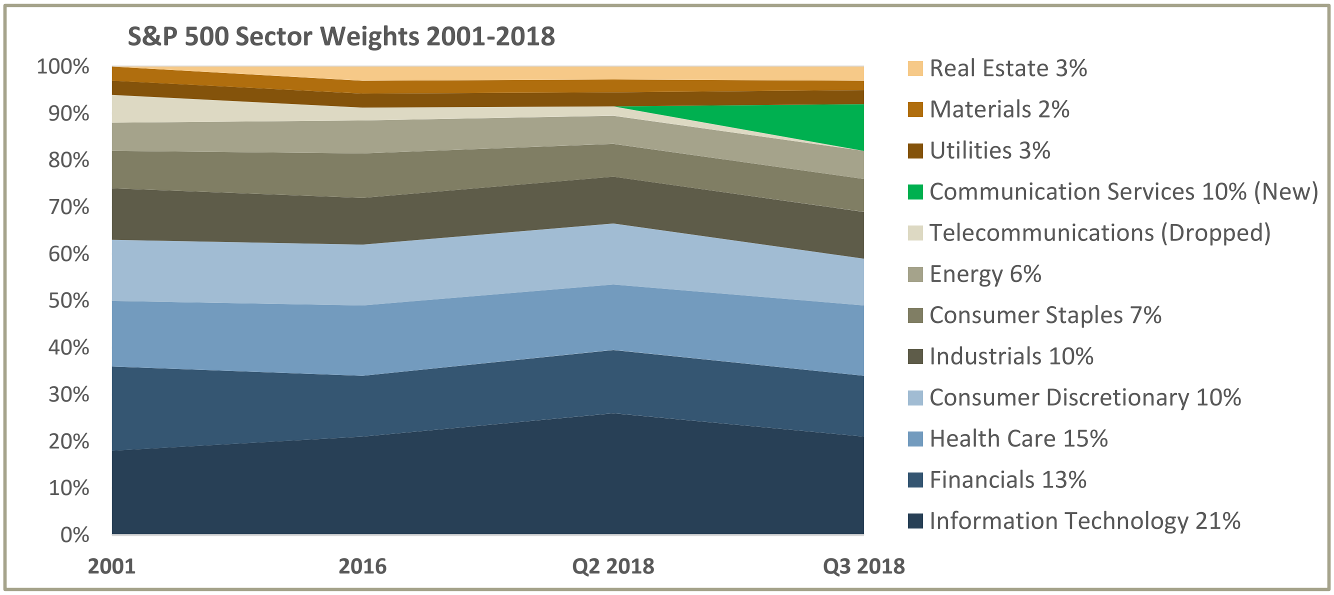
"We are effectively living in a world of communications and information abundance."

Peter Diamandis

Reshuffling the deck: The S&P is modifying the major categories of the market in the most significant reclassification of industry groups since the index officially adopted standardized sectors back in 2001. 'Communication Services' debuted as a stand-alone group on September 30th, representing ~10% of the S&P 500. This replaces the Telecommunications sector, which was absorbed by the new group, along with select constituents from Information Technology and Consumer Discretionary. The only other sector reclassification since 2001 was the separation of Real Estate from Financials in 2016.



Why did the index authority decide such a major move was necessary? For the most part, the reclassification reflects the evolution of our economy over the past twenty years. Most sector weights in the S&P 500 have been relatively static over this time. There are two major outliers to this statement: Since 2001, the weight of the Telecommunications sector has fallen from 6% to 2% and the weight of the Information Technology sector has risen from 18% to 26%. The growth of the Tech sector weight makes sense when you consider the role of technology in our lives today compared to the early 2000s. However, as companies have evolved since the introduction of the Internet, industry definitions have blurred, and certain legacy sector classifications became less meaningful.

For example, there are many hedge funds or industry analysts who invest or follow what they call "TMT," referring to: Technology, Media, and Telecommunications. These are three industries whose products, services and customers overlap and interlace. However, they don't reside in a single sector. Consider that Alphabet (Google's parent company) owns YouTube, the world's largest video content platform, with a reach of over 1 billion views per day. Alphabet was classified as a Tech company while AT&T (owner of Time Warner) was in the Telecom sector and Comcast (owner of NBC) was in the Consumer Discretionary sector. Meanwhile, Microsoft, which operates the second largest public cloud database (Azure) is a Tech stock, while Amazon, owner of the largest public cloud database (AWS) is a Consumer Discretionary stock. Verizon (was in Telecom) is a phone company that also provides Internet and cable service. Verizon competes with Charter (was in Consumer Discretionary), a cable and Internet company that is launching wireless phone service. While the sector classification for all these companies made sense originally, it has become less accurate as the scope of their businesses has expanded.

The recalibration is an acknowledgement that technology has branched out from tools and machines used by the corporate world — whether computers, software, or semiconductors — to products that now permeate the consumer market.

While the reclassification will not resolve all the conflicts mentioned above, it does address many of them. The new Communication Services sector will include the following industries:

Sector: Communication Services	
Industry	**Company examples**
Diversified Telecommunication Services	AT&T, Verizon
Entertainment	Disney, Netflix, video game companies
Interactive Media & Services	Alphabet, Facebook, Twitter
Media	CBS, Comcast, Charter, Discovery

While we will still have Amazon in Consumer Discretionary providing a video platform that competes with Netflix, most content creation and distribution companies now reside in a single sector. One large firm with a major presence in the life of consumers that has escaped mention so far is Apple, the largest company by market capitalization. Apple will remain in the Tech sector, likely because its primary source of revenue is generated from the development and sale of computer hardware (e.g., phones, tablets, computers). The takeaway message here is that the delineation is complicated.

Post-reclassification, Technology will still be the largest group with a 20.6% weighting. In addition to Apple, software (Microsoft, Oracle, Salesforce), semiconductors (Intel, Nvidia), IT Services (Visa, IBM), and networking equipment (Cisco) remain in this silo. The new Communications Services sector will be the fourth largest, with a 9.9% weight.

How might these classification changes affect the market? This is really a question of how closely investors, mutual or index funds, and exchange-traded funds (ETFs) want to align with the weight in each sector. For example, an S&P 500 index fund would not need to make any changes because the individual weight of each of the 500 names is not changed, only the sector weights. However, an ETF mirroring the S&P Technology Index would need to sell the stocks that are moving out of the group and reweight its remaining positions. Presumably, new Communications Services index funds and ETFs would be buyers of the names the tech funds may be selling.

The next question for the allocation gods is whether other changes should follow. It has become obvious that technology drives evolution and disruption across many sectors including media, retail, food delivery, transportation, and lodging. But there are no clear definitions for where a stock resides based on the company's end users or the source of its revenue. Some sectors, such as Materials, are so small that it might make sense to combine it with Industrials, a sector with similar cyclical and secular drivers.

As for making investment choices, there is a school of thought among closet index investors that betting on sectors is more important than the stocks themselves. Sector moves, both positive and negative, can last for extended periods as we have experienced with Technology over the past few years, Energy in the 80's, Health Care in the 90's. With sector boundaries blurring, that strategy becomes much more of a challenge. At Aureus, our primary focus is on a deep understanding of the fundamentals of the companies in our client's portfolios. Our investment process uses sector weightings as an element of the risk-management process, but secondary to the individual stocks in a portfolio.