FINANCIAL STANDARD GUIDE TO

THEMATIC INVESTING

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INDUSTRY SNAPSHOT

SELECTING STOCKS BASED ON MARKET TRENDS has been an accepted part of funds management investment philosophy for well over 20 years. But it is only recently that the term "thematic investing" has become a more accepted lexicon of asset management.

Growing awareness that thematic funds have delivered on their outperformance objectives has generated strong fund inflows, with total funds under management (FUM) from Australian investors now estimated at $6 billion.

Now one of the biggest investment trends globally, thematic funds have grown exponentially since the early 1990s, and growing popularity is expected to bring new product offerings to the market locally.

Since the global financial meltdown, much of the thematic investor's time has been spent anticipating future turning points within a transitional global economy. And given the unsustainability of the growth of credit, many thematic investment strategies are centered around what a world with less – and more costly – credit will look like.

Other core themes continuing to garner momentum include new regulatory regimes, increased government stimulus programmes, nationalisation of financial systems, new policies around climate change and global food shortages.

Identifying these themes is one thing, but thematic investors believe it is critical they stay ahead of the tailwind in any theme. That means identifying major secular, cyclical and structural influences in the early stages of their development. Getting time and timing in the market right delivers the sort of returns most global equity funds miss out on.

What is more, many equity funds hug benchmark performance and are, by default, wired to short-term relative returns. In contrast, thematic funds aim for longer term return outperformance.

According to Goldman Sachs forecasts, China is set to eclipse the US as the world's largest economy by 2035, with India close on its heels. The global financial crisis could have only accelerated this shape-shifting trend.

This guide explores opportunities in thematic investing and the practical applications for financial planners who are considering incorporating thematic funds into their clients' portfolios.

WHAT IS THEMATIC INVESTING?

ESTABLISHED IN THE LATE 1980s, the thematic investment philosophy assumes there is only one global stock market within which everything is ultimately connected. This rationale was borne out of a realisation that investment management techniques were struggling to keep pace with or capitalise on changing global dynamics.

As a subsector of global equities, thematic funds view the world as an increasingly integrated global marketplace. They endeavour to deliver a more diversified range of favourable "opportunity sets" than mainstream investment philosophies, which typically focus on past events. That is why traditional benchmark allocations of countries or sectors play no part in the thematic investment process. It is this "benchmark unaware" strategy that really differentiates thematic funds from many conventional funds.

One of the key tenets of thematic investing is ensuring that the secret embedded within any theme's underlying story isn't already out in the market and factored into the price. Instead of investing on a country, sector or cyclical basis, thematic investment diversification comes from the diametrically different nature of investment trends themselves.

These funds identify the best future global investment opportunities by examining significant structural, macroeconomic, social, demographic or political shifts taking place around the world. Oil shortages or gold exposure amid geopolitical risk are classic examples.

The purpose of identifying global trends or themes is to reveal individual stocks most likely to benefit from them. It is by successfully aligning superior stocks with key themes that these funds expect to fulfil the expectation of long-term outperformance, relative to regional benchmarks, like the narrow confines of the MSCI World Index universe.

For example, one fund has the stated aim of outperforming the MSCI World Index by 2.5 per cent annually over rolling three to five year periods.

Thematic funds do not believe fund managers that use major market capitalisation-weighted indices, like the MSCI World Index, as their starting point for portfolio construction have sufficiently wide or diverse mandates needed to deliver truly superior returns.

By avoiding benchmark-aware "hard limits" (or index compositions) on their funds, thematic funds successfully avoid the risk of increasing their weighting into sectors experiencing varying levels of over-valuation, and Japan is a classic case in point.

Japanese shares rose to comprise 43 per cent of MSCI World Index by the late 1980s, even larger than the representation of US companies despite its economy being demonstrably smaller. Little did benchmark-aware investors realise but the subsequent plunge of the Nikkei Index over the ensuing 14 years made this the worst possible time to allocate 43 per cent of their equities to Japan.

One of the key tenets of thematic investing is ensuring that the secret embedded within any theme's underlying story isn't already out in the market and factored into the price.

Having had its origins within the global pension fund industry, thematic funds have progressively moved into the retail space.

