# Thematic Investing: Investment Goldmine or Pitfall?

**Keith:** Welcome to the Empowered Investor. My name is Keith Matthews, and I'm joined by my co-host Marcelo Taboada. Marcelo, how are you today?

**Marcelo:** Keith, I'm doing great. It's great to be back in the podcast. I was in the last show with Jackson on the US election. And just so people know, it's kind of hard to not laugh right now because you're wearing a very nice costume and we're in Halloween today.

**Keith:** But I did win the competition, Marcelo.

**Marcelo:** Yes, you did.

**Keith:** Best dressed Halloween outfit. I came as a 70s dude.

**Marcelo:** We're going to post a picture somewhere, no?

**Keith:** Maybe, maybe.

Today's episode is on thematic investing. Pros and cons. But essentially what we're going to do is we're going to define thematic investing. We're going to highlight the challenges that come from this enticing investment concept. So, we'll review thematic investment returns.

Actually what the genesis was behind this show is Morningstar produced a report that talks about exactly the returns that investors get using thematic strategies. And that's key because I think it’s a lot of the common sense belief based on the investment philosophy that all of us champion. We know that this thing sometimes doesn’t work, but the report is nice because it shows some hard data.

And then finally, we're going to discuss best practices, the do's and don'ts around thematic investing. So, Marcel, let's get into the definition. What exactly is thematic investing?

**Marcelo:** Look, we had some formal definitions, but I think it boils down to the fact that you're trying to identify macro trends and profit from them.

So, think about AI, gold, things like you think that are going to shift the world and change the way we live. And you're going to profit, you're going to buy a product and you're going to get a great return. That's what it is.

**Keith:** And in particular fund or ETF manufacturers have historically always been looking for thematic strategies.

Why? Because it brings in a lot of assets into the investment firm. They also tend to charge two to three times the fee. So, from an investment product perspective, it ranks very high from a profitability, and you see this a lot with manufactured products.

**Marcelo:** Yeah. And what do we know about investing, right?

It's the fees is one of the biggest predictors of investment performance. So not a great start.

**Keith:** Lets jump into the challenges. Why is thematic investing? Why is it a challenge? And what are the sort of the traps embedded in the process?

**Marcelo:** We've identified two. So, the one is thematic investing is appealing.

It feels appealing. It feels like it can capture people's imagination. And it feels like you have to jump in and take action, right? Like you want to profit from AI. You want to profit from technology. Pandemic stocks, we've seen this many times. So, I think it feels like there's a call to action there, so to speak.

And people care about their money, and they want to make money. Right. So, it just happens. And then the second one is people want to buy low and sell high, but in a given period, it's really hard to do that. The data proves it. It's really hard to get in at the right time and sort of like get out at the right time.

And we were talking about off mic, but the problem with that statement of buy low and sell high is that like you were telling me off the mic is it implies a call to action. So, you combine those two things. And that's the problem because first of all, the enticing part is the fact that you're going to be chasing something.

We know that in investing that just doesn't work. And the second part is the idea that you have to be trading.

**Keith:** Yeah, I think the two mixed together are very serious hurdles that create obstacles for individuals. So, this report that we're alluding to, which was really the foundation of wanting to put this episode together, was produced by Morningstar, it came out, in fact, it just got more press in the last two weeks.

It was a report that studied the actual live returns of investors in thematic funds.

**Marcelo:** Right, and that's important.

**Keith:** Why don't we discuss some of these returns, start sharing some concepts here.

**Marcelo:** The idea is that you evaluate returns in two ways. You have essentially time weighted, which is beginning period, end period, and then you have dollar weighted returns, which is money in money out. So, when you're driving back home and you hear the S&P 500 return 5% for the day, it doesn't mean that every investor,

**Keith:** whoa, that's a big day, Marcelo.

**Marcelo:** Well, I'm just making an example, but call it 2-3%, just because you hear that. It doesn't mean that every single investor that is in the S&P 500 got that return.

I mean, think about it in terms of a month, two months.

