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Marketing Material

S&P 500 SECTOR COMPOSITION: MORE TECH, LESS ENERGY THAN EVER BEFORE

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IN A NUTSHELL

_ The S&P 500 remains a broad equity index, but its sector mix has changed.
_ It is not 1999: we would consider this a structural shift in S&P 500 sector composition.
_ Rising share of S&P 500 makeup is not the same as delivering superior returns.
_ But a changing sector composition influence the fair aggregate S&P 500 P/E.
_ Tech's strong fourth quarter EPS and outlook support the S&P 500, but risks remain.

THE S&P 500 REMAINS A BROAD EQUITY INDEX, BUT ITS SECTOR MIX HAS CHANGED

As the S&P 500 sets new record highs this month – led by tech reaching new highs, while energy revisits 2016 lows – we decided to reexamine the S&P 500's sector composition now vs. history. This note presents the percentage share of S&P 500 market capitalization and net income by sector back to 1967. We point out that while the S&P 500 still represents a well-diversified equity index with broad industry and sector exposure, more of its earnings come from technology related businesses and less from energy related than ever before. While 1999-2000 witnessed a surge in tech's market cap share of the S&P 500, today's heft of tech is at both S&P 500 market cap and earnings.

S&P 500 SECTOR COMPOSITION BY MARKET CAP AND EARNINGS

Compared to 1980, tech market cap share of the index rose from 9% to 22% and healthcare from 7% to 13%. These two sectors are 35% of the index by market cap and 33% by earnings now, and they are usually high price-to-earnings (P/E) sectors. Tech plus communication services is about 35% of S&P 500 market cap and 30% of earnings. Share of energy, industrials and materials declined from 46% in 1980 to 15% now.

IT IS NOT 1999: WE WOULD CONSIDER THIS A STRUCTURAL SHIFT IN S&P 500 SECTOR COMPOSITION

Some investors might consider the record share of S&P 500 market capitalization and earnings at technology, communications and internet retailing, indicative of an economic imbalance; which market forces or some form of mean reversion will eventually correct. However, we think today's situation is very different from that of 1999-2000.

First, we point to the alignment of market capitalization and earnings share this time around. The P/E premium of tech plus communications vs. the S&P 500 is about 20% to 25% now, whereas in 1999-2000 the P/E premium for tech was over 100% vs. the S&P 500.

Second, we consider earnings conditions across sectors fairly normal. While our 2020 estimates for energy, materials and industrials are likely below their full mid-cycle normalized earning power, we think only moderately so, and we consider earnings at tech and communications to be normal or sustainable with healthy growth ahead. We know that energy profits are 40% of levels in 2011 and a third of 2008, but we think such conditions are unlikely to return. Thus, we do not think a reversion to normal earnings across sectors will reverse today's S&P 500 sector composition.

Third, we see more long-term growth potential at technology related businesses and also at healthcare. We believe earnings reinvestment rates will probably stay high at these sectors relative to the others. And that the returns on reinvestment will probably be good. As the United States and global economy continue to shift more toward services and knowledge-based businesses, we think the potential for new companies to emerge and surge is greater at new economy sectors than old. To be clear, we think competition in new economy sectors is fierce and predicting which individual companies win or lose will be difficult (high idiosyncratic risk). But we think that today's dominant sectors will gain more S&P 500 share over long-term; especially tech, com-

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munications and healthcare. Exceptions, probably shrinking financials and possibly larger utilities.

RISING SHARE OF S&P 500 MAKEUP IS NOT THE SAME AS DELIVERING SUPERIOR RETURNS

Total return includes both price appreciation and dividend yield. Some sectors might shrink further in size as a share of S&P 500 market cap and net income, but deliver good and possibly superior total returns by raising dividends and repurchasing shares. For the growing sectors to outperform, it is important that reinvested capital earn healthy returns and drive economic profit growth. We consider such prospects encouraging.

BUT A CHANGING SECTOR COMPOSITION INFLUENCE THE FAIR AGGREGATE S&P 500 P/E

Out of recessions, the average trailing S&P 500 P/E is 16.5 since 1960 and 18 since 1985. If we apply each sector's average P/E from these periods to a weighted sector mix that reflects today's weights, then on an adjusted basis, the historical trailing S&P 500 P/E rises to 19.3 since 1960 and 18.8 since 1985. We think compositional shifts and low interest rates support a fair S&P 500 trailing P/E of about 20. Assuming healthy earnings-per-share (EPS) growth and benign U.S. election outcome, a trailing S&P 500 P/E of about 20 should hold in 2021.

TECH'S STRONG FOURTH QUARTER EPS AND OUTLOOK SUPPORT THE S&P 500, BUT RISKS REMAIN

The S&P 500 climbed much faster than we expected the past several months. We stick with our "Next 5%+ price move" as "Down." We think dropping below 3,200 is more likely than exceeding 3,550 as the next move. We remain concerned about still slow S&P 500 EPS growth, election risk, the virus and the longer stretch of days without a 5%+ dip.

GLOSSARY

In relation to currencies, appreciation refers to a gain of value against another currency over time.

A dividend is a distribution of a portion of a company's earnings to its shareholders.

The dividend yield is the dividend that a company pays out each year divided by its share price.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Idiosyncratic risk is a risk which is related solely to the individual company and has no correlation with the general market risk.

Market capitalization, in the context of an individual firms, is the number of shares issued multiplied by the value of the shares.

Mean reversion is a theory that prices and returns eventually move back toward the mean, or average.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

APPENDIX: PERFORMANCE OVER THE PAST 5 YEARS (12-MONTH PERIODS)

	01/15 - 01/16	01/16 - 01/17	01/17 - 01/18	01/18 - 01/19	01/19 - 01/20
S&P 500	-0.7%	20.0%	26.4%	-2.3%	21.7%

Past performance is not indicative of future returns.
Sources: Bloomberg Finance L.P., DWS Investment Management Americas Inc. as of 2/14/20

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