



Thematic investment and performance – What your clients need to know

Change is a constant in today's global economy. The challenge for investors is to take advantage of the shifts and turn them into positive investment outcomes. Here are some key messages you can share with your clients to help them understand recent events.

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Investment strategies based on a benchmark-centric approach have had their time. Our Global Thematic investment team, Lazard Asset Management (Lazard) sees this way of investing as backward-looking, risk-averse and short-term. In a world that is undergoing waves of structural change, it is surely better to be forward-looking, conviction-led and patient.

Three years after COVID-19 inflamed economic, social and geopolitical volatility worldwide, global analysts are predicting everything from bull to bear to wildly erratic markets for months, even years, ahead.

Central banks are acting to fight soaring inflation by raising cash rates and the world's politicians are grappling with both the political and economic fallout from Russia's invasion of Ukraine.

In 2022, the tech-heavy Nasdaq-100 dropped nearly 33%, the broader S&P500 lost nearly 20%, and cryptocurrencies nosedived as Bitcoin shed over 60% of its value. Despite a rebound at the start of 2023, investors remain nervous. Global thematic funds were not exempt, with heavy outflows in 2022 as investors became apprehensive.

Morningstar reported that thematic funds had a record outflow of US\$6.3 billion in the first half of 2022, compared with an inflow of US\$142.9 billion in the same period in 2021.¹ Their net assets also dropped to US\$616.9 billion at the end of June, a 24% fall over the previous corresponding period.

And only 65 new thematic funds were introduced in the first half of the year, compared with a record 234 in the first half of 2021.

Thematic funds and feather dusters – know the difference

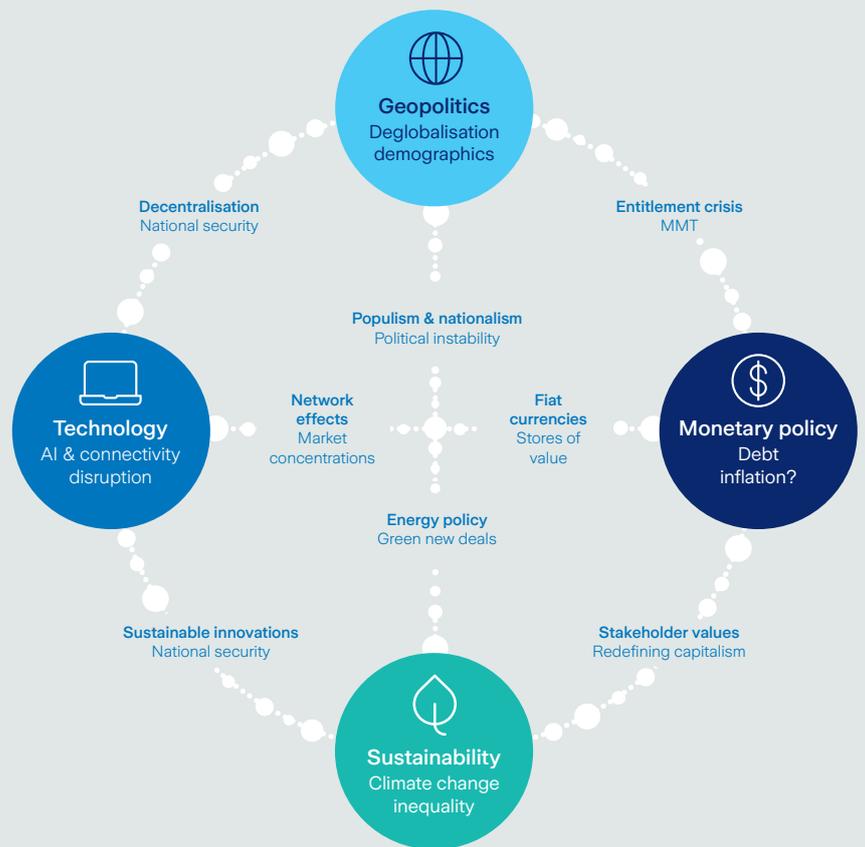
This outflow was possibly unsurprising, given the tripling of investments in thematic funds in recent years as investors pursued high-growth sectors and stocks tied to single trending themes – such as artificial intelligence, electric vehicles, working-from-home and climate change.

Analysts agree that investors piling into thematic funds after their initial big run-ups are often quick to exit at losses. In a bear market, investors also tend to be incredibly risk averse.

