Principal Equities

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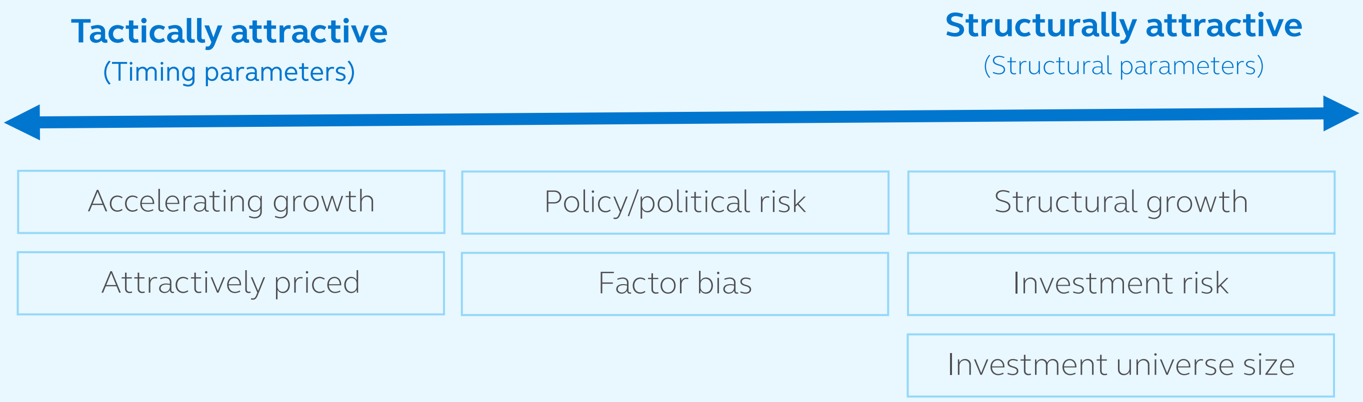
Strategic perspectives on thematic investments

AUGUST 2024

Author:
MARTIN SLIPSAGER FRANDSEN
Portfolio Manager,
Principal Equities

Over recent the years, thematic investing has grown rapidly from $223bn USD in 2019 to $479bn USD by 2023, as investors are increasing wanting to directly benefit from the most attractive parts of the equity markets, such as climate solutions, AI, or sustainable food. While the promises of these megatrends are significant, investors have historically been left hoping for more, either because the growth potential was pushed out or because the companies in the thematic portfolios were too expensive. As such, the Financial Times found that asset owners over the 5-year period leading to 2023, missed out on two-thirds of the return generated by thematic funds.

At its best, thematic investing gives you direct access the most attractive investments opportunities, but its worst can leave you waiting a long time for the promises to pan out. To combat this, this piece will propose 7 different parameters that are important to consider when wanting to successfully invest in thematic investments. These include both structural parameters that are important for the long-term value creation potential, as well as shorter term tactical parameters that work to help ensure that investors do not buy at an unattractive entry point. While the structural parameters are arguably the most important element in the long run, this piece argues that investors often tend to neglect the tactical parameters, which means that investors risk investing when the companies are unattractive.



Accessing the structural attractiveness of a theme

One of the most important parameters for a theme to be attractive long-term, is that it has structurally superior growth relative to the market. This superior growth can stem from structural shifts in the global economy, such as the innovation wave coming from the adoption of artificial intelligence or the secular push towards a greener future, which consistently has pushed climate investments up by 50% annually from 2019 to 2022.

While superior structural growth is a key requirement for a theme to be attractive, it cannot be overshadowed by associated investment risk. In this context it is important to both consider risk as it relates to the uncertainty that the growth will play out, as well as the investment risk that investors not be exposed. If we consider AI in relation to this, few will dispute the growth potential, but as the secular megatrend is still in its early stages, there remains risk for the multitude of stocks where their share prices have skyrocketed, but the follow-through to earnings remains a thing of the future. These companies may well be winners of the AI transition, but for the ones where the hype exceeds reality, significant risks persist.

