

# Why a diversified approach to thematic could boost performance

Published 25 September 2023

## Pierre Debru

Head of Research, WisdomTree Europe.

When investing in thematic, investors' objectives are usually to:

- align investments with emerging trends and structural changes early on and as they evolve
- maximise the long-term growth potential while optimising the risk-return profile
- maximise diversification between themes, stocks and multi-thematic portfolio and core equity exposures

## Maximising the growth potential by diversifying the portfolio

When talking about maximising growth, the accepted wisdom is that the more concentrated a portfolio the more different it is to the benchmark and, therefore, the higher the tracking errors and chance to outperform. For multi-thematic/megatrend strategies, this is arguably not true.

To test this axiom, we compare the correlations and tracking errors versus the MSCI All Country World of:

1. The average of all the funds in Diversified Thematics in the WisdomTree Thematic Classification. Those funds are usually called multi-thematic or megatrends, they are mostly actively managed, and they are very concentrated (on average 99 stocks).
2. 10,000 simulated diversified baskets of 5 themes; that is, 5 funds focused only on one investment theme each. Each simulation invests every quarter in five randomly selected themes. The performance of each investment theme is calculated as the average of every exchange-traded fund (ETF) and open-ended fund that was active at a given time, irrespective of its future survival or success in that theme.

## Figure 1: A top-down approach would offer less correlated returns and have a higher tracking error vs the MSCI All Country World Index than a bottom-up approach

*Sources: WisdomTree, Morningstar, Bloomberg. From December 1999 to June 2023. Returns are calculated in US dollars on a quarterly basis. This graph represents the volatility and tracking error of 10,000 simulated portfolios. Each simulated portfolio randomly picks five investment themes (across three clusters—Social & Demographic Shifts, Technological Shifts and Environmental Pressures) every quarter. The monthly performance of each simulated portfolio is calculated as the average of each of the five themes' monthly performance. The monthly performance of each investment theme is calculated as the average monthly performance of every Europe-domiciled fund live at that point in time and classified in*

*the theme, as explained in the appendixError! Bookmark not defined.. Historical performance is not an indication of future performance and any investments may go down in value.*

Our analysis shows that every single one of the 10,000 random portfolios investing in five separate themes exhibits a lower correlation and higher tracking error to the broad market than multi-thematic funds. It is worth noting that the portfolios of 5 themes would, on average, invest in between 300-600 stocks.

This analysis shows that, for multi-thematic, a more diversified approach could improve the chance to outperform and create a differentiated portfolio compared to a more concentrated one. The reason behind this unintuitive result is that, when trying to cover 10 or 20 themes with only 100 stocks, most managers will invest in mega cap tech stocks that are dabbling in many themes. On the contrary, single-theme strategies invest in smaller stocks that have the potential to become tomorrow's mega cap.

### **Three layers of alpha generation**

A top-down approach to multi-thematic investing allows investors to control the balance between diversification and increased exposure to high-growth stocks and benefit from a three-layer approach.

- **Strategic thematic asset allocation**  
Pick themes with the highest growth potential that are the most important for existing, and future, megatrends and maximise diversification between themes while controlling the precision of the capital allocation to the different themes.
- **Tactical thematic asset allocation**  
Leverage individual theme dynamics to improve capital allocation over time and improve the risk-return profile through the systematic use of signals, such as momentum.
- **Thematic stock selection**  
Creates a diversified portfolio of stocks that best represent a theme, its underlying story and its long-term growth potential. The objective is to ensure the portfolio invests in the future winner for each selected theme while maintaining liquidity and tradability. A focus on expert-selected, pure-play stocks allows further improvement of the growth potential of the overall strategy but also enables investors to cast a wide net across the different themes to maximise the chances of picking the future winners in each theme.

### **Figure 2: 3 layers of alpha generation for a top-down approach to building multi thematic portfolios**

01

02

03

Strategic Thematic Asset Allocation	Tactical Thematic Asset Allocation	Thematic stock selection
<ul style="list-style-type: none"> <li>+ The foundation of a multi-thematic portfolio</li> <li>+ focuses on highly diversified, high-conviction themes with exposure to structural changes</li> </ul>	<ul style="list-style-type: none"> <li>+ capitalises on theme-specific dynamics</li> <li>+ incorporating tactical overlays based on momentum or news can enhance performance and deliver an improved risk-return profile</li> </ul>	<ul style="list-style-type: none"> <li>+ Expert driven selection approach for each theme</li> <li>+ Balancing selectivity and diversification is key to mitigating risks</li> <li>+ Momentum can help select stocks further</li> </ul>

Through a top-down multi thematic construction, investors could:

- link each stock of the portfolio directly to a specific theme, its story and the underlying tailwinds for its growth
- invest early in high-growth-potential companies with a chance to become tomorrow's Apple and Amazon
- over-weight the stocks with the highest chance of success by over-weighting them in their own theme sub-portfolio and over-weighting their theme in the thematic allocation itself
- maximise diversification by spreading risk and capital across themes and selecting differentiated stocks in each theme

### Related blogs

+ [Thematic investing: look for the future Amazons or avoid the Yahoos?](#)

+ [Is 'price momentum' the answer to timing thematics?](#)

### Related products

+ [WisdomTree Artificial Intelligence UCITS ETF – USD Acc](#)

+ [WisdomTree Cybersecurity UCITS ETF – USD Acc](#)

This material is prepared by WisdomTree and its affiliates and is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed are as of the date of production and may change as subsequent conditions vary. The information and opinions contained in this material are derived from proprietary and non-proprietary sources. As such, no warranty of accuracy or reliability is given and no responsibility arising in any other way for errors and omissions (including responsibility to any person by reason of negligence) is accepted by WisdomTree, nor any affiliate, nor any of their officers,

employees or agents. Reliance upon information in this material is at the sole discretion of the reader. Past performance is not a reliable indicator of future performance.

## Important Risks Related to this Article

### Important Information

**Marketing communications issued in the European Economic Area (“EEA”):** This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

**Marketing communications issued in jurisdictions outside of the EEA:** This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as “WisdomTree” (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

**For professional clients only. The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.**

The application of regulations and tax laws can often lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.