INTRODUCTION

BACKING THE RIGHT HORSE

The premise behind thematic investing, picking the long-term winners from global trends such as reducing carbon emissions and ageing populations, strikes a chord with wealthy investors, writes Elisa Trovato

Thematic investing originates from the conviction that global mega trends or powerful seismic shifts which have a major impact on humankind give rise to winners and losers, like in a Darwinian process. The thematic investment approach, by anticipating change, aims to gain a long-term perspective on global financial markets and economies, and identify the beneficiaries of those changes, while avoiding risk. This forward-looking investment approach certainly appeals to wealthy individuals. Themes, such as those related to water scarcity or clean energy, are easy to understand and to explain, they often incorporate an ethical or responsible investing component, meeting investors' increasing interest in this area.

"Thematic investments are all quite intuitive for clients to understand and their long-term bet is very clear," says Paolo Molesini, chief executive officer at Intesa Sanpaolo Private Banking in Milan. Water, alternative energies, climate change and global demographics are the most successful themes at the Italian bank.

"Whether population in Europe or the States will be older in the future than it is today is an easy bet to win, beyond short-term volatility in the product. Ageing populations open up a new world of investment opportunities, where the goal is to identify those companies in various sectors such as healthcare, payment systems, communication, bespoke tourism, which are well positioned to benefit from this trend over the long-term."

Ageing is indeed bound to have a huge impact on society, on consumer habits, demand, and on companies' activity and financial performance. One of the recent product launches in this area is the Golden Age Fund by Lombard Odier. The combination of rising life expectancy and falling fertility rates is increasing the proportion of the world population over the age of 50. Baby boomers are gradually joining the over-60 age group and will dedicate a growing part of their income to remaining active and in good health. By 2050 it is believed that there will be over 2bn of these so called 'golden-agers', according to the Swiss bank.

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As the typical total exposure of clients' portfolios to themes is typically less than five per cent, it is essential to focus only on the themes that look solid and are most convincing, explains Mr Molesini. Thematic active funds are typically employed in the satellite part of a client's portfolio and they are long term investments. Thematic certificates or structured products, which offer capital protection, also find their way into more risk-averse clients' portfolios, improving asset diversification.

Thematic funds are pro-cyclical investments as they come back into the spotlight when markets are going up, notes Nicolas de Skowronski, head of investment advisory at Bank Julius Baer. "When investors want to gain some equity exposure, they look at these niche opportunities for diversification. But when markets are going down, asset protection becomes paramount and investment themes fall in the background."

Today, investors still have a big proportion of cash in their portfolios and they are just starting building back some equity allocation. The initial step into equity is through global equity. Bric (Brazil, Russia, India, China) countries or Asia are one of the first building blocks investors are adding, says Mr de Skowronski.

Country, currency and sector allocation drive portfolio construction and even if water or clean energy are global themes, they are focused ideas and can be added just as satellite investments, he says. Active management is really important in this area, though increasingly there is more availability of thematic exchange traded funds (ETFs) and the Swiss bank offers both kinds of products to its clients in an open architecture approach, but ETFs are less popular, states Mr de Skowronski.

Julius Baer investment strategists currently favour the agriculture commodity theme, as it is thought to be more de-correlated from the market. The theme suggests that a growing population, changing dietary habits with increased meat consumption are generating increasing demand for soft commodities, while supply is negatively affected by climate change. There will be an exponential need for soft commodities and as a long-term theme is really worth investing in, he says.

However, over the last couple of months, clean energy has been the most popular theme amongst high net worth individuals, says Mr de Skowronski. Historically, the attractiveness of the theme has been inversely correlated to the level of oil prices. Generating clean energy is still more expensive than producing old energy, such as oil, so when the price of oil goes up, the price difference between producing new energy and old energy reduces, drawing investors' interest in this area. "But from an investment perspective, people have to invest with a long-term view, not on the theme of the day."

Often the sustainability component can be very much a selling point for those themes, especially those regarding the environment. If the new generation of wealthy individuals are particularly sensitive to it, the old generation is also gradually converting to the sustainability themes, says Mr de Skowronski.

Some fund houses, such as Newton Investment Management, the UK asset manager of the BNY Mellon group, make of the thematic approach the overarching philosophy driving all their fund management activities. "Any Newton fund is invested based on our view of the world as identified by our themes," says director Phil Collins. Thematic investing is predominantly a top down approach; but a bottom up analysis is carried out to make sure that, within those themes, only the stocks that are valued attractively are included in the funds. On average the vast majority, or 85 per cent of stocks in the funds, are beneficiaries of those themes, explains Mr Collins. But there is also room for attractive stocks which may be region specific ideas, which do not fit in any major global theme, he explains.