**Keith:** To use your micro example, if the S&P 500 returns 2%, but an investor in the middle of the day said the S&P is up one at noon and sells at one o'clock in the afternoon, they don't get that extra one.

**Marcelo:** So, the return of that investor is actually one and not two.

**Keith:** And that's the problem though. And that's what we're trying to look at here. We're trying to see, okay, we have all this thematic investing. We have the data. That's the return of the market, but what did the investor get? What did the end at the end of the day? That's what matters because that's what is in your pocket.

So, what is this Morningstar report show?

**Marcelo:** The report, it has a lot more data than we're going to discuss today, but I think we boil it down to one very interesting data point and it's this Keith. When Morningstar aggregates all the thematic funds, they have to standardize it somehow.

So, they bundle them together and they look at what is the annualized return of the thematic funds that they're studying. That was 7.3%. So that's what the market returned.

**Keith:** Again, the market, not the market of the themes.

**Marcelo:** Correct. The end investor. The average return was 2.4 and the same time, the S&P 500 returned 14%.

So, somebody just buying a very plain vanilla ETF with a very low fee that tracks the S&P 500 would have gotten a better return.

**Keith:** There's two stories inside here. Let's unpack them. One is that thematic investing didn't do as well as broad, and it's not just S&P 500 driven by tech stocks. It's Russell 3000, it's Russell 1000, thematic investing, people would be better off in a broad benchmark.

**Marcelo:** Yes. Number one.

**Keith:** To me, the big issue is that big gap between the 7% and the 2%. Yeah, it's a 5% gap. People who were investing in the thematic strategies trailed the actual strategy by 5 full percent. And that's the gap that's missing.

**Marcelo:** You know this better than anyone, that what that means is that people are getting on the top.

**Keith:** Well, it means that they're entering and exiting at the absolute worst times.

**Marcelo:** Correct.

**Keith:** Or not the appropriate times.

**Marcelo:** Yeah, because a 5% gap, that's huge. If you tell me like one percent, maybe that could be many different things, but 5% is like,

**Keith:** Yeah, no, no, no. When they talk gap, so it's still not even fees. Morningstar has this very interesting thing. I think it's a play on words, but it's a very interesting concept. Mind the Gap. Mind the Gap refers to the difference between a live time weighted return in any strategy, and what does the actual investor get underneath it?

What does their money earn? And that shows when they're coming in and when they're leaving STRAT. And the gap has historically always existed.

**Marcelo:** I mean, that report is old, it's been around for a long time.

**Keith:** yes, but they do the Mind the Gap report all the time. Every year, they'll do Mind the Gap.

The reports we've seen would say things like, on average, investors miss maybe 1%, maybe two, depending on the strategy of what they're getting versus what the strategy gets one or two thematic is 5%. That is off the charts.

**Marcelo:** Yeah. It makes no sense to me.

**Keith:** Well, what it means is the investors that are in thematic strategies are not doing themselves any real service because on average, They're not getting the results.

And what it also means to me, and this is just a general, what I find fascinating is the next time people hear, Oh, I'm in this thematic strategy. I've done so well. They might've done well, but on average, most people who are investing in the thematic strategies aren't doing that well. The data doesn't lie.

**Marcelo:** No, it doesn't lie. And that's the thing, right? Like what I was saying at the beginning is we know these things lead to bad outcomes. And sometimes the investors end up getting burned because they're getting at the wrong time. But the hard data, like we have the numbers, right? And it shows a disastrous result.

**Keith:** It was interesting in the Morningstar report, they referred to, in order to do well in thematic investing, you got to get three things right. Not one. Not two, but three things, right? What are the three things that they speak about?

**Marcelo:** You have to get the right theme, number one. Number two, the fund, the fund that you've used to buy the theme has to pick up the right stocks.

Doesn't mean they're going to pick every single stock that's a winner just because you got the right theme, right? Number three, the timing of when you buy the fund. It's key. Those are the three things.

**Keith:** That's fascinating. And it's so true because an investor can get a theme right, but if they pick an ETF that doesn't include the top stock that's winning in that theme, then they may not do well.

