



# From indexes to insights:

## The rise of thematic investing

**Leading institutions say this new approach can deliver better performance over the long term than their traditional methods. Here's how they're putting it in place.**

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Over the past few years, a number of structural economic changes—a persistent bout of historically low interest rates, the polarization of growth between developed countries and emerging economies, and global deleveraging—have had an impact on how institutional investors deploy capital. The “metabolic rate” of the economy is also accelerating, with industry dynamics evolving faster than ever and profit pools shifting across value chains in many industries, thanks to unprecedented technological innovations.

In this challenging environment, many institutional investors have started to question their traditional “relative investment” frameworks, which are structured around either adhering to or deviating from benchmarks and indexes. These frameworks often fail to achieve the specified rate of absolute return for three reasons. First, the short-term focus of quarterly benchmarking works against one of institutional investors’ great advantages, their long-term investment horizon. A zealous focus on the benchmark means investors can miss chances to capture mispriced

assets; they can also miss out on the liquidity premium, which they collect by buying illiquid long-term assets at a discount. Second, relative-investment frameworks can lead to an undesirable exposure to certain risks. Finally, the very nature of the strategic asset-allocation process used to select benchmarks also holds investors back. Strategic asset allocation is backward looking and fails to incorporate emerging trends and forward-looking perspectives on the economy.

To meet their absolute-return targets, many institutional investors are therefore starting to complement relative investing with a number of “absolute focused” investment strategies, which can take the form of a greater allocation to illiquid asset classes, concentrated portfolios, or relationship-investing strategies, among other options.

In addition, many are turning to “thematic” investment strategies. That was the most intriguing insight we took from a series of interviews we conducted in 2013 with about

a dozen pension funds, sovereign-wealth funds, and other institutional investors. Broadly speaking, thematic-investment approaches seek to capture, across asset classes and around the world, the opportunities created by long-term structural trends and the medium-term cyclicalities often associated with these trends. Some investors have deployed thematic strategies for years; they appreciate the way these allow them to actively manage risk and ensure that their capital is deployed against the opportunities that best reflect their investment convictions. However, many institutions have not yet taken advantage of such approaches. In this article, we outline a process that some investors are using to develop and execute thematic-investing strategies.

### **Demystifying thematic investing**

Thematic investing requires a fundamental understanding of the impact of long-term economic, political, and social trends on regions and sectors, which reveals investable opportunities. Thematic investors develop proprietary views on how the second- and third-order effects of structural trends will create hot spots or discontinuities in certain sectors and regions where value and risk will be concentrated. This is a big departure from relative strategies; Exhibit 1 illustrates some of the differences.

Adopting a thematic-investing approach can yield three types of benefits for investors. First, it allows investors to generate alpha at scale by focusing on investment opportunities in hot spots where a significant amount of capital can be deployed. Second, the more systematic investment process and in-depth research required for thematic investing builds a deeper understanding of the underlying drivers of value creation and risk; investors can use this knowledge not just in

thematic investing but also in other strategies. Third, it provides investors with a dynamic and flexible way to validate and express their hunches by applying a forward-looking lens to investment decisions.

Investors have long been aware of thematic investing, but many thought it too complex to implement because of restrictive portfolio structures, risk limits, and the challenge of putting in place the capabilities and processes needed to develop truly distinctive investment insights. In recent years, however, a number of investors have taken tactical and creative approaches to implement some form of thematic investing, usually as an addition to their overall investment framework. Exhibit 2 illustrates four of these approaches. It should be noted that newcomers to the strategy tend to allocate a significant portion of their active risk budget to it. This gives them the same total risk budget as before—though the risk profile may shift as a result of more concentrated and less liquid investments—but focuses it on opportunities that are more aligned with their convictions.

### **Embarking on the journey**

The ability to fold a thematic strategy into a relative-investing framework is good news for investors that have held back because they did not wish to completely overhaul their approach and their portfolio. But it still requires the right research capabilities and a disciplined investment process. Our focus here is on the latter.<sup>1</sup>

A structured and rigorous approach is required not only to identify investable themes but also to prioritize them. The following five-step approach does both and has been implemented by a number of leading thematic investors.

