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AlphaCurrents

Five Rules of Thumb for Thematic Investing

Denny Galindo, CFA
Investment Strategist
Denny.Galindo@morganstanley.com

James Ferraioli
Investment Strategist
James.Ferraioli@morganstanley.com

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What is thematic investing? Broadly speaking, it's about uncovering big ideas—emerging trends and innovations that have the potential to shape the future, impact industries, drive market action and present opportunities for investing.

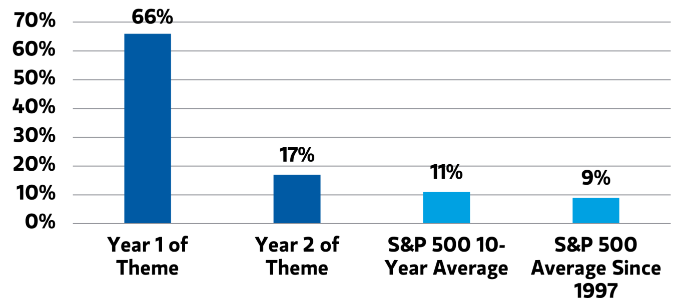
Thematic investing has gained popularity in recent years as exchange-traded funds (ETFs) have become more widely used, technology has disrupted many industries and momentum investing has gained mindshare among value investors. In this approach, investors hope to identify a durable theme, create a basket of investments tied to it and either buy and hold or dollar-cost-average until the theme no longer seems relevant.

It's generally understood that identifying themes early can be critical to maximizing returns, but there isn't a broad consensus around the structure of thematic investing. Themes may also be difficult to spot if there are no obvious catalysts, whether in technology or policy. That said, Morgan Stanley & Co. Research has studied decades of thematic investing data and outlined five general rules of thumb. We discuss them here, based on the April 10 report, "The Art and Science of Picking Themes," and share our favored investing ideas as we apply the rules to the current environment.

Rule 1: History Says It's Better To Stick With Outperforming Themes Than To Pivot to New Ones

The MS & Co. thematic research team studied whether it was better to hold on to investments related to a theme that's working (and risk selling too late) or attempt to find and pivot to a new theme (and risk being too early). Data over approximately the past 30 years supports the former approach. Since 1997, the best-performing themes of each year returned 66%, on average (see chart). In the subsequent year for the respective themes—or their "Year 2"—returns averaged 17%. In other words, even if investors were initially late to a developing theme, if they began investing in it and held through the year following its best year, history suggests they still would have seen double-digit returns—typically comfortably ahead of those of the S&P 500 Index.

Leading Themes' Returns Versus S&P 500 Returns



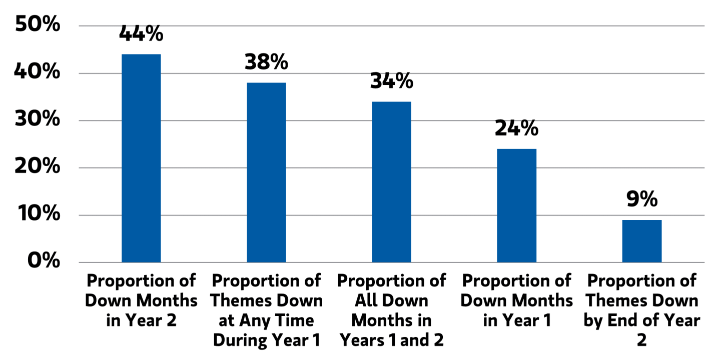
Note: S&P 500 Index data is as of Jan. 31, 2024.
Source: Refinitiv Eikon, Datastream, Solactive, S&P Global, Morgan Stanley & Co. Research, Morgan Stanley Wealth Management Global Investment Office as of June 25, 2024

Opportunity: Applying this rule to the current environment, "powering artificial intelligence (AI)" appears to be an emerging theme that may be a viable investing opportunity for at least another year. Increased power and data center demand will likely impact a wide array of sectors, and beneficiaries may include fuel cell manufacturer Bloom Energy (BE) and solar systems maker First Solar (FSLR). Broader infrastructure exposure may be achieved via ETFs such as First Trust NASDAQ Clean Edge Smart Grid Infrastructure Index Fund (GRID).

Risk: Data center growth may not keep up with demand, while changes in policy and supply chain disruptions can impact companies' operations and profitability.

