

# Thematic Investing: What Is It, and How Should Investors Think About It?

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## KEY TAKEAWAYS

- Thematic investing allows investors to pursue market exposure to specific ideas or values.
- Fidelity has identified five different types of thematic investing, each with a different overall approach.
- Within each type, there may be different strategies for reflecting the theme, including different approaches to selecting investments.
- Thematic mutual funds and exchange traded funds (ETFs) may provide focused exposure to a theme plus the benefits of professional research and management.

## Introduction

“Thematic investing” refers to strategies through which investors can invest in long-term ideas and trends, allowing them to capture potential opportunities created by the impact of economic, technological, and social changes. Approaches based on themes can help investors “personalize” their portfolios to include more investments that align with their focused interests or expectations.

It differs from more traditional approaches, such as investing by region (U.S. stocks), market capitalization (small cap), style (growth stocks), or economic sector (consumer discretionary). Instead, thematic investing allows investors to express a view that may cut across market capitalization, sector classification, and region. Although investors often approach thematic investing through stocks, it can include other asset classes (such as bonds or real assets) as well.

Thematic investing has been increasing in popularity. Mutual funds and ETFs focused on style, region, sector, or industry exposures still hold the majority of assets, whether those approaches are broad or more specific. However, interest in thematic investments has been growing with many new thematic strategies becoming available in recent years.<sup>1</sup>

There are several categories of thematic investing, which differ in both investor expectations and the philosophies that help determine the underlying investments. This article will:

- 1 Introduce a framework for the five types of thematic investing as identified by Fidelity.
- 2 Describe some of the characteristics of each type, to help investors think about which kinds of thematic investments may suit them best.

### The five types of thematic investing

Through internal research, and analysis of investment strategies and prevalent themes currently available, Fidelity's Asset Management group has identified several different approaches that define the world of thematic funds (which include mutual funds and ETFs) broadly available to investors.

To help investors think about their preferences, we have grouped thematic investing into five different categories:

- Disruption
- Differentiated Insights
- Megatrends
- Outcome Oriented
- Environmental, Social, and Governance (ESG)

The world changes fast, and many successful companies today may be replaced 10 years from now by companies that don't yet exist. Disruption funds focus on understanding long-term shifts in business economics, as the market evolves in response to advances in technology, merging industries, and changing consumer preferences.

By investing in these expected shifts, investors in disruption may benefit from opportunities that arise when the market tends to underestimate the pace of change. Indeed, the market may especially underestimate how quickly technology can cause rapid shifts in "business as usual."

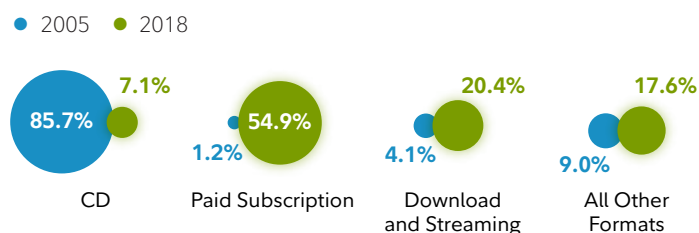
A disruption fund may focus on long-term trends where we could be still in the early stages of development. Some examples may include:

- Cloud computing
- Autonomous driving
- Mobile payments

An illustration of this dynamic: In 2005, compact discs accounted for 86% of recorded music revenues, and paid subscriptions accounted for just 1.2% in their first year of contributing to industry revenues. By 2018, paid subscriptions accounted for 55% of revenues, and CDs just 7% (Exhibit 1). The business of selling music has been quickly disrupted by the rise of technology to transmit data over broadband and wireless networks.

#### EXHIBIT 1: Disruption could come to other industries as it did to music distribution, shifting the flows of revenue from one path to another.

Percentage of U.S. Recorded Music Revenues by Format



CD includes CD and CD single. Paid subscription includes paid subscription and limited tier paid subscription. Download and streaming includes download album, download music video, download single, on-demand streaming, other ad-supported streaming. Numbers may not total 100% due to rounding. Source: <https://www.riaa.com/u-s-sales-database/>, accessed on October 15, 2019.

