



GICS Sector Changes and Implications for Investors

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Changes have been made to the Global Industry Classification Standard (GICS), a system that index providers and investment managers use to classify businesses into sectors and sub-sectors. Among the changes, a new Communication Services sector replaces the former Telecommunication Services sector. In addition, certain e-commerce companies have moved from Information Technology to either the Communications Services or Consumer Discretionary sectors. In this Q&A with Matthews Asia Portfolio Strategist Jeremy Murden, we review the changes to the GICS sector structure and discuss their implications for investors.

What is GICS?

The Global Industry Classification Standard (GICS) is an industry classification system for all major public companies. It was developed in 1999 jointly by Standard & Poor's and MSCI and has since become the standard sector reporting system for index providers and asset managers globally, including Matthews Asia.

What is changing and why?

In the largest change to GICS since its inception, the Telecommunications Services (Telecom) sector was broadened and renamed Communication Services. The expanded and renamed sector will now include companies that facilitate communication and offer content and information through various forms of media. These changes are being made to better reflect modern communication and information delivery.

Many of the companies that are moving to the newly constituted Communication Services sector were formerly classified as interactive media and services companies within the Information Technology (IT) sector. This includes the megacap Chinese internet companies Tencent and Baidu, their U.S.-based peers including Facebook and Alphabet (Google), and media and entertainment companies such as NetEase, Nintendo and Momo. Media companies including Naspers and Netflix that were formerly included in the Consumer Discretionary sector also have moved to the newly formed Communication Services sector.

Additionally, all remaining e-commerce companies have moved from the IT sector to Consumer Discretionary, regardless of whether they hold inventory. This move included online marketplace Alibaba and its peers globally, while Amazon has always been classified as a Consumer Discretionary stock.

What is not changing?

The weights of individual securities within the index are driven by their market capitalization and are not impacted by the sector classification changes. Additionally, outside of the aforementioned changes to the Consumer Discretionary, IT, and Telecom sectors, the other eight of 11 GICS sectors are unaffected.

When are the changes being made?

The changes were announced in January of 2018 and became effective as of September 30. Most asset managers and index providers chose not to make the change effective for the September 30 reporting period. Clients will begin to see the updated sectors in published portfolio data, including the Matthews Asia website, between now and year end.

What will be the impact of these changes?

The changes led to a major shift in sector weights across indices globally as many of the aforementioned stocks moved away from IT. Within the MSCI Asia ex Japan Index, for example, the weight of the IT sector as of September 30 dropped from 30.6% to 18.1% and the 4.1% weight in Telecom became 12.6% in Communication Services, a threefold increase. Meanwhile, Consumer Discretionary increased from 8.3% to 12.2%.

The sector changes are most apparent within the MSCI China Index where “BAT” stocks (Baidu, Alibaba and Tencent) made up 30.5% of the benchmark, all of which have moved to new sectors. As a result, the IT sector weight of the MSCI China Index has fallen from 36.5% to 3.2% as Communication Services increased to 26.7% from 5.1% in Telecom. The Consumer Discretionary weight also increased from 8.5% to 20.3%.

As sector composition changes, the characteristics of the sectors impacted will change with their new constituents. The largest change will come in Communication Services versus the legacy Telecom sector. Telecom was long seen as a defensive sector that typically traded at lower valuations, provided lower volatility and had a higher dividend yield versus the broad market; it historically outperformed the broad market when global growth was slowing. With the addition of interactive media and services companies from IT and traditional media businesses from Consumer Discretionary, the newly formed Communications Services sector takes on more cyclical and growth exposure, while meaningfully reducing its dividend yield. It is likely to exhibit higher volatility than the former Telecom sector as a result.

The IT and Consumer Discretionary sectors also have been impacted. Across broad Asian and Emerging Markets indices, Consumer Discretionary's weight in indices will increase as IT will become a much smaller portion of the benchmark. The price-to-earnings ratio (P/E) and earnings growth profile of the new IT sector will decrease and the sector's dividend yield will increase as lower-yielding interactive media and services stocks exit. Meanwhile, the newly rebalanced Consumer Discretionary sector trades at a higher P/E multiple with a higher earnings growth profile than it did previously.

Does this affect how Matthews Asia manages its portfolios?

At Matthews Asia, we build portfolios that look very different than the benchmarks by design. As bottom-up investment managers, our portfolios are sector-agnostic and managed without benchmark-relative constraints. This means our portfolios are unaffected by the change. The largest impact will be to investors who rely on sector-based products. Access to innovative companies will now need to come from a more diversified set of equity sectors versus just Information Technology.

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As of 9/30/2018, Matthews Asia portfolios held positions in Baidu, Inc., Alibaba Group Holding, Ltd., Tencent Holdings, Ltd., NetEase, Inc., Momo, Inc. and Naspers, Ltd. As of 9/30/2018, accounts managed by Matthews Asia did not hold positions in Facebook, Inc., Nintendo, Netflix, Inc., Amazon.com, Inc., or Alphabet Inc. Current and future portfolio holdings are subject to change and risk.

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