Gyroscope Capital Management Group

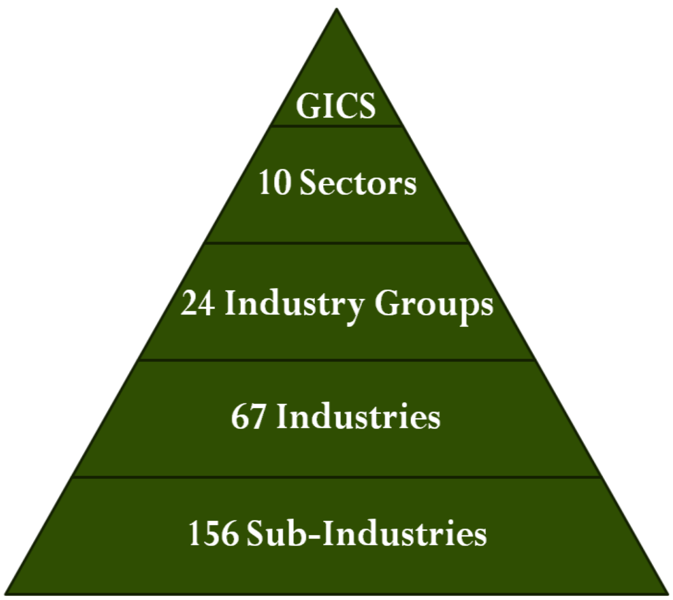
Thursday, October 13, 2017

Quarterly Review and Commentary

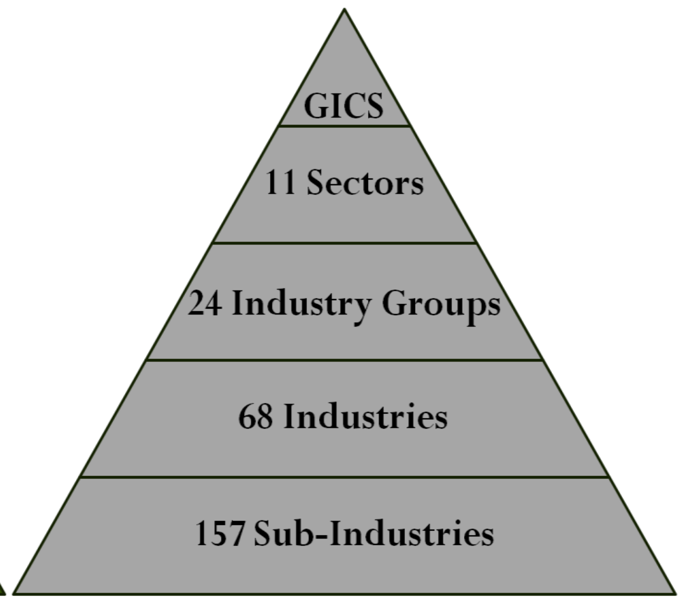
After Historic Sector Addition, Real Estate is Now a New Sector

For the first time since the Global Industry Classification System (GICS) was established in 1999, a new industry sector has been created. After the market closed on Wednesday, August 31st, 2016, Real Estate became an entirely new and distinct sector. The old GICS structure consisted of 10 sectors, 24 industry groups, 67 industries and 156 sub-industries. The new structure now has 11 sectors, which has significant implications for equity allocation in the U.S.

Old GICS Structure



New GICS Structure



Background of the GICS Framework and the Change

The GICS framework is a collaboration between MSCI and Standard and Poor's (S&P) which has become the de-facto global standard for subdividing industries. Companies are classified with similar peers based primarily on the main business from which revenues are derived with consideration given to earnings and market perception.

Prior to the change, real estate company equities, which are mostly real estate investment trusts (REITs), had been included as an industry group within the Financials sector. The newly-formed Real Estate sector contains REITs and real estate management and development companies, with the exception of mortgage REITs, which will remain in the Financials sector because of their high correlation to the financial industry.

