MARKET COMMENTARY

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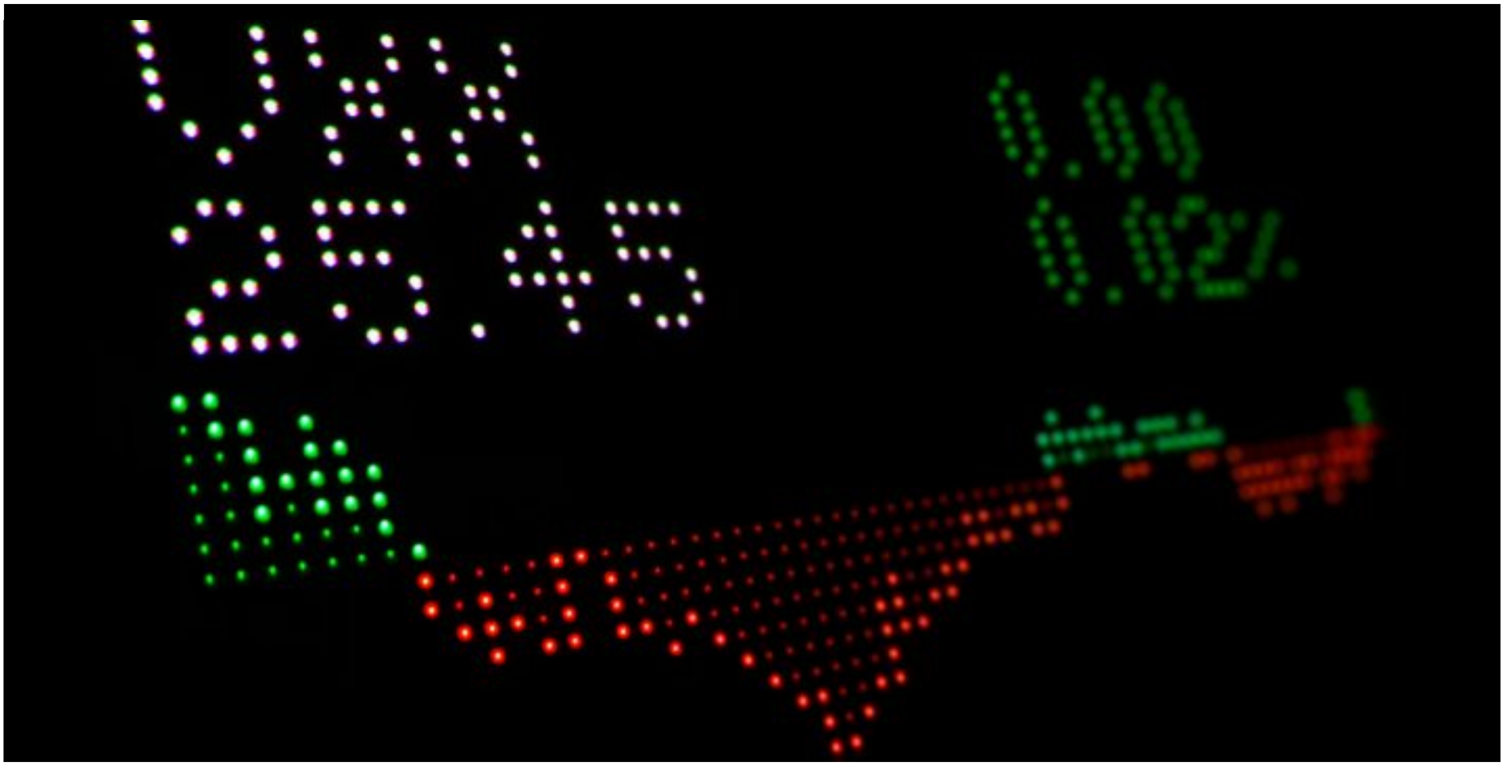

At the outset, let me be clear: This is a blog post about a very narrow band of specialised or thematic exchange-traded funds (ETF), not broader ETFs that track major stock market indices.

Understanding the allure of thematic ETFs

Imagine for a moment I suggested the following investment strategy: buy a group of stocks directly exposed to whatever theme is currently enjoying the most hype and hold onto it for a few years.

Sound dumb? Perhaps. Let's see.

Of course, the investment strategy isn't pitched that way. The pitch – and here I am only referring to narrowly-focused 'specialised' or thematic ETFs – tends to be, for example, 'gain exposure to the transition to green energy' or 'get set in new disruptive technology' and invest in the companies likely to benefit from that 'structural' trend.

Challenges of timing and performance

It sounds logical and even tempting to invest in the technology and themes that are changing the course of the world. The reality, however, is that buying a thematic ETF can often be a loss-making proposition.

There are a few reasons for this, which we will explore in a moment.

Research findings on specialised ETFs

From the inverse Cramer ETF that bets against the stock calls of TV personality Jim Cramer to the Procure Space ETF that invested in the commercialisation of space, and from bets on the Metaverse to the Roundhill Meme ETF that invests in meme stocks by tracking those with the most chatter on social media, there's no end to the trends and fads investors are invited to participate in.

According to Morningstar, last year saw the highest number of new ETFs launched in the U.S. in the past decade. It was a plethora of funds offering access to environmental, social and governance friendly (ESG), and disruptive technology themes that dominated the launches of 2022.

Investor sophistication and thematic ETFs

The question is whether these thematic ETFs are worth considering for a portfolio?