TYPES OF THEMATIC FUNDS

THE GLOBAL ECONOMIC CLIMATE emerging from the credit crisis is characterised by deleveraging, uneven wealth distribution and increased competition for resources. This new environment, which has been wiped free of the excesses of the latest bull market, created more investment opportunities than capital markets have experienced for a decade.

Consequently, thematic funds have focused on anticipating the new market dynamics and what untapped opportunities can be exploited from a range of key future drivers.

While some thematic funds choose to focus on just one theme, like emerging markets or the transition to a low-carbon economy, other funds look at eight or more uncorrelated themes where each theme may be represented by up to 12 stocks.

This fund manager claims that when blended together, the themes deliver consistently lower levels of volatility over time relative to other international share managers.

One of the nine themes within another thematic funds portfolio centres around identifying mature blue chip multinationals (like Microsoft or Procter & Gamble with market capitalisation of US$1 billion or greater) that are characterised by high-beta themes. Currently trading at a significant discount (to intrinsic value), these stocks are deemed to be best positioned – through superior brands and cashflow generation – to survive the transition to a new global economic order.

Built around asymmetric negotiators, another fund's theme seeks to identify companies (notably global miners and energy companies) that are able to conduct one-sided price negotiations courtesy of their privileged access to raw materials like energy and minerals.

Underscoring this theme is the scarcity or supply constraint on one side and ongoing demand (supported by Asian growth) on the other.

Meantime, a rival thematic fund manager attempts to capitalise on the transitional global economy by developing a new theme around regulatory change. The fund manager believes lopsided wealth distribution and the crisis in the financial system will provide many positive opportunities in future years.

Having had its origins within the global pension fund industry, thematic funds have progressively moved into the retail space, with Australia's two multi-themed funds – Zurich Global Thematic Fund and DWS Global Equity Thematic Fund – having the lion's share of funds under management (FUM).

The value of thematic investment philosophy is reflected in favourable research house ratings both locally and offshore.

PORTFOLIO CONSTRUCTION AND STOCK SELECTION

ONCE CORE THEMES HAVE BEEN IDENTIFIED, the next step is "proving up" a base case for investment worthiness. That means stress testing these themes to see if they can be populated with a sufficiently large number of attractively valued stocks. Part of this stress test is knowing when to buy and exit within the lifecycle of each theme.

Significant structural shifts within the composition of the global economy, notably the "China and India factor" plus the urbanisation of other developing economies has significantly influenced a handful of "megatrends" upon which many global investment themes are in varying degrees based.

According to Goldman Sachs forecasts, China is set to eclipse the US as the world's largest economy by 2035, with India close on its heels. The fiscal firepower and government policy intent that is driving urbanisation within China, India and other emerging economies is expected to sustain GDP growth at rates unachievable within most developed economies.

This in turn spells greater opportunity for wealth creation than within first world economies, especially now that the "super cycle" of credit growth – which left developed world households, corporations and administrations increasingly indebted – is over.

A corresponding deleveraging out of OECD economies and into their emerging counterparts creates new internal and external opportunity sets for thematic funds to explore.

Once core themes have been identified, the next step is "proving up" a base case for investment worthiness. That means stress testing these themes to see if they can be populated with a sufficiently large number of attractively valued stocks.

INVESTMENT THEMES AND OPPORTUNITY SETS

WHETHER IT IS COURTESY of a transitional global economy or changing global demographics, thematic funds attempt to identify what individual stocks can benefit from "opportunity sets" playing out globally, some of these include:

