

Allianz Global Investors Thematic Investing

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THEMATIC INVESTING: BE PART OF THE STORY

In the days of millennials inheriting the Earth and information at the swipe of our fingers, many investors are uninspired by plain vanilla investment products. People want more out of their investments, and this isn't limited to the size of the return – it includes the ability to invest in the areas of the economy that are of personal interest to them – and moreover for their money to be aligned with their personal views of the world. They want to be part of the story.

How is thematic investing different?

Thematic funds serve the large market of investors who have forward-looking

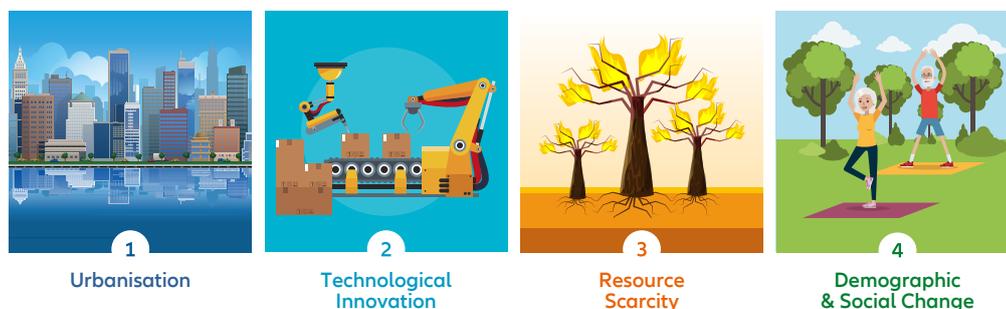
convictions and want to identify longer-term growth opportunities. Typically, themes are well-known, starting as topics of conversation among budget decision makers within companies, and will later become visible in most people's personal experience.

Themes are best characterised as powerful and secular shifts, triggered by innovation or regulation, a narrowing supply-demand situation or socio-economic factors. Thematic funds aim to identify the winning themes impacted by these shifts and to allow investors to participate in them. They permit anyone who has a view on a theme to take it forward with an investment.



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Portfolio Manager

Figure 1: Four megatrends



Source: Allianz Global Investors. This is for illustrative purposes only.

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A key benefit of thematic investing is the unconstrained investment universe. While traditional investing still largely adheres to narrow country boundaries or sector classifications, thematic investors view companies through a prism of either winning or losing regarding their respective theme, which typically attracts investments over many years if not decades.

Thinking long-term has the benefit of taking advantage of most investors' myopia: the majority of market participants focus on forecasting short-term earnings while the real value is in the long term. Also, traditional investors, constrained by sector or region, will likely fail to identify all of the beneficiaries along a theme's value chain. These factors leave room for mispricing in overlooked stocks even when the theme itself might already be widely acknowledged.

In addition to financial returns, however, thematic investing offers more: it means channelling investment only into the areas of greatest growth potential globally. This provides the social benefit of helping up-and-coming companies in the most cutting edge industries to raise capital and fulfil their potential.

Breaking down megatrends

An investible theme will typically have its origin in at least one of four sources of

structural shifts (megatrends). These are: 1) Urbanisation, 2) Technological Innovation, 3) Resource Scarcity, and 4) Demographic and Social Change (Figure 1).

