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BARON INSIGHT

OCTOBER 2018

An Overview of the New Communication Services GICS Sector

When the Global Industry Classification Standard (GICS) launched the new Communication Services sector on September 28, 2018, the classification of thousands of stocks, including some of largest and best-known names in the S&P 500 Index, was affected.

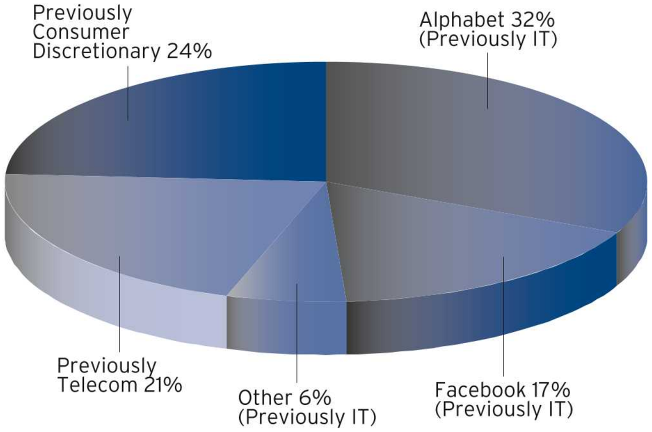
Facebook, Inc., **Alphabet, Inc.**, and **Netflix, Inc.** all joined the new sector. The recategorization of these three so-called FANG stocks was a part of a larger change that impacted the entire Telecommunication Services sector as well as 2,174 global, publicly traded companies that were previously classified as Information Technology and Consumer Discretionary.

The changes reflect the first major shakeup of GICS since MSCI, Inc. and S&P Dow Jones jointly introduced the industry taxonomy in 1999. S&P implemented the new categorization system at the end of September; MSCI will follow suit on December 3, 2018. Meant to reflect the evolving nature of the U.S. economy over the last two decades, the reclassification makes tech less concentrated in the S&P 500 by spreading it across three, instead of two, sectors and reducing the weight of the Information Technology sector in the index.

Communication Services expands beyond the Telecommunication Services sector, having brought in 1,148 media and internet retail companies previously classified as Consumer Discretionary and 570 companies from IT. The replacement is a nod to the increasing obsolescence of Telecommunication Services, which had accounted for roughly 2% of the S&P 500, down from 7.9% at the end of 1999 when GICS was launched. At the end, just two stocks – AT&T Inc. and Verizon Communications Inc. – comprised 96% of the Telecommunication Services sector. As MSCI explained, "[t]he last several years have seen rapid evolution in the way people communicate, access entertainment content and other information. This evolution is a result of the integration between telecommunications, media, and internet companies. Companies have moved further in this direction by consolidating through mergers and acquisitions and many now offer bundled services such as cable, internet services, and telephone services. Some of these companies also create interactive entertainment content and aggregate information that is delivered through multiple platforms such as cable and internet, as well as accessed on cellular phones."[1]

Aside from Telecommunication Services, the new sector also incorporates many former IT and internet-related companies that offer communication platforms and content and information. Facebook and Alphabet, which derive the majority of their revenue from digital advertising, were placed within the interactive media & services sub-industry of Communication Services. Netflix, whose main source of revenue is its movie and television streaming subscription base, was classified under Communication Services' movies & entertainment sub-industry.