- **Megatrends in global infrastructure:** Fiscal stimulus packages, government intervention and regulatory change designed to bolster first world economies are expected to result in unprecedented infrastructure spending and greater government involvement in running and repairing certain parts of the economy, notably the financial sector. And given that new regulatory changes will make it harder for banks to deliver the extraordinary gains experienced during the "super cycle", one thematic fund manager has taken a significantly underweight position within this sector.
- **Sector-specific "gorillas":** Companies, favoured by government, with the strength and freedom to price their business correctly, that are most capable – due to robust cash flow and market dominance – of surviving within a new global economy.
- **Uneconomic growth:** Predicated on the view that a significant proportion of global economic activity is currently being distorted by the fixing of key prices, such as exchange rates, energy, food and utility prices and by mispricing of others, such as environmental inputs, principally in the developing world.
- **Emerging economies:** Due to growing urbanisation, domestic consumption within Asian economies like China and India will contribute incrementally more to GDP. This also creates unprecedented opportunities for other Asian tigers like Hong Kong, Singapore and Taiwan, and other BRIC countries like Russia and Brazil. As a case in point, one thematic fund plans to capitalise on growing middle-class consumption within China by including two local retailers within its portfolio. Given that the Asia/Pacific region represents a small percentage of the GDP index, but a disproportionately large percentage of GDP growth, thematic funds believe they are suitably positioned to warrant overweight exposure. And with one thematic fund, emerging economies comprise 13 per cent of their overall portfolio.
- **Lifestyle trends:** Intergenerational conflicts as ageing Baby Boomers and Generation X compete for resources, plus greater dependency on healthcare services by an aging population globally.

- **Population growth:** A projected 40 per cent increase in the global population to more than nine billion in coming decades, declining available agricultural land and global warming are all exerting upward pressures on food prices globally and squeezing supplies. Fierce demand for food created unprecedented opportunities within the global agribusiness.
- **The shortage of fossil fuels:** While energy, notably oil is in great demand, supplies are constrained by underinvestment and concerns over investing within economies displaying greater geopolitical risk. This has spurred attempts to replace reliance on fossil fuels with renewable energy sources.

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At a time when global markets are undergoing significant change, traditional formulae and rules of thumb, as well as backward looking indices may not be a useful guide.

PREPARING FOR THE NEXT ECONOMIC CYCLE

Sponsored statement

Patrick Noble, Senior Investment Specialist, Zurich Investment Management Ltd

Zurich Investment Management Ltd

MAJOR COMPANIES COMPETE for customers and capital in a single global marketplace. Investing, therefore, requires a global perspective. As geographic boundaries become less relevant, it makes sense to structure an investment portfolio that seeks to understand the complexity of this single system by focusing on its global connections, relationships and themes, rather than geographic regions or traditional industry sectors which have become blurred.

Thematic investing seeks to identify and exploit the major influences on the world's economies and stock markets in the early stages of their development. It is designed to identify longer term trends in the marketplace and to take advantage of them through individual stock selection. These investment themes will then determine the shape and strategic direction of an investment portfolio. As these themes play out over time, stock holdings in thematic funds should by nature exhibit low turnover.

At a time when global markets are undergoing significant change, traditional formulae and rules of thumb, as well as backward-looking indices may not be a useful guide. The global economy is immensely complex and simple solutions do not exist. At this time, gaining an understanding through research and analysis is crucial and can offer greater potential rewards.

The turmoil experienced in financial markets in the aftermath of the global financial crisis can be understood as a transition from one long economic cycle to another. With the era of easy credit behind us, the cycle over the last 30 years featuring falling inflation, falling interest rates and corporations as drivers of change, looks to have ended. And while the characteristics of the new cycle are not yet fully defined it is likely to include deleveraging, wealth sharing and investment in public goods. Re-regulation is likely to be prominent along the emergence of bigger government and challenges to globalisation.

Investment opportunities, therefore, exist in themes which can either deal with the stresses of this transition or are favourably disposed to the new cycle.

Themes such as “Gold & Precious Metals” attempt to deal with the financial stress of the transitional economy we are currently in. While exposure to “emerging economies” can provide shelter from slower global economic growth, which is likely to plague most western economies for the next decade. Even now China is still achieving GDP growth in the vicinity of 6–8 per cent per annum.

Indeed, the deleveraging in the Western economies will place the burden of world growth on Asian countries and their domestic policies will be critical. While competition in many sectors will be fierce, national and potentially new global champions will emerge. Infrastructure development will be an essential precondition to capitalise on opportunities in this new environment.

Investment in “intergenerational assets” such as energy infrastructure, which has not been renewed for many years, and the environment have also emerged as a key challenge. As these assets will be paid for by one generation but enjoyed by the next, the issue of equity automatically raises questions of intergenerational choices and of regulation. Returns on existing projects will have to be high enough to incentivise new projects and accommodate the long time horizon.

