PROFESSIONAL WEALTH MANAGEMENT

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'Unstoppable' trends find favour in uncertain world

BY ELLIOT SMITHER

Thematic funds had been gaining in popularity before the Covid-19 outbreak and as investors struggle to imagine what the future may hold, their appeal looks likely to grow

LARGEST THEMATIC FUNDS

PROVIDER	FUND	MANAGER	DOMICILE	CURRENT NET ASSETS*	PERFORMANCE 1 YEAR RETURN	3 YEAR RETURN	5 YEAR RETURN	KIID CHARGE
Pictet	Pictet-Global Megatrend Sel I USD	Hans Peter Portner	Luxembourg	€7bn	-6.74%	7.08%	13.66%	1.17%
Pictet	Pictet-Water I EUR	Team	Luxembourg	€4.8bn	-5.42%	5.03%	22.29%	1.15%
Pictet	Pictet-Security I USD	Yves Kramer; Alexandre Mouthon; Rachele Beata	Luxembourg	€4.3bn	-3.79%	15.31%	25.47%	1.16%
Pictet	Pictet - Robotics I dy EUR	Peter Lingen & John Gladwyn	Luxembourg	€4.3bn	-1.45%	23.98%	N/A	1.14%
Pictet	Pictet-Digital PUSD	Team	Luxembourg	€2.7bn	-5.41%	18.15%	46.57%	2.01%
Fidelity	Fidelity China Consumer Y-Acc-USD	Raymond Ma	Luxembourg	€2.6bn	-4.63%	17.54%	22.82%	1.06%
Credit Suisse	CS (Lux) Digital Health Equity SB USD	Thomas Amrein & Christian Schmid	Luxembourg	€2bn	7%	N/A	N/A	0.65%
BlackRock	BGF Sustainable Energy A2	Alastair Bishop & Charlie Lilford	Luxembourg	€1.9bn	-2.91%	2.54%	7.93%	1.97%
Credit Suisse	CS (Lux) Robotics Equity SB USD	Patrick Kolb & Angus Muirhead	Luxembourg	€1.8bn	-6.83%	24.48%	N/A	0.84%
iShares	iShares Automation & Robotics ETF USD Acc	N/A	Ireland	€1.8bn	-9.73%	10.42%	N/A	0.4%

** Supplied by Morningstar; Returns through to 31/03/2020*

The number, and range, of thematic funds, which attempt to harness secular growth trends, has massively increased in recent years. As have the assets held within them – in the three years to the end of 2019, the assets within them rose threefold, from $75bn to $195bn worldwide, according to Morningstar.

In addition, there is some evidence that the long-term focus of this approach is reassuring to investors left reeling from a world trying to overcome the coronavirus, as many of the themes they are targeting, such as technology, cyber security or healthcare, have if anything been reinforced by the crisis.

"Thematic investing is, without doubt, one of the most successful and fastest growing of all investment approaches and an issue that is on every chief investment officer's mind," says Victor Allende, executive director of CaixaBank Private Banking, adding this approach forms an essential part of the Spanish bank's portfolio construction process.

He believes this gives portfolios greater potential for long-term growth going forward, while also improving risk/return profiles.

"Investors engage easily with the ideas behind thematics and are willing to accept market volatility, because they understand the investment thesis," says Mr Allende. "Emphasising the long-term benefits is probably one of the best ways to help our clients to address their own myopic behaviour."

Nevertheless, there are various challenges that need to be taken into account when including a thematic approach. First, it is crucial to determine what is a truly global trend. Investors must then be able to correctly identify the companies with real exposure, while getting the timing right can be difficult. And a diversified portfolio is important.

"These challenges aside, thematic investments are nowadays, without doubt, the best strategy to capture future growth," concludes Mr Allende.

At Citi Private Bank, the idea is to identify themes which are reaching a "tipping point" and soon to undergo dramatic change, says head of EMEA investment strategy, Jeffrey Sacks.

When preparing the bank's outlook for the year ahead, Citi's research team identifies around 60 trends, of which three are presented in the outlook. In 2020, it was fintech, cyber security and alternative energy which made the cut.

