

Promotional communication for all audiences

From megatrends to thematic allocation



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From megatrends to ...

Foreword

The objective of thematic investing is to take advantage of megatrends, whether also sometimes referred to as “long-term trends term”. The idea is simple and attractive. But many questions arise in practice, such as “What is the connection between megatrends and investment themes?”, “Are there any natural biases in thematic investing?” or “Does investing in long-term trends mean that day-to-day events don’t matter?”. We aim to answer them in this document and we address in particular the topic of the place of thematic investing in asset allocation.



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thematic allocation



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1.01

WHAT IS

THE CONNECTION

BETWEEN

MEGATRENDS AND

THEMATIC

INVESTMENT?

The intrinsic force of megatrends is where thematic investment begins, since that is what it takes advantage of. The basic principle of thematic investment is to develop the best possible understanding of major human, technological and planetary trends, in order to build bridges between the financial markets and the real world.

If thematic investment had existed as such in the early 20th century, it probably would have taken an interest in electricity and the impact that its widespread roll-out would have. If it had existed as such in the 1960s, it would probably have looked into the democratisation of leisure & entertainment.

The challenge of thematic investment is therefore to anticipate tomorrow's world as accurately as possible.



1.02

WHAT IS AN INVESTMENT THEMATIC?

After identifying the most meaningful megatrends, investors must try to determine the impacts those megatrends have on various financial variables, such as asset classes, sectors or sub-sectors, and geographical regions. Thematic investment goes one step further in trying to determine “investment thematics”, which can be defined as powerful economic trends or shifts that arise from megatrends, based on well-defined themes that transcend traditional financial classifications, such as sector, country, etc.

For example, climate change is a megatrend that makes an energy transition mandatory. An energy transition, in turn, may take several different forms (such as developing renewable energies or new technologies such as hydrogen,

etc.) and, hence, give rise to several investment thematics. These can already be clearly identified, while others are emerging little by little.

With this in mind, a fund dedicated to creating and developing a hydrogen-based ecosystem makes a lot of sense.

INVESTMENT THEMATICS OBVIOUSLY HAVE MAJOR DEVELOPMENT POTENTIAL, AND ONE OF THEIR MAJOR CHALLENGES IS IN DETERMINING, AT THE EARLIEST STAGE POSSIBLE, FUTURE TRENDS IN REVENUE AND EARNINGS OF COMPANIES INVOLVED IN THE THEMATIC IN QUESTION.

One difficulty in constructing a thematics-based portfolio is that companies that are involved in a thematic are not all involved in the same way.

Pure players are all-in on a thematic, whereas other companies may be only partially or even marginally so. This is where the concept of thematic funds' "purity" comes in.

■ ■ THE CHALLENGE OF THEMATIC INVESTMENT IS THEREFORE TO ANTICIPATE TOMORROW'S WORLD. ■ ■



WHAT IS THE CONNECTION BETWEEN THEMATIC INVESTMENT AND INNOVATION IN GENERAL?

The speed at which innovations spread throughout society depends not just on their features, but also on the broad societal and economic environment. Regardless of an innovation's quality and value, it will not necessarily be adopted. Moreover, the insufficient uptake of technological innovations has often been cited as one of the main causes of the productivity gains in the early 20th century (the well-known "productivity paradox")².

Companies' adoption of new technologies depends, for example, on both human factors (managerial skills and quality of strategic vision, level of employee training, suitability of employee skillsets) and market factors (barriers

Naturally, thematic fund managers keep a close eye on technological innovation, as their goal is to capture megatrend-driven structural changes in the economy. Keeping up with technological innovations is obviously crucial, but it is also necessary to keep a close eye on how such innovations are adopted.