Following the near collapse of the global financial system, governments around the world will be loath to embrace unbridled capitalism again. Zurich believes bigger government and regulatory change will be the hallmarks of the new cycle. This is likely to throw up investment opportunities across a broad number of areas, such as renewable energy and the reintermediation of the financial sector.

While valuable lessons can be learnt from history, every economic cycle is different. Consequently, those investors looking for opportunities in the aftermath of the global financial crisis will not find them by looking at events of the past. Yet a common starting point for many investment decisions does just that. Markets, by their nature, are typically forward looking and those choosing to reference their decision making to a benchmark that typically draws from historical events may find themselves poorly equipped to deal with the emergence of a new economic cycle.

ESG TRENDS

EARLY ADOPTERS OF ETHICAL FUNDS were originally mandated to negatively screen companies operating in "vice" industries such as alcohol, tobacco, gambling, nuclear power or arms manufacturing.

While this investment strategy continues today, there is a new breed of environmental, social and governance-driven (ESG) funds that invest in companies delivering positive social, community-based or environmental outcomes.

The integration of ESG issues into the investment process saw broad responsible investment grow 8 per cent from $52.8 billion to $57.1 billion in the year to 30 June 2008. Over three and five year periods (to 30 June 2008), ESG managed funds in Australian shares, overseas shares and balanced growth categories outperformed the average conventional managed fund.

The current investment focus of Australia's 40-plus ESG fund managers is heavily influenced by policy around climate change. Much of their time is spent positively screening for companies with the technology and/or services needed to be part of an environmental solution on two primary fronts: to either help deliver alternative energy as economically as gas-fired coal (with carbon emissions below a baseline of around half a tonne per megawatt hour (MWH) or alternative transport solutions to oil (like battery technology).

Most funds are heavily invested in technologies designed to reduce greenhouse gas reductions. For example, much of today's focus is on gas and renewable energy, notably wind (which produces zero emissions), and other clean technologies like geothermal, wave, tidal and large-scale solar projects. The Federal Government has even allocated $1.3 billion towards power station development in Australia.

ESG investing has developed over the years to the point that it warrants discussion outside the scope of this guide. But it is worth mentioning here as an example of a thematic fund that has become mainstream, signaling what the uptake of other thematic funds could be in the future.

FEES

RANGING FROM between 0.90 and 0.98 per cent (plus 0.22 per cent cost recovery), thematic funds incur fees in line with other Australian equities funds. Minimum investment is typically around $25,000 with subsequent lump sums of $1,000 or more.

CASE STUDY 1
First-mover advantage

Phil Moore, Financial Planner
Kinvale Financial Planners

IT WAS THE FUND MANAGER'S exceptional expertise, research capability and ability to consistently outperform established benchmarks (like the MSCI World Index) that attracted Phil Moore, principle of Kinvale Financial Planners to thematic funds three years ago.

He believes their knack of gaining a first-mover advantage by pre-empting the market to evolving investment themes means they will eventually outperform traditional funds over the longer term.

He cites the theme of one fund, built around the significant German-based landbank held by Europe's largest engineering conglomerate, Siemens AG as a case in point.

"The fund manager has been able to factor in (before the capital market) a major valuation re-rating that Siemen's huge landbank – currently valued at cost – will experience once new regulations are passed within Germany."

He was also attracted to the same fund manager's "switch to gold" theme, which created a significant defensive play during the massive equities sell-down that followed the Lehman Brothers collapse.

"While traditional indices are typically backward looking, I like the way thematic funds are more preoccupied with what's going to happen, especially within the developing world."

That's why Moore recommends that client allocate the bulk of their international portfolio exposure to thematic funds.

He said what differentiates thematic funds from their traditional counterparts is their mandate and resources to explore different investment strategies.

He believes their knack of gaining a first-mover advantage by pre-empting the market to evolving investment themes means they will eventually outperform traditional funds over the longer term.

"In addition to having great distribution locally, these funds provide great transparency into how they're investing and why."

But because thematic funds take time to play out, Moore said they best complement long-term investors who have sufficient funds under investment ($50,000) to provide the necessary diversification.

