

# Themes can come true

It's often said that “Change is the only constant in life.”



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When we look at today's world, we continue to see change everywhere, grouped into different evolving themes such as AI, clean water and clean energy. In this piece we will consider these prevalent themes in more detail, and how charities can seek to harness them in portfolios.





## Why invest in themes?

**1. Target transformative change:** population growth, climate change and digitalisation pose huge challenges and huge opportunities. Thematic investing provides a way of getting exposure to the companies that could benefit from tomorrow's growth drivers – in a way that traditional sector classifications can't.

## Today's themes are tomorrow's sectors



**Clean energy:** companies enabling technologies that could help realise the vision of net-zero carbon emissions



**Healthcare tech:** innovative technologies can improve quality of life and reduce the burden on health services



**Clean water:** specialist technologies could hold the key to protecting our most precious resource

- 2. Themes provide diversification:** investing in a broad range of themes can help provide a diversified portfolio of companies with varied exposure to different growth drivers.
- 3. Span sectors as well as geographies:** traditional sector classifications are simultaneously too broad and too narrow as the applications of technologies increasingly defy existing categorisation.

## Thematic investment can direct capital towards drivers of positive change



### Energy

#### The challenge:

Despite huge growth in renewables, with investment in renewables for electricity generation surpassing fossil fuel investments in 2015<sup>1</sup> and continuing to rise, the window to achieve net zero carbon emission by 2050 is closing fast.

#### How could technology help?

Continued falls in the cost of renewables will make the economic case for phasing out fossil fuels ever stronger. Batteries are also critical for decarbonising transportation (which accounts for 20% of global carbon emissions<sup>2</sup>) and storing the variable output from renewables in the grid, and hydrogen can reduce emissions from 'hard to abate' sectors.



### Clean water

#### The challenge:

Global population growth and climate change are combining to leave millions without access to clean water. By 2030, global freshwater demand is expected to exceed supply 40%.<sup>3</sup> Ageing water infrastructure in developed countries compounds the problem. Annually, 32 billion cubic metres of clean, processed water are lost through leaks.<sup>4</sup>

#### How could technology help?

Smart meters can play a part in identifying leaks across the network, while also encouraging consumers to reduce their consumption of water. Increasingly sophisticated digital monitoring of water systems will also allow AI to play a part in optimising the water network.



### Healthcare

#### The challenge:

The UK needs an increasingly large NHS workforce to care for an ageing population with complex care needs. Today, it's estimated that the health service is operating with 154,000 fewer full-time staff than it needs, and this shortfall is forecast to rise to 571,000 by 2036.<sup>5</sup>

#### How could technology help?

Technologies such as medical imaging, genomics and AI can reduce the burden of chronic illness by accelerating diagnosis, improving patient outcomes. Implantable devices, meanwhile, can provide treatment options that reduce the need for hospital stays.



1. Source: IRENA, 2022

2. Source: [Global CO2 emissions by sector, 2019-2022 – Charts – Data & Statistics - IEA](#)

3. Source: <https://www.weforum.org/agenda/2023/03/global-freshwater-demand-will-exceed-supply-40-by-2030-experts-warn/>

4. Source: <https://business.bofa.com/content/dam/flagship/bank-of-america-institute/esg/addressing-scarcity-in-a-transforming-world-april-2022.pdf>

5. Source: <https://www.theguardian.com/society/2023/mar/26/nhs-england-staff-shortages-could-exceed-570000-by-2036-study-finds>

## How can themes be added to a portfolio?

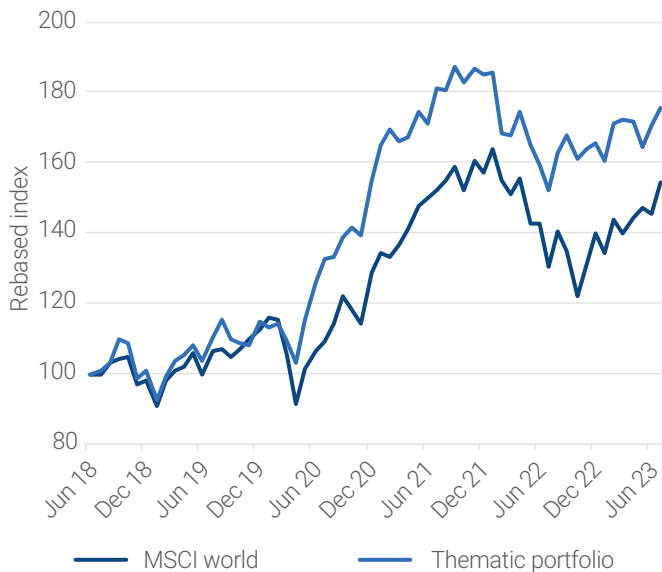
For charity investors looking to allocate to themes (and by doing so increase their holdings in areas such as renewable energy, clean water and healthcare technology), the key questions are where does it fit in the overall portfolio, and how much allocation might be appropriate?

Themes are long-term growth assets, with similar overall characteristics to equity benchmarks, which are therefore its natural comparator.

However, the percentage overlap with a conventional world index is low. The chart below shows deviations in historical performance over the past five years of a thematic portfolio and the MSCI World.

Correlation over this period is only 66%, highlighting potential diversification benefits from allocating to a multi-thematic portfolio.

