

## ETF Stream Presents:

# The importance of thematic index design

There can be significant performance dispersion between ETFs tracking the same megatrend. This stems from how the index is constructed and the metrics used to ensure the strategy offers appropriate exposure to the theme. **Chair:** Tom Eckett editor of *ETF Stream*

**Chair: How do you view the thematic ETF market at the moment?**

**Christoph:** It was a tough year in 2022 because of the large tech sell-off and surrounding concerns about rising interest rates and inflationary pressures. In 2023, we have seen some recovery with around 80% of our thematic indices outperforming the global market. It is not just tech-related themes either – with AI running hot at the moment – but there has also been a lot of interest in sustainability-related themes and values-based investing.

**Rob:** Over the last 18-24 months, we have seen a growth-to-value rotation, which many investors assumed would lead to large outflows from

thematic strategies. But what we have seen at an industry level is a rotation within the product set, which would not have been possible a short while ago as there were not enough thematic products to rotate into. Since the rotation, tech has seen outflows while climate themes have been particularly resilient, driven by a number of special situations such as Russia-Ukraine and some of the value-oriented themes such as timber and agribusiness. Now, tech has come back into play because of the potential returns and new themes are emerging such as a transition to a low-carbon economy.

**Irene:** What I find incredible are the blockchain ETFs returning almost 100% this year. They are

**“There is a lot of good product out there and also a lot of rubbish. In thematic, it is about differentiating between genuine long-term opportunities and fads by looking at their methodologies, their target markets and what they are trying to achieve”**

**Paul Dennis,** Holden & Partners

very volatile but it is just incredible and I would not have expected this at the beginning of the year. We are now positioning ourselves for a potential recession in the US and this is putting our focus on fixed income. It is a shame there is not such thematic granularity in fixed income as there is in equities – and I understand liquidity plays a big part in this. There are sustainable options such as green bonds but to move from general sustainability to themes such as climate technology would be appealing.

**Vincent:** Thematic investing tends to be medi-



## Meet the experts



**Irene Bauer:**

Irene co-founded Algo-Chain almost six years ago as an ETF-based model portfolio and portfolio solutions provider. She is also the CIO of investment adviser Twenty20 Investments, which she also co-founded almost 12 years ago. Previously, she spent more than five years as director of product research and consulting at BlackRock and two years as a quantitative analyst at ABN AMRO Bank. Irene holds a PhD from in Mathematics from the University of Heidelberg, Germany.



**Paul Dennis:**

Paul joined Holden & Partners as an investment manager in 2019 and became investment director after seven months. Previously, he spent a few years building innovative investment management solutions for two fintech start-up businesses, implementing advanced technologies and modern-day processes to the more traditional portfolio and investment management techniques. Before this Paul spent almost six years at Arbuthnot Latham where he was responsible for managing risk-based investment portfolios of private clients, charities and small businesses whilst undertaking the role of analyst of several asset classes within the wider team. Paul holds Chartered MCSI status through a combination of CISI Private Client Investment Advice and Management, the IMC and CISI Securities.



**Vincent Denoiseux:**

Vincent Denoiseux head of investment strategy at Amundi ETF, index and smart beta – Vincent has two decades of experience in quantitative research, derivatives, structuring and portfolio construction. Before joining Lyxor, Vincent was DWS’s head of portfolio solutions. Within DWS he spearheaded the research initiatives of the passive business, covering topics including ETFs vs futures, market liquidity and quantitative investing. Previously he developed fund linked investment solutions at Exane Derivatives (BNP Paribas), focusing on hedge funds and liquid absolute return strategies. Prior moving to capital markets, Vincent was a head of quantitative research, firstly at BNP Paribas Investment Partners and subsequently for Lehman Brothers Asset



**Christoph Schon:**

Christoph is senior principal of applied research at Qontigo, provider of the STOXX indices. He is a client-facing quantitative analyst and has spent four years in his current position. He has spent over ten years in day-to-day client coverage; has extensive expertise in risk modelling and return attribution; knowledge of the leading portfolio analysis platforms; and experience in portfolio optimisation and hedging. He also has experience in index construction and calculation as a former member of the iBoxx Technical Committee from 2002 to 2006. He is a CFA charterholder and holds the CIPM designation.



**Rob Powell:**

Rob is head of thematic and sector product strategy at BlackRock. He covers the business development, product strategy and client communications within iShares’ thematic ETF and mutual fund suites. He joined BlackRock in 2015 from Legal & General Investment Management (LGIM) where he was product specialist for the fundamental active equity business focusing on Asian and UK equity income strategies. Prior to this, Rob was a member of the sales team at hedge fund provider Gartmore. He earned a degree in Modern Languages from Newcastle University and is a CFA Charterholder.

