The New GICS Framework: The Impact of Adding Real Estate as the 11th Equity Sector

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KEY TAKEAWAYS

- Real estate will become the 11th equity sector within the GICS structure as of the market close on August 31, 2016. It will be elevated from its current position as an industry group within the financials sector.
- With the removal of real estate, the financials sector may become more volatile, with positive exposure to long-term interest rates.
- The new real estate sector is likely to be relatively low beta, with high correlations to defensive sectors such as utilities and health care.

MSCI Inc. and S&P Dow Jones Indices previously announced that real estate, currently an industry group within the financials sector, will become a separate equity sector in the Global Industry Classification Standard (GICS®) structure after the market closes on August 31, 2016, resulting in the first new sector since GICS was created in 1999.[1] The following article explains some of the potential changes that sector investors may see as a result of the new GICS framework.

GICS changes may have significant effects on sector characteristics

GICS is an industry classification structure developed by MSCI and Standard & Poor's, and is used throughout the asset management industry. As one of the most widely used sector classification structures, GICS is employed as one basis for market index structure and in reporting on portfolio performance and positioning. Therefore, any change in GICS sector and industry weights can have investment implications. For 15 years, GICS has classified all major public companies in these indexes as belonging to one of 10 sectors: consumer discretionary, consumer staples, energy, financials, health care, industrials, information technology, materials, telecommunication services, and utilities. With the elevation of real estate from its subsidiary position within financials, the new framework will consist of 11 sectors.

GICS is an integral component of sector-based investing, and the expansion of the framework may have significant effects on benchmarks, positioning, and risk-and-return profiles for sector mutual funds and exchange-traded funds (ETFs). Investors who use sectors for specific purposes—to reduce portfolio exposure to market volatility, for example, or to take advantage of a sector's relatively high dispersion of returns—will need to take into account the changed nature of the financials sector after real estate is removed from it, as well as the diversification and alpha-generating opportunities that will open up with the creation of the new real estate sector.

Financials may become more volatile

Investors using the financials sector as a portfolio building block may find that the removal of real estate means they are now exposed to a slightly less diversified, potentially more volatile sector with positive exposure to long-term interest rates.

Based on sector performance correlations during the past three years, the new financials sector appears likely to experience lower correlations with eight other sectors (see Exhibit 1). However, correlations would decline most sharply against utilities, telecommunication services, consumer staples, and health care—traditionally the more defensive sectors. These recent sector correlation trends suggest that financials, minus real estate investment trusts (REITs), may become more correlated with the economically sensitive sectors of the equity market. However, it is important to keep in mind that while REITs have been particularly steady during the past four years, given low interest rates and a relatively stable commercial real estate cycle, they have not always performed in exactly the same way, and have been more cyclical at various points in their history.

The new financials sector, without real estate, would have higher absolute risk—in other words, a higher variance of expected return—as well as higher beta, a measure of sensitivity to broader market returns, compared with the current sector (see Exhibit 2). (Note: financials' absolute risk and beta remain in the middle of the pack compared with other sectors.) The new financials sector also would have a larger average market capitalization, as smaller-cap real estate companies are moved out, shifting the average toward larger-cap banks and diversified financial services companies. It would have a lower dividend yield, given the removal

Exhibit 1 Under the new framework, financials sector correlations would likely decline against most other sectors, with particularly sharp declines against the utilities, telecommunication services, consumer staples, and health care sectors.

