

## Perspective

# How to find the most powerful investment themes

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Thematic investing offers the opportunity to invest in the trends transforming the world around us. David Docherty explains how to identify those themes that combine a meaningful impact with the possibility of strong returns.



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Thematic funds focus on powerful, long-term global trends which are transforming the world and creating a wealth of investment opportunities. At Schroders we believe that the purpose of a thematic portfolio is to invest profitably in the most powerful of these themes. In our view, these are where human ingenuity ignites innovation to address imbalances in the world.

### Investing in people and planet

These imbalances affect both people and planet and several potent themes are playing out today. Many of these themes relate to the UN Sustainable Development Goals, encompassing urgent global priorities such as the environment, sustainable infrastructure, responsible consumption, inclusion, and health and welfare. All of these are underpinned by the imperatives of protecting our planet and investing for people. As the corporate sector increasingly commits capital with these goals in mind, exciting new thematic investment opportunities are emerging.

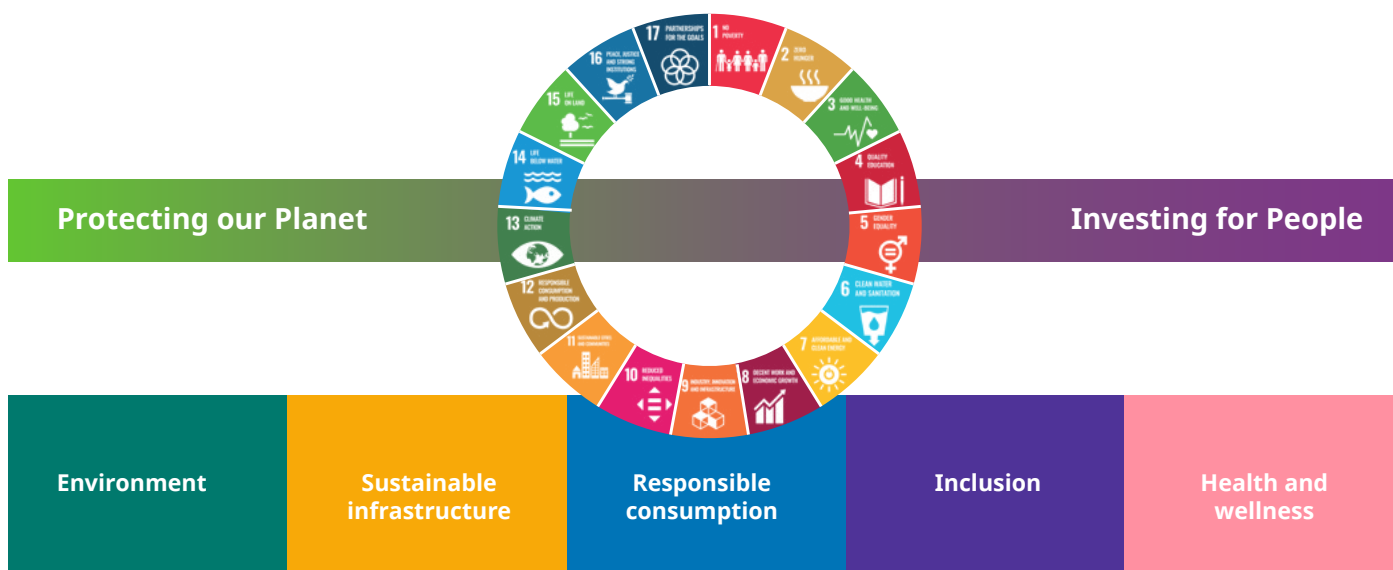
Themes also emerge where people's behaviours and preferences create imbalances between supply and demand in individual industries. In such cases we see unmet demand or inefficient supply, the response to which might be disruption where innovators come in and challenge the status quo.

As we all know, people and planet all too often come into conflict. From these interactions emerge themes such as climate change, a response to which is the energy transition theme where human ingenuity is being mobilised to execute the move from fossil fuels to clean energy.

Demographic trends can also create global imbalances, such as the challenge of keeping healthy a growing and ageing world population through healthcare innovation. Similarly, the provision of sustainable food and water is an urgent requirement inextricably linked to the priority of responsible consumption.

Urbanisation and digital infrastructure are also powerful themes as we try to establish the necessary infrastructure to cater both for people's move from the countryside to cities and for their rapidly growing, and changing, digital needs.

