Sectors Are Shifting: The Impact of the New GICS Framework

Four important considerations for sector investors.

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Key Takeaways

- The structures of certain equity sectors are changing: The telecommunication services sector will be expanded to become the communication services sector and will include some stocks currently classified within information technology and consumer discretionary.
- These adjustments to the widely used GICS sector framework will have a number of implications for investors.
- For example, telecom has been a more defensive sector, with less sensitivity to market moves, while communication services will likely be more cyclical, with higher volatility relative to the broader market.
- The dividend yield of communication services may be lower than telecom but investors can continue to gain exposure to high-dividend-paying telecom companies either at the industry group or individual stock level.
- Communication services will likely have higher return dispersion than telecom, which should provide opportunities for active stockpicking.

As of September 28, 2018,[1] a number of changes will be made to the way some equity sectors are classified. The Global Industry Classification Standard (GICS®) is an industry classification framework developed by MSCI and S&P Dow Jones (S&P®). As one of the most widely used frameworks to delineate sectors, GICS is employed as one basis for market index structure and in reporting on portfolio performance and positioning. This year's updates are some of the most notable since GICS was launched in 1999 and are likely to have a number of implications for investors.

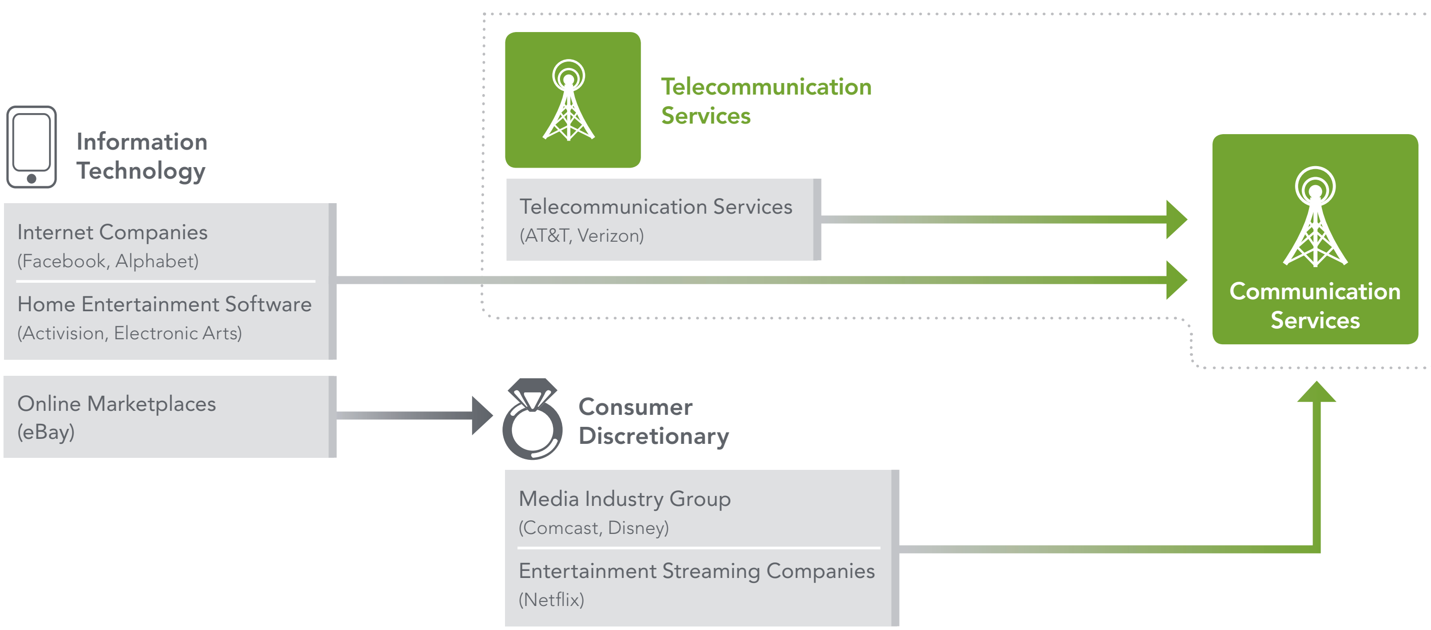
Following the annual review of the GICS structure, MSCI and S&P announced that the telecommunication services (telecom) sector would be expanded to become the communication services sector. Telecom will become one of two industry groups in the new sector, and will be joined by media and entertainment, to be composed of media companies formerly classified within consumer discretionary and Internet companies formerly classified within information technology. In addition, all remaining e-commerce companies (regardless of whether they hold inventory) will move from information technology to consumer discretionary.