Communication Services breakdown



Source: FactSet

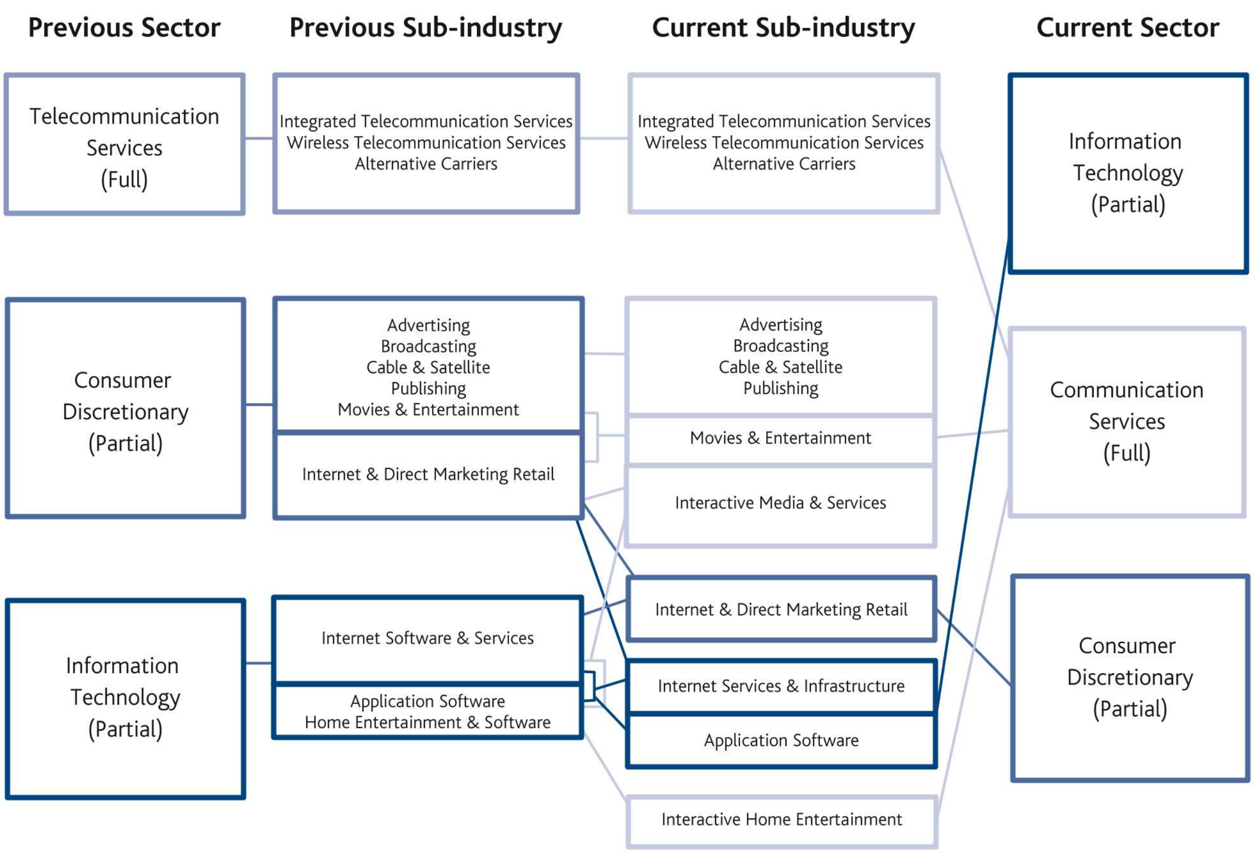
Changes also happened within IT and Consumer Discretionary, with 98 IT companies shifting over to Consumer Discretionary, while one Consumer Discretionary stock moved over to IT. In addition, 355 companies across the IT and Consumer Discretionary sectors were recategorized at the sub-industry level. Overall, 9.5% of the S&P 500 was affected by the GICS changes.

Overview

At the industry group level, Communication Services was split into Media & Entertainment and Telecommunication Services. Media & Entertainment breaks down into three industries: media, entertainment, and interactive media & services, while Telecommunication Services is composed of diversified telecommunication services and wireless telecommunication services providers.

[1] MSCI

Communication Services breakdown by classifications



Source: Morgan Stanley Research

On September 28, when the changes came into effect, Communication Services became the sixth largest sector in the S&P 500, accounting for roughly 9% of the index by weight. Consumer Discretionary decreased to 11% from 13% of the index, while IT shrank to 21% from 26% – although it remains the largest S&P 500 sector.

Facebook and Alphabet together comprise roughly 49% of Communication Services by weight. AT&T Inc. and Verizon Communications Inc., both currently within Telecommunication Services, make up 20% of the new sector by weight.