You could have picked an electric vehicle theme and if you didn't have Tesla in it, you would have gotten all those electric vehicles where the stock price is absolutely tanked in the last couple of years.

**Marcelo:** Yeah. And that's one of the problems with the theme is sometimes it's hard to get a pure exposure to everything in that theme.

And more likely than not, you're going to end up buying an ETF for a mutual fund that has a manager that's picking and choosing something. And as we know, that doesn't work.

**Keith:** Yeah. And one of the things we were supposed to speak about it a little bit later in the show, but I'll speak about it now.

This idea of ARK, ARK innovation. If you were to read the description of ARK, it would say, we're looking for investment technologies that are disruptive and that will change the world. And so, if you're somebody who says artificial intelligence is going to change the world, you would expect ARK to have that exposure in their innovation fund.

They got very little exposure. And since they fell off out of grace, maybe two, three years ago, they haven't followed the surge of AI.

**Marcelo:** That's crazy.

**Keith:** They just haven't done it. In fact, I believe they sold Nvidia way long ago.

**Marcelo:** Yeah. They have a few really bad calls in their portfolio. And we did a podcast on that.

And that was one of the bundles of stocks that. Did really well during the pandemic and then when everything started going down in 2021, it really took a deep dive. And even when he was at the peak, like, and after before, like people weren't getting, like talking about the gap, like people weren't getting the same return as the fund was getting.

I mean, we have the numbers, right? But it's not surprising.

**Keith:** So, let's talk about history of themes. How long have people been hearing themes?

**Marcelo:** We had this discussion off mic I think the first theme was the tulip bubble, right? Because that was in the 1600s. People went crazy for a flower. And I mean, we know how that ended. But I think most recently we have the nifty 50, which I wasn't even born or even close to it.

**Keith:** I got good news for you, Marcel, nor was I.

Yes, actually, I think I was, it was in the late sixties, early seventies, where essentially everybody said, you've got to buy these 50 companies are global brands, they're big consumer brands, and they're You're never going to go wrong if you buy the nifty 50 theme.

**Marcelo:** From those 50, are some of the companies still alive?

**Keith:** There are, but there aren't as many as people think. Not all 50 are in the S&P 500.

**Marcelo:** That's interesting. Even when you look at where the top 10 stocks in 2008, they're not even in the top 10 today.

**Keith:** You know, listen, I've been an advisor since the early 90s and the themes that the clients and advisors would have had to go through would have been, I remember the mid 1990s, it was all about U.S. consumer big brand. It was the Walmart's, it was, Home Depot was considered a sexy stock to own, a sizzling stock. And then we went to technology, then we went to pharmaceuticals, finance, technology, telecommunication was massive. Marcello, there was a company called Nortel. Back in the day, Nortel represented like 33% of the TSX.

**Marcelo:** That's crazy.

**Keith:** So, when you bought an ETF in the year 2000, Canadian ETF, you were getting 33% Nortel. So those were massive themes. They committed fraud, right? Well, it was a bit more complicated, but they basically went from 33% to a bankrupt company. It took them, I think, 5 or six or seven years.

Back then it was tech and tell. Those were the two themes that people were talking about. You then had income trusts and everybody chasing income based on mostly resource driven, but it could have also been royalty driven companies that produce regular income. In 2007, you had energy. Believe it or not, Marcel, if you turned on CNBC in 2008, When the Canadian dollar, do you remember what that Canadian dollar would have been worth relative to a U.S. dollar?

**Marcelo:** That was close to one, no? Over one.

**Keith:** Over one,

**Marcelo:** But I do remember oil being close to 110, 120.

**Keith:** Over one. And essentially, the theme was energy, oil, pipelines, and it would be completely opposite. Then we had brick. So, tell a little story about BRIC.

How did that come about?

**Marcelo:** It was coined by an economist, uh, Goldman Sachs, and it was essentially that these were these stocks that the countries that were going to do the best based on population growth, prospects of economic growth, globalization. a bunch of different factors. And he pretty much said like, this is where the future is, and this is where the investment has to go.

