

## Structural changes coming to stock sectors

*Date: July 24, 2018*

### Situation overview

On September 28, 2018, the Global Industry Classification Standard (GICS®) will undergo structural revisions that will reclassify roughly 2,150 companies globally within the following GICS sectors:

- Consumer Discretionary
- Information Technology
- Communications Services (formerly Telecommunications Services)

The proposed changes are intended to reflect two ongoing trends:

1. Several companies are integrating the once standalone businesses of advertising, content and information delivery.
2. New technologies and business models, such as social media, e-commerce and the cloud, are disrupting and/or being integrated into mature industries, such as retail and leisure.

The revisions are significant because GICS underpins the construction and measurement of widely used market indices — in particular, indices offered by such firms as S&P Dow Jones and MSCI. Within the S&P 500 Index, 23 companies, representing 10.7 percent of the index's market capitalization, will be affected. That said, no company is expected to leave the index, nor see a change in its index weight, due to the reclassification.

### Investor takeaways

- 1. Diversified investors are unlikely to be affected and should ignore short-term volatility.**  
Portfolio rebalancing being undertaken by major market participants may briefly heighten volatility in the weeks leading up to and after September 28, 2018. For most clients with diversified equity holdings, the long-term economic impact of the revisions should be negligible.
- 2. Growth-oriented investors should revise their mental models and sector exposures.**  
The Communications Services sector will be transformed from a small, yield-oriented and low-growth sector (legacy telecom companies) into a low-yielding and high-growth sector, with exposure to media (traditional, social and streaming), entertainment and internet services. Growth-oriented investors should no longer ignore the sector.
- 3. The revisions enable sector-constrained active managers to make bigger sector bets.**  
The reclassification of technology-linked companies out of the Information Technology sector provides active managers with more flexibility to overweight or underweight technology-linked themes. Constrained active managers can now make bigger, bolder bets, which makes a robust manager selection process that much more important.

Consult with your portfolio manager or advisor to learn how the upcoming GICS revisions may impact equity risk within your portfolio and, if changes are warranted, how to appropriately re-position your investments going forward.