### Historical performance of thematic investing vs MSCI World



Source: Bloomberg MSCI World Index and Solactive Global L&G Thematic Aggregate Index since Jun 2018. **Past performance is not a guide to the future. The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested**

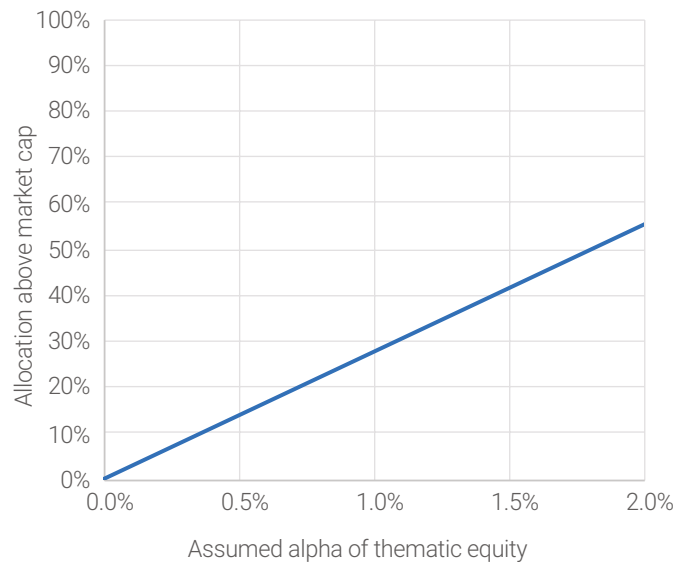
However, it is also important to note the limited availability of historical data. Even with a very long history, it is hard to prove the characteristics of alternative equity indices with a high degree of statistical significance.

6. We have modelled both index and thematic portfolio using a Black-Litterman model, with the goal to maximise the expected return per unit of risk (volatility). The model is calibrated using index information since June 2018 and our long-term assumptions of the equity risk premium.

As such, a multi-thematic portfolio relative to a global index requires belief that the aforementioned factors will outperform over the long term.

The question that then arises is how much belief, and how much do I allocate? To calibrate this, we have considered a charity investor whose portfolio consists of 100% equities and is deciding between allocating to a standard global developed equity index or themes. The investor is looking to 'optimise' the risk-adjusted return of their portfolio.<sup>6</sup> The chart below shows how much the charity investor should hold above the market cap in a thematic portfolio given their belief in the outperformance or alpha it offers over the standard market cap index.

### How much should I allocate to a thematic portfolio?



Source: LGIM as at 30 June 2023, Source: LGIM calculations. Uses a Treynor-Black approach applied to MSCI Daily TR Net World and SLGTHEME index monthly returns since the end of 2015. **Past performance is not a guide to the future. The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested**

Clearly, if you assume no alpha from themes, then you should just allocate in line with market cap if looking solely through a risk/return lens (this ignores the social aspect of themes detailed above).

However, the 'optimised' allocation quickly increases if you believe that it will outperform. For example, a 0.5% expected outperformance would indicate allocating c.15% of your equity allocation to a multi-thematic portfolio.

While this depends on investment belief, mathematical models utilised and historical characteristics continuing, the overriding message is that a little bit of faith can go a long way.

## LGIM’s expertise in thematic investing

### What sets us apart

#### Unique themes:

We identify growth themes that are driving structural and foundational changes to society – we focus our efforts on the themes we truly believe in, not the latest fads.

#### Expert research:

We partner with leading industry experts that provide unique market insights and research, whose insights are implemented by an experienced ETF team.

#### Investment strategy:

Intelligent investment strategy that captures each theme through a disciplined, transparent approach, resulting in low overlap, diversification and purer exposure to underlying themes.

#### ESG screening:

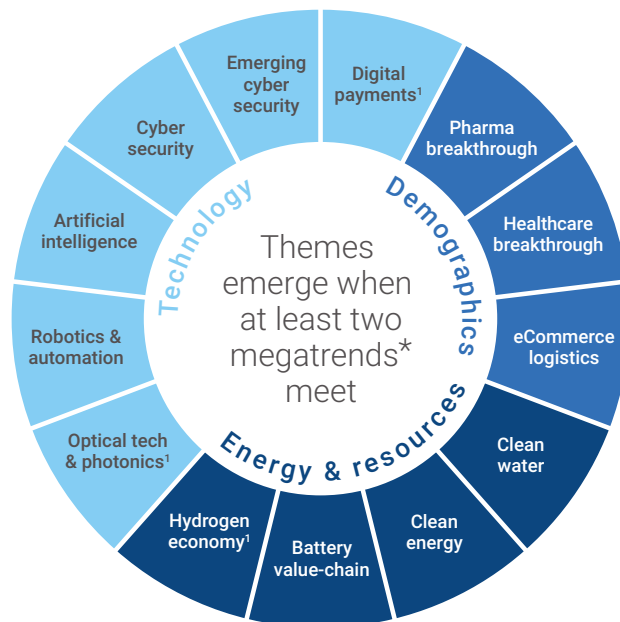
The fund excludes companies engaged in harmful activities through each building-block Thematic ETF, which all have an ESG overlay implemented at its individual index level.

#### Cost:

The total expense ratio of the fund is 60bps, which includes the cost of trading the fund of funds.

## How themes are selected for the fund

Our approach to thematic investment is driven by our belief in three ‘megatrends’ that are propelling fundamental changes in how we live.



\* Megatrends refers to energy and resources, demographics and technology.

#### For illustrative purposes only

1. These investment strategies are not yet eligible to be included in the Unit Trust.



## Contact us

For further information about LGIM, please visit [lgim.com](https://lgim.com) or contact your usual LGIM representative



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### Key risks

The value of investments and the income from them can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance.

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