Navigating cybersecurity: Revealing cutting-edge players via top performing portfolios

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Key Takeaways

- Cybersecurity thematic funds delivered strong performance in 2023
- Expertise is required to better capture the cutting-edge companies in the cybersecurity segment
- The anticipation of rate cuts, increasing geopolitical risks and further development of AI could be tailwinds behind cybersecurity theme in 2024

2023 was a year full of variables. Increasing geopolitical risks, declining inflation in major economies and significant advancements in Artificial Intelligence (AI) development – all these factors contributed to uncertainty, but also to investment opportunities across various segments. To seize these opportunities, investing in trending themes can be a viable approach and one of the most prominent themes we've observed is cybersecurity.

While following these hot themes allows us to capture megatrends, the same logic doesn't necessarily guide us toward identifying strong performing companies. Predicting the performance of individual stocks, especially in the ever-evolving tech industry, remains challenging. Identifying a promising trend is often more straightforward than pinpointing specific winning stocks in many situations.

WisdomTree's Thematic Universe

WisdomTree consistently monitors the Exchange Traded Funds (ETFs) and open-ended mutual funds that it considers part of the 'Thematic Universe' – the monthly report is available here. It enables us to pick specific themes, including cybersecurity, and compare them to the peer funds in the markets. While no theme or fund can consistently outperform others, through monitoring and comparison we can identify hot themes with growth potential within the thematic universe. Once a hot theme is identified the next step is to determine which fund that tracks that theme has best captured the performance wave.

Cybersecurity surged in late 2023

The cybersecurity theme benefited from both macroeconomic factors and company fundamentals in 2023. The anticipation of rate cuts, driven by falling inflation in major economies, worked in favour of cybersecurity

companies – especially those that have recently gone public – regarding funding costs and valuation. Simultaneously, significant advancements in AI bolstered the cybersecurity theme from both demand and supply perspectives. As AI-related threats continue to rise, investment in cybersecurity remains a top priority for large firms. Additionally, cybersecurity companies have begun leveraging AI to enhance their solutions. It is well known that the demand for cybersecurity professionals is way beyond the supply of these workers, so anything that can help the professionals that we do have operate more efficiently could be invaluable. The favourable impact of these developments is evident in strong Q3 financials and a positive revenue outlook.

All 11 cybersecurity thematic funds (including both ETFs and open-ended funds) in Europe demonstrated strong performance in 2023 – the top five best performing achieved returns exceeding 40% and all 11 funds delivered positive returns in 2023. This trend has maintained continual growth this year.

As of 29 February 2024, the total assets under management (AUM) in cybersecurity thematic funds reached about $6.5 billion[1], reflecting a growth of around 26% since the beginning of 2023. Notably, approximately $5.3 billion of this AUM is managed through ETFs.

The index-based thematic ETFs enable investors to access specific themes and 2023 provided an opportunity to review a period when cybersecurity got hot. Let's look closely at three example cybersecurity indices: WisdomTree Team8 Cybersecurity UCITS Index (WTCBR), STOXX Global Digital Security Index USD (STXTDSL) and ISE Cyber Security UCITS Index (HUR).

Since the start of 2023 WTCBR consistently exhibited higher volatility compared to both STXTDSL and HUR. Despite a dip in April 2023, it experienced a pronounced acceleration in returns when cybersecurity became a hot topic in November and December. However, this higher volatility also translated into greater losses when compared to STXTDSL and HUR when the theme declined in 2022. STXTDSL and HUR, while also accelerating in terms of performance, maintained a similar trajectory to each other and did not exhibit the same sharp upward trend as WTCBR.

Figure 1a: Standardised performance as of 29 February 2024

Name	YTD	6-month	1-Year	2-Year (Ann.)	3-Year (Ann.)
WisdomTree Team8 Cybersecurity UCITS Index	7.5%	35.8%	55.0%	7.2%	5.7%
STOXX Global Digital Security Index	5.4%	17.0%	29.9%	6.9%	4.8%
ISE Cyber Security UCITS Index	2.7%	17.8%	33.3%	4.1%	2.3%

Source: WisdomTree, Bloomberg. The performance is based on the net total returns (NTR) in USD term as of 29 February 2024. Return figures for time periods longer than 1 year are annualized.

Figure 1b: WTCBR vs. STXTDSL & HUR since 2023 (30 December 2022 to 29 February 2024)



Source: WisdomTree, Bloomberg. The performance is based on the net total returns (NTR) in USD term as of 29 February 2024. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investment may go down in value.**

How to get closer to cutting-edge companies?

Getting closer to cutting-edge companies in the cybersecurity theme is crucial for unlocking growth potential. Companies that closely align with cutting-edge technologies are better positioned to gain a competitive advantage. However, there is a premium on accessing the newest companies pursing the most current defences.

WTCBR, STXTDSL and HUR are all tracking returns of indices, but how close can these indices get to the newest technologies? Figure 2 shows the top 10 positions of each fund, it shows that:

- WTCBR and HUR have a roughly similar weight in the top 10 holdings (40-50%) while STXTDSL has a less concentrated weight (<20%).

