Shifting sands: **What's in your market?**

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Like **sand shifting** underfoot, **fluid index sector weights can jeopardize** the carefully **diversified foundation** of your **portfolio**.

As an early believer in "buying the market", long before exchange traded funds (ETFs) became trendy, you invested in the Toronto Stock Exchange's Toronto 35 Index Participation Units, or TIPS, when they were first listed way back in 1990. For a little bit of foreign exposure, you added S&P 500 Depository Receipts (SPDRs), or "spiders", when they were launched in January 1993. Then you sat back, content that these market exposure instruments provided all the sector diversification you needed for a balanced portfolio.

Boy, was that a miscalculation! In less than a decade your exposure to technology skyrocketed dangerously. The sector's weight in the S&P 500 surged from 6% when SPDRs were introduced, to almost 30% seven years later. Meanwhile, on the Toronto Stock Exchange (TSX), Nortel alone commanded more weight than that! Market exposure was crushing when the tech sector collapsed over the following two years.

Not much later it was financials' turn. Starting the 1990s with a single digit weighting in the S&P 500 and only mid-teens on the TSX, the sector more than doubled its footprint in both markets before the financial crisis of 2008 unfolded. Once again, many investors who thought they were well diversified were devastated.

In our recent piece on home-country bias (Home is where the heart is), we looked at the danger of inadvertent sector concentration in a smaller, less-diversified market. The examples cited above illustrate that perilous sector concentration can arise over time – even in a broadly-diversified market. This paper takes a closer look at the shifting sector composition of the Canadian and U.S. equity markets in recent decades, and demonstrates the importance of regular portfolio review and re-balancing in an investment plan.

CONTENTS

The 'market' does not necessarily provide diversification

In *Home is where the heart is*, we noted how poorly diversified the Canadian equity market is, with almost 75% market weight attributable to only three sectors (Table 1). Investors buying units of index participation units, index tracking mutual funds or ETFs – or even actively managed equity funds that benchmark their neutral exposures to index weights – may be surprised at how dangerously concentrated a portfolio such a strategy produces.

TABLE 1

Sector and issuer concentrations

SOURCES: WORLD BANK/WORLD FEDERATION OF EXCHANGES, FORBES 2016 GLOBAL 2000 (DATA AS AT APRIL 22, 2016), MSCI.

	CANADA	U.S.	U.K.	FRANCE	GERMANY
% Top Sector	41.1	20.2	21.1	19	19.8
% Top Three Sectors	74.7	50.4	53.9	53.6	51.1
Top Sectors	Financials	Technology	Financials	Industrials	Cons. Disc.
	Energy	Financials	Staples	Financials	Financials
	Materials	Health Care	Energy	Cons. Disc.	Health Care
% Top Ten Sectors	36.2	14.7	22.1	33.2	45.6
% Top Issuers	5.7	2.3	3.2	5.8	6
	Royal Bank	Apple	HSBC Holdings	Total	Bayer

	SWITZERLAND	AUSTRALIA	JAPAN	HONG KONG	CHINA
% Top Sector	36.5	51.8	20.6	59.4	30.9
% Top Three Sectors	77	72.7	57.5	87.5	70.4
Top Sectors	Health Care	Financials	Cons. Disc.	Financials	Financials
	Staples	Materials	Industrials	Industrials	Technology
	Financials	Staples	Financials	Utilities	Telecom
% Top Ten Sectors	64.1	45.1	16	11.8	20.5
% Top Issuers	15.5	8.4	3.6	2.3	2.9
	Nestle	Commonwealth Bank	Toyota Motor	AIA Group	China Mobile

For many, the solution to this sector concentration problem is to balance Canadian core exposure with sector funds, or exposure to foreign markets that emphasize different sectors. An even broader approach would be look to global or international funds for greater diversification across multiple parameters, not just by sectors.

But even these broad-brush approaches may not yield adequate sector diversification on a lasting basis. Why? Because market trends, investment fads, and deliberate alteration can quickly change the market-cap composition of indices – even as seemingly diverse as the S&P 500. What appeared reasonable when an investment position was initiated can mutate into a perilously unbalanced state that can destroy wealth surprisingly quickly, particularly if not observed in a portfolio review and dealt with through timely rebalancing.

