THEMATIC INVESTING: A PRACTITIONER'S GUIDE

Thematic investing presents equity investors with the unique opportunity to gain exposure to forces that are rapidly reshaping the global economy. Here, our Portfolio Construction and Strategy Team explores the opportunity-set from a client point of view and key considerations when putting thematic investing into practice.

As major economies adjust to a higher interest rate regime, there is every expectation that the next decade of equity market returns could be more challenging than investors have become accustomed to in recent years. With a higher cost of capital likely having ended the era of tenuous business models accessing financial markets on the cheap, we believe the pendulum has shifted back to strong, innovative businesses that will help reshape the global marketplace. These initiatives lend themselves well to thematic investing, as their potential for market-beating earnings growth will likely become an important means of generating outperformance.

Distinguishing the themes that will change how society operates is the first step in identifying the companies that have the potential to change our lives and become the next Microsoft or Google. From a portfolio construction perspective, the potential for alpha is significant as are the diversification benefits of integrating a themes-based framework into an allocation process. Furthermore, the successful identification of winning themes could potentially generate strong returns irrespective of a market or economic cycle.

With respect to identifying themes that can deliver on expectations, there are, several considerations:

Breadth: Some themes can be quite narrow both in definition and in the range of available securities. This presents risks, namely concentration and liquidity. Alternatively, other themes may be so broad that the link between the theme and returns is tenuous. What are likely to become the most effective thematic strategies lie somewhere in the middle.

Placement: Thematic investing does not naturally fit into the traditional approach to portfolio construction where investors typically start with regional and sector breakdowns. A theme can cover multiple sectors, meaning effective portfolio construction requires looking through each portfolio holding to determine the optimal mix to achieve the desired exposure.

Timing: Theme timing is as impossible as market timing. Therefore, just as one would do when constructing a portfolio of individual securities or funds, investors need to prioritize diversification to increase the chances of hitting their objectives.

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What is the difference between a thematic and a sector fund?

Before looking at how to integrate thematics in a portfolio, there is an important point to clarify ... what is the difference between a thematic and a sector fund?

At a high level, a theme is the structural change occurring in society. A thematic fund can be focused solely on that theme. As we explain later, this can have benefits but in our view many that we see are too narrow in focus.

In contrast, a sector fund may have exposure to a number of themes. Or simply be a collection of holdings from across a sector chosen with no reference to overarching themes.

Portfolio construction considerations:

In recent years, "thematic investing" has grown, both in use and in terms of investors' awareness. This is partly due to the recognition of how incorporating themes into portfolios can potentially benefit performance. Another reason for thematic investing's apparent ubiquity is the concerted marketing effort by many asset managers to rebrand existing strategies as 'thematic' to attract flows going into the space. Given the scale of interest, investors need to be aware of the benefits and the challenges.

The benefits

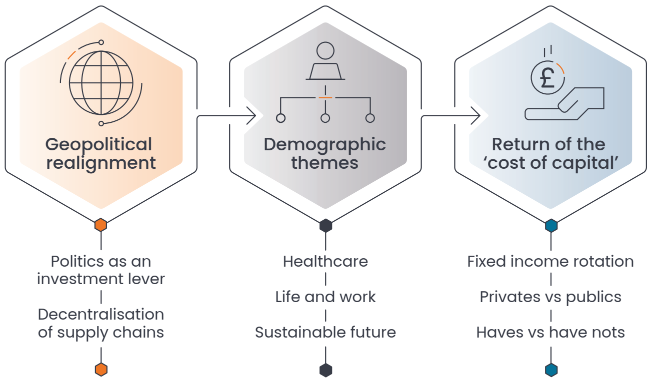
Return potential

Thematic investing, when effectively deployed, has the potential to generate excess returns over long-term horizons. It is not a new phenomenon. Themes have always been a key component of an active manager's investment process, even if the concept was not given a marketable title.

The role of an active manager is to identify the companies that will experience above-average growth in the future. One of the key drivers of corporate success relates to being early to a fundamental shift in the economy and providing the goods and services essential in bringing about that shift. This, in essence, is a theme.

