



FAANG STOCKS UNDERPIN NEW GICS SECTOR

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- In October, S&P Dow Jones and MSCI will implement a major GICS overhaul, headlined by expansion and renaming of the Telecommunication Services sector as Communication Services.
- The revisions will noticeably change benchmark indexes' sector weightings; FAANG stocks Facebook, Netflix, Google (Alphabet) will leave their current sectors for Communication Services.
- The changes will flow through to Acadian's process via forecasting and portfolio construction channels, although we do not anticipate a material impact on our potential to add value.

In November 2017, S&P Dow Jones and MSCI announced the renaming and expansion of its GICS Telecommunication sector. The change recognizes the convergence of telecommunications, media, and internet services that rendered the existing Telecommunication Services sector obsolete.

The sector will be renamed Communication Services, and it will consist of both Telecommunication Services and Media & Entertainment industry groups. As a result, the new sector will absorb companies that facilitate communication and interactivity as well as companies that produce and provide content. In January, S&P Dow Jones and MSCI published a preliminary list of companies that will be reclassified.

In this note, we explain key elements of the changes and how they will likely affect benchmark equity indexes and Acadian's process.

RATIONALE FOR THE CHANGE

The revisions to GICS classifications reflect developments in communications industry structure and breadth. First, the creation of a new Communication Services sector

acknowledges a dramatic transformation in how people interact and how they consume entertainment and information, which has been associated with a convergence among telecom, media, and internet companies.

Second, for the purposes of financial practitioners, S&P Dow Jones and MSCI contend that the Internet Software & Services industry has become too large and diverse to be useful for analysis or index construction. As a result, this industry will be discontinued in October. Its current members, including Facebook and Alphabet, will be repositioned, with the vast majority finding their new home in the Communication Services sector. Others will migrate to Consumer Discretionary or join new or existing sub-industries in Information Technology.

THE NEW STRUCTURE

As depicted in Figure 1, the Communication Services sector will include two industry groups, Telecommunication Services and Media & Entertainment. Telecommunication Services will remain unchanged in terms of membership and focus (companies that provide communication services through a fixed-line, cellular, wireless, high-bandwidth and/or fiber optic cable network).

FIGURE 1

New GICS Communication Services Sector

SECTOR	COMMUNICATION SERVICES				
INDUSTRY GROUP	TELECOMMUNICATIONS SERVICES		MEDIA & ENTERTAINMENT GROUP		
INDUSTRY	DIVERSIFIED TELECOMM SERVICES	WIRELESS TELECOMM SERVICES	MEDIA	ENTERTAINMENT	INTERACTIVE MEDIA & SERVICES
SUB-INDUSTRY	ALTERNATIVE CARRIERS INTEGRATED TELECOMM SERVICES	WIRELESS TELECOMM SERVICES	ADVERTISING BROADCASTING CABLE & SATELLITE PUBLISHING	MOVIES & ENTERTAINMENT INTERACTIVE HOME ENTERTAINMENT	INTERACTIVE MEDIA & SERVICES

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Media & Entertainment will consist of three industries:

- **Media:** This will contain four sub-industries from the existing Media industry group in the Consumer Discretionary sector, Advertising, Broadcasting, Cable & Satellite, and Publishing.
- **Entertainment:** This will be composed of two sub-industries: Movies & Entertainment and Interactive Home Entertainment. The former will migrate from the existing Media industry. The latter will include producers of interactive gaming products (e.g., Activision Blizzard Inc. and Nintendo Co. LTD) and educational software drawn from two existing IT sub-industries, Home Entertainment Software and Application Software.
- **Interactive Media & Services:** This will consist of a single sub-industry representing companies that provide social media, search engines, photo sharing, and mobile messaging applications. Constituents will be drawn from the existing IT sector's Internet Software & Services and Application Software sub-industries. It will include some of the largest and most prominent companies, including FAANG stocks Alphabet Inc. and Facebook Inc.

Retirement of IT's Internet & Software and Services sub-industry will require reclassification of its constituents. These include members of key benchmark indexes, for example 25 stocks in the MSCI World Index (based on Apr 30, 2018 composition) and 5 stocks in the S&P 500 Index. Figure 2 shows the top 10 affected companies.

