Adding thematic equities to diversified portfolios

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Once considered niche, thematic equities have in recent years evolved into mainstream investments.

Their ability to transform broad, long-term macro-economic, technological and environmental trends into investments has struck a chord with a growing circle of investors.

Even so, questions remain over how to incorporate such stocks within portfolios that use traditional asset allocation frameworks. We propose three broad approaches where investors can incorporate thematic equities in their diversified portfolios.

1. Satellite allocations within a core-satellite framework

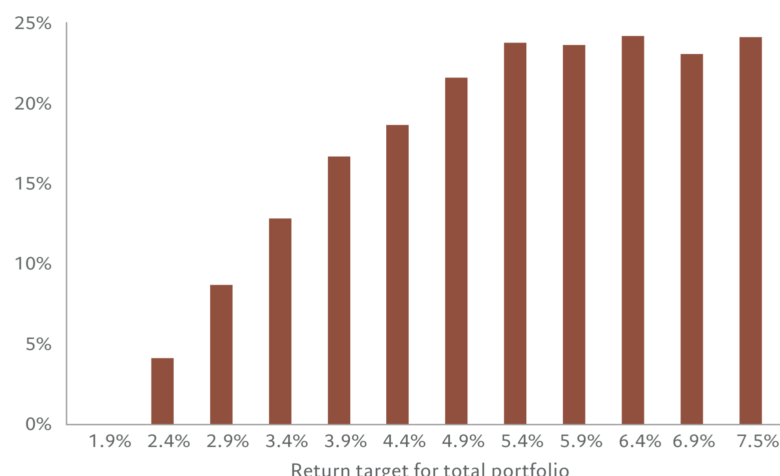
Under this approach, a portfolio is split into two distinct parts. The ”core” is well diversified and typically contains traditional investments such as equities and bonds. It is built using a standard asset allocation framework and its goal is to capture the market return from various asset classes, or their “beta”.

“Satellites”, in contrast, allocate capital to assets that fall outside the boundaries of the traditional asset allocation framework.

They account for a smaller portion of the total portfolio, typically up to a maximum of quarter of total assets.

Allocations to satellites are either made to express an investors’ structural, long-term view or to take advantage of opportunities that unfold over much shorter timeframes. Either way, the objective is either to access additional sources of alpha (a return that’s in excess – or independent of – the market) or to diversify risk.

Allocation to representative thematic strategy
Optimised allocation to thematic satellite
(no return advantage assumed)



Source: Pictet Asset Management; data covering period 31.12.2008-28.02.2021. Thematic portfolio randomly drawn every month from avilable thematic strategies. Simulation based on 100 random draws and subsequent calculation of efficient frontier. Chart represents the bottom thrid allocation to thematic equities across all simulations.

Our model suggests for portfolios with higher targeted return and risk tolerance, up to 20 per cent of investible assets can be allocated to thematic equities.

This testifies to the targeted and benchmark-unconstrained approach that thematic strategies pursue.

2. Thematic equities as global equity allocations

In this approach, investors incorporate thematic equities as a differentiated global equity asset class and add into an asset allocation as a complement for regional or country-based portfolios. This helps diversify sources of risk and return.

In building customised thematic portfolios for some of our clients, we have discovered that combining two or more thematic strategies with different risk profiles and style factor exposures into one allocation has much to commend it. For example, we can group strategies such as clean energy transition, timber, nutrition and water under the Climate Change umbrella.

The advantages are twofold. First, grouping thematic portfolios can make sense from a fundamental perspective. Some thematic portfolios complement one another – in other words, strategies that are underpinned by the same structural trends naturally fit together. By combining such portfolios into one larger investment, investors have the opportunity to harness the same megatrends but through a much broader range of investments.

The second advantage is diversification of return and risk, resulting in a portfolio with a potentially superior risk-return profile.

3. Fully diversified thematic portfolios

Thematic equity strategies can also serve as alternative to – or replacements for - global equity portfolios that invest across country or sector lines.

As the thematic equity landscape has expanded, the number and range of thematic equity investments has grown. This means that, by investing thematically, investors can now reasonably hope to achieve the same degree of diversification as they would investing in a strategy referenced to mainstream stock indices.

Attractive risk-return profile

Looking ahead, we think thematic stocks should retain their distinctive risk-return profile. This is thanks to a number of structural reasons.

To begin with, there’s the make-up of thematic investment universe itself. It consists to a much less degree of large mega-cap companies than traditional indexes. This has significant investment implications. There is a large body of evidence showing that the stocks of specialised firms do better than those of large, diversified companies over the long run. Essentially, large firms suffer from what is known as the “conglomerate discount”. Put another way, broadly diversified companies are worth less than the sum of their parts.

By contrast, specialised firms – sometimes known as “pure play” companies – typically have a much clearer view of their strategic priorities and concentrate spending in areas that promise the strongest growth. Their capital allocation is more efficient which, in turn, builds a premium into their share prices over time, according to a BCG research.

Because they are specialised in their activities, they have little in common with the huge, diversified multi-nationals that dominate mainstream equity indices such as the MSCI World or the S&P 500 Index.

This carries over to the portfolio. The investment approach is index-unconstrained, delivering a portfolio that bears little, if any, resemblance to those whose reference index is a mainstream equity benchmark. Thematic strategies’ high active share is an indication of this.

And while the risk and performance of thematic equities may vary over the different phases of the market cycle, their structural design features should lead to portfolios with market characteristics that are relatively predictable over full market cycles. This is why we think they merit a place in a diversified global portfolio.

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