The way people communicate and access entertainment content has changed significantly over time, and has driven a broad integration of telecommunication, media, and internet companies. The expansion of telecom to communication services was proposed in recognition of this important market trend, and many global market-leading stocks will shift sectors as a result. See Exhibit 1 for some additional detail on the companies and industries that will be reclassified.

The shift in the GICS sector framework will result in 8.5% of the market capitalization of the S&P 500® changing sectors (Exhibit 2). For context, when the GICS sectors were previously adjusted in 2016, and real estate was elevated to become the 11th sector, that change represented only about 3.1% of the S&P 500. After the new framework is implemented, the weights of the

EXHIBIT 1: The telecom sector will be expanded to communication services, and will also include companies currently classified within the information technology and consumer discretionary sectors.

Summary of the Announced Sector Composition Changes



The companies listed are examples of U.S. stocks shifting sectors, shown for for illustrative purposes only and are not necessarily indicative of current or future portfolio holdings of Fidelity Investments. References to specific company stocks should not be construed as recommendations or investment advice.

impacted sectors will change. Telecom is currently the smallest sector by market capitalization in the S&P 500, while communication services is anticipated to become the fourth-largest (Exhibit 2). The weights of information technology and consumer discretionary will decline following the change, as some stocks will be reclassified out of those sectors.

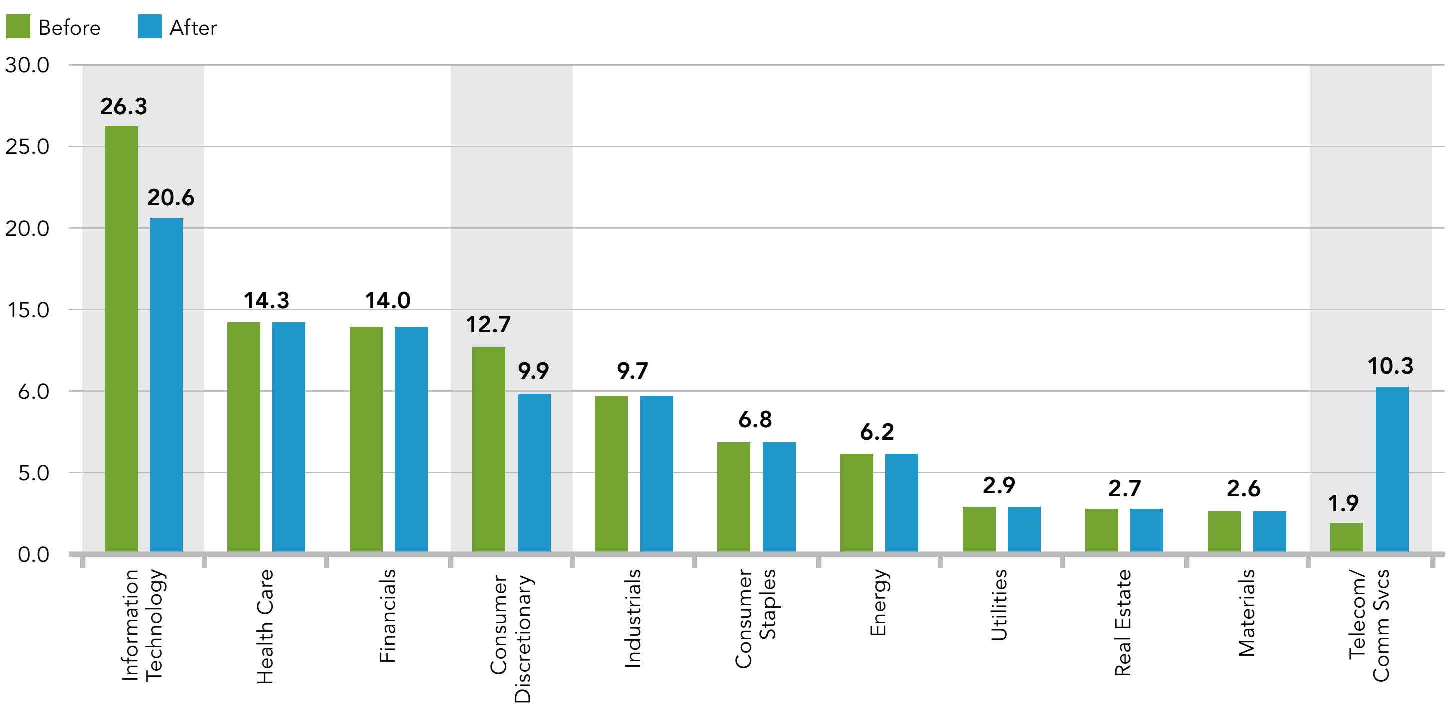
Investors who use sectors for specific investment purposes—to reduce volatility or to increase yield, for example—will need to take into account the changed nature of the sectors involved and the potential new opportunities that may arise. This article highlights four key investment implications of the updated GICS classification framework.