Lastly, an overlooked structural parameter that needs to be in place for a theme to be structurally attractive is that there needs to be a sufficiently large investment universe for investors to be able to construct efficient portfolios, as well as have a large enough bench of attractive companies, that can be “substituted” in when portfolio companies become too expensive. If this is not the case, then investors may be forced to hold stocks that are too expensive.

Accessing the tactical attractiveness of a theme

While the structural parameters will be a requirement for any theme to be attractive long-term, they will seldomly be enough if an investor enters at an unattractive entry point. In our view, the most important things to consider from a tactical perspective is if the growth is accelerating and the stocks are attractively priced. It is seldomly enough to have high structural growth if it is not on a positive upward trajectory. The reason for this is that as stocks tends to be priced on incremental news. Similarly, a portfolio can consist of the best stocks in the world, but if they are too expensive both relative to their own history and fundamental value, then it can become detrimental to investors. These two parameters may seem like common sense to many, but they are often neglected and overshadowed by to narrow a focus on the promises of the future. The risk in such situations is that the investors can end up sitting around for a very long time waiting for growth promises to play out while they keep losing money.

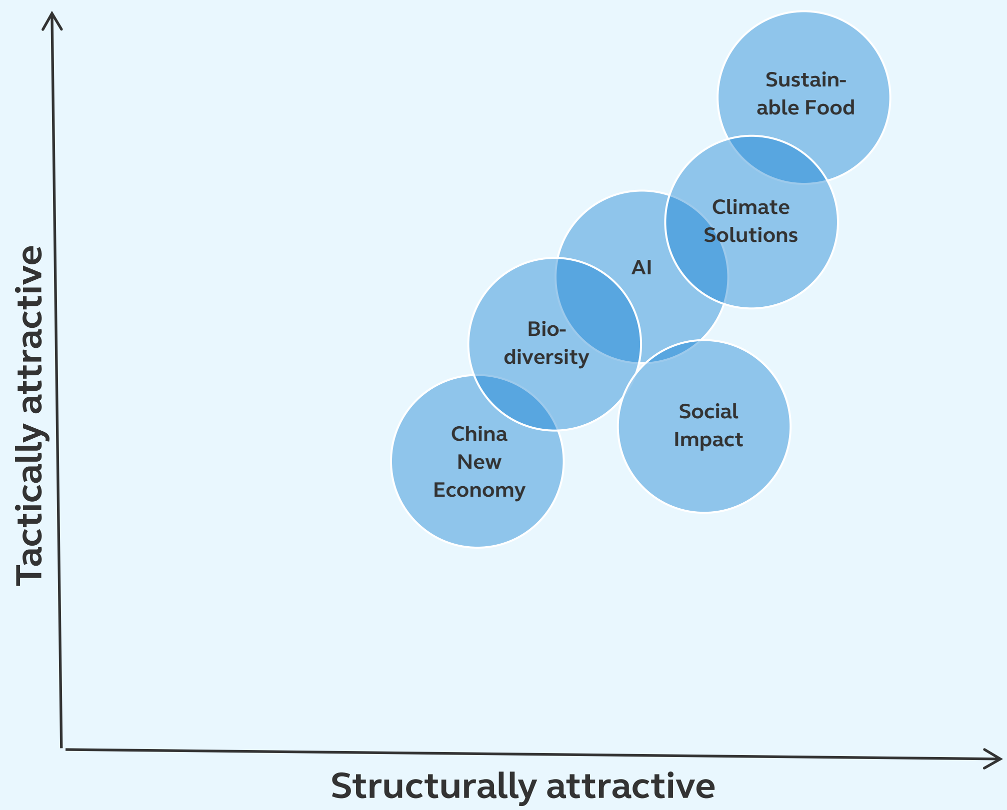
Policy/political- & factor risks

While some parameters are inherently either structurally or tactically relevant, this piece that investors also need to consider policy/political and factor risks both from a structural and from a tactical perspective. Policy and political considerations can be a powerful tailwind for an investment theme, which green investments have benefitted from over the previous decades as the share of countries committing to net zero emissions reached 91%, but if these commitments come into question, which some fear will be the case for the Inflation Reduction Act (IRA) in the US, it may result in sustained headwinds for share prices until the risk gets resolved.

