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GICS Sector Reshuffle Exacerbates Top-Heavy Concentration For Certain Sectors

Author:

Ryan O. Issakainen, CFA
Senior Vice President
Exchange Traded Fund Strategist
First Trust Advisors L.P.

Summary of Q3 2018 ETF Flows and Trends[1]

- Total US-listed ETF Assets reached $3.74 trillion at the end of Q3 2018, an 18.0% year-over-year increase. Estimated net asset flows totaled $90.3 billion in Q3 2018, compared to $57.4 billion Q2 2018.
- US Equity ETFs received the strongest estimated net inflows in Q3 2018, for the second straight quarter, with a total of $50.4 billion, compared to $37.6 billion in Q2 2018. Estimated net inflows for Sector Equity ETFs increased to $15.3 billion in Q3 2018, rebounding from a lackluster Q2 2018.
- Taxable Bond ETFs had the second highest estimated net inflows in Q3 2018 with $23.5 billion. Municipal Bond ETFs received $0.8 billion in estimated net inflows in Q3 2018. Notably, neither fixed income category has had net outflows during a calendar quarter since 2013.
- International Equity ETFs had relatively light estimated net inflows in Q3 2018, totaling $2.0 billion, after shedding $11.6 billion in estimated net outflows in Q2 2018.
- Commodities ETFs faced accelerating estimated net outflows in Q3 2018 totaling $3.1 billion, while Alternatives ETFs had estimated net inflows totaling $1.2 billion.

Table 1

	Total US-Listed ETF Assets		Estimated Net Asset Flows	
US Category Group	As of 9/30/2018	Year-over-year % change	Q3 2018	Prior Quarter (Q2 2018)
US Equity	$1,789,416,908,542	26.4%	$50,381,576,705	$37,614,288,007
International Equity	$714,728,240,712	7.0%	$1,964,832,040	($11,636,818,414)
Taxable Bond	$598,342,951,833	12.8%	$23,460,137,438	$28,630,857,296
Sector Equity	$480,604,177,985	19.9%	$15,287,146,969	$2,322,868,270
Commodities	$61,808,015,268	-7.1%	($3,119,347,858)	($869,361,775)
Alternative	$50,406,409,951	5.2%	$1,180,093,069	($828,206,192)
Municipal Bond	$32,494,526,799	16.5%	$816,779,611	$1,968,274,104
Allocation	$13,146,254,522	6.7%	$356,973,395	$194,666,264
Total	**$3,740,947,485,612**	**18.0%**	**$90,328,191,369**	**$57,396,567,560**

Source: Morningstar, as of 9/30/18. Includes all US-listed exchange-traded funds, exchange-traded notes and other exchange-traded products. All net inflow and outflow numbers are estimates based on information provided by Morningstar.

Major changes to index holdings are big news in the world of passively managed ETFs, for which holdings are usually relatively static. Which is why so much attention was garnered in the third quarter as S&P and MSCI—joint developers of the Global Industry Classification Standard (GICS)—prepared to recast sector classifications, which affected some of the world's largest companies. These changes were important not because they altered which stocks were in or out of broad indices, such as the S&P 500 Index, but because they changed the composition of sectors within broad indices. Accordingly, for investors in certain sector ETFs that follow GICS classifications, these changes were quite significant.

As discussed below, GICS sector reclassifications shifted the makeup of three important sectors, which together comprise 41.3% of the S&P 500 Index (as of 9/30/18). An important byproduct of these changes, particularly for ETF investors, is the resulting concentration within the top few holdings of these three market cap-weighted sectors. For investment advisors seeking to better diversify the idiosyncratic risk exposure to the largest companies in market cap-weighted sectors, we highlight ETFs that employ equally weighted, multi-factor, and thematic approaches.

GICS Sector Reclassifications: What Changed?

The three sectors of the S&P 500 Index that were directly impacted by GICS reclassification were the Telecommunication Services sector, which was renamed the Communication Services sector, the Information Technology sector, and the Consumer Discretionary sector. The new Communication Services sector grew from 3 holdings to 22 unique holdings, 6 of which came from the Information Technology sector, and 13 of which came from the Consumer Discretionary sector.[2] Notable among the stocks that shifted out of the Information Technology sector were Alphabet, Facebook, and Twitter; notable shifts out of the Consumer Discretionary sector included Netflix, Walt Disney, and Comcast.[3]

Considering these changes, the "new" Communication Services sector represented 10% of the S&P 500 Index at the end of Q3 2018, increasing the weight of the "old" Telecommunications Services sector by roughly 8 percentage points. The "new" Information Technology sector represented 21% of the S&P 500 Index at the end of Q3 2018, compared to 26.3%, based on "old" GICS classifications. Lastly, the "new" Consumer Discretionary sector represented 10.3% of the S&P 500 Index at the end of Q3 2018, compared to 13.1%, based on "old" GICS classifications.