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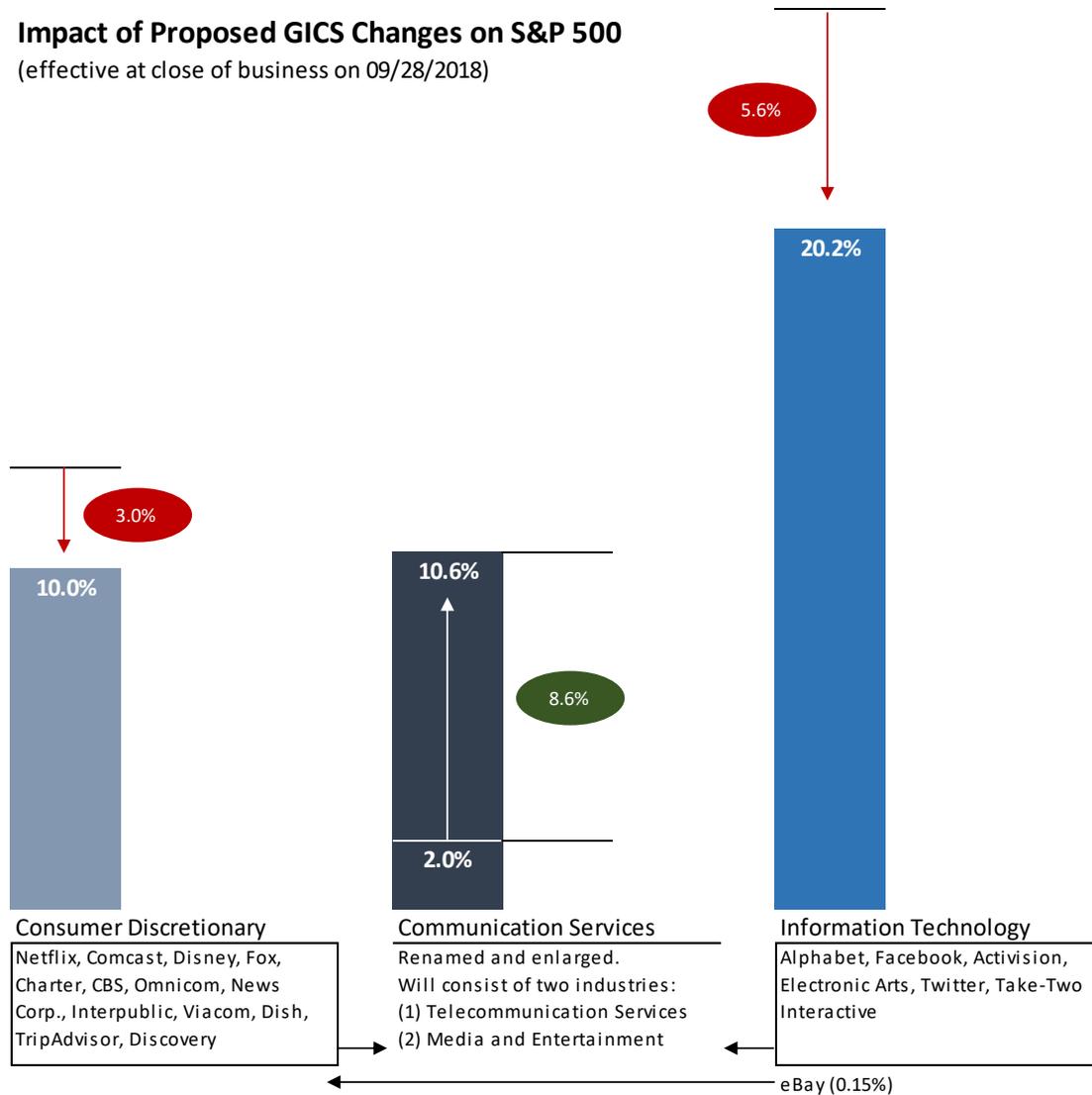
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## SITUATION ANALYSIS

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### Impact of Proposed GICS Changes on S&P 500

(effective at close of business on 09/28/2018)



Source: U.S. Bank Wealth Management

Note: Numbers may not add up due to rounding.

### GICS structure to undergo significant change

On November 15, 2017, MSCI and S&P Dow Jones announced revisions will be made to the GICS structure. These changes will be implemented as of the close of business on September 28, 2018.

The key changes are:

- Telecommunication Services will be broadened and renamed as Communication Services.
- Media companies will move from Consumer Discretionary to Communication Services.
- Internet services companies will move from Information Technology to Communication Services.
- E-commerce companies will move from Information Technology to Consumer Discretionary.

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The most significant of these proposed changes is that Communications Services will be broadened by the inclusion of roughly 1,700 companies globally (19 in the S&P 500 Index) previously classified under Consumer Discretionary and Information Technology.

Content providers, such as Netflix, Facebook and Alphabet (YouTube), use phone and cable companies' infrastructure to deliver services and products that are more popular than what the infrastructure owners themselves can provide. Meanwhile, legacy communications companies have long been willing to spend tens of billions of dollars to acquire content they can bundle with infrastructure (e.g., AT&T/Time Warner and Comcast/Fox). Under the new GICS structure, both content providers and distribution infrastructure providers will be housed within the same sector (i.e., Communications Services).

#### Media industry group finds a new home

Media will move into the Communication Services sector and will be renamed Media & Entertainment. It will contain three sub-industries:

Media	Entertainment	Interactive media & services
<i>Advertising, broadcasting, cable and satellite and publishing.</i>	<i>Film studios, theaters, online streaming video, games and gaming applications.</i>	<i>Content and information creation (esp. proprietary platforms), including search engines, social media and networking platforms and online review companies.</i>

#### Internet Software & Services to be discontinued

Internet Software & Services is both an industry and a sub-industry under Information Technology. It will be discontinued and its constituent companies will be reclassified and distributed between the Communication Services, Consumer Discretionary and Information Technology sectors.