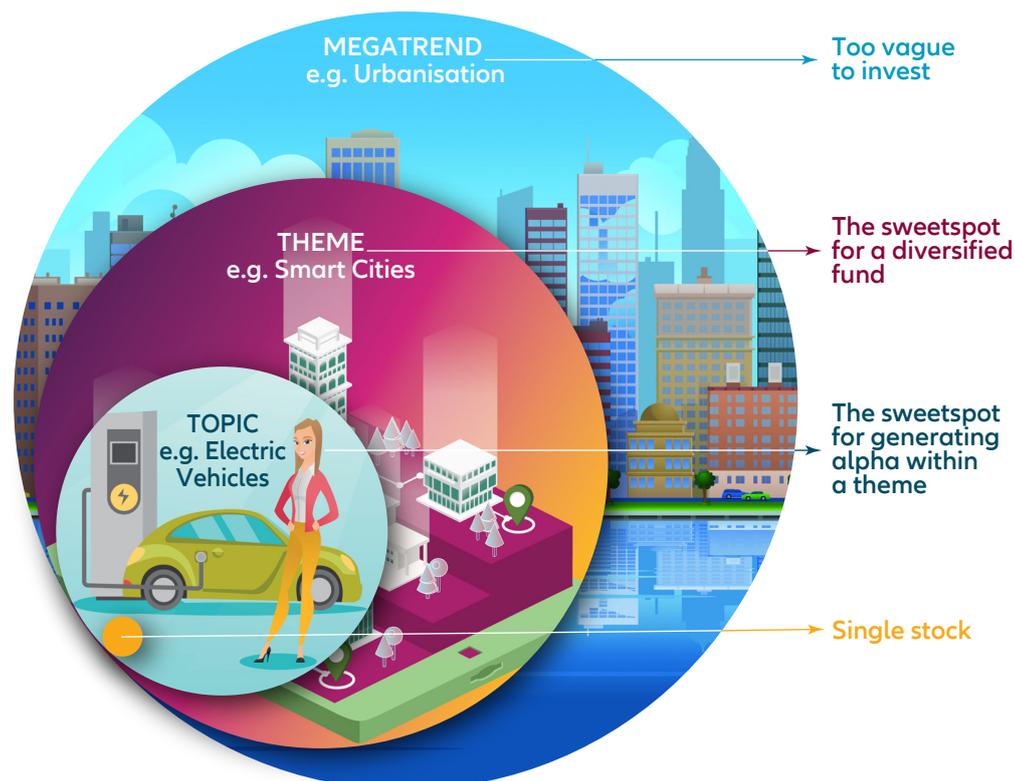
These megatrends, however, are too vague to invest in directly. They have a broad definition and perhaps a 20-100 year time horizon. In order to gain exposure to them, we need to break them down into investable themes with more like a five-20 year time horizon (Figure 2). In a diversified fund, within each theme there are several topics which adapt and change over time (Figure 3).

For example, the theme of Artificial Intelligence, with the potential to disrupt every industry and change how we live and work, is a way to access the megatrend of Technological Innovation.

The Water theme grants access to the Resource Scarcity megatrend – allowing investors to take part in developing solutions for a key environmental and social issue while generating an attractive return. Likely topics include water quality, water supply and water efficiency.

Some themes, however, are less obviously linked to megatrends, such as consumer preferences that shift slowly but surely in response to demographic factors (megatrend: Demographic and Social Change). The growing Pet Economy for example falls into this category. Its investable topics include pet healthcare and

Figure 2: Breaking down megatrends



Source: Allianz Global Investors. This is for illustrative purposes only.

pharmaceuticals, biotech, insurance and food. This theme is particularly popular with pet owners and animal lovers who experience the rising costs for their loved ones first hand.

How to be successful in thematic investing

Without a clear definition in the marketplace and so many products around trends available, it is important to be able to distinguish between true long-term themes and short-term trends (fads) – the latter of which are typically priced in quickly but don't last much longer than a news cycle, as they lack the support of a secular growth theme.

Secondly, a thematic fund needs to have enough stocks available of sufficient market capitalisation in order to be invested in that theme rather than just in a few stocks. A thematic fund should be sufficiently broad to diversify away the stock-specific factors.

Thirdly, in order to make the most of a theme's upside potential, a thematic fund should have "pure" exposure to the theme. This means it invests only in companies for which the theme accounts for all, or at least a significant amount of, their business. As the degree to which a company is benefitting from a theme can change over time, the best way to ensure participation as an investor is to look for actively managed products that can adapt and react.

Once you have picked an investment theme worthy of its name, it will have a long lifespan ahead of it, but that doesn't automatically make it a good investment at every point in time. Themes such as renewable energy, the internet and biotechnology have turned out to become material parts of our daily lives, but all of them experienced years of volatility and poor investment performance along the way as investors priced in too much too fast.