**Key point:** Investing in a disruption theme may mean investing in companies that are directly driving a long-term change. It may also mean looking more widely at all sorts of companies potentially affected by a disruptive shift.

## Megatrends

Some significant changes happen gradually, over the course of decades. Many observers can see these changes coming but might not realize how the world will be transformed in response. Megatrend funds focus on understanding long-term growth in profits, as aided by forces such as demographics and/or resource scarcity.

By identifying these gradually moving trends, megatrend investors may benefit from anticipating the effects. Some examples of potential megatrends that may reshape the markets include:

- Aging populations causing shifting consumption patterns
- A growing population requiring more efficient use of resources

An illustration of a megatrend could be the gradual decrease in agricultural land per person, which is down nearly 50% since 1961. As this trend continues, new farming and alternative food-production techniques may become more necessary to support the needs of a growing global population (Exhibit 2).

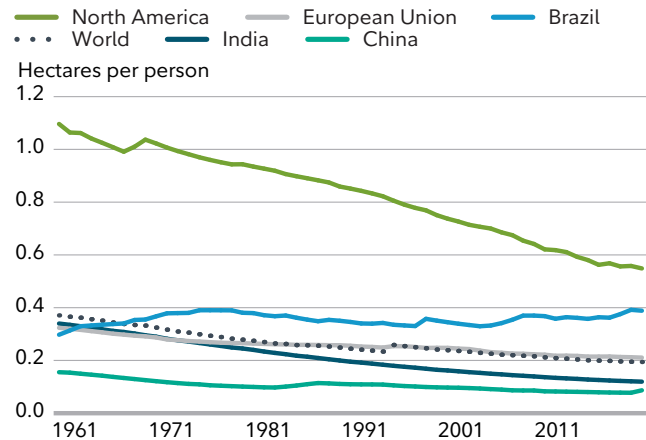
**Key point:** Investing in megatrends may include identifying trends that could lead to major transformations over time, and searching for the companies most likely to benefit.

## ESG

ESG stands for “environmental, social, and (corporate) governance,” three important factors that an investor or a fund manager might consider before investing in a company. Many investors are interested in exposure

### EXHIBIT 2: World population growth and less land dedicated to farming may support a megatrend focus on food production and efficiency.

Arable Land Use per Person, 1961–2015



The per capita allocation of land to arable agriculture, measured as the area under arable cultivation divided by the national or regional population. Source: <https://ourworldindata.org/land-use>, accessed October 14, 2019.

to long-term trends such as sustainable business practices, social or human capital factors, and sound corporate governance. ESG thematic investing may provide a way to invest in a strategy that reflects a disciplined evaluation of these considerations.

This category isn't new, but it has been evolving over the years and now includes a wide range of different approaches, which Fidelity would separate into three major groups (Exhibit 3). While all three types can support investors' values, we believe “thematic” ESG funds can help investors align their objectives to longer-term trends using an ESG lens.

Thematic ESG investment approaches may require active research and analysis to determine which companies are truly focused on achieving the desired outcome alongside long-term market performance.

**EXHIBIT 3: Fidelity has identified different ways to be an ESG investor, each with a different approach to selecting investments.**

Negative/ Exclusionary Screening	ESG Integration	ESG Thematic Investing
Avoids investments in companies or industries deemed unacceptable or controversial, based on moral values and standards	Incorporates ESG factors explicitly into investment decisions to help better identify risks and opportunities	Focuses on long-term themes broadly tied to specific areas of sustainability
<ul style="list-style-type: none"> <li>• Excluding tobacco companies</li> <li>• Excluding fossil fuel companies</li> </ul>	<ul style="list-style-type: none"> <li>• Corporate sustainability as a selection factor</li> <li>• Responsible stewardship of community resources as a selection factor</li> </ul>	<ul style="list-style-type: none"> <li>• Alternative/clean energy</li> <li>• Gender and diversity</li> <li>• Alleviating poverty</li> </ul>

Source: Fidelity Investments.