Past performance is not a guarantee of future results and there is no assurance that the events or improvements mentioned herein will continue.

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As holdings changed among these three sectors, so too did the fundamental attributes of each. For example, by certain valuation metrics, such as price-to-forward earnings ratio, the Consumer Discretionary sector got a bit more expensive, increasing from 22.6 on 9/21/18 (before changes were made) to 23.1 on 9/24/18 (after changes were made), while the Information Technology sector got a bit cheaper, decreasing from 19.8 on 9/21/18 to 19.4 on 9/24/18. On the other hand, the price-to-forward earnings ratio for the Communication Services sector increased dramatically, from 10.7 on 9/21/18 to 18.0 on 9/24/18. In our opinion, investors in ETFs tracking these sectors should evaluate the degree to which changes in fundamentals may have impacted their investment theses.

Top-Heavy Concentration

One of the potential drawbacks of market cap-weighted sector ETFs is that they tend to have high concentrations in a small number of very large companies. Of course, there is nothing inherently wrong with large companies. In fact, many large companies are market leaders that are run extraordinarily well. But when sector ETFs are too concentrated in just a few stocks, investors may have more exposure than they realize to the idiosyncratic risks associated with those stocks. At the same time, they may miss out on participating in the growth of smaller companies to which an index may have relatively insignificant exposure.

While all three S&P 500 Index sectors affected by GICS reclassification were top-heavy before changes were made, the Information Technology and Consumer Discretionary sectors became even more so after these changes. As shown in Table 2 below, allocations to the two largest Information Technology companies grew from 30.4% in August 2018 to 37.1% in September 2018, and allocations to the 2 largest Consumer Discretionary companies grew from 32.8% in August 2018 to 41.8% in September 2018. Moreover, although the concentration in the top two holdings of the Communication Services sector declined from August (from 95.6%) to September in 2018, it remains the highest of the three sectors under consideration, at 45.6%.

Table 2: S&P 500 Sector Index Holdings and Weightings

		S&P 500 Information Technology		S&P 500 Consumer Discretionary		S&P 500 Communication Services	
		8/31/18	9/30/18	8/31/18	9/30/18	8/31/18	9/30/18
	# of Holdings*	73 (72)	65 (65)	80 (76)	65 (64)	3 (3)	26 (22)
Index Weights**	Top 2 Holdings	30.4%	37.1%	32.8%	41.8%	95.6%	45.6%
	Top 10 Holdings	66.9%	66.1%	63.8%	68.0%	N/A	91.6%
	Bottom 10 Holdings	1.5%	1.9%	1.8%	2.4%	N/A	5.2%

Source: Morningstar. For illustrative purposes only and does not represent any actual investment. All of the indices are unmanaged, statistical composites that cannot be purchased directly by investors.

By the same token, reducing the number of holdings in the Consumer Discretionary and Information Technology sectors did little to increase allocations to smaller companies; allocations to the 10 smallest holdings increased by just 0.6% for the former, and 0.4% for the latter, from August 2018 to September 2018.

In recognition of these issues, many market cap-weighted sector ETFs track special versions of these indices that cap exposure to individual stocks at levels between 20%-25%. Even so, for many investors these caps may not go far enough in reducing the level of stock-specific risk, in our opinion.

Alternative Approaches

In light of these issues, many investment advisors have chosen ETFs that employ alternative approaches to market cap-weighted sectors, such as equal-weight, thematic, and multi-factor ETFs.

Equal-Weight

The First Trust NASDAQ-100-Technology Sector Index Fund (QTEC) is the ETF industry's largest equal-weight technology ETF, with $2.6 billion in assets, as of 9/30/18. QTEC's holdings are not selected based on GICS classifications; instead the ETF holds 37 companies that are members of the Nasdaq 100 Index and are classified as technology companies by the index provider. The portfolio is rebalanced to equal-weight on a quarterly basis. As such, unlike many market cap-weighted technology ETFs, the fund's returns are less dependent on a few huge companies, while providing more exposure to other significant technology stocks that are not among the largest few.