The imbalances of people and planet and the imbalances of supply and demand within individual industries are so often interlinked. The theme of healthcare innovation, for example, is a response to demographic imbalances as well as to supply inefficiencies within the healthcare industry itself which create challenges in the delivery of medical solutions to those in need.



Likewise, the playing out of themes such as climate change, energy transition, sustainable food and water, urbanisation and digital infrastructure will all have significant implications for supply and demand dynamics within numerous industries.

Thematic portfolios, in our view, should therefore invest in those companies with the requisite ingenuity to innovate, often through technology, to address these imbalances and, in so doing, achieve our clients' performance and sustainability objectives. Thematic investing is continuing to grow in popularity as clients' intellectual and emotional connections to themes relating to people and planet are increasingly reflected in where they seek investment returns. Investee companies for their part are also ever more aware of the importance of 'doing the right thing' in terms of sustainability. This is both for its own sake and also because they recognise the significant risk factors threatening their businesses inherent in doing otherwise.

### Investing with precision

In years gone by, clients wanting to access these most powerful of themes might have invested in a sector-specific vehicle. For example, many investors backing technology companies do so because they believe that these companies are winning market share from more traditional businesses. The underlying theme here is disruption but the sector allocation approach is often a flawed way to gain exposure to this theme.

This is a function of sector definition whereby in some senses a sector can be too broad, and in others too narrow, a way to gain exposure to a theme. On the specifics of the technology sector, for example, breadth is expressed by the existence of several sub-industry groupings, ranging from IT consulting to internet services; from systems software to semiconductor equipment, often with their own distinct characteristics as relates to disruption.

In other senses, a sector can be too narrow because it may not capture the full range of companies set to benefit from a particular theme. A portfolio dedicated to accessing disruptive companies, for example, is likely to find many opportunities outside technology in sectors such as communication services, industrials, consumer discretionary or healthcare.

Thematic investing is different because it involves breaking traditional sectoral, and indeed regional, boundaries when putting together a portfolio of those companies best placed to benefit from a theme. In so doing, thematic investing allows investors to invest with precision in themes which are important to them, like those above, and which they believe can deliver superior returns.

Themes like these are long term in nature, playing out not over months or even years but over decades. To that extent, the wider market often struggles correctly to model and value longer term themes, thereby creating some attractive mispricing opportunities for thematic investors.

### Investing with discipline

While we are firm believers that a thematic approach can add considerable value, it is imperative that it is done in a disciplined manner.

To do this, we believe the following seven elements are essential when selecting an investment theme.

#### 1. An overarching framework

This is critical as a means of ensuring that our thematic strategies are robust, durable and capable of delivering long-term alpha for our clients. In this sense, the framework is at least as important in rejecting potential themes as it is in identifying them.

We believe the optimum approach is to identify themes where human ingenuity ignites innovation to address the fundamental planet and people imbalances discussed above. The inputs informing this process at Schroders are many and varied, drawing upon the knowledge of our investment teams and the non-traditional research findings driven by the team of data scientists in our Data Insights Unit.

#### 2. Longevity

It is essential that themes have longevity and so they must be structural in nature rather than cyclical or short-lived fashions. In this respect, it is often very useful to look at what we call the 'history of the future' because many of the most powerful themes for the future are those which have driven innovations in the past.

Indeed, since ancient times, human ingenuity has helped to transform the world, and the way we live and work, through innovations in numerous areas. Driven by existential needs such as survival and the quests for efficiency and enjoyment, innovations have spanned diverse areas like healthcare, manufacturing, energy, urbanisation, infrastructure, shopping and entertainment.

A theme's structural characteristics should therefore allow investors to make long-term returns, weathering any short-term periods of underperformance. A key test for a theme is whether we have confidence that it can outperform the MSCI All-Country World Index on a time horizon of three years plus.

#### Choosing an investment theme: dos and don'ts

**Do learn from the "history of the future":** A number of complex factors have influenced how numerous themes have played out historically and, while they are not necessarily predictive, they do shape outcomes.

**Disruptors can be disrupted:** In the US, the mass construction of canals in the first half of the 19th century was the first disruption to the horse and cart as a mode of transport. As the interstate highways of their time, these were genuinely game changing. However, they were soon superseded by the rapid expansion of the railroads in the second half of the century. The winners and losers, at both the technological and corporate level, are continually evolving.

