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# ARK Innovation and Others Offer Tempting 'Thematic' ETFs. Just Say No.

By Karishma Vanjani Follow Updated Dec. 9, 2022 8:39 am ET / Original Dec. 9, 2022 1:30 am ET

Illustration by Simoul Alva

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Electric vehicles, crypto, and genomics excite many investors with their potential for innovation and big returns. But betting against those sectors with an exchange-traded fund has been the winning strategy this year. Stocks like Tesla TSLA +3.23%, Coinbase Global COIN -6.00%, and Crispr Therapeutics are all down sharply, fueling gains for the AXS Short Innovation Daily SARK +1.36% ETF, up 61%.

AXS didn't pick those stocks out of a hat. They're held by ARK Innovation ARKK -1.45% (ticker: ARKK), the big thematic tech ETF run by Cathie Wood. The AXS Short Innovation ETF (SARK) is a mirror image of ARK Innovation—shorting the very stocks that Wood favors. This year, ARKK's 62% losses have been SARK's gains.

ARK Innovation isn't the only thematic ETF to fall on hard times. It has plenty of company, highlighting the dangers of these products. Some of these funds *do* perform well, for a while. But with few exceptions, they inadvertently make a strong case for a lowly S&P 500 SPX -0.73% index fund, which remains hard to beat over long periods.

Thematic ETFs home in on niches within a sector or invest across varied industries, ranging widely across the market. Funds focus on themes like cloud computing, clean energy, or global aging. The limitations? The imagination of product marketers, and a framework of regulations established by the Securities and Exchange Commission, requiring that fund companies follow disclosure rules and other parameters for ETFs.

With around 280 thematic ETFs on the market, anything goes. Recent launches include the KPOP & Korean Entertainment ETF (KPOP), aiming to capitalize on the BTS band craze with stakes in Korean music stocks. Metaverse-themed ETFs have launched, too, along with other crypto-themed funds.

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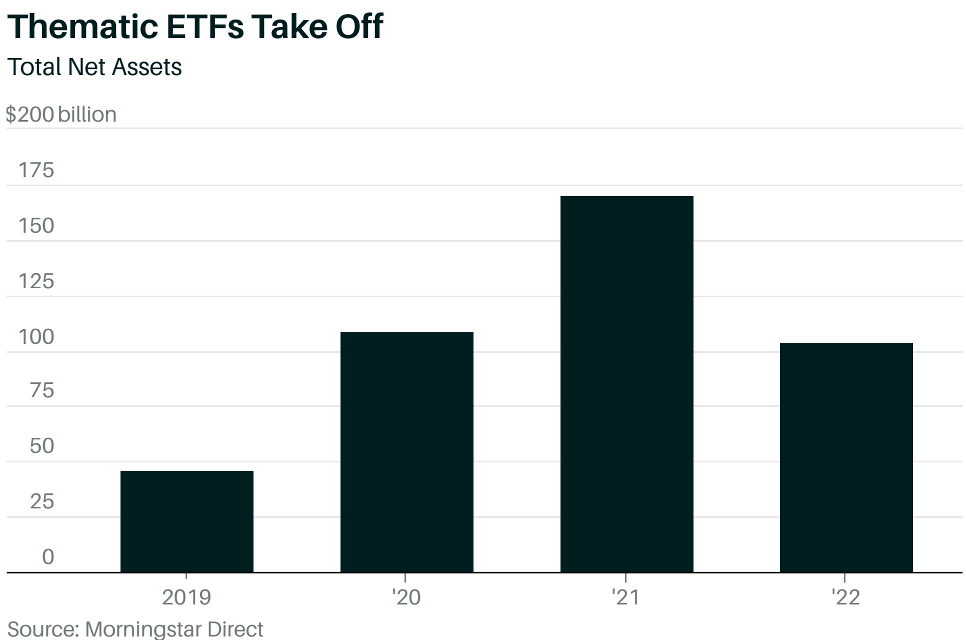
Big ETF sponsors like BlackRock's (BLK) iShares, Invesco (IVZ), and Fidelity Investments now have thematic products. BlackRock, for instance, offers exposure to "megatrends" like demographics in its BlackRock Future Health ETF (BMED). Sustainable construction is the theme behind the Invesco MSCI Green Building ETF (GBLD). Fidelity offers several thematic ETFs, including funds focused on digital health, crypto, and electric vehicles.

Any of these ETFs could have a shining stretch, outperforming the broader market. But finding one that beats a standard index through market cycles is tough.

Today, it's especially challenging. Many thematic funds focus on high-growth stocks that have fallen out of favor. ARK Innovation soared nearly 153% in 2020 but has since fizzled; its share price is back to prepandemic levels. The WisdomTree Cloud Computing (WCLD) and TrueShares Technology, AI & Deep Learning (LRNZ) ETFs are both down more than 50% this year, compared with a 30% loss in the Nasdaq Composite.

