AN AMERICAN PORTFOLIOS' GUIDE

Thematic Investing:
Turning Insights into Alpha

Text by Clifford T. Walsh, CFP®, *Chief Investment Officer, American Portfolios Financial Services, Inc. —an Independent Broker/Dealer*

The pace of economic and technological change is accelerating at the fastest pace in human history. Consider this: There have been only 24 transformative general purpose technologies (GPT)* (e.g., steam engine, electricity, computer) introduced in all of human history. Seven of the 24 were developed in the 20th Century. In the first 20 years of this new century, already three new GPTs have emerged—business virtualization, nanotechnology and artificial intelligence—positioning our current century to double the pace of the most innovative 100 years in human history.

For much of human civilization, about 6,000 years, generations of humans may have lived without ever seeing any real change. For instance, from start of the 17th Century to the late 18th Century, there were zero GPTs introduced. Today, at the current pace, we'll see a new GPT emerge every seven years.

The significance of this rapidly-changing landscape is as obvious as it is profound. From an investment perspective, the accelerating pace of change forces investors, advisors and money managers to consider whether a relative investment framework tied to an index largely comprised of old-economy stalwarts will remain relevant amid successive waves of economic and technological revolution.

Recognizing the quickening velocity of change, market participants will increasingly reorient their drive for alpha by relying on insights rather than scratching out alpha by managing around the margins of some static index.

In this white paper, Thematic Investing: Turning Insights into Alpha, we define thematic investing, discuss the different approaches to investing in themes, explore the varied ways to execute on a thematic thesis, and highlight the advantages and potential pitfalls inherent in thematic investing.

** A transformative general purpose technology (GPT) is defined meeting four criteria: it is a single, recognizable generic technology; has much room for improvement, but is widely adopted; has many different uses; and creates spillover effects.*

What is Thematic Investing?

Rather than attempting to generate alpha through the overweighting or underweighting of individual securities relative to an index, thematic investing looks to generate alpha by identifying broad social and technological trends that are expected to drive above-market growth in the stocks that benefit from these trends.

Thematic investing can take on two distinctive approaches:

Cyclical themes, which by definition are of short- or medium-term duration. Outperformance is unlikely to be sustained over longer periods of time since its cyclical nature tends to make such investments mean reverting.

Structural themes are singular, permanent shifts in the existing landscape. These themes, which are often based on disruptive technologies, changing demographics or shifts in consumer behaviors, have the potential to provide much longer and more profound outperformance.

These approaches are not necessarily mutually exclusive, but exploiting them will likely entail different investment strategies. For instance, investing in cyclical themes often involves basing buy-and-sell decisions on stock price momentum and shorter holding periods, while structural themes often require a longer-term view that demands patience until these themes permeate more broadly through the economy.

A Thematic Investing Framework

Constructing a thematic investment portfolio differs from building a traditional portfolio in a number of important ways. For instance:

1. Rather than asset classes as the building blocks of a portfolio, sector and country exposures are the starting points to constructing a thematic portfolio.

2. Instead of weighting asset classes on the basis of economic cycles or market conditions, thematic portfolio allocations are based on broad economic, social and technological trends.

3. Thematic portfolios will roam to where the opportunities exist, regardless of the capitalization, style or geographic boundaries that typically exist with traditionally-managed portfolios.

It should be clarified that there is no fundamental conflict in the traditional investment approach and thematic investing. In fact, for most individual investors, the thematic and traditional strategies easily and comfortably exist side-by-side, with a traditionally-managed portfolio acting as a core holding and a thematic investment portfolio as a satellite holding that seeks to generate incrementally higher returns.

Crafting a thematic investment strategy is a multi-step process that begins with developing a thematic thesis and setting the appropriate portfolio risk parameters, and ends with constructing the portfolio.

In between these two points lie many questions that investors and money managers need to ask themselves: Is the trend cyclical or structural? What is the economic size of the opportunity? Is the theme investable? Are the available investments in highly liquid public companies or confined to less liquid companies or companies with diluted exposure to the theme? What is the risk to an investment should a theme not materialize? Is the theme's value chain fully understood? What is the conviction level for a particular theme, i.e., is it based on observable data or an individual hunch?

Executing on a Thematic Investing

Investors can pursue thematic investments in one of two ways: either through individual securities or via thematic ETFs. Going the route of individual securities requires, of course, the research and analysis normally attendant with stock investing. However, this analysis presents an additional layer of challenge since it involves novel technologies and nascent macro social and economic trends that require an understanding that goes beyond company financials. As with all individual stock investing, diversification is also a challenge for investors with limited funds to devote to such a strategy.

Thematic ETFs are an ideal alternative to individual securities since they take care of security selection and offer greater diversification within a theme than an individual investor is likely to achieve on his or her own.

