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Real Estate Sector Classification

REITs Break Out from Financials Starting August 31

What's Happening?

For the first time since the Global Industry Classification Standard (GICS) was created in 1999, a new sector will be added, elevating real estate to a separate category from its current inclusion in the financials sector.

The new real estate sector will include equity real estate investment trusts (REITs) and real estate management and development companies. Mortgage REITs, which facilitate the financing of commercial and residential real estate, will remain in the financial sector.

When is this happening?

Changes to GICS classifications will occur on August 31, 2016 and will be implemented in MSCI and S&P indexes on September 16, 2016 as part of the annual index rebalancing.

Why is this happening?

The decision to promote real estate to a stand-alone sector is an affirmation of the increasing size, scope, and importance of real estate in equity markets. For instance, today there are 24 REITs in the S&P 500 with a combined market capitalization of over $500 billion, or over 3% of the index. REITs and REIT-like structures are represented in greater magnitude in many other small, mid, and large cap U.S. and global indexes.

GICS also cites a greater understanding and rising demand for real estate investments as a portfolio diversifier and income generator. In addition, the creation of a separate real estate sector will allow the remaining financial sector to be more focused in the core businesses of banking, insurance, asset management, and other financial services.

How has the financial and REIT sectors performed in 2016?

The performance of the financial and REIT sectors vary among individual indices due to differences in constituent holdings based on capitalization and style classification. The table below shows how the sectors have done in the broadly diversified Russell 3000 Index so far in 2016.

Index	YTD as of August 19, 2016
Financial Sector (Current)	1.87%
REIT Sector	11.92%
Financial Sector (x-REITs)	-0.76%

What implications does re-classification have for investors?

The re-classification of real estate into its own sector will have a different impact on each diversified equity index depending on its weighting in the financial sector. For instance, the S&P 500 has a current financial sector weighting of 15.9% with 3.1% allocated to REITs; while the Russell Mid-Cap Value Index has a financial sector weight of 29.5% with a REIT exposure of 16.7%.

The re-classification of the real estate sector will also have implications on mutual funds and ETF's that are managed to track the financial sector. After re-classification, funds indexed to the financial sector will be forced to remove their holdings in re-categorized REITs. Conversely, REIT-only funds will have to rebalance out of mortgage REITs in order to track the new index that does not include these types of REITs.

Rebalancing could have an impact on income. The current financial sector has a dividend yield of 2.5%. However, excluding REITs the new financial sector's yield will drop to 2.1% - a 40 bps decline. In addition, depending on the magnitude of rebalance required there will likely be a tax implication for taxable fund holders.

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Source: Factset, S&P, MSCI, Russell, Cohen & Steers

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