Exhibit 1

**Relative and thematic frameworks differ in several dimensions.**

	<b>Relative framework</b>	<b>Thematic framework</b>
<b>Asset allocation</b>	Asset classes as building blocks	Sector and country exposure as building blocks (matrix view)
<b>Portfolio construction</b>	Weight of asset classes in portfolio based on economic cycles and market conditions	Selection of themes, sectors, or regions across asset classes based on underlying market trends
<b>Alpha generation</b>	Based on security selection relative to an index	Based on selecting groups of companies that will benefit from long-term support of structural trends
<b>Decision process</b>	Portfolio managers allocate capital within defined mandates	Investment committee arbitrages opportunities across themes
<b>Investment performance</b>	Measured relative to an index (typically on an annual basis)	Measured against an absolute target or a risk-adjusted index (over a 3- to 5-year rolling history)
<b>Expertise</b>	Investment professionals with experience in a given asset class or sector	Investment professionals with a combination of in-depth regional and sector experience across asset classes
<b>Research</b>	Typically occurs within portfolios, with research performed at security level	Central group develops house views on priority themes and opportunities for institution

**1. Consider the trends**

Identifying the right trends to consider is essential. At this early stage, investors should hold broad internal dialogues to make sure all relevant trends are considered and to gain agreement on the rationale that will be used to prioritize and ultimately select some for more research.

A few factors are important to consider when prioritizing trends. First, is the trend really structural, or is it conjectural or short term in nature? Does it have material implications for the evolution of certain sectors or regions? Second, does the institution have the ability to generate distinctive insights about that specific trend and

## Exhibit 2

## Institutions are using a range of approaches to develop thematic-investing strategies.

	Approach	Example
<p>Lower commitment to thematic strategy</p>  <p>Higher commitment to thematic strategy</p>	<p><b>Develop thematic views within existing structure</b></p> <p>Develop and implement thematic investments within the risk limits and structure of the current portfolio</p>	<p>Use current risk limits in an international equity portfolio to increase exposure to specific solar-module producers in response to a renewable-energy theme</p>
	<p><b>Put in place a thematic overlay</b></p> <p>From the center, establish a thematic-overlay portfolio or shift asset allocations and increase their duration based on house views on sector/geography</p>	<p>Gain long-term exposure to wheat price by investing in wheat futures as part of a thematic-overlay portfolio</p>
	<p><b>Create a single-asset-class thematic mandate</b></p> <p>Allocate capital to portfolios or mandates with investment strategies that rely on developing forward-looking thematic views</p>	<p>Create and capitalize an equity portfolio with a clear purpose of gaining long-term exposure to renewable energy</p>
	<p><b>Create a multiasset-class thematic mandate</b></p> <p>Create a thematic fund to generate the most attractive long-term risk-adjusted returns by investing in various asset classes</p>	<p>Create a portfolio—governed by a multiasset-class committee—looking into technology investments through a combination of venture-capital funds, direct private-equity investments, and public-equity positions</p>

identify sufficient investment opportunities?

Third, are research and investment professionals excited about the trend and willing to invest time looking into it?

At this stage, investors should also develop a robust view of the institution's explicit and implicit exposure to the selected trends before adding more long-term risk to the portfolio. For instance, an Australian investor may not own shares in companies serving the rising middle class in China, yet a commodity-filled Australian equity benchmark can significantly expose that same

investor to a slowdown in Chinese consumerism.

In a nutshell, investors must ensure that they understand their true exposure—both direct and indirect—to these trends before conducting additional analyses and seeking greater exposure.

### 2. Move from trends to themes

Once key trends have been selected, investors must trace them through to the themes they produce, typically the implications for a region or sector of interest. While the increased consumption of food in emerging markets is a powerful trend, for example, the changing market for dairy protein

in China is a theme that can be realistically investigated for opportunities. In our experience, the most attractive opportunities are found when multiple themes converge and reinforce one another in a specific region or sector and when themes are expressed as discontinuities and divergences from common knowledge.

