# Pumped up GICS®

## SECTOR CLASSIFICATION CHANGES SET TO UPEND ALLOCATION STRATEGIES

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The system used by virtually all investors to classify companies by economic sectors is about to undergo a seismic shift.

The realignment of the Global Industry Classification Standard (GICS®) will move some of the world's largest and best-performing companies into totally new classifications. The changes in Canadian benchmarks will be fairly limited, but in others, like the widely followed S&P 500, they will be substantial. Most significantly, the small and traditionally value- and income-oriented telecommunications sector will become one of the largest and "growth-iest" sectors of the U.S. equity market. *Continued…*

The changes will propel massive money flows from one sector to another as index-hugging mutual funds and ETFs (exchange traded funds) re-balance their portfolios to align with new-look benchmarks. Investors of all sizes will have to re-examine and perhaps shift their asset allocations to keep them in line with their objectives. And much historical data underpinning security analysis and strategy back testing will be rendered irrelevant, making meaningful fundamental analysis more difficult.

The change is coming Friday September 28, 2018, but some of the effects in markets may be felt earlier as funds with many billions of dollars in assets work to smooth the transition of their portfolios. This paper explains what is happening and why, and examines the implications for retail investors.

## What is GICS® and why is it changing?

GICS is a standardized classification system for equities developed by Standard & Poor's and MSCI Inc. in 1999. It currently consists of 11 sectors (e.g., financials, energy, information technology, etc.), which are then sub-divided into standard industry groups, industries, and sub-industries. It is used by both MSCI and S&P in the construction of all their indices, both domestic and international, including the S&P 500 Composite Index, and Canada's S&P/TSX Composite Index (*Figure 1*). The GICS system, and the indices based on it, are the de facto global standard framework for investment research, asset allocation, and portfolio management. And for the trillions of dollars of investments worldwide that are passively managed in index-tracking ETFs, they guide what stocks are bought and sold.

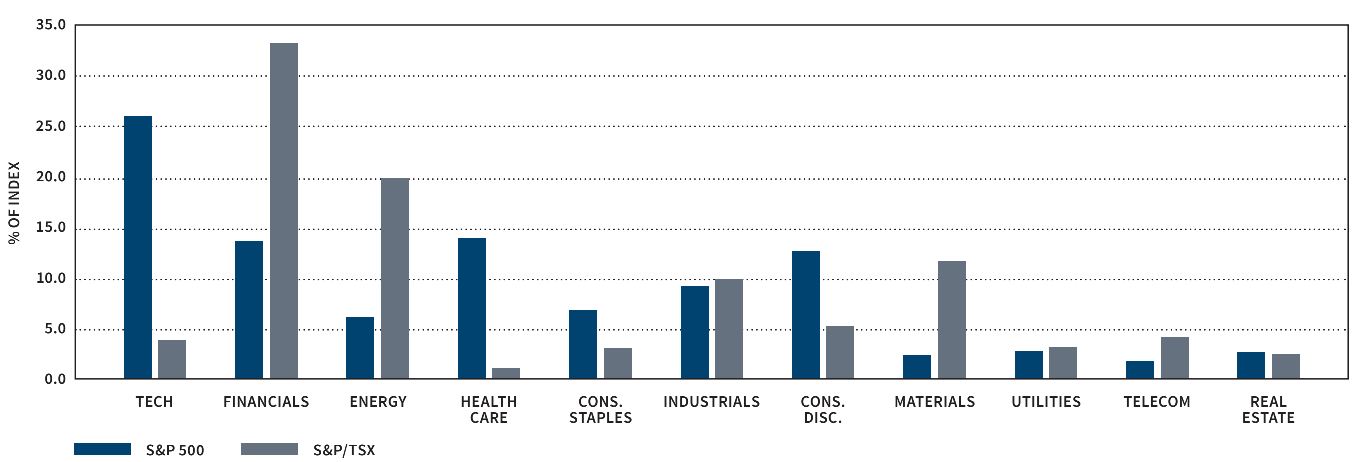
Since the adoption of GICS, the system has had only one previous sector change. In 2016, real estate, which had previously been an industry group within the financials sector, was separated out to become its own sector. The split was fairly straightforward and involved a relatively small portion of market capitalization: less than 3% each of the S&P 500 and S&P/TSX indices.

The GICS structure is intended to approximately represent global equity markets in a way that enables investors and analysts to make consistent, meaningful comparisons by industry. The changes set to take effect in September recognize that technology, particularly internet technology, has become integrated into almost all aspects of the way companies do business. It has also changed the nature of many industries, in terms of who competes with whom, for which customers, and by what means.