**Keith:** His theme was this is going to be the fastest growing area in the world, and you must overload your portfolio in this theme. It's actually now called the BIC.

**Marcelo:** The BIC, yeah.

**Keith:** They've removed Russia out of this investment strategy now for two years since it started. The Ukraine war. In Ukraine. So, the BIC, if you look at the BIC, it goes back to 2007. In 2007 it was worth 50 and right now it's worth 40.

That's a holding period of 18 years. So, 18 years, you're negative on the hottest theme of 2007 by one of the, perhaps the best-known investment firms in the world as to what their choice theme was for the next decade. So most recently, Marcel, we've had other themes.

2018, we had the marijuana stocks, we had Bitcoin, we had electric vehicles, we had batteries, and now we're in the middle of ai. All these. Concepts definitely have winning stocks, but a lot of it is thematic investing and individuals have to be careful What's the concept of core and explore? Let's speak about that a little bit because I think that's how investment advisors and firms support the idea of thematic.

**Marcelo:** It's the idea that your core, call it 70, 80, 90% of your portfolio will be in a well-diversified portfolio of indices or something like that, safe. And the rest can be used to play around, for lack of a better term, or allocate this money into all these themes that are sexy and sound so nice and go get them, right?

**Keith:** Yeah. You're absolutely right. I mean, it's this idea of the vast majority of my portfolio is in either an index, core, or a very well diversified group of stocks that cover off major asset classes, Canada, U. S., international, and emerging market.

**Marcelo:** Another term people use is satellite position.

**Keith:** Correct. And I recall in, uh, Version 2 of the Empowered Investor, we've dedicated an entire chapter on why Core Explorer doesn't work.

You can get sort of short-term hits, but my experience in watching people with Core Explorer, Core Satellite, is all the energy goes into the satellites, and they're always chasing. It's always chasing themes. And then the core ends up. The core does fine. The core does fine. But look, we just went through the Morningstar report, where the thematic investing has a gap of 500 basis points.

So, if you've got 30% of your portfolio in some kind of thematic or explore, component, and you're not getting the returns of the theme

**Marcelo:** because you've got to get three things right,

**Keith:** then you're really putting yourself at a disadvantage. And so, we've never been fans of core and explore. We actually, I mean, we speak about it all the time.

We think the winning strategy is just put everything in your core positions, diversify your portfolio. I mean, when we buy us exposure for clients or Canadian exposure with the investment vehicle, we own, we tell the client or an investor, you're owning that for life. I would tell every investor, if you're going to build a portfolio on your own using an exchange traded fund, when you buy Canada.

You're owning Canada for the rest of your life. When you buy the United States, you should own that for the rest of your life. Maybe different proportions.

**Marcelo:** yeah, your asset allocation will change as you go. But yeah, it's buy and hold essentially.

**Keith:** Yeah. So, listen, Marcel, a couple different things here. We talked about how these major trend and chasing trends and themes is not necessarily new.

Let's talk a little bit about how it's also linked to the idea of chasing manager performance. We won't spend a lot because that's not what the show's about, but there's so many similarities to it.

**Marcelo:** It is because people hear a mutual fund or a manager doing well, and then the returns will pile up.

And we've seen this in the Morningstar reports, the higher the star rating. So just for the listeners, Morningstar is a very well-known research firm, and they rank mutual funds by stars. And you look at. The money going into the 5-star funds and then the return of that fund after all, the money has piled in and it tends to massively underperform because we're going back to the same topics, right?

Like it's chasing, it's getting in at the wrong time because when people are throwing the money at the 5-star manager, It's already too late, right? They've already got the big numbers and now everybody knows about it. And you're probably getting in a bit too late.

**Keith:** Well, typically speaking, a lot of these managers are in themes too.

**Marcelo:** Correct. So, if the manager's got a nice 5-year return, chances are it's the winning part of a theme or an overweight or a strategy. All the money comes flying in. And then as you say, Morningstar clearly shows that the 5 star underperformed the worst after they get their 5-star rating. It's like, once you make it big, it's like, it just goes sideways or down.