Rule 2: Volatility Picks Up in the Second Year

While returns may be solid in Year 2, studies showed that volatility does tend to pick up, leading to diminishing risk-adjusted return prospects. In aggregate, years following peak performance tended to see a major deterioration in Sharpe ratios. That said, MS & Co. Research analysts say the risk of calendar-year drawdowns for leading themes is less than what they had previously assumed. In the year in which themes performed best, only 24% of months were down (see chart). And among the themes observed, only 9% were down by the end of two years of buy-and-hold.



Source: Refinitiv Eikon, Datastream, Solactive, S&P Global, Morgan Stanley & Co. Research, Morgan Stanley Wealth Management Global Investment Office as of June 25, 2024

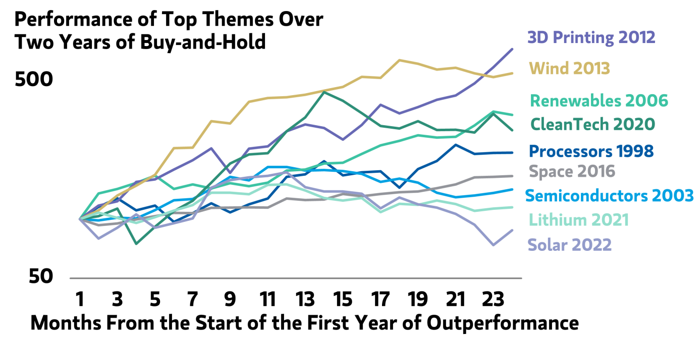
Opportunity: We may be in Year 2 of the theme around the GPU technology underlying AI. There's been some volatility among chipmakers recently that may portend more ahead. That said, history suggests established themes take time to unwind. With this in mind, stocks that may have more runway to deliver positive performance include AI enablers such as Nvidia (NVDA) and Advanced Micro Devices (AMD).

Risk: The appeal of AI enablers may be strong enough to cause investors to hold on to or add exposure to the theme even as their portfolios potentially face heightened volatility.

Rule 3: Sustainability Themes See More Extremes

Data suggests sustainability-related themes such as alternative energy have experienced greater extremes while tech themes have seen a relatively narrow range of returns (see chart). Sustainability themes have been among the biggest outliers to the upside, while they've also been more likely to mean-revert to the downside in Year 2. There is not a simple explanation for this empirical finding, though for certain themes, profit margins and interest rate volatility may be contributing factors.

Interestingly, research shows that many performance reversals occur in January. This inflection point was particularly relevant for themes that were up or down at least 20% the prior year. With greater downside likely in sustainability themes once they do reverse, it may be prudent to take gains in such themes earlier in the year.



Note: Performance of select top themes over two years is rebased to the start of the first year of outperformance. The Y-axis is set to a logarithmic scale.
Source: Refinitiv Eikon, Datastream, Solactive, S&P Global, Morgan Stanley & Co. Research, Morgan Stanley Wealth Management Global Investment Office as of June 26, 2024

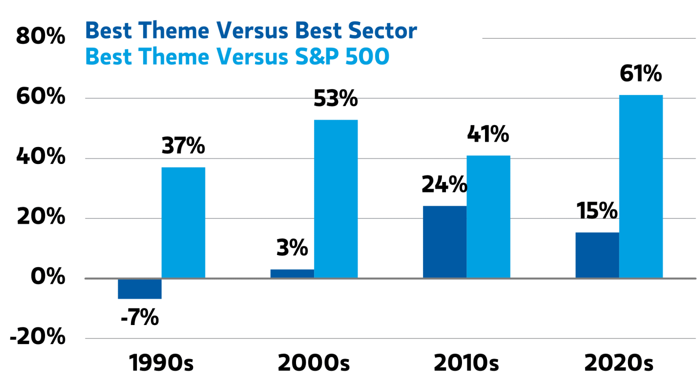
Opportunity: With large tech companies making net-zero commitments and looking to secure clean energy resources amid the AI boom, data center and infrastructure investments will likely pair with clean energy efforts. Beneficiaries of such a backdrop may include large-scale renewable developers AES (AES) and NextEra Energy (NEE), plus related funds like iShares Global Clean Energy ETF (ICLN) and Invesco WilderHill Clean Energy ETF (PBW).

