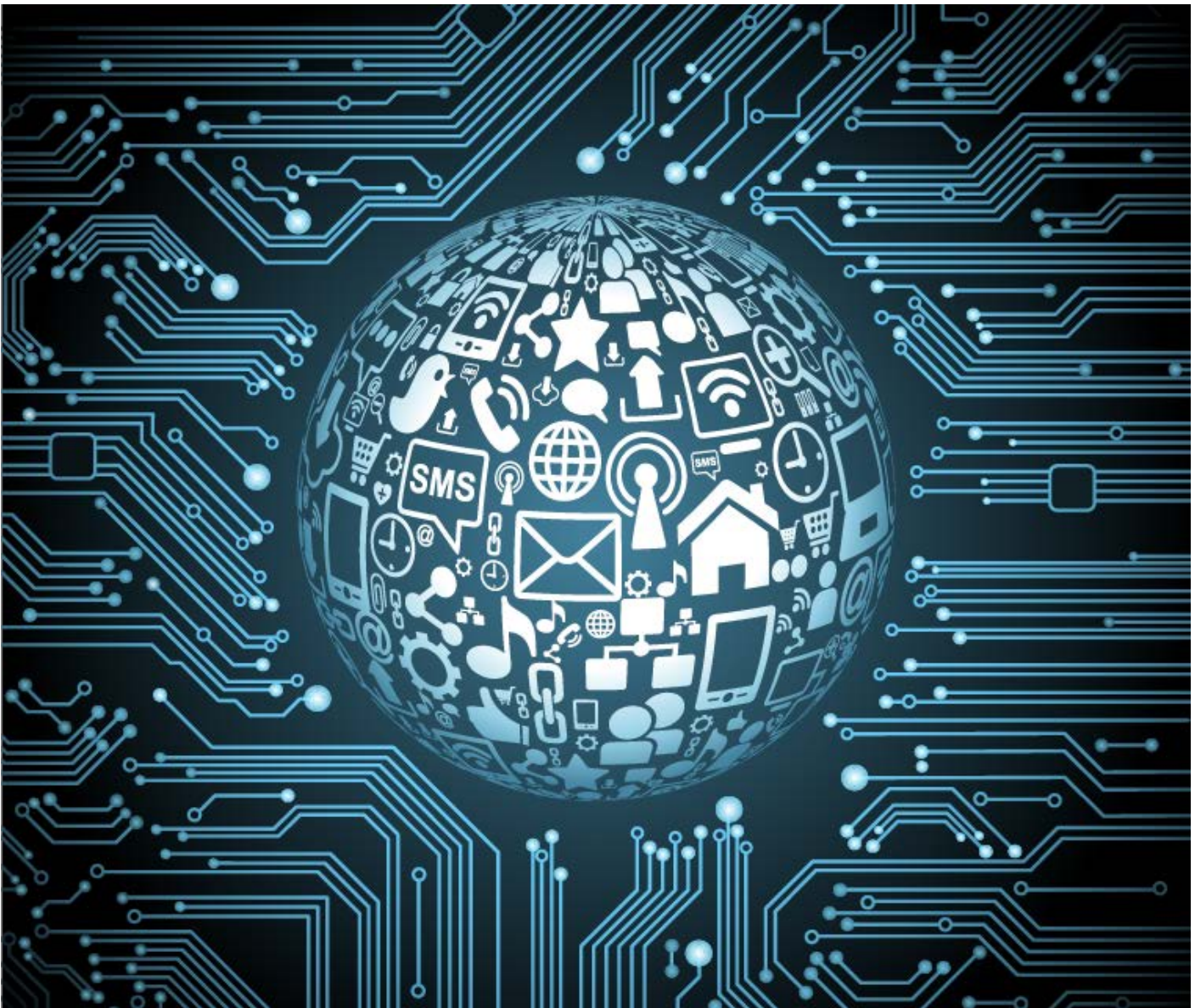


# The Times are a Changin'

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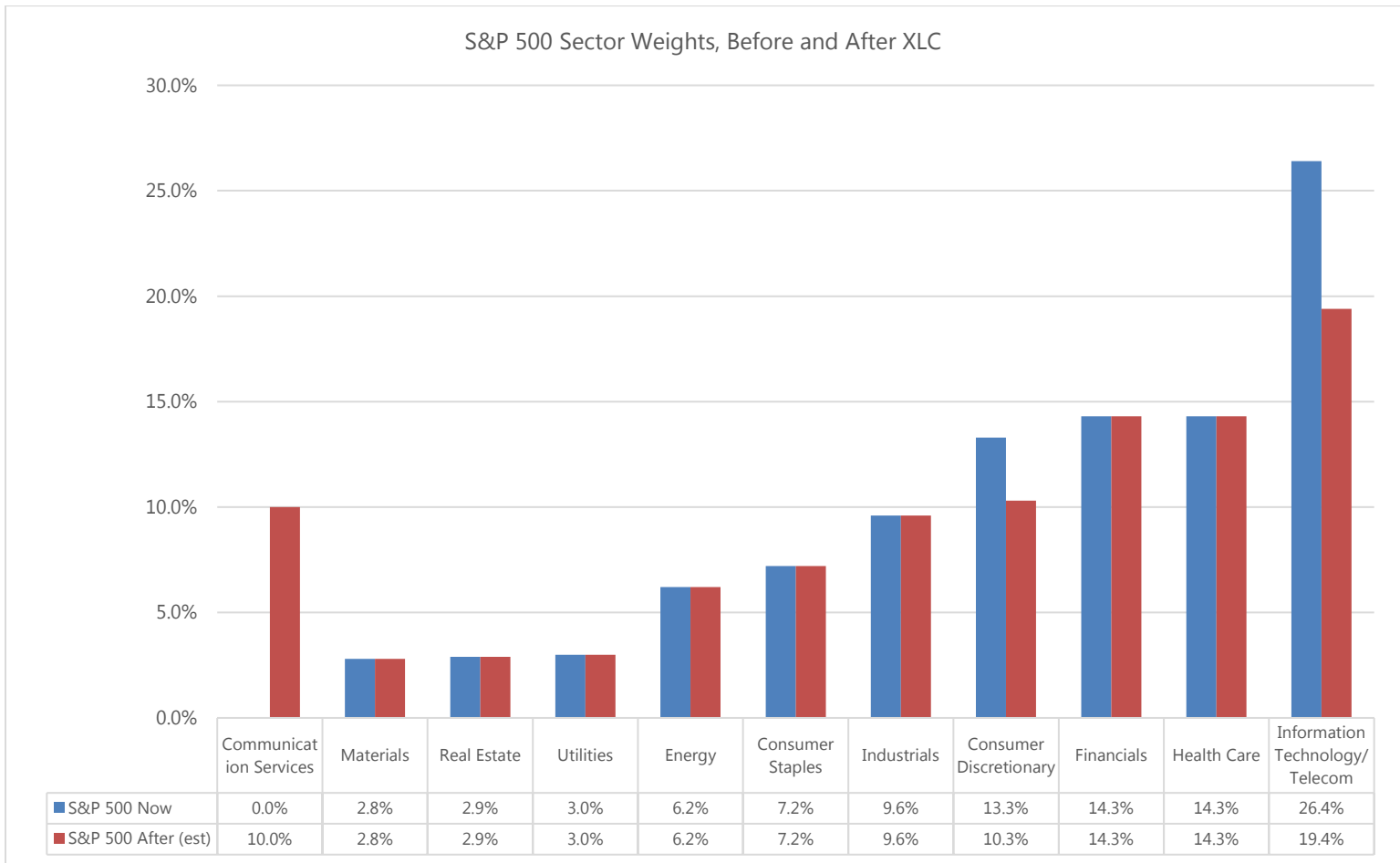
The Creation of a New Sector and How It Affects the DRS



## Creation of a New Sector: Communication Services

S&P Dow Jones Indices and MSCI are responsible for the development and maintenance of the Global Industry Classification Standards (“GICS”). Near the end of 2017 they announced the creation of a new sector, Communication Services. This new sector will be comprised of stocks currently in Information Technology, Consumer Discretionary, and Telecom sectors.

This change was designed to reflect the ever-changing nature of our economy. As social media, internet services, and integrated media & entertainment companies take a bigger role in our lives, a new sector was deemed necessary to capture these changes. This is one of the biggest changes to the GICS structure since its inception.



