WHY A DIVERSIFIED APPROACH TO THEMATICS COULD BOOST PERFORMANCE

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When investing in thematics, investors' objectives are usually to:

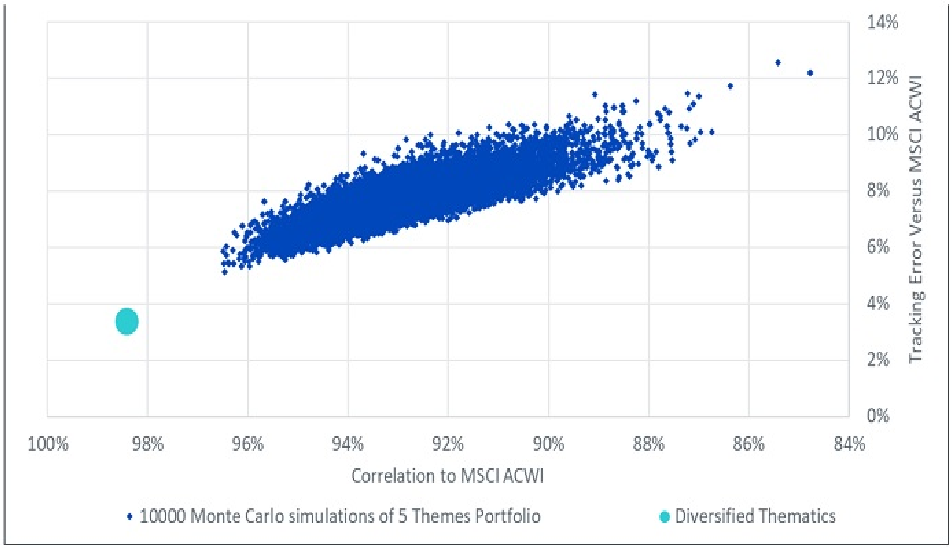
- align investments with emerging trends and structural changes early on and as they evolve
- maximise the long-term growth potential while optimising the risk-return profile
- maximise diversification between themes, stocks and multi-thematic portfolio and core equity exposures

Maximising the growth potential by diversifying the portfolio
When talking about maximising growth, the accepted wisdom is that the more concentrated a portfolio the more different it is to the benchmark and, therefore, the higher the tracking errors and chance to outperform. For multi-thematic/megatrend strategies, this is arguably not true.

To test this axiom, we compare the correlations and tracking errors versus the MSCI All Country World of:

1. The average of all the funds in Diversified Thematics in the WisdomTree Thematic Classification. Those funds are usually called multi-thematic or megatrends, they are mostly actively managed, and they are very concentrated (on average 99 stocks).
2. 10,000 simulated diversified baskets of 5 themes; that is, 5 funds focused only on one investment theme each. Each simulation invests every quarter in five randomly selected themes. The performance of each investment theme is calculated as the average of every exchange-traded fund (ETF) and open-ended fund that was active at a given time, irrespective of its future survival or success in that theme.

Figure 1: A top-down approach would offer less correlated returns and have a higher tracking error vs the MSCI All Country World Index than a bottom-up approach



Sources: WisdomTree, Morningstar, Bloomberg. From December 1999 to June 2023. Returns are calculated in US dollars on a quarterly basis. This graph represents the volatility and tracking error of 10,000 simulated portfolios. Each simulated portfolio randomly picks five investment themes (across three clusters–Social & Demographic Shifts, Technological Shifts and Environmental Pressures) every quarter. The monthly performance of each simulated portfolio is calculated as the average of each of the five themes' monthly performance. The monthly performance of each investment theme is calculated as the average monthly performance of every Europe-domiciled fund live at that point in time and classified in the theme, as explained in the appendixError! Bookmark not defined.. **Historical performance is not an indication of future performance and any investments may go down in value.**

Our analysis shows that every single one of the 10,000 random portfolios investing in five separate themes exhibits a lower correlation and higher tracking error to the broad market than multi-thematic funds. It is worth noting that the portfolios of 5 themes would, on average, invest in between 300-600 stocks.

This analysis shows that, for multi-thematic, a more diversified approach could improve the chance to outperform and create a differentiated portfolio compared to a more concentrated one. The reason behind this unintuitive result is that, when trying to cover 10 or 20 themes with only 100 stocks, most managers will invest in mega cap tech stocks that are dabbling in many themes. On the contrary, single-theme strategies invest in smaller stocks that have the potential to become tomorrow's mega cap.

Three layers of alpha generation

A top-down approach to multi-thematic investing allows investors to control the balance between diversification and increased exposure to high-growth stocks and benefit from a three-layer approach.

- **Strategic thematic asset allocation**
  Pick themes with the highest growth potential that are the most important for existing, and future, megatrends and maximise diversification between themes while controlling the precision of the capital allocation to the different themes.

- **Tactical thematic asset allocation**
  Leverage individual theme dynamics to improve capital allocation over time and improve the risk-return profile through the systematic use of signals, such as momentum.

- **Thematic stock selection**
  Creates a diversified portfolio of stocks that best represent a theme, its underlying story and its long-term growth potential. The objective is to ensure the portfolio invests in the future winner for each selected theme while maintaining liquidity and tradability. A focus on expert-selected, pure-play stocks allows further improvement of the growth potential of the overall strategy but also enables investors to cast a wide net across the different themes to maximise the chances of picking the future winners in each theme.

Figure 2: 3 layers of alpha generation for a top-down approach to building multi thematic portfolios

01	02	03
Strategic Thematic Asset Allocation	Tactical Thematic Asset Allocation	Thematic stock selection
+ The foundation of a multi-thematic portfolio + focuses on highly diversified, high-conviction themes with exposure to structural changes	+ capitalises on theme-specific dynamics + incorporating tactical overlays based on momentum or news can enhance performance and deliver an improved risk-return profile	+ Expert driven selection approach for each theme + Balancing selectivity and diversification is key to mitigating risks + Momentum can help select stocks further

Through a top-down multi thematic construction, investors could:

- link each stock of the portfolio directly to a specific theme, its story and the underlying tailwinds for its growth
- invest early in high-growth-potential companies with a chance to become tomorrow's Apple and Amazon
- over-weight the stocks with the highest chance of success by over-weighting them in their own theme sub-portfolio and over-weighting their theme in the thematic allocation itself
- maximise diversification by spreading risk and capital across themes and selecting differentiated stocks in each theme

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