Risk: Policy may pose a challenge to sustainability-related themes. A Republican sweep in this year's US elections, for instance, could put clean energy incentives and investments at risk.

Rule 4: Momentum Is a Key Factor

Data suggests momentum is a key driver of thematic performance. In comparing best-performing themes with a wide array of factors, MS & Co. Research has found that themes tend to be most highly correlated with a clutch of momentum factors—with the highest correlation being with short-term momentum. By extension, themes were most negatively correlated with short-term momentum reversals. Meanwhile, they were generally negatively correlated with valuation metrics, such as price/earnings ratios and free cash flow yield.

Perhaps helped along by momentum, best-performing themes have also generally extended their degree of outperformance versus the broader market and leading sectors. As shown in the chart, in the 1990s, the best themes outpaced the S&P 500 by 37%, a lead that has widened to more than 60% in the 2020s.



Source: Refinitiv Eikon, Datastream, Solactive, S&P Global, Morgan Stanley & Co. Research, Morgan Stanley Wealth Management Global Investment Office as of June 25, 2024

Opportunity: The momentum factor is having a strong year, with the S&P 500 Momentum Index up about 34% for the year to date as of late June, suggesting potential for capturing yet higher returns among winners if trends continue. Momentum's relative outperformance on the back of AI has helped drive tech names such as Amazon (AMZN) and Meta Platforms (META), as well as related ETFs like iShares Semiconductor ETF (SOXX).

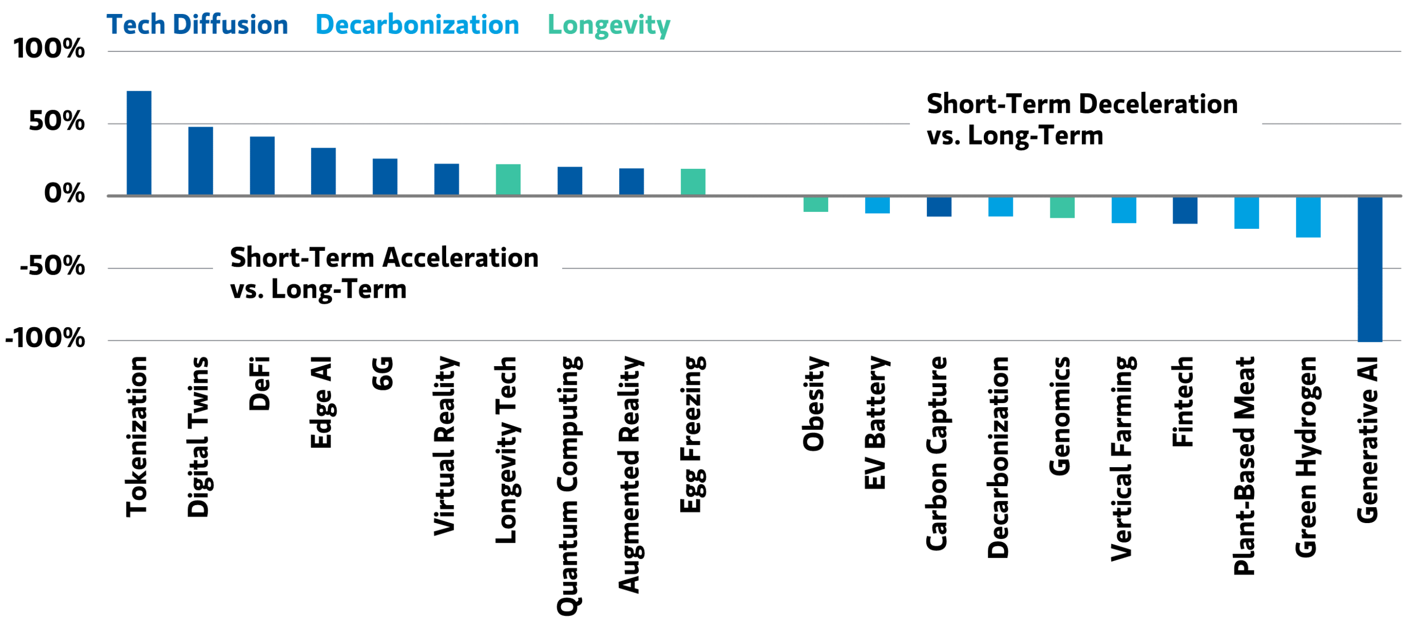
Risk: While momentum factor exposure can contribute to outperformance of the broader market, a reversal can be abrupt and can touch off significant losses.