Some examples of themes within this category include:

- Environmental themes, such as investing in companies that are responding to consumer demand for sustainable practices or are focused on delivering innovative solutions such as alternative energy
- Social themes, such as investing in companies that identify and target business opportunities in underserved areas, or companies committed to a diverse and inclusive workplace or providing safe working conditions
- Governance themes, such as investing in companies committed to incorporating best-in-class governance through aspects such as board composition and oversight, management incentives, allocation of capital, and shareholder-friendly policies

**Key point:** Many different approaches are included under the umbrella of ESG, so investors may want to consider their most important goals to help them decide which type or types of ESG themes they want to focus on.

### Differentiated Insights

Some thematic investing strategies will be built around unique insights that don't fit into the categories listed above and are different from a traditional investment process using something like market capitalization or style as a basis. These investment themes may reflect ideas about which types of companies make attractive investments, backed by empirical evidence and ongoing research.

By investing in a differentiated insight fund, investors can gain exposure to companies sharing some characteristics that may give them an advantage over the long term.

Some examples of a differentiated insights fund include:

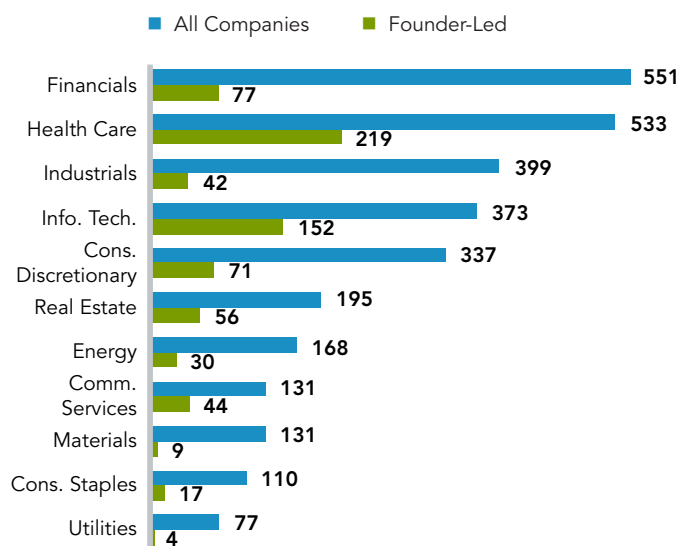
- Focusing on companies still led by their founders
- Focusing on stocks of companies using higher than average leverage (outstanding debt)

One illustration of how a differentiated insight may shape a thematic fund comes from the observation that some investors believe that founder-led companies, on average, have an advantage in the marketplace thanks to the passionate involvement of the founder. A fund that focuses on researching and investing in high-quality founder-led companies would be one example of a differentiated insight strategy. As shown in Exhibit 4, there are a substantial number of founder-led companies ranging across most sectors of the U.S. market, suggesting that a fund focusing on that theme may find a wide variety of companies to consider.

**Key point:** In choosing investments that start from a common differentiated insight, these thematic funds can give investors exposure to targeted ideas and investment selections.

**EXHIBIT 4: With nearly 750 founder-led companies across many sectors, an investor interested in this theme could hold a well-rounded portfolio of U.S. stocks.**

Founder-Led vs. Total Number of Companies per Sector in the Russell 3000 Index



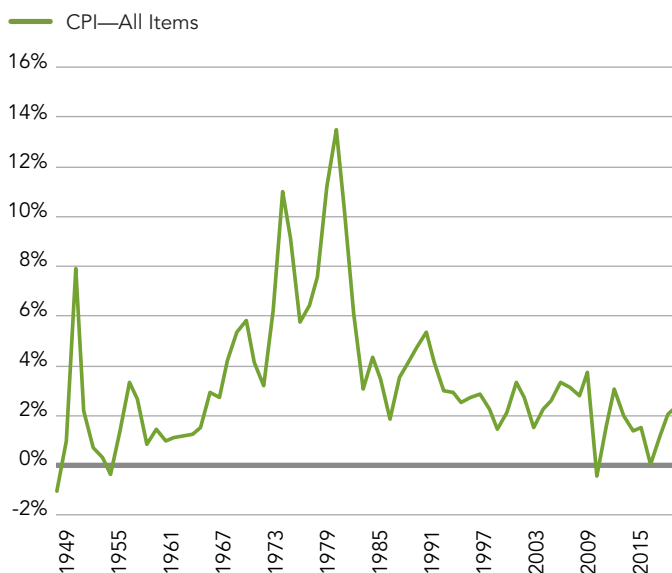
Founder-Led: Companies for which one or more founders are on the board of directors or on the management team. Source: FactSet, Fidelity Investments analysis, as of September 27, 2019.

