

Patrick Hosking



Investors are sold on the story of thematic funds, but returns are poor

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There are few things as seductive to the intellectually curious investor as thematic funds.

These are investment vehicles that try to identify future trends in science, engineering, politics, social mores and consumer tastes and then to harness them.

Name just about any modern phenomenon and a fund has been created to exploit it. The legalisation of cannabis, the advent of drones, the obesity crisis, artificial intelligence, genetic advances, driverless cars, space travel, changing eating habits, ageing populations — there are specialist funds for all of them.

Once upon a time, equity fund investors had very dull choices. There were funds categorised by country and funds categorised by whether they were invested in low-growth, income-producing companies or spicier and riskier faster-growing companies — and that was about it.

Now they can back hunches about the way technology, politics or demographics are changing the world and who is likely to profit. Forget worthy but unexciting research into return on capital and p/e ratios; this is big-picture stuff — the kind of topics that might actually be discussed down The Dog and Duck.

Take batteries. If you believe that only by getting better at storing electricity will we ultimately be able to move to a low-carbon world, then Legal & General has just the thing for you: its Battery Value-Chain fund, a vehicle purely dedicated to investing in companies developing battery technology and the miners extracting the cobalt and lithium they require.

The \$60 million fund, launched in January 2018, is invested in turn in companies such as Tesla, the electric carmaker, Hitachi Chemical, the conventional batteries group, and Orocobre, the Australian listed miner of lithium in Argentina.

L&G makes no attempt to pick winners in the batteries space. It merely tracks a specially

created index of relevant companies, giving a roughly equal weighting to all 30.

It's a neat, unambiguous and undiluted bet on a compelling idea — an idea that may or may not prevail. Who knows, hydrogen fuel cells may be the future instead?

These funds can capture the imagination of investors, or more likely the wealth managers and other advisers who create portfolios on their behalf. Narrative ideas are powerful persuaders; belatedly, the investment industry has cottoned on. The total aggregate value of thematic funds has almost tripled in the past three years to \$195 billion, according to Morningstar, the fund research house. It has 923 thematic funds in its database, of which 154 were launched in the past 12 months.

Robots are the single biggest technological theme, with \$27 billion invested in thematic funds betting on their success. Water scarcity is another persuasive topic, with \$25 billion allocated, while connectivity and the internet-of-things has chalked up \$23 billion. Some buttons are hotter than others. An L&G fund dedicated to cybersecurity companies has mushroomed to \$1.1 billion in just over four years, attracting new investors while also delivering strong returns. Investors are stampeding to invest in stories they understand.

There's only one problem, and it's a big one. These funds are not very good. First, they get shut down an awful lot because many don't reach a critical mass that makes sense for the fund manager: only 69 per cent survive five years and 45 per cent are still going ten years later.

And even those that survive produce poor returns: only 41 per cent beat the MSCI World Index over

five years. That success rate drops to 26 per cent after ten years, according to Morningstar. Most of the time, investors would have been better off in a cheap global tracker.

There have been winners — ARK Next Generation Internet, a \$500 million fund making bets on cloud computing, ecommerce, artificial intelligence and

social media, has produced three times the return of global equities in the past five years — but they are outnumbered by the duds. Investors in that promising-looking batteries fund have lost 10 per cent in its first two years, although it has at least outpaced global equities more generally.

Why the lacklustre performance? The biggest problem is the faddishness of so many of the themes. Critics argue that thematic investing is fashion investing. Fund management houses will seize only on themes that have already caught a tailwind. They have to sell them, after all, publishing those cheeky backdated charts that show what the fund would have done if it had existed before it was created. By the time the fund is launched, the share market has already priced in the potential upside to the sector. They are too late.

Even the biggest technological mega-trends sometimes yield meagre of returns because of the sheer weight of new capital-chasing finite profits. We've known that since the 19th-century railways boom. Then there is the restriction on most funds to invest solely in listed securities. That's fine for some themes, but hopeless for others, where most of the relevant companies are private.

Costs also weigh on returns. Fees for actively managed thematic funds average 1.25 per cent per year, which is a strong headwind. The answer has been the recent creation of passive thematic funds: these simply track a suitably compiled index. Average fees for these drop to 0.52 per cent.

Finally, scale is a problem. These funds struggle to scale up because of tight restrictions on how much any other wholesale investment institutions can plough into them at any one time. Small wonder that many are scrapped, with money paid back to investors after the high costs of liquidating them.

Thematic funds certainly work as a marketing tool. They sell funds. They engage investors. They may even help to channel capital towards relieving the most pressing problems of the day. They're just not very good at producing even average returns. It's a pity.

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