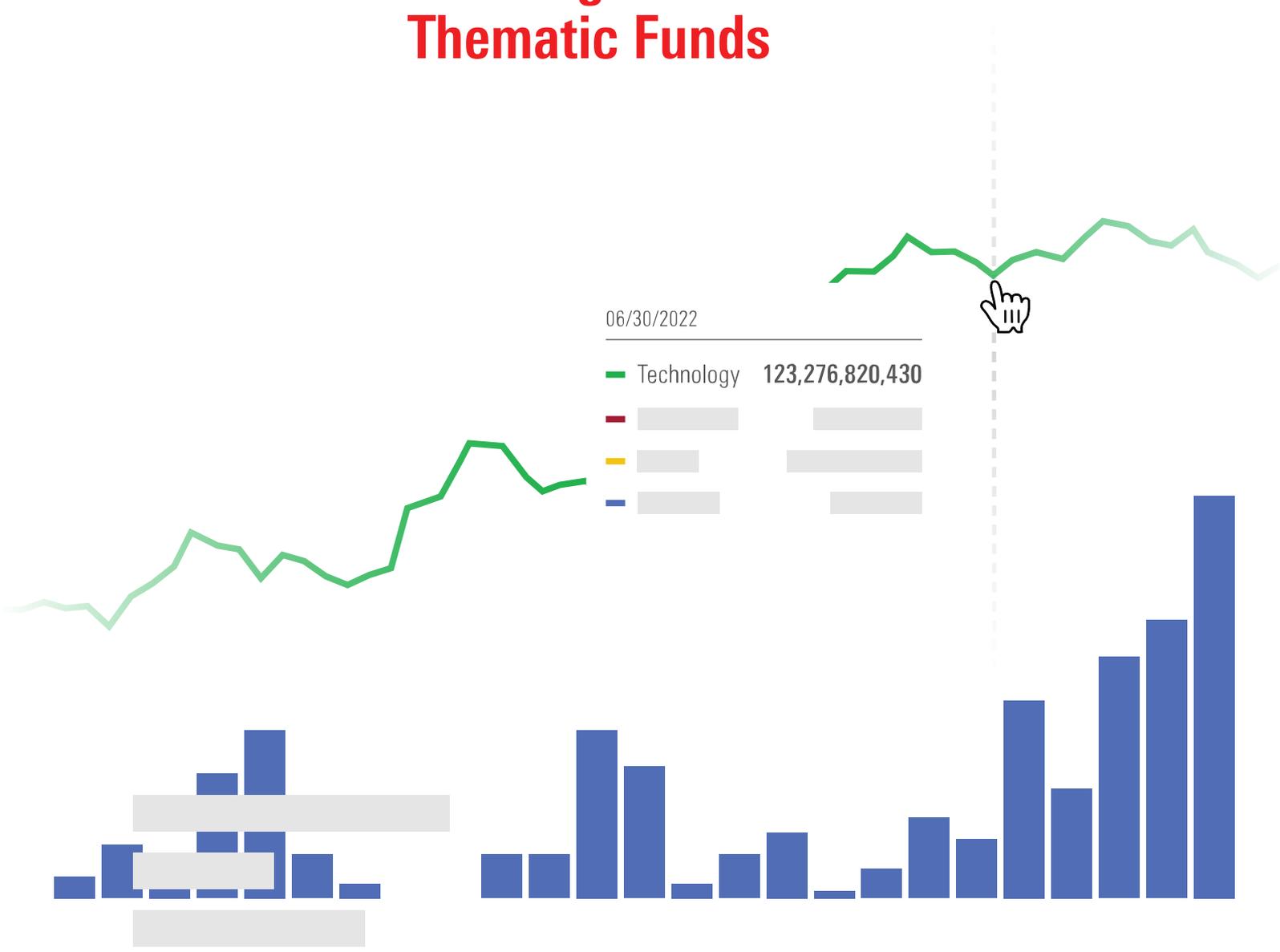


Morningstar's Guide to Thematic Funds



Cloud Computing ✓

[Redacted]

Fintech ✓

Making Sense of Rapidly Shifting Investment Trends

Thematic funds became increasingly popular with the onset of the coronavirus, with many posting eye-catching returns over the period. These investment vehicles attempt to harness various secular growth themes, from energy transition to connectivity to artificial intelligence to cannabis to disruptive healthcare technologies. Since the pandemic hit full force in March 2020, assets in global thematic funds have trebled in value. The upsurge has been fueled in part by intense retail investor interest, with more people looking to invest while working at home. The inflows should also serve as a reminder to the phenomenon of chasing trends during a late-stage bull market.