Source: State Street, MSCI, S&P Dow Jones

The State Street Global Advisors Select Sector SPDRs ETFs are designed to track the GICS indices. In order to accommodate this change, SSgA has created the Communication Services Select Sector SPDR Fund with the ticker XLC. When the reclassification of those stocks into Communications Services occurs on September 21, 2018, just over two dozen names will be sold out of the existing ETFs and then only available in the XLC ETF.

## What are the stocks that are being reclassified?

The new XLC ETF will contain the following. Weights are estimates, and change based upon daily price fluctuations.

Holdings	Ticker	Weighting (%)
Facebook Inc A	FB	18.38
Alphabet Inc C	GOOG	12.98
Alphabet Inc A	GOOGL	12.88
Comcast Corp Class A	CMCSA	5.04
Walt Disney Co	DIS	4.97
Verizon Communications Inc	VZ	4.88
AT&T Inc	T	4.64
Charter Communications Inc A	CHTR	4.55
Activision Blizzard Inc	ATVI	4.54
Electronic Arts Inc	EA	4.17
Netflix Inc	NFLX	3.94
Twenty-First Century Fox Inc Class A	FOXA	3.00
Twitter Inc	TWTR	2.21
CenturyLink Inc	CTL	1.97
CBS Corp Class B	CBS	1.88
Omnicom Group Inc	OMC	1.67
Take-Two Interactive Software Inc	TTWO	1.39
Twenty-First Century Fox Inc Class B	FOX	1.23
Viacom Inc B	VIAB	1.09
The Interpublic Group of Companies Inc	IPG	0.92
Discovery Inc C	DISCK	0.89
DISH Network Corp Class A	DISH	0.75
TripAdvisor Inc	TRIP	0.67
News Corp A	NWSA	0.62
Discovery Inc Class A	DISCA	0.44
News Corp B	NWS	0.20
Cash	-	0.10

Source: Morningstar Direct, 7/30/18

## The Sector Change and the Defined Risk Strategy

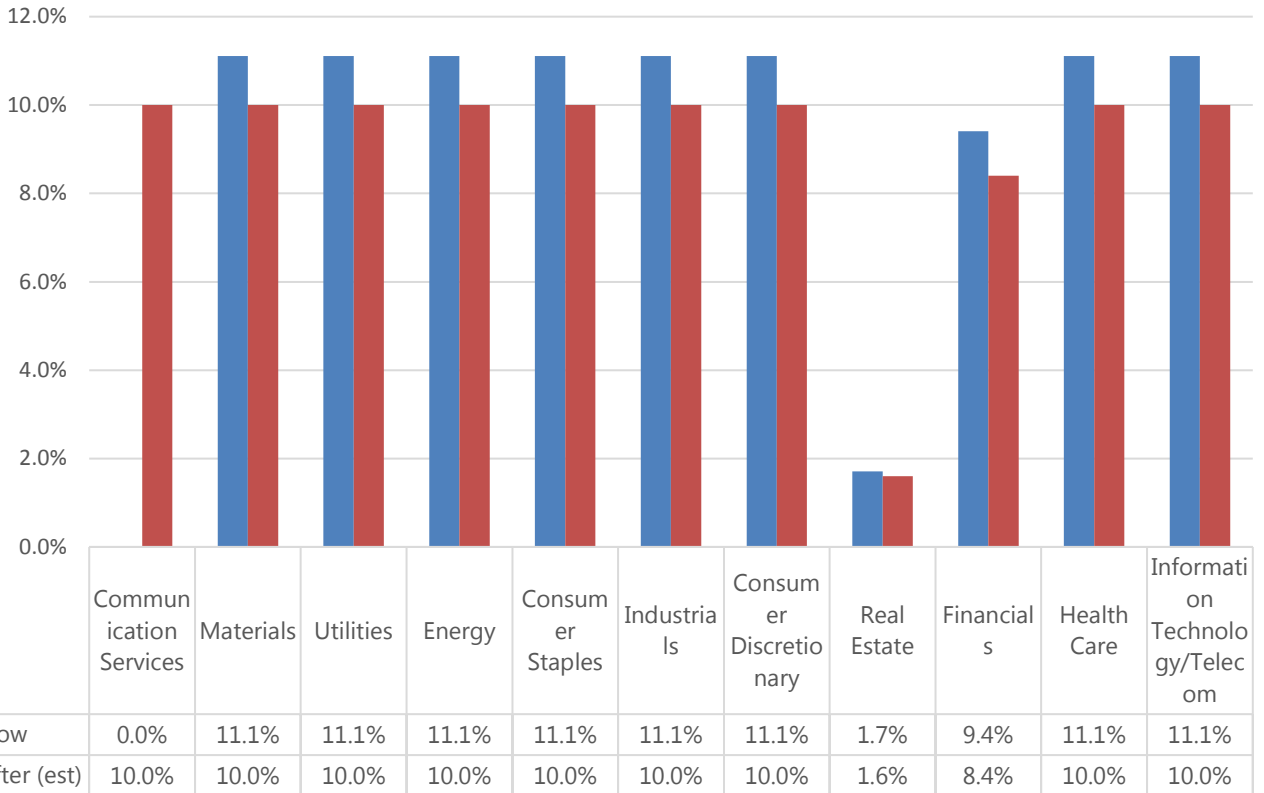
Swan currently uses the line-up of SSgA Select Sector SPDRs to gain access to the U.S. Large Cap market in its flagship Defined Risk Strategy offering. Each sector is given a target weighting equal to the others. With nine primary sectors available, each sector currently has a target allocation of 11.11% of the total equity allocation<sup>1</sup>.

