Thematic investing: look for the future Amazons or avoid the Yahoos?

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Pierre Debru
Head of Research, Europe

Thematic investing allows investors to focus on specific trends and ideas expected to significantly impact the economy and society. By investing in companies that are positioned to benefit from these trends, investors can aim to invest in tomorrow's mega caps and capture the potential growth of these companies, were the promise of the theme to be realised.

However, not all artificial intelligence (AI) companies or battery companies will become the next Apple. Some companies will fail, some will stagnate, and a handful will become tomorrow's giants. This 'winner takes all' effect is very well documented and summarised nicely in 'Do Stocks Outperform Treasury Bills?' (Bessembinder, 2018). It shows that only 4% of all US companies account for the entire wealth creation of the US stock market since the 1920s.

How investors interpret these results is interesting. Passive-minded investors tend to use it to underscore the challenges of stock picking and interpret it as a reason to invest in index-linked strategies like a Nasdaq exchange-traded fund (ETF), for example. Active-minded investors tend to use it to defend very concentrated portfolios aiming to invest only in the 4% of winners' stocks.

This tendency to overconcentrate portfolios is evident when looking at multi-thematic/diversified thematic or megatrend funds in Europe. As illustrated in Figure 1, the average number of holdings in such funds is 99 stocks; 99 stocks to invest in ten or twenty different themes at the same time!

Figure 1: Average number of holdings in multi-thematic and single-theme funds and ETFs

Sources: WisdomTree, Morningstar as of 30/06/2023. Historical performance is not an indication of future performance and any investments may go down in value.

In the context of thematics, at WisdomTree, we think that both approaches are flawed. By investing in the whole universe of stocks, passive strategies do not use the tools that a thematic lens offers to narrow their investment universe. They, therefore, dilute their potential long-term returns. Active funds are too ambitious by trying to invest only in the future winners and avoiding all future losers. They fail to learn from the past and to acknowledge that it is a lot more damaging for long-term returns to miss the next Apple than it is to invest in a few Yahoos.

Lessons learned from investing in internet stocks

To illustrate this effect, we can take the example of the internet theme and how investors could have tried to benefit from it as early as 1998. To do so, we test two different approaches:

- investing in a diversified portfolio of the ten biggest dot-com stocks at the time that will include duds but will also include Amazon
- investing in a more concentrated portfolio and potentially miss Amazon

Over the period from 31 December 1998 to the end of June 2023, the S&P 500 gained +472.43% (or 7.38% per annum), and the Bloomberg US Aggregate gained +148.8% (+3.8%)[1]. Assuming a simple equal-weight allocation in the ten biggest internet stocks at the end of 1998, an investor would have gained 797% or 9.4% per annum. Despite three companies becoming worthless and only three with decent returns over the period, investors would still have beaten the market by 1.9% on average per year. This is, of course, the result of the exceptional growth of Amazon, eBay and Booking.com.

Let's now look at a more concentrated portfolio. Let's assume that the investor decided to pick only five stocks to invest in. The dispersion of results in those portfolios is huge, with the worst portfolio losing -94% of its value over the 24 years and the best portfolio gaining 1281%.

Figure 2 shows the dispersion of annualised returns of all the potential five stock portfolios. 40% of all portfolios beat the S&P 500 and the diversified basket of ten stocks, while 60% of them underperformed the S&P 500. Digging further, the difference between beating the S&P 500 and not beating the S&P 500 is the investment in Amazon. Every single portfolio that included Amazon beat the market.

Figure 2: Distribution of annualised returns since December 1998 for all possible portfolios of five stocks

Sources: WisdomTree, Bloomberg. From December 1998 to June 2023. In USD. Historical performance is not an indication of future performance and any investments may go down in value.

The obvious conclusion is that while 'seeing' the growth potential of the internet could have been a winning investment long-term, a positive outcome would have hinged not on avoiding the many companies that did not make it but on making sure to own the one company that won the war.

Conclusion

By investing in themes, investors can access powerful sources of growth. However, this thematic growth is not shared equally across all the stocks in the theme. It is a 'winners take all' world, after all. The success of a thematic investment will therefore hinge on the following:

- focusing on a successful theme that allows increased exposure to a narrower universe of companies compared to an investment in the market at large
- increasing the chances that the portfolio includes the future winners in the themes, which means having a diversified approach to the thematic stock selection

Such a diversified approach can increase investors' exposure to the next Apple while minimising the potentially disastrous risk of missing it.

[1] Source: WisdomTree, Bloomberg. 31 Dec 1998 to 30 June 2023.

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