

PERSPECTIVES

THEMATIC FUNDS: IS SUCCESS HERE TO STAY?

It goes without saying that the past five years have been particularly challenging for active equity managers. While investment performance has been fueled by strong bull markets, fund proliferation and competition from passive have led to fierce competition and increasing fee pressure.

But one bright spot for asset managers has been the significant success and popularity of thematic equity funds. Are they here to stay?

With the many market-shaking events of 2022, the investment category is being challenged, both with regards to net flows and due to increasing skepticism because of the underlying portfolio style biases to which the strategy lends itself.

A look back on thematics' recent success may help us understand the key market factors and overall sentiment that led to the investment category's achievements—and how the asset management industry should approach this opportunity moving forward.

The historical playbook - what led to success?

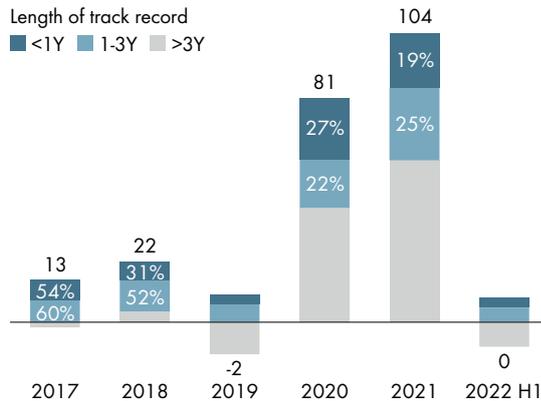
Thematic investments started as an extension of sector funds, with a new framework allowing for portfolio construction across structural trends. While not new, they experienced a "boom" since 2019. Total AuM more than doubled in less than 3 years. Two thirds of AuM growth stemmed from net inflows, primarily in the retail segment, where the "storytelling power" of these products play to the hands of distributors. Success was further accelerated by the following factors:

- The focus on sustainability has led to an emergence of a key investment "theme", which attracted significant inflows (up to €50bn+ in 2021);

- An agile product development process, in combination with an aggressive "always-on" marketing and sales platform, enabled thematic leaders to gain a head start over competition by offering a comprehensive suite of funds that catered to investor interests.

For such leaders, thematics have consistently proven their ability to fast-track asset gathering. Over the past five years, more than half of net inflows came from products with track records below three years, which is highly unusual for an industry well known to respect this criterion.

Net flows for active thematic equity funds by inception (2017-2022 H1) [in €bn]



Sources Morningstar, Indefi analyses.

New challenges for thematics

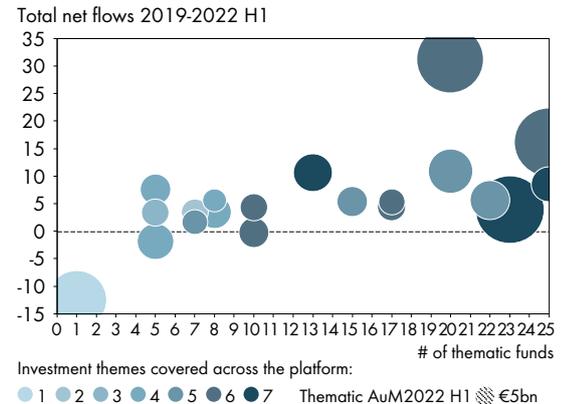
Indefi predicts several upcoming challenges for thematic funds heading into 2023 and beyond. Market volatility is expected to persist as economies may face recession and new monetary policies come into place. We believe thematic fund leaders will need to focus on the following to solidify continued success moving forward:

- *Diversifying client bases.* Historically, compared with retail clients, institutional investors have shown limited appetite for these relatively volatile investment propositions, but for those ESG-focused. As sustainability continues to take center stage, asset owners should offer new sources of capital to launch and grow these strategies.
- *Rebalancing risk profiles.* Thematic fund leaders should acknowledge the growth bias of their funds, which has been a core engine of performance over the past three years, and diversify their set of strategies to appeal to a wider audience.
- *Effectively managing the risk of overdrive and the churn rate.* While thematic funds offer fast-tracked asset gathering, they also highlight the volatility of flows and the surge of new fund themes being launched at peak valuation levels. This list of themes is not finite. It's important to note that highly niche themes will lead to constraints related to sector biases and capacity issues.

Advice for asset managers - how to tackle thematics onward

To be clear, thematics are here to stay. They have proven their competitiveness versus other equity categories, even in 2022. Considering the following

Top 20 largest active equity thematic platforms (2019-2022 H1) [in # & €bn]



Sources Morningstar, Indefi analyses.

factors will help managers drive success in the current market environment:

- *Sustainability as core.* Asset managers should adopt a barbell approach to their thematic platforms and specifically consider sustainability-linked funds that are supported by resilient growth drivers as a core, while simultaneously leveraging a select number of new and topical themes as satellites. Investors, both retail and institutional, are expected to continue to value non-financial returns when making investment decisions, and specifically consider the actions of European regulators, who have impacted the fund management industry profoundly with recent sustainability-linked regulations.
- *Client-centric solutions.* Thematic funds form natural building blocks that allow for highly individualized solutions. Developing tailored asset allocation capabilities and services for distributors will prove to be a key competitive advantage for asset managers. This capability will also become increasingly critical following the implementation of MiFID II's sustainability preference requirements, which mandates distributors to ensure that client sustainability preferences are implemented in their portfolio. Hence, close collaboration with distributors will be key in identifying an optimal thematic fund line-up aligned with end-investor demand.
- *Multi-asset products.* Thematic funds started off with liquid equity strategies, but there are growing opportunities to implement new ways of building and delivering multi-asset products with both liquid and illiquid elements. Increasingly diversified risk/return profiles, in combination with various investment themes, allow for multiple new opportunities to actively achieve a differentiated positioning in the space.

Indefi is a leading strategy advisor for the global investment management business. Established in 2007, Indefi helps asset managers shape their business strategies and build a sustainable competitive advantage. The firm's expertise spans public and private markets, including infrastructure, private credit and equity, and real estate. A pioneer in advising asset managers on ESG development and integration strategies, Indefi is a PRI signatory. For more information, please visit www.indefi.com.