TUTTLE
CAPITAL MANAGEMENT

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Contact: mtuttle@tuttlecap.com

Matthew Tuttle is CEO and owner of Tuttle Capital Management, LLC, and manages publicly-traded ETFs.

Thematic Investing

Tuttle Capital Management

Overview

Thematic investing involves creating a portfolio (or portion of a portfolio) by gathering together a collection of companies involved in certain areas that you predict will generate above-market returns over the long term (source: Wikipedia).

Thematic ETFs have been some of the most popular types of ETFs to launch in the past couple of years. There are a number of reasons for this, including the fact that these ETFs have the potential to outperform traditional market indices (and have done so by leaps and bounds on a backtested basis) and, from an optics perspective, they are just more interesting. However, in most cases, higher returns also mean higher risk, so there are a number of pitfalls investors need to be aware of: indexing, rebalance frequency, overweighting, and volatility drag.

The Problem with Indexing

Most thematic ETFs track some sort of index. This can be attractive from an investment standpoint because you know exactly what you have and what the rules are. However, indices are developed based on what has worked the best in the past, not based on what is going to work best in the future (that's because nobody knows what is going to work best in the future). Let's say it's 1900 and I develop and index to track companies in the horse drawn carriage industry. Such an index probably would have been great in the 1800s, but once cars were produced, it would be obsolete. That's an extreme example, but many of these indices that look attractive today may not be attractive tomorrow.

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Rebalance Frequency

Another way an investment theme becomes obsolete is if you don't rebalance frequently enough. Most ETFs rebalance quarterly or semi-annually. In a fast-moving market that is not quick enough to stay in harmony with what is going on in markets.

Weighting

In an effort to generate higher returns, many thematic ETFs have large weights on a small number of holdings. For example, Tesla makes up almost 11% of the ARK Innovation ETF (as of 5/6/21 source: Bloomberg). Large weightings can amplify returns, but it can substantially amplify risk.

Volatility Drag

The name of the game in thematic investing is to generate the highest returns possible. Overweighting certain names is one way this is done, and the other is to pick themes that can move a lot. This creates volatility drag, which comes from the fact that returns are geometric and not arithmetic. If an ETF makes 20% and then loses 20% your first assumption probably is that your return would be flat (+20%-20%=0) but you would actually have a 4% loss. This is volatility drag. The more volatile an investment, the more impact the drag has.

A Better Way to Do Thematic Investing

You can have rules that decide what stocks to own in a theme, but picking the universe should be discretionary. That way you don't run the risk of your universe of stocks becoming obsolete. Rebalancing should be weekly to stay in harmony with market trends. Secondly, you should have a weighting methodology that takes risk into account. The downside of this is that on a day-to-day basis this could impact returns, but over the longer term it will substantially reduce single stock risk and volatility drag.

Where Thematic Fits in a Portfolio

We are big believers in a Core/Satellite approach. The core of a portfolio could be things that would provide a normal ride without any surprises. Thematic investments could fit into the satellite; this is where one could be pursuing above market returns.

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