SPDR SPOTLIGHT

GICS® Sector Structure Changes: What Do They Mean for Investors?

By Matthew J. Bartolini, CFA, *Head of SPDR Americas Research* and Anqi Dong, CFA, CAIA, *Senior Research Strategist*

Key Takeaways

- On September 21, 2018, the Telecommunication Services sector will be expanded to include companies from the **Consumer Discretionary** and **Information Technology** sectors and renamed **Communication Services.**
- The changes will boost the presence of Communication Services and reduce the weight of the Technology sector in the S&P 500 Index.
- Adding some Technology and Consumer Discretionary names will increase the Telecommunication Services sector's global footprint, making it less domestically-focused.
- The new Communication Services sector will potentially provide investors a growth-oriented exposure with lower leverage, higher operating margin and potentially less volatile Return on Equity (ROE), making it less of a bond proxy.
- The updated Communication Services and Consumer Discretionary sectors are trading at higher multiples than the old sector while Technology valuations remain largely the same.

The Biggest Impact on the Sector Landscape in GICS History Affects:

- **8%** of the S&P 500 Index market cap
- **80%** of the S&P 500 Telecommunication Services Index
- **25%** of the S&P 500 Consumer Discretionary Index
- **20%** of the S&P 500 Information Technology Index

Source: Bloomberg Finance L.P., State Street Global Advisors, as of 02/28/2018.

Following the annual review of the Global Industry Classification Standard (GICS®) structure in 2017, S&P Dow Jones Indices and MSCI announced some major upcoming changes to the GICS structure. Specifically, on September 21, 2018, the Telecommunication Services sector will be expanded to include selected companies from Consumer Discretionary and Information Technology sectors and renamed Communication Services. In addition, eBay will be moved from the Information Technology sector to the Consumer Discretionary sector.

Given that more than 8% of the S&P 500 Index Market Cap will be re-classified,[1] these changes will have the biggest impact on the sector landscape in GICS history. The impacts on individual sectors are even more significant. Approximately 80% of the S&P 500 Telecommunication Services index market cap will be reallocated to the new names, and approximately 25% and 20% of the S&P 500 Consumer Discretionary and Information Technology Index market cap will be removed from the indices (See Figure 1). They will create a new landscape of growth-oriented exposures and require sector investors to alter their sector evaluation.

To explore the potential impact of these shifts on sector investing, we performed an analysis of new sectors based on the currently known list of large-cap companies expected to be impacted by the upcoming changes. To create the new sectors, we:

- Reallocated these companies to their new sectors and weighted them by market cap.
- Took a bottom-up approach, capturing historical information at the stock level and aggregating it at the sector level, and evaluated the new sector at the time when we composed the piece.

This allowed us to avoid back testing — our analysis represents historical information repackaged under a different label and only evaluates the new sector at the time when we composed the piece.

STATE STREET GLOBAL ADVISORS

SPDR®

Figure 1: Announced List of the S&P 500 Securities Expected to Be Re-classified

Ticker	Name	Weight (%) within their Current S&P 500 GICS Sector Index	Current Industry Group	Current Sub-Industry
From Consumer Discretionary to Communication Services				
IPG	Interpublic Group of Cos Inc/The	0.31	Media	Advertising
OMC	Omnicom Group Inc	0.59	Media	Advertising
CBS	CBS Corp	0.65	Media	Broadcasting
DISCA	Discovery Communications Inc — Class A	0.13	Media	Broadcasting
DISCK	Discovery Communications Inc — Class C	0.16	Media	Broadcasting
SNI	Scripps Networks Interactive Inc	0.29	Media	Broadcasting
CHTR	Charter Communications Inc	2.24	Media	Cable & Satellite
CMCSA	Comcast Corp	5.81	Media	Cable & Satellite
DISH	DISH Network Corp	0.32	Media	Cable & Satellite
TWX	Time Warner Inc	2.50	Media	Movies & Entertainment
FOXA	Twenty-First Century Fox Inc — Class A	1.33	Media	Movies & Entertainment
FOX	Twenty-First Century Fox Inc — Class B	0.54	Media	Movies & Entertainment
VIAB	Viacom Inc	0.41	Media	Movies & Entertainment
DIS	Walt Disney Co/The	5.33	Media	Movies & Entertainment
NWSA	News Corp — Class A	0.21	Media	Publishing
NWS	News Corp — Class B	0.07	Media	Publishing
NFLX	Netflix Inc	4.75	Retailing	Internet & Direct Marketing Retail
TRIP	TripAdvisor Inc	0.15	Retailing	Internet & Direct Marketing Retail
	Total Weight	**25.79**		
	Total Number of Stocks	**18**		
From Information Technology to Communication Services				
ATVI	Activision Blizzard Inc	0.95	Software & Services	Home Entertainment Software
EA	Electronic Arts Inc	0.65	Software & Services	Home Entertainment Software
GOOGL	Alphabet Inc — Class A	5.65	Software & Services	Internet Software & Services
GOOG	Alphabet Inc — Class C	5.72	Software & Services	Internet Software & Services
FB	Facebook Inc	7.30	Software & Services	Internet Software & Services
	Total Weight	**20.27**		
	Total Number of Stocks	**5**		
From Information Technology to Consumer Discretionary				
EBAY	eBay Inc	0.71	Software & Services	Internet Software & Services