"What we are looking to do is to find ways of getting commercial exposure to those themes," he says. Typically that would be equity or equity-related exposure, through funds and private equity. Less typically, fixed income.

Portfolios are constructed in a traditional way, by regions and asset classes, but Citi tries to apply its chosen themes as an overlay. "We aim to have a defined goal when applying themes to client portfolios, in terms of a percentage of overall equity exposure linked to a particular theme," says Mr Sacks.

He refers to these themes as "unstoppable trends", and believes this has been borne out by the Covid-19 crisis, drawing attention to the bank's chosen themes for this year.

"Many of our clients are asking us for ways to play the lockdown," he says, pointing out many of the companies enabling working from home could be described as fintech-related. Meanwhile the need to secure one's data is going to be higher than ever with so many people working remotely, so cyber security will become even more important.

And recent weeks have seen huge falls in the oil price and much smaller profits for producers, which could accelerate the push towards alternative energy such as solar and wind, he believes.

When looking to play a theme an investor must choose whether to go for a well-established company which derives some of its revenues from this new growth area, or to target a start-up company whose business is entirely driven by the new theme.

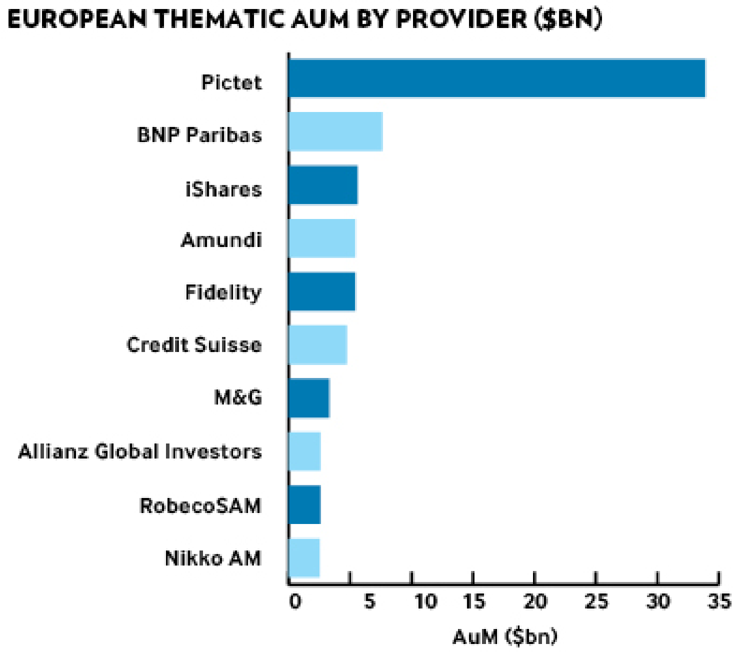
"The former would be lower risk but also return, because even if it had exposure to a theme it would be diluted by the rest of its business. The latter, if they got it right could be a much better investment, but the risk would be much higher," says Mr Sacks, advising investors who want a mix to consider investing through a fund.

Thematic investing has grown in popularity in the past five years, as more fund managers have broadened their offering in this space, reports Willem Sels, chief market strategist at HSBC Private Banking, and is an approach finding favour with clients across age groups and geographies.

Yet the bank believes thematics should be only a 'satellite' investment within a well-diversified portfolio as excessive thematic exposure could mean factor concentration.

Focusing on long-term trends does bring several advantages, he explains. "First, if you are implementing themes through funds or structured products, you don't want the theme to be too short-lived, because buying into and out of them could be costly. Second, timing theme outperformance is difficult. And third, it gives direction to the portfolio, allowing investors to 'look through' some of the 'noise' of short-term volatility."

Europe is the largest market for thematic funds, with 293 domiciled in the region as of December 31, 2019 holding more than half (54 per cent) of global assets. Pictet Asset Management dominates the thematic space in Europe.



Source: Morningstar Research; data as of 31/12/2019

When it comes to identifying themes and their subsequent evolution, the firm has established a dedicated advisory board, with external experts from academia, industry or think-tanks. "They are not there to give us stock ideas, but to provide guidance over both short-term and longer-term issues surrounding how we think about the theme," explains Steve Freedman, senior product specialist at Pictet Asset Management.