## In association with



um-to-long term but investors are generally more short-term in their thinking during periods of volatility. This has meant our discussions have focussed less on themes over recent months and more on style and defensive allocations.. One very strong bright spot has been luxury goods on the back of China’s re-opening. There are also flows into tech but these are still fairly limited versus what we have seen in past years.

**Paul:** There is a lot of good product out there and also a lot of rubbish. In thematics, it is about differentiating between genuine long-term opportunities and fads by looking at their methodologies, their target markets and what they are trying to achieve. How much of it is marketing-driven? From our

perspective, we are generalists so it is a process of researching, reading a lot and asking contacts that are genuine experts in particular fields.

**Chair: How do you differentiate between a fad and a structural opportunity and how do you define the scope of an investable theme?**

**Rob:** We have resisted pressure to launch themes in every megatrend and focus on the quality of the construction to deliver purity of exposure. This allows us to form a view as to whether a theme can add long-term value to client portfolios rather than being a fad. We have an internal expert advisory board which feeds into the product development for our actively-managed strategies

and ETFs. They discern the top-down rationale behind each theme and research which securities constitute each one. We are often approached by clients requesting relatively esoteric or nascent exposures – in some there is a potentially interesting future opportunity but today there are just not enough companies. It is a matter of educating our sales team and our clients on what makes an exciting theme versus an investable portfolio. One challenge in thematics is this fragmentation in approach to capturing a theme, with two AI ETFs looking very different beneath the bonnet. Access to that information is crucial for participants, even more so than S&P 500 or CAC 40 ETFs.

**“You have to reverse engineer your understanding of what constitutes a theme such as AI. This might involve looking at keywords, company reports, exploring company business models and revenue share. Often it is more an art than a science and it is about comparing methodologies and investment philosophies”**

**Vincent Denoiseux**, Amundi

**Vincent:** Humility, as well as research and process, is key to identifying fads and opportunities as you cannot know everything. The key difference between a sector, factor and a theme is the latter is fairly intuitive – you know what you are looking for. You have to reverse engineer your understanding of what constitutes a theme such as AI. This might involve looking at keywords, company reports, exploring company business models and revenue share. Often it is more an art than a science and it is about comparing methodologies and investment philosophies. Does it make sense? Is it stable? It takes a lot of time and effort to get it right.

**Irene:** One issue is ETF issuers’ websites do not always say enough about what the benchmark index tracked by their product does and how their ETFs are capturing themes. One has to then go on to index provider websites and then drill down and search for the necessary information. Especially for retail investors, it would be good if they provided succinct summaries of what the index does and where revenues are derived from. Make it easier for the investor to find out whether an ETF’s methodology matches its name. Having clear and straightforward access to key information rather than general disclaimers might inspire more asset gathering.

**Chair: When using natural language processing (NLP) for stock universe construction, how do you avoid those pitfalls of companies using buzzwords in their company reports and press releases?**

**Christoph:** As an index provider, data sources are very important for us. Our strategies have to be rules-based, transparent and replicable. Using NLP and artificial intelligence in the stock selection process cannot currently guarantee this. We have to be very careful about having good, reliable and sustainable data. As these technologies are still in development, we do not know yet whether they will be available and suitable in the future. Traditionally, thematic strategies would be based on high revenue thresholds but that only works for relatively mature themes with established industries. For new themes such as

AI or the metaverse, we have to rely on alternative data sources. Some studies suggest only 10-15% of the market potential has been realised in the metaverse so we look at data such as patent filings to identify the key innovators and future beneficiaries in that space.

**Chair: Why are thematic ETFs useful from an asset allocation perspective?**

**Paul:** Thematics are useful both from a diversification perspective but also for aligning with our clients’ values. Investors have increasing access to information and want to invest in areas driving positive real-world impacts. They also want to be invested in the themes they are reading about – for example we are often asked about semiconductors – and people want to be aligned with these areas and potentially outperform. We have had a look at active and passive products and thematic ETFs often offer a more stringent approach. Rather than relying on individual subjectivity to define a theme, index-based thematics have very strict rules, revenue exposure and as such might end up being more sustainable than active in exposures such as SRI. While actives might have a justification for some exposures, we like a rules-based approach.

**Christoph:** Our clients use our leading thematic approaches predominantly as a strategic approach but also as a tactical allocation, as they offer access to unique niches which may differentiate from traditional exposures. Last year, energy utility and smart waste management related themes such as clean energy and the circular economy benefitted following Russia’s invasion of Ukraine. Having a thematic approach allows you to hone in on those niches which are often at the cutting edge, such as cybersecurity.