***FIGURE 1.***

GICS Weights

SOURCE: BLOOMBERG, IG INVESTMENTS – JUNE 30, 2018



In its November 2017 announcement of the proposed changes, S&P Dow Jones Indices said "the last several years have seen an evolution in the mode in which people communicate and access entertainment content and other information. This evolution is a result of the integration between telecommunications, media, and internet companies. Companies have moved further in this direction by consolidating through mergers and acquisitions and many now offer bundled services such as cable, internet services, and telephone services. Some of these companies also create interactive entertainment content and aggregate information that is delivered through multiple platforms such as cable and internet, as well as accessed on cellular phones." According to David Blitzer, Chairman of the S&P Dow Jones Index Committee, "it is time to acknowledge this convergence and the overlapping services these companies provide."

## What are the proposed changes?

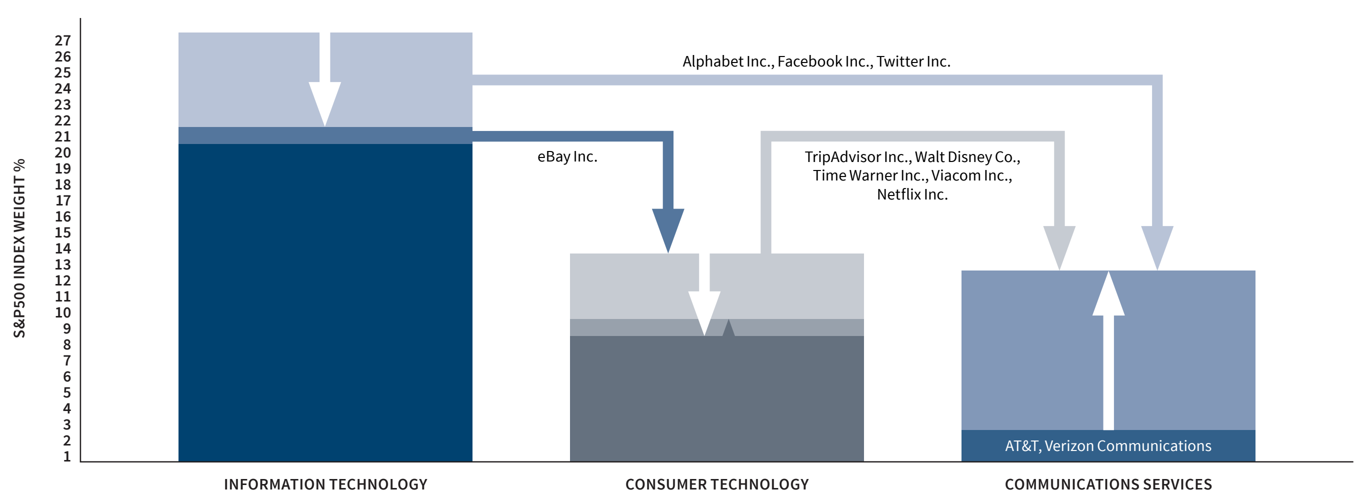
### Overview

The coming changes to GICS can be lumped into three broad components.

1. The telecommunications services sector is being broadened and renamed as **communications services** to include companies that facilitate communication, or offer information or content through various media. This element will reclassify many companies currently found within the information technology and consumer discretionary sectors (see Figure 2).
2. Within consumer discretionary, the **internet & direct marketing retail** sub-industry will be updated to include all online consumer marketplaces, regardless of whether they hold inventory. This will draw into consumer discretionary some names currently found in the internet software & services group within the information technology sector, such as eBay Inc.
3. Within the information technology sector, the remaining names currently classified as internet software & services will be redistributed to the application software group or to a new sub-industry within IT Services called **internet services & infrastructure**.

*FIGURE 2.*

Proposed 2018 GICS sector shifts with select S&P 500 company examples



## The communications services sector

The renamed sector is about to become a lot more exciting and relevant. The injection of three out of the four FANG stocks (Facebook, Netflix, and Google (Alphabet)) will make the hitherto bland and defensive sector home to some of the market's darlings. Other prominent names the new sector will inherit include Disney and Viacom. Whereas the sector until now has drawn mainly risk-averse investors seeking reliable dividends from bond-proxy stocks, it will going forward have the highest exposure in the S&P 500 to growth-style factors among all 11 GICS sectors, according to an analysis conducted by State Street Global Advisors based on Morningstar style definitions (Matthew J. Bartolini "GICS Changes Upend the Sector Apple Cart", SPDR Blog, State Street Global Investors, January 19, 2018).