When it comes to launching new products, the aim is to capitalise on the growth generated by the megatrends, but new themes should also be additional in terms of exposure, he insists. "We don't want something that replicates things we already have."

Mr Freedman gives the example of the Smart Cities theme, which launched in 2018. "We felt the secular growth drivers were compelling and there was a bit of shift. The smart city concept is about urbanisation and the use of technology to overcome challenges and city governments were becoming much more proactive."

The theme also provided access to securities not accessed in others, he claims, with more real estate and infrastructure exposure.

The shift at wealth management firms towards providing more tailored advice has given thematic investing a boost, believes Mr Freedman. "Rather than offering a generic experience investing along regional lines, for example, thematic ideas have a tangible and relatable angle that allows advisers to have a more interesting discussion with the client."

A good thematic fund should be global to allow access to the very best companies that have exposure to the trends identified, while also have a lot of long-term drivers, believes Rudi Van Den Eynde, head of thematic global equity at Candriam. This should continue driving performance no matter what happens to the macro environment. "And so this pandemic has been the litmus test of thematic selection and investing and it has passed with flying colours," he claims.

The themes Candriam believes in, such as innovation, the ageing population, healthcare, and technology, fared pretty well in the recent market correction, while businesses in these areas are also key if the economy is to "somewhat" continue functioning.

Maximising impact

If you get a theme right in emerging markets the potential upside can be even greater than it is in developed markets, says Daire Dunne, portfolio manager at Wellington Management.

"What you really need for a theme to be enduring is it needs to take time for people to fully understand the scale of the idea, its longevity and scope across geographies. You need some sort of informational inefficiency or a lack of coverage of an idea for it to really be a long term theme," he explains, adding those characteristics tend to be particularly relevant in emerging markets.

Business models can be harder to understand and companies more opaque, he says, but the themes can be really enduring, plus you are starting from a much lower base and dealing with massive populations.

There is a huge differentiation in return outcomes between passively-orientated thematic strategies and good active ones, claims Mr Dunne. Active strategies are much better suited to dealing with changes in policy dynamics, he insists, pointing for example, to shifts in subsidies in the electric vehicle space. "They are changing from geography to geography, the size and scope is ever evolving, so unless you have a mechanism for understanding those and leaning into those countries where it is a tailwind and away from where it is a headwind, you are missing out."

In addition, the companies themselves change radically over time, for example many of today's big tech companies are dealing in very different areas from where they started out.

"Also, you often get big winners in these spaces and if you built a portfolio on a market cap basis then it would be massively skewed towards those names," says Mr Dunne. "You want a diversity of different exposures. Not to hitch yourself to one or two names."

The belief over at BlackRock though, is that there is room for both passive and active strategies in the thematic space. The firm has five megatrends which underpin its thinking – climate change and resource scarcity; demographics and social change; technological breakthrough; rapid urbanisation; and shifting economic power – and runs 19 thematic funds targeting them, 13 ETFs and 6 active products.

"Because of the scale of our ETF business and how big we are in active as well, we are quite unique; there are not many who have both," explains Rob Powell, director of product strategy for thematic investing at BlackRock.

If there is a broad set of companies operating in the space, the firm would be much more likely to take an active approach, he explains. An ETF needs a set of rules to follow, and a lot of companies means you run the risk of having a very broad, over-diversified product, with returns no different to the market. Whereas an active manager could pick the best ideas within the theme, says Mr Powell.

On the other hand, the robotics or cyber security spaces, each with 100-120 stocks in their respective universes, are well suited to the ETF approach.

Given the Covid-19 outbreak, it is no wonder healthcare has been of real interest to investors. The BB Healthcare Trust was set up in 2016 to take advantage of a belief that healthcare systems in the Western world were broken and need of reimagining.

"We live a world with an ageing population burdened with chronic medical conditions. There are statistics like one in four medical appointments is not necessary, one in four dollars in healthcare is spent to no medical benefit, 30 per cent of frontline staff's time is spent on admin and so on," says its manager Paul Major.

Coronavirus has brought many of the themes he looks at, for example point of care diagnostics and telemedicine, into focus, he says.

