HOW TO IMPROVE STRATEGIC THEMATIC INVESTMENTS BY INCREASING DIVERSIFICATION?

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Investment themes and thematic strategies are intimately grounded in the long term. Their growth potential is linked to transformative megatrends that promise to change the world over multiple years, not multiple weeks. Using thematic strategies strategically to benefit from the long-term growth inherent to investing in world-changing megatrends is therefore pretty logical.

Having said that, the considerable return potential of thematic investments is also linked to significant risks. Going in tandem with higher return expectations, thematic investments tend to exhibit higher volatility as well as higher valuations.

In this blog, we will show the strong diversification potential of Thematic strategies and how a diversified basket of investment themes could provide long-term growth while controlling for downside risk.

Each investment Theme is driven by its own story

Even if all thematic strategies are bundled up in what is called thematic investments, each strategy and each investment theme is, in fact, subject to idiosyncratic tailwinds and challenges. This is a strong driver for diversification among thematic strategies. Looking at 2020 as an example:

- In H1 2020, a large part of the world transitioned from office working to remote working, boosting thematic strategies such as cloud computing.

- In H2 2020, with the pandemic continuing unabated, the demand for laptops, video games, entertainment, or streaming increased, leading to increased demand for semiconductors.

- With President Joe Biden's election and the promise that the US.would re-enter the Paris Climate Accord and focus on climate change issues, environmental oriented themes benefitted from a boost in late 2020.

A strategic basket of differentiated thematic funds would have handled such events more robustly than a single investment. In everything investment-related, diversification is crucial, and it is the case for thematic investments as well.

Figure 1 shows the correlation matrix of historical excess returns (vs MSCI All Country World Index) between ten Themes out of the 35 investment Theme in the WisdomTree Thematic Classification. This matrix demonstrates the significant diversification potential between the themes. In building a strategic thematic portfolio, higher diversification could be achieved by spreading the investments across themes, clusters, and sub-clusters.

Figure 1: Historical correlation of the excess return versus the MSCI All Country World Index of some Themes in the WisdomTree Thematic classification.

	Aging Population	Rise of the Middle Class	Wellness	Sustainable Energy Production	Sustainable Resource	Natural Resources	HealthTech	Robotics & Automation	Platforms & Digital Markets	Fintech & Digitalisation of
Aging Population	100%	19%	55%	-2%	55%	14%	64%	13%	25%	10%
Rise of the Middle Class		100%	22%	10%	21%	11%	5%	3%	15%	21%
Wellness			100%	3%	25%	40%	52%	-26%	21%	20%
Sustainable Energy Production				100%	42%	25%	-4%	-2%	12%	15%
Sustainable Resource Management					100%	26%	27%	15%	22%	12%
Natural Resources						100%	9%	-43%	6%	23%
HealthTech							100%	9%	11%	13%
Robotics & Automation								100%	29%	-24%
Platforms & Digital Markets									100%	12%
Fintech & Digitalisation of Finance										100%

Source: WisdomTree, Morningstar, Bloomberg. From December 1999 to February 2021. Returns are calculated in US dollars on a monthly basis. The correlation is calculated only when returns are available from both themes in the considered pair. Themes are colour coded according to the cluster they belong to.

Historical performance is not an indication of future performance and any investments may go down in value.

Controlling downside risk in thematic investments through diversification across Themes

In Figure 2, we highlight the advantages of this diversification in 4 case studies.

1. In the top-left graph, we focus on a portfolio that would invest in one theme only at any point in time:

- We create 10,000 portfolio simulations. In each simulated portfolio, every quarter, a different theme is selected. This random sampling of themes' proxies for the fact that investors cannot in advance know for sure which theme will perform the best going forward. It also simulates the performance of a typical investment rotating between multiple concentrated strategies, focused on one theme, as opposed to thematic investments offering a more diluted exposure.

- Each quarter, the performance of the simulated portfolio is represented by the historical average performance of the chosen theme.

- As illustrated in the graph, on average, such an investment in one theme would have gained 172% net of fees from the end of 2005 to the end of 2020. However, the performance dispersion of the simulated portfolio paths is very high. 10% of the simulations would have returned less than 56% over the 15-year periods. Depending on the themes an investor would have picked each quarter, the thematic portfolio could have done very well or very poorly.

2. In the top right graph in figure 2, we increase the diversification potential by picking randomly not one but three different themes to invest in at any point in time:

- We create 10,000 portfolio simulations. In each simulated portfolio, every quarter, three different themes are selected.

- Each quarter, the performance of the simulated portfolio is represented by the average performance of the three chosen Theme.

