HOW TO USE MOMENTUM TO CREATE TACTICAL THEMATIC STRATEGIES?

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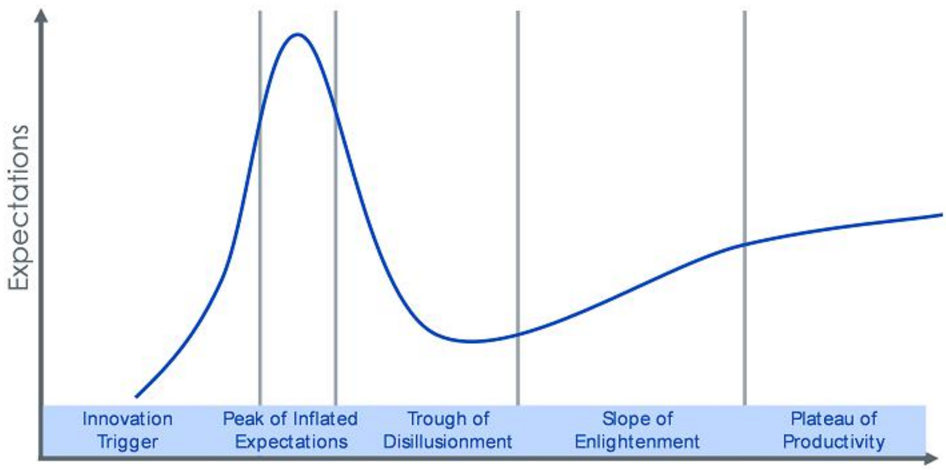
Investment themes and thematic strategies are intimately grounded in the long term. They tap into megatrends' long-term growth potential. However, they do not guarantee linear market-beating returns. Each theme has its own set of idiosyncratic factors and, therefore, its own path to success or failure. Companies' financial performance and, by extension, funds' performance will fluctuate over time, following the meandering course of the relevant Theme's development and adoption globally. Such a meandering path to growth could lend itself to a more tactical approach. In this blog, we aim to highlight the potential of tactical investing in thematic strategies. We will, in particular, show how combining innovations (thematic investments) with established principles (momentum) can lead to better potential overall.

The Gartner Hype Cycle

The Gartner Hype Cycle is a helpful conceptual framework to illustrate how the world tends to behave in the face of new technological innovations and, by extension, showcases the different steps in the evolution of a theme. While it would be nice if expectations were linear and 'accurate', the 'Hype Cycle' helps characterise how emotions come into this important equation.

Figure 1: The Gartner Hype Cycle.



Source: Gartner.

Phase 1: The Innovation Trigger

When the information about new technology is first introduced and comes out, it begins to proliferate widely. It gets picked up by journalists and media in general, and the excitement about its potential starts to build. It tends to climb steeply as people's expectations rise quickly.

Phase 2: The Peak of Inflated Expectations

When the news about a given technology has been shared widely, the story itself is no longer new. Everyone is excited, and all you might hear are incredibly optimistic forecasts about upcoming trends and events. It is unlikely to hear too much about risks at this stage. It is usually much easier (and faster) for people to raise their expectations than it is for the technology to scale and gain wide adoption. At this point in the cycle, expectations frequently outrun the fundamentals.

Phase 3: The Trough of Disillusionment

The Trough of Disillusionment is the result of people awakening to the concept of risk during Phase 2. Upon recognising the risk, and the realisation that while the technology's potential is still intact, its development or adoption will take time. What can happen is akin to the 'bursting of a bubble'. People awaken to the potential unforeseen challenges and circumstances that can extend the time before the new technology is widely and fully adopted in a profitable, efficient manner.

Phase 4: The Slope of Enlightenment

Investors start to see how the various risks realised in phase 3 could be productively dealt with. This is usually a phase where adoption gets more sweeping. Investors now have a more appropriate baseline, recognising the risks and challenges while seeing how their effects could be mitigated.

Phase 5: Plateau of Productivity

The end of the cycle. The new technology is no longer 'new' – it is now fully adopted across its addressable market. Instead of being viewed as an 'innovation', it might be more appropriate to think of it as part of the world, as part of everyday life.

Investors, particularly tactical investors, in thematic funds would be well-served to have some version of this framework in mind. Using that 'Hype Cycle', investors could better position their investments in this continuum, and better set their expectations.

Thematic Tactical investment, the example of Momentum-driven strategies

One exciting example illustrating the potential of tactical investment in the thematic landscape is a momentum-driven thematic strategy. Academics have shown over and over that momentum is pervasive across asset classes, across time periods and delivers improved risk-adjusted returns through rotation. We create two illustrative strategies to test this hypothesis:

1. The **WisdomTree Illustrative Thematic Momentum Portfolio** invests every quarter in the five themes that performed the best in the prior twelve months (with one month lag to deal with short-term reversal effect and ensuring that no front running is involved). The performance of each investment Theme is calculated as the average performance of all the funds in the Theme. In this strategy, no fund selection is applied.
2. The **WisdomTree Illustrative Thematic Tactical Portfolio**, which uses momentum

to select the themes as well as the investment vehicles. This strategy aims to harness both the momentum between themes and the dispersion among investment funds targeting each investment theme. The portfolio invests in the same momentum-selected themes as the first strategy, but instead of investing in all the funds, the portfolio picks the fund with the best performance in the prior twelve months in each of the five selected themes (with one month lag).

