The Footsie Shuffle

For Investment Professionals Only

When the Financial Times Stock Exchange (FTSE) 100 launched in 1984 at the base level of 1000, it consisted of the 100 largest companies that were listed on the London Stock Exchange. Out of the 100 principal companies in 1984, only 22 remain today. Although the majority of these changes can be traced back to mergers and acquisitions, bankruptcies and relegations, the composure of the 100 blue chip companies and the factors driving them has changed significantly. This is important to monitor as an index's industry-composition correlates to overall economic exposure and risk. In this article we evaluate the FTSE 100's constituent changes and the important differences with its little brother, the FTSE 250.

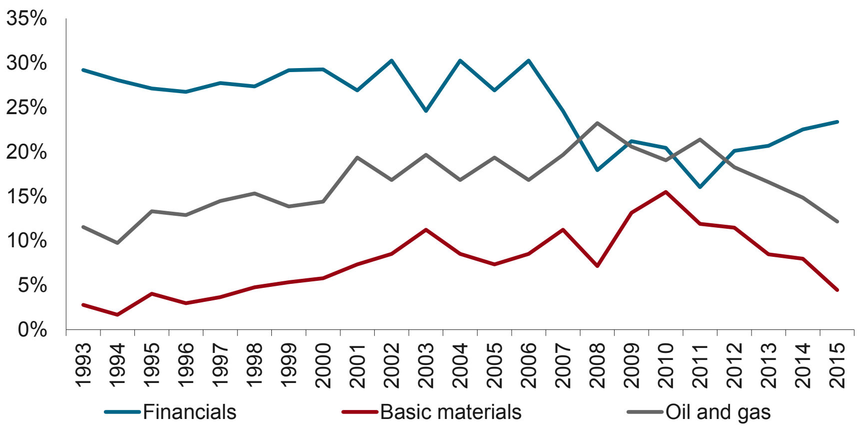
Rapid changes

Historical data of the constituents of the FTSE 100 displays how rapidly the index changes. Take the oil and gas sector for example. In 1994, the sector constituted 9.7% of the index, and in less than six years the sector doubled to represent nearly 20% of the entire index. Another example is the basic materials sector. Back in 1993 it covered a minor 2.8% of the weighted market cap, hitting an all-time high of 15.5% in 2010, and finally dropping back to 6.3% by July 2016.

Why is this important? "No big deal" you could say, as sector fluctuations allow the index to evolve in line with the economy. However, whilst minor changes will not dramatically affect an index, structural changes over long periods can change its performance characteristics.

Furthermore, understanding the sector breakdown of an index is the key to understanding its economic exposure. In 2007 the financial sector got hit hard as problems in the US mortgage market rang the starting bell for the global financial crisis, its dominant weight in the index contributing to the FTSE 100's significant drawdown and causing the financial sector's weight to halve in less than four years.

FTSE 100 selected sector breakdown



Source: Datastream

The Survivors (1984-2016)
Associated British Foods
Barclays Bank
BAT Industries
BP
Hammerson
Guest, Keen & Nettlefolds (GKN)
Johnson Matthey
Land Securities
Legal & General
Lloyds Bank
Marks & Spencer
Pearson
Prudential
Rio Tinto
Royal Bank of Scotland
Royal Dutch Shell
Sainsbury
Smith & Nephew
Standard Chartered
Tesco
Unilever
Whitbread

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Driven globally

Over the past 30 years the FTSE 100 saw its biggest players expand overseas, as well as an increasing number of predominantly foreign companies listing on the London Stock Exchange. Take the example of Fresnillo, a company operating gold and silver mines in Mexico, headquartered in Mexico City, but listed on the London Stock Exchange. As a result, more than 70% of total revenues for FTSE 100 companies are generated overseas rather than within the UK borders. Therefore, what was once a UK domestic index is now mainly driven by global influences so can no longer be seen as a proxy for British economic prosperity.

As the majority of the FTSE's earnings come from overseas, foreign currency movements often drive its performance. This was seen as recently as 23 June when Britain voted to leave the EU. The pound fell by over 10% in value yet many London listed stocks gained in the days that followed as foreign earnings were boosted by the devaluation of the pound.