GICS changes: Four key takeaways for sector investors

The long-term performance patterns of the legacy telecom sector and a proxy for the communication services sector relative to the broader market have been markedly different (Exhibit 3, page 4). The most notable contrast can be seen leading up to and following the 2007–08 global financial crisis. Since 2009, the relative performance of the communication services sector has been on a solid long-term uptrend, while telecom has been on a steady decline relative to the broader market. These differences can partially be explained by the two sectors' distinct characteristics.

EXHIBIT 2: The new GICS structure will reduce the weights of information technology and consumer discretionary in the S&P 500, and communication services will become the fourth-largest sector.

Weight in S&P 500 (%)



Source: Standard & Poor's, FactSet, as of June 30, 2018.

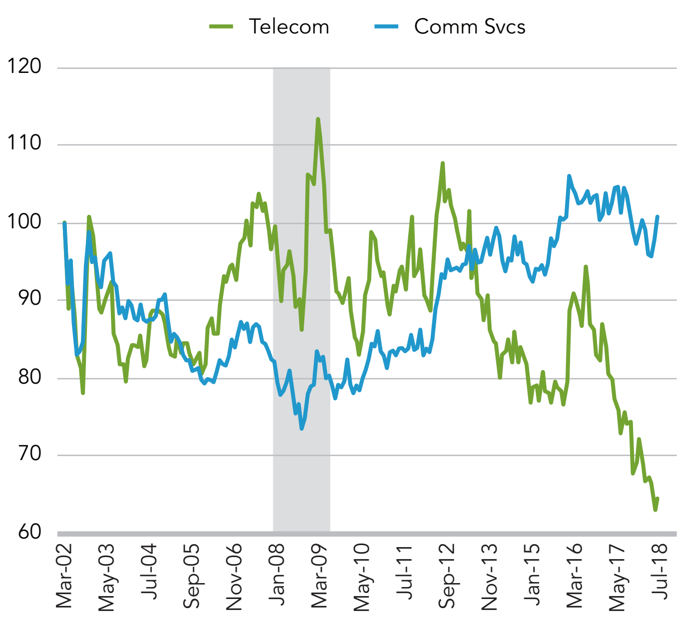
1. Communication services will be a "cyclical" sector, while telecom was "defensive."

Sectors are often categorized as either cyclical or defensive. Cyclical sectors tend to outperform when economic growth is accelerating, and tend to exhibit more sensitivity to market moves, as defined by beta (Exhibit 4). Beta measures the volatility of a stock or group of stocks relative to the volatility of the broader market. Defensive sectors, on the other hand, tend to outperform when economic growth is slowing, and tend to exhibit less market sensitivity and lower overall volatility. These sectors characteristics have been relatively consistent through time. As a result, investors can tilt their portfolios toward cyclical or defensive sectors based on the current economic environment to control the level of risk they are taking in their portfolios, relative to the broader market.

