The changing face of the FTSE

The make-up of the Footsie effectively charts the changing nature of the UK economy over time. Here we take a look at how its make-up has shifted over time... and how it might look if all the current takeover targets were to be gobbled-up.

The make-up of the Footsie effectively charts the changing nature of the UK economy over time. So just how much has it changed? We take a look back… and a look forward to see what effect the current wave of takeovers would have.

Established in January 1984 at a base level of 1,000 points, the FTSE 100 is seen as the benchmark for the performance of the UK stock market.

The history of the index marks many key moments in the UK market's performance over the last 23 years, including the impact of 'Black Monday' (19 October 1987), the rise – and fall – of the technology sector over the period 1999–2003, and '9/11' (2001) to mention but a few from recent times. 21 of the companies that were included in the original list of the UK's 'blue chip' companies are still in the index today.

Individual companies have come and gone over the last 23 years, but, as just one component of a hundred, in themselves they have had little impact on the shape of the index. So rather than look at the individuals we've focused on the sectors, for it is in the weighting of the sectors that the overall shape of the index is revealed. True, the definition of some sectors has changed, and companies have moved from one sector to another as they re-fashioned their businesses to reflect current (and future) trends. So sector analysis isn't a perfect science, but it does give us a reliable feel for the trends that have shaped British business over this time.

In the beginning ...

The table opposite shows what the Footsie initially looked like based on the current sector definitions.

Some seemingly significant events had, in reality, only a short-lived impact on the index. Partly this is because the index is reviewed quarterly with companies being promoted or relegated according to a strict formula (see the explanation on pages 4 & 5) – so a rapid rise in market value, followed by an equally rapid fall could see an individual company miss making it into the index altogether. But other, more structural changes, do leave their mark. One such change was seen between 1999 and 2003.

'Dotcom' was on everyone lips and, as with many a fashion, was hyped above reasonable expectations. It wasn't unusual to see 'dot com' companies on p/e ratings in the high 80s, despite many (if not all!) having not actually made a penny in profit.

Naturally, the index reflected this phenomenum. Out went boring old sectors like Utilities, to make way for the booming TMT (Telecoms, Media and Technology) companies – Vodafone was a dominant player, accounting on its own for virtually 14% of the overall index. The likes of Severn Trent and Thames Water made way for Kingston Communications, Psion (the makers of hand held personal organisers) and Cable and Wireless. Even Associated British Foods, one of the original cast from 1984, was demoted. In fact, in the quarterly review of the index in March 2000 there were 20 changes in all.

But come September 2000 it was clear the TMT 'bubble' had burst. Having risen to an all-time high of 6,930 in December 1999, and held onto much of those gains through 2000, the market started to freefall. The slide was to last until March 2003, when it just about managed to stay in the 3,200s. By this point there had been further significant changes to the overall structure of the index.

% share of the FTSE 100 Index as at: Top sectors:	01/01/1984*	05/04/2007	Forecast post-M&A activity
Banking	6.00	22.80	21.70
Insurance	5.80	5.70	5.10
Mining	2.00	10.10	11.20
Oil & Gas	15.00	17.00	17.00
Pharmaceuticals	4.00	9.70	10.70
Retailers	11.00	6.00	6.70
Technology	3.00	0.25	0.50
Telecoms	7.00	7.80	8.60
Tobacco	2.60	4.00	4.00
Travel & Leisure	6.00	2.20	3.10
Utilities	0.00	6.00	5.70

*allocating companies to current sectors

Source: The Share Centre analysis

By March 2003, of the 6 technology companies in the FTSE 100 in March 2000, just one remained: Sage Group had managed to cling onto its FTSE 100 status, but only just. 10 Banking companies accounted for some 23% of the index, while Vodafone had seen its slice of the index fall to 8.8%. In the space of those 3 short years the Telecom sector had seen 7 of its number fall out of the index, and its overall share fall to 11.1%. Oil was making a comeback too, accounting for 14% of the index value.

And in the future?

The above chart shows where we would be if we take away all 13 companies featured on pages 6 & 7 and promote the next largest companies.

Waiting in the wings for promotion, if all the takeovers mooted to date were to happen, are the likes of Punch Taverns, Mitchells & Butler and Rentokil. Then would come well-known names, but not necessarily big companies in capitalisation terms, such as EasyJet, Wimpey, Barratt Developments and, perhaps ironically, the London Stock Exchange (LSE) itself. And what's equally interesting is that a number of these too are potential takeover targets: the LSE have already rebuffed several approaches, and consolidation is once again flavour of the day, particularly in the building sector. Other companies ripe for promotion include Inchcape, British Energy, LogicaCMG, Group 4 and Tullow Oil.

In terms of sector spread, not really a great deal changes. But the value of the FTSE 100 will be affected: with some £197bn of market value leaving the index, and companies with a combined capitalisation of only some £48bn entering it, the overall worth of the FTSE 100 will fall by over 11%. And this effect will ricochet further down the market ladder.

Promoting companies from the FTSE 250 leaves space for smaller companies from the FTSE Small Cap index to move up: companies like Babcock International, Eurotunnel, Dignity and Morgan Sindall, for instance. The combined market cap of these 13 promoted companies is £7.8bn, compared to the 'loss' from the 250 into the FTSE 100 of £48bn. So the FTSE 250 loses nearly 15.5% of its value, and the Small Cap loses some 12%, with no new companies around to fill the void.

Of course, you might think this could create opportunities for companies to move from AIM to the main market. Already the largest AIM companies are much bigger than the smallest companies on the main market. But AIM is a very different marketplace, where lighter regulation and more generous tax treatment are key factors in a company's choice of market. So there is no reason to expect transfers to the main list purely as a result of 'vacancies' arising from index adjustment.

There are two key lessons to be learned from this exercise: the first is that the loss of a large block of leading companies from the public market may represent an increased risk for investors. Smaller companies (in terms of their financial size) carry a higher risk factor than larger ones and so investors want a higher return to compensate for that increased volatility.

The second lesson is that looking at sectors can be a good place to start when choosing investments. And as the chart shows the Footsie is more concentrated now than it was in 1984. Removing a chunk of the FTSE 100 companies now would have little impact, but the changing shape over time, from 1984 to today, reveals the longer-term migration of the UK economy towards 'added value' industries such as banking and telecoms, with a more 'seasonal' role being played by sectors such as mining, and pharmaceuticals. For investors, this adds credence to the 'top-down' approach to investing – first pick your market, then pick your company. There's also the 'promotion' effect on the share price of those going into the FTSE 100 – the need for 'tracker funds' to buy into them typically creates a price rise in the short-term – so perhaps it's time for you to take a look now at their prospects?

Whatever happens in the weeks and months ahead, over time the market will change, reflecting both UK and global economic trends. How you anticipate it, and how you choose to react to it, can make a big difference.

At a glance

Changes in sector composition reflects changing economic activity.

Current takeover activity could reduce the Foosie's market value by some 11%.

This has knock-on effects across the whole market.

Highlights the value of the 'top down' approach, but a role for stock picking too.