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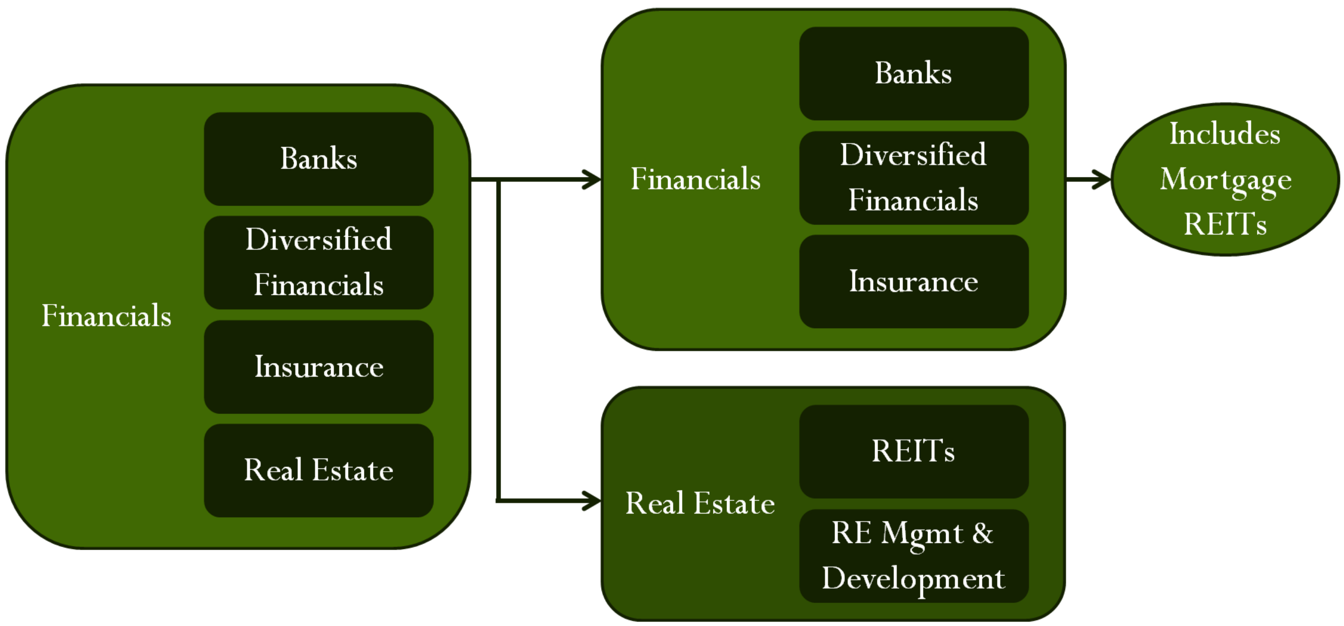
Old GICS Structure **New GICS Structure**



Why does it matter?

While the classification does not affect the weightings of real estate companies within the MSCI and S&P Indices, the change is still significant for several reasons. First, the switch affirms Real Estate's significance and establishes it as a bona-fide equity allocation rather than an alternative investment. Second, the re-classification facilitates increased analyst coverage and investor attention to REITs. Most importantly, however, because many investment mandates and investment policy statements require money managers to maintain a certain minimum level of diversification relative to the GICS distribution of a reference benchmark, many equity managers will likely increase their capital allocations and attention to real estate equities. With over \$7.8 trillion indexed to the S&P 500 alone, the potential for increased capital flows into Real Estate is considerable.

The new sector will most likely be a relatively low beta sector with a negative correlation to interest rates and similarly, high correlation to Utilities and Telecommunications. Also, Financials are likely to become more volatile with greater positive exposure to interest rates in the absence of the carved-out real estate companies. Portfolio managers and investors must also consider how the resulting changes in the earnings growth rate and dividend yield of the Financials sector will impact their portfolios.

How is Gyroscope Capital going to handle the change?

Over the remainder of 2016, we are going to continue treating real estate companies as if they are still constituents of an industry group within Financials. During this time we will examine the impact that the reclassification will have on our portfolios and analyzing historical information on the new GICS structure in order to determine how to best handle GICS sector allocations. We may prefer to maintain the flexibility of being able to allocate capital to an additional financial stock or a real estate company at our discretion. Also, Real Estate's relatively low weighting in the S&P 500 (roughly 3% as of 9/22/16) makes its allocation decision less significant than that of most other sectors.

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Dividend Income Portfolio constraints currently require us to maintain sector weightings within 5% of the GICS Sector weights of the S&P 500 with the additional constraint that every sector has representation in the portfolio. Of course, Real Estate will remain an exception to this rule until the Investment Committee determines that a consistent Real Estate allocation is beneficial to client portfolios.

Growth & Income Portfolio sector allocations must consist of a minimum of six GICS sectors. Because of the relatively lax sector restrictions of the portfolio, it is unlikely that the creation of the Real Estate sector will have a meaningful impact on the Growth & Income Portfolio over the foreseeable future.

Low Volatility Portfolio constraints, like those imposed on the Dividend Income Portfolio, also require that GICS sector weights be within 5% of S&P 500 weights. The Low Volatility Portfolio currently owns four REITs, which represent roughly 14% of the portfolio's value (as of 9/28/16). Again, however, Real Estate will be treated as if it were a Financials industry group, which would result in a total allocation to Financials of roughly 21% (as of 9/28/16).

As always, we welcome your questions/comments and are available at your convenience to discuss the Portfolios.

Thank you for investing with us!