At Janus Henderson, we see three areas that we believe are important considerations as part of the structural change and thematic narrative.

Exhibit 1: Global challenges combined with societal shifts leads to structural change



The correlation benefits

The nature of thematics is that, if utilised well, they should generate long-term positive returns irrespective of economic or market cycles. Utilising a series of MSCI sector indices as an example, we can see numerous risk and diversification benefits from building thematic exposures into an existing equity allocation.

Long-only equity strategies tend to be relatively correlated with each other. Any lowering of these correlations not only increases the benefits of diversification within an equities allocation, but also within a broader multi-asset portfolio. As illustrated in Exhibit 2, correlations among certain MSCI sector equity indices are considerably lower than for equity markets in aggregate.

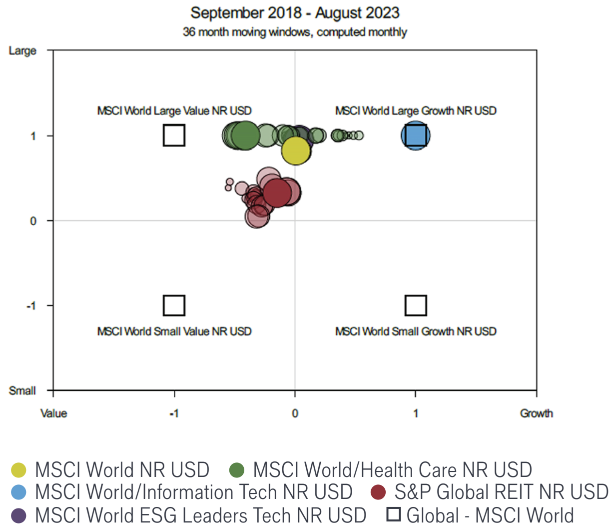
Exhibit 2: Correlations among sector equity indices are lower than for global markets

	Global Equities	Global Healthcare	Global Technology	Global Property	Global Sustainable
Global Equities	1.00				
Global Healthcare	0.82	1.00			
Global Technology	0.91	0.72	1.00		
Global Property	0.88	0.70	0.74	1.00	
Global Sustainable	0.99	0.84	0.92	0.88	1.00

Source: JHI Edge, Global Equities = MSCI ACWI NR USD, Global Healthcare = MSCI World/Health Care NR USD, Global Technology = MSCI World/Information Tech NR USD, Global Property = S&P Global REIT NR USD, Global Sustainable = MSCI World ESG Leaders NR USD, as at 31 August 2023. **Past performance does not predict future returns.**

As illustrated in Exhibit 3, based on a rolling 36-month composition, equity sectors that can serve as a rough proxy for established themes are fairly dispersed across the value/growth universe and to some extent, by size. This allows for considerable customization, ie. adjusting the blend of a thematic-based strategy to meet an investor's bespoke – often factor-based – parameters. Such customization, in our view, can be a powerful tool in constructing a truly diversified portfolio. For example, if an investor wants to increase their growth footprint, they can lean further into IT or take a greater value tilt by increasing exposure to REITs or Healthcare.

Exhibit 3: Where themes fit into style and market-cap categorisations



Source: JHI / Morningstar, September 2018 to August 2023. Shows a rolling 36-month window, computed monthly, that indicates where selected indices lie, in terms of their investment style and market capitalization categorisation over time. **Past performance does not predict future returns.**

The Challenges

The perils of 'theme washing'

While themes are arguably interesting from an investment perspective, much of the attention paid to them has been driven by aggressive marketing by asset managers. This represents a potential risk. We have seen numerous instances of 'theme washing', where strategies have been constructed not for the purposes of efficiently participating in a long-term theme, but rather for the purposes of hitching onto an increasingly popular investment trend.

Haphazardly thought-out themes are likely to fall short of investors' expectations, incurring an opportunity cost for missing out on the developments that are truly reshaping the global marketplace. Two notable risks are themes being either too narrow or too broad in scope.

