three more rate increases in 2019. We have brought that down a bit and now think it is more likely that the economy will grow in a way that will call for two interest rate increases over the course of next year."

Fast forward seven months from that statement and the Powell Fed had implemented zero additional rate hikes and, instead, made the first of two rate cuts so far in 2019. In July, and again in September, Chairman Powell noted that the Fed's policy evolution was driven by weak global growth, trade policy uncertainty and muted inflation.

The view that the Fed's policy has caught up to market expectations and, therefore, its policy is falling into place, is supported by Federal Funds futures pricing as of September 30, which reflected just a 40% chance of a rate cut at the upcoming October Fed meeting. Standing pat at the October meeting would also be consistent with the FOMC median 'dot plot', which projects the year-end rate expectations of each of the Fed's 17 voting members.

However, a mismatch between futures market pricing and the dot plot could support the idea that Fed policy is falling behind. Federal Funds futures pricing on September 30 also reflected a 70% chance of a rate cut by year-end (at either the October or December meeting). Furthermore, as of the September FOMC meeting, less than half the voting members, specifically seven of seventeen, project a lower rate by year-end, and five of the seventeen project a rate hike at one of the two remaining meetings of 2019. In short, it appears that a significant portion of bond futures market participants have assessed Fed policy as behind and in need of additional evolution.

While the Fed may or may not be playing catch-up with respect to its policy rate, for three days in September it appeared the Fed was behind the curve with respect to a different policy tool. After more than a year of allowing its balance sheet to shrink as the government bonds it owned matured, the Fed restarted asset purchases to address a lack of liquidity in the overnight lending market. From September 16 through 18, the effective Federal Funds rate (the interest rate at which overnight borrowers within the Federal Reserve system actually pay) spiked well above the mid-point of the target range and even went above the upper bound of the targeted range on September 17. The spike was driven by a shortage of liquid reserves that could be lent within the system. To remedy the situation, the Fed was compelled to conduct market operations involving the purchase of longer-term assets from lending institutions, thus supplying them with liquid reserves that could be used to satisfy demand for overnight loans. The Fed had not enacted such transactions since the financial crisis 11 years ago.

Though the Fed's action brought the effective Federal Fund's rate back to the mid-point of its target range and helped calm markets that had been unnerved by the overnight reserves rate spike, the change in policy is a potentially troubling sign. This is because Chairman Powell had earlier indicated that the policy approach was such that open market operations, like September's, would not be needed. Specifically, when pressed for clarification on its balance sheet policy during a post-meeting press conference in January, Chairman Powell explicitly articulated that the "ample reserves" policy approach of the Fed would entail setting the Federal Funds rate "without managing the supply of reserves actively." He went so far as to say that their approach would provide "good control of short-term money market rates in a variety of market conditions and effective transmission of those rates to broader financial conditions." In mid-September the market sent a clear signal that reserves were not "ample" enough and a resumption in the growth of the Fed's balance sheet ensued.

Whether the Fed policy evolution is ahead, behind or right on-time remains uncertain. What is more certain is that, if the Fed fails to continue meeting market expectations, there is significant potential for an increase in volatility and a possible disruption of the strong returns posted by both equity and fixed income markets so far this year. As we wrote in our May and August Market Perspectives, we see the differing responses to upticks in uncertainty from implied volatility markets and interest rate markets as an indicator that many market participants are counting on the Fed to be effective managers of investment risk. Recently, at the same time there has been a strong downtrend in interest rate markets in response to negative developments and increasing uncertainty, there has been a muted response from markets that price future equity volatility, like the Chicago Board Options Exchange Volatility Index.

The combined signals from interest rate and implied volatility markets send the message that if interest rates go down, equity market volatility is likely to be low. As investors ponder the contingency in that statement, consider that the mandate of the Fed is to manage employment levels and price stability (inflation). Investors counting on the Fed to perform a function not explicitly part of its mandate may be setting themselves up for disappointment.

Important Information

All data as of 09.30.2019, unless noted otherwise.

For more information and access to additional insights from Gateway Investment Advisers, LLC, please visit www.gia.com/insights.

Gateway Investment Advisers, LLC (Gateway) is an independent registered adviser and a successor in interest to Gateway Investment Advisers, L.P. as of February 15, 2008. Performance information for the Gateway Index/RA Composite shown in this illustration is an asset-weighted composite of discretionary accounts under Gateway's management which share the same investment objectives and hedging strategies.

The Composite was created in January 1993. Prior to January 1, 1993, not all fully discretionary portfolios were represented in composites. Results shown for 1988 through 1992 are those of one representative account.

The Gateway Index/RA Composite net of fee performance results reflect the reinvestment of dividends and other earnings, and reflect the deduction of investment advisory and fees.

The effectiveness of Gateway's strategy might be reduced if the portfolio doesn't correlate to the performance of the index underlying its option positions. Rebalancing of a portfolio may involve tax consequences.

Selling index call options can reduce the risk of owning stocks, but limits the opportunity to profit from an increase in themarket value of stocks in exchange for up-front cash at the time of selling the call option. Unusual market conditions or the lack of a ready market for any particular option at a specific time may reduce the effectiveness of the Composite's option strategy, and for these and other reasons the Composite's option strategy may not reduce the volatility to the extent desired.

Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results. A more detailed description of Gateway's standardized fees is included in Form ADV, Part 2.

The Annual Disclosure Presentation for the Gateway Index/RA Composite is included with this document. Additional copies are available upon request by calling 513.719.1100.