The perils of index tracking

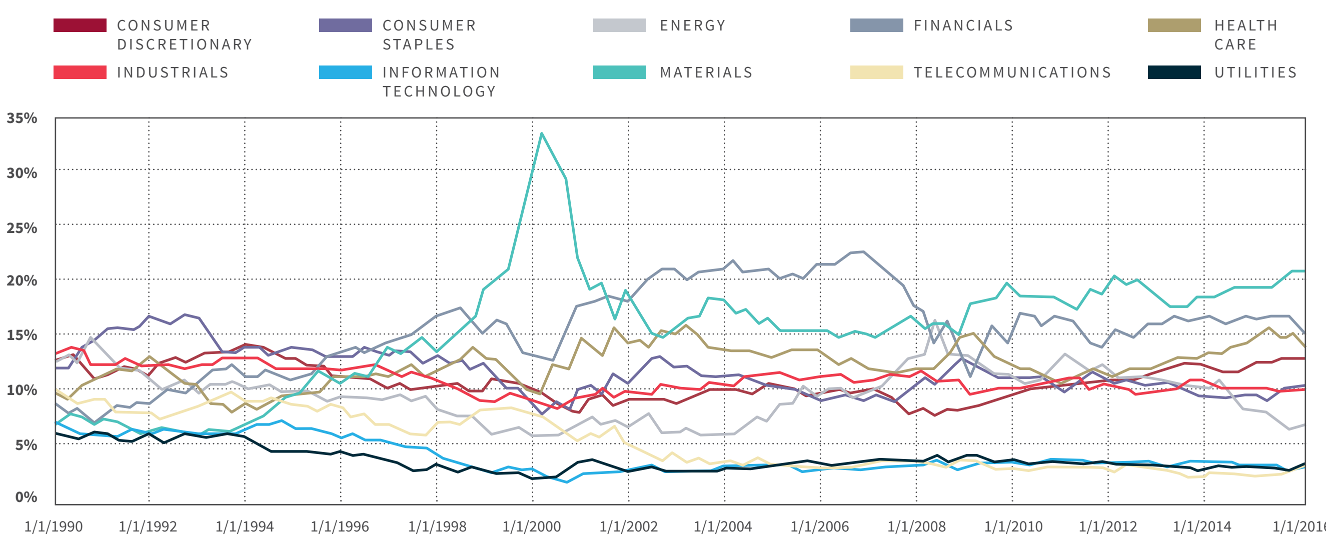
Figure 1 (below) depicts the shifting composition of the S&P 500 Composite Index by sector since 1990. Clearly, the standout shift was the technology bubble of the late 1990s that quadrupled the sector's index weight in less than eight years. The pain inflicted by the halving of that weight in barely two more years is still scarring investors today. Other changes worth noting include:

- In less than a decade and a half, financials tripled its footprint in the U.S. equity benchmark. Then the sector saw the global financial crisis of 2008 cut its weight by more than half to only 11%, before rebounding somewhat. Even today the sector comprises 6% less of the index than it did before the crisis.
- Energy began the charted period at close to 15% of the index. A decade later it was half that. The bull market of the new millennium saw a return in 2009 to its earlier highs, only to be halved again as oil prices retreated in recent years (if we were to extend the chart back a decade earlier, we would see Energy at 25% of the S&P, the largest sector in the index!).
- Utilities, materials, and telecommunication services have each been roughly halved over the period depicted in Figure 1.
- Technology has been making a comeback. Largely on the strength of the 'FANG' stocks (Facebook, Amazon, Netflix, Google), tech has climbed from 15% to back above 20%, a roughly 30% increase in its relative weight.

FIGURE 1

S & P 500: Sector Weightings 1990 – Q1 2016

SOURCE: SIBLIS RESEARCH



The TSX moves like Jagger too

Sector weights in Canada's primary benchmark have been just as fluid. Unlike in the U.S., where the 2008 financial crisis set back the financial sector to an extent from which it has still not recovered, financial services in Canada now make up 37% of the S&P/TSX Composite Index – up from its pre-crisis weight of less than 30%.

In 1981 the sector commanded barely one third its current weight. Where has that weight come from? Mostly from industrials, base metals and consumer products, as many giants of domestic industry and iconic Canadian flagship brands were lost to foreign takeovers – names like Alcan, Noranda, Falconbridge, Seagrams, Molson and Labatt's, for example.

Energy and materials together today comprise roughly one third the S&P/TSX Composite weight. Eight years ago, with the oil, gas and commodity boom in full swing, it was closer to half. Yet one has only to go back to 2002 to find their combined total at just 15%.

Information technology grew in less than a decade from less than 5% to a peak of over 42% in August 2000. Even after the spectacular collapse of Nortel, the sector still represented over 9% of the index weight in early 2004. Today the sector is a shadow of its former self at less than 3% (though that is more than double its low in 2011).

The bursting of the high-tech bubble and the 2008 financial crisis highlight the need to drill down below country or regional allocations of investments, even if you're holding so-called "market-baskets" and examining underlying sector exposures on a regular basis. These shifts demonstrate that even without the occasional deliberate tinkering with weights, there is nothing fixed about index composition.

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Put a cap on it!