Another attraction of thematic ETFs is that they have high active share and high beta, distinguishing those portfolios markedly from broad-based indices and providing investors with the potential for higher returns and increasing their overall portfolio diversification.

In implementing a thematic strategy, it is important not to confuse sector investing with thematic investing. For example, a technology sector ETF may be chock full of companies with disruptive technologies, but they may include technologies that are not part of an individual's thematic thesis, thus diluting an investor's exposure to a desired theme.

Because themes—both cyclical and structural—are subject to booms and busts in investor popularity, and a theme's adoption curve and stock prices rarely operate in tandem, a momentum investment strategy may be a particularly valuable approach for executing on a thematic investing strategy since it has a defined entry and exit discipline.

The reputation of momentum investing as a reliable and successful investment strategy is long established, supported by a large body of academic research, including the pioneering 1993 research paper, Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency, and the 2014 study, Fact, Fiction and Momentum Investing, authored by Clifford S. Asness and members of his AQR Capital Management team.

A Profile of the Thematic ETF Market

One of the easiest ways to implement a thematic investing strategy is through ETFs, and the growth in thematic ETFs evidences growing public awareness and participation.

At the end of Q2 2020, there were 129 thematic ETFs with an aggregate of $41.3 billion in AUM, up by 65 percent from Q1 2020. In 2015, there was just over $10 billion in thematic ETF assets.

The most popular theme with $31.1 billion in AUM is disruptive technologies. Themes revolving around people and demographics (e.g., health, new consumer) had $4.86 billion in AUM, while ETFs associated with the physical environment (e.g., climate change, infrastructure) has $5.36 billion in AUM.

Among the most popular disruptive technologies were Big Data ($9.97 billion in AUM), Connectivity ($5.7 billion) and Robotics ($3.39 billion).

The themes that saw the largest AUM increases were Cloud Computing, Cybersecurity, AI/Automation and Clean Energy.

Source:
https://www.globalxetfs.com/content/files/Thematic-ETF-Report-Q2-2020-1.pdf

Weighing the Benefits and Risks of Thematic Investing

As with any investment style or discipline, thematic investing comes with a number of potential benefits and risks.

Benefits	Risks
With expectations of modest capital market returns in the next decade, thematic investing may be one of the few ways to generate above-market returns.	High volatility due to high portfolio concentration and uncertain future prospects.
Thematic investments may act as a hedge to traditional portfolio holdings. For example, if a retiree is investing in carbon-era companies (e.g., oil) for dividends, a clean energy ETF may hedge the stranded asset risk of oil investments.	Identifying the wrong theme or a theme that takes too long to blossom may mean sub-par returns for an extended period of time or outright capital losses. For example, robotics—a hot theme in the 1980s—may be finally beginning to realize the future many expected for it 40 years ago.
A forward-looking discipline is more likely to profit from future progress than indices that reflect the old economy. For instance, the leading manufacturer of electric cars, which is not in the S&P 500, has a larger market capitalization than all the auto companies in the S&P 500.	A thematic thesis may be potentially upended by a change in tax policy, regulatory changes or disruptive technologies. Even a worldwide pandemic may undermine an investment thesis. For instance, one money manager has touted a trend toward urbanization, which the pandemic and work-from-home puts into serious doubt.
Low correlation to traditional equity indices.	Thematic investing requires being right three times: on the theme, the fund or company selection, and the entry point.

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Final Thoughts

Advisor interest in thematic investing has grown sharply, perhaps in part driven by client interest. As advisors develop an approach to thematic investing that fits the needs of their clients and practices, our investment experts at American Portfolios can help.

One of the ways American Portfolios is helping advisors adapt thematic investing to their practices is through ThemeCatcher, a quantitative tactical portfolio comprised of thematic ETFs and managed in partnership with Toroso Investments and Newfound Research Defense. For more information on ThemeCatcher, call Manager of Due Diligence Sam Rozzi at 631.439.4600, ext. 136.

Sources:

[1] https://en.wikipedia.org/wiki/General_purpose_technology

American Portfolios Financial Services, Inc. has just the resources in place to help its advisors on many fronts. Reach out to *Vice President of Marketing Strategy* **Kimberly A. Branch, CFP®** at **631.439.4630**, or via e-mail at kbranch@americanportfolios.com, to strike up a conversation today on programs and needs of the advisor.

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** Based on a poll of registered representatives conducted by Investment Advisor magazine. Broker/dealers rated highest by their representatives are awarded "Broker/Dealer (B/D) of the Year."*

*** Wealthmanagement.com Industry Award finalists are selected by a panel of independent judges made up of subject matter experts in the industry. Award is based on support provided to AP's affiliated people and does not reflect public customers nor their account performance.*

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