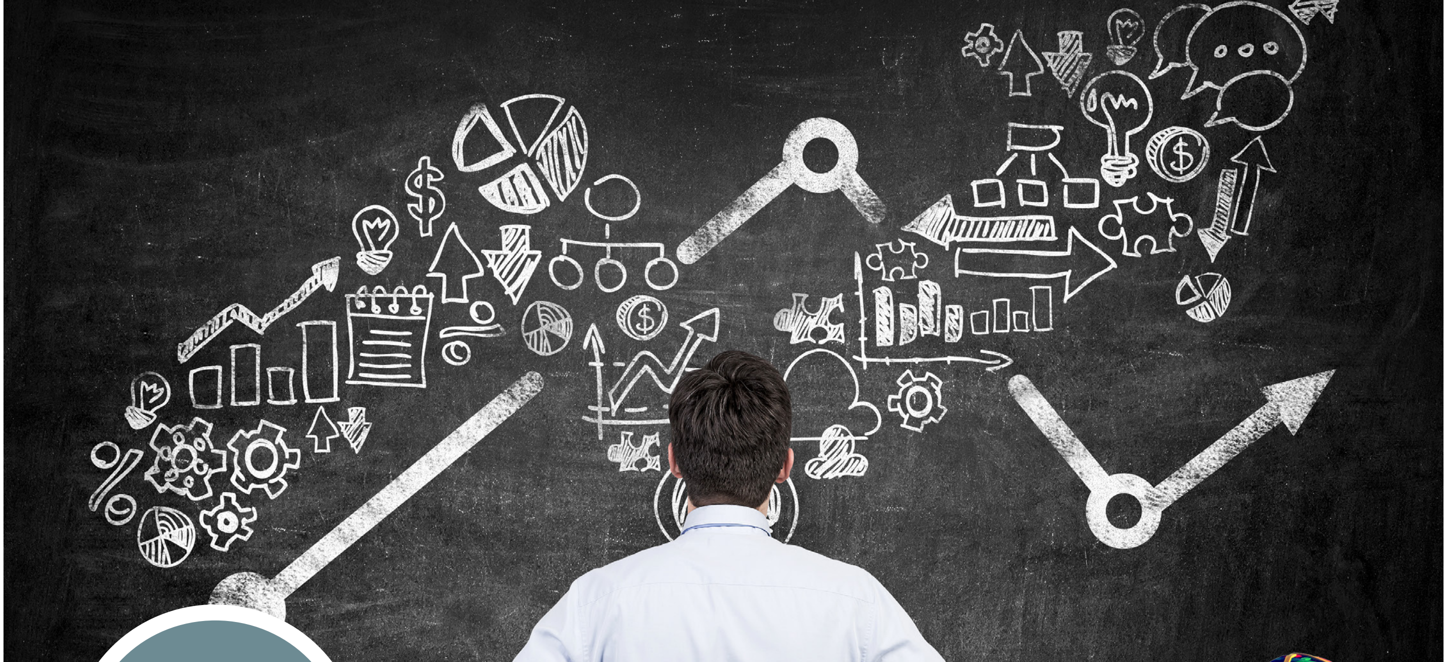
MARCH 2017

THE RISE OF THEMATIC INVESTING



MARCH 2017
WHITE PAPERS

WEALTHMANAGEMENT

Over the past few years, a number of structural economic changes—a persistent bout of historically low interest rates, the polarization of growth between developed countries and emerging economies, and global deleveraging—have affected how Investment Advisors (IAs) deploy client capital.

The "metabolic rate" of the economy is also accelerating as industry dynamics evolve faster than ever and profit pools shift across value chains in many industries, thanks to unprecedented technological innovations. Life-changing developments such as driverless cars are years, not decades, away.

In this environment, many IAs have begun to question the traditional "relative investment" frameworks that have been in pace for nearly 30 years. This decades-old discipline is mostly structured around either adhering to or deviating from benchmarks and indexes to either increase returns or limit downside risk. Traditional investment frameworks often fail to achieve the specified rate of absolute return, for three reasons:

1. The short-term focus of quarterly benchmarking works against IAs. One of their great advantages, in our opinion, is their long-term investment horizon. A zealous focus on the benchmark means investors can miss chances to capture mispriced assets. They can also miss out on the liquidity premium, which they collect by buying illiquid long-term assets at a discount.

2. Relative-investment frameworks can lead to an undesirable exposure to certain risks.

3. The very nature of the strategic asset-allocation process investors have used to select benchmarks also holds those investors back. Strategic asset allocation is backward-looking and fails to incorporate emerging trends (themes) and forward-looking perspectives on the economy.