Meanwhile, high-profile asset management firms have fed the demand, coming up with new-fangled approaches in attempt to give investors new ways to capitalise on the secular trends. Often, recently opened funds attract flows very quickly. The most popular funds typically encompass themes with promising futures, such as cloud computing, disruptive innovation, robotics, cybersecurity, clean energy, genomics, and blockchain.

This guide is intended to introduce users to Morningstar's "Thematic Funds" data set, which launched in November 2021 to provide advisers, wealth managers and asset managers an effective way to evaluate all of the choices in the thematic universe and uncover investment opportunities.

The issue historically with thematic funds is the sheer volume of them. They come with all different types of themes, and sometimes have holdings that seem to stray from their said purpose. By giving a clear picture of asset flows, the data set will help Morningstar Direct users make a more informed decision on how and what thematic funds could serve as an addition to investment portfolios. Access to vast amounts of data, and the capability to analyse that data to produce actionable insights, will offer users another way to boost efficiency and distinguish themselves in the financial services industry.

An Introduction to Thematic Funds

Thematic funds are essentially exchange-traded funds and mutual funds that have exposure to one or more investment themes. These themes may pertain to structural or macroeconomic trends transcending the traditional business cycle. The intent is to offer investors a way to harness secular growth themes. Over time, the global menu of thematic funds has expanded in number and breadth, and quite rapidly in recent years. Yet the proliferation of funds has also added some confusion to the market, with investors having to sift through a fast-growing supply, some with greater complexity, and some with more refined niches. What had been lacking for investors, wealth managers and asset managers, is a systematic way to sort through all of the noise and see what's a prudent and timely choice in terms of adding specialised themes to an investment portfolio.

At a high level, Morningstar breaks down the funds into the following classifications:

1. Broad Thematic (includes wide-ranging topics such as Future Trends and Smart Industries)
2. Physical World (topics such as Green Energy and Logistics Transportation)
3. Social (topics such as Post-Corona, Wellness, and Political)
4. Technology (topics such as AI, Blockchain, and Battery Tech)

Interest in thematic funds was sparked by retail investors, advisers and wealth managers that have increasingly examined the category. Until now, there hasn't been a tool able to quickly sort through all the choices and allow investment professionals to present a list of possibilities to clients. Given that thematic funds are virtually the opposite of a diversified portfolio, they could serve as a complement rather than replacing existing core holdings. In fact, narrower exposures that express a view on a particular theme might be considered as single-stock substitutes.

Caveat Emptor

Despite all of the enthusiasm for thematic funds, it's important to keep things in perspective. Historically, thematic funds have underperformed their benchmarks, and the concentrated nature of these strategies tends to cause higher volatility returns. Investors need to be careful.

For a successful investment, holders of thematic funds need to accomplish three things:

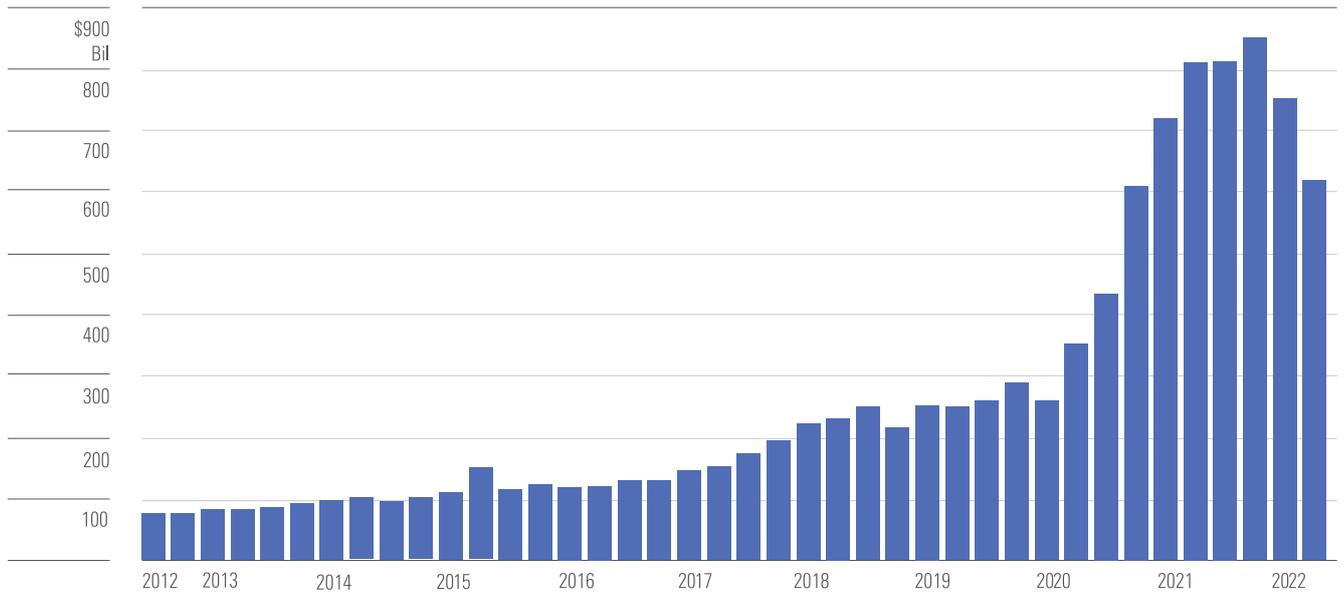
1. Pick a winning theme, one that is real and durable.
2. Select the right fund, one that owns stocks positioned to capitalise on the theme in a meaningful way.
3. Make sure the market hasn't already priced in the theme's potential.

The Evolution of the Global Thematic Funds Landscape

Investor interest in thematic funds has increased dramatically in recent years. In the 10 years up to mid-2022, thematic funds have tripled their share of global equity fund assets from 0.8% to 2.2%

Europe is currently the largest market for thematic funds, accounting for 55% of global thematic fund assets. Strong performance, persistently high inflows, and an abundance of new launches powered the rapid growth.

Exhibit 1 Global Thematic Fund Asset Growth (USD Billions)



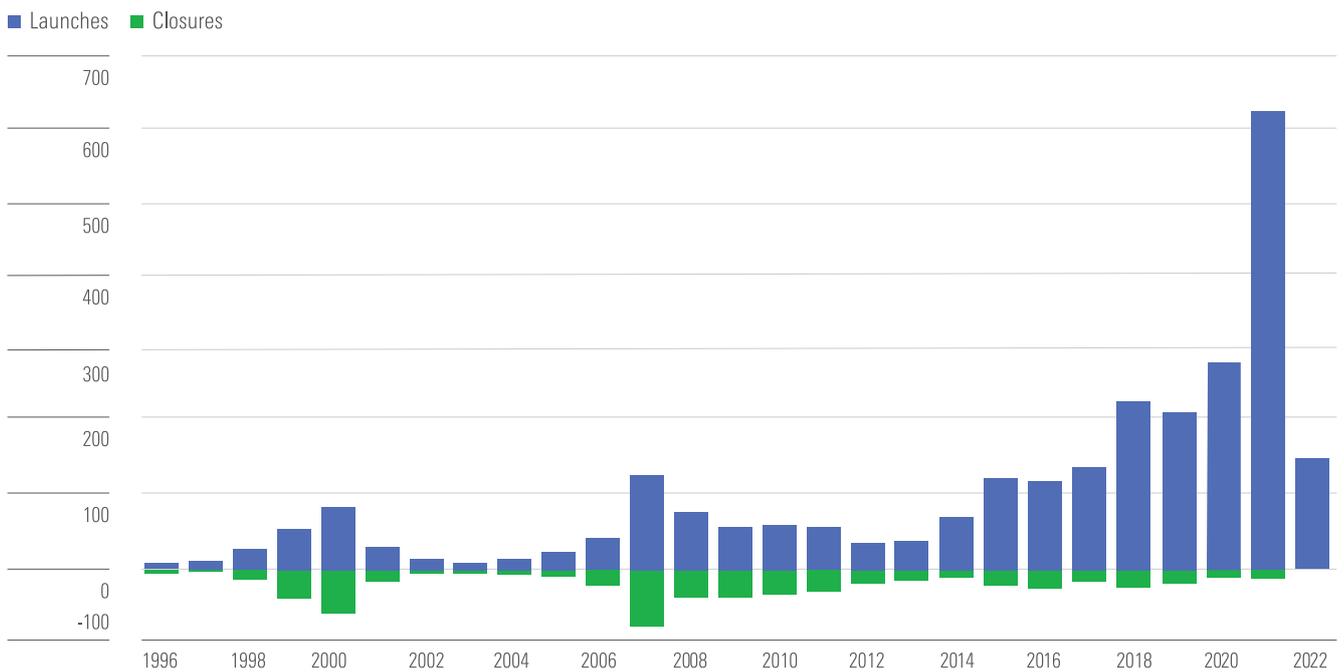
Source: Morningstar Direct. Data as of 30 June 2022.