**Outcome Oriented**

Fidelity defines outcome-oriented thematic approaches as investment strategies designed to pursue a specific outcome in an overall portfolio, in connection with a particular economic or market theme. For example: An investor wants to be invested in U.S. stocks, but is particularly worried about the uncertainty of inflation over time (Exhibit 5). An outcome-oriented thematic fund could provide additional exposure to market segments and

**EXHIBIT 5: Historical data shows that low and stable inflation has not always been constant, inspiring some investors to seek out historically inflation-resistant assets.**

U.S. Inflation, 1950–2018



U.S. inflation: Core Consumer Price Index (CPI)—All Items. Chart shows 12-month changes in prices. Source: FactSet, BLS, Fidelity Investments as of October 14, 2019.

companies that have historically performed well during times of high or rising inflation. Other examples of an outcome oriented strategy might be funds designed to provide lower volatility of returns or to reduce the impact of market downside, by investing in stocks that have historically been less volatile or performed better during market declines, respectively.

For investors in an outcome-oriented strategy, seeking that outcome over the long term may be a higher priority than short-term returns from that strategy.

**Key point:** Outcome-oriented thematic funds are designed to fulfill a specific objective within a portfolio, which may help an investor prepare for long-term market changes and trends.

## Why consider a thematic investing fund?

Thematic investing is a way of expressing a view on the market that is different from region, sector, style, or market capitalization exposure. Investors can use thematic investments to increase their portfolio's exposure to selected trends, values, or insights. To help investors achieve that end, thematic investing may offer more targeted ways to add specific exposures to a theme than other types of funds.

Indeed, some investors who buy individual stocks are, at least in part, thematic investors. They may buy securities from companies they think will disrupt the current competition, or invest in companies with values they agree with. Or they may invest with a certain portfolio outcome in mind: for example, buying stocks or market segments to support their portfolio during times of high inflation.

For investors with these types of convictions, thematic investing may be a helpful portfolio building block, whether a mutual fund or an exchange traded fund (ETF), for several reasons.

- Extensive amounts of research are needed to identify and monitor the best representatives of a theme. Buying a fund may allow a professional research team and portfolio manager to do that work.
- Diversification is another advantage. For example, an individual investor may choose a small number of stocks related to a theme. But putting too much of an investment in any single stock brings concentration risk. Buying a fund based on a thematic strategy can spread the stock-specific risk while keeping the thematic focus.
- Not all companies will benefit equally from their connection to a particular theme. Having a fund management company evaluate investments through fundamental research may be a benefit.

## Understanding different thematic approaches

Each thematic category may have a range of investment approaches that are worth considering. Because thematic investing expresses targeted ways of thinking about investing, different providers may use similar names for very different approaches.

For example, two funds called "megatrend" or "clean energy" might have very different ways of applying the theme. Investors should do their own research to make sure the approach of a thematic fund provides the types of investments they are seeking.

## How is the fund managed?

By their nature, thematic funds involve some form of active decision-making on how to turn the concept into a strategy for finding specific investments. This analysis and judgment can be enacted either through an actively managed fund, or through a rule-based approach. Regardless of the management style, we believe investors may benefit from considering funds managed by firms with deep research resources to help define a theme and maintain the intended thematic focus over time.