The prospective new communications sector is expected to have a dividend yield below that of the revised technology group, likely well below 1%, forcing investors currently in the sector for higher dividends to look elsewhere. With many mega-cap names moving to a new sector that will have fewer components than either the current technology or consumer discretionary sectors, the more highly concentrated new sector is likely to display elevated volatility and stock-specific risk compared to the two other revised groups. The new sector will be more cyclical, rather than defensive, and also be much more sensitive to the value of the U.S. dollar. Under the current classifications, foreign sales represent less than 3% of the S&P 500 sector's revenues. Foreign revenues for the revised sector will be over 30% of sales.

The communications sector will jump from less than 2% of the S&P 500's weight to roughly 12%, making it the fourth largest of the S&P 500's 11 groups. It will contain two industry groups: Telecommunications Services and Media & Entertainment. The telecommunications services industry group will include the sector's legacy service providers such as AT&T and Verizon. Providers of internet access service will also be classified here.

The media & entertainment group, which will draw many names currently classified in consumer discretionary or information technology, will be divided into three sub-groups: media, entertainment, and interactive media & services:

- **Media** – will include companies engaged in advertising, broadcasting, cable and satellite, and publishing.
- **Entertainment** – will include firms producing and selling entertainment products and services, as well as those making interactive home entertainment, games, mobile gaming applications, and online entertainment streaming companies.
- **Interactive media & services** – will include companies creating content or distributing content or information through proprietary platforms. This includes search engines, social media and networking platforms, and online classified ads or review companies (e.g., TripAdvisor).

In Canada, the shakeup will see media names such as Shaw Communications, Cogeco Communications, Québecor, Corus Entertainment, and Cineplex moved from consumer discretionary to join Rogers Communications, BCE Inc., and TELUS under the new communications sector umbrella, boosting the sector from roughly 4.4% of the S&P/TSX weight to approximately 5.3%.

## The information technology sector

The information technology sector is going to lose some of the prominent names that have helped drive its recent market leading performance, notably Facebook and Google parent Alphabet. These two names alone have a combined market capitalization of US$1.3 trillion and an S&P 500 weight of roughly 4.9%. The removal of these tech giants will meaningfully change the look of the information technology GICS sector in the S&P 500, making allocations to the sector or to technology mutual funds and ETFs significantly less attractive to many investors. In fact, the sector will no longer house any of the so-called FANG stocks (Facebook, Amazon, Netflix, Google (Alphabet)) that have been widely associated with the sector's dominance. (Technology will still include Apple Inc., for those more interested in the broader '*FAANG*' grouping.) The technology sector in Canada's S&P/TSX Composite, currently comprising only 4% of the overall index weight, will be relatively unaffected.

The tech sector in the S&P 500 will shrink from roughly 27% of the index to approximately 20%. Within the technology sub-index and funds tracking it, such as the iShares S&P 500 Information Technology Sector ETF, Facebook and Alphabet together comprise 19%. State Street's style analysis of the index components concluded that the exposure of the S&P 500 tech sector to "Growth" will drop from 61% to 49%, ranking it only third among the 11 sectors in terms of growth exposure.

Most of the names being removed from technology come from the Internet Software & Services industry and sub-industry. With the changes, this category will be discontinued and replaced with a new sub-industry called **internet services & infrastructure**, within the IT services industry. The new group will include data centres, cloud networking and storage infrastructure, and web hosting services. Cloud-based software companies will be included in the **application software** sub-industry.

### The consumer discretionary sector

The consumer discretionary sector is set to shrink from roughly 13% to 9% in the S&P 500, and from approximately 5.5% to 4.6% in the S&P/TSX Composite.

The most significant change to the sector is the loss of the media industry group. With this shift, consumer discretionary is going to lose some of the stocks that have boosted performance in recent years, most notably NetFlix Inc. But it will also lose many names in more traditional media that have struggled in recent years, and gain some high-growth internet retailers. According to State Street's style analysis, the new consumer discretionary will see its "Growth" orientation jump from 51% to 58%, greater than that of the current technology sector.

### Internet & direct marketing retail sub-industry

The update to the internet & direct marketing retail sub-industry recognizes that online marketplaces and e-commerce are becoming a significant share of the overall retail segment. By moving internet shopping platforms like eBay from technology to this group, which already includes Amazon.com Inc., the shift acknowledges that marketplaces for consumer products and services target the same consumers and compete with one another regardless of whether they hold inventory.