Note that China-domiciled funds have been excluded from this calculation because of inconsistencies in reported assets.

The number of thematic funds has also multiplied—in what proved to be a record year for the sector, 2021 saw 589 new thematic funds debut globally, more than double the previous record of 271 in 2020. And at the end of the year, there were a total of 2,018 surviving funds in our global database that fit our definition of thematic. (Next year's annual [Thematic Funds Landscape Report](#) will reveal how 2022 fared in the wake of significant market uncertainty.)

Historically, asset managers have tended to launch funds in the late stages of a bull market, after various trends have taken hold. The pattern is clear in the chart below, which shows spikes in funds launched near previous market peaks.

Exhibit 2 Global Thematic Launches and Closures by Year



Source: Morningstar Data as of June 2022.

The large number of funds launched since 2014 stands out. Riding one of the longest bull markets in history, asset managers harnessed the structure of ETFs as a way to package these products. Thematic funds are a way for asset managers to offer a differentiated product that can support high fees, rather than the highly-competitive, low-cost options indexed ETFs offer.

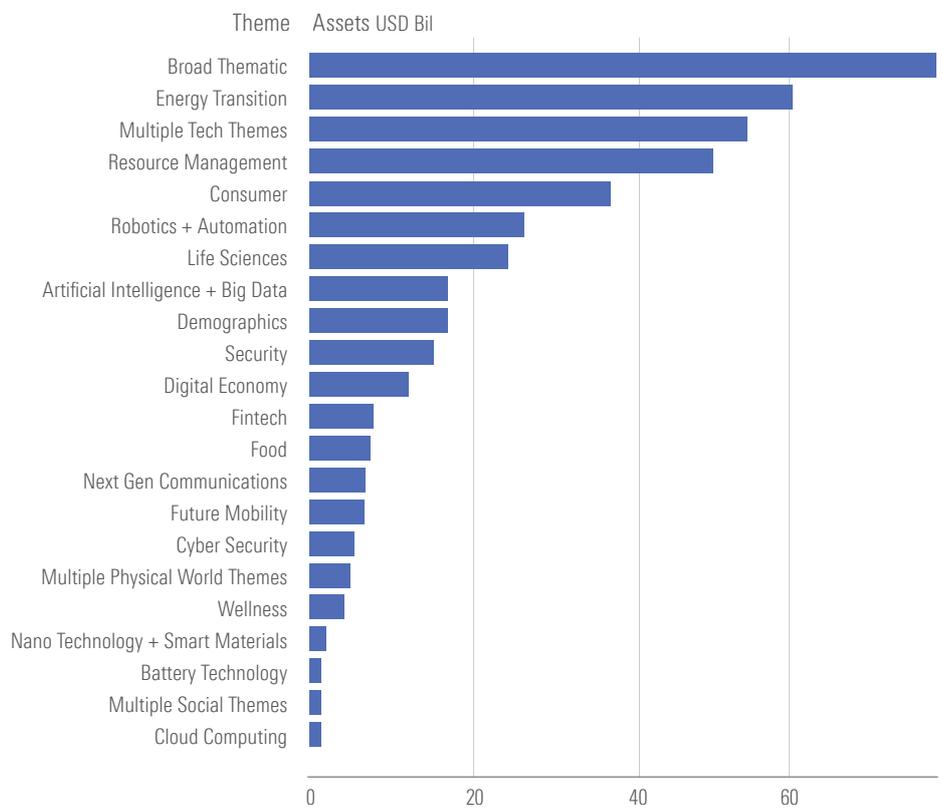
Popularity: What's Attracting Investors

Broad thematic funds make up the most popular theme grouping by assets in Europe. The largest thematic fund in the region is included in there: Pictet Global Megatrend Selection.