Themes evolve over time, old ones may cease to be relevant and new ones emerge as the investment

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backdrop changes. "All change" is one of the latest themes identified by the firm. It was introduced in 2009, based on the difference in the level of indebtedness between western developed countries and emerging markets. While Western developed nations are likely to want to pay down their debt, emerging economies are in a stronger position and are likely to be able to increase their level of debt, explains Mr Collins. "On that basis we are attracted to more growth-orientated equities in emerging markets and more defensive high yield equities in developed markets. All our portfolios have a strong leaning towards the 'all change' theme."

Another investment theme post-crisis is "more government", which explores how state intervention and forms of managed capitalism are becoming more prevalent around the world. One of the major areas affected is the banking sector, as governments are now majority shareholders in some of the major banks.

"Generally this theme leads us to be more cautious in those areas where government is involved, because it tends to lead to greater regulation and greater cost around compliance. The general concern with the greater government interference is that the government is driven by vote winning measures, which from time to time are at odds with profit boosting measures," says Mr Collins, explaining that the theme is primarily an avoidance one.

Themes give no particular clues on timing, so you can be into a theme very early or quite late, he says. "The risk is primarily in being in too early, so what we can do is position portfolios so that when the theme is recognised by the market, you have sufficient exposure."

Newton has identified and currently invests in 12 global themes. "Themes don't all have to come through at once. We can't predict what the timing of each theme will be, but you have high probability that a few of them will give a positive push every year," says Mr Collins. These are core allocations which investors need to keep for at least three to five years, he says.

The multi-themed fund launched by Pictet at the end of 2008, the Global Megatrend Selection fund, is also meant to be a core allocation. The fund, which saw net inflows increase by around 50 per cent over the past couple of months, allows investors gain exposure to all the nine individual themes that the Swiss bank already offers in single-themed funds.

The product, which does not include any financial stocks, since launch outperformed the MSCI world index by 11 per cent, states Denis Schmidli, thematic fund product specialist at Pictet & Cie in Geneva. It has an equal weight investing in all nine themes, with monthly rebalancing. "This investment approach is not only interesting for private investors but also for activities around portfolio management products, such as unit linked business of insurance companies," he says.

Any new thematic fund will be automatically included in the global mega trend, and equally, if a fund is liquidated, it will be removed immediately. The firm is currently working on its tenth thematic product, which will focus on the health space. "Unless you launch a product which replicates partly what another one does, I don't expect the number of thematic funds at Pictet to grow in the next few years. We monitor very closely the correlation between themes when we decide to launch a fund, and we follow it closely over the lifespan of the product," says Mr Schmidli.

Leveraging on their proven track record of running a US and global multi-themed strategy in the United States, AllianceBernstein has recently launched a multi-themed Luxembourg Ucits III fund, which invests in a global universe of companies in multiple industries and sectors that stand to benefit from innovation. There are five key themes including genomic medicine – which exploits the latest developments in personalised medicine – the internet's widening use, looking at Web 2.0 and the broadband revolution – emerging middle class, harnessing the rapid growth of emerging economies, heightened cyclicality, which suggests that stimulus efforts are leading to a reshaped environment of cyclical opportunities, and abating climate change.

"Some of the themes may be old – many managers now play the climate change theme – but it is not necessary for the success of our fund that every time we have a completely unique theme. What is necessary is that we have some different conclusions in our themes," says Anthony Bor, senior portfolio manager at AllianceBernstein. "For example most thematic managers are playing the climate change element in alternative sources of energy, such as wind power, solar power, bio diesel. Our research has taken us in a completely different direction. Our investments are heavily focused on the nuclear industry as a solution to climate change."

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Wind, solar and bio diesel energies are less appealing as they suffer from significant policy and subsidy related constraints, and many of the stocks are already reflecting some very aggressive growth in their valuation, he says. But in nuclear exposure or carbon capture plays, there are companies that have a chance to make a much bigger difference to reduce carbon emissions – as they may have a very attractive set of assets to implement such a business model, or special technology to capture the carbon, compress it, minimise it and store it – and that opportunity is not fully reflected in their valuations. And many companies have limited or no subsidy risk.

Mr Schmidli at Pictet believes it is important to analyse each stock individually, in order to understand which one is more dependent on subsidy than others. But the growth potential in these alternative energies is enormous over the longer-term, regardless of today's valuations. Pictet's clean energy fund suggests that the ultimate goal is the reduction of carbon emission, he says. Natural gas makes up only 40 per cent of the fund's portfolio, the vast majority is in renewable energy. Nuclear energy may be a very clean source in terms of production, but there are unresolved issues in terms of waste, accidental risk and costs. "We think we'd better wait to invest in nuclear energy until these issues have been addressed."