Let's reflect on how these ETFs become available in the first instance. A theme is often already well underway by the time a financial services firm wakes up to the idea of launching an ETF based on it. Then, more time passes while the creating, licencing, and launching the fund takes place. Then, there's the marketing that must occur before the investor even hears about it. Often, that marketing includes charts of what the investor hypothetically could have made if they'd invested in the ETF when the theme began. Of course, the ETF didn't exist then, so the investor couldn't have made that return.

More importantly, by the time investment is finally available, the theme has been up and running for a long time, many investors have already adopted it, and some of the earliest adopters may already be considering existing because the launch of associated ETFs possibly marks the final phase of the boom.

Just when you are getting in, sophisticated early investors are getting out, selling their shares to the ETF you have just bought.

One cannot escape the fact these products are designed to appeal to investors by offering themes that are the subject of the most investor excitement and sometimes irrationality. Moreover, it's very difficult to discern the difference between the beginning of a structural trend and a fad.

If that sounds like a strategy destined to underperform, then don't be surprised to hear that research has concluded they can generate poor returns for investors.

In a research paper entitled, *Competition for Attention in the ETF Space*, first published in January 2021 and revised in October last year, authors Itzhak Ben-David, Francesco Franzoni, Byungwook Kim and Rahib Moussawi concluded, "evidence suggests that specialized ETFs appear to cater to overoptimistic investors. Specialized ETFs are launched just after the very peak of excitement around popular investment themes. Over the years following the launch, the underlying assets shed some of their initial overvaluation, and so do the prices of specialized ETFs."

The research found these specialised ETFs generate a negative alpha of three per cent per year. More generally, they revealed that "over the first five years of their life, specialized ETFs lose about 30 per cent on average in terms of risk-adjusted returns."

As we alluded to earlier, the reason for the poor returns is these thematic ETFs lure investors who have 'a preference for lottery-like payoffs' by demonstrating high pre-launch market-adjusted returns.

Thematic ETFs trade on popularity, and it has always been the case that a public opinion poll will not make you rich in the stock market.

Lessons from the past

Think about the types of ETFs that have been launched in recent years. In 2019, the ETFs were focused on cannabis, cybersecurity, and video games. A year later, it was ETFs based on the Black Lives Matter movement, COVID-19 vaccines, and the work-from-home trend. In 2021, the themes behind ETF launches included the post-Covid reopening stocks linked to the travel industry, real estate, and construction.

In 2022 the U.S. exchange-traded fund industry saw 413 new ETFs launched, slightly less than the 446 in 2021, with net inflows of U.S.$607.2 billion that were also the second highest on record, behind 2021's U.S.$919.8 trillion.

Unsurprisingly, the ETF themes of 2022 included generative AI, climate action and floating income.

That was also the case in Australia. According to Morningstar, '14 of the 41 new ETFs launched in 2022 [are] geared towards one or more environmental, social or governance themes.'

Also, unsurprisingly, Ben-David, Franzoni, Kim and Moussawi, found evidence that 'securities in thematic ETFs are overvalued' and that the promoted run-up of underlying thematic stocks in the period preceding the launch subsequently underperforms after launch, with stocks reversing their earlier overvaluation.

Current trends and closures

Finally, the researchers concluded 'unsophisticated investors are more likely to be attracted to thematic ETFs'. Warren Buffet and Charlie Munger were prescient when they observed, 'Wall St will sell what Wall St can sell'.

And let's not forget how challenging it is to invest successfully in world-transforming trends and technologies.

If you had been at Kitty Hawke when the Wright brothers successfully flew a plane for the first time, you might have recognised the transformative potential. However, you still would have lost billions as a shareholder in commercial airlines.

And if you had been in Germany when Karl Benz drove the first horseless carriage, again, you might have recognised the potential. But since then, not one U.S. car manufacturer exists today that is profitable and was not rescued by either the government or private equity after first going broke.

Picking winners from transformation is difficult, which is why thematic ETFs are a popular alternative. It's just that investors tend to jump in at all the wrong times.

And that seems to be a particularly poignant observation in 2023. According to the research by exchange-traded fund global insight (ETFGI), what used to be hot is now not, with many of the popular thematic ETFs of the past closing in 2023.

ETFGI recently observed that global fund closures have climbed to 929 in 2023, rising at a record pace from 373 at the same point last year, reflecting "weaker inflows, waning enthusiasm for niche investment products and competition from big asset managers driving down the fees niche ETF providers charge.

Interestingly, many of the ETFs that closed this year were those with a narrow thematic focus launched just a year or two ago, including a metaverse ETF, a "Generation Z" ETF, ETFs that acquired stocks purchased by Republican or Democratic members of Congress, and a cannabis-themed ETF whose shares have fallen 90 per cent since its initial public offering (IPO) in 2021.

So far, in 2023, 178 exchange-traded products have closed. We aren't even two-thirds of the way through the year, and the number of closures exceeds the 142 total ETF closures in 2022. U.S. ETF closures this year could be the second highest after 2020 when plunging oil prices led to the collapse of energy-themed ETFs.

Investing in thematic ETFs sounds like a good idea, but perhaps the best strategy is to ignore them for a year or two after launch and wait to see if, like a phoenix, the theme booms for a second time. In addition to the tendency to be unfortunately timed, investors in thematic ETFs have the additional challenge of trying to discern the difference between a trend that might be structural and a fad. And if the ETF is backing a structural trend, trying to determine when the inevitably associated hype will end is even more challenging.

It may be worth seeking a second, third and fourth opinion before diving in.