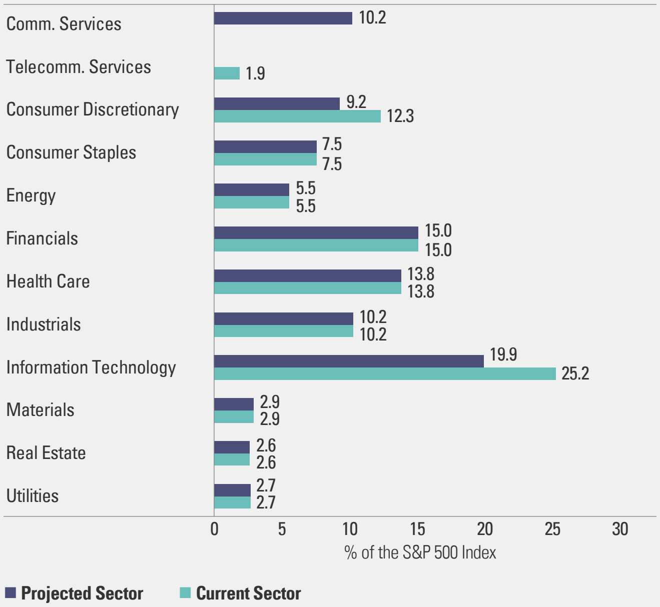
Source: S&P Dow Jones Indices, as of 02/28/2018.

The New Communication Services Sector

The new Communication Services sector will broaden its reach to include companies that facilitate communication and offer related content and information through various types of media. Under the new definition, the sector will include existing Telecommunication companies, such as AT&T; selected companies from the Media Industry Group, such as Comcast and News Corp; selected companies from the Internet & Direct Marketing Retail Sub-Industry, such as Netflix and selected companies from the Information Technology sector, like Facebook. This upgrade of the Telecommunication Services sector is designed to reflect modern communication activities and information delivery mechanisms.

The Communication Services sector will represent roughly 10% of the S&P 500® Index market cap, compared with the 2% weight of the current Telecommunication Services sector. The new sector will be comprised of approximately

Figure 2: S&P 500 Index Sector Weights



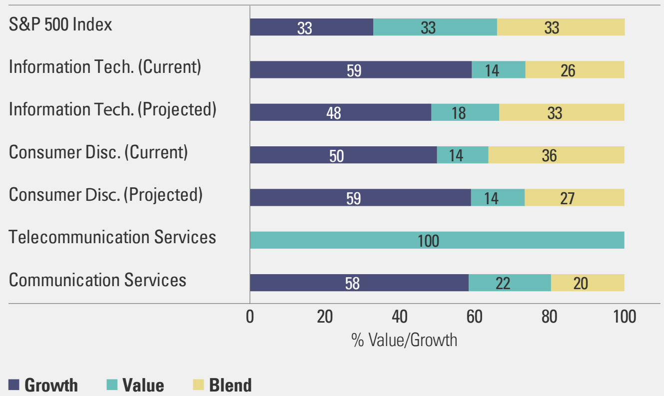
Source: Bloomberg Finance L.P., as of 02/28/2018. Characteristics are as of the date given and should not be relied upon as current thereafter.

31% Consumer Discretionary, 50% Technology and 18% Telecommunication stocks based on their current GICS sector classification. Because of the joining of tech companies, the new sector will increase its global footprint, with 32% of revenues coming from overseas, compared to merely 3% in the current Telecommunication sector.

More Growth Options for Sector Investors

Historically, the Telecommunication Services sector was viewed under a "value" lens due to its number of bond-proxy, high dividend-paying stocks. As more growth-oriented stocks are moved to Communication Services, the new sector may capture more growth exposures and be viewed under the "growth" lens. Based on the Morningstar Style Box classification of new constituents, Communication Services will hold a majority — 58% — of growth stocks, whereas the current Telecommunications Services consists of 100% value stocks. However, the changes do not completely strip growth from Consumer Discretionary and Information Technology. These sectors will have a 59% and a 48% allocation to growth stocks, respectively — numbers that are higher than the broader market. See Figure 3.