Some examples of cyclical sectors include information technology, financials, and materials, while defensive sectors include consumer staples, health care, and utilities. Telecom has historically been a defensive sector, but when it is expanded to communication services, our analysis suggests that it will become a more cyclical sector, with a beta more in line with financials and materials—likely to outperform when the economy is improving.

EXHIBIT 3: The historical performance profiles of the telecom sector and a proxy for the communication services sector have been significantly different.

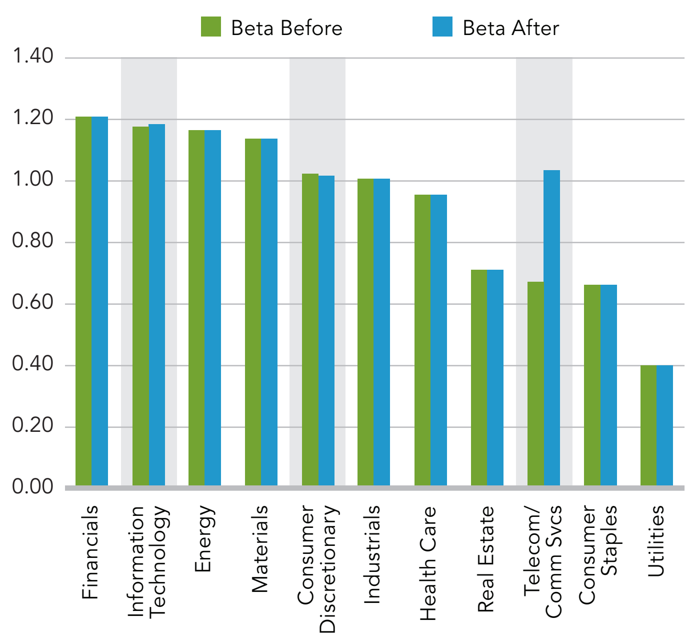
Telecom and Communication Services Relative Performance



Past performance is no guarantee of future results. Performance relative to the top 3,000 stocks by market capitalization. Cumulative historical returns of the communication services sector are represented by a proxy composed of the telecom sector, media industry group, and internet software and services industry. Note, however, that not all stocks within the internet software and services industry group will be moving out of information technology. Gray bar indicates recession as defined by the National Bureau of Economic Research (NBER). Source: NBER, Haver, as of June 30, 2018.

EXHIBIT 4: With higher market sensitivity, communication services will be cyclical rather than defensive like its predecessor, telecom.

Market Sensitivity (Beta) by Sector



Beta: a measure of volatility relative to the broader market, as represented by the S&P 500, which has a beta of 1. A sector with a beta of 1 has historically exhibited the same level of volatility as the market. A sector with a beta less than one has historically exhibited less sensitivity to market moves, while a sector with a beta greater than one has exhibited more sensitivity to market moves. Betas shown are for the 36-month period ending June 2018. Source: Standard & Poors, FactSet, as of June 30, 2018.

2. Communication services will have a lower dividend yield.

Investors seeking income from their portfolios may opt for exposure to higher yielding sectors in their equity portfolio. Telecom has historically been one of the sectors with the highest dividend yield, but its yield will be diluted when it is expanded to the communication services sector (Exhibit 5). Investors may need to seek alternative sources of income from their investments—likely from other relatively high dividend yielding sectors such as real estate, utilities, or consumer staples. Note that investors can still seek exposure to the benefits of telecom stocks (including their generally higher dividend yield and more defensive characteristics) at the industry group or individual stock level.