Too Narrow: A theme that is too narrow is most likely to carry a series of material risks for investors, including:

- **Concentration:** if a theme only holds companies that are specifically exposed to that theme and the theme is narrow. This leads to a material risk that the thematic portfolio will be highly concentrated.
- **Impurity:** a narrow theme could also cause a portfolio manager of the theme to loosen the definition of the theme to ensure a sufficient population of companies from which to select. This results in a portfolio not specifically exposed to the targeted theme.
- **Liquidity:** we see many examples of narrow themes largely using small and mid-cap stocks. That isn't a significant issue; however, it does introduce additional risks associated with liquidity that investors may not be fully aware of.

The issue of narrowness can be seen from a study of the MSCI Thematic Index suite. MSCI produce a large number of thematic indexes broken down into five high-level categories (plus one multi-themed). To demonstrate the point, we selected one of these: Transformative Technologies, which has 12 underlying themes and accompanying indexes (in our view, already a lot of themes around which to construct an efficient portfolio). We then looked at the underlying top 10 holdings under each theme.

Exhibit 4: Commonality of holdings across the Transformative Technologies theme

MSCI Robotics	MSCI Robotics & AI	MSCI Cyber Security	MSCI Digital Economy	MSCI Disruptive Tech	MSCI Future Mobility	MSCI NG Internet Innovat'n	MSCI Autono Tech & Ind Innov	MSCI FinTech Innovat'n	MSCI Space Explor'n	MSCI Smart Security & Defense	MSCI Blockchain Economy
Nvidia	Nvidia	Palo Alto	Nvidia	Nvidia	Nvidia	Nvidia	Nvidia	Nvidia	Boeing	Palo Alto	Marathon
Accenture	Meta	Datadog	Meta	Apple	Tesla	Meta	Tesla	Alibaba	Ansys	Boeing	Coinbase
Ad MicroD	Amazon	Cloudflare	Amazon	Microsoft	Uber	Amazon	Meta	Accenture	Ametek	Fortinet	Riot
J&J	Apple	Equinix	Apple	Visa	Adv MicoD	Apple	Apple	Mastercrd	Autodesk	Equinex	Mcrostrat
Keyence	Microsoft	Crowdstrk	Microsoft	Mastercrd	Taiwan Sm	Microsoft	Adv MicoD	Visa	Dassault	Cisco	Nvidia
Salesforce	Adobe	Fortinet	Visa	J&J	Texas	Mastercrd	Accenture	Meituan	L3Harris	Northrop	Bread
ABB	Netflix	Synopsys	Mastercrd	Tencent	Toyota	Visa	Alphabet A	Tencent	Northrop	Lockheed	Block
Intuitive	Ad MicroD	Cisco	Tencent	Alphabet	Mercedes	Tencent	Adobe	Paypal	Textron	RTX	Glb Unichip
Alphabet	Oracle	Checkpoint	Adobe	Roche	O'Reilly	Adobe	J&J	Fiserv	Lockheed	Crowdsrk	Paypal
Autodesk	Taiwan Sm	Motorola	Alibaba	Oracle	GM	Tesla	Alphabet C	CME Group	Teledyne	Datadog	Alchip

Source: MSCI, as at 31 August 2023. Names are highlighted when they are present in three or more theme indices.

The concentration risk is apparent: A portfolio blending the *Digital Economy* theme with *Autonomous Tech and Internet Innovation*, for example, would give investors almost identical top-10 positions.

Too broad: Conversely, other thematic strategies are arguably too broad. This is slightly harder to quantify but we see many examples of themes being so broad it is hard to grasp to what degree theme drives performance, rather than general market moves.