Changes at the sub-industry level

The 1,718 Consumer Discretionary and IT stocks that joined Communication Services fall into sub-industries as follows:

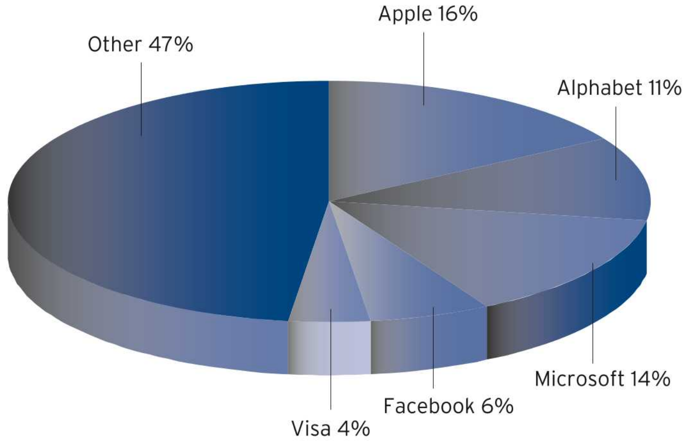
Communication Services sub-industry	S&P 500 Stocks	Global Stocks
Movies & Entertainment	3	404
Advertising	2	323
Interactive Media & Services	4	263
Publishing	1	244
Interactive Home Entertainment	3	233
Broadcasting	2	149
Cable & Satellite	3	74
Integrated Telecommunication Services	2	23
Alternative Carriers	1	4
Wireless Telecommunication Services	–	1

Source: FactSet, MSCI

The tech sector looks different, as well. Apple, Inc. retained its top spot by weight while Microsoft, Inc. stepped in as the second largest stock, and Visa, Inc. became the third largest stock in the sector.

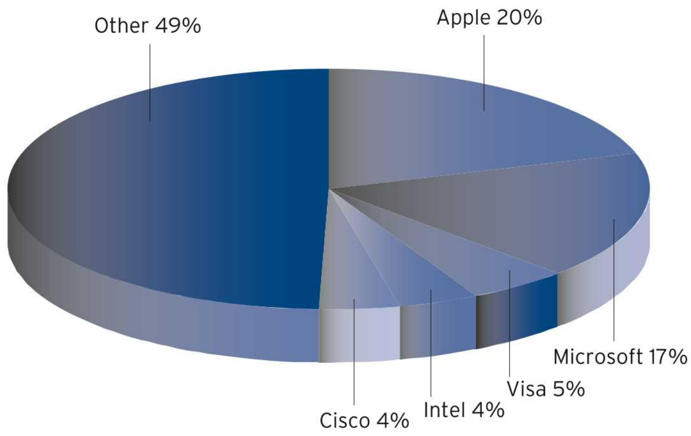
The internet software & services sub-industry within IT was eliminated and the 792 affected stocks will disperse into new and existing sectors and sub-industries, mostly within Communication Services, but also within IT, and two names went into Industrials.

Previous IT breakdown



Source: FactSet

Current IT breakdown



Source: FactSet

Changes in Sector Characteristics

With the addition of the IT and Consumer Discretionary names, the new Communication Services sector is significantly more growth-oriented than the old Telecommunication Services sector, which consisted largely of dividend-yielding value stocks. Roughly 57% of Communication Services consists of growth stocks, where Telecommunication Services had none.[2] Conversely, and as one would expect, the dividend yield for the Communication Services sector is less than 1.5%, in contrast to the 5.4% weighted-average yield for Telecommunication Services, as of September 28.[3]

Communication Services vs. Telecommunication Services growth characteristics

As of 9/28/2018	Historical 3Y Sales Growth	Estimated 3Y-5Y EPS Growth
Communication Services	17.2%	12.9%
Telecommunication Services	3.3%	5.4%

Source: FactSet

Based on forward price-to-earnings ratios, the new sector is pricier than Telecommunication Services, and also trades at a 4% premium to its 15-year average forward P/E ratio.

Communication Services vs. Telecommunication Services next twelve months price-to-earnings ratios

As of 09/28/2018	Current NTM P/E Ratio	15Y Average NTM P/E Ratio
Communication Services	17.2	16.6
Telecommunication Services	10.4	13.6

Source: FactSet

IT is now also less expensive. While the sector's current forward P/E multiple was above its 15-year average before the GICS change, it looks cheaper today, trading at a 10% discount to the new 15-year average P/E ratio. On the other hand, Consumer Discretionary remains priced at a small premium to its 15-year average P/E multiple.

