LPL RESEARCH

WEEKLY MARKET COMMENTARY

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S&P SECTOR SWITCHEROO

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KEY TAKEAWAYS

S&P 500 GICS sectors will undergo a significant shift later this month with a big revamp and expansion of the telecommunication services sector.

Investors employing sector strategies should be aware of the changes, which will also alter the makeup of the consumer discretionary and technology sectors.

S&P GICS sectors to undergo a significant makeover later this month. Effective September 28, S&P Dow Jones Indices will make significant changes to its Global Industrial Classification Standard—referred to as GICS. Index provider MSCI will follow with its own updated indices in early December. Reclassifying companies into different sectors may not sound like a big deal, but this one will be quite meaningful—even more so than the addition two years ago this week of real estate as an S&P GICS sector. Here we discuss the implications of creating the new communication services sector and changes to the consumer discretionary and technology sectors.

WHAT'S HAPPENING

About three weeks from now, the telecommunication services sector will be greatly expanded and renamed "communication services." The stocks that will be added to the expanded sector are mostly media and internet companies within the consumer discretionary and technology sectors, with a focus on digital advertising and social media. In fact, after the changes, three of the original four "FANG" stocks (Facebook, Amazon, Netflix, and Google) will be part of the new communication services sector.

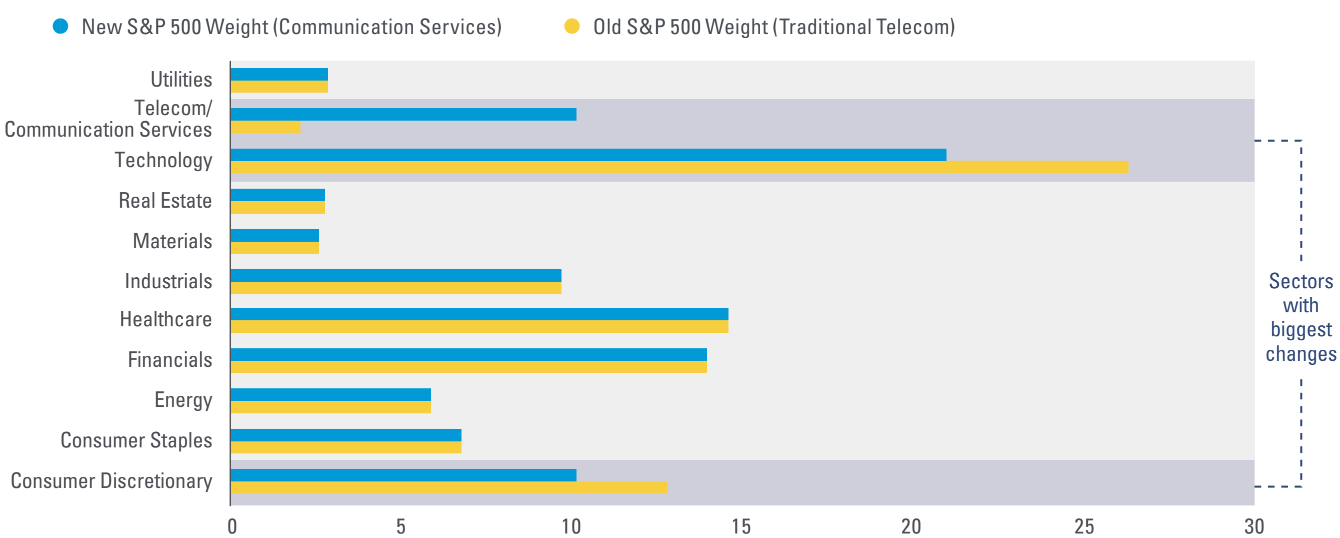
The information technology sector, which will be impacted most, will see about 5 percentage points trimmed from its current 26% weight in the S&P 500 Index. The haircut for consumer discretionary will be smaller at just under 3 points (from 12.8% to 10.1%), and is tempered by eBay's move from technology to consumer discretionary. The end result is that the S&P 500 Index weighting for the telecom services sector—rebranded as communication services—will increase from 2.0% to 10.1% [Figure 1]. Given that more than 8% of the S&P 500 is being reclassified, these changes will have the biggest impact on the sector landscape in the history of the GICS.