Many Registered Investment Advisors, like WT Wealth Management, are turning to "thematic" investment strategies for portions of our clients' assets when we construct portfolios. That was one of the most intriguing insights we gleaned from a series of interviews we conducted with about a dozen institutional investors, including investors in pension and sovereign-wealth funds. Broadly speaking, thematic-investment approaches

THEMATIC INVESTING CONTINUED ON P2

seek to capture, across asset classes and around the world, the opportunities created by long-term structural trends and the medium-term cyclicality often associated with these trends.

Some managers, like WT Wealth Management, have deployed thematic strategies for years. We appreciate the way this enables us to actively manage risk and to ensure deployment of client capital against the opportunities that best reflect our clients' investment objectives and personal risk tolerance. However, many institutions have not yet taken advantage of such approaches. In this white paper, we outline the process by which we develop and execute thematic-investing strategies in our client accounts.

DEMYSTIFYING THEMATIC INVESTING

Thematic investing requires a fundamental understanding of the impacts of long-term economic, political and social trends on regions and sectors—and such an understanding reveals investable opportunities. Thematic managers develop proprietary views on how the second- and third-order effects of structural trends will create hot-spots or discontinuities in certain sectors and regions in which value and risk will be concentrated.

This is a big departure from relative, traditional strategies. Exhibit 1 illustrates some of the differences.

	Relative framework	Thematic framework
Asset allocation	Asset classes as building blocks	Sector and country exposure as building blocks (matrix view)
Portfolio construction	Weight of asset classes in portfolio based on economic cycles and market conditions	Selection of themes, sectors, or regions across asset classes based on underlying market trends
Alpha generation	Based on security selection relative to an index	Based on selecting groups of companies that will benefit from long-term support of structural trends
Decision process	Portfolio managers allocate capital within defined mandates	Investment committee arbitrages opportunities across themes
Investment performance	Measured relative to an index (typically on an annual basis)	Measured against an absolute target or a risk-adjusted index (over a 3- to 5-year rolling history)
Expertise	Investment professionals with experience in a given asset class or sector	Investment professionals with a combination of in-depth regional and sector experience across asset classes
Research	Typically occurs within portfolios, with research performed at security level	Central group develops house views on priority themes and opportunities for institution

Exhibit 1: Relative and thematic frameworks differ in several dimensions.

DEMYSTIFYING CONTINUED ON P3

In our opinion, adopting a thematic-investing approach can yield three types of benefits for investors:

1. Such an approach allows managers to generate alpha, at scale, by focusing on investment opportunities in hot-spots where capital can be deployed.

2. The more systematic investment process and in-depth research required for thematic investing builds a deeper understanding of the underlying drivers of value creation and risk. Managers can use this knowledge not just in thematic investing but also in other strategies.

3. The thematic-investing approach gives managers a dynamic, flexible way to validate and express their hunches by applying a forward-looking lens to investment decisions.

Managers have long been aware of thematic investing, but many have thought it too complex to implement because of restrictive portfolio structures, risk limits, and the challenge of putting in place the capabilities and processes needed to develop truly distinctive investment insights. In recent years, however, a number of managers have taken tactical and creative approaches to implement some form of thematic investing, usually as an addition to their overall investment frameworks.

Exhibit 2 illustrates four of these approaches.

	Approach	Example
Lower commitment to thematic strategy	**Develop thematic views within existing structure** Develop and implement thematic investments within the risk limits and structure of the current portfolio	Use current risk limits in an international equity portfolio to increase exposure to specific solar-module producers in response to a renewable-energy theme
	Put in place a thematic overlay From the center, establish a thematic-overlay portfolio or shift asset allocations and increase their duration based on house views on sector/geography	Gain long-term exposure to wheat price by investing in wheat futures as part of a thematic-overlay portfolio
	Create a single-asset-class thematic mandate Allocate capital to portfolios or mandates with investment strategies that rely on developing forward-looking thematic views	Create and capitalize an equity portfolio with a clear purpose of gaining long-term exposure to renewable energy
Higher commitment to thematic strategy	**Create a multiasset-class thematic mandate** Create a thematic fund to generate the most attractive long-term risk-adjusted returns by investing in various asset classes	Create a portfolio—governed by a multiasset-class committee—looking into technology investments through a combination of venture-capital funds, direct private-equity investments, and public-equity positions

Exhibit 2: Institutions are using a range of approaches to develop thematic-investing strategies.

