Xtrackers by DWS

Thematic Investing: Skating to the Economic Puck

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"I skate to where the puck is going to be, not where it has been"
Wayne Gretzky, Professional Ice Hockey Player, and Coach

IN A NUTSHELL

– Thematic investing looks at equity markets in a different way — not according to the companies' business activities (like sectors), nor according to fundamental, statistical, or macro metrics (like factors), but with an eye on how an economy may evolve in the future.
– Since many themes involve portfolios of stocks that a well-diversified investor likely already holds, the financial merit of thematic investing is not in diversification, but in overweighting exposures in a sensible way to perceived alpha-generating companies.
– Investors need to think carefully about where thematic investing sits within the tactical and strategic spectrum. Many themes will take time to play out, but they also can't be expected to outperform forever. We believe that a thematic approach sits somewhere in the middle.

Slicing and Dicing in the Securities Kitchen

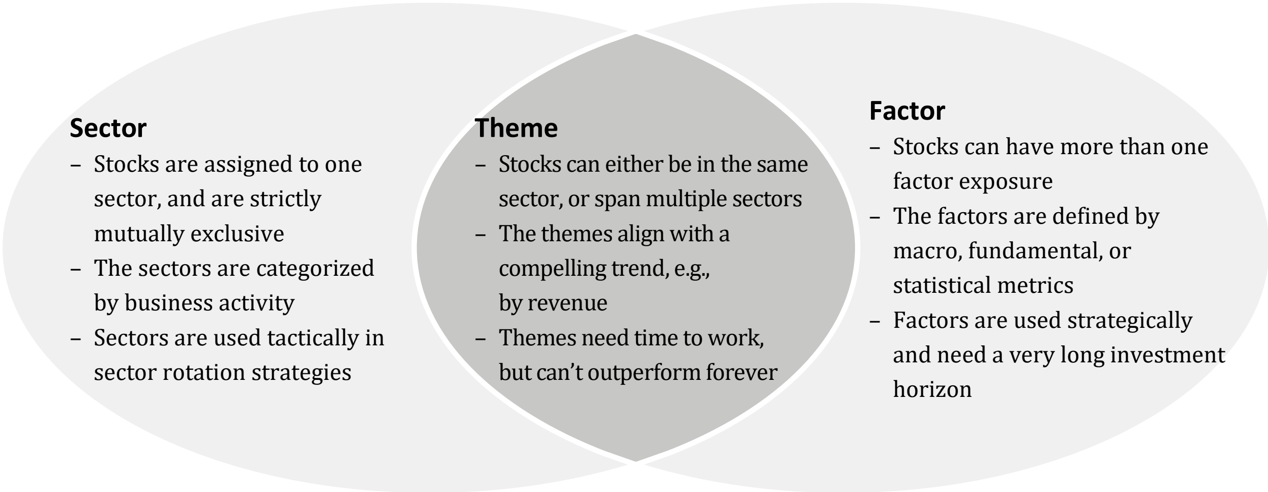
The most common method for investors to categorize the equity market is to allocate stocks into one of the 11 sectors of the Global Industry Classification Standards ("GICS") created by MSCI and S&P. These sectors examine a company's principal business activity and allocate it accordingly to one sector. The sectors are "mutually exclusive," one company can't be in more than one sector. Accordingly, sector performance will differ to where the economy is in the business cycle and is also incorporated into a well-known investment strategy ("sector rotation").

Another common way to split-up stocks is according to "style tilts," with perhaps the most common delineation being between "value," "growth," and "blend". Usually, value implies a stock that is cheap versus some accounting metric, and growth implies the opposite (with blend of course somewhere in the middle).

At DWS, thematic investing represents another innovative way to slice up equity markets. It has similarities to the sector approach in that, often, though not always, the companies are broadly involved in a similar economic activity, but it differs because, like the factor approach, one company can appear in more than one thematic idea (and many companies can appear in none).

In some ways thematic investing sits between sector and factor approaches, but also retains elements of both. The Venn Diagram in Figure 1 shows our way of capturing these differences succinctly.

Figure 1: Some Characteristics, Definitions, and Uses of Sectors, Themes, and Factors



Source: DWS.