Factor risks is similarly an area that both has long-term and tactical ramifications. If a theme inherently exposes an investor to factors such as growth or value, then investors should want to be compensated accordingly on expected return. At the same time, if an investor enters a factor exposed theme at the wrong time, then that can be detrimental to financial returns.

Assessing key themes on the 7 parameters

The below image offers perspective on how 6 selected themes stack up on the 7 proposed framework parameters. These 6 themes are Artificial Intelligence (AI), Climate Solutions, Sustainable Food, Biodiversity, Social Impact, and China New Economy.



While Climate & AI have higher acceleration and level of structural growth than Sustainable Food, they are both pulled down by political/policy and factor risk, as well as investment risk specifically for AI. On its own, Sustainable Food comes out as the most attractive theme, as it is only investment universe size that is pulling its structural attractiveness slightly down. China New Economy is both cheap and has attractive structural growth, but it is pulled down by decelerating growth in recent years and high policy and investment risk. Biodiversity has both accelerating and attractive structural growth, but a relatively small investment universe and investment risk, which dampens the attractiveness of the theme on its own. Lastly, while Social Impact has attractive structural growth, the growth at his point is not accelerating and the stocks are not cheap enough to offer an additional point of attractiveness to compensate.

Paths to better outcomes

While both Sustainable Food and Climate Solutions on their own screened attractively on the 7 parameters, respective parameters such as investment universe size, and a combination of factor risks and policy/political risks still negatively affecting the desirability of the themes. There are a few possible paths that can help mitigate these challenges and lead to better risk adjusted returns over time, without compromising the thematic credibility.

The first suggestion is to combine Sustainable Food and Biodiversity. The key to this argument is that research shows that the food and agricultural sector has, by far, the most biodiversity exposure globally. As such, many of the solutions that can help increase the sustainability of the global food systems can do so while incrementally improving the biodiversity impact of these systems. From an investor perspective, the combination also has material benefits, as it helps to mitigate the common challenge of the size of the respective investment universes.

While Climate Solutions has the investment universe size and structural growth potential to stand on its own, a narrow focus on this theme can entail periods of higher volatility due to the inherent factor biases and policy/political risk aspects. For these reasons, we propose two options. If direct access to the high secular growth from the green transition is desired, a preferable path is to embrace the full palette of solutions required to reach net zero emissions, rather than myopically on renewable energy. This would entail adjacent opportunities, such as electrification, energy efficiency, green hydrogen, and technologies for decoupling material usage and economic growth. An alternative path would be to combine Climate Solutions with Social Impact and/or Environmental Solutions. Such a multi-thematic approach can help improve diversification and thus improve risk adjusted returns over time.

Risk Considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. Equity markets are subject to many factors, including economic conditions, government regulations, market sentiment, local and international political events, and environmental and technological issues that may impact return and volatility.

Asset allocation and diversification do not ensure a profit or protect against a loss. Integration of sustainability considerations and/or environmental, social and governance (ESG) factors is qualitative and subjective by nature. There is no assurance that any strategy or integration of sustainability considerations and/or ESG factors will be successful or profitable. Robotics and artificial intelligence companies typically engage in significant amounts of spending on research and development, and there is no guarantee that the products or services produced by these companies will be successful. Robotics and artificial intelligence companies, especially smaller companies, tend to be more volatile than companies that do not rely heavily on technology. International investing involves greater risks such as currency fluctuations, political/social instability, and differing accounting standards. International investing involves greater risks such as currency fluctuations, political/social instability, and differing accounting standards.

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MM14126 | 08/2024 | 3804327-082026