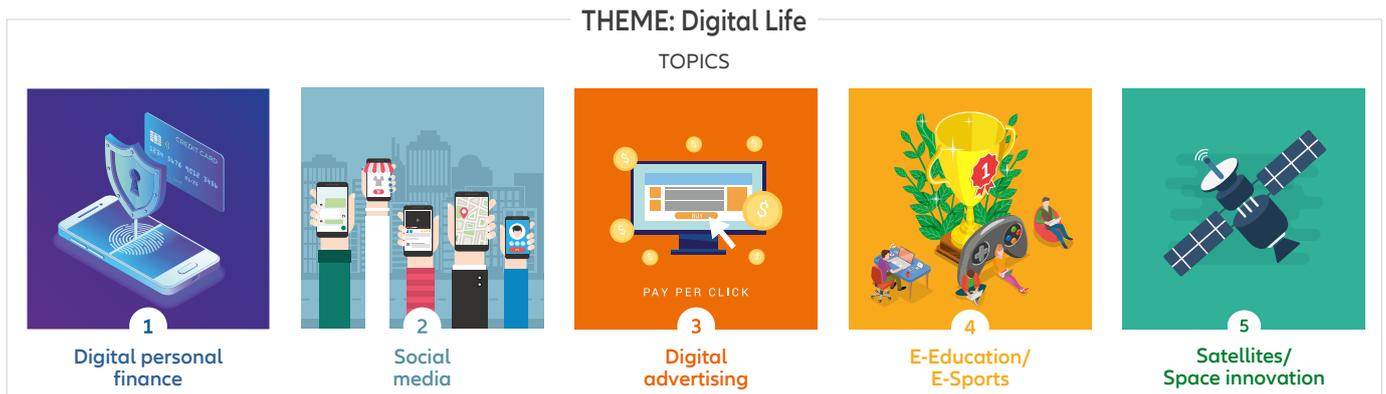
The best timing for thematic investing is (unsurprisingly) usually at the very beginning, once a theme starts to attract actual real-life investments that allow companies to generate profits. This is when the attention of mainstream investors and corporate decision makers starts to rise. Stocks typically rally in these early years on the back of high expectations, which are then often followed by a sobering sell-off when things turn out to move much more slowly than originally thought. This then creates the second entry opportunity into the theme after the initial hype has passed, as the underlying trends which fuelled the theme will remain intact.

In order to mitigate timing risks, investors could consider investing in a multi-theme fund that actively manages the selection of themes for them.

Whether investing in a single-theme or a multi-theme fund, investors should give preference to actively managed portfolios rather than their passive counterparts. An ETF which replicates an index will invest in the theme's entire investable universe, without taking into consideration factors such as valuation, growth potential and corporate governance. One may find a few years later that a theme's investable topics have changed and the ETF has been left behind. It is, in fact, the topic level that provides the real alpha generation (Figure 2) – and these usually have a much shorter time horizon than themes. An actively managed fund will be able to adapt not just its stock holdings but also its topics held under the theme umbrella (Figure 3).

Choosing an actively managed fund allows the investor to benefit from the upside of the theme with purity of exposure while it is also likely to reduce the risk of being invested in overvalued stocks or in topics that have already peaked or passed.

Figure 3: Example of a theme and its related topics



Source: Allianz Global Investors. This is for illustrative purposes only.

Key takeaways

With thematic investing, the investor becomes part of the story. Those with strong convictions about the future economic success of a theme (and/or its social or environmental benefits) are able to follow their convictions and channel investments into them. As well as financial return, investing thematically can provide the social benefit of helping companies in the most cutting edge and important industries to fulfil their potential.

However, with the many products available, it is crucial that the investor does his/her homework to differentiate between long-term themes and fads. Size of the investable universe, purity of exposure and investment timing also need careful consideration. Those who follow these rules will be rewarded with better performance¹ thanks to support from secular growth. We believe that in the area of thematic investing in particular, actively managed products have a lot to offer.

Figure 4: Checklist for the thematic investor

- 1 Distinguish between long-term themes and short-term trends (fads) ✓
- 2 Check that the theme is broad enough not to be overexposed to individual stocks ✓
- 3 Does the fund have "pure" exposure to the theme? ✓
- 4 Timing risks check (unless it's a multi-theme product) ✓
- 5 Is it an actively managed fund – to stay forward-looking with topic and stock selection? ✓

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¹ A performance of the strategy is not guaranteed and losses remain possible.

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