Thematic

Thematic ETFs, which may not be constrained by GICS sector classifications, provide another alternative for ETF investors. The First Trust Dow Jones Internet Index Fund (FDN), is made up of US stocks that generate a majority of sales/revenues from the Internet. While FDN does employ a float-adjusted market capitalization weighting scheme, the fund's underlying index caps single stock exposure at 10% upon quarterly rebalance, limiting the degree to which one or two stocks can dominate performance compared to the market-cap weighted sectors discussed above.

Moreover, as a thematic ETF not constrained by broad GICS sector classifications, FDN's holdings as of 9/28/18 included Internet stocks from the Information Technology (41.2%), Consumer Discretionary (27.3%), Communication Services (23.7%), Financials (5.3%), and Health Care (2.4%) sectors.

Multi-factor

Multi-factor ETFs, sometimes referred to as "smart beta" or "strategic beta," have grown in popularity in recent years. In 2007, First Trust was a pioneer in launching 9 multi-factor sector ETFs, known as AlphaDEX® funds. Rather than attempting to replicate traditional market cap-weighted benchmarks, these ETFs employ the patented AlphaDEX® stock selection methodology, which seeks to provide exposure to holdings based on investment merit, rather than size.

[1]Based on Morningstar data, as of 9/30/18.

[2]Counting multiple share classes of a single company as one unique holding.

[3]Additionally, eBay joined the Consumer Discretionary sector from the Information Technology sector.

[4]Counting two share classes of Alphabet once.

*Number of companies if multiple share classes are counted as one holding in parentheses.

**Counting multiple share classes as one holding.

In so doing, the AlphaDEX® methodology generally assigns portfolio weights more evenly than market cap-weighted sectors. For example, the top 10 holdings for the First Trust Consumer Discretionary AlphaDEX® Fund (FXD) had an 18.0% portfolio weighting, compared to 68.0% for the S&P 500 Consumer Discretionary sector, as of 9/30/18. Similarly, the top 10 holdings for the First Trust Technology AlphaDEX® Fund (FXL) had a 22.6% portfolio weighting, compared to 66.1% for the S&P 500 Information Technology sector, as of 9/30/18.

For most investors, GICS sector reclassifications came and went without much notice. We believe, however, that investment professionals should investigate how these changes may have impacted their portfolios. Shifting fundamental attributes and more top-heavy concentrations should not be dismissed out of hand. Fortunately, for those concerned about these issues, there are a variety of alternative investments.

You should consider a fund's investment objectives, risks, and charges and expenses carefully before investing. Contact First Trust Portfolios L.P. at 1-800-621-1675 or visit www.ftportfolios.com to obtain a prospectus or summary prospectus which contains this and other information about a fund. The prospectus or summary prospectus should be read carefully before investing.

ETF Characteristics

An index fund's return may not match the return of the applicable index. Securities held by an index fund will generally not be bought or sold in response to market fluctuations.

Investors buying or selling fund shares on the secondary market may incur customary brokerage commissions. Investors who sell fund shares may receive less than the share's net asset value. Shares may be sold throughout the day on the exchange through any brokerage account. However, unlike mutual funds, shares may only be redeemed directly from a fund by authorized participants, in very large creation/redemption units. If a fund's authorized participants are unable to proceed with creation/redemption orders and no other authorized participant is able to step forward to create or redeem, fund shares may trade at a discount to the fund's net asset value and possibly face delisting.

Risk Considerations

A fund's shares will change in value, and you could lose money by investing in a fund. One of the principal risks of investing in a fund is market risk. Market risk is the risk that a particular stock owned by a fund, fund shares or stocks in general may fall in value. There can be no assurance that a fund's investment objective will be achieved.

A fund may invest in small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies.

FDN and QTEC invest in information technology companies, which are subject to certain risks, including rapidly changing technologies, short product life cycles, fierce competition, aggressive pricing and reduced profit margins, loss of patent, copyright and trademark protections, cyclical market patterns, evolving industry standards and frequent new product introductions. Certain companies may be smaller and less experienced companies, with limited product lines, markets or financial resources. Information technology company stocks, especially those which are Internet related, have experienced extreme price and volume fluctuations that are often unrelated to their operating performance.

The success of consumer discretionary companies is tied closely to the performance of the overall U.S. and international economies, interest rates, competition, consumer confidence, disposable household income and consumer spending. Changes in demographics and consumer tastes can also affect the demand for consumer discretionary products.

FDN is classified as "non-diversified" and may invest a relatively high percentage of its assets in a limited number of issuers. As a result, the fund may be more susceptible to a single adverse economic or regulatory occurrence affecting one or more of these issuers, experience increased volatility and be highly concentrated in certain issuers.

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