The Economy of Tomorrow

Thematic investing introduces two novel concepts that investors need to incorporate into their mindset. The first concept is to recognize that the reason for slicing the market differently is to capture a novel investment thesis – that the economy will be significantly influenced by the theme in the future, and that the capital markets will eventually price in that influence (hence the title of the paper, *Skating to the Economic Puck*). So, for example, someone investing in a semiconductor theme should believe that the economy will evolve in a way that makes the design, manufacture, and supply of semiconductors more relevant than the market is likely pricing in today. The idea is not so much that the themes are critical in today's economy, but that they will be even more critical or pervasive in the future economy.

The second concept is subtle, but important. Many investors (especially in the passive camp) believe that equity markets are fairly representing a future economy today, and that any future growth is already accurately priced in. Others believe that through fundamental, technical, or quantitative analysis, investors can pick specific winning stocks that are expected to outperform. Thematic investors are in a third camp, believing both that certain trends will be more relevant in the future than priced in today, and that implementing that view via investing in a broader group of companies is preferable to specific stock picking.

What is the Timeframe?

Our view is that successful thematic investing is likely to play out over a timeframe that is too long to be useful for Tactical Asset Allocation (TAA), which tends to capture short-term dynamics. We believe that a thematic investing process strives not to concern itself with most of the "noisy" day-to-day market dynamics.

Of course, having said that, we need to consider the end of the timeframe too. The idea behind factor investing is that there are long run alpha generators that investors can capture without an end date in sight. They historically do not work all the time, and indeed can detract from performance for extended periods. However, for those investors with extremely long horizons, they might be of interest.

In contrast to this we don't argue that thematic investing can, or will, always outperform. And the reason for this is that, just as an investor believes that a theme is not currently priced in by today's market, they should probably accept that one day this condition will go away, i.e., that there will be some sort of convergence between their view and the market's. One would anticipate that outperformance should attract other investors who will bid up prices and lower expected returns to align with the rest of the market more closely. So, the bottom line is that investors should think hard about what they are trying to achieve with their thematic allocations, and, in addition to the decision to buy, should think carefully about what would represent the right time to sell.

Portfolio Risk

Introducing thematics into an allocation does not necessarily reduce overall portfolio risk. An important aspect of risk is that of single stock positions (idiosyncratic risk) versus baskets of securities (systematic risk).

Investors that express a thematic view via a single stock holding take on specific company risk that is hard to eliminate. This may be acceptable, but for those that approach this from a more “top-down” approach, company specific risk may be an unintended consequence. Investing in a broad portfolio of stocks enables investors to minimize the volatility that a single or limited number of stocks can potentially generate.

Conclusions

Thematic investing represents a relatively new way of carving up equity markets, and, as such, requires investors to think carefully about several issues. Amongst these are:
Whether the thematic aligns with their view of how the economy, and the stock market, will develop in the future.
The timing of the exposure – we believe that thematics are not tactical in nature, but nor can they be expected to outperform forever.

The impact that the thematic will have on the portfolio, in terms of volatility. Thematics often do not play the role of diversifiers (in the sense that allocations blended with a market weighted portfolio tend to slightly increase risk), though that may not be true all of the time.

The potential advantage that thematic approaches have over single stock exposures. Expressing a thematic view via holdings in one, or just a few, single stock positions, runs the risk of company specific exposures for which investors are not compensated. Thematics typically contain multiple holdings, and that idiosyncratic risk tends to diversify away as a result. Investors will still have other risks to consider, including market risk, and, of course, risk to the theme itself.

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War, terrorism, sanctions, economic uncertainty, trade disputes, public health crises and related geopolitical events have led and, in the future, may lead to significant disruptions in U.S. and world economies and markets, which may lead to increased market volatility and may have significant adverse effects on the fund and its investments.

CRTC
Risk: Critical technologies are technologies that are deemed to be vital to maintaining the national security of the U.S. now and in the future. Companies involved in critical technologies may be subject to a significant amount of governmental regulation, and changes in governmental policies and the need for regulatory approvals may have a material adverse effect on the critical technologies and the companies involved with them. Critical technologies companies are heavily dependent on patent and intellectual property rights which may be difficult to protect. Investing involves risk, including the possible loss of principal. Stocks may decline in value. This fund is non-diversified and can take larger positions in fewer issues, increasing its potential risk. An investment in the fund should be considered only as a supplement to a complete investment program for those investors willing to accept the risks associated with the fund. Please read the prospectus for more information.