## Implications for investors

### Your assumptions about some industries have to change

Some basic assumptions and rules-of-thumb used by investors are about to change. The telecommunications sector has been used for stability and income. Now it will offer one of the lowest dividend yields and be a premier destination for investors seeking high growth. Information technology may no longer be the "go-to" for growth investors.

### The reason you purchased a fund or ETF may no longer be relevant

As suggested above, some mutual funds and ETFs may become a lot less attractive to investors who have used them as shortcuts to get exposure to specific themes such as FANG stocks. Funds using the underlying indices to guide investments, especially the trillions of dollars in passively managed ETFs worldwide, may see drastic rearrangements in their holdings that will alter the characteristics of the funds – in terms of risk, growth potential and income generation. Investors will need to review the strategies of the funds they own to ensure they still own (or will own) the kinds of exposures they are seeking.

In the case of individual stock holdings, some may experience short-term price pressures up or down, depending on whether the repositioning of assets driven by the GICS changes results in the names being either net "buys" or net "sells" (see below). But if you have found a company stock you like with solid fundamentals, it is unlikely that the reclassification of the company from one industry to another within GICS will alter the investment outlook.

## Your industry allocations will likely need to change

Obviously, the changes outlined above suggest investors will need to re-evaluate the sector allocations within their portfolios and reallocate if necessary. Growth opportunities will be more widespread (in terms of GICS). For example, FAANG will now be distributed across three sectors instead of two. If you were seeking growth through the technology sector, it may be more appropriate to spread things out a bit. If you relied on the telecommunications sector for income, you will definitely need to look elsewhere.

## Track records and back-tests will be rendered useless

With such drastic changes to three major sectors, investors and analysts will have a tougher time conducting research and due diligence. Historical relationships and track records of performance based on GICS classifications will become virtually meaningless. For example, broad screens comparing relative valuations within technology and communications services will not provide much insight into the relative attractiveness of current conditions.

Furthermore, investors and individuals constructing back-tests of strategies may find the process no longer reliable. Will a strategy back-test of a technology sector fund still be relevant if companies like Facebook and Alphabet, that were some of the largest contributors to past performance, are no longer in the sector?

## ETF shakeup means some stocks and sectors will be large net *sells or buys*

The GICS reclassifications will impact the vast majority of funds, especially ETFs, that track the information technology, consumer discretionary, and telecoms sectors. In a December 2017 note, Credit Suisse listed 26 passive ETFs with combined assets of over US$60 billion that it warned could be subject to massive money flows as they are compelled to sell holdings that will no longer be in their benchmark indices ("Expect a US$60-bn scramble in ETFs during indexer shakeup," Bloomberg News, December 6, 2017). As implied by the shifts depicted in Figure 2, ETFs that focus on technology and consumer discretionary industries may be forced to sell 20% to 25% of their holdings. Given that the asset sizes of existing telecommunications ETFS are considerably smaller than those devoted to technology and consumer discretionary, it is not unreasonable to assume that in the short term, the stocks of companies moving to the new communications sector will be large net sells. MSCI and S&P Dow Jones plan to release updated lists of all affected securities on August 1 and September 3.

On the other hand, if large amounts of cash are generated in funds selling stocks migrating out of their benchmarks, much of that cash is likely to be reinvested in the remaining names in the technology and consumer discretionary sectors. Stocks like Microsoft, Apple, and Amazon.com could be big beneficiaries of the reinvestment.

Managing the transition poses a challenge to large asset managers with funds that will be forced to mimic the index changes. The release of the list on August 1 of affected companies could pre-empt some of the shock by giving the market time to price in the changes. Some asset managers may use other strategies, such as using special dividends akin to spinoffs, to transition to the new positioning while maintaining continuity for their customers. Some ETF firms used this approach to manage the 2016 separation of real estate from the financials sector. Other funds may look to amend their strategies or benchmarks prior to the September change.

## Now is a good time to review your investment portfolio with your advisor

The upcoming changes to the GICS system promise to shake up the strategies and methodologies of investors large and small. Some of the changes could make mutual funds and ETFs that have been market darlings significantly less attractive to investors. The growth and income characteristics of some of the largest market sectors are going to change dramatically, especially given the outsized impact some of the migrating tech giants have had on recent returns. Managers of many investment funds – not just passively managed ones – may have to overhaul their methodologies. It may be a good idea to sit down with your financial advisor now to review your asset allocation and take any steps necessary to avoid being caught with inappropriate or unwanted exposures. ●