With the creation of the new Communication Services ETF, Swan plans to maintain its equal-weight approach across the primary sectors. So rather than nine sectors with 11.11% each, there will be ten sectors with a target of 10.00% each<sup>2</sup>.

<sup>1</sup> An exception is made to the roles of real estate (XLRE) and finance (XLF). The two have a current combined weight of 11.11%. This is discussed in greater detail towards the end of this FAQ.

<sup>2</sup> The exception for real estate and finance will be maintained. The two will have a combined allocation of 10%.

## Equal Weight Sector Approach, Before and After XLC



Source: Swan Global Investments

So essentially 1.1% will be shaved off of every existing sector and allocated to XLC.

This change is simply too big to ignore. If Swan were to exclude XLC from its allocation, it would be missing a significant part of the market, including some of the biggest names in the S&P 500.

### What will the impact be from a top-down, total portfolio basis?

The equal weight sector approach gives the aggregate portfolio more of a value-tilt and a lean away from some of the mega-cap names that dominate the S&P 500. Sectors like health care, financials, and most notably technology are underweighted. More value-oriented sectors like energy, utilities, and materials are overweighted.

Post reclassification, the revised equal weight will still have a bias towards value and away from mega-cap, but the difference will not be as pronounced. This change moves the aggregate portfolio a little closer to the S&P 500 in some ways. Because 1) many names in the newly created Communications Services sector will be sourced from the Technology sector and 2) the target weight for Communications Services is now a full 10%, the overall exposure to the “new economy” names will increase.

If one created a spectrum with value on one side and growth on the other, it might look like the following:



### What will be the impact from a bottom-up, individual stock basis?

The upper half of the table below shows estimates of the five biggest over- and under-weighted positions relative to the S&P 500. The lower half shows the same information after the reclassification.

#### Current

<i>Biggest Overweights</i>			<i>Biggest Underweights</i>		
Name	S&P 500 Weight	Swan Weight	Name	S&P 500 Weight	Swan Weight
DowDuPont	0.7%	2.4%	Apple	3.9%	1.7%
Exxon Mobil	1.5%	2.7%	Microsoft	3.3%	1.4%
NextEra Energy	0.3%	1.3%	Alphabet	2.9%	1.2%
Chevron	1.0%	1.9%	Facebook	2.0%	0.8%
Duke Energy	0.2%	0.9%	AT&T	1.0%	0.4%

#### Post-Reclassification

<i>Biggest Overweights</i>			<i>Biggest Underweights</i>		
Name	S&P 500 Weight	Swan New Weight	Name	S&P 500 Weight	Swan New Weight
DowDuPont	0.7%	2.3%	Apple	3.9%	1.9%
NextEra Energy	0.3%	1.2%	Microsoft	3.3%	1.5%
Exxon Mobil	1.5%	2.3%	Alphabet	2.9%	2.3%
Chevron	1.0%	1.7%	Berkshire Hathaway	1.6%	0.9%
Praxair	0.2%	0.8%	JPMorgan Chase	1.5%	0.9%

Source: Swan Global Investments, Bloomberg

Those positions that move from Technology to Communication Services get the biggest boost. Those names that remain in Technology make up a larger slice of a now smaller pie, so they get a slight increase.