CHPS
Risk: Companies in the semiconductor field face intense competition, both domestically and internationally, which may have an adverse effect on profit margins. Cybersecurity companies also face heightened risk due to their dependence on the availability of materials that meet exacting standards, to reliance on a limited number of suppliers and by potential loss or impairment of patent and intellectual property rights. Incorporation of ESG criteria in the fund's investment strategy does not guarantee a return or protect against a loss, limits the types and number of investment opportunities available to the fund and, as a result, the fund may underperform other funds that do not have an ESG focus. Regulatory changes or interpretations regarding the definitions and/or use of ESG criteria could have a material adverse effect on the fund's ability to invest in accordance with its investment policies and/or achieve its investment objective, as well as the ability of certain classes of investors to invest in funds following an ESG strategy such as the fund. Foreign investing involves greater and different risks than investing in U.S. companies, including currency fluctuations, less liquidity, less developed or less efficient trading markets, lack of comprehensive company information, political instability and differing auditing and legal standards. Any fund that focuses in a particular segment of the market or region of the world will generally be more volatile than a fund that invests more broadly. This fund is non-diversified and can take larger positions in fewer issues, increasing its potential risk. An investment in the fund should be considered only as a supplement to a complete investment program for those investors willing to accept the risks associated with the fund. Please read the prospectus for more information.

PSWD

Risk: Companies in the cybersecurity field face intense competition, both domestically and internationally, which may have an adverse effect on profit margins. Companies in the cybersecurity field also face heightened risk caused by obsolescence due to rapid technological developments, by potential loss or impairment of patent and intellectual property rights and by the risk of cyber-attacks. Incorporation of ESG criteria in the fund's investment strategy does not guarantee a return or protect against a loss, limits the types and number of investment opportunities available to the fund and, as a result, the fund may underperform other funds that do not have an ESG focus. Regulatory changes or interpretations regarding the definitions and/or use of ESG criteria could have a material adverse effect on the fund's ability to invest in accordance with its investment policies and/or achieve its investment objective, as well as the ability of certain classes of investors to invest in funds following an ESG strategy such as the fund. Foreign investing involves greater and different risks than investing in U.S. companies, including currency fluctuations, less liquidity, less developed or less efficient trading markets, lack of comprehensive company information, political instability and differing auditing and legal standards. Any fund that focuses in a particular segment of the market or region of the world will generally be more volatile than a fund that invests more broadly. This fund is non-diversified and can take larger positions in fewer issues, increasing its potential risk. An investment in the fund should be considered only as a supplement to a complete investment program for those investors willing to accept the risks associated with the fund. Please read the prospectus for more information

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Risk: The fund will be sensitive to, and its performance will depend to a great extent on, the overall condition of green or low carbon infrastructure companies. These investments are considered to be speculative and are subject to greater risk of loss, greater sensitivity to interest rate and economic changes, valuation difficulties and potential illiquidity. The fund will be sensitive to, and its performance will depend to a greater extent on, the overall condition of green or low carbon energy companies. Such companies face enhanced risks caused by factors including changes in government regulations, the impact of adverse weather conditions and on the demand for renewable energy production. Incorporation of ESG criteria in the fund's investment strategy does not guarantee a return or protect against a loss, limits the types and number of investment opportunities available to the fund and, as a result, the fund may underperform other funds that do not have an ESG focus. Regulatory changes or interpretations regarding the definitions and/or use of ESG criteria could have a material adverse effect on the fund's ability to invest in accordance with its investment policies and/or achieve its investment objective, as well as the ability of certain classes of investors to invest in funds following an ESG strategy such as the fund. Any fund that focuses in a particular segment of the market or region of the world will generally be more volatile than a fund that invests more broadly. This fund is non-diversified and can take larger positions in fewer issues, increasing its potential risk. An investment in the fund should be considered only as a supplement to a complete investment program for those investors willing to accept the risks associated with the fund. Please read the prospectus for more information.

XAIX
Risk: Companies involved in artificial intelligence and big data face intense competition, may have limited product lines, markets, financial resources and personnel. Artificial intelligence and big data companies are also subject to risks of new technologies and are heavily dependent on patents and intellectual property rights and the products of these companies may face obsolescence due to rapid technological developments. Incorporation of ESG criteria in the fund's investment strategy does not guarantee a return or protect against a loss, limits the types and number of investment opportunities available to the fund and, as a result, the fund may underperform other funds that do not have an ESG focus. This fund is non-diversified and can take larger positions in fewer issues, increasing its potential risk. An investment in this fund should be considered only as a supplement to a complete investment program for those investors willing to accept the risks associated with the fund. Please read the prospectus for more information.

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