The booming popularity of ESG funds in Europe has also spilled over into the world of thematic investing. In late 2020, the promise of huge government spending plans announced by the incoming Biden administration in the U.S. prompted massive inflows into funds with an energy transition theme. Despite a subsequent drop in net flows, funds seeking to profit from the transition away from hydrocarbon-based energy sources, such as alternative energy funds, have risen to become the second-most popular theme grouping in the region.

Funds tracking multiple technology themes take third place, buoyed by success of ARK Disruptive Innovation, which is sold under the Nikko Asset Management brand in Europe. Total assets across all funds fitting this theme reached a record \$53 billion at the end of last year.

Exhibit 3 European Thematic AUM by Theme (USD Billion)

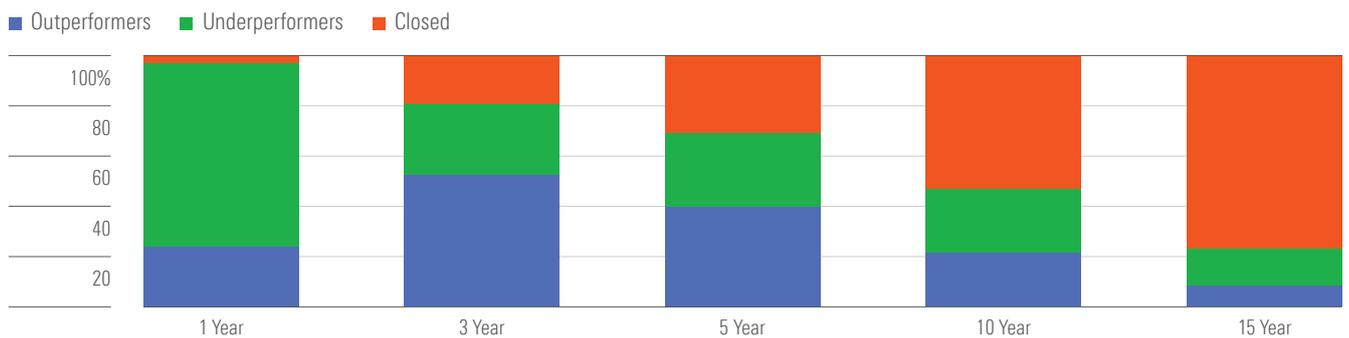


Source: Morningstar Research. Data as of 31 December 2021.

Performance: Nice Return, If You Can Get It

While investor interest in thematic funds has increased dramatically in recent years, the chances of beating market benchmarks are low. When we look at data up to the end of the last year (2021), more than half of the thematic funds in our global universe both survived and outperformed the Morningstar Global Markets Index over the trailing three years. However, thematic funds' success rate drops to just one in 10 when we look at the trailing 15-year period. More than three fourths of the thematic funds that were available to investors at the onset of that period have since been closed. Funds that close are generally associated with poor returns of holdings within and heavy outflows, forcing sales of the holdings.

Exhibit 4 European Thematic Fund Survival and Success Rates



Source: Morningstar Research. Data as of 31 December 2021.

The graph above lays bare the challenge faced by investors in thematic funds. Over short periods—for example, 2020—many of these funds survived and outperformed global equities, but over longer periods the number that survive and outperform tumbles. Over the trailing five-year period, less than half of these funds survived and outperformed the index. That figure plunges to just 9% over the trailing 15 years.

A few factors underpin the lackluster results. Launching thematic funds in the final years of a bull market raises the odds of poor outcomes in the near future, in part because latecomers are chasing past performance. Many of these funds have loaded up on stocks with recent strong performance, those that are more likely to be trading at prices above their intrinsic values. Even if a thematic fund isn't holding the best stocks, it is still exposed to market risk. So, funds can get caught in the downdraft of a market correction or a bear market.