That said, his decision in May 2007 to diversify a client's overexposure to one large bank stock into thematic funds proved to be prudent and timely. While the thematic funds lost 27 per cent at most, shares in the bank stock lost 43 per cent over the same period.

"Having held up well against traditional benchmarks during the worst financial crisis in 80 years has been the ultimate stress test for thematic funds," he said.

He expects the thematic funds he invested in to outperform the MSCI World Index by at least 3 per cent over five-plus years.

CASE STUDY 2
Longtime advocate of thematic funds

Perry Wilkey, Financial Planner
Financial Services Partners

PERRY WILKEY HAS BEEN INCORPORATING thematic funds into his client's core fund recommendations for over eight years. He estimates that he has included one of two core thematic funds into around 12 client portfolios (via a wrap account) in one month alone (May 2009). In addition to an initial lump sum, he also encourages clients to incrementally increase their exposure to these thematic funds through dollar cost averaging (DCA).

He is particularly attracted to the flexibility thematic funds have to change their focus and pick the eyes out of the market in a way that is not mandated for by the predetermined charters that limit traditional equity funds.

"Funds that hug the index will struggle to provide the outperformance they did in the past, and are less equipped to deal with the changes in how future financial markets operate," he said.

With the markets becoming significantly more volatile, Wilkey believes the ability to "chop and change" their investment focus according to "opportunity sets" that present themselves is a distinct advantage.

He cites the recent decision by one fund manager to surrender one of its newer themes, "Rescue And Regulate", as a case in point. Due to the possible restrictive regulatory framework and nationalisation of western financials, the fund manager concluded that the upside for this theme was becoming increasingly problematic.

"This is what you're paying these global fund managers with vast access to worldwide research to do. Given their flexibility to run with a theme or drop it, their ability to monitor any change in investment direction is critical and particularly helpful for less experienced financial advisers."

"This is what you're paying these global fund managers with vast access to worldwide research to do. Given their flexibility to run with a theme or drop it."

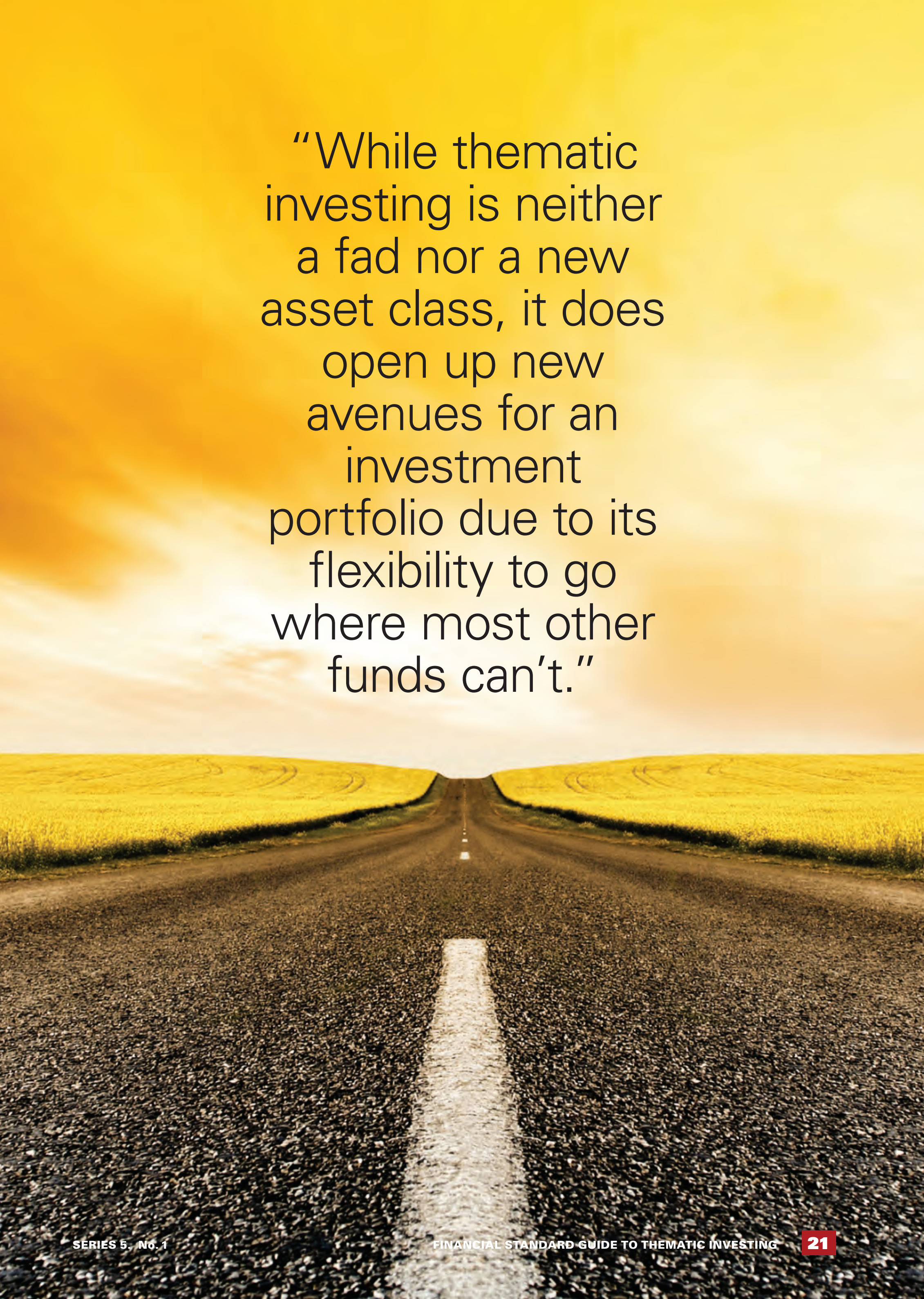
What Wilkey expects thematic funds to add to a client's portfolio is added fund manager diversification, extra alpha (or top quartile returns) and more sustained returns over the longer term. Depending on the size of the portfolio, Wilkey recommends clients place between five to 12 per cent of their overall portfolio (or 20 to 30 per cent of their international exposure) into thematic funds over a minimum horizon of three years.