The challenge with single-theme ETFs (exchange traded funds), which enjoyed the bulk of the inflows in 2021, is that they are typically built around one static theme. These can be in vogue one year and then out of favour the next – last year's rooster becomes this year's feather duster.

Legitimate thematic funds, on the other hand, don't outsource the key decision of theme selection. A multi-themed approach establishes healthy competition for capital between themes, where each theme included must represent a genuine underlying investment opportunity.





Disruptions, interactions and policies are set to define the next decade.

Lazard's investment process is presented here in sequential steps for illustrative purposes only. In practice, the process may not be sequential and will, as needed, weigh certain criteria over others.² Source: Lazard.

Given the current levels of investor anxiety globally, it's vital that advisers and investors understand the difference between fly-by-nighters, ETF products, and appropriately modelled and structured thematic funds such as the Zurich Investments Global Thematic Share Fund and Zurich Investments Global Thematic Focus Fund.

We believe that placing structural change at the heart of an appropriately constructed long-term equity portfolio immediately faces us forward. Structural change over the next decade may represent a differentiated and valuable source of returns.

Precise implementation and diversification

Various asset classes – such as stocks, bonds or cash – behave differently in changing market environments, but instead of chasing past performance, we believe an appropriately diversified portfolio can help minimise the effects of market ups and downs.

Thematic investing could be included in any portfolio to complement other investments. Used this way, it can offer less risk with more balance and diversification.

Our thematic funds are based on the robust implementation of Lazard's global thematic framework which identifies four key areas of structural change. Each presents generational opportunities for investors willing to take a differentiated approach.²

The thematic strategy is based on the profound transformations we see taking place in technology, sustainability, geopolitics and in monetary policy, with interconnected forward-facing themes identified around these four areas of structural change.

This framework is designed so that we stay on the right side of policy change. Funds that fight against the expectations of society or shareholders, or who aren't applying best practice in their own industry, will be toast sometime in the future.



Holistic approach

Recent years have reminded us that predictions are a guessing game. We don't really know what's going to happen tomorrow, but if we understand how companies are investing for the future, there's more inevitability about the long term, because we actually know how companies are executing their strategy over that period.

We understand that markets, companies and competition are always evolving. And that our themes need to be based on the observations of companies themselves and be equally dynamic. This allows us to understand how they're investing their capital for the long term and to maintain long-term structural winners rather than being 'hot money' – here today, gone tomorrow.

This dynamic approach means we understand that themes can be retired, with capital in the portfolio allocated to better ideas, or they can evolve as companies develop and continue to compete.

Strategies with long-term time horizons also need to integrate sustainability throughout the investment process. They must demonstrate their commitment to traditional environmental, social and governance (ESG) and broader sustainability considerations.

As long-term investors, we believe it's critical to understand the evolving societal and policy landscape and associated opportunities and risks. We believe traditional investment analysis alone can understate both the risks and the opportunities faced by some companies today.

Risk management

Investors have different requirements and objectives, which is why we have two versions of our strategy, one diversified and one more return focused.

Our diversified fund targets risk-adjusted returns while our focus fund is a return-seeking strategy with some simple diversification benefits. Our focus fund concentrates on themes that our investment team believes offer the highest returning opportunities for investors. When choosing themes we use a scalpel rather than a sledgehammer. Generic investment ideas are sledgehammers – often too broad in scope to target the actual return opportunity. Theme design and stock selection needs precision.

The Global Thematic Focus Fund identifies what our team believes are the highest return-seeking opportunities of the next decade. Focused on just three to six themes, the portfolio holds between 35 and 55 stocks.

The diversified strategy, the Global Thematic Share Fund, combines return opportunities with risk mitigation to target strong risk-adjusted returns. Invested across eight to twelve themes, the portfolio typically holds between 80 and 120 stocks.

Both strategies represent benchmark-agnostic, style-agnostic, high conviction, best-ideas portfolios. Unconstrained by geography, sector or style, they can add a differentiated return stream to most asset allocations.

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¹ "Global thematic funds see big outflows as growth stocks falter," Patturaja Murugaboopathy. Reuters. 2 August 2022. <https://www.reuters.com/markets/europe/global-markets-funds-2022-08-01/>

² Global Thematic Equity Global Framework. Lazard Asset Management. 12 December 2019. https://www.lazardassetmanagement.com/docs/product/-s32-/95424/GlobalThematicEquityGlobalFramework_en.pdf

To learn more about the Zurich Investments Global Thematic strategies and how you and your clients can invest, visit advisers.zurich.com.au/globalthematic

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