PICTET
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Asset Management

MARKETING MATERIAL - FOR PROFESSIONAL INVESTORS ONLY

Thematic equity: the active element of a global stock portfolio

Readers of the financial press could be forgiven for thinking that active investing isn't worth the time and effort.

We are told that, as stock prices now accurately capture all available information, investors should abandon their pursuit of alpha altogether.

It's a persuasive argument. Passive investing is an inherently attractive proposition, not least because every investor welcomes low fees and greater transparency. But it would be wrong to claim that long-only active equity investment has outlived its usefulness.

Research shows that a fair proportion of active equity strategies do distinguish themselves over time.[1] When investment managers stay true to their very strongest convictions and avoid holding stocks simply to alter a portfolio's tracking error, such strategies can deliver.

A growing number of institutional investors are considering allocating more of their capital to thematic equity, an approach that is both research intensive and index-agnostic.

All of which helps explain why a growing number of institutional investors are considering allocating more of their capital to thematic equity, an approach that is both research intensive and index-agnostic.[2]

1 See, for example, https://www.aqr.com/Insights/Research/Alternative-Thinking/Active-and-Passive-Investing-The-Long-Run-Evidence

2 See, for example, https://docfinder.bnpparibas-am.com/api/files/de3e08aa-b212-42f8-99c3-3134ceaf6aaf

The importance of megatrends

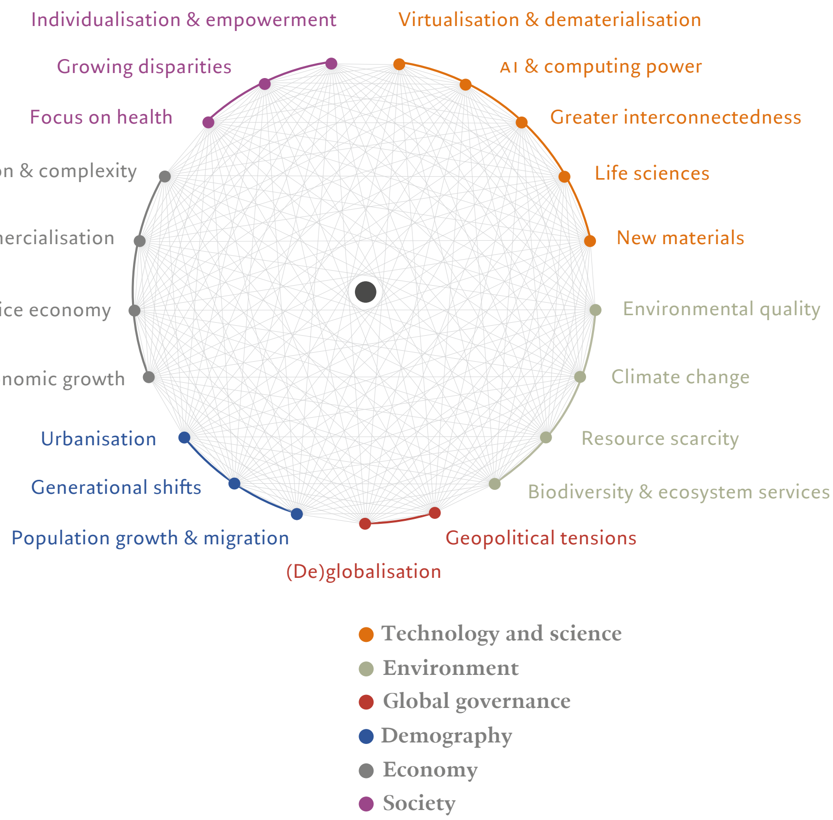
The main goal of a thematic equity strategy is to invest in companies profiting from structural forces of change that evolve independently of the economic cycle.

In other words, it seeks to transform long-term technological, environmental and societal megatrends – such as urbanisation, globalisation or climate change – into long-term investment opportunities.

Expertly deployed, the megatrend-led thematic approach can present portfolio managers with a greater number of alpha generating opportunities than mainstream equity strategies. That's partly because it demands a deep understanding of complex economic and non-economic phenomena – research that requires resources on a scale that aren't available to every asset manager.