PERFORMANCE CORRELATIONS: NEW GICS FRAMEWORK

	Energy	Materials	Industrials	Cons. Disc.	Cons. Staples	Health Care	Financials	Info. Tech.	Telecom Services	Utilities	Real Estate
Energy	1.00	0.75	0.67	0.54	0.34	0.42	0.59	0.54	0.32	0.13	0.22
Materials	0.75	1.00	0.88	0.76	0.40	0.66	0.72	0.77	0.22	0.01	0.38
Industrials	0.67	0.88	1.00	0.88	0.61	0.72	0.82	0.82	0.19	0.17	0.46
Cons. Disc.	0.54	0.76	0.88	1.00	0.67	0.77	0.83	0.87	0.22	0.13	0.48
Cons. Staples	0.34	0.40	0.61	0.67	1.00	0.61	0.50	0.57	0.58	0.57	0.52
Health Care	0.42	0.66	0.72	0.77	0.61	1.00	0.73	0.66	0.18	0.24	0.53
Financials	0.59	0.72	0.82	0.83	0.50	0.73	1.00	0.76	0.10	0.04	0.36
Info. Tech.	0.54	0.77	0.82	0.87	0.57	0.66	0.76	1.00	0.26	0.06	0.45
Telecom Services	0.32	0.22	0.19	0.22	0.58	0.18	0.10	0.26	1.00	0.37	0.29
Utilities	0.13	0.01	0.17	0.13	0.57	0.24	0.04	0.06	0.37	1.00	0.65
Real Estate	0.22	0.38	0.46	0.48	0.52	0.53	0.36	0.45	0.29	0.65	1.00

CHANGE TO FINANCIALS CORRELATIONS

	Energy	Materials	Industrials	Cons. Disc.	Cons. Staples	Health Care	Financials	Info. Tech.	Telecom Services	Utilities
Financials	0.01	(0.01)	(0.02)	(0.02)	(0.07)	(0.04)	0.00	(0.02)	(0.06)	(0.14)

Sectors represented by the MSCI USA Investable Market Index (IMI) Sector Indexes. Performance correlations measured from Oct. 31, 2011, to Apr. 30, 2016. Sources: FactSet, MSCI Indices, Fidelity Investments, as of Apr. 30, 2016.

of REITs, which are required to distribute at least 90% of their taxable income in the form of dividends (see Exhibit 3).

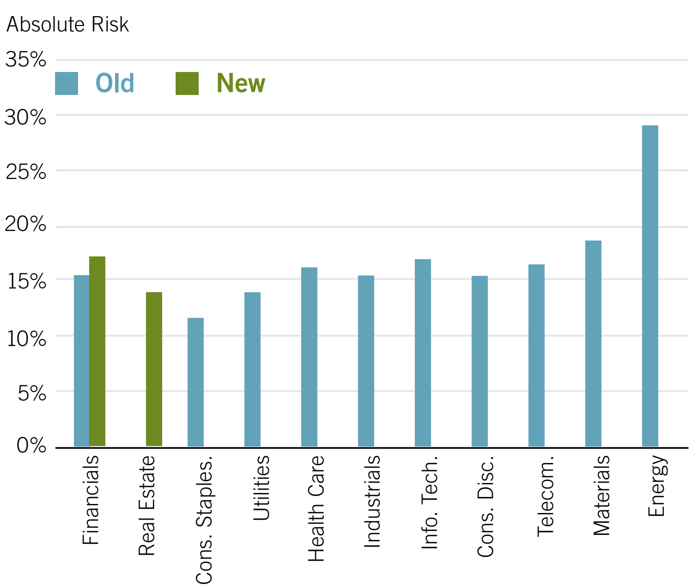
The revised sector also would have greater positive exposure to long-term interest rates and more negative exposure to short-term rates (Exhibit 3). Despite general investor concern about rising interest rates, higher long-term rates have positive implications for banks, which would become a larger portion of the sector after the removal of real estate. Banks borrow capital at short-term rates (e.g., the rates they pay for deposits) and lend it out at longer-term rates, a spread known as net interest margin. When long-term interest rates rise relative to short-term rates, net interest margin expands, a situation that can benefit bank earnings.

New real estate sector: Low correlations, modest volatility
Meanwhile, real estate as a standalone sector would be driven almost entirely by REITs (an estimated 97% of the new sector's capitalization).[2] The real estate sector would have a fairly low correlation to other sectors (Exhibit 1), giving investors another lever to consider at the sector level for portfolio exposure. Interestingly, the new sector would have a higher historical performance correlation to seven other sectors than to financials, its former parent sector, underscoring the differences between them. Its lowest correlations would be to energy and information technology, and its highest would be to the relatively defensive utilities and health care sectors.