FIGURE 2

Top 10 Companies Moving to A Different Sector Ranked by Market Capitalization

	Market Cap (USD Billions)	Current Sector / Industry	New Sector / Industry
Alphabet Inc	707.0	Information Technology / Internet Software & Svcs	Communication Services / Interactive Media & Svc.
Facebook Inc	498.1	Information Technology / Internet Software & Svcs	Communication Services / Interactive Media & Svc.
Tencent Hldgs	473.4	Information Technology / Internet Software & Svcs	Communication Services / Interactive Media & Svc.
Alibaba Group	457.3	Information Technology / Internet Software & Svcs	Consumer Discretionary / Internet & Direct Marketing Retail
Disney (Walt)	150.9	Consumer Discretionary / Movies & Entertainment	Communication Services / Movies & Entertainment
Comcast Corp	144.4	Consumer Discretionary / Cable & Satellite	Communication Services / Cable & Satellite
Netflix Inc	135.8	Consumer Discretionary / Internet & Direct Marketing Retail	Communication Services / Movies & Entertainment
Naspers Ltd	107.7	Consumer Discretionary / Cable & Satellite	Communication Services / Cable & Satellite
Baidu Inc	87.4	Information Technology / Internet Software & Svcs	Communication Services / Interactive Media & Svc.
Time Warner	74.2	Consumer Discretionary / Movies & Entertainment	Communication Services / Movies & Entertainment

For illustrative purposes only. This should not be considered a recommendation to buy or sell any specific security.

IMPACTS: BENCHMARK INDEXES

The overall set of changes is large enough to materially affect sector compositions of benchmark indexes.

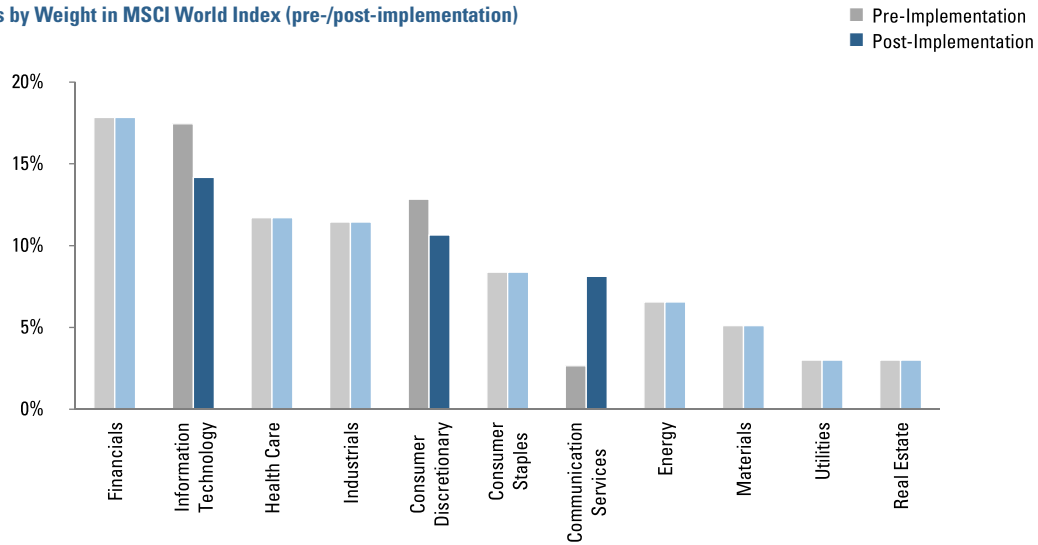
MSCI World: Data from S&P Dow Jones and MSCI indicates that 68 companies within the MSCI World Index will be reclassified. The Communication Services sector will gain 63, 43 from Consumer Discretionary and 20 from Information Technology. In addition, two

companies, EBay Inc. and Mercadolibre Inc., will move from the Information Technology sector to the Consumer Discretionary sector.¹ As illustrated in Figure 3, these changes will increase the weight of the Communication Services sector from 2.7% to 7.2%, with Facebook and Alphabet alone accounting for a 2.6% increase. Information Technology will fall by 2.5%, dropping to 15%. Consumer Discretionary will lose 2.1%, reducing its weight to 10.7%.

¹ Within the Information Technology sector, 3 companies will be repositioned into different sub-industries and therefore do not impact sector weight.