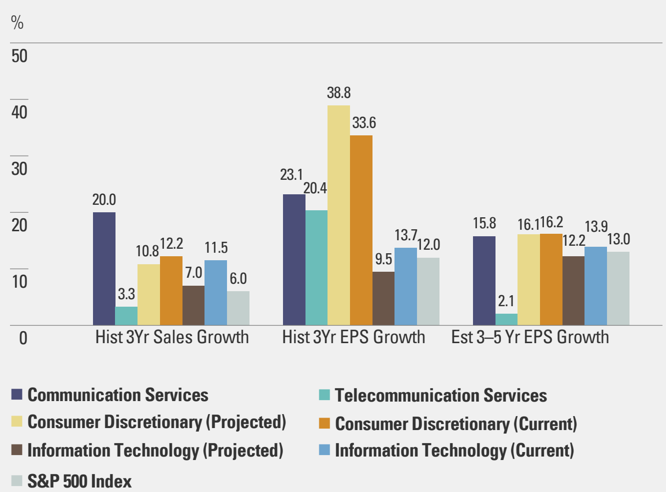
Figure 3: GICS Sector Style Exposure



Source: Morningstar, FactSet, as of 02/28/2018. Characteristics are as of the date given and should not be relied upon as current thereafter.

Nevertheless, Communication Services' growth tilt is reinforced when examining the historical growth rates of its underlying companies and their consensus analyst estimates for the next three to five years. As shown in Figure 4, the new sector will result in a portfolio of stocks that have produced — and are expected to produce — a high level of earnings and sales growth. These growth rates are projected to be above that of the broader market.

Figure 4: GICS Sectors' Underlying Growth Dynamics



Source: FactSet, as of 02/20/2018. Characteristics are as of the date given and should not be relied upon as current thereafter. Estimated growth rates based on Consensus Analyst Estimates compiled by FactSet.

Figure 5: Valuation Characteristics

	Communication Services	Telecommunication Services	Consumer Discretionary (Projected)	Consumer Discretionary (Current)	Information Technology (Projected)	Information Technology (Current)	S&P 500 Index
Price to Earnings	16.7	7.1	26.8	21.4	29.2	31.9	22.2
Forward Price to Earnings	18.6	10.7	22.1	21.0	18.2	19.4	17.6
Price to Cash Flow	10.9	5.4	14.6	12.4	17.1	18.4	13.1
Price to Book	3.7	2.1	6.1	5.0	6.1	6.0	3.2
15 Year Average P/E	19.8	19.4	18.9	18.8	20.1	20.7	17.3
% Above/Below 15 Year Avg P/E (%)	-16	-64	42	14	45	54	28
Premium/Discount to S&P 500 based on P/E (%)	-25	—	21	—	31	—	—
15 Year Avg Premium/Discount to S&P 500 (%)	15	—	9	—	16	—	—

Source: FactSet, as of 02/28/2018. Characteristics are as of the date given and should not be relied upon as current thereafter.

Growth at What Cost?

What is the price associated with these new growth dynamics? To answer this question, we chose four fundamental metrics, while also comparing the current aggregated sector level Price-to-Earnings (P/E) ratio versus the same group of stocks historical average P/E ratio over the past 15 years. The latter point may provide insight into whether the new sector will be more expensive, fundamentally speaking, versus what history would indicate.

Figure 5 shows the new Communication Services and the Consumer Discretionary sectors are trading at higher multiples than the old sector while tech valuations remain largely the same. However, a value opportunity exists in the new Communication Services, as the new sector is trading below its 15-year average P/E and at a greater discount to the S&P 500 than its historical average.

Impact on Sector Quality

The ROE of the Telecommunication Services has historically been volatile. As measured by standard deviation, its ROE volatility is almost three times that of the broad market.[2] Part of the reason for this volatility is the sector's high financial leverage. As shown in Figure 6, the new sector will have far less leverage, measured by the long-term debt-to-capital (LTC) percentage. As its ROE comes down from an abnormally high number, relying less on leverage makes it potentially less volatile. The operating margin for the new sector will be higher, indicating greater profitability from ongoing business. The leverage and profitability profile of the other two sectors shifts only slightly after the change. See Figure 7.