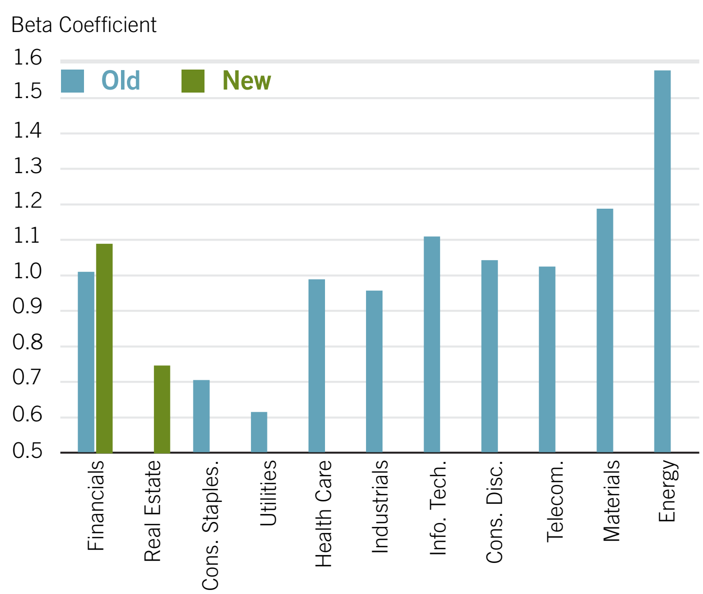
The new real estate sector also would have moderate market sensitivity, with beta that matches health care and is higher than only two sectors, consumer staples and utilities (Exhibit 2). This could make it a potentially useful additional tool for investors seeking to reduce portfolio volatility while maintaining exposure to equities. However, it is important to remember that real estate has not historically been "defensive" in the way the consumer staples, utilities, and health care sectors are. Even during an economic downturn, con-

Exhibit 2 Financials' absolute risk would increase slightly under the new framework. Real estate would debut as one of the lower-beta sectors, behind consumer staples and utilities.

Absolute Risk



Beta



Sectors represented by the MSCI USA Investable Market Index (IMI) Sector Indexes. Absolute risk reflects standard deviation as measured by the MSCI Barra U.S. Equity Long-Term Model (USE3L). Beta is a measure of the covariance of a security (or sector) compared with the broader market, in this case the S&P 500® Index. A beta coefficient of more than 1.00 suggests the security (or sector) is more volatile than the market, while beta of less than 1.00 indicates the security typically is less volatile than the market. Sources: MSCI Barra, Fidelity Investments, based on data as of Apr. 30, 2016.

sumers generally will continue to buy toothpaste and soap, pay the electric bill, and find funds for necessary health care treatment. The commercial real estate business, on the other hand, can be dependent on supply and demand for real estate, employment rates, interest rates, cost of capital, and other factors.

Change may highlight market underweight to REITs

Another consideration of the GICS changes is the potential for capital movement among these sectors as investors adjust their portfolios. For example, financials sector funds and ETFs that utilize the GICS may need to align to the new GICS structure by selling or transitioning their real estate positions. Conversely, investors who have constructed portfolios using such funds may look to offset the rebalancing by adding to real estate exposure. A total of $38.9 billion was invested in mutual funds and ETFs within the financials category (as defined by Morningstar) as of April 30, 2016, while $5.0 billion of that was held in the real estate industry group.[3]

In addition, many investors have been underexposed to REITs as an asset category,[4] a fact that may become more evident as real estate is elevated to a separate sector (see Exhibit 4). It is impossible to tell at this point whether REIT buying to correct underexposure will outweigh REIT selling from funds that need to remove REITs from their financials sector exposure. Either way, it is possible that the market will experience increased volatility and flows between these two sectors as the changes are made.