- The average performance of those portfolios is very similar to the previous example, but the performance dispersion of simulated portfolios is significantly reduced. Now the worst 10% percentile stands at 107% instead of 56%.

3. In the bottom left corner in Figure 2, we further improve diversification by randomly investing in six themes:

- We create 10,000 portfolio simulations. In each simulated portfolio, every quarter, six different Themes are selected.

- Again, the average performance is the same, at 172%, but the performance is significantly reduced, the worst 10% percentile stands at 130% instead of 107%.

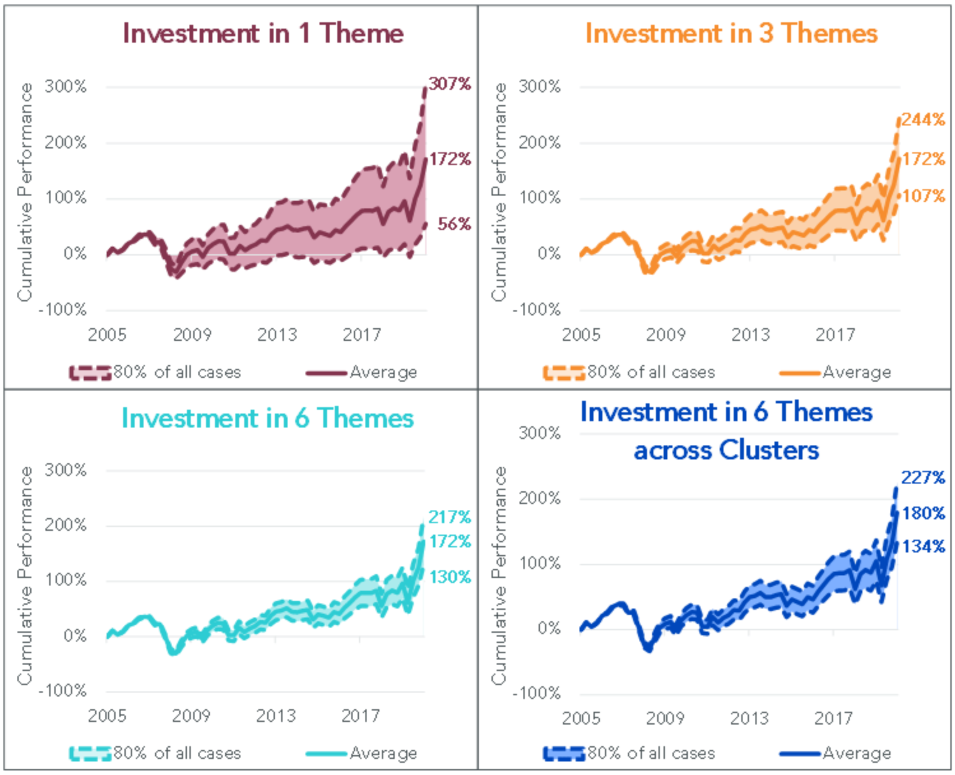
4. In the bottom right corner, we increase the diversification by forcing a diversification across clusters:

- We create 10,000 portfolio simulations. Every quarter, in each simulated portfolio, six different themes are selected with the constraint that every quarter, two themes per cluster are picked.

- The increased diversification improves the average performance to 180%. Even more importantly, the worst 10% percentile stands at 134%. This is a 78% improvement compared to the portfolios investing in one Theme.

The conclusion of this analysis is that by investing in multiple themes (through multiple thematic investments dedicated each to one specific theme), it is possible to improve the thematic portfolio's robustness without compromising the performance.

Figure 2: Performance dispersion of simulated thematic Portfolios based on the number of Themes they randomly select each quarter.



Source: WisdomTree, Morningstar, Bloomberg. From December 2005 to December 2020. Returns are calculated in US dollars on a monthly basis. Each graph plots the average of the simulated cumulative performance of 10000 simulated portfolios. In each simulation, a group of investment themes are picked randomly (one Theme, three themes or six themes in the respective graphs) every quarter. The monthly performance of the portfolio in each simulation is calculated as the average monthly performance of each of the themes in the portfolio. 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.

Historical performance is not an indication of future performance and any investments may go down in value.

When investing strategically in thematics, diversification is key to benefit from the long term growth potential and minimize the performance dispersion. However, fund selection is also very important. To leverage a strategic investment in thematic funds to its full potential, expertise and differentiation are critical, as discussed in our i nisght last week. It stands to reason that the selected strategies need to provide exposure to stocks that do not traditionally feature in core investments and that are best placed to benefit from the investment themes developing.

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