HOW TO SELECT THEMATIC FUNDS? FIVE CRITERIA TO SEPARATE THE WHEAT FROM THE CHAFF

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While providing an innovative investment approach, thematic investments also create risks for investors as they force us to rethink how we evaluate strategies. The main challenge in selecting thematic funds is that standard fund selection approaches are severely limited, while the performance dispersion between funds can be larger than for traditional groupings (see blog 2) . In this blog, we present a holistic framework to approach fund selection in the thematic space. Our goal is to provide clear steps for understanding which strategy might best represent an investor's conviction in a theme and its underlying story.

Introducing our framework for selecting thematic strategies

Our framework is conceptualised below in five intuitive building blocks that we believe provide some keys to choosing successful funds in the long run:

- **Clarity of theme:** The investment is focused on benefitting from a well-defined theme aligned with an investor's long-term views around megatrends. The selected strategy is built to focus on the theme precisely.
- **Expertise:** The investment process harnesses the necessary expertise to identify the companies that offer exposure to a Theme and stand to benefit the most from its further proliferation.
- **Purity of exposure:** A strategy is focused on pure players and companies within a given theme's ecosystem that are expected to benefit the most as themes experience increasing adoption. At the same time, the strategy reduces the exposure to companies that only dabble in the theme.
- **Differentiation:** The portfolio is additive to an investor's existing equity portfolio, i.e. the overlap with traditional equity benchmarks is minimal. The portfolio also stands out among the peers by offering a unique play on a theme of choice through differentiated geographical or sectorial exposure, expertise, or compelling strategy construction.
- **Transparency, investability & discipline:** The portfolio is constructed for scalability and liquidity. The investment process is also fully transparent allowing investors to monitor their portfolio. A strategy of choice should also demonstrate discipline in the investment process and time consistency so that investors can efficiently manage their investment.

By combining the above framework and the de-facto peer-groups generated by the WisdomTree thematic classification that we introduced in a previous blog, investors are equipped with a road map to identifying compelling thematic investments poised for future growth.

Clarity of theme tends to give strategies a better focus on growth

While discussing the five building blocks above would take a lot more space than what we have available here, let's look at two of them, starting with clarity of theme. Focusing on a single theme tends to provide multiple advantages:

1. Comprehensive exposure to a theme with a higher degree of granularity

2. Differentiation away from established equity benchmarks. A portfolio that would try to harness multiple themes would need to compromise and pick larger companies mimicking traditional indices.

3. Flexibility in timing of the theme-specific adoption cycle

In Figure 1, we compare the historical performance of broad-focus thematic funds (classified as diversified thematics in our classification) and funds that invest in one investment theme only.

To do so, we compare two possible ways to invest in a diversified group of investment themes:

1. A broad-focus thematic fund proxied by the average historical performance of all funds classified in the diversified thematics cluster.

2. A diversified basket of 6 thematic funds with clarity of theme, i.e. each fund focuses on one investment theme only. To create a fair comparison, we construct 10,000 random portfolios of 6 investment themes removing hindsight from the analysis. Each portfolio invests every quarter in six randomly selected themes, where two themes come from each of the three following clusters - social & demographic shifts, technological shifts and environmental pressures. The performance of each investment theme is calculated as the equal-weighted average of the performance of every fund investing in the theme at any point in time.

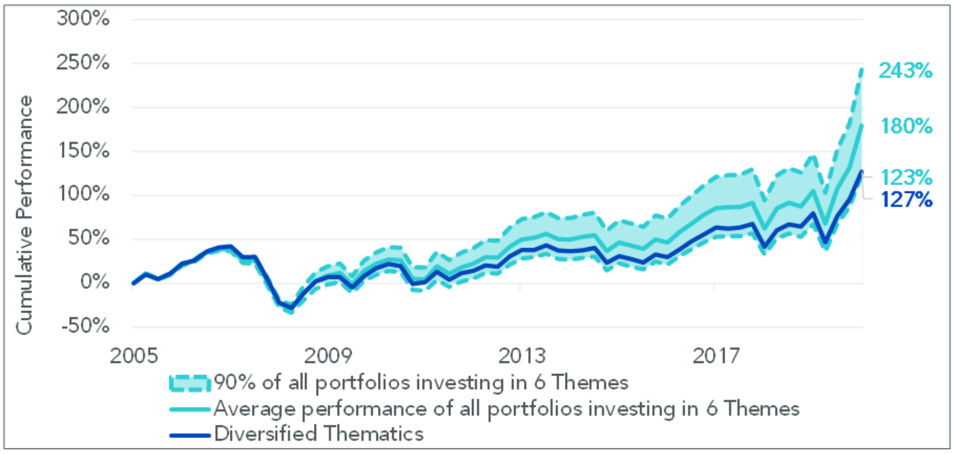
The result is fascinating - the diversified thematics investments would have underperformed 94% of the 10,000 simulated portfolios investing randomly in 6 different investment themes. In fact, figure 1 shows that:

- the funds in the diversified thematics cluster would have delivered an average cumulative performance of 127% in the last 15 years;

- on average, the 10,000 portfolios randomly investing in 6 Themes would have delivered an average cumulative performance of 180% over the same period;

Historically, a diversified basket of thematic funds with clarity of theme in many cases would have significantly outperformed a fund with a broad-focus approach to thematic investing.

Figure 1: Historical Performance of broad-focus thematic funds (i.e. classified as belonging to Diversified Thematics cluster) versus portfolios randomly allocating to six stand-alone themes.



Source: WisdomTree, Morningstar, Bloomberg. From December 2005 to December 2020. Returns are calculated in U.S. dollars on a monthly basis. This graph represents the cumulative performance of 10,000 simulated portfolios. Each simulated portfolio randomly picks six 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 six Themes' monthly performance. Each investment theme's monthly performance 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.

Purity of exposure – is purer better?

The third building block of our approach to thematic fund selection is the purity of exposure. Our belief is that thematic strategies should be focused on pure players and companies within a given theme's ecosystem that are expected to benefit the most as the theme evolves further and experiences increasing adoption.

Purity of exposure can be hard to estimate as it might be a subjective concept. However, a high number of holdings or high overlap with large-caps and mega-caps in classic indices, for example, could point to a lack of purity. In this way, we are indicating a relationship between 'purity' and 'differentiation.'

While diversification of holdings in a fund is very important, it is pretty evident that investing in many companies is not the best way to concentrate the fund's exposure on pure players. For example, in the A.I. peer group, looking at 11-European domiciled strategies (named A to K here), fund F invests in 256 stocks, almost three times more than any other peer. This is a first indication that this fund's exposure to the success of any single company may be quite diluted.

In Figure 2, for each fund in the A.I. peer group, we calculate the weight allocated to the top 10 stocks in the NASDAQ-100. The dispersion, here again, is vast:

- Fund E and G allocate almost a third of their assets to those ten tech mega-cap stocks when Fund D or Fund F invest less than 5%. We believe that most investors do not invest in a thematic fund to double down on their exposure in mega-caps.

- Furthermore, due to the diversified nature of the tech giants, it is hard to view them as pure-play businesses within the artificial intelligence theme. So significant exposure to mega-caps could also signal a lack of purity.

Figure 2: Weight allocated to the top 10 stocks in the NASDAQ-100 Index within the funds in the Artificial Intelligence Peer Group.

	Fund A	Fund B	Fund C	Fund D	Fund E	Fund F	Fund G	Fund H	Fund I	Fund J	Fund K
# Holdings	70	98	40	56	66	256	56	34	70	44	44
Apple		1.1%		0.4%	1.7%	0.4%	2.9%		3.7%		2.1%
Miscrosoft	1.6%	0.8%	1.3%	0.4%	4.9%	0.4%	3.0%	2.0%	0.4%	3.1%	2.1%
Amazon.com	1.6%	0.9%		0.4%	4.9%	0.4%	3.9%	2.1%	3.8%		1.9%
Tesla	1.4%			0.5%	0.8%	0.4%	2.8%		4.9%		
Facebook		0.9%			4.5%	0.4%	3.9%		2.8%	0.5%	1.4%
Google	1.5%	0.9%	1.8%	0.4%	5.5%	0.4%	4.0%		2.2%	3.6%	1.8%
Nvidia	1.5%	1.1%	1.8%	1.4%	1.8%	0.4%	3.0%	4.0%	0.5%	1.6%	2.9%
Paypal		1.0%			1.4%	0.4%			1.0%		
Adobe	1.2%	0.9%	1.3%		1.6%	0.4%	3.0%		1.0%		1.6%
Comcast						0.4%					
TOTAL	9%	8%	6%	3%	27%	4%	26%	8%	20%	9%	14%

Source: WisdomTree, Morningstar, Bloomberg. Holdings data as of 31st December 2020.

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Selecting a successful thematic investment vehicle is easier said than done. While there is never any guarantee in investing, the five building blocks listed in this chapter form a framework that can help investors differentiate between potentially compelling thematic strategies and those that are not as well-positioned to capture the potential offered by a given theme.

Thematic investing is usually characterised by passion and conviction in a story, so this framework may better align the specific areas of an investor's conviction within a given strategy.

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