

Behavioural Investment

Why Do Thematic Funds Fail?

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The enduring appeal of thematic funds can seem somewhat puzzling given their track record of delivering disappointing returns to investors (and sometimes worse).^[i]^[ii] Yet from a behavioural angle, there is no puzzle to solve. Their composition exploits some of our most damaging psychological traits. No matter how many flavour of the month funds fail, there will always be a new story to sell.

Although we like to frame our investment decisions with rigorous analysis and metrics, more often than not it is the stories that really matter. Our desire to believe a compelling narrative that draws a comforting line between cause and effect is an inescapably human trait. Financial markets are noisy, capricious and uncomfortable, persuasive stories help to remove that nagging pain of uncertainty.

Thematic funds prey on our desire for clarity by making everything easy. Something significant is happening in the world (usually some seismic and profound change) and we can profit by investing in it.

The vital sleight of hand played by the purveyors of thematic funds is that a story being true means that we are going to make money from it. These are always framed as being one and the same question – if you believe, then you should invest – but in fact they are two entirely distinct issues. There have been countless cases of narratives, themes and stories being valid – the internet was transformative / emerging markets did grab a far larger share of global GDP – and investors still losing plenty of money.

Key to avoiding the allure of thematic funds is finding some way of living with this cognitive dissonance – if the story is true how, how

can it not be a good idea to invest?

Thematic funds are built on three core components that form a (for a time) virtuous circle: strong performance, a convincing story and social proof. Each element feeds the next inflating a form of micro-bubble. High returns need an explanation, so a narrative is forged, more investors are drawn in boosting performance, which further bolsters the credibility of the story. And so on...

At some point this circle of virtue (or profit) will turn vicious when each element will damage rather than support the next as the hype fades or shatters. In most circumstances we can be confident that this will happen, we just don't know when.

All investors are either valuation or momentum driven. We invest because we believe that an asset is undervalued or because we think the price will (continue to) go up. Thematic fund investors are almost always momentum investors – they just might not know it. Why can't thematic investors be focused on valuation? Because it is tough to believe that an area of the market can be underappreciated / materially undervalued *and* have a specialist fund launched to exploit it.

Momentum investing is a perfectly robust and proven approach, so why can't thematic fund investing work on this basis? Because too many thematic investors don't realise they are chasing momentum, instead they rely on the fundamentals of the story. Momentum investing works because of the deliberate and dispassionate application of rules – it is following a system not chasing a story. Engaging in it without acknowledging it is a recipe for disaster.

While it may be difficult for investors to make money from thematic funds, it is easy for asset managers. Stories sell and thematic funds come with in-built marketing. The investment thesis and sales pitch are the same thing. Not only is the sales message readymade, but financial markets are narrative generating machines. There is always the next story to place on the shelf.

Given the evidence around the disappointing outcomes from thematic funds, what accounts for their ongoing popularity? It is a classic inside / outside view problem, where we focus on a specific issue and ignore the general lessons. When we are considering the latest area of thematic fervour (AI anyone?) our attention is trained on the strength of that particular story, so we ignore the litany of failures of other themes that have momentarily captured and overwhelmed investor attention. It is the base rate of success in thematic funds through history that matters. Although the stories are different, the behavioural drivers and lessons are the same.

Most thematic fund investing is founded upon ideas that are simply not credible:

- Buying expensive, in-vogue assets tends to end well.
- Unsustainably strong performance will in-fact be sustained.
- We can make accurate forecasts about fiendishly complex economic / technological developments.
- Being correct about economic / technological developments mean that we will outperform.
- Abandoning diversification for thematic concentration can be a smart idea.

These make for a toxic set of implicit and erroneous beliefs. Maybe we can strike lucky and succeed with thematic investing, but the odds are horrible.

The sad truth is that the type of thematic fund most likely to make money would be one that very few people would want to buy.

[i] Ben-David, I., Franzoni, F., Kim, B., & Moussawi, R. (2023). Competition for Attention in the ETF Space. *The Review of Financial Studies*, 36(3), 987-1042.

[ii] <https://www.morningstar.co.uk/uk/news/236136/comment-thematic-investing-appeals-to-our-worst-instincts.aspx>
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My first book has been published. *The Intelligent Fund Investor* (https://www.amazon.co.uk/Intelligent-Fund-Investor-Practical-Results/dp/0857198769/ref=sr_1_1?crid=340ZVCRAIBRCB&keywords=intelligent+fund&qid=1654696027&prefix=intelligent+fund%2Caps%2C70&sr=8-1) explores the beliefs and behaviours that lead investors astray, and shows how we can make better decisions. You can get a copy [here](https://www.amazon.co.uk/Intelligent-Fund-Investor-Practical-Results/dp/0857198769) (<https://www.amazon.co.uk/Intelligent-Fund-Investor-Practical-Results/dp/0857198769>) (UK) or [here](https://www.amazon.com/Intelligent-Fund-Investor-Practical-results/dp/0857198769/ref=sr_1_1?crid=28LDSO418MLTZ&keywords=the+intelligent+fund+investor+by+joe+wiggins&qid=1676359573&prefix=intelligent+fund+%2Caps%2C168&) (https://www.amazon.com/Intelligent-Fund-Investor-Practical-results/dp/0857198769/ref=sr_1_1?crid=28LDSO418MLTZ&keywords=the+intelligent+fund+investor+by+joe+wiggins&qid=1676359573&prefix=intelligent+fund+%2Caps%2C168&)

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