The top overweights are slightly reduced by the reclassification. In fact, it is not just the top five - it is almost all of the overweights. Even though many of the sectors are not impacted by the reclassification at all, the fact that Swan will be reducing the standard weight from 11.1% to 10.0% reduces many overweight positions and slightly increases some underweight positions in sectors like Financials and Healthcare.

## What will be the tax consequences?

When it comes to taxes, there are two topics to discuss: the impact of the change within the ETFs like Technology (XLK) and Consumer Discretionary (XLY) and the impact as Swan rebalances from 11.1% to 10.0% weightings as the Communication Services ETF (XLC) is added.

State Street Global Advisors has stated that they expect little to no impact from rebalancing XLK and XLY and moving those two dozen names over to XLC.

When it comes to Swan adjusting the equal weight sector targets from 11.1% each to 10.0%, the tax impact is also expected to be minimal compared to regular rebalances. The existing targets are only being reduced by 1.1% each. In addition, Swan has carry forward losses from past years' put options from hedging the portfolio.

Moreover, due to the daily price moves on the various sectors, the actual allocations to the sectors are often a bit different from their targets. Swan monitors these actual allocations and when they drift too far will initiate a rebalance back to target.

With the addition of XLC to the portfolio, this will create a situation where most of sectors will likely be slightly off-target. Using their existing rebalancing infrastructure, Swan plans to give XLC its targeted 10% allocation by slightly reducing all other sectors.

## Why does Swan equal-weight the sectors in the first place?

Since 2012 Swan has opted to equally weight the various GICS sectors rather than use the capitalization weighted S&P 500 for its market exposure. The Achilles Heel of capitalization-weighting is that the only thing that matters is a company's price. The more a company's stock price goes up, the bigger the company gets, the more a cap-weighted index is forced to buy it. This creates a positive feedback loop that can lead to bubbles in sectors or individual stocks. The equal-weighted approach is a way to introduce more of a value-tilt into the portfolio.

A full discussion of equal-weight sectors can be found in these two blog posts:

[Worth the Weight](#)

[Worth the Weight. Q&A](#)

## Differences from the Real Estate sector change and carve out (XLRE) in 2016

In 2016, S&P and MSCI had a reclassification where they created a sector for Real Estate. There are two key differences between the Real Estate reclassification two years ago and the pending Communication Services.

1. All of the REIT stocks that went into Real Estate were sourced from the Financials sector
2. The overall REIT sector, relative to the market, was rather small (2.9%)

With the Communication Services reclassification, stocks are migrating over from multiple sectors, namely Information Technology, Consumer Discretionary, and Telecom. Moreover, the new sector will be a significant part of the S&P 500, anticipated to be around 10% of the market. It could be argued that the Real Estate carve-out was unnecessary.

Two years ago, Swan made the decision to keep the relative weights between the Financials ETF (XLF) and the newly created Real Estate ETF (XLRE) in roughly the same 4:1 ratio they were before the carve out. The combined XLF/XLRE position was kept at its original 11.1% weight, since those stocks in the past had always been classified as Financials.

## Learn More about the Communication Services Reclassification

State Street Global Advisors has produced a wealth of information on this topic. A good starting point would be these links:

<https://us.spdrs.com/en/etf/communication-services-select-sector-spdr-fund-XLC>

<https://global.spdrs.com/blog/post/2018/jun/communication-services-investing-to-reflect-a-new-reality-gics-sector-changes-part-1.html>

<https://global.spdrs.com/blog/post/2018/jun/a-new-gics-sector-is-on-its-way-how-to-prepare-portfolios-gics-sector-changes-part-2.html>

<https://www.etftrends.com/new-sector-spdr-etf-debuts-with-3-faang-stocks/>

### About the Author:



**Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Client Portfolio Manager**, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly, Marc was the Director of Research at Zephyr Associates for 11 years.

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