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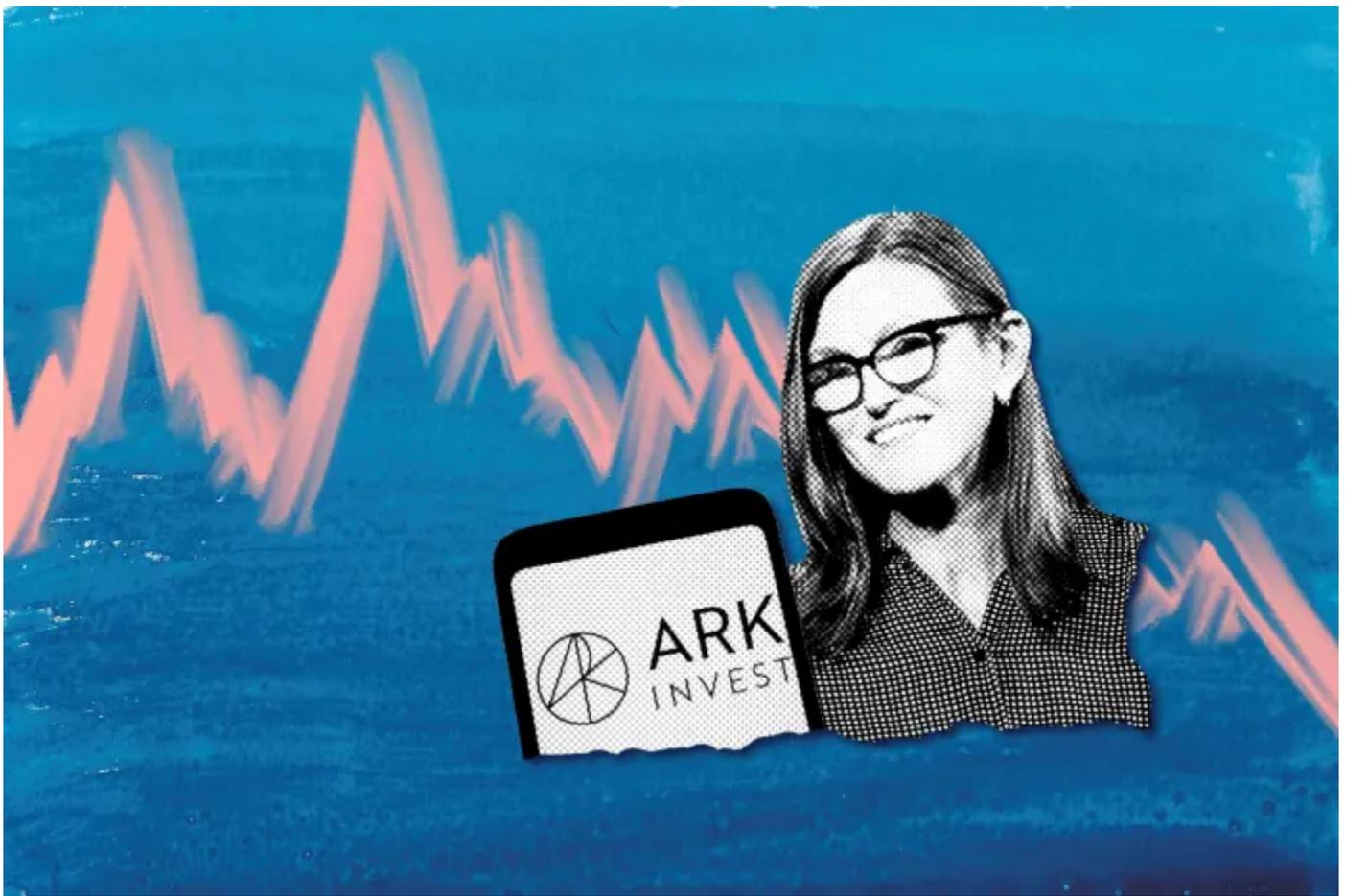
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Thematic ETFs tend to launch just before a steep fall in returns

Research finds tailored funds have a poor record of returns despite their strategies' appeal



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Emma Boyde MARCH 7 2022

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Any investors short selling shares in the most famous 'thematic' ETF — Cathie Wood's

flagship Ark Innovation ETF (ARKK) — will have made a killing in recent months.

By mid-February, the exchange traded fund had lost more than half its value since its peak a year earlier. And there were no signs of an end to the sell-off, even though Wood has been [insisting](#) the innovation stocks it holds were “way undervalued”.

But while these developments will have been disappointing to Wood’s legions of fans, the sell-off will have come as no surprise to a team of investment academics: their [latest research](#) suggests that investors in thematic ETFs, on average, lose money.

