
HOW TO LEVERAGE THEMATIC INVESTMENTS IN EXISTING PORTFOLIOS?

Pierre Debru – Head of Quantitative Research and Multi Asset Solutions, WisdomTree Europe.

11 May 2021

Thematic investment is new and exciting. It aims to harness long-term growth, but this innovative investment approach also breaks from traditional investment silos like countries, sectors, factors, or regions. Whether thematic investments are used tactically or strategically, investors' portfolio allocation should be able to accommodate them efficiently. Since thematic funds do not conform to traditional investment classification, clear, innovative portfolio allocation strategies are necessary to leverage their full potential. In this blog, we propose three possible approaches to fit both tactical and strategic investments in thematic funds:

1. The Core Satellite Approach
2. The Global Equity Approach
3. The Long-Term Approach

The Core Satellite Approach: Using thematic Investments as satellites to a core allocation

A Core-Satellite portfolio is split into two main parts:

- The core represents the strategic asset allocation of the portfolio and aims to deliver long-term positive returns while controlling for risk;
- the satellite aims to provide diversification and high growth potential.

This approach is particularly well suited to add tactical investments in thematic funds. Satellites can be added to the portfolio without disrupting the core, leaving the investor's strategic asset allocation intact. It is also designed to accommodate and rotate multiple satellites and, therefore, multiple thematic funds, allowing for diversification.

Of course, such a portfolio's success relies on the fact that the satellites deliver additive value to the core portfolio. This means, first and foremost, that the satellites have the potential to deliver high growth. However, it is also important that

the thematic investments exhibit very high differentiation with the core, i.e. traditional indices. Characteristics that we have described in more details in the [3rd blog](#) of this series.

The Global Equity Approach: Using a global equity sleeve to fit thematic investments

Most portfolio allocations tend to be built as an assemblage of region and sectors, but thematic investments tend not to fit such an approach. To accommodate such investments in an existing portfolio, it is possible to create a global equity sleeve. Such a sleeve can accommodate classic investments like global equity funds as well as thematic investments. It also leaves the investor free to deal with regional and sectorial funds in the rest of the portfolio. The approach is well suited to both tactical and strategic use of thematic investments.

In the analysis below, we try to ascertain the optimal historical allocation to a strategic investment in thematic funds. Figure 1 shows the efficient frontiers of:

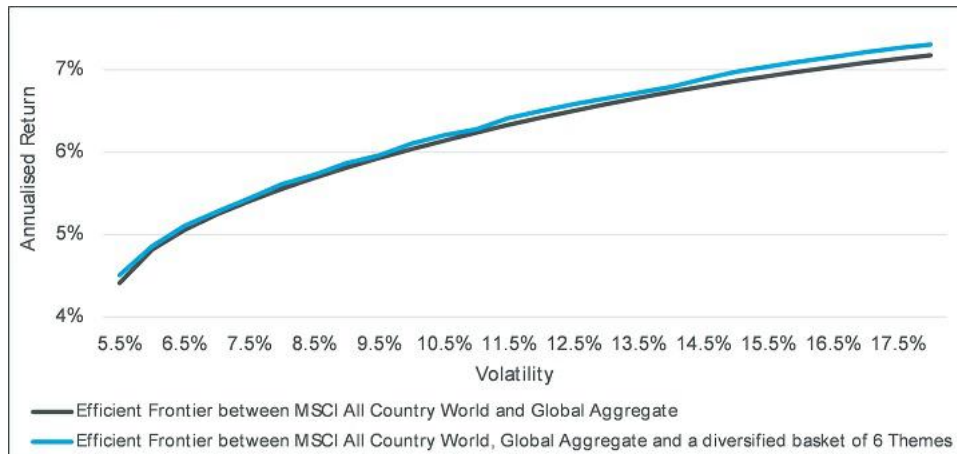
- A two-asset portfolio between Equity (MSCI All Country World Index) and Fixed Income (Bloomberg Barclays Global Aggregate Index).
- A three-asset portfolio between Equity, Fixed Income, and a diversified thematic sub-portfolio. As an illustration, we decide to use a portfolio of six investment themes spread across three clusters (as described in the [WisdomTree Thematic Classification](#)), which means the thematic sub-portfolio invests in two Themes per cluster¹.

We construct the performance of a set of 5,000 simulated thematic sub-portfolios from 2005 to 2020. Each quarter every portfolio randomly selects the six themes it invests in until the next quarter. The performance of each theme is estimated using the performance of all the funds in the Theme. This random sampling of themes simulates the case when investors have no views around which themes will perform the best in the next quarter. It also simulates a typical investment in multiple concentrated thematic investments, each focused on a different single theme.

For each of the 5,000 simulated portfolios, we then calculate the efficient frontier for a set of three assets, the simulated thematic sub-portfolio, global equities (through the MSCI All Country World Index) and global bonds (through the Bloomberg Barclays Global Aggregate Index). For each of the 5,000 simulated, thematic sub-portfolios, the efficient frontier changes. In Figure 1, we show the average of all 5,000 efficient frontiers.

We observe that the introduction of the thematic sub-portfolio improves the efficient frontier for all volatility levels on average, demonstrating the advantages of investing strategically in thematic funds.

Figure 1: Average Markowitz efficient frontier for a set of three assets: MSCI All Country World Index, Bloomberg Barclays Global Aggregate Index, and a simulated thematic sub-portfolio.