The next step for investors is of course to identify the opportunities from this transition, and he advises heading to the US to find the winners.

"There is no greater incentive to invest in something than the ability to make a profit from it, and the healthcare system in the US is essentially a for profit system. Their healthcare expenditure as a proportion of GDP is dramatically higher than the rest of the world. We all need to do this, but they have a more pressing need."

In contrast, there is not yet an ecosystem in Europe or the UK that supports early stage healthcare innovation, says Mr Major. He gives the example of GWC Pharmaceuticals, a company from British academic roots, which manufactures in the UK, but lists in the US. "When they needed a chunk of money to do clinical trials and take this thing to the next level, British investors didn't stump up the money. And that story has been played out across Europe a thousand times."

Coronavirus has devastated markets across the world, and while some healthcare companies are doing well, for example those manufacturing ventilators or equipment for emergency rooms, and the potential benefits for those who successfully develop a vaccine are considerable, other parts of the industry have not been immune.

With hospitals focused on fighting the virus, elective surgeries, those knee and hip replacements that normally keep operating theatres full and make companies so much money, have largely been put on hold.

Yet those operations will still need to be done, so healthcare companies can be more confident that business will come back than other sectors.

As well as being resilent, healthcare could also be in for a considerable boost, says Mr Major. "There has been chronic underinvestment in productivity and technology by the healthcare industry on a global basis for decades. We need to be nimbler, more efficient and to have more capacity. Historically the population has baulked at paying more for healthcare. But now all of a sudden everyone wants to pay a bit more for healthcare. That is a potential, substantial, multi-year tailwind that none of us imagined."

Of course, not all trends offer a viable path for investment. Some are too short-lived or not supported by tangible hard figures which can be harnessed within a sound investment process, says Vafa Ahmadi, head of thematic equity management, CPR Asset Management, a fully-owned subsidiary of Amundi.

"As an illustration, the space conquest theme is really trendy but is lacking information and data in order to benefit from an economic perspective," he says.

It is also wise to avoid narrowly-defined investment themes, such as AI, 3D printing or e-sports that would be essentially dependent on one macro factor or indicator, says Mr Ahmadi.

"Thematic strategies should be diversified enough over different sectors. A broad investment universe delivers flexibility to cope with different market conditions, allowing portfolio managers to allocate away from underperforming sub-sectors and stocks, while still remaining true to the structural stories that drive long-term performance."

VIEW FROM MORNINGSTAR: Inflows continue as investors seek out stability

Europe is home to the largest market for thematic funds by assets globally. These funds attempt to harness secular growth themes ranging from artificial intelligence to cannabis.

Total thematic fund assets in Europe doubled to £75bn ($93bn) over the three years to the end of Q1, 2020. This has been supported by an unbroken streak of positive quarterly net inflows amounting to £37bn over the period.

The menu of thematic funds in Europe has mushroomed. A total of 60 new thematic funds have debuted since the beginning of 2019, bringing the total number to 301. Most thematic funds in Europe are actively managed, although indexed funds have been gaining ground. Passives now account for 10 per cent of thematic assets, up from 4 per cent three years ago.

Pictet Asset Management is the largest thematic fund provider in Europe by a considerable margin. Pictet's range includes the five largest thematic funds in Europe.

Over the trailing three years, Technology themes such as robotics have attracted £17.8bn or almost half of net inflows. Physical world themes, which include popular water strategies, account for 22 per cent of flows while social themes which include ageing population funds claim 18 per cent.

Despite seeing AuM fall by 10 per cent over Q1, thematic funds registered impressive net inflows of £4.7bn. As a cohort, thematics track macroeconomic or structural trends which transcend the traditional business cycle and for that reason may be less prone to outflows in the face of economic shocks.

The standout thematic performer in Q1 has been the VanEck Vectors Video Gaming & eSports ETF. This passive fund tracks a narrow basket of global gaming stocks such as US graphics specialist Nvidia and Japanese gaming giant Nintendo.

Buoyed by the global lockdown relating to Covid-19, this ETF returned 8 per cent while broad markets such as the S&P 500 fell more than 15 per cent in Q1.

Kenneth Lamont, senior manager research analyst, Morningstar