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Thematic Investing: Not your daddy's portfolio

Paradigm #1: Imagine an unchanging fairy-tale world of tinkers, tailors, and candlestick makers.

In this static place, devoid of economic, social, and technological change, an investor could earn a predictable return simply by investing in an index of all of the tinkers, tailors, and candlestick makers.

Paradigm #2: Envision a hyper-volatile world of social upheaval, economic turmoil, and technological revolution, where thousands of businesses, industries, trading platforms, and even countries are rebuilt every day.

In this turbulent and chaotic place, indexes are almost meaningless. To survive here, an investor must choose the right investments.

It's quite evident which of these paradigms we are approaching today. If you remember rotary telephones, black and white TV, and rock 'n' roll with real drums, you know firsthand how quickly things change. In this volatile place, tinkers, tailors, and candlestick makers had better innovate, or else face extinction.

For investors looking to build and preserve wealth in this environment, it may be time to re-draw the lines of investing and take a different approach than the traditional asset allocation most of our fathers employed.

One intriguing alternative is to take a more forward-looking, "thematic" approach to investing, in which the key is to identify and understand the top-down macroeconomic drivers that will boost or hinder investment returns over the next few decades. Thematic investments seek to anticipate major regional or global opportunities that will be created by economic, political, social, technological, and environmental trends.

Thematic investors don't only think about asset classes like U.S. small cap and international as the buckets that define their portfolios. They look ahead to broad new trends and economic changes, identifying those themes that will position them to take advantage of the coming change. Theme-driven investing is typically a long-term mindset, not a market timing game.

Today's geopolitical shifts and global changes offer a multitude of themes in which investors may choose to participate.

What characterizes an investable theme? Thematic investing is based on structural changes and shifts — not short-term trends — where material changes are likely to occur. Importantly, the investor must have some insight into those changes in order to identify the investment opportunities. Some current themes that are attracting investors' attention include:

Demographics and consumption: Shifting demographics are driving changes in consumer demand. For example, some regions, such as Africa, have a rapidly expanding population of young people. This growing working class is expected to demand higher-quality food and consumer goods and services. Other regions, such as the United States and Europe, are experiencing a maturing of the population, and health care services and technology will likely be in high demand.

Sustainable technology: New technologies protect and extend the supply of natural resources such as land, water, minerals and food, while satisfying consumer demand for sustainable products such as efficient housing, transportation and food. As sustainability becomes a global goal, widespread changes in consumer habits, regulation, taxation, land use, waste management and other practices will create a variety of new enterprise activities.

Globalization: Newly emerging trade alliances can create major new investment opportunities, while creating upheaval in existing protected regional industries. Efficiencies gained through trade, investment, sharing of intellectual capital, and labor mobility provide additional opportunities.

Societal and technological trends: Thematic investors are looking at how rapid changes in social, lifestyle, and political behavior have the potential to transform our economy over the next decade. Focal areas include immigration rights, wealth inequality, the "sharing economy" as evidenced by trends in home and car sharing, civil rights such as gay marriage and marijuana decriminalization, social and political networking, telecommuting, artificial intelligence, automation as in the "Internet of things" and self-driving cars



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and information and personal security.

Financial innovation: New tools for buying, selling, financing, investing, advertising, taxing and insuring have the potential to revolutionize the financial industry. Digital wallets, peer-to-peer lending, electronic banking, online markets, and customer data warehousing are examples of areas of investment for thematic investors.

Macroeconomics: There is enormous opportunity for those who can understand the coming trends and inflection points in the cycles of debt, interest rates, inflation, growth, employment, trade and currency exchange rates.

The shift from a traditional investment approach to thematic investing creates some interesting changes and challenges, including:

Benchmarking: A traditional asset allocation is designed as a relative portfolio, built around an index or set of indexes as a performance goal, but how do you benchmark thematic investing?

Complexity: Thematic investing brings a new level of complexity, requiring considerable research, creativity, and vision.

Strategy: Theme-driven portfolios don't necessarily need to be long-only portfolios, adding a layer of intricacy with shorting and hedging.

With the additional potential to align investors' assets with their convictions, this approach may be the next evolutionary step from the traditional, or "Daddy's," portfolio.