IT next twelve months price-to-earnings ratios

As of 9/28/2018	Current NTM P/E Ratio	15Y Average NTM P/E Ratio
IT pre-change	19.2	16.9
IT post-change	16.3	18.2

Source: FactSet

Consumer Discretionary next twelve months price-to-earnings ratios

As of 9/28/2018	Current NTM P/E Ratio	15Y Average NTM P/E Ratio
Consumer Discretionary pre-change	16.2	15.7
Consumer Discretionary post-change	16.4	15.4

Source: FactSet

[2] FactSet
[3] FactSet

Conclusion

The change in the GICS structure could significantly affect managers whose portfolios are either managed on a relative basis against a benchmark or built with active consideration of sector weights. It could also potentially benefit technology stocks, as managers are able to gain a broader exposure to tech, while smaller stocks in IT could draw more attention from investors.

Although we may see some near-term volatility as passively managed index funds and ETFs are forced to reallocate billions of dollars and some active fund managers readjust their portfolios, we do not believe the change will cause any major long-term shifts. Companies may have moved across GICS category lines, but their market caps and fundamentals did not change as a result of the reclassification.

While we and many other fund managers are applauding the changes to GICS, these changes also reflect the difficultly of pigeonholing many companies in the new economy within a single industry category. For example, when it was founded in 2004, Facebook was an online social networking service for college students. Today, in addition to its main revenue generator – digital advertising – Facebook owns the photo-sharing app Instagram, cross-platform messaging service WhatsApp, and the virtual reality company Oculus VR, along with dozens of other businesses.

Alphabet, which launched in 1998 as Google, Inc., started as a browser service. It has since morphed into a multi-faceted conglomerate generating much of its revenue from advertising while also making smartphones, operating the video-sharing channel YouTube and the home automation company Nest, as well as offering email, maps, document sharing, calendars, and cloud-based storage services to consumers.

While **Amazon.com, Inc.** is remaining in the Consumer Discretionary sector, it is no longer just the online book retailer it was at its 1994 founding. Amazon Web Services, its cloud computing business, has grown rapidly to become a market leader. Amazon Prime provides membership incentives for its online shopping and media streaming services channels, while Prime Now offers quick deliveries of groceries and household products ordered digitally. Although the company still derives most of its revenue from its retail segment, it has built a digital service platform based on scalable IT and online infrastructure.

Because of the wide array of offerings by these and other companies, it may be an exercise in futility to try and categorize them into definitive sectors. There is a level of artificiality with the GICS sector and the classifications may not be perfect fits for all companies.

To learn more about the GICS sector reclassification pertinent to how Baron manages our portfolios, please refer to our upcoming Baron Perspective for the third quarter of 2018.

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S&P 500 Index measures the performance of 500 widely held large-cap U.S. companies. One cannot invest directly into an index.

Earnings per share growth is defined as the percentage change in normalized earnings per share over the previous 12 month period to the latest year end. It gives a good picture of the rate at which a company has grown its profitability. **Dividend yield** is a financial ratio that indicates how much a company pays out in dividends each year relative to its share price. **Price/Earnings Ratio** (trailing 12-months) is a valuation ratio of a company's current share price compared to its actual earnings per share over the last twelve months.

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Portfolio Holdings As a Percentage of Net Assets
As of September 30, 2018

	Baron Opportunity Fund	Baron Fifth Avenue Growth Fund	Baron Global Advantage Fund	Baron Durable Advantage Fund
Alphabet Inc.	4.8	4.7	4.7	4.4
Amazon.com, Inc.	6.3	16.4	5.5	–
Apple, Inc.	4.1	2.7	–	4.2
Facebook, Inc.	1.5	3.6	3.6	–
Microsoft Corporation	5.0	–	–	5.0
Netflix, Inc.	1.3	–	–	–
Visa, Inc.	1.7	4.1	–	–

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