WHY DOES THIS MATTER?

For some, this may not be such a big deal. For those investing solely with active mutual funds in the traditional asset classes (small caps, large caps, growth/value, and international), this change may not affect you at all. But for those of you who invest by sector, including using sector exchange-traded funds (ETFs), we think this change may be significant for several reasons:

- **We lose a defensive sector.** Historically, telecom has been considered a defensive sector, meaning its prospects were less dependent on economic growth than the more cyclical, or economically sensitive, sectors. In a weakening economy, consumers tend to forego more discretionary purchases before they give up their cell phones. As a result, telecom stocks—along with consumer staples, real estate, and utilities—have tended to be less volatile than the broader market during sell-offs. The sector's makeover will significantly increase its volatility because more stocks that are sensitive to the fluctuations in the economy and stock market are being added and overwhelming the more defensive dividend-paying stocks that made up most of the legacy telecommunication services sector. The sector will enjoy stronger growth prospects—the average consensus long-term earnings growth forecast is 13% for stocks (FactSet data) that will make up the communication services sector, well above the 3% growth rate for the legacy sector. Investors will have to pay up for that significantly enhanced growth outlook, however, as the sector's next 12 month price-to-earnings ratio (PE) will increase from 10 to approximately 24 (FactSet data, as of August 29).
- **Technology may be lower octane.** Some of the digital advertising and social media stocks that are leaving the technology sector are high-fliers. Losing these historically faster growing technology leaders may dampen the growth prospects for the technology sector, but it also slightly reduces valuations. The five technology companies leaving the sector have an average consensus long-term growth rate of 17%, compared with 14%

1 TELECOMMUNICATION SERVICES REVAMP WILL LEAD TO SIGNIFICANT SHIFT IN S&P 500 SECTOR WEIGHTS



Source: LPL Research, S&P Dow Jones Indices, MSCI, FactSet 08/29/18

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results.

for the sector overall. But those stocks carry an average PE of 29, compared with 19 for the sector (FactSet data). Also keep in mind the smaller technology sector will be more concentrated in its largest holding: Apple.

- **Potentially more demand for traditional telecom names.** The traditional telecommunication services sector had been whittled down to just three stocks after years of consolidation and business model disruption. As a result, the sector drew little interest among sector investors. In fact, most sector strategies were unable to replicate the sector due to rules around concentrated investment products. The revamped communication services sector has become much more attractive to investors, in our view; this may lead to more demand for products tracking the sector and, therefore, some incremental buying in traditional telecom stocks.

These are meaningful changes. Peter Lynch, the famed portfolio manager, once said about stock portfolios, "Know what you own." That advice holds here. For those who own telecom strategies in particular, but also those who use or are considering using consumer discretionary or technology sector strategies such as ETFs, these changes are important to keep in mind.

CONCLUSION

Nearly 10% of the S&P 500 will see a change in sector classifications on September 28, the biggest impact on the sector landscape in the history of the GICS sectors going back to the 1990s. While a company's reclassification may not impact the holder of that particular stock, or its growth or return prospects, the change matters for those using sector equity strategies.

The revamped and rebranded telecom sector—to communication services—will look much different than its predecessor, with superior growth prospects and higher valuations, but also higher volatility. It will no longer be one of the so-called defensive sectors. At the same time, the consumer discretionary sector will have less emphasis on traditional media, while the technology sector will lose some of its internet high-fliers and see its weight in the S&P 500 drop quite a bit. We believe these changes are important for investors to consider. ■

IMPORTANT DISCLOSURES

An investment in exchange-traded funds (ETF), structured as a mutual fund or unit investment trust, involves the risk of losing money and should be considered as part of an overall program, not a complete investment program. Exchange-traded funds concentrating in specific industries are subject to higher risks and volatility than those that invest more broadly.

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INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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