**Do beware the hype:** The invention of the internet spurred a wave of new technology companies in the 1990s. At their peak, IT stocks captured 26% of the total US equity market cap before tumbling to 13%. Firms such as Microsoft and Amazon recovered strongly, but many others failed and went bankrupt. Just because an innovation is catching on does not remove the need to undertake fundamental analysis of its investment prospects.

**Don't write off the incumbents:** Studebaker, originally a company which made carts to be used with horses, released an electric vehicle in 1904 and a petrol car soon after. It survived for over 60 years until its demise in the 1960s.

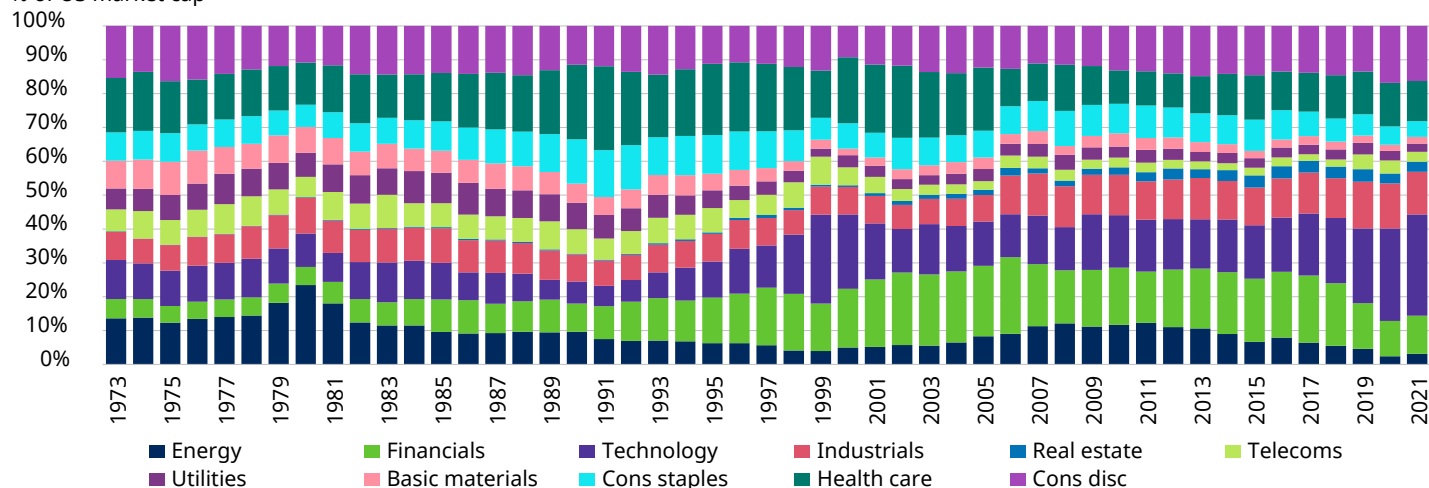
#### 3. Investability

As obvious as it may sound, there must be a supply of investment instruments through which exposure to a theme can be achieved. This is not always the case in practice.

Some areas of thematic growth may be dominated by governments or universities, such as areas of early stage research and development. While these innovations are often eventually commercialised, the reality is that the best way to gain access to themes is through the corporate sector. Thus far this has

## Industry winners and losers have evolved over time

% of US market cap



Source: Datastream Refinitiv and Schroders. Data to 31 August 2021. Notes: based on Datastream US sector indices.

taken the form of investment in public equity markets but, as thematic investing becomes more sophisticated, private equity will increasingly feature as a mechanism to expand the opportunity set available to thematic investors.

### 4. Universes which are neither too narrow nor too broad

Once the overall 'investability' of a theme has been established, the themes chosen must also have investment universes which are of an optimal size. If they are too narrow, they deny the portfolio manager the flexibility to chart their way through evolving themes; if they are too broad they lack the precision which clients seek when they invest in a particular theme.

This element is absolutely critical because it ensures that the themes are authentic and precise enough to ensure that the portfolios are 'doing what they say on the tin'. We feel that many themes have too narrow an opportunity set. For example, there is only a small handful of dedicated robot manufacturers and this is insufficient to form a robotics universe, even if supplier companies are included. We feel instead that automation is a powerful sub-theme within a broader smart manufacturing strategy and prefer this to a standalone robotics thematic.