Rule 5: Consider Broadening Out to Sub-Themes

A truly big theme like the internet in the 1990s or AI eventually broadens out to sub-themes. Specifically, in AI, broadening out could mean shifting from first-layer plays in foundational technologies toward categories such as power, grid infrastructure or Edge AI. In fact, MS & Co. Research has called out Edge AI—the deployment of AI models locally on devices rather than on a centralized cloud—as a key sub-theme, based on its quantitative framework for tracking themes. The chart below illustrates that metrics in the framework are accelerating for Edge AI while those for Generative AI are decelerating.

Opportunity: As AI diffusion continues at both the consumer and enterprise levels, Edge AI's rise as a sub-theme may be the play to focus on next year. Stocks to consider include Apple (AAPL), Dell Technologies (DELL) and Qualcomm (QCOM). Beyond AI, in "diabesity"—another prominent theme—broadening out may mean moving from glucagon-like peptide-1 (GLP-1) drug makers toward fill-and-finish consolidation targets, or even businesses perceived to be disrupted, like sleep apnea treatment provider Inspire Medical Systems (INSP) and diabetes tech company Insulet (PODD).

Risk: Implementation and scalability of Edge AI may face challenges, such as that of limited computing power in everyday devices like smartphones. The GLP-1 theme is in its early stages, and questions remain, including those around long-term health impacts, costs and insurance coverage.



Note: The graph is truncated at -100%. The figure for generative AI is -345%.
Source: Refinitiv Eikon, Google Trends, PatentScope, WIPO, AlphaSense, PitchBook, LinkUp, Morgan Stanley & Co. Research, Morgan Stanley Wealth Management Global Investment Office as of June 26, 2024

Conclusion

There may not be an exact definition of what constitutes a theme, but as thematic investing continues to rise in prominence and draw investor attention, it should become increasingly formalized through guidelines such as these rules of thumb.

With dynamic economies and markets bringing various short- and long-term trends to the fore, the framework we've discussed may help investors develop a more thoughtful approach to thematic investing as part of a diversified portfolio.

Securities Mentioned in Report

Bloom Energy Corp (BE; $13.04; MS & Co. Rating: Overweight/ Industry View: Attractive)
First Solar Inc (FSLR; $249.92; MS & Co. Rating: Overweight/ Industry View: Attractive)
First Trust NASDAQ Clean Edge Smart Grid Infrastructure Fund ETF* (GRID; $115.85; MS & Co. Rating: Not Covered/ Industry View: Not Covered)
NVIDIA (NVDA; $123.99; MS & Co. Rating: Overweight/ Industry View: Attractive)
Advanced Micro Devices (AMD; $159.47; MS & Co. Rating:
AES CORP (AES; $19.09; MS & Co. Rating: Overweight/ Industry View: Attractive)
NextEra Energy Inc (NEE; $73.72; MS & Co. Rating: Overweight/ Industry View: Attractive)
iShares Global Clean Energy ETF* (ICLN; $13.77; MS & Co. Rating: Not Covered/ Industry View: Not Covered)
Invesco WilderHill Clean Energy ETF* (PBW; $20.89; MS & Co. Rating: Not Covered/ Industry View: Not Covered)
Amazon.com Inc (AMZN; $197.85; MS & Co. Rating: Overweight/Industry View: Attractive)
Meta Platforms Inc (META; $519.56; MS & Co. Rating: Overweight/Industry View: Attractive)
iShares Semiconductor ETF* (SOXX; $244.16; MS & Co. Rating: Not Covered/ Industry View: Not Covered)
Apple Inc (AAPL; $214.1; MS & Co. Rating: Overweight/ Industry View: In-Line)
Dell Technologies Inc (DELL; $139.43; MS & Co. Rating: Overweight/ Industry View: In-Line)
Qualcomm Inc (QCOM; $195.15; MS & Co. Rating: Equal-weight/ Industry View: Attractive)
Inspire Medical Systems Inc (INSP; $135.33; MS & Co. Rating: Overweight/ Industry View: Attractive)
Insulet Corp (PODD; $206.98; MS & Co. Rating: Overweight/ Industry View: Attractive)

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Note: Prices as of market close on June 27, 2024

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