The identification of relevant themes depends on investors' ability to rapidly identify the effects of a trend on revenues and profit pools in affected subsectors. Making sense of vast amounts of information and identifying new economic patterns in it is notoriously difficult. Most successful investors use external experts as thought partners and sounding boards to supplement their internal knowledge. Our experience also suggests that investors that can rapidly move from interesting trends to themes before trying to identify specific investment opportunities move faster, get more impact from their research investment, and develop more detailed insights.

### 3. Select themes

Prioritizing themes is even more challenging, as investors must make decisions based on imperfect information and diverging points of view within the institution. The process can be time consuming and frustrating without the right approach but rapid and effective if appropriately designed.

To be successful at this important stage, institutions typically agree first on simple criteria based on their risk/return profile and capabilities to invest in a distinctive way. This boils down to four questions that should be asked about each theme:

- **Is the theme investable?** Investors should assess the high-level attractiveness of the theme and make sure there are ways to deploy capital against it at the ground level. Are there companies whose businesses are heavily exposed to the

theme? Are there other assets that might do well if the theme materializes? Can potential investments be made without running excessive risk?

- **What is the risk that the theme will not materialize?** The focus should be on countervailing forces and what they might mean for a potential investment. Investors typically try to avoid binary outcomes, as they present higher risks.
- **Does the institution have the capabilities to differentiate itself?** Factors such as distinctive knowledge, market access, a superior understanding of the assets and their value chains, and existing relationships with or privileged access to the right partners should all be considered.
- **Does the theme fit within the current portfolio construction and investment policies?** Choosing themes whose potential investments can be easily integrated and monitored within the investment structure enables investors to move rapidly and focus on building capabilities rather than addressing governance issues.

Themes should be debated and prioritized by representatives from the investment, research, and risk teams to ensure both the soundness of the thinking and the alignment of the theme with the overall corporate perspective. This will prevent thematic portfolios from becoming vehicles for individuals to place large bets based on their personal biases.

### 4. Develop an investment thesis

Once priority themes have been identified, investors must form an investment thesis describing how and why value could be created from these themes over time. This typically involves two stages. First, investors develop an understanding

of the value chains associated with a given theme, including the key players, industry dynamics, and performance drivers. Next, they develop a perspective on how industry dynamics will be altered by the theme, forcing players to adapt and creating winners and losers.

To be successful at this stage, investors must first ensure that their thesis is clear, grounded in objective facts, and based on themes that have a high degree of probability of materializing. Second, they must find insights into business systems beyond those most directly affected by the theme. For example, an investor looking into the impact on the transportation sector of populations migrating to suburbs from large city centers may determine that the best investment opportunity will be in the manufacturers of batteries that will power light trains rather than in the transportation companies themselves or in the related infrastructure.

### 5. Build the portfolio

With a clear investment thesis in mind, investors can start a “scan and screen” process across asset classes to find the best ways to take a position in the theme. Several characteristics mark the most distinctive investors at this stage:

- a clear perspective on the factors that will lead to success (that is, a concrete understanding of how value will be created and in what time frame)
- a list of potential targets that is systematically assessed against the success factors and monitored over time to find the right entry (and exit) points
- a selection of investments that have both high exposure to the theme and solid industry fundamentals to offset the potential long-term nature of the investment and the risk that the theme will take time to materialize
- a clear investment approach—likely a set of discrete investments, a portfolio of related assets, or a platform for operations and subsequent roll-up acquisitions

Finally, depending on the size of the portfolio and the number of investments it includes, additional consideration might be given to the level of correlation of the various assets, as well as the key sensitivities of specific thematic risk factors.



Thematic investing provides an alternative to traditional strategies—one that leverages the greatest strengths of institutional investors while providing the opportunity to develop proprietary knowledge and informed opinions. By understanding implicit sector exposures and then determining where and how to invest based on well-researched and debated themes, institutions increase their chances of delivering superior returns over time in an increasingly complex investment landscape. ○

<sup>1</sup> Regarding research, we heard from our interviewees that thematic investors are shifting the emphasis of their sector experts from following companies to understanding sector dynamics. They are also finding new ways to combine sector and macroeconomic perspectives.