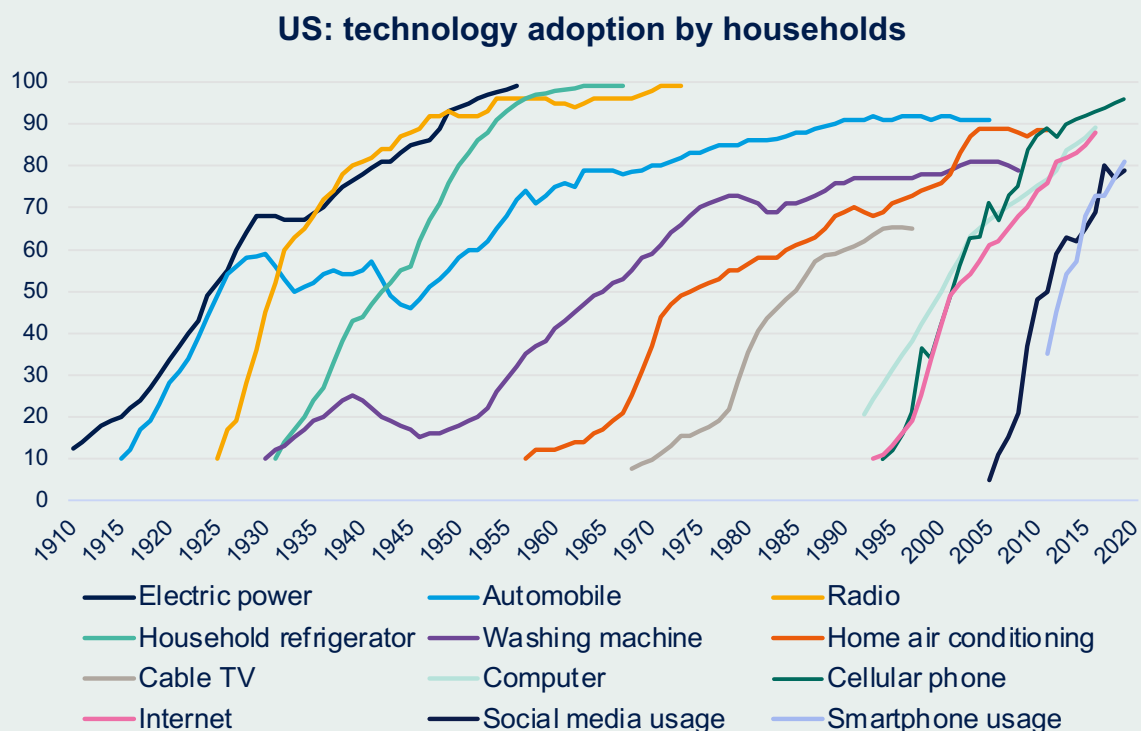
². Acemoglu, Daron, David Autor, David Dorn, Gordon H. Hanson, and Brendan Price. 2014. «Return of the Solow Paradox? IT, Productivity, and Employment in US Manufacturing.» *American Economic Review*, 104 (5): 394-99. Andrews, D. C. Criscuolo and P. Gal (2016), "The Best versus the Rest: The Global Productivity Slowdown, Divergence across Firms and the Role of Public Policy", OECD Productivity Working Papers, No. 5.

to entry and exit, trade restrictions, ability to finance innovations, existence of infrastructures necessary for using the innovations, tax incentives, excessive bureaucratic hurdles)³. When the barriers are too high, technological innovations disseminate only slowly, **which is why the performances of an investment thematic, even a high-potential one, may take time to show up**. Public policies to combat such barriers (training programmes, facilitating financing, subsidies, development of infrastructures, etc.) may help a the-

matic develop faster, as there is very often an alignment of interests between the public and private spheres. In some areas (energy transition or strategic autonomy, for example), cooperation between various actors is necessary. .

The same type of phenomenon can be seen in households' adoption of new technologies. Here again, public policies (subsidies in particular) can help speed up the adoption of a new technology.

3. OECD, 2018, "Digital technology diffusion: a matter of capabilities, incentives or both?", Economics Department working paper n°1476.



Source: CPR AM, Our world in data



are there any natural biases in thematic investment??

1.04

By definition, thematic investment is often associated with so-called growth stocks, as it deals with companies whose growth potential is thought to be greater, thanks to their exposure to megatrends. Growth stocks have some specific features. In his seminal book *The Intelligent Investor*, Benjamin Graham explains: “The term ‘growth stock’ is applied to one which has increased its per-share earnings in the past at well above the rate for common stocks generally and is expected to continue to do so in the future. Obviously stocks of this kind are attractive to buy and to own, provided the price paid is not excessive.” It’s easy

to see how the issue of valuation can be more challenging than for the shares of more standard companies. The sometimes high valuations of some companies related to thematic investment show how important timing is in stock-picking, and one of the roles of the thematic manager is to buy growth stocks at reasonable valuations.

Also, by definition, thematic investment may identify companies that will be leaders in new technologies (for example, clean technologies, artificial intelligence, or cybersecurity). Some thematic funds are, in fact, on the lookout for “tomor-

row's Teslas" (see boxed article on Tesla). In some cases, these companies are too young and lose money for quarters or for years before becoming very profitable. That makes valuation even more challenging, and some thematic funds may have a "size" bias.

Trying to identify "tomorrow's Teslas" has important implications. First, in the race for innovation, a number of young companies will obviously fail or even disappear. Tesla has succeeded, but Fisker Automotive or Lordstown Motors, two other electric vehicle makers, have failed and have disappeared. Other EV makers are still there, but have not managed to expand as fast as Tesla or have

simply been taken over. So even within a winning investment thematic, there will be winners and losers, and that is why active investment is so important.

Given thematic funds' natural growth bias, it is crucial to keep track of monetary policy. Most of growth companies' earnings are expected in the future and not necessarily in the present, so an higher interest rates lowers those companies' present value. Growth stocks are almost twice as sensitive to interest rates as value stocks⁴. Phases of monetary tightening may therefore often penalise thematic funds.

4. BIS, 2022, "Rotation from growth to value stocks and its implications"



**GIVEN THEMATIC FUNDS'
NATURAL GROWTH BIAS,
IT IS CRUCIAL TO KEEP
TRACK OF MONETARY
POLICY.**





1.05

Does investing in long-term trends mean that day-to-day events don't matter?

One pitfall consists in believing that, since thematic investment deals with long-term trends, it is little affected by the current macroeconomic situation. This is wrong, for at least five reasons:

1. Our understanding of megatrends and their thematic implications grows each day. There can be tipping points and phases of acceleration in megatrends (for example, when a highly-populated age group reaches retirement age, or possible non-linearities in climate dynamics). There are also technological innovations that are developed each day, which is why it is important to keep up with scientific research.

2. As we have seen, a thematic's performances can take time to show up, regardless of its potential, **due to the many barriers to dissemination of technological innovations.** That's

why keeping up with fiscal policy, particularly public investment plans, is absolutely essential, as such choices can accelerate the development of some thematic and/or help some thematic succeed more than others. While megatrends are generally uncorrelated to economic cycles, the development of investment thematic is at least a little tied to them.

3. In thematic funds in which there are few or no pure players, performances can be driven by a wide range of factors and not just by the megatrend identified.

4. Geopolitical developments have a significant impact on the development of thematic.

In some cases, such as measures against climate change, international cooperation is a decisive factor in success (in concrete terms, a binding international agreement can accelerate a thematic). However, rivalries between major powers, for example for technological leadership or control over commodities, may lead them to adopt trade or investment restrictions, broadly

defined, which can have a heavy impact on the development of certain thematic (for example, a thematic could be handicapped by trade restrictions on critical items in the value chain).

5. Given the rather common “growth” bias in thematic universes, monetary policy developments have direct impacts. Phases of monetary tightening are, on average, more unfavourable to thematic than to the equity market as a whole, and vice versa.

So, even though thematic funds are focused firmly on the long term, like all investment funds, they can be impacted by the short-term micro-financial environment (fiscal and monetary policies, trade policy, geopolitics, economic prospects, etc). Moreover, the quarterly results of some young companies focused on our investment thematic may give rise to short-term, above-average volatility. But we believe it is worth staying the course and keeping one’s exposure to long-term thematic, as they offer meaningful megatrend-driven growth potential.

BUT WE BELIEVE IT IS WORTH STAYING THE COURSE AND KEEPING ONE’S EXPOSURE TO LONG-TERM THEMATIC, AS THEY OFFER MEANINGFUL MEGATREND-DRIVEN GROWTH POTENTIAL.



1.06

WHAT ROLE DO THEMATICS PLAY IN FUND ALLOCATION?

The answer to this question obviously depends on the investor's profile and must be adjusted carefully to his pre-existing allocation (size, diversification, risk profile, factor exposure, etc.) and constraints. **One possibility is adding thematic funds as “satellites” to a traditional diversified allocation**, for example for investors subject to tight constraints. Incidentally, keep in mind that, contrary to popular belief, thematic funds are not equity funds alone; there are more and more bond thematic funds. In some cases allowed by risk constraints, it is also possible to substitute “thematic” equity funds for traditional equity funds. Moreover, it is important to keep in mind that not all thematic funds are the same. A fund investing in digital disruption, for example, doesn't have the same risk/reward profile as a fund focused on the senior economy or a hydrogen ecosystem fund.

TO BUILD UP A VIABLE "THEMATIC ALLOCATION", IT IS ESSENTIAL TO BE FAMILIAR WITH THE MEGATRENDS FROM WHICH INVESTMENT THEMATICS ARISE.

To classify megatrends in terms of long-term opportunities, we have laid out a framework for analysing them around three fundamental criteria:

1. maturity in the development cycle, i.e., emergence, growth, maturity or normalisation. For example, urbanisation has been an ongoing process since the Second World War, whereas the fight against climate change has only just begun.

2. Weight/economic materiality, including public and private investments in each challenge, changes in lifestyles, level of appropriation by public authorities and public opinion. Investments in energy and infrastructures will accordingly rise sharply, based on governments' "net zero" goals.

3. Investability: existence of proper investment media. The thematic investment universe must be sufficiently deep, diversified and optimal in terms of purity to exploit megatrends.



WHAT GREAT economists are ASSOCIATED WITH thematic investment?

1.07

One