Given that the thematic fund manager actively manages their themes and the stocks held within them, he says there's no need to lock in gains by selling out. And while both thematic funds Wilkey uses are down over the past 18 months, he said their outperformance relative to deep value funds is sufficient validation that his overall thematic investing strategy is working.

Wilkey says most clients are pretty in tune with the rationale behind emerging global themes. He said they also realise that down markets present the best opportunities to make money over the next five years or more, especially as fundamentals again start to drive investor sentiment.

Given that emerging economies are seen by thematic funds as a continued engine of growth, Wilkey said they are more attractive than sticking money into a BRIC fund, especially given their ability to find the right companies to invest in.

"While thematic investing is neither a fad nor a new asset class, it does open up new avenues for an investment portfolio due to its flexibility to go where most other funds can't."



"While thematic investing is neither a fad nor a new asset class, it does open up new avenues for an investment portfolio due to its flexibility to go where most other funds can't."

EASY GUIDE

CONTRARY TO POPULAR MISCONCEPTION, the types of themes that multi-themed funds invest in are not static. Instead, some themes only offer a small window of opportunity while other themes play out over a longer period of time. Thematic fund managers adjust their portfolio allocations accordingly and, in due course, introduce new themes or drop "old" themes. As an illustrative guide only, below is a list of themes that the Zurich Investments Global Thematic Share Fund invested in, as at June 2009.

THEME	DESCRIPTION	STOCK EXAMPLE
Anti-matter	Investing in what appears to be a trend going in the opposite direction of a major investment pattern. For example, while the rest of the world has been through a 20-year bull market and borrowing binge, Japan has been the anti-matter, suffering from a prolonged bear market and playing outside the Anglo world's credit cycle.	Daiwa Securities
Intergenerational Assets	Investing in companies that would address the needs of the next generation. For example, new clean power generation technologies and companies that address future climate change issues.	ABB Limited
Regulatory Change	After almost 30 years of falling inflation and interest rates, technological change and credit availability, the market is seemingly in transition from one long cycle to another. This theme is intended to deal with this change. While the new cycle has yet to be defined, it will likely address such issues as deleveraging, lopsided wealth distribution, competition for resources and the challenges to globalisation. The political cycle will support this change, creating opportunities in future years.	Vestas Wind Systems
Emerging Economies	One of the more well-known themes. It's about investing in emerging economies including China, India and Eastern Europe, which are expected to outpace the growth of the current largest economies in the world such as the US and the UK.	Hong Kong Exchanges and Clearing