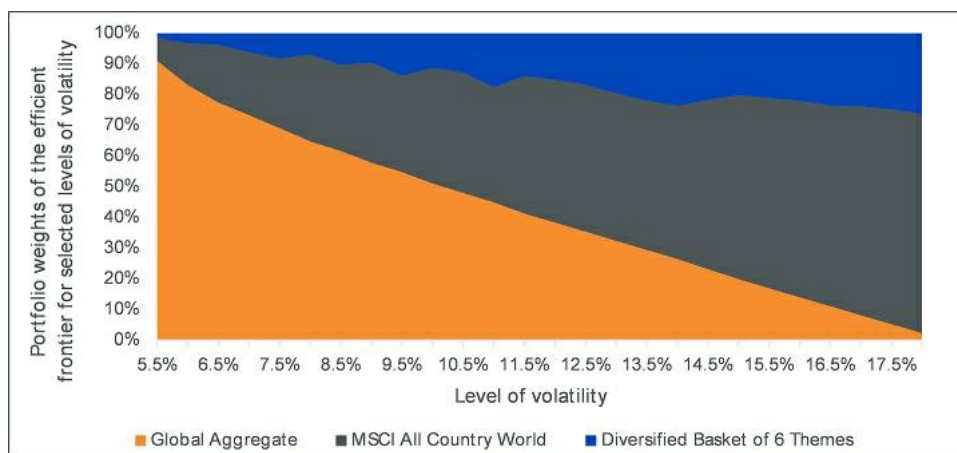


Source: wisdomTree, Bloomberg, Morningstar. December 2005 to December 2020. Returns are calculated in US dollars quarterly. The average efficient frontiers are constructed as follows. 5,000 thematic portfolios of 6 investment Themes are created by randomly selecting six Themes every quarter. For each one of those portfolios, a historical efficient frontier is calculated for a set of 3 assets: the simulated thematic sub-portfolio, MSCI All Country World net TR Index and Bloomberg Barclays Global Aggregate TR Index. The average efficient frontier is the average of those individual 5000 historical efficient frontiers. The performance of a simulated thematic portfolio is derived from the performance of the six investment Themes held in the portfolio in each quarter.

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

In Figure 2, we exhibit the average optimal weight of each of the three assets in the efficient portfolio for each level of volatility. We observe that the optimal weight of the thematic sub-portfolio increases with the target volatility. For most volatilities, the optimal weight in the thematic sub-portfolio is higher than 10% and reaches close to 30% for the highest level of volatility.

Figure 2: Average weights in the efficient portfolios for a set of three assets: MSCI All Country world Index, Bloomberg Barclays Global Aggregate Index, and a simulated thematic sub-portfolio.



Source: wisdomTree, Bloomberg, Morningstar. December 2005 to December 2020. Returns are calculated in US dollars quarterly. The average efficient frontiers are constructed as follows. 5,000 thematic portfolios of 6 investment Themes are created by randomly selecting six Themes every quarter. For each one of those portfolios, a historical efficient frontier is calculated for a set of 3 assets: the simulated thematic sub-portfolio, MSCI All Country World net TR Index and Bloomberg Barclays Global Aggregate TR Index. The average efficient frontier is the average of those individual 5000 historical efficient frontiers. The performance of a simulated thematic portfolio is derived from the performance of the six investment Themes held in the portfolio in each quarter.

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Such an approach relies on the thematic strategies' growth potential, but their diversification benefits are extremely important as well. If the differentiation of thematic investments versus the core is not high enough, then the potential to improve the efficient frontier is lessened significantly. This again elevates the fund selection's utmost importance for the success of the portfolio allocation, as discussed in the [third blog](#) of this series.

The Long-Term Approach: Replacing the portfolio's core with a high-potential diversified basket of thematic funds.

Core holdings in a portfolio are meant to deliver the strategic foundation for an investor's long-term allocations. They are intended to provide long term consistent returns reliably. Those core holdings are critical to the long-term performance of an investor's portfolio. Traditionally, investors pick a low-risk diversified basket of global large-cap stocks as their core, very often wrapped in index funds, ETFs, or mutual funds.

Recent academic research has shown that historically, the return for equity markets has been dominated by a tiny number of very successful companies. In contrast, most listed companies delivered sub-par returns. The top best 4.31% of listed stocks in the U.S. accounted for all the wealth creation from equity investment above U.S. Treasury between 1926 and 2016². Internationally, only 1.33% of all companies accounted for the net global wealth creation³. In other words, the equity market's long-term outperformance is driven by a handful of businesses benefitting from structural growth. These findings highlight the value that can be created by focusing on these high growth names at the expense of the rest of the market. However, there are also considerable risks attached to such an approach. It is very possible, indeed, that investors do not select the right companies to invest in. This is why most approaches rely on diversified equity investments in their core holdings, depending on casting a wide net, so to speak.

Thematic investments could provide a better solution to this problem. By design, thematic strategies provide exposure to companies with significant exposures to megatrends and, therefore, with high growth potential. Thus, a thematic investment could be an innovative way to filter between companies and create sub-baskets of companies with a higher likelihood of ending up as long-term winners. Creating a core portfolio made of a very diversified basket of thematic investments spread across clusters and sub-clusters could offer an innovative new solution to build long-term asset allocations. By diversifying their investments across multiple themes, investors could create diversification in their core portfolio and allow for the core to providing long term consistent returns reliably.

As with everything in investment, there will always be below average, average, and above-average thematic investment vehicles. We hope that reading these 6 blogs on Thematic strategies will have inspired you to dive into the thematic

space and embrace its opportunities and challenges.

Sources

¹ We do not use data from Geopolitical Shifts as the number of Europe-domiciled funds and the length of track record is limited

² Bessembinder, H. 2018. Do Stocks Outperform Treasury Bills?. Journal of Financial Economics, 129(3): 440- 457.

³ Bessembinder, H., Chen, T., Choi, G., & Wei, K. 2019. Do Global Stocks Outperform US Treasury Bills?. SSRN Electronic Journal.

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