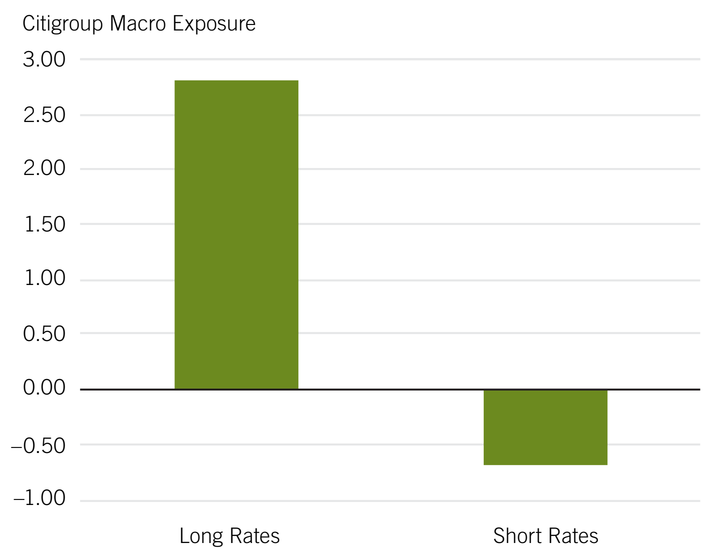
Investment implications

The announced GICS revisions are not expected to be implemented until August/September 2016. Based on recent trends, we see several potential investment implications in the new GICS framework. For one, removing real estate—the industry with the least correlation to the other components of the financials sector—will make financials a more focused tool for investors using sectors to diversify risk or capture alpha. In becoming less diversified, the financials sector likely

Exhibit 3 The new structure will change style and rate exposures for the financials sector.

Change in Financials Exposure to Style

Change in Financials Exposure to Rates



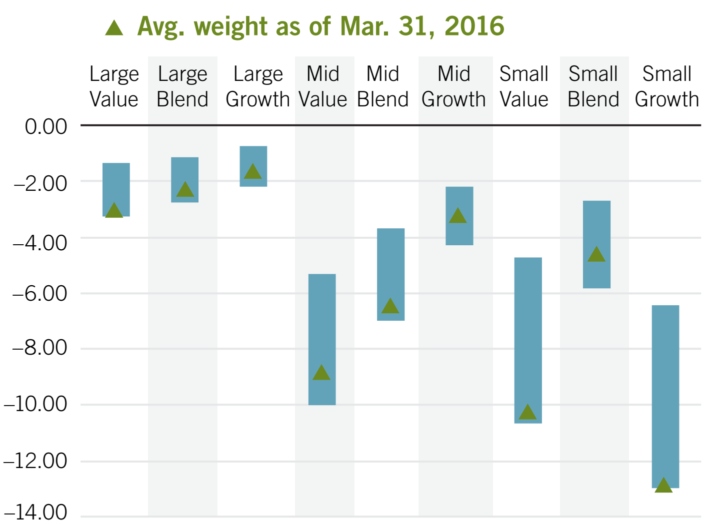
MSCI Barra U.S. Equity Long-Term Model (USE3L) used for earnings yield, size, and dividend yield exposure; see methodology for definition. Citigroup U.S. Equity Risk Model used for rate exposure; see methodology for definition. Long-term rates are represented by the 10-year U.S. Treasury bond, and short-term rates are represented by the three-month U.S. Treasury bill. Vertical axes show degree of change in factor exposure. Sectors represented by the MSCI USA Investable Market Index (IMI) Sector Indexes. Sector characteristics with regard to earnings yield, market capitalization, dividend yield, and rate exposure are not fixed, and have changed over time. Past performance is no guarantee of future results. Sources: MSCI Indices, Citigroup, MSCI Barra, Fidelity Investments, based on data as of Apr. 30, 2016.

will have more upside potential, but also more downside risk. This could provide investors with a sharper tool to use in sector allocation strategies.

Meanwhile, the new real estate sector may provide a new lower-beta tool for investors seeking to diversify risk or reduce their exposure to market volatility. Given that many investors have been underweight to REITs, they may want to take a closer look at their exposure to determine whether it is adequate given their investment objectives.

Exhibit 4 Many U.S. equity mutual funds across style categories have been relatively underweight to real estate based on their history.

