The case for an allocation to thematics in long-term portfolios

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Thematic investing can offer a different lens through which to identify long-term opportunities across sectors and geographies. This Thought Piece considers how themes develop into investable ideas, how T. Bailey looks for inflection points and why valuation, diversification and risk remain central to the process.

Traditional investing looks for opportunities within a defined sector or geography, such as technology or UK equities.

In contrast, thematic investing offers asset managers another lens with which to view the investable universe. It does this through analysing multi-decade trends and structural shifts to identify investment opportunities regardless of sector or geographic boundaries.

For example, a structural shift, such as an ageing population or the transition to a lower-carbon economy, cuts across multiple sectors and countries simultaneously, and a portfolio sticking solely to traditional boundaries can miss, or only partially capture, the companies best placed to benefit.

In practice, the two approaches are rarely treated as opposites. A thematic allocation is typically held alongside, rather than instead of, more conventional regional or sector positioning.

A 'nebulous concept'

The forward-looking and ever-evolving nature of thematic investing, however, means it can be "something of a nebulous concept" for investors to fully grasp, says T. Bailey Asset Management CEO Elliot Farley.

In the interests of keeping things simple, it can be broken down into three broad levels:

1. Megatrends

The term 'megatrend' dates to 1982 when US author John Naisbitt came up with 10 large-scale, transformative social, economic, political and technological processes with global reach and a long duration that were expected to shape society over the decades to come.[1]

[1] Naisbitt, John, Megatrends: Ten new directions transforming our lives (1982) (The 10 megatrends are: Industrial society to information society, Forced technology to high tech/high touch, National economy to world economy, Short term to long term, Centralisation to decentralisation, Institutional help to

Thirty years later, PwC produced its own list of five forces disrupting the economy, business and society[2]: namely climate change, technological disruption, demographic shifts, fracturing world and social instability.

Firms across financial services can have their own interpretation of what constitutes a megatrend, meaning there is no consensus on how many there are and what to precisely name them.

They are overarching categories that describe the ways in which the world is changing, for better and for worse.

2. Themes

Each megatrend can be broken down into a series of themes, which is where the theoretical becomes practical, or, more specifically, investable.

Asset managers take a top-down approach and seek to identify and assess opportunities that span sectors, industries and geographies. For example, the megatrend climate change can be approached from multiple angles of opportunity, such as energy supply, waste management, access to water etc.

Themes can also ladder up to multiple or even all megatrends. Arguably, there is not an area that is insulated from AI advancements.

3. Sub-themes

Each theme is then made up of sub-themes, which inform and guide the ways individual asset managers seek to invest.

For example, the theme of healthcare (which can sit under the megatrend demographic shifts) can be accessed via infrastructure (building hospitals), pharmaceuticals (drug development), and even AI (improved scanning and diagnostics).

In a nutshell, megatrends and themes are fixed for extended periods because they reflect the trajectory of global transformation. Sub-themes are more changeable because they represent arising investment opportunities and global developments.

This layered structure is what allows fund managers to combine a long investment horizon with tactical flexibility.

Not about being a dedicated follower of fashion

Modern use of the word ‘trend’ has made it synonymous with short-term popularity, and it is important for investors to understand that thematic investing is not about chasing fads.

"Thematic investing is a way of broadening how you look at equities and think more long-term about how you're positioning portfolios," says Farley. "People can conflate a theme being popular with it delivering value for a portfolio. But the two are very different."

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self-help, Hierarchy to networking, Representative democracy to participatory democracy, North to south, Either/or to multiple option.)

[2] https://www.pwc.com/gx/en/issues/megatrends.html

When a theme becomes trendy, the T. Bailey team knows to tread cautiously.

For example, as a means of helping people live healthier lives, weight-loss medications such as Novo Nordisk's Wegovy and Eli Lilly's Mounjaro have been a game changer.

As an investment, however, things are less clear cut, Head of Equities Ben Ridley explains: "As active fund of fund managers, we have conversations with generalist and specialist managers, including those who run healthcare funds.

“You can see the benefits of this new drug, that isn't in question. But what about pricing? What is the strategy of the big providers? Is it going to be a race to the bottom? How will the market react if pricing is weaker than last year or last quarter? Will there be more competitors coming into the market? Is the regulation going to change?"

For T. Bailey, the lack of transparency plus the uncertainty among investment specialists is sufficient cause to think twice, no matter how compelling the story.

Ridley frames it as a matter of portfolio construction as much as stock selection: a thematic allocation, in his view, is only worth holding if it avoids simply trading one form of concentration for another, and stepping back from a compelling but opaque story is as much a part of that discipline as the positions the team does take.