Thematic ETFs amplify trends "when there's hype about the theme," says Rabih Moussawi, associate professor of finance at Villanova University. In a working paper, Moussawi and his colleagues found that over the first five years of their life, specialized ETFs lose about 30%, on average, in risk-adjusted returns. The ETFs often focus on overvalued stocks when they launch, tracking "attention-grabbing themes" that do not produce long-term outperformance.




"It's a really dangerous strategy to buy something that has performed very well recently," says Rob Arnott, founder of investment strategy firm Research Affiliates. "That's rarely going to be something cheap and priced to provide [high] returns."

Without long-term track records, many actively managed ETFs essentially ask investors to trust them in picking stocks—despite a poor overall record for active managers. Only 40% of actively managed funds beat their passive peers over the 12-month period through mid-2022, according to Morningstar. ETFs based on thematic indexes, moreover, haven't been studied as extensively as those based on factors like growth or value.

Fund companies aiming to build assets may take liberties with ETF names, marketing around a theme that has scant impact on the performance of its holdings. The SEC appears to think that's a problem—the agency proposed rules this year requiring ETFs to have at least 80% of their asset value tied to a theme in the fund's name.

Investors still need to read the fine print. Take the PSYK ETF (PSYK). Launched this February, it's pitched as a play on the "medical psychedelic drug industry," noting that studies using psychedelics to treat depression have reported success rates up to 80%. That sounds promising for new (legal) drugs. But since few companies have such products in advanced development, the fund's prospectus allows it to own companies in life sciences broadly.

The ETF looks similar to a biotech fund. Its top holding, Intra-Cellular Therapies (ITCI), is a company advancing a schizophrenia drug. Other top holdings include Jazz Pharmaceuticals (JAZZ), Myriad Genetics (MYGN), and Biogen (BIIB), the last a big player in Alzheimer's treatments. The ETF does own shares in Compass Pathways (CMPS), a United Kingdom–based company investigating psilocybin, along with a few other companies in the psychedelics field. But the ETF's performance appears driven far more by the big biotech stocks.

Elemental, the fund's sponsor, didn't respond to requests for comment. Solactive, the ETF's index provider, says its criteria includes identifying companies expected to have significant exposure to psychedelics. It includes broader biotech companies when its method finds fewer than 25 pure-plays.

Whether these themes might pay off long term is hard to gauge. There is little, if any, backtesting of indexes—looking at how they would have performed before the ETF went live.

Fund companies do internal performance testing before launching a product, says Amrita Nandakumar, a former industry consultant who helped develop ETFs. But industry regulations allow backtests to be marketed only to institutional investors, due to regulatory concerns that the tests could be misleading to retail investors. The test "could be garbage," says Nandakumar, but it's "less about performance and more about selling the investment."

For some ETF sponsors, the product seems to be more about marketing to a belief. "At the end of the day, we are moving toward a society that is going to make decisions and purchases based on political ideology," says Hal Lambert, founder of the Point Bridge GOP Stock Tracker ETF (MAGA), which has a ticker geared to Republicans.

MAGA emphasizes companies with relatively high donations to GOP politicians. Whether that's a positive factor isn't known, since Point Bridge hasn't released a backtest. "Why do we have to look at the hypothetical? I'm crushing the S&P," Lambert says. The ETF has had some good years, partly because it owns blue-chip industrials, such as Deere (DE) and Caterpillar (CAT). Its five-year annualized return of 9.2% trails the S&P 500 by about one percentage point through Dec. 7.

Investors need to get lucky with timing a thematic ETF. The psychedelics fund, for instance, was down roughly 40% before August this year, then climbed 80% through mid-November in the run-up to Colorado legalizing psychedelic mushrooms.

Many thematic ETFs may also shut down after floundering for years with tiny asset levels. Only 24 thematic ETFs have crossed $1 billion in assets, according to Morningstar Direct.

Thematic bets can pay off. Low-volatility ETFs like iShares MSCI USA Min Vol Factor (USMV) have been relative winners this year, down about 8%. The traditional energy sector has been a superstar, gaining an average of 58%. Investors can play the theme through ETFs like Energy Select Sector SPDR ETF (XLE) or SPDR S&P Oil & Gas Exploration & Production (XOP).

But the narrower the niche, the more trouble it may pose, especially in today's challenging market. "When the market is more defensive, as it currently is, and where there are land mines everywhere, you want to be more diverse than focused," says Ken South, CEO of advisory firm Tower 68 Financial Advisors.

ARK Innovation has a lot of ground to make up. Its five-year annualized total return is less than 1%, well behind the S&P 500's 10.2% return. "We don't look at volatility as the taboo," says Dan White, an associate portfolio manager at ARK. "Our portfolio will likely outperform in the next five years."

He may be proved right. But staying broadly diversified with an S&P 500 index fund is a theme that may never go out of style.

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