Battle of the FTSEs

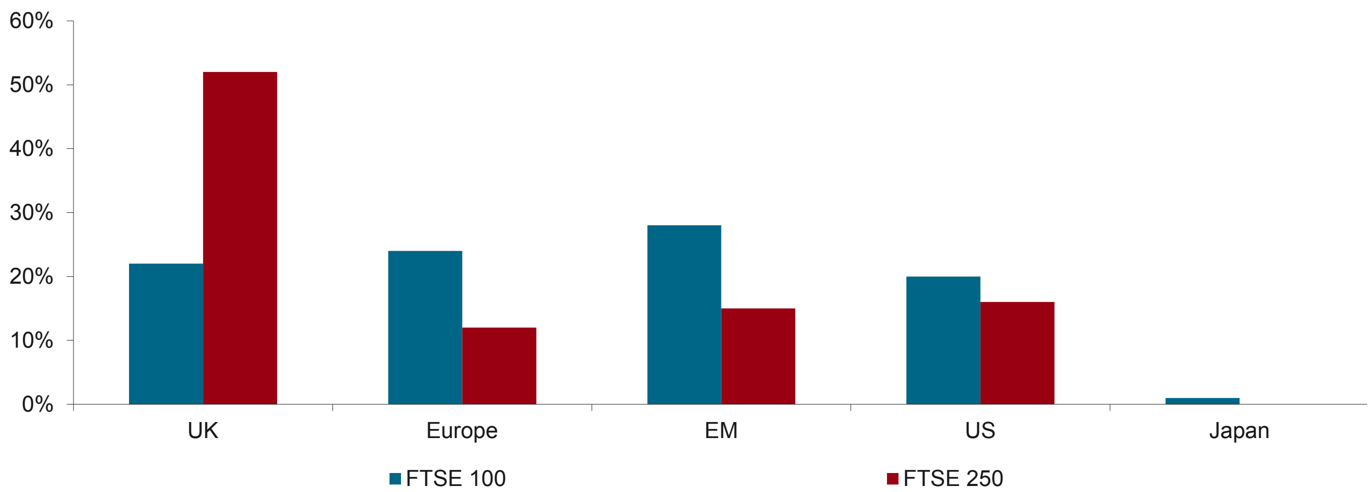
The FTSE 250, however, consisting of the 101st to the 350th largest companies on the London Stock Exchange, is better suited to valuing the UK's economic performance. It is less globally exposed, and more correlated to the fluctuations of the pound, and while the FTSE 100 contains more defensive stocks, the FTSE 250 is made up of more cyclical companies.

%	FTSE 100	FTSE 250
Defensive	42%	10%
Cyclical	26%	51%

Source: Bloomberg

The FTSE 100 and FTSE 250 also differ in terms of commodity exposure, especially oil. FTSE 100 oil and gas companies constitute 13.5% of the index, whereas only 2.6% of the FTSE 250 operates in the same sector. Meanwhile, investment trusts make up over 14% of the FTSE 250, whereas the FTSE 100 contains none. This needs to be taken into account when determining total exposure.

Regional sales exposure



Source: Datastream

Mega cap concentration

Another change that has been occurring in the FTSE 100 is the size of the mega caps included. In 1997 the top 10 companies by market cap covered 55% of the entire index. Since then, the size of the top 10 companies has trended lower, with the current group at 44.3% - this is still a way off 37.2%, the level back in 1993.

Top 10 companies by market cap (1993 - 2016)

Source: Datastream

A low concentration in a few companies is important to look at when assessing an index's exposure. The Swiss Market Index, for example is dominated by just three large companies holding a combined weight of over 60%. This compares to the S&P 500 where the top 10 accounts for just 17.9% of the index.

When considering portfolio allocations to UK equities today, many may use the FTSE All Share to ensure a diversified holding, which combines the FTSE 100, the FTSE 250 and smaller companies. This index contain over 600 companies yet unbelievably still has a 35% weight in the top 10 stocks. Investors should question whether this is truly diversified. Adding an additional explicit allocation to the FTSE 250 or small cap stocks would help to diversify UK equity positions.

Conclusion

Many factors influence the FTSE's movements with some easily forgotten, underrated or overlooked. Investors must recognise the FTSE 100 and the FTSE 250 are as much influenced by their changing composition as news about the UK economy, pound or interest rates. The allocation to certain sectors, mega cap concentration and regional sales exposure are just some of these factors that investors need to take into account. Ignore the FTSE shuffle at your peril.

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