FIGURE 3

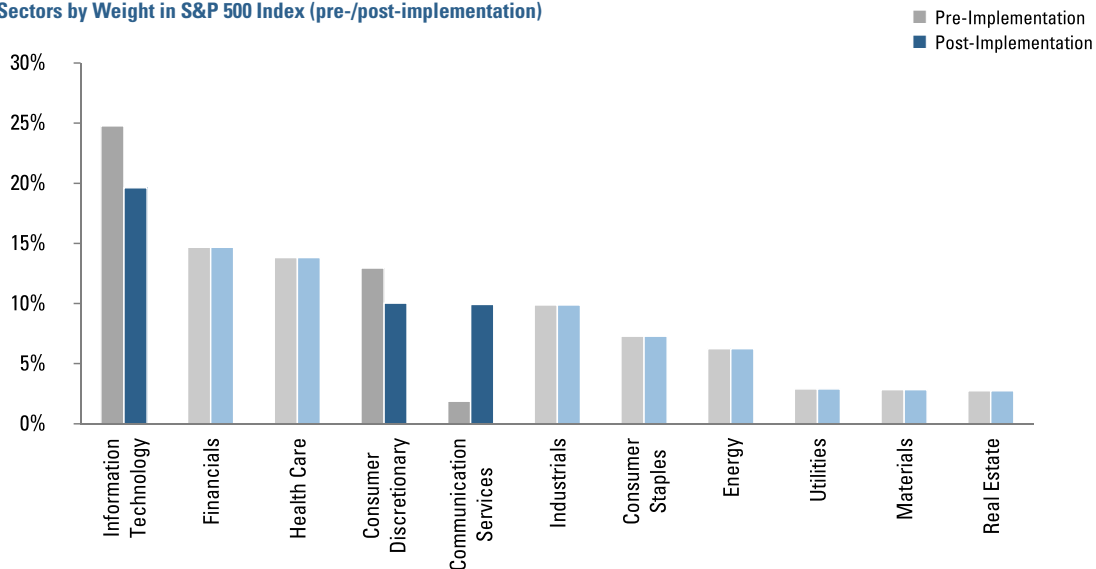
GICS Sectors by Weight in MSCI World Index (pre-/post-implementation)



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FIGURE 4

GICS Sectors by Weight in S&P 500 Index (pre-/post-implementation)



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S&P 500: We anticipate that 22 companies will be re-categorized. The Communication Services sector will take 19 of them, 14 from Consumer Discretionary and 5 from Information Technology. Similar to the MSCI World Index, S&P 500's Information Technology grouping will relinquish EBay Inc. to Consumer Discretionary.² As a result, the weight of the Communication Services sector will jump from 1.9% to 9.9%, as shown in Figure 4. Currently, the Telecommunication sector contains only Century Link Inc., AT&T Inc., and Verizon

Communications Inc. The addition of Alphabet and Facebook alone will account for a 4.5% increase in weight. Additions of Walt Disney, Comcast, and Netflix from Consumer Discretionary will contribute another 2%. The weight of the Information Technology sector will fall from 24.8% to 19.6% following the reclassification of several large stocks. Consumer Discretionary's weight will fall from 13.4% to 9.9%.

² Two companies will realign within Information Technology sector.

IMPACTS: ACADIAN'S PROCESS

The transformed GICS structure will better align with current economic realities and provide clearer sector, industry, and sub-industry definitions. These changes will influence Acadian's process through a few channels.

For one, Acadian's bottom-up stock forecasts are formed on a peer-relative basis, where the peer groups are defined by the intersection of stocks' regional and industry group affiliations. More precise, economically relevant industry group definitions will change these peer group definitions and should make them more informative. As prominent examples, peer sets based on the new Media & Entertainment industry group will include large internet stocks Alphabet and Facebook. These stocks will no longer influence peer sets based on the Software & Services industry group.³

The GICS changes will also influence our top-down model, which relies on GICS for industry classifications, although we do not expect the changes to have a meaningful impact on our process. Acadian is currently phasing out its single top-down model and in its place, integrating three separate models: country, industry, and country/industry intersection. All three top-down models generate forecasts for developed markets, emerging markets, and frontier markets. We do not expect the new models to be materially impacted by the reclassifications and may be well suited to acclimate to the GICS modifications due to the new models' tiered stock evaluation approach. Direct comparisons to the new GICS classifications versus the old, in the context of our new top down models, are essentially moot as the new models are being gradually implemented between now and year-end, and therefore will not have any material history with the old GICS classifications.

The GICS reclassifications will also have some impact on portfolio construction, because we constrain portfolios' active exposures at the industry group and sector levels. Implementation of the reclassifications may cause a one-time increase in turnover in portfolios where the risk controls now "bind" where they had not previously, or vice versa. We will be able to forecast the impact of the changes with greater precision when the full list of affected stocks is announced on July 2, 2018.

CONCLUSION

As quantitative investment managers, significant consumers of market data, and users of the GICS framework, Acadian welcomes the upcoming GICS restructuring, which will better align classifications with economic realities. The last significant GICS change was in 2016 when Real Estate became its own sector. By comparison, the current reclassification is more extensive as it impacts more sectors, industry groups, industries, and sub-industries. Despite the complexity of the reorganization, Acadian believes the revised structure will offer more precise, informative, and economically meaningful categories, each populated by a more homogeneous set of companies. We will closely monitor markets as the implementation of the GICS change approaches later this year although the influence of these changes on our process will be minor. We do not expect that they will materially affect our potential to add value.

³ Importantly, the characteristics, or factors, used in generating peer-relative stock return forecasts will not change as a result of the GICS reclassifications.

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