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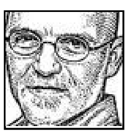
THE INTELLIGENT INVESTOR

The Story Behind the Market's Hottest Funds

Thematic ETFs allow investors to bet on trends and concepts—but their narrow focus increases their risk

ILLUSTRATION: ALEX NABAUM



By

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Investors used to love "story stocks." Now they love story ETFs.

A story stock is driven not by earnings or assets but by a simple, alluring narrative: a dynamic new boss, dazzling technology or customers going ga-ga for its products. A story ETF is an exchange-traded fund that invests not in an entire market or single sector but rather in a concept or trend.

You're probably better off buying a story ETF than a story stock; at least the fund is somewhat diversified. But story ETFs carry their own risks.

Often called thematic ETFs, these funds cut across industries, trying to capitalize on ideas like alternative energy, cloud computing or 3-D printing. Others buy stocks that could benefit as more people work from home, demand gender or racial diversity, or lavish money on their pets.

Assets in these funds have grown at an average of 45% annually over the past three years, says William Baun of Fuse Research Network in Needham, Mass.

In the fourth quarter of 2020 alone, thematic ETF assets shot up 78% to $104 billion, according to Global X Management Co. LLC, which offers several such funds.

One reason is performance. Invesco WilderHill Clean Energy ETF gained 205% last year. ARK Genomic Revolution ETF returned 181%, and its four sibling funds each went up at least 100%.

In addition, the pandemic undercut the traditional belief that stocks in the same sector tend to move together, says Jay Jacobs, head of research and strategy at Global X. Norwegian Cruise Line Holdings Ltd. and Amazon.com Inc. are both consumer discretionary stocks, but Norwegian's shares sank 56% in 2020 while Amazon shot up 76%. Meanwhile, ETFs pursuing the online-shopping theme across several industries were up between 74% and 123% last year.

In 2020, with investors stuck at home, trends hit home. "People now understand themes like cloud computing and collaborative software in ways they might not have appreciated before," says Scott Helfstein, head of thematic investing at ProShare Advisors LLC in Bethesda, Md. "All of a sudden, here they were. It was like, 'Invest in what you know.'"

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Investors pursuing themes that seem obvious should remember a few principles that ought to be even more obvious.

Investing in only a slice of the market, instead of the entire market, lowers your diversification and raises your risk. Management fees can be at least 10 times higher than on ETFs that track the stock market as a whole. If a theme appeals intuitively to you, chances are it appeals to millions of other investors too, making a fund's underlying holdings more expensive.

A new study by several finance professors finds that, on average, such ETFs hold only about one-quarter as many stocks as do broad-based funds. Looking at more than 1,000 ETFs of all types between 1993 and 2019, the researchers found that thematic funds underperformed the overall stock market by about 0.5 percentage points per month, adjusted for risk.

They also found that these funds tend to launch months after a theme has gotten hot—amid a crescendo of media hype and stocks earning eye-popping returns.

It takes several months to launch an ETF, according to industry executives. Between the time a compelling theme emerges and an ETF hits the market, the stocks that play off that trend can become dangerously overvalued. That means fund managers are often "packaging dreams," says Itzhak Ben-David, one of the study's authors.

In other words, investors have a natural tendency to buy at exactly the wrong time, and these funds can make that even worse.

"That is a risk," says Robert D. Nestor, president of Rafferty Asset Management LLC, which manages several thematic ETFs under the Direxion name. "It would be disingenuous to say otherwise."

Quirky rules of portfolio construction can also crop up. At the U.S. Vegan Climate ETF, the size of any single stock position is limited to 4.5%. Yet Tesla Inc., the fund's largest holding, has mushroomed to 7.9% of total assets.

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Have you invested in any thematic ETFs? Which ones and why? Join the conversation below.

The 4.5% limit is enforced twice a year, when the fund rebalances, or adjusts the size of its holdings, each June and December.

In its semi-annual rebalancing, the Vegan fund reduces any positions that are above 4.5%. It uses the proceeds of such sales to buy more of its other top holdings, says Claire Smith, chief executive of the fund's adviser, Beyond Investing LLC.

That could concentrate the fund in a handful of winners over time. The policy would come under review if it ends up making the fund too top-heavy, she says.

Overall, story ETFs are more fun than plain old index funds that hold everything in the market—but riskier, too.

In years past, "people might get a stock tip from a taxi driver," says Deborah Fuhr, founder of ETFGI, a fund-research firm in London. "Now, most people can have their own view on a theme."

These ETFs are "the new version of stock tips for the new world," she says.

Well, I've got a tip for you. If you think you've spotted a theme that other investors haven't fully appreciated yet, ask yourself how come there's already a thematic fund for it.

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