A "capped index" is one way to avoid some of the danger arising from shifting weights. Indices such as the S&P/TSX Capped Composite index, launched in 2002 after the rise and fall of Nortel, attempt to prevent any single security from exerting undue influence on the index. Typically, capped indices limit individual components to a maximum weight of 10%, regardless of actual market capitalization. While this may mitigate the risk, it does not eliminate it, since sector booms are usually manifested in more than one stock at a time.

The S&P 500 indices: Capricious as well as composite?

The S&P 500 is one of the most commonly followed benchmarks of the U.S. equity market. It is widely viewed by investors as a rather unbiased or neutral representation of U.S. equities – or at least of large market capitalization equities – and has become the most commonly used proxy for gaining broad exposure to the market and to the U.S. economy in general. So it may strike some investors as shocking that prior to 1976 the composite contained no financials. Zero. The components of the S&P 500 are selected by committee (unlike many other strictly rules-based indices). Therefore the composition of the index is driven not just by market forces, but sometimes by arbitrary changes to the committee's selection criteria and composition guidelines.

Although the index was first introduced in 1923, it was not expanded to its current size of 500 stocks until March 1957. At that time the composition was fixed at 425 industrial companies, 60 utilities, and 15 railway companies. No financials, no health care, no services, no retail – not a broad representation of the U.S. economy.

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In 1976 the formula was amended to 400 industrials, 40 utilities, 40 financials, and 20 transportation companies. (To be fair, remember there was no way for a retail investor to "buy" the S&P 500 at that time anyway, although it was already being widely used as a market benchmark.) The fixed 400-40-40-20 system was finally dropped in 1988 and the committee was given more freedom to select components, supposedly with an eye to reflecting the American business landscape (not necessarily the landscape of publicly traded companies).

Even with this freedom, whole groups and subgroups of businesses are sometimes overlooked or snubbed. For example, it wasn't until 1999, a full five years after the IPO of Netscape and well into the internet boom, that the index added its first Internet company, America Online Inc.

A more recent change in methodology that had a significant impact on S&P sector weights was the 2005 move to weighting by "free-float". When the S&P selection committee decided not to include in its weightings the portion of a company's stock that was not available to the public, a number of large constituent companies with a lot of non-traded shares saw their index representation shift significantly.

For example, Walmart, whose stock is more than 40% owned by members of the Walton family, saw its influence on the index drop by a similar amount. Despite being the largest company by revenue in the world, not just in the U.S., it currently doesn't even make the top 30 in the S&P 500.

Other stocks with a large percentage of ownership by insiders and strategic holders that underwent material adjustments in 2005 included Microsoft, Oracle, Ebay and Goldman Sachs Group. On the other hand, large companies with lower than average insider ownership saw increases in their index weights. These included General Electric, Citigroup, Bank of America, Pfizer and Exxon Mobil.

In Canada, the benchmark index underwent radical change in May 2002 when it came under the management of Standard & Poor's and adopted the U.S. index rules. Rather than being fixed at 300 constituents, as its predecessor TSE 300 had been since launch in 1977, the renamed S&P/TSX Composite Index has its unfixed number of components selected by committee once a quarter.

Although the changes were phased in over six months, the look of the index changed quickly, with the number of components dropping to 232 by the end of 2002. Most of the stocks dropped were from technology, health care, financials and utilities. Since then the number has ranged as high as 278 and as low as 204.

Another radical shift occurred in the Canadian index in December 2005 when income trusts became eligible for inclusion. Overnight the index jumped from 208 to 278 components, with 37 new names in the energy sector alone.

Final words

Many observers have long felt that S&P indices – because they are managed by committee selection, adding growing companies and dropping laggards – are more akin to large actively-managed mutual funds than true indices. It has also been noted that, in Canada especially, composition changes have at times been so radical as to make historical data comparisons illegitimate (i.e., investors should not compare pre-2002 Composite Index data in Canada to post 2002 data).

Our purpose here is not to pass judgement on the merits of index methodologies and the changes in them, the performance implications, or to examine how changes have impacted the indices' abilities to serve as market-tracking benchmarks. Our goal has simply been to illustrate the ever-changing nature of the indices' composition – both by market action and by design – and how a simplistic reliance on "owning the market" can result in dangerous swings in a portfolio's economic exposure over time.

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Worldwide economic globalization and liberalization of goods and capital markets can drive whole industries to relocate to areas of competitive advantage. An investment strategy built on country or regional geographic diversity alone, without a careful analysis of exposure to industry sectors, is not sufficient in a global economy.

A personal Investment Policy Statement within a comprehensive financial plan should include a schedule for monitoring and periodic review – perhaps quarterly, semi-annually, or annually, depending on the complexity of the portfolio.

One objective of such reviews is to identify any undesired overlaps or concentrations that have arisen. Portfolio construction is not a "set-and-forget" activity, even when employing broadly diversified country funds. An iterative review process within a formal strategy will help ensure a portfolio stays balanced. ■