**Chair: How are thematic ETFs offering new avenues for capturing sustainability and ESG investing?**

**Rob:** Looking at the flows data from the last few years, it is hard to deny sustainability-focused themes have become very important to investors. Last year, there was a large focus on clean energy through active strategies and ETFs and









the narrative of energy independence drove demand. Interest in the sustainable theme has not caught on across the board but special situations are driving demand for these themes. Thematics are offering a more targeted approach thanks to advances in data over a relatively short timeframe. Previously, robotics and automation felt like the super long-term theme in 2015 to 2016. AI has now really increased people's focus on disruption in that space. We do not have a crystal ball. Back then, nobody could have guessed clean energy would be the theme it is today.

**Vincent:** I would differentiate ESG and thematics. One is trying to reduce the carbon intensity of an existing portfolio, the other is trying to focus on a defined area where you anticipate sources of future growth that could deliver long-term outperformance. While this has focused on green themes in the past, this could also change.

**Chair: Themes are often considered to be growth style biased but how have they fared in a regime with potentially structurally higher inflation?**

**Vincent:** Some investors have asked us for products with the lowest exposure to growth but obviously there are conflicting views in the market about what constitutes growth and value and which is preferable. We should be conscious that we are looking at long-term themes, so we can only say what exposures our products currently offer, what exposures may be beneficial to include but

we can only say so much about what will happen in the long-term.

**Christoph:** One of the thematic indices we saw generate a lot of interest last year was breakthrough healthcare, with healthcare being a relatively defensive sector with a lot of pricing power during times of high inflation. Breakthrough healthcare is also a particularly interesting theme, with a lot coming in the next years such as COVID-19 vaccines opening up new opportunities in areas including oncology. While some have used the theme as a tactical allocation in 2022, there may be a lot of long-term potential.

**Paul:** Macro is hugely important at the moment. Everyone has become a central banking expert. A recession may actually be good for growth stocks as interest rates start getting cut. Overall, not many have had practical experience investing in this kind of high rate, high inflation environment – it is uncharted territory for anyone that is not a

Warren Buffett. One can make educated guesses about things like central bank policy but overall, it is a difficult environment to allocate in. More often than not, you have to stick to your principles.

**Rob:** If you look at the equity market over the last couple of years, the macro events most talked about have been pervading events such as the Russia-Ukraine conflict. The beneficiaries of this have been thematic in nature to benefit, for example, from the acceleration for energy independence.

**Chair: What is the process when deciding to wrap a theme in an ETF or a mutual fund structure?**

**Rob:** We can be pragmatic about the view we take and it is our firm belief you do not need active managers in every exposure. The risk-return profiles for rules-based approaches are often very strong. The nature of the themes and their investment universes – such as how well-defined they are –

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**Christoph Schon, Stoxx**



dictate whether we take an active or ETF-based approach. Nascent themes are often more poorly defined and require an ongoing dynamism that is better suited to an active fund. IPOs and the private market are also areas active managers can access more directly. It is also about client demand for exposures in particular product structures. For now, the circular economy is something we just look at through an active wrapper as it is something we did not believe there was good enough data for when we began constructing it in 2018-2019. Robotics and cybersecurity are well-defined themes that we only target using thematic ETFs and not active funds.

**Vincent:** What we need to launch an ETF is a high level of conviction in the basket. It must be well-diversified, have a high number of stocks (depending on each investment universe) and a weighting element. We also need liquidity to manage the expected success from an ETF. Overall, conviction, diversification and liquidity are crucial.

**“Purity is extremely important. Investors want to be able to look under the bonnet and see the things they would expect to be in there rather than generic companies that are not specific to the theme”**

**Rob Powell**, BlackRock

**Rob:** One very important thing with ETFs and indices that provide access to themes is index design. Working with an index provider and looking at themes individually, examining the rules to see how they track a theme and the liquidity picture within a theme and whether they are scalable. We do not have a range of pre-set rules in mind but we do have certain requirements surrounding minimum market cap and trading volume. Liquidity screens are central to turning a theme into an investment.

**Christoph:** Liquidity screens such as market cap and average trading volume are innate parts of our index construction process. Our methodology also typically tries to equal weight constituents as often the most specialised companies in a theme can be among the smallest so we do not want them to be dominated by the bigger players. For some themes, such as the metaverse, the index methodology scales up the weights of companies that are very specialised in the theme and have lots of patents filed in a particular technology.

We take the entire STOXX universe as eligible for inclusion in a theme. Sometimes our process identifies companies that are relatively small. Right now, there are plenty of articles criticising indices dominated by just five or six companies. This could potentially be a lot worse in themes containing small companies where it could be just two or three companies dominating. To capture the innovators, we equal weight to focus on these long-term structural trends rather than capturing the broad market.