3. Communication services may provide additional opportunities for stock picking.

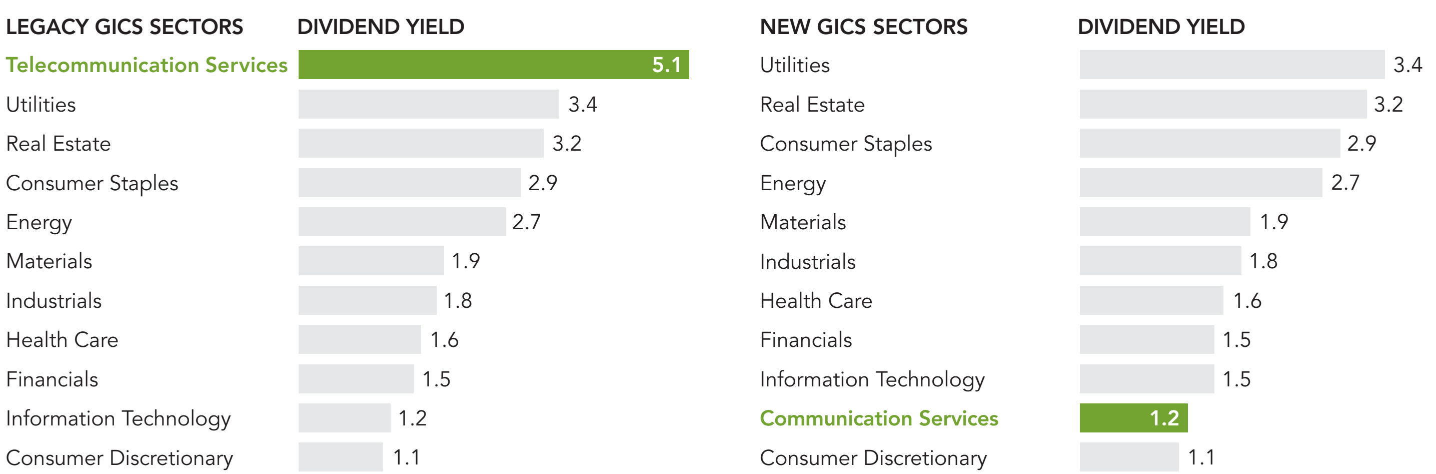
When dispersion of returns within a sector is high, that means that there is a wide gap between the results of the best- and worst-performing stocks. When dispersion is low, that gap is narrow. With insightful fundamental analysis, the opportunity for active managers who can pick winning stocks and avoid losing stocks may be higher amid greater return dispersion. Over the past three years, the return dispersion between stocks in the communication services sector has been higher than in the telecom sector as measured by the standard deviation of returns (Exhibit 6, page 6). Therefore, the expansion to communication services may open the door for particularly interesting opportunities for active stock picking.

4. The composition of information technology and consumer discretionary will also shift following the reclassification.

The most dramatic shifts for sector investors as a result of the upcoming changes to the GICS framework stem, of course, from the expansion of telecom to communication services. But information technology

EXHIBIT 5: The communication services sector will have a lower dividend yield than the legacy telecom sector.

Dividend Yield (Weighted Average)



Past performance is no guarantee of future results. Weighted-average dividend yield by S&P 500 sector. Source: Standard & Poor's, FactSet, as of June 30, 2018.

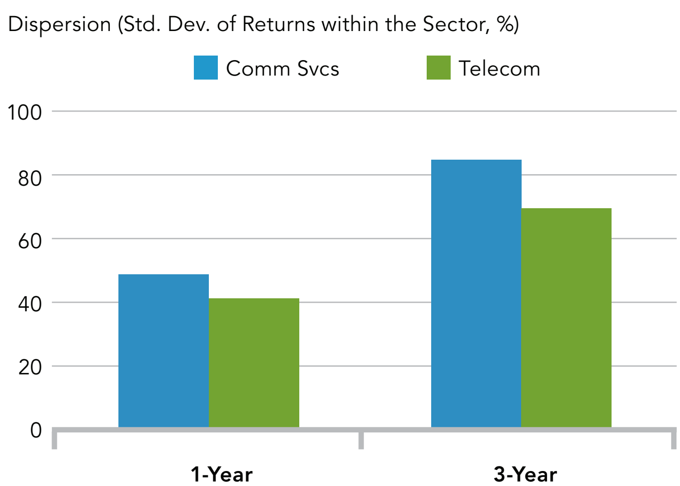
and consumer discretionary will also experience changes as a result, due to the companies and industries that will be reclassified within communication services. As described above, many internet software and services companies and home entertainment companies will shift out of information technology and media companies will shift out of consumer discretionary. As part of those moves, three of four recent market-leading FANG stocks, including Facebook, Amazon, Netflix, and Google (Alphabet), will be reclassified within communication services. (Amazon will remain within consumer discretionary.)