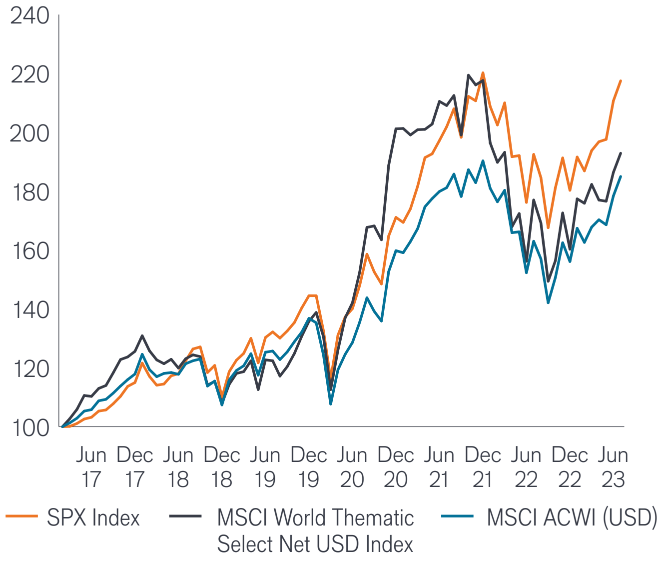
Using the same group of MSCI indices previously discussed, Apple features prominently in a number of indices, namely *Robotics & AI, Digital Economy, Disruptive Technology, Internet Innovation and Autonomous Tech & Industrial Innovation.*

While there is no disputing Apple's exposure to each of these categories, we know that iPhone sales accounts for around half of the company's revenue, and the success of phone sales will (at least for the time being) drive returns, rather than the array of individual themes in which Apple has been categorised.

Holding a multinational company in a thematic portfolio can be a perfectly logical decision. However, we also need to recognize the risk posed by using global conglomerates in thematic investing. The purpose of gaining exposure to a specific theme is to participate in the returns derived from that particular theme. This can be easily diluted or misdirected. It therefore needs to be managed carefully when including global corporations with multiple businesses, with many of them completely unrelated to the desired theme.

We can further see the impact of dilution when using the MSCI World Thematic Select Index against US and Global Equities. As illustrated in Exhibit 5, the returns of the combined, most-popular global themes in the Thematics Select Index, based on media mentions, are diluted to such an extent that they largely replicate the returns of the traditional equity indices.

Exhibit 5: Risk of being too geographically broad when selecting a theme



Source: Bloomberg, 1 February 2017 to 31 July 2023, rebased to 100 at start date. Chart shows a correlation of 0.92 and 0.93 between the MSCI World Thematic Select Index and the S&P 500 Index and MSCI All-Country World Index respectively over the period, using monthly data. **Past performance does not predict future performance.**

The need to blend...appropriately!

We believe value can be derived by blending multiple individual themes into a broader portfolio. In the same way that timing the market is an unreliable strategy, perfectly timing the entry and exit of particular themes is equally a fools' game.

To do this effectively, the underlying component strategies must be clearly related to the themes the investor wishes to blend. In this respect, the investor is able to effectively control the exposures on a look-through basis. A benefit of this approach is keeping the name overlap to a minimum and, thus, increasing the likelihood that the theme – rather than the broader market – drives the returns.

In summary

We believe that thematic strategies can be an important and powerful complement to a broad investment portfolio. However, the recent enthusiasm surrounding thematic investing and the large growth in offerings have resulted in the marketplace getting swamped. As with other examples of hype, many of these strategies have been largely created for the purposes of selling products, with potentially undifferentiated products or suspect rationales, rather than for enhancing investor portfolios.

As such we believe that there are a series of questions that investors should ask when assessing thematic strategies:

- What is the purpose of this investment, eg. returns/diversification?
- What is the proposed investment timeline?
- How closely aligned is the strategy to the targeted theme?
- What are the sector, region or factor tilts in any fund under consideration, and how will that blend alongside existing holdings?

Our Janus Henderson Portfolio Construction and Strategy Team is on hand to assist you with working through these questions. Please contact us to arrange a portfolio consultation.

About the Portfolio Construction and Strategy Team

The PCS Team provides tailored analysis and insight on investment portfolios. From thousands of consultations, the team identifies trends and opportunities in portfolio construction.

Our goal is to help investors make sense of what's happening in the market, the portfolio implications and how to seek an investment edge through our practical insights.

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