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Data Source: Gateway Investment Advisers, LLC and Morningstar Direct℠

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Gateway Index/RA Composite

GIPS® Composite Report

Year End	Annual Performance Results				3-Year Standard Deviation			Number of Composite Accounts	Composite Dispersion	Composite Assets (millions)	Firm Assets (millions)
	Composite Gross	Composite Net	S&P 500® Index	Bloomberg Barclays U.S. Aggregate Bond Index	Composite	S&P 500® Index	Bloomberg Barclays U.S. Aggregate Bond Index				
1993	8.44%	7.75%	10.08%	9.75%	N/A	N/A	N/A	15	0.7	$348	$408
1994	6.27	5.62	1.32	-2.92	N/A	N/A	N/A	14	0.5	303	660
1995	12.52	11.75	37.58	18.47	4.07%	8.34%	4.30%	12	1.6	283	473
1996	11.83	11.11	22.96	3.63	4.44	9.72	4.65	27	0.9	329	360
1997	13.34	12.58	33.36	9.65	3.83	11.30	4.06	27	1.1	399	476
1998	13.21	12.49	28.58	8.69	5.53	16.24	3.58	44	1.2	686	805
1999	12.94	12.27	21.04	-0.82	5.39	16.76	3.25	76	1.4	1,348	1,470
2000	6.55	6.08	-9.10	11.63	5.30	17.67	3.06	107	1.2	2,052	2,206
2001	-2.69	-3.28	-11.89	8.44	6.29	16.94	3.40	85	0.5	1,853	1,944
2002	-3.87	-4.45	-22.10	10.25	9.41	18.81	3.40	67	0.4	1,651	1,744
2003	12.53	11.84	28.68	4.10	9.70	18.32	4.26	59	0.4	2,029	2,160
2004	7.84	7.22	10.88	4.34	8.35	15.07	4.34	53	0.5	3,350	3,636
2005	5.86	5.17	4.91	2.43	4.09	9.17	4.12	35	0.5	3,879	6,134
2006	11.06	10.35	15.79	4.33	2.64	6.92	3.25	29	0.5	4,569	6,946
2007	8.67	7.99	5.49	6.97	3.10	7.79	2.80	25	0.5	4,780	7,892
2008	-13.39	-13.95	-37.00	5.24	8.41	15.29	4.03	22	1.0	5,073	7,071
2009	7.37	6.70	26.46	5.93	10.36	19.91	4.17	15	0.4	5,054	7,188
2010	5.76	5.11	15.06	6.54	11.01	22.16	4.22	12	0.1	5,552	7,699
2011	3.82	3.16	2.11	7.84	8.27	18.97	2.82	11	0.3	5,729	8,081
2012	5.41	4.74	16.00	4.22	5.84	15.30	2.42	10	0.2	7,424	10,517
2013	9.35	8.64	32.39	-2.02	4.23	12.11	2.75	11	0.2	8,899	12,475
2014	4.23	3.59	13.69	5.97	3.45	9.10	2.67	10	0.3	8,997	12,239
2015	3.20	2.54	1.38	0.55	3.97	10.62	2.92	11	0.2	8,783	12,210
2016	6.23	5.57	11.96	2.65	4.30	10.74	3.02	10	0.3	8,159	11,601
2017	10.73	10.07	21.83	3.54	4.01	10.07	2.81	10	0.2	9,028	12,559
2018	-3.43	-4.04	-4.38	0.01	5.11	10.95	2.88	10	0.1	8,534	11,641

N/A: The gross three-year annualized ex-post standard deviation of the Composite and benchmarks is not presented as 36-month returns are not available.

Gateway Index/RA Composite contains fully discretionary hedged equity accounts which hold common stock and sell index call options on at least 95% of the underlying stock value. This call activity reduces volatility and provides cash flow. The accounts typically buy index put options that can protect the Composite from a significant market decline that may occur over a short period of time. Indexes utilized for call and put option activity are U. S. domestic equity indexes that include all sectors of the economy. The creation and inception date of the Gateway Index/RA Composite was January 1, 1993. As of June 1, 2009, the Composite definition was refined to more accurately reflect the criteria used to determine membership. No membership changes resulted from the revision.

For comparison purposes the Gateway Index/RA Composite is measured against two indexes, the S&P 500® Index (a popular indicator of the performance of the large capitalization sector of the U. S. stock market) and the Bloomberg Barclays U. S. Aggregate Bond Index (an unmanaged index of investment-grade bonds with one- to ten-year maturities issued by the U. S. government, its agencies and U. S. corporations).

Performance results are based on fully discretionary accounts under management, including accounts that may no longer be with the firm, and are expressed in U.S. dollars.

Performance returns are presented gross and net of management fees and include the reinvestment of all income. Past performance is not indicative of future results. The annual Composite dispersion presented is an asset-weighted standard deviation calculated using gross returns for the accounts in the Composite the entire year. The 3-year standard deviation is calculated using gross returns. Net of fee performance was calculated using actual management fees. The current investment management fee schedule is as follows: 0.85% on the first $5 million; 0.65% on the next $5 million; 0.50% on the next $40 million; and 0.45% on assets in excess of $50 million. Actual investment management fees incurred by composite accounts may vary.

Gateway Investment Advisers, LLC (Gateway) is an independent registered investment adviser and a successor in interest to Gateway Investment Advisers, L.P. as of February 15, 2008. Gateway claims compliance with the Global investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. Gateway has been independently verified for the periods January 1, 1993 through September 30, 2019. A firm that claims compliance with the GIPS® standards must establish policies and procedures for complying with all the applicable requirements of the GIPS® standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS® standards and have been implemented on a firm-wide basis. The Gateway Index/RA Composite has had a performance examination for the periods January 1, 1993 through September 30, 2019. The verification and performance examination reports are available upon request.

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Policies for valuing portfolios, calculating performance and preparing GIPS® reports are available upon request. Gateway's lists of composite descriptions and broad distribution pooled funds are also available upon request.