At Schroders, our Data Insights Unit of data scientists helps us create and also curate these investment universes. Indeed, their work has on occasion dissuaded us from developing new thematic strategies where the overall strength of the proposition has not been matched by the availability of bottom-up actionable stock opportunities. We have previously investigated the theme of education, for example, but we found that in many cases companies' exposure to education was either diluted by other business activities or was represented by the provision of non-educational services, such as catering or other support activities, to educational institutions.

The Data Insights team is also invaluable in helping our investors to find exciting companies exposed to our favoured themes which have not yet been fully recognised by the market. In this context, the use of the latest data science techniques has helped us locate ingenuity in the shape of patents, the inventions stemming from which can power the innovation needed to solve the problems and imbalances so central to thematic investing.

### 5. Valuation upside

The themes need to have valuation upside because thematic investors are ultimately investing in stocks and shares rather than in themes as abstractions. Once the fundamental attraction of a theme is discerned, the potential investee companies need to be identified and a judgment made on their prevailing valuations.

In this context, there can often be a disconnect between the fundamental duration of a theme and the market's pricing of that theme. In short, themes which are long term and structural in fundamental terms can from time to time experience bouts of over-valuation as investors discount their long-term potential. A focus on sub-themes is thus important so the portfolio manager can navigate a wider theme as it develops and as valuation opportunities come and go.

In the case of the energy transition, for example, parts of the value chain may vary in their investment attractiveness such that a portfolio manager's relative preferences might move between, say, energy generators, transmission companies and energy storage businesses.

### 6. An active approach

We believe that an active, global and unconstrained approach is optimal for a thematic fund. If themes are powerful and pervasive, they must not be constrained, as discussed above, by the index weightings of stocks, sectors, countries or even regions.

Another reason why an active approach is the best way to invest in a theme is because it can provide a material, above-index exposure to companies when a theme is developing and when we believe these businesses' prospects are not reflected in prevailing share prices. By following an active approach, portfolio managers can also avoid large index components which may well have become expensive and 'oversized' as a theme matures.

The opposite applies with passive thematic investing because it is slow moving, inflexible and less capable of gaining adequate exposure to emerging investment opportunities in evolving themes.

An active approach also ensures engagement with investee companies to ensure that, as discussed above, they are 'doing the right thing' in terms of sustainability.

### Choosing an investment theme: dos and don'ts

Do take a hard-headed, disciplined approach. While resolving global planet and people imbalances is clearly very important, we must remember from an investment standpoint that history is littered with great themes that have been poor investments.

#### Pitfall 1: Getting in too early

In order to stem climate change, we need to transition from heavily polluting coal and oil towards greener forms of electricity. This was as true a decade ago as it is today. But, if you'd invested in a fund backing this theme a decade ago, you'd have lost a lot of money compared with simply investing in the broader stock market. For example, if you had invested in the MSCI Global Alternative Energy Index over the last 10 years, you would have underperformed the MSCI All-Country World Index by 5.3% per year. Alternative energy was simply too expensive and the technology too under-developed to make it a profitable investment opportunity. It is only now that various inflection points have been reached that the potential to make real money can start to be realised.

#### Pitfall 2: Overpaying

Our lives may have been transformed by technology but, with hindsight, investing in technology stocks at the peak of the Dotcom boom would have meant waiting for over 15 years before you recouped your losses. You may get the theme right in the end, but timing is crucial.

In short, active, global and unconstrained thematic portfolios can best identify and invest in those companies grasping the opportunities in the powerful, long-term global themes discussed above. In so doing they can deliver the higher alpha non-index outcomes increasingly sought by investors today.

### 7. A governance structure

If our overarching framework is at least as important in rejecting themes as it is in accepting them, so too we must be vigilant in assessing the ongoing viability of all of our thematic investment strategies. Governance is thus a critical element of thematic investing in a number of senses. If the fundamentals of a theme are no longer working we must recognise this. If a theme as played out has expected but the valuations are such that there is no longer any upside then we must accept this too.

## Conclusion

We are firm believers that a thematic approach can add considerable value. The requirements for success are many and varied but to make superior investment returns over the long term through thematic investing we believe that a

robust intellectual framework and a disciplined approach are essential if clients are to invest with precision in the most powerful investment themes.

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