#### Major indices will be impacted

Roughly 10.7 percent of the market capitalization of the S&P 500 Index (23 companies across three sectors) will be affected. However, no company is expected to leave the index, nor see a change in its index weight, due to the reclassification.

Sector weight impact (S&P 500)	Current <sup>1</sup>	Proposed <sup>2</sup>	Difference
Consumer Discretionary	12.9%	10.0%	-2.9%
Information Technology	25.9%	20.2%	-5.7%
Telecommunication Services	2.0%	-	-2.0%
Communication Services	-	10.6%	+10.6%

<sup>1</sup> as of 06/29/2018

<sup>2</sup> effective 09/28/2018, based on 06/29/2018 closing weights

Sources: S&P Global, FactSet, U.S. Bank Wealth Management

#### Key dates

- July 2, 2018: First official list of impacted companies released
- September 21, 2018: S&P Indices implementation date
- September 28, 2018: GICS structure officially changed at close of business
- November 30, 2018: MSCI indices implementation date

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### Characteristics of affected sectors

1. Consumer Discretionary
  - Revenue and earnings growth, as well as dividend yield, should remain largely unchanged.
2. Information Technology
  - Slight decrease in revenue and earnings growth rates, with yield increasing slightly.
3. Communication Services
  - Significantly higher revenue and growth but lower dividend yield.

Estimated impact (S&P 500)	Revenue growth (last 12 months) <sup>2</sup>		Dividend yield		Price/earnings (P/E) (last 12 months) <sup>3</sup>	
	Current <sup>1</sup>	Proposed	Current <sup>1</sup>	Proposed	Current <sup>1</sup>	Proposed
Consumer Discretionary	14.6%	15.2%	1.3%	1.3%	23.5x	30.9x
Information Technology	18.7%	15.3%	1.2%	1.6%	31.5x	28.8x
Telecommunication Services	1.0%	-	5.7%	-	7.3x	-
Communication Services	-	20.0%	-	1.4%	-	17.7x

<sup>1</sup> as of 06/29/2018

<sup>2</sup> index-weighted average of underlying companies

<sup>3</sup> (total market cap of sector) ÷ (sum of trailing 4-quarter net incomes of underlying companies)

Sources: S&P Global, FactSet, U.S. Bank Wealth Management

### Implications for individual stocks

The reclassification of a company has no bearing on its operating and financial fundamentals and thus no impact on its intrinsic value in the long run. Also, since the reclassification itself neither removes any constituent from the broad index nor alters its index weight, any impact on individual stocks should be short-lived.

Lastly, because the proposed changes have been communicated well in advance, major market participants are likely to have completed their rebalancing activity in advance of the transition date. Stocks that are typically volatile may see a period of above-normal volatility, but that is unlikely to persist.

### Potential indirect consequences

Many institutional investors and active managers are sector constrained (i.e., their mandates do not allow overweighting or underweighting sectors beyond nominal amounts). Managers are sometimes also constrained by limits to the number of holdings in a fund or portfolio.

Under the new GICS structure, sector-constrained managers who seek higher technology exposure may now achieve that more easily since they can *both* purchase (or continue to hold) technology stalwarts that have been reclassified to other sectors *and* purchase additional lesser-known technology companies (still within the Information Technology sector) that may have been crowded out in the past.

The opposite could also be true. Sector-constrained managers who seek lower technology exposure may now achieve that more easily since they can *both* sell the technology stalwarts they may have owned and that have now been reclassified to other sectors *and* underweight the updated (smaller) Information Technology sector.

### Conclusion

Diversified investors are unlikely to be affected by the upcoming GICS revisions and should ignore any related short-term volatility. Growth-oriented investors may wish to revise their mental models and sector exposures particularly since the once-sleepy Telecommunications Services sector will now house names like Facebook and Alphabet (Google). Last, but not least, previously sector-constrained active managers may now be able to make bigger technology-themed bets, which could, in some cases, lead to higher risks.

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