EQUITY

Innovation Stretches Beyond Labels

October 1, 2018

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Some of the market’s most innovative companies now call a new sector home, as part of a revamp of the Global Industry Classification Standard used by index providers to classify stocks. Franklin Equity Group’s Matt Moberg explains why he thinks the changes may not go far enough.

On September 28, MSCI and S&P Dow Jones Indices officially renamed and reconstituted the telecommunications services sector under the Global Industry Classification Standard (GICS) they use to categorise stocks. The new communications services sector includes media and telecom stocks, as well as companies currently in other sectors.

It may seem like a simple administrative change, but some of the world’s largest companies, as defined by market capitalisation, migrated to the new sector. For example, Google-parent Alphabet moved from the information technology (IT) sector, as did Facebook. Netflix shifted out of the consumer discretionary sector.

In November 2017, MSCI and S&P suggested there has been an evolution over the last several years in how we communicate and access content.[1] As a result, the index providers said they were constructing the new communications services sector to include a mix of companies that “facilitate communication and offer content through various media”.[2]

Innovation Is Often Misclassified

We broadly agree with the GICS reclassification and believe the new sector homes for many stocks better reflect their core business lines. However, we might suggest the GICS reform doesn’t go far enough. As long-term investors, we classify companies according to their “end-market”, or the need that is being met.

For example, certain credit card companies are addressing a massive shift in the consumer finance landscape, enabling the huge growth in e-commerce, but also convenience at the point of sale. Ten years ago, it would have been rare to pay for a cup of coffee with a credit card. Now it’s standard practice. So, in our view, these credit card companies belong in the financials sector, not the IT sector where they will continue to reside.

In addition, video game manufacturers are competing for the money in your pocket that might otherwise go to a round of golf or a night at the movies. As such, we think these companies should have moved from the IT sector to the consumer discretionary sector, not the new communications services sector.

Innovation Is Everywhere

We look beyond standard industry classification to spot where innovation is taking place. We’ve always recognised that the influence of technology stretches across more than just a single sector.

As we mentioned in a previous article, we see innovation as the main driving force behind value creation in the global economy. As growth-oriented investors, we believe one must invest in innovation across industries to have the potential to outperform the market.

We believe now is a ripe time to invest in innovation. We are encouraged by the new technology-driven themes we see across many industries.

However, we see these themes evolving at different paces and becoming investable at different times. That's why we think active management can really prove its worth—guiding investors into these themes when they intersect well with a good investment. In particular, we look for select investments in companies in industries where the penetration rates are low, but the addressable market is huge, and where prospects for monetisation are readily visible.

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What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Investments in fast-growing industries, including the technology and health care sectors (which have historically been volatile) could result in increased price fluctuation, especially over the short term, due to the rapid pace of product change and development and changes in government regulation of companies emphasizing scientific or technological advancement or regulatory approval for new drugs and medical instruments. Small- and mid-capitalisation companies can be particularly sensitive to changing economic conditions, and their prospects for growth are less certain than those of larger, more established companies.

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1. Sources: S&P Dow Jones Indices/MSCI, "S&P DOW JONES INDICES AND MSCI ANNOUNCE REVISIONS TO THE GLOBAL INDUSTRY CLASSIFICATION STANDARD (GICS®) STRUCTURE IN 2018," November 15, 2017. Indexes are unmanaged and one cannot directly invest in an index. They do not include fees, expenses or sales charges.
2. Ibid.