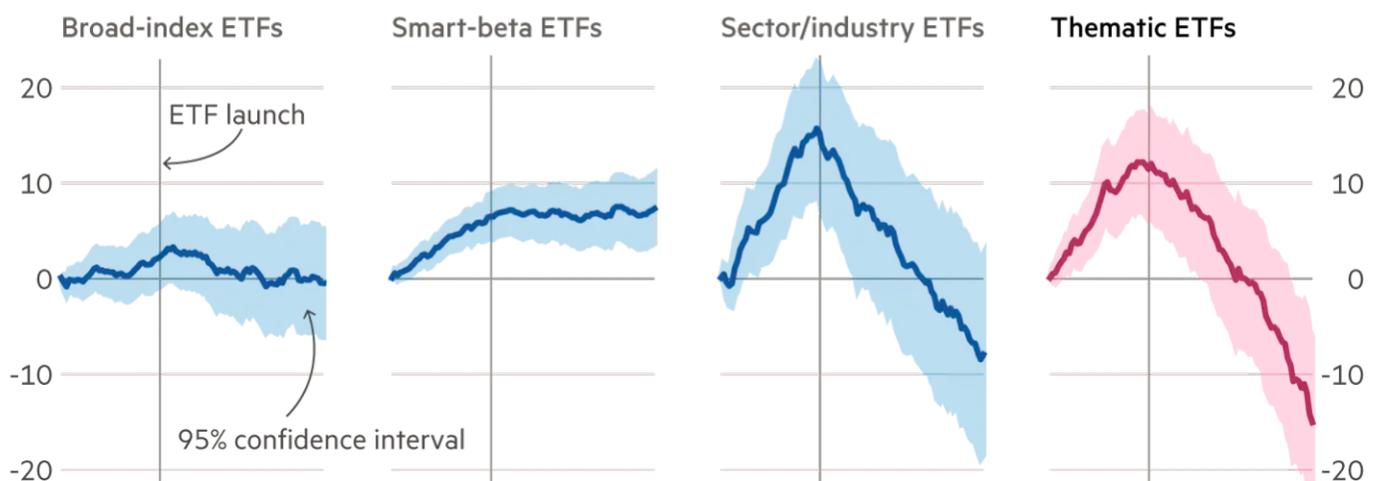
According to the academics — Itzhak Ben-David, Rabih Moussawi, Francesco Franzoni and Byungwook Kim — the very worst time to buy thematic ETFs, which hold shares that follow a popular investment trend or theme, is when they launch.

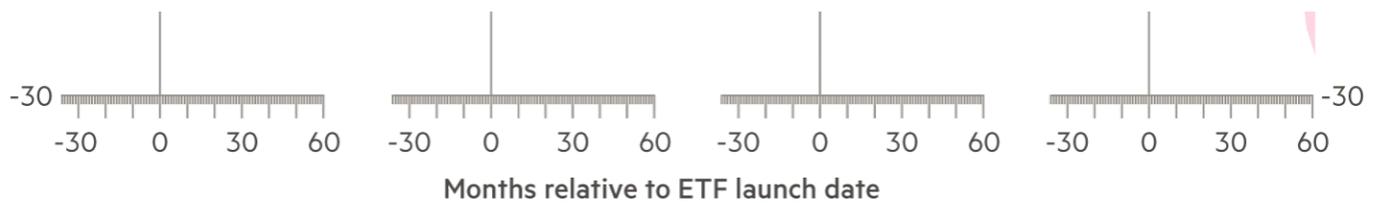
That is principally because the funds tend to launch just after the peak of their theme, and immediately before a steep fall in returns.

The research focused on US equity ETFs, traded on the US stock market, between 1993 and 2019. It found that not only did thematic ETFs struggle, but sector-focused ETFs performed almost as badly and accounted for a larger segment of the ETF market. Together, the two categories accounted for nearly 20 per cent of assets under management and generated 36 per cent of the fees.

Thematic ETFs on average have missed the peak of their theme

Cumulative risk-adjusted return of underlying indices (%)*





* Based on Fama-French-Carhart four-factor model (FFC-4) alpha US equity ETFs 1993-2019

Source: Ben-David, Franzoni, Kim, Moussawi (Competition for attention in the ETF space, Feb 15 2022)

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According to Franzoni, thematic ETFs can be a losing proposition for several reasons: the theme is often overvalued; the ETFs charge higher fees which eat into returns; and thematic ETFs are less diversified and are therefore riskier.

However, that does not mean that outsized returns cannot be made from them. For example, ARKK delivered net annual returns in excess of 150 per cent to investors who held the fund in the year to the end of 2020. As a result, those who remained invested in ARKK since its inception in 2014 are still sitting on returns approaching 270 per cent, compared with a rise of just under 150 per cent in the S&P 500 over the same period.

Its sister fund, the Ark Genomic Revolution ETF (ARKG), was an even better bet in 2020, returning 180 per cent.

But despite these examples of strong performance, the academics warn that longer-term assumptions cannot be drawn from them. For example, one commonly held belief is that today's investment themes are destined to "mature" into sectors so, even if you experience early volatility, you are still bound to benefit if you buy in early and stay for the long run. This could hold true, Moussawi agrees, for certain investment themes such as batteries. However, other themes may never mature, he says.

"I don't think that there will ever be an innovation sector," he says. "Innovation themes exist in multiple sectors," he points out, adding that the same would apply to themes such as women's empowerment, which is a factor across a range of sectors. This distribution of trends and themes across multiple sectors means they could never "mature" into sectors in their own right.