At Pictet Asset Management, our thematic teams have for many years worked with a strategic consultancy – the Copenhagen Institute for Futures Studies – academics and business leaders to devise a framework that tracks both the evolution, and industry effects, of 21 megatrends.[3]

Mapping megatrends



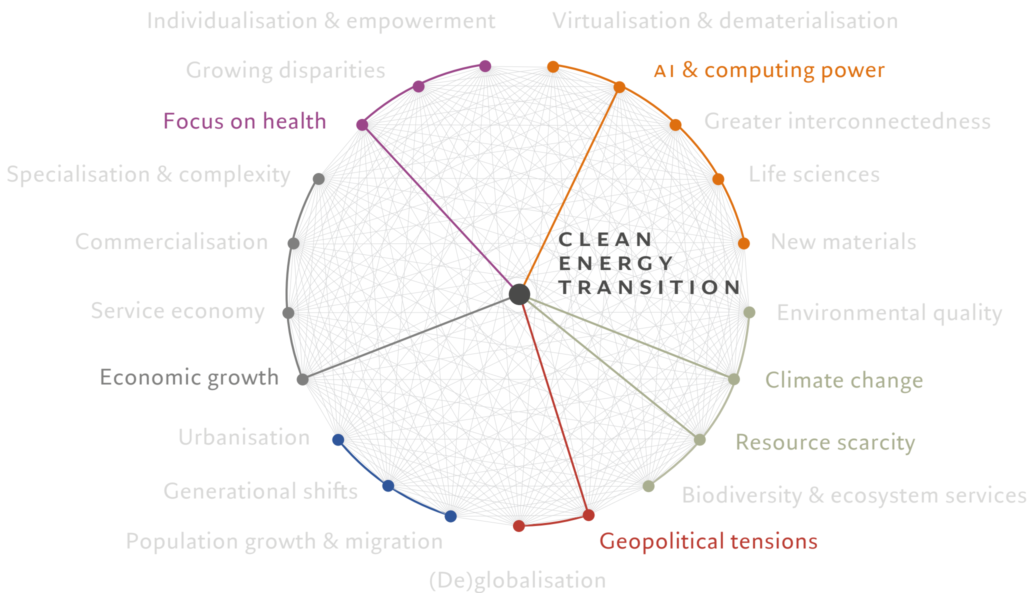
Source: Pictet Asset Management

3 For more details, see https://am.pictet.com/ch/en/institutions/investment-views/active-equity/2022/pictet-megatrend-framework

Using this model, we have identified 16 distinct investible universes – industries that are composed of companies with above-average growth prospects.

Among them is clean energy. Our analysis shows that firms that form part of the clean energy supply chain operate in an environment in which structural forces of change abound. A government-led green transition and ongoing advances in clean technology, for example, will not only lift the fortunes of utility companies but also those of firms supplying the hardware and software required to electrify big industry and transport.

Megatrends underpinning the Clean Energy Transition theme



Source: Pictet Asset Management, 2023

Another industry that is both undergoing a rapid transformation and home to a rich variety of investment opportunities is robotics. Here, advances in artificial intelligence and automation technology mean robots are becoming part of everyday life, whether that's in the home, in the office or on the factory floor.

Healthcare companies are also seeing their prospects brighten courtesy of powerful structural trends. On the one hand, advances in technologies such as artificial intelligence promise to improve diagnostics and quicken drug development. On the other, a longer living population and the growth of the middle classes in emerging markets should boost demand for healthcare and diagnostic services for years to come.

According to our forecasts, returns from each of these three thematic universes could beat those of the MSCI World Index by as much as 20 per cent over the next five years.[4]

4 For more detail, please see Pictet Asset Management's Secular Outlook 2024: https://am.pictet.com/ch/en/institutions/investment-research/secular-outlook-2024

Thematic stocks as complements to index allocation

While thematic stocks can, then, be a potential source of alpha, another conclusion to draw from this analysis is that there are several reasons why such investments might complement an allocation to passive equity.

The first is that the thematic universe is large. There are almost as many thematic stocks as there are companies represented in mainstream equity indices. By our calculations, there are some 2000 listed firms that qualify as thematic investments. That compares to 1400 companies represented in the MSCI World ACWI index. This suggests that it is just as easy to diversify an equity portfolio with a thematic approach as it is with a traditional one that is benchmarked against a standard world equity index.

The second distinguishing feature of thematic companies is that they are specialised in their business activities; 'pure play' firms make up a significant part of the investible market.

In Pictet AM thematic portfolios, pure play stocks are always favoured over more diversified companies. That is a deliberate choice.