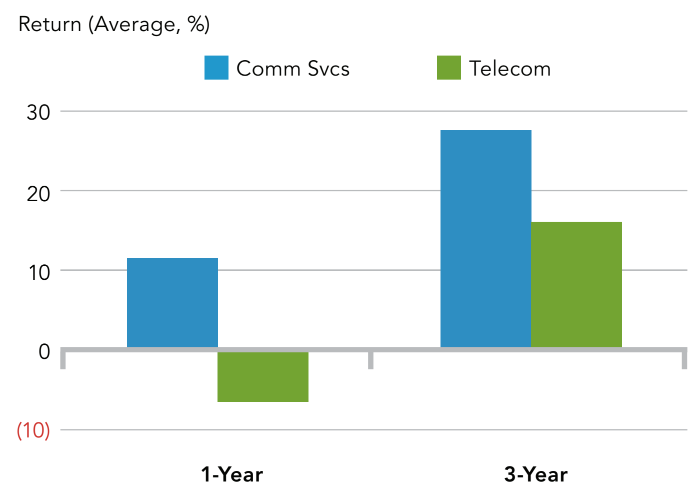
Exhibit 7 (page 7) explores how the industry composition of the consumer discretionary and information technology sectors will shift following the reclassification, and may shed some light on how the characteristics of those sectors may change moving forward. For example, the retailing industry group will remain a critical component of consumer discretionary. Even with Netflix shifting out of consumer discretionary, retailing companies will compose nearly 66% of consumer discretionary's market capitalization within the S&P 500 (Amazon and Home Depot represent the two largest companies). Notably, three of the top five consumer discretionary stocks by market capitalization (Disney, Comcast, and Netflix) will be reclassified within communication services.

With internet companies shifting to communication services, the weight of the software and services industry group within information technology will be reduced, but it will continue to represent more than 51% of the sector's market capitalization. At the margin, we expect information technology to be more enterprise-focused and less consumer-driven moving forward than it has been, with Microsoft and Visa among the largest stocks in the sector, as Alphabet and Facebook move out.

EXHIBIT 6: Over the past three years, the communication services sector may have provided potential opportunities for active stockpicking based on its high return dispersion and strong performance.