Actively managed funds include those in which a portfolio manager selects securities through research. In an actively managed thematic strategy, the portfolio manager selects from among companies that offer exposure to that theme. A megatrend fund, for example, might be designed to offer exposure to a chosen long-term trend, with the portfolio manager selecting companies expected to benefit from that trend.

Alternatively, a thematic fund may be "rule-based," where securities are selected according to pre-set rules. An outcome-oriented fund, for example, might be created with a rule in mind such as "investing in companies that have done better in inflationary environments in the past." Or a corporate governance ESG fund may select companies according to pre-set rules about governance practices. But it is important to remember that setting these rules requires active decision-making on the part of the fund manager.

## How broad is the thematic exposure?

Another consideration for investors is the role thematic investing can play in their portfolio, and whether a broad or concentrated fund is preferable. A broad fund that allows for a widely diversified range of holdings may make a fund appropriate for a larger

portion of a portfolio, because the approach may more closely resemble broad-market investments in their return and risk characteristics. Many ESG funds, for example, are designed to resemble the exposure of a broad market index, but favor companies that align to a set of values.

A more narrowly defined theme with concentrated exposures may be more appropriate as a targeted building block within a portfolio. For example, a disruption fund focused on cloud computing and other emerging digital systems may invest heavily in leading-edge companies developing new technologies. This type of fund may represent a small portion of an investor's desired exposure to stocks, with other investments included to fill out the remaining equity exposure in their portfolio.

Outcome-oriented funds may have a highly specific approach that could be either broad or targeted. They may be designed to be a large portion of the portfolio or a small portion of the wider asset mix.

In all cases, investors may want to examine the underlying strategies of the thematic funds under consideration, to understand how they may fit into their asset mix and overall investment goals. Additionally, investors may need to evaluate how closely the investments included in a thematic fund match the desired thematic exposure.

## Implications for investors

Many investors want their investments to align with their views on how the world is changing, the risks and opportunities they see in the market, or their values for making the world a better place. Thematic investing gives them a way to express those views, assisted by the research and professional management of vehicles such as a mutual fund or an ETF. The five thematic categories defined by Fidelity can help investors understand their options and define their interests as they research available funds. Ultimately, thematic funds are about giving investors new ways to personalize their portfolios by reflecting their ideas and values.

## Endnotes

<sup>1</sup> Morningstar as of Dec. 31, 2018. Fidelity analysis based on classifying funds into the general categories described in this article.

**Sectors are defined as follows:** **Communication services:** companies that facilitate communication or provide access to entertainment content and other information through various types of media. • **Consumer discretionary:** companies that manufacture goods or provide services that people want but don't necessarily need, such as high-definition televisions, new cars, and family vacations; businesses tend to be the most sensitive to economic cycles. • **Consumer staples:** companies that provide goods and services that people use on a daily basis, like food, clothing, and other personal products; businesses tend to be less sensitive to economic cycles. • **Energy:** companies whose businesses are dominated by either of the following activities: the construction or provision of oil rigs, drilling equipment, and other energy-related services and equipment, including seismic data collection; or the exploration, production, marketing, refining, and/or transportation of oil and gas products, coal, and consumable fuels. • **Financials:** companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, and insurance and investments. • **Health care:** companies in two main industry groups: health care equipment suppliers, manufacturers, and providers of health care services; and companies involved in research, development, production, and marketing of pharmaceuticals and biotechnology products. • **Industrials:** companies whose businesses manufacture and distribute capital goods, provide commercial services and supplies, or provide transportation services. • **Information technology:** companies in technology software and services and technology hardware and equipment. • **Materials:** companies that are engaged in a wide range of commodity-related manufacturing. • **Real estate:** companies in two main industry groups—real estate investment trusts (REITs), and real estate management and development companies. • **Utilities:** companies considered to be electric, gas, or water utilities, or companies that operate as independent producers and/or distributors of power.

**Index definitions:** Russell 3000® Index is constructed to provide a comprehensive, unbiased, and stable barometer of the broad market and is completely reconstituted annually to ensure that new and growing equities are reflected.





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*Fidelity Vice President Vic Tulli, CFA, provided editorial direction for this article.*

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