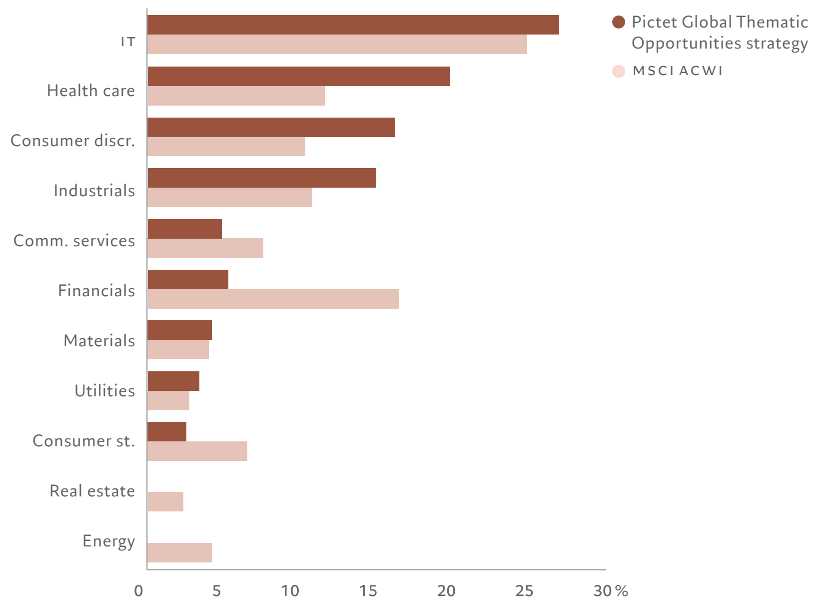
There is a large body of research that suggests specialist companies make for better long-term investments than larger, more diversified firms. This literature points to the existence of a "conglomerate discount" – that tendency for large, diverse firms to be worth less than the sum of their parts.[5]

A third defining characteristic of thematic equity investments is that – in most cases – they are not accessible via mainstream stock indices.

In other words, the make-up of a thematic equity portfolio bears little resemblance to standard global benchmarks. This also reflects the fact that our investment teams have complete freedom in the selection of their stocks, eliminating 'forced' investment decisions that are made simply to alter a portfolio's tracking error.

5 Ammann, Manuel and Hoechle, Daniel and Schmid, Markus M., "Is There Really No Conglomerate Discount?"(Working paper, 2011). Larry H. P. Lang, and René M. Stulz. "Tobin's Q, Corporate Diversification,and Firm Performance". Journal of Political Economy 102.6 (1994): 1248–1280.

Thematic portfolios differ from mainstream benchmarks
Allocation by sector, %, representative thematic portfolio vs MSCI ACWI benchmark



Source: Pictet Asset Management, as at 31.08.2024
The index MSCI ACWI does not influence portfolio construction and the strategy's investment universe extends beyond the components of the index. Therefore, the similarity of the Compartment's performance to that of the benchmark may vary.

None of this is to say that the thematic approach is suitable for every type of investor. Those that invest over short time horizons of one to three years or – for whatever reason – are unable to tolerate deviations from the standard benchmarks from time to time may find thematic stocks inappropriate. But for investors who are willing and able to move away from the herd and take a longer-term view, the thematic approach offers the prospect of superior equity returns.

Thematic investment solutions – active investing on your own terms

Thematic investing offer investors the opportunity to capitalise on the commercial potential of more than 2,000 specialist companies operating across more than 100 industry segments.

Investing in single theme strategies is one way to capitalise on this growth. But it is not the only route.

Institutional investors often face constraints on the risks they can take, the size of company they can invest in and the liquidity of the stocks they can hold. This means many cannot easily allocate capital to single-themed thematic strategies.

A solution to this problem would come in the form of a customised portfolio that can meet an investor's operating requirements without compromising returns. As it happens, the thematic equity universe lends itself easily to such an approach.

At Pictet AM, we have been building customised thematic portfolios for asset owners for several years. The process involves working closely with clients to identify stocks and investment themes that meet their specific needs.

The fundamental assessment takes into account factors such as market capitalisation, stock volatility and liquidity as well as the long-term structural trends investors are looking to harness. The result is a tailored portfolio that allocates capital across multiple investment themes.

A recent example of tailored solution we've developed is one that focuses investments in "land use and urban planning". It has been designed to invest in specific thematic segments of food production, timberland and cities within our Nutrition, Timber and SmartCity strategies.

Specifically, we identified companies specialised in:

- Food production: new types of food, consumer staples, lab-grown products alternative proteins, food waste, food security, food chains at risk, vertical farming
- Timberland: carbon capture and storage from soil, solutions to tackle deforestation and harm to biodiversity
- Urban development: tech that helps minimise waste and use resources much more efficiently due to density and scale effects

Another recent thematic solution is a "reshoring" investment strategy which is designed to capitalise on countries' growing desire to repatriate manufacturing or production operations.[6]

The reshoring investment universe includes companies that develop enabling technologies, factory automation and intelligent buildings; many of these firms already feature in our Clean Energy Transition, ReGeneration and SmartCity portfolios.

At the time of writing, we manage USD1.6 billion in thematic solutions across 19 customised portfolios.[7]

6 Mandate not yet operational
7 As of 30.09.2024

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