Dispersion and Returns of Communication Services vs. Telecom





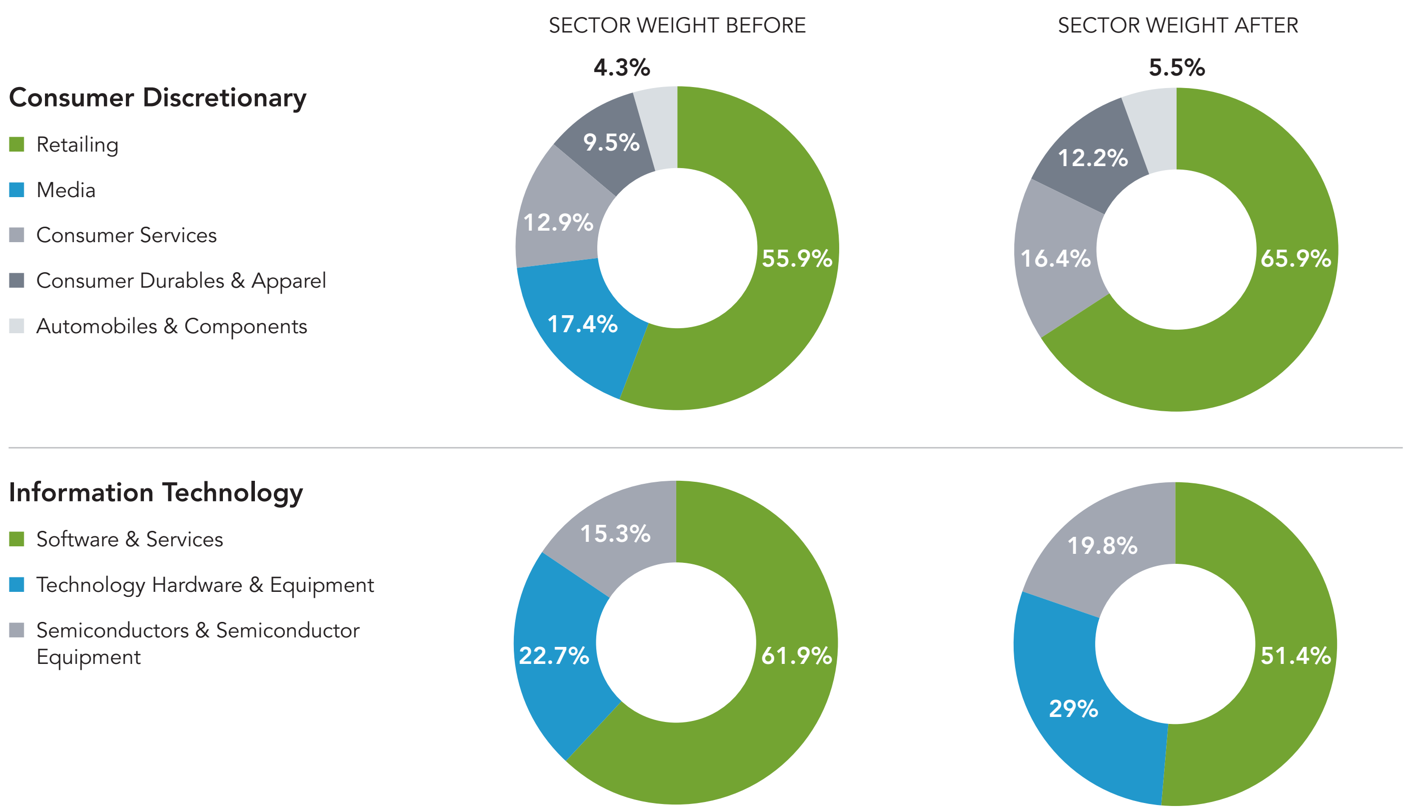
Past performance is no guarantee of future results. Dispersion measured by the standard deviation (a measure of volatility) of returns across stocks in each sector. Sector returns and dispersion within the MSCI USA IMI 2500 Index. Source: FactSet, as of June 30, 2018.

The historical benefits of sector investing will persist

Despite the upcoming changes to the GICS framework, it is important to note that 8 of 11 sectors will be unaffected by the shift. Moreover, the key benefits of a sector-based approach to investing will remain intact. Investing in equity sectors enables investors to play an active role in managing their portfolios. For example, with sectors, investors can gain exposure to potentially attractive segments of the market or to certain investment themes. The communication services sector will give investors exposure to the broad integration of telecommunication, media, and internet companies. Sector exposure has historically been a major driver of stock returns, and the attributes of equity sectors and their distinct risk and return characteristics will continue to provide investors with the opportunity to create an equity portfolio with favorable risk-adjusted performance.

EXHIBIT 7: Following the shift, the retailing industry group will be even more important to consumer discretionary, while software and services companies will be less of a driver of information technology.

Industry Weights within S&P 500 Sectors



Source: Standard and Poor's, FactSet, Fidelity Investments, as of June 30, 2018.

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Endnotes

1. S&P has announced that it will implement its benchmark changes before the market open on Sep. 24, 2018. MSCI has announced that it will implement its benchmark changes following the market close on Nov. 30, 2018.

2. Internet and home entertainment software companies will be shifting out of technology and into communication services.

3. Prior to Sep. 28, 2018, Netflix was classified within the consumer discretionary sector, within the internet and direct marketing retail subindustry.

Index definitions

S&P 500 is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

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