Even where it is possible to correctly identify an investment theme that will remain relevant

Thematic fund launches are clearly a bull market phenomenon

Kenneth Lamont, Morningstar

into the future, thematic ETFs have dismal survival rates. So, an investor could pick the right long-term theme but find the fund does not persist.

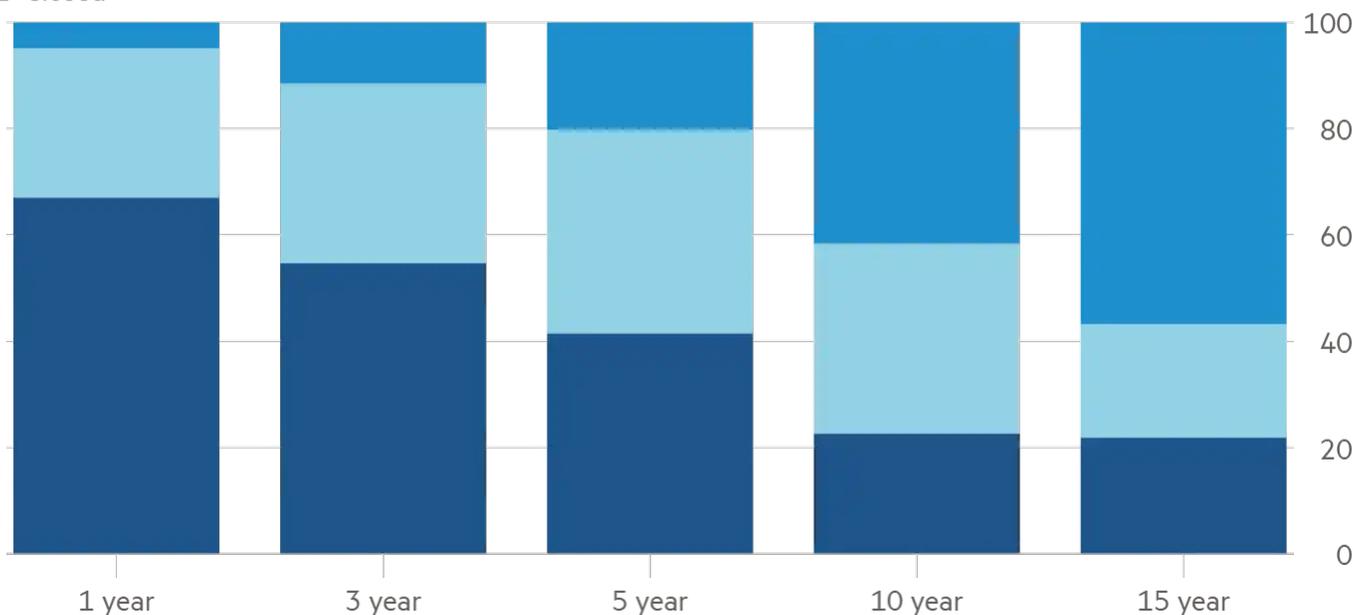
Kenneth Lamont, senior research analyst at Morningstar, the data provider, notes that many early investors in internet funds 20 years ago failed to profit from the theme. As the dotcom bubble grew in tech share prices, in the late 1990s, a glut of internet-related funds launched. However, just a handful survived — and most closed immediately after the bubble burst.

“Thematic fund launches are clearly a bull market phenomenon — this year we have seen a record number of launches,” Lamont says. “History tells us that the majority of those new funds won’t survive long enough to fully capture their chosen theme.”

Global thematic fund survival and success rate

Per cent

- Outperformers
- Underperformers
- Closed



Source: Morningstar
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One reason why investors may overlook or discount these probabilities, says Abraham Lioui, professor of finance at Edhec Business School, is that there are other dynamics at work. “When people like something, it’s likely that they will be willing to sacrifice something,” he says.

Ben Johnson, director of global ETFs and passive strategies research at Morningstar, agrees, pointing out that thematic ETFs tend to “appeal to investors’ appetite for narrative, belonging and the prospect of big returns”.

However, by the time many thematic funds actually make it to market, the enthusiasm has already been priced in, he says.

People think if they are winners, they will be winners forever

Abraham Lioui, at Edhec Business School

Lioui and Lamont still think thematic ETFs have their place in a portfolio, though.

“In defence of thematic funds, picking a basket of stocks tracking a theme reduces some of the idiosyncratic risk associated with buying a single stock,” Lamont argues.

Lioui agrees that thematic ETFs’ ability to offer a narrow bet can bring rewards but warns that the investment still needs reviewing. “For sure, I would invest in the short run,” he says. “There is money to be made in the short run. But then inertia sets in. People think if they are winners, they will be winners forever.”

Morningstar [research](#) published last year also showed the gap between the total returns of a fund and investor returns. This shortfall, which stems from badly timed purchases and sales of shares in funds, was particularly severe for theme-based sector funds.

“Lofty valuations are rarely the starting point for long-term investment success,” says Johnson. “Investors generally tend to buy thematic funds high and sell low — a pattern that has recently manifested prominently in the case of ARKK.”

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