I had a friend, one asked me, how can I invest? Give me some tips. And I said, Hey man, if you're not working with someone, just buy VQT, you know, you get exposure to all the indices. And his response was like, That's too boring. I just go on Morningstar and buy Pfizer funds, which is like, no, that's the worst thing you can do.

**Keith:** Do you remember Peter Lynch? Do you know that name?

**Marcelo:** Oh, yeah. Magellan.

**Keith:** Magellan fund. Peter Lynch had a record that was better than the S&P 500 by four full percentage points over a 14-year period. That's crazy. I read his books, by the way. Did you ever read his books?

**Marcelo:** No, no, no.

**Keith:** And he took over the fund from 1977 at an obscure Fund that nobody knew of.

I think it had $80 million and he managed it until 1990. So, 13 years. He got an average compound rate of return of 29%, 29% over 13 years. Marcel, that is unbelievable. The S&P was 24. However, many, many, many of the investors in the strategy, actually, if you say, how did you do in the Magellan Fund, they'd say, I lost money.

And the average investment return is something like. a thousand points, thousand basis points under what the Magellan fund.

**Marcelo:** So, 10%?

**Keith:** Correct. What's the Magellan fund. Again, it's another chasing performance and it's about dollar weighted returns versus the live way to return. So, it's this idea of Either chasing a theme, chasing a manager, has always been around and it will unfortunately continue to be around.

So, part of this show is really trying to educate our listeners and show some proof and evidence based on this Morningstar report, which clearly shows that investors in thematic strategies aren't getting the returns of the strategy and far from it.

**Marcelo:** Yeah. Before we end, we did touch on ARK, but we didn't go through the gap.

That gap is crazy. So, the fund. In 5 years, up to 2021. So that's the latest numbers that we have on that specific return. So, the fund returned about 40%. The investors over 5 years, the people putting in the money got 10%.

**Keith:** Yeah. That's probably the largest gap I've ever seen.

**Marcelo:** Yes, me too.

**Keith:** And again, we know what happened.

They bought the strategy at the top of the market. That's when all the money went into the strategy and then they had to take the negative years.

**Marcelo:** I used to bring my dog to the dog park, and I used to be friends with a bunch of people who have dogs there. And when I told them what I did, every single person in the park asked me about ARK investments and that was at the peak and it totally collapsed like a few years after, but it was just funny because like, that's how these things work.

They really capture people's imagination. Like they get into this mindset of like, I must have this. Or I'm not going to make money. And it's very irrational.

**Keith:** You're hinting on what your takeaways are. So, what are the takeaways for today's show?

**Marcelo:** Well, look, I think the dangling carrot will always be there for humans and investing.

It's been around for years. It's always going to be there. And there's no way avoiding that. You know that we live in a world with constant stimulation, news, phones, Instagram, TikTok, you name it. So, this stuff is always going to be there. So, my takeaway is just resist the temptation. And I know it sounds boring, but that's a lot of the things that we pride ourselves in being advisors is that we can look at people in the eye and say, look, this is just a bad idea. And it prevents a lot of bad outcomes.

I'm proud of that, but it's also tough. So, if you're not working with an advisor, I would say, be mindful and just be aware of the numbers because the numbers don't substantiate people getting into this type of strategies.

**Keith:** Well said. I mean, I'm going to echo that. That was a long answer. No, I'm going to echo it, but it'll be a little bit more to the point. I mean, I think the way investors should think about their portfolios is they should invest in the core. And forget the Explore. So, you stay away from thematic investing because I think it gets people into trouble.

**Marcelo:** Yeah. If you want to get in, buy the gadget, but don't buy the stock.

**Keith:** So, listen, thanks again for being on today's show. It's nice to be together. We haven't done one in a little while. And to our listeners, thank you so much and have yourself a great week.

**Marcelo:** Thank you.