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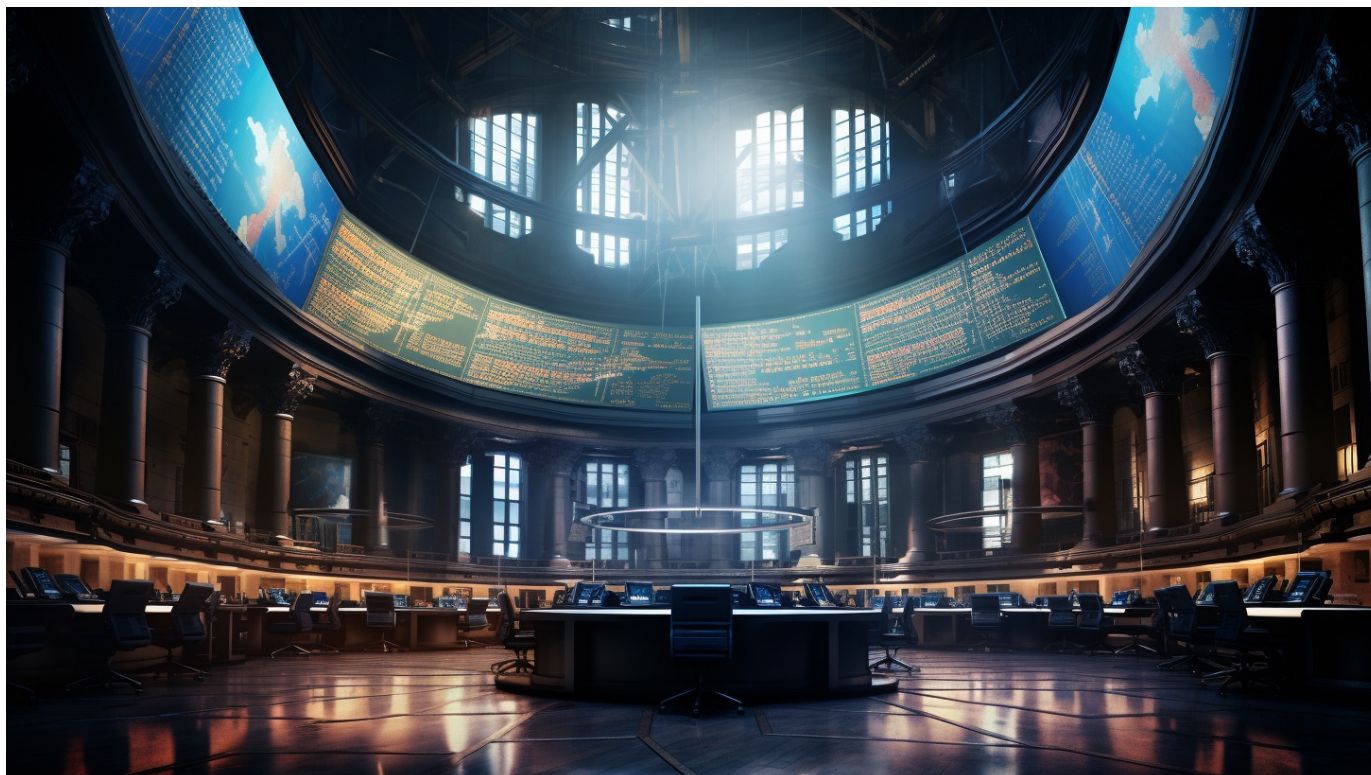
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The Perils of Investing in Thematic ETFs



By **Emmanuel Ellerbee**

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Thematic exchange-traded funds (ETFs) have gained popularity in recent years, offering investors exposure to specific themes or trends such as green energy, disruptive technology, and meme stocks. However, investing in these narrowly-focused ETFs may not be as lucrative as it seems.

Thematic ETFs are designed to capitalize on popular investment themes that are already well underway. By the time these ETFs are launched, many early investors have already entered the market and may be looking to sell their shares. This means that as a new investor, you may be buying in just as sophisticated investors are cashing out.

Research has shown that thematic ETFs often generate poor returns for investors. A study titled “Competition for Attention in the ETF Space” found that specialized ETFs tend to cater to overoptimistic investors and are launched right after the peak of excitement

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around a particular theme. These ETFs can experience initial overvaluation that eventually corrects, leading to negative alpha and underperformance compared to broader market indices.

Investing in thematic ETFs also comes with the challenge of discerning between a genuine structural trend and a short-lived fad. Many of these ETFs trade on popularity and investor excitement, making it difficult to determine their long-term potential.

Furthermore, thematic ETFs tend to appeal to unsophisticated investors who are attracted to the possibility of high returns. However, research has shown that these investors are more likely to be drawn to overvalued securities within thematic ETFs.

It is important to learn from past examples. In recent years, we have seen ETFs focused on cannabis, cybersecurity, and pandemic-related themes. While these themes may have generated initial excitement, the subsequent performance of these ETFs has varied.

In conclusion, investing in thematic ETFs can be a risky proposition. While they may seem enticing, these ETFs often attract investors at the tail end of a trend, making it difficult to achieve significant returns. It is crucial for investors to carefully evaluate the long-term prospects of thematic ETFs and consider diversifying their portfolios with broader market index ETFs.

Sources:

- “Competition for Attention in the ETF Space” – Itzhak Ben-David, Francesco Franzoni, Byungwook Kim, Rahib Moussawi
- Morningstar research



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