Average Relative Weight in Real Estate (April 1, 2006–Mar. 31, 2016)



Bars represent the range of funds' relative positioning over the past 10 years, while diamonds indicate positioning as of Mar. 31, 2016. Index weightings represented by: Large Value—Russell 1000® Value Index; Large Blend—Russell 1000® Index; Large Growth—Russell 1000® Growth Index; Mid Value—Russell Midcap® Value Index; Mid Blend—Russell Midcap® Index; Mid Growth—Russell Mid Cap® Growth Index; Small Value—Russell 2000® Value Index; Small Blend—Russell 2000® Index; Small Growth—Russell 2000® Growth Index. Indexes are used as a proxy for fund benchmarks, and may not represent any given fund's primary benchmark. Average fund REIT weights are simple averages of the percentage of total assets invested in REIT securities for all equity funds categorized within the nine Morningstar U.S. equity fund categories that have reported holdings. Source: Morningstar, FactSet, Fidelity Investments, as of Apr. 30, 2016.

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All indices are unmanaged. You cannot invest directly in an index.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

Because of its narrow focus, sector investing tends to be more volatile than investments that diversify across many sectors and companies. Sector investing is also subject to the additional risks associated with its particular industry.

Endnotes

[1] Source: Press release, Nov. 10, 2014, S&P Dow Jones and MSCI Inc.

[2] Based on MSCI U.S. IMI Financials 25/50 Index. Source: FactSet, Fidelity Investments, as of Apr. 30, 2016.

[3] Source: Morningstar, as of Apr. 30, 2016.

[4] For more information, please see *Leadership Series* article "REIT Stocks: An Underutilized Portfolio Diversifier" (April 2016).

Methodology

Earnings yield, dividend yield, and size exposure were analyzed using the MSCI Barra U.S. Equity Long-Term Model (USE3L). The Barra earnings yield, dividend yield, and size exposure is the weighted average of the index constituents' exposure to the selected Barra factor.

Interest rate exposure was analyzed using the Citigroup U.S. Equity Risk Model. Long- and short-term rates exposure is the weighted average of the index constituents' exposure to the selected Citi factor.

Index definitions

The S&P 500® Index 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. S&P 500® is a registered service mark of Standard & Poor's Financial Services LLC. Sectors and industries are defined by the Global Industry Classification Standard (GICS®).

The Russell 1000® Value Index is an unmanaged, market capitalization-weighted index of those stocks of the 1,000 largest U.S.-domiciled companies that exhibit value-oriented characteristics. The Russell 1000® Index is an unmanaged, market capitalization-weighted index of the stocks of the 1,000 largest companies included in the 3,000 largest U.S.-domiciled companies. The Russell 1000® Growth Index is an unmanaged, market capitalization-weighted index of those stocks of the 1,000 largest U.S.-domiciled companies that exhibit growth-oriented characteristics. The Russell Midcap® Value Index is an unmanaged, market capitalization-weighted index of the smallest 800 companies included in the Russell 1000 Index that exhibit value-oriented characteristics. The Russell Midcap® Index is an unmanaged, market capitalization-weighted index of the smallest 800 companies included in the Russell 1000 Index. The Russell Midcap® Growth Index is an unmanaged, market capitalization-weighted index of the smallest 800 companies included in the Russell 1000® Index that exhibit growth-oriented characteristics. The Russell 2000® Value Index is an unmanaged, market capitalization-weighted index of the stocks of the 2,000 smallest companies included in the 3,000 largest U.S.-domiciled companies that exhibit value-oriented characteristics. The Russell 2000® Index is an unmanaged, market capitalization-weighted index of the stocks of the 2,000 smallest companies included in the 3,000 largest U.S.-domiciled companies. The Russell 2000® Growth Index is an unmanaged, market capitalization-weighted index of the stocks of the 2,000 smallest companies included in the 3,000 largest U.S.-domiciled companies that exhibit growth-oriented characteristics.

The MSCI USA IMI Sector Indexes are derived from the broad MSCI USA Investable Market Index (IMI), which includes more than 2,400 large-, mid-, and small-cap U.S. stocks. There are 10 MSCI USA IMI Sector Indexes, which cover up to 99% of the free-float-adjusted market cap of the U.S. equity market.

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