EMBARKING ON THE JOURNEY

The systematic change to fold a thematic strategy into a relative-investing framework is good news for investors, as many managers have held back because they did not wish to completely overhaul their approach or their portfolio. But thematic investing still requires the right research capabilities and a disciplined investment process. WT Wealth Management has dedicated substantial resources to developing our thematic approach to investing and the subsequent strategy.

A structured, rigorous approach to thematic investing is required, not only to identify investable themes, but also to prioritize them. The following five-step approach does both, and has been implemented by a number of leading thematic investors.

1. Consider the trends

Identifying the right trends to consider is essential. At this early stage, broad internal dialogues make sure all relevant trends are considered, in order to gain agreement on the rationale that will be used to prioritize and ultimately select some trends for more research so trends can be prioritized. A few questions must be considered when prioritizing trends:

- Is the trend really structural, or is it conjectural or short term in nature? Does it have material implications for the evolution of certain sectors or regions?
- Does the institution have the ability to generate distinctive insights about that specific trend and identify sufficient investment opportunities?
- Are research and investment professionals excited about the trend and willing to invest time looking into it?

At this stage, managers should also develop a robust view of the institution's explicit and implicit exposure to the selected trends before adding more long-term risk to the portfolio. For instance, an Australian manager may not own shares in companies serving China's rising middle class, yet a commodity-filled Australian equity benchmark can significantly expose that same investor to a slowdown in Chinese consumerism. In a nutshell, managers must ensure that they understand their true exposure—both direct and indirect—to these trends before conducting additional analyses and seeking greater exposure.

2. Move from trends to themes

Once key trends have been selected, managers must trace them through to the themes they produce—typically the implications for a region or sector of interest. With the increased developments in driverless cars and drone technology, literally dozens of companies could benefit from this widespread implantation into American and world society. In our experience, the most attractive opportunities are found when multiple themes converge and reinforce one another in a specific region or sector and when themes are expressed as discontinuities and divergences from common knowledge.

The identification of relevant themes depends on a manager's ability to rapidly identify a trend's impacts on revenues and profit pools in affected subsectors. Making sense of vast amounts of information and identifying new economic patterns is difficult. Most successful managers use external experts as thought partners and sounding boards to supplement their internal knowledge. Our experience also suggests that managers who can rapidly move from interesting trends to themes before trying to identify specific investment opportunities move faster, get more impact from their research investments, and develop more detailed insights.

EMBARKING ON THE JOURNEY CONTINUED ON P5

3. Select themes

Prioritizing themes is even more challenging, as managers must make decisions based on imperfect information and diverging points of view within the institution. The process can be time-consuming and frustrating without the right approach but rapid and effective if appropriately designed.

To succeed at this key stage, institutions typically agree first on simple criteria based on their risk/return profile and capabilities to invest in a distinctive way. This boils down to seven questions that should be asked about each theme:

- Is the theme investable? (Managers should assess the theme's high-level attractiveness and make sure there are ways to deploy capital against it at the ground level.)
- Are there companies whose businesses are heavily exposed to the theme?
- Are there other assets that might do well if the theme materializes?
- Can potential investments be made without running excessive risk?
- What is the risk that the theme will not materialize? (The focus should be on countervailing forces and what they might mean for a potential investment. Investors typically try to avoid binary outcomes, as those present higher risks.)
- Does the institution have the capabilities to differentiate itself? (Factors such as distinctive knowledge, market access, a superior understanding of the assets and their value chains, and existing relationships with or privileged access to the right partners should all be considered.)
- Does the theme fit within the current portfolio construction and investment policies? (Choosing themes whose potential investments can be easily integrated and monitored within the investment structure enables investors to move rapidly and focus on building capabilities rather than addressing governance issues.)

Themes should be debated and prioritized by representatives from the investment, research and risk teams to ensure both the soundness of the thinking and the alignment of the theme with the overall corporate perspective. This will prevent thematic portfolios from becoming vehicles for individuals to place large bets based on their personal biases.

4. Develop an investment thesis

Once priority themes have been identified, managers must form an investment thesis describing how and why value could be created from these themes over time. This typically involves three stages:

1. Managers develop an understanding of the value chains associated with a given theme, including the key players, industry dynamics, and performance drivers.

2. They develop a perspective on how industry dynamics will be altered by the theme, forcing players to adapt and creating winners and losers. To be successful at this stage, managers must first ensure that their thesis is clear, grounded in objective facts, and based on themes that have a high degree of probability of materializing.