**Chair: Which themes are you particularly bullish on?**

**Paul:** Given we are sustainability-focused, impact, SDGs and sustainable food are particularly interesting to us. Each year, we survey clients to find out what their interests are and this feeds into the four major themes we embed within our portfolios. It is what you would expect from investors hoping their assets have a positive impact. This year, it has been about sustainable food – looking at better fertilisers, machinery – as well as water and waste. I appreciate the UN SDGs may not have been expressly designed for investing but they sit in our due diligence questionnaire and comprise around four questions. It is very important they are accounted for.

**Irene:** Water will be one of the big themes for investors. It is not only important for individuals but also for companies as there is a lot of practical need for water for them to operate. Even AI needs water for cooling and traditional manufacturers are reliant on water in their supply chains.

**Rob:** We have a lot of conviction in the forward-looking potential of water. Water has been one of the larger allocations in our multi-theme strategy in recent years as valuations have been attractive. Our clients are now asking for a more nuanced view on capturing climate-related themes. While they still want clean energy and the circular economy, they want to target the enablers of this so areas such as metals producers and the mechanisation of energy production are attractive. Copper for wiring and solar plants, lithium for batteries, steel for construction infrastructure such as wind turbine. The companies within this space have a structural demand driver there but the challenge is they are among the highest emitters so those with the fastest path to net zero will be the biggest beneficiaries of the focus on a low carbon transition.

**Paul:** Divestment does not solve the problem though – which is why many are realising you cannot divest and expect these businesses to go away. Demand is still there for their products and other investors will stay put. How are you engaging with these companies and what processes are in place to do this from an ETF perspective?

**Rob:** Meeting with the companies is a very important part of our active strategies. There are

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**Irene Bauer**, Algo-Chain

specific areas we will be engaging companies on across the piece but not on an individual product level in ETFs.

**Vincent:** Engagement is central to us and it is conducted at the Amundi company level, whether this be for our active or passive products. As for thematic in focus, water is something we launched over a decade ago and it is our oldest thematic at Amundi. We are constantly engaging with clients about water and new energy, even at a time when thematic are not as popular. Biodiversity has also come to the fore as a key priority we are looking at.

**Chair: What are the challenges and key considerations in thematic index construction?**

**Christoph:** Constructing a thematic index is fundamentally different from how we go about constructing our broad market or sector indices. For the latter, it is about country or region and market capitalisation. It is usually very binary. Thematic index construction is targeted but also flexible and dynamic due to the alternative data sources we are using, ranging from revenue exposure to patents. The challenge is deciding which of these metrics to use, based on the maturity of the theme, the sustainability of the data – will it be there in years to come? When measuring theme maturity, we look at the size of the market and the revenues linked to a particular theme. Then, using studies from research institutes, we look at their estimates of what market size will be over the next ten years and how much of that potential has already been reached. On something like the metaverse, we need something that is forward-looking. We have to be conscious of demand from ETF providers so we are in constant conversations with issuers such as Amundi and BlackRock but we also have an internal think-tank that looks at the development of themes, alongside market consultations. We are currently looking at biodiversity, critical metals and green real estate as areas we are either actively developing or have recently launched indices.

**Rob:** When deciding what themes to launch, we have historically worked closely with index providers to make sure themes are defined in a way that reflects our internal view. We may pick off-the-shelf indices but they have to be aligned

with our own research so we can stand behind the product.

**Vincent:** We look at data and their level of transparency. Investors are now looking for more than just a Key Information Document (KID). At the very least, will we be able to answer all the questions using our current index provider? Will the investment philosophies make sense going forward? Can we explain the rationale behind each stock as the building blocks of an ETF?

**Chair: What makes a good thematic ETF?**

**Irene:** First of all, liquidity, a pure exposure and often a compromise between the two. SDGs are becoming more important. Index providers have each developed their own conception of ESG, but to me, there should be one general standard. We should have the SDGs as a single standard and then general ESG.

**Paul:** Two major points we look at are methodology – how is it built, does it meet our expectations of what we would want from the theme, does it fit in with client values, is it genuinely long-term? And then does it satisfy the ‘mum test’ – would I be able to explain it to my mum and our clients or is it overly complex?

**Christoph:** There is not necessarily a trade-off to be made between liquidity and purity – they are not necessarily mutually exclusive. Once we apply liquidity screens, only then will we implement other criteria for selecting companies and the weighting methodologies.

**Rob:** Purity is extremely important. Investors want to be able to look under the bonnet and see the things they would expect to be in there rather than generic companies that are not specific to the theme. This is of course subjective and people’s views will not always be aligned. ETF issuers need to have a view on how to best access a theme and this is why we focus on the research process before launch, having the rationale and being able to stand behind this after we launch.

**Vincent:** It is not about ranking priorities. The product has to be liquid or we will not launch it, there has to be high conviction level in the theme and it has to be diversified. It is about investors getting what they expect. We cannot predict performance but the product should track expectations of how a theme will progress.