Liquidity for the fund is also an ongoing concern, particularly for those funds tracking the narrowest of themes. In some cases, a single thematic fund has been found to hold more than a fourth of the free float of a single stock. Also, the long-term poor performance can be partly explained by the fact that thematic funds' fees tend to be higher than those levied by their nonthematic counterparts. Many popular funds have expense ratios in the range of 0.75%, compared with 0.10% or less for mainstream index funds.

How Morningstar Can Help Identify Investment Opportunities

The Thematic Funds data set allows users to easily track assets and asset flows, and analyze fund details for one or more investment themes. We went through our universe of roughly 114,000 mutual funds and ETFs, tagging ones that specialise to give users near-instant results from searching via different attributes.

Funds that qualify as thematic get tagged with broad classifications:

1. Broad Thematic
2. Physical World
3. Social
4. Technology

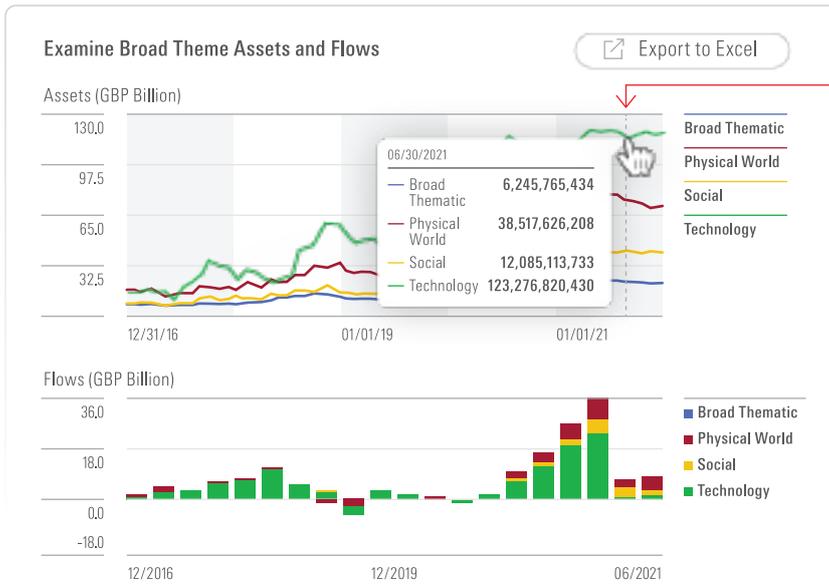
They also get tagged for any subthemes they fall under in each broad classification.

The data set is part of a series of similar tools powered by a new analytics capability within Morningstar Direct, called "Analytics Lab." The lab is a workspace that centralises data, analytics, and visualisation so users can automate processes that were previously cumbersome or impossible to accomplish. The custom-built analytical flows are powered by open source Jupyter notebook technology to automate the research and analytics.

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Using the Thematic Funds data set, you can:

1. Understand the Morningstar thematic funds' landscape; what investments are classified as thematic funds, and where do they fall in the thematic taxonomy.
2. Analyse the asset growth for specific investment themes and highlight which have caught on as being most popular with investors.
3. Identify which open-end funds and ETFs are classified to a specific theme.



Hover the cursor over a chart to see a pop-up window with information for that time period

Largest Thematic Funds

Select a Date

2021-09-30

Export to Excel

Fund Name	Fund ID	Bread Theme	Theme	Sub-Theme	Net Assets USD
AdvisorShares Hotel ETF	FS0000GLRW	Social	Post-Corona	Hotel	10032881
AdvisorShares Restaurant ETF	FS0000GLRX	Social	Post-Corona	Restaurant	
Drexion Work From Home ETF	FS0000GOKE	Social	Post-Corona	Work From Home	
Emles @Home ETF	FS0000G25D	Social	Post-Corona	Work From Home	3352354
Global X Health & Wellness Thematic ETF	FS0000CFTH	Social	Wellness	Health + Wellness	39756287
IQ Healthy Hearts ETF	FS0000GB75	Social	Wellness	Wellness	6813343

Click a column header to sort data

Morningstar Direct enables one of the most comprehensive fund data sets in the industry to be incorporated into research, investment analysis, portfolio construction, strategy analytics, and reporting, creating quality portfolios and products that empower investor success.

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