THEME	DESCRIPTION	STOCK EXAMPLE
Gold & Precious Metals	In a world of inflation, uncertainty and geopolitical risks, gold remains a vital safety asset. It is the only currency that is in limited supply and can, therefore, be used to protect the portfolio from any future inflation outbreak.	Newmont Mining
Global Platforms	Also called "assets of choice". It's about investing in global companies that are in a mature phase of operation following years of consolidation in their respective industries. This means the companies boast strong cashflow and/or are cash positive and investors are likely to receive higher dividends or benefit from share buy backs.	Microsoft
National Platforms	As opposed to 'Global Platforms', these companies are subject to physical or regulatory boundaries but their reliable income and strong cash flow make them attractive enough to become strong market performers.	CVS Caremark Corp
Oil	This theme is focused on energy producers where capacity is limited and balance sheets are solid. Geopolitical uncertainty, constraints on future supply and soaring demand create a strategic underpinning for our holdings.	Anadarko Petroleum

Source: "Theme Today, Growth Tomorrow", Zurich Investments Global Thematic Share Fund, June 2009

GLOSSARY

Agribusiness	Large-scale business operation embracing the production, processing and distribution of agricultural products and the manufacture of farm machinery, equipment and supplies.
Alpha	The abnormal return on an overvalued or undervalued investment.
Asymmetric	Reflects the one-sided nature of the relationship large scale suppliers of natural resources have with their customers.
Benchmark unaware	Focuses on absolute returns and not wired to specific indices like the MSCI World Index.
BRIC economies	The four emerging economies of Brazil, Russia, India and China which collectively represent a powerhouse of future growth opportunity.
Dollar cost averaging	A technique that consists of regularly placing a fixed sum of money into the same investment. By doing this, investors will always be purchasing units at an average cost which is lower than the average unit price over the entire period.
Deleveraging	The process by which individuals or businesses reduce the relative size of their assets (debt) to equity.
Emerging markets	Countries outside the mainstream western and more successful Asian economies that are rapidly industrialising but remain volatile.
GDP	The total value of all the goods and services produced within a country's borders.
Gorillas	A company that has the greatest market share in a particular industry without having a monopoly. A gorilla usually has greater leeway in its decisions. For example, it may charge a higher price for its products without fear of losing too much business.
Intrinsic value	The value of a security, justified by factors such as assets, dividends, earnings, and management quality.
Macroeconomic	Focuses on the major aggregates, such as gross domestic product and the balance of payments, and the links between them in the context of the national economy.
MSCI World Index	A benchmark for international equity performance typically used by traditional equity fund managers.
Megatrend	Major developments with huge and potentially enduring implications globally, like urbanisation, climate change, the scarcity of fossil fuels and the burgeoning population growth.
Opportunity sets	Market dynamics providing investors with significant upside opportunity and limited downside risk that focus more on the long-term than today's trading fundamentals.
Super cycle of credit	Refers to the multi-decade era of breakneck growth in credit, financial instruments and sophistication which the credit crunch brought to an end late in 2007.
Urbanisation	Denotes the redistribution of populations from rural to urban settlements, notably within emerging economies like China and India that have a burgeoning consumer class.
Wrap account	An investment consulting relationship for the management of a client's funds by one or more money managers that bills all fees and commissions within one comprehensive fee.

Sources: Zurich, DWS, ANZ, www.investopedia.com, www.financial-dictionary.thefreedictionary.com

Life Insurance

Investments

General Insurance

The more baskets, the safer your eggs

Reduce risk by investing in a number of themes

It is possible to achieve long-term out-performance with less risk than the market by investing in a number of themes that each focus on different investment opportunities. Investors in the Zurich Investments Global Thematic Share Fund, managed by our strategic investment partner Lazard Asset Management, benefit from diversification across 8–12 themes. To learn more, call 1800 004 480 or visit www.zurich.com.au

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