In Figure 2, we compare the performance of the two strategies above to:

- The MSCI All Country World Index

- A diversified basket of five investment themes. We construct 10,000 random portfolios of five investment themes removing hindsight from the analysis. Each portfolio invests every quarter in five randomly selected themes.

We observe that:

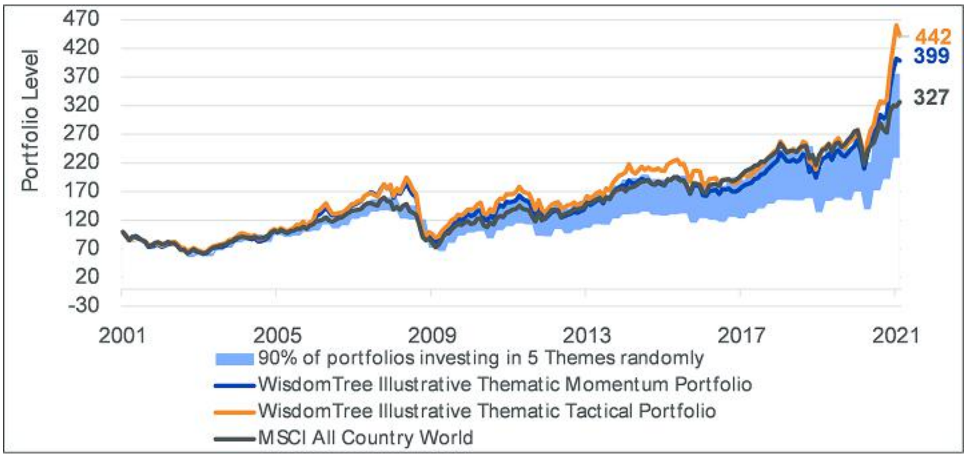
- Over the last 19 years, the WisdomTree Illustrative Thematic Momentum Portfolio would have outperformed the MSCI All Country World Index by 1.0% on average per year while only raising the volatility slightly. The Sharpe ratio is improved from 0.29 for the MSCI All Country World Index to 0.31.

- Over the last 19 years, the WisdomTree Illustrative Thematic Tactical Portfolio would have outperformed the MSCI All Country World Index by 1.6% on average per year. The Sharpe ratio is further improved to 0.33.

- The WisdomTree Illustrative Thematic Momentum Portfolio would have outperformed 96% of the 10,000 portfolios randomly investing in five investment Themes.

- The WisdomTree Illustrative Thematic Tactical Portfolio would have outperformed 99% of the 10,000 portfolios randomly investing in five investment themes.

Figure 2 Performance of the two WisdomTree portfolios versus MSCI All Country World Index since 2001.



	Annualised Return	Volatility	Sharpe Ratio
WisdomTree Illustrative Thematic Momentum Portfolio	7.1%	18.1%	0.31
WisdomTree Illustrative Thematic Tactical Portfolio	7.7%	18.8%	0.33
MSCI All Country World	6.1%	16.1%	0.29

Source: WisdomTree, Bloomberg, Morningstar. 31st January 2001 to 28th February 2021. Returns are calculated in US dollars on a monthly basis. The Momentum score is calculated using the last 12-month historical performance, with the most recent month return removed. Both Portfolios are rebalanced quarterly in March/June/September/December. The WisdomTree Illustrative Thematic Momentum Portfolio invests in five themes at all times. The performance of each Theme is represented every month by the average monthly performance of all the funds in the Theme at that point in time. The WisdomTree Illustrative Thematic Tactical Portfolio invests in five themes at all times. Each Theme is represented by one fund selected as the fund with the best Momentum in that Theme.

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

Both approaches are not foolproof, of course. They benefit from numerous periods of outperformance but also suffer from some periods of underperformance. Momentum, as a strategy, tends to suffer from sharp changes in regimes, and this is the case here as well. However, both approaches underscore the potential for alpha generation through tactically rotating between themes.

When investing tactically in thematics, it is necessary to conceptualise where each Theme stands in their adoption cycle. However, fund selection is also key. To leverage a tactical investment in thematic funds to its full potential, the clarity of purpose, the expertise, and the purity of exposure of the funds used by an investor are critical, as discussed in our blog last week. It is paramount that the selected fund focuses on the exact Theme that the investor has identified for short-term performance. If the selected fund invests in adjacent themes, the investor will not benefit from the entire upside of its tactical allocation when she/he is right. This is a very real pitfall, as demonstrated in Chapter two.

The fund also needs to deliver a direct exposure to the Theme. Any diluted or unfocused funds would not allow the investor to benefit from his/her investments, even if the timing and theme selection were accurate. This is why the framework highlighted in Chapter two may help investors pinpoint the most efficient funds for a tactical thematic investment.

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