- As part of the methodology behind the WisdomTree Team8 Cybersecurity UCITS Index (which is tracked by WCBR), Team8 – leveraging its cybersecurity expertise – evaluates each company's cybersecurity practices based on what they consider to be the eight most crucial functional aspects of this discipline. The focus is on the future of what will be needed in cybersecurity, and a broad focus is telling us that the company is doing at least three things that Team8 views as critical to the future of cybersecurity.
- STOXX Global Digital Security Index selects companies based on their exposure to the digital security theme. It encompasses companies which are involved in the transmission, safeguarding and/or handling of sensitive data, and/or access control of secure locations. The #N/A in figure 2 means that Team8 did not classify the company into any of its eight critical cybersecurity areas.
- ISE Cyber Security UCITS Index focuses on companies that work to develop hardware and/or software that safeguards access to files, websites and networks from external origins, or those that utilise these tools to provide consulting and/or secure cyber based services to their clients. The Team8's classification is telling us that the companies are involved in eight distinct focal areas on the future of cybersecurity but not all of them are fast-growing players.

Figure 2: Top 10 Company exposures within WTCBR, STXTDSL and HUR (average weights from 30 December 2022 to 29 February 2024)

WisdomTree Team8 Cybersecurity UCITS Index		
Name	**Avg. Weight**	**Team8 Classification**
Datadog Inc	5.4%	Broad Focus & Growing Fast
Crowdstrike Holdings Inc	5.4%	Broad Focus & Growing Fast
Palo Alto Networks Inc	5.2%	Broad Focus & Growing Fast
Cloudflare Inc	5.2%	Broad Focus & Growing Fast
Elastic NV	5.2%	Broad Focus & Growing Fast
SentinelOne Inc	5.1%	Broad Focus & Growing Fast
Fortinet Inc	5.0%	Broad Focus & Growing Fast
Rapid7 Inc	4.8%	Broad Focus & Growing Fast
Okta Inc	4.7%	Broad Focus & Growing Fast
Tenable Holdings Inc	4.7%	Broad Focus & Growing Fast

Total	50.8%	

STOXX Global Digital Security Index		
Name	**Avg. Weight**	**Team8 Classification**
Nutanix Inc	2.2%	N/A
Arista Networks Inc	2.0%	N/A
Accton Technology Corp	1.9%	N/A
Booz Allen Hamilton Holding Corp	1.7%	N/A
Palo Alto Networks Inc	1.7%	Broad Focus & Growing Fast
CyberArk Software Ltd	1.7%	Broad Focus & Growing Fast
Qualys Inc	1.7%	Broad Focus & Growing Fast
Cloudflare Inc	1.6%	Broad Focus & Growing Fast
Crowdstrike Holdings Inc	1.6%	Broad Focus & Growing Fast
Otsuka Corp	1.6%	N/A
Total	17.8%	

ISE Cyber Security UCITS Index		
Name	**Avg. Weight**	**Team8 Classification**
Crowdstrike Holdings Inc	4.7%	Broad Focus & Growing Fast
Juniper Networks Inc	4.6%	Broad Focus & Growing Fast
Palo Alto Networks Inc	4.4%	Broad Focus & Growing Fast
Cloudflare Inc	4.4%	Broad Focus & Growing
CyberArk Software Ltd	4.4%	Broad Focus & Growing
Fortinet Inc	4.4%	Broad Focus & Growing Fast

Broadcom Inc	4.3%	Broad Focus & Growing
SentinelOne Inc	4.3%	Broad Focus & Growing Fast
Trend Micro Inc/Japan	4.3%	Broad Focus & N/A
Check Point Software Technologies	4.2%	Broad Focus
Total	43.9%	

Source: WisdomTree, Bloomberg, Team8.

While certain rules – such as filters based on stock liquidity and market capitalisation – can be universally applied when constructing a portfolio, selecting stocks within a theme that have significant growth potential requires a bespoke approach with a forward-looking vision. Collaborating with Team8, whose professionals include individuals experienced in dealing with cyber activities in Israel's military and the U.S. National Security Agency, ensures that the companies' focus on cybersecurity evolves swiftly within the index.

Conclusion

Over the past three years, cybersecurity companies have experienced fluctuations. The theme declined, as did most of other themes in 2022, due to the fastest series of interest rate hikes since early 1980's. Following an upswing in 2021 they began to climb in 2023, culminating in a late 2023 rally. Interest rates played an important role during this period. Looking ahead to 2024, we believe that cybersecurity remains an exciting theme due to its high sensitivity to both megatrends and interest rates, benefiting from potential tailwinds – such as the anticipation of rate cuts led by the falling inflation in the major economies, increasing geopolitical risks due the tension in middle east and across the Taiwan strait, further development of AI and the synergy between AI and cybersecurity.

Sources

[1] Source: WisdomTree, Bloomberg

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