How to identify themes worth pursuing

When it comes to how much investors understand about how thematic investing works in practice, Ridley notes there are still some knowledge gaps: "Some people think it involves picking from a laundry list of themes, such as defence or renewable energy, then you sit back and hope they perform well. That's absolutely not the case."

The investment team running the T. Bailey Global Thematic Equity Fund, which was launched in 1999, approaches thematic investing as a dynamic and continuously evolving process, not a static allocation to long-term growth trends.

"Thematic investing is a lens we use to see the world and the investable universe. We take an interesting theme and look at the value chain to determine where the profit pool lies," adds Ridley.

"It's never a case of someone in the team saying they like a particular theme. It's about identifying an inflection point and understanding where the industry or sub-industry is, in terms of its capital cycle," he adds.

Themes are identified through a global opportunity set and may include secular growth drivers, such as resource efficiency or demographic change, and more cyclical dislocations, including sectoral, regional or macro-driven opportunities.

The objective, says Ridley, is to identify themes with the potential to generate attractive risk-adjusted returns over varying time horizons.

"We look for businesses where the theme is driven by an oligopolistic set of companies, the return profiles are very robust, and the economic moats are strong. As fund of fund managers, we identify active managers who are invested in that pool and believe the valuations and risk/reward of those

companies are attractive," he adds.

"Markets tend to price in a fade when it comes to future earnings and the managers we're investing in believe the return profiles will be higher for longer, which means improvement in the share price and the multiples," says Ridley. "The market also always assumes competition is going to come in or regulation or technology will change."

These inflection points can sometimes take years to play out. As Ridley and Farley both note, that means the approach works best for investors prepared to stay invested for the long term rather than trading in and out as sentiment shifts.

Finding the inflection points

The capital cycle is also a strong indicator when it comes to identifying areas where companies have either been starved of capital or are suddenly awash with cash.

"For the former, it means the downside risk is limited," Ridley explains. "For the latter, it's about looking at where in the value chain that capital could be deployed."

A good example of where capital proved elusive and valuations remained cheap was Japan, which the T. Bailey team has had exposure to in the Global Thematic Equity Fund for many years.

"Historically, the ROE from Japanese companies was very low," says Ridley. "This was reflected in the valuation multiples the market was putting on firms, in terms of the price to book."

The inflection point came when the Tokyo Stock Exchange (TSE) introduced its capital efficiency initiative in 2023, requesting companies publish plans on how they were going to improve their valuations.

There have been multiple instances in the past decade where market commentators predicted the return-to-favour of Japanese equities, but turnarounds inevitably proved short-lived. The TSE-driven initiative proved to be a genuine inflection point that resulted in a tangible incentive to demonstrate proactivity to shareholders.

Similarly, UK banks have had a very low return profile and been starved of capital for many years. "But the ability to return excess cash to shareholders through buybacks and growing dividends, plus other measures, has seen UK banking stocks perform very well over the past few years," Ridley explains.

He cautions that this theme has likely run its course but describes it as a prime example of a sub-theme that reached an inflection point where the market view was challenged.

As with Japan, the pattern he points to is an under-owned, capital-starved area of the market re-rating once the constraint holding it back eased, something he says the team look to identify before it becomes consensus.

Weighing the risks

No investment approach is risk free. When it comes to thematic funds, exposure can become concentrated in a narrow set of ideas or companies, they can carry higher fees than broad market exposure, and there is a real risk of buying into a theme once it has already become consensus

and priced accordingly, rather than at the inflection point that makes it attractive.

To address these challenges, T. Bailey's Global Thematic Equity Fund aims to provide access to a broad and evolving global opportunity set across themes, sectors and geographies, with diversification across multiple themes intended to reduce reliance on any single stock or sector.

When it comes to late entry, the team's primary objective is to identify managers investing in areas starved of capital or awash with cash before that dynamic is reflected in price, rather than after.

And the decision to step back from weight-loss drugs, despite a compelling underlying story, is the clearest evidence Ridley offers that popularity and value are treated as separate questions in practice, not just in principle.

"Our approach is a risk-conscious one," says Harry Forman Hardy, Client Portfolio Manager. "It involves evaluating opportunities from a downside view, prioritising growth and long-term capital preservation.

"While an investment, on paper, may seem incredibly attractive and look like it's flying, if the investment case doesn't stack up and the sector is in the wrong part of its capital and structural cycle, it will not merit inclusion in our portfolio."

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