3. They must find insights into business systems beyond those most directly affected by the theme. For example, an investor looking into the impact on the transportation sector of populations migrating to suburbs from large city centers may determine that the best investment opportunity will be in the manufacturers of batteries that will power light trains rather than in the transportation companies themselves or in the related infrastructure.

EMBARKING ON THE JOURNEY CONTINUED ON P6

EMBARKING ON THE JOURNEY CONTINUED

5. Build the portfolio

With a clear investment thesis in mind, managers can start a "scan and screen" process across asset classes to find the best ways to take a position in the theme. Several characteristics mark the most distinctive investors at this stage:

- A clear perspective on the factors that will lead to success (that is, a concrete understanding of how value will be created and in what time frame);
- A list of potential targets that is systematically assessed against the success factors and monitored over time to find the right entry (and exit) points;
- A selection of investments that have both high exposure to the theme and solid industry fundamentals to offset the potential long-term nature of the investment and the risk that the theme will take time to materialize;
- A clear investment approach—likely a set of discrete investments, a portfolio of related assets, or a platform for operations and subsequent roll-up acquisitions;
- Finally, depending on the size of the portfolio and the number of investments it includes, additional consideration might be given to the level of correlation of the various assets, as well as the key sensitivities of specific thematic risk factors.

Thematic investing provides an alternative to traditional strategies—one that leverages the greatest strengths of institutional investors while providing the opportunity to develop proprietary knowledge and informed opinions. By understanding implicit sector exposures and then determining where and how to invest based on well-researched and debated themes, institutions increase their chances of delivering superior returns over time in an increasingly complex investment landscape.

CONCLUSIONS

At WT Wealth Management, we divide most investors' portfolios into three distinct pools: (1) core investments, (2) individual equities, and (3) sector/themes:

1. No portfolio should be constructed without a sound base. The core portion of client portfolios, comprising exchange-traded funds (ETFs) allows clients to participate in rising markets while out-performing in declining ones.

2. Depending on portfolio size, individual equities are our best picks. Companies in this group need to be culturally significant and dominant within their industry, and they need to have large barriers to entries and wide moats to keep new players out. If we have gotten to the point where the company is so entrenched in consumer culture, we like it. It could be Adobe, Amazon, Facebook, FedEx, Google, MasterCard, Starbucks, UPS, and Visa, among others.

3. We allocate portions of client portfolios to our best themes/sector ideas. We focus on identifying sectors, industries and related themes that we believe will outperform in the next 12-24 months, which is paramount to our client's success. It could be an allocation to technology, biotech, financials, semi-conductors, regional banks, aero and defense companies, virtual reality, 3D printer technology, cyber technology, electronic payment systems, or maybe even cloud technology.

This triad of different and unique strategies within one portfolio is what makes WT Wealth Management different from other financial services firms. Having three unique strategies within one portfolio delivers little overlap and expedites the selection process, and the strategies complement each other in constructing a well-rounded, fully diversified portfolio—which is always our goal at WT Wealth Management.

DISCLOSURE

WT Wealth Management is a manager of Separately Managed Accounts (SMA). Past performance is no indication of future performance. With SMA's, performance can vary widely from investor to investor as each portfolio is individually constructed and allocation weightings are determined based on economic and market conditions the day the funds are invested. In a SMA you own individual ETFs and as managers we have the freedom and flexibility to tailor the portfolio to address your personal risk tolerance and investment objectives – thus making your account "separate" and distinct from all others we potentially managed.

An investment in the strategy is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency.

Any opinions expressed are the opinions of WT Wealth Management and its associates only. Information is neither an offer to buy or sell securities nor should it be interpreted as personal financial advice. You should always seek out the advice of a qualified investment professional before deciding to invest. Investing in stocks, bonds, mutual funds and ETFs carry certain specific risks and part or all of your account value can be lost.

In addition to the normal risks associated with investing, narrowly focused investments, investments in smaller companies, sector ETF's and investments in single countries typically exhibit higher volatility. International, Emerging Market and Frontier Market ETFs investments may involve risk of capital loss from unfavorable fluctuations in currency values, from differences in generally accepted accounting principles or from economic or political instability that other nation's experience. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Bonds, bond funds and bond ETFs will decrease in value as interest rates rise. A portion of a municipal bond fund's income may be subject to federal or state income taxes or the alternative minimum tax. Capital gains (short and long-term), if any, are subject to capital gains tax.

Diversification and asset allocation may not protect against market risk or a loss in your investment.

At WT Wealth Management we strongly suggest having a personal financial plan in place before making any investment decisions including understanding your personal risk tolerance and having clearly outlined investment objectives.

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