Figure 6: Quality Characteristics: Communication Services and Telecom

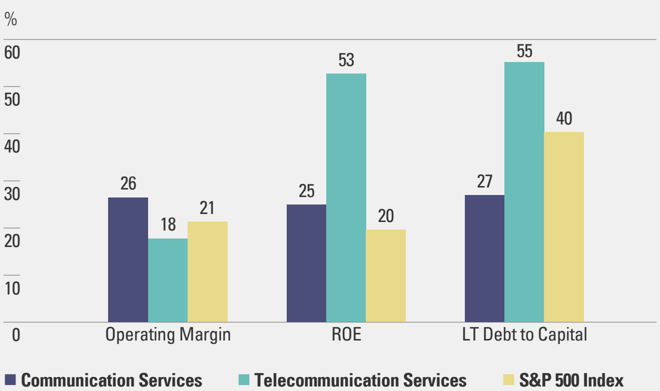
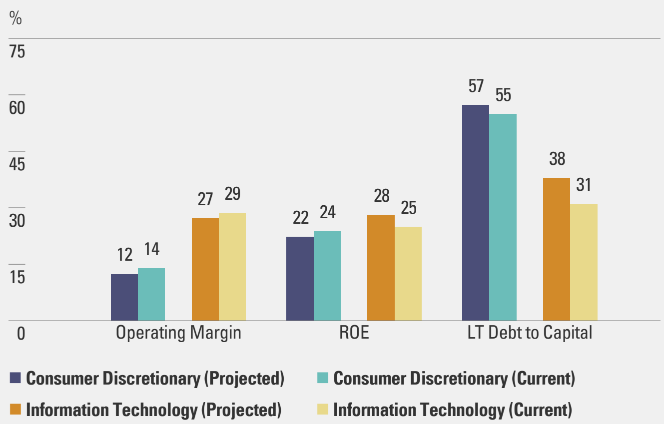


Figure 7: Quality Characteristics: Consumer Discretionary and Information Technology



Source: FactSet, as of 02/28/2018. Characteristics are as of the date given and should not be relied upon as current thereafter.

Changes Nix Communication Services as a Bond Proxy

Sectors are closely aligned to specific economic variables. Figure 8 shows the beta of the new and current sectors based on the constituents' beta. Note that the Communication Services sector will be more sensitive to the equity market and less sensitivity to the US 10-year Treasury yield. This is no surprise, given that the dividend yield of the new sector is less than 2%, compared to more than 5% for the current Telecommunication Services sector.[3] The new set of communication stocks will not be the typical bond proxies like the current Telecommunication sector.

Figure 8: 36-Month Beta Sensitivity

	US 10 Year Yield	Yield Curve (US 10 Yr– US 2 Yr Yield)	S&P 500 Index
Communication Services	0.01	-0.01	0.98
Telecommunication Services	-0.10	-0.04	0.54
Consumer Discretionary (Projected)	0.09	-0.02	1.13
Consumer Discretionary (Current)	0.11	0.02	1.15
Information Technology (Projected)	0.08	0.00	1.16
Information Technology (Current)	0.05	-0.02	1.13

Source: FactSet, as of 02/28/2018. Characteristics are as of the date given and should not be relied upon as current thereafter.

Time to Upgrade Your Sector Due Diligence

These upcoming GICS changes mean sector growth opportunities will become more widespread. The new Communications Services sector also will be more cyclical than Telecommunication Services, which was more defensive.

Unfortunately, this sector revamp also means performing a bottom-up fundamental analysis or a top-down macro analysis will become more difficult. Investors can no longer simply run a screen based on historical values because the Informational Technology sector from the last ten years will look different for the next ten. Momentum-based sector rotation strategies will also need to course-correct given that the new Communication Services sector will have 11 constituents that rank in the top 50% of performers in the S&P 500—while the former Telecommunication Services sector had none.[4]

[1] Bloomberg Finance L.P., as of 02/28/2018.

[2] FactSet, as of 02/28/2018. The broad market is represented by the S&P 500 Index.

[3] FactSet, as of 02/28/2018.

[4] FactSet, as of 02/28/2018.

Glossary

Back testing The process of testing a trading strategy or method on relevant historical data to analyze its accuracy and viability before the trader risks any actual capital. A trader can simulate the trading of a strategy over an appropriate period of time and assess the results for the levels of profitability and risk.

Beta measures the sensitivity of the return of a security or portfolio in relation to other indicators. A beta of 1 indicates the security will move with the indicator. A beta of 1.3 means the security is expected to be 30% more volatile than indicator, while a beta of 0.8 means the security is expected to be 20% less volatile than the market.

GICS, or Global Industry Classification Standard A financial-industry guide for classifying industries that is used by investors around the world.

Price-to-earnings multiples, or P/E Ratio A valuation metric that uses the ratio of the company's current stock price versus its earnings per share.

Return on Equity (ROE) The amount of net income returned as a percentage of common shareholders' equity. ROE shows how well a company uses investment funds to generate earnings growth.

S&P 500 Index A popular benchmark for U.S. large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.

Sector Rotation A strategy based on moving investments across business sectors to take advantage of cyclical trends in the overall economy whereby a portfolio may overweight positions in strong sectors and underweight positions in weaker sectors.

Yield Curve A graph or line that plots the interest rates or yields of bonds with similar credit quality but different durations, typically from shortest to longest duration.

State Street Global Advisors One Lincoln Street, Boston, MA 02111-2900.
T: +1 866 787 2257.

ID12328-2055319.1.1.GBL.RTL 0318 Exp. Date: 02/28/2019