

Can ‘passive’ thematic strategies really provide expert stock selection? Absolutely.

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In our recent survey, 39% of European professional investors said they don't believe passive strategies provide the expert stock selection required and, therefore, prefer actively managed thematic strategies¹. The first thing to note is that not all thematic exchange-traded fund (ETF) strategies are created equal. The second is that some indices are actually very much built by experts with an approach that may well look very similar to the ‘active’ stock selection investors are familiar with. This is, indeed, the expert-driven approach that WisdomTree takes with its thematic range of ETFs.

In thematics, there are no easy selections

Some of the largest investment vehicles in the world track passive indices. If an investor is selecting an ETF tracking the FTSE 100 or the Euro STOXX 50, if there is familiarity with the Index, there is automatically familiarity with the strategy. These ‘beta’ type ETFs tended to see uptake first, and during the strong equity bull markets experienced since the Global Financial Crisis of 2008-09 they served investors very well.

But can one choose thematics so simply, basically picking ‘the topic’ based on the name of the strategy and being done with it?

We would say unequivocally...no! But, before looking at theme selection, we should probably take a step back, for context, and consider the growth of thematic ETF strategies.

Inertia is important everywhere, particularly in investing

When you start out in investment management, a lot of the focus goes into thinking about how you can ‘win’ if you have the right idea, or at least an idea that is better than that of your competition. With experience, you come to realise that, frequently, the best thing you can do is ‘act first.’ There are examples where the largest funds in particular categories are just those that were first-to-market.

To that end, across the European landscape of thematic strategies it can be clearly seen in Figure 1 that open-ended funds were there first, now having the benefit of simply having existed as options for about 20 years. On top of that, during much of that 20-year period, the ‘growth’ style of investing was very much in favour over the ‘value’ style.

What we find interesting in Figure 1 is that, more recently, exchange-traded fund usage within thematics has been growing quickly. Does this mean that we'll soon see equal AUM in open-ended funds and ETFs?

Probably not—we may have some years to go before that happens, if indeed it does. We do, however, hear certain ideas being repeated about why some investors are making this shift:

1. Thematic ETFs frequently allow the investor to focus on a single thematic topic
2. They allow the investor to see underlying holdings each day
3. They can have lower fees than their actively managed peers

Depending on what the rest of an investor's portfolio looks like, and how they prefer to manage it, having the toolkit and option to use an array of ETFs as opposed to a single active approach can be helpful.

Figure 1: Open-ended funds have been available for roughly 20 years

Source: WisdomTree, Morningstar, Bloomberg. From 31 December 1999 to 31 August 2022. The list of Europe-Domiciled ETFs and Open-ended mutual funds has been compiled by WisdomTree as part of the WisdomTree's own thematic classification.

Historical performance is not an indication of future performance and any investments may go down in value.

Now, let's go back to the topic of theme selection, which ties in nicely with one of the ideas we hear investors talk about: 'thematic ETFs frequently allow the investor to focus on a single thematic topic'.

Figure 2 displays 36 underlying themes. Each dot represents a strategy that is seeking to generate returns of an investment in that theme. A wider vertical dispersion of the dots is telling us that within the same thematic topical group, we are seeing a wide range of performance. In 'Sustainable Energy Production' (furthest to the left), for instance, one strategy delivered around +30% for the first 8 months of 2022, whereas other strategies in this same topic group delivered returns worse than -20%.

At a minimum, Figure 2 tells us that the due diligence process that happens after a theme is selected, and before a specific fund is chosen, is of the utmost importance. While it would be impossible to know ahead of time which strategies would be the best or the worst, investors will want to be sure that they completely agree with the methodology being used to capture the theme.

Figure 2: Methodologies to capture themes can differ greatly, leading to large performance dispersion

Source: WisdomTree, Morningstar, Bloomberg. From 31 December 2021 to 31 August 2022. Returns are calculated in US dollars on a monthly basis. Only funds live for the whole year-to-date period and classified in the indicated investment themes above are considered.

Historical performance is not an indication of future performance and any investments may go down in value.

Conclusion: thematic methodologies represent a spectrum

There are thematic strategies that exist that are completely rules-based. Certain revenue measures are made, or natural-language artificial intelligence processing systems are run, and the companies are selected. While these strategies may have their moments in the sun performance-wise, in our opinion, these strategies are not going to be based upon the highest level of expertise and, ultimately, this is what investors should be expecting.

In contrast, there are strategies where third-party industry experts are doing something that looks very similar to active stock selection within the construction of thematic indices. For example, it's worth considering whether an index being built with third-party experts whose business is based on understanding developments in the cloud computing space, will be able to build an index which is a more true reflection of that industry and ecosystem versus a generic index provider. Also, to what extent can that generic index provider identify the companies that are growing or have recently become publicly listed companies, and could be at the future of innovation within that industry. This approach seems to have limitations.

It's true that a one-size fits all approach to thematic investing is always going to be hard to find and deliver but, looking under the bonnet, we can see that some thematic ETFs actually represent more expertise in the construction than might initially meet the eye. One thing is clear, not all thematic ETF strategies are created equal.

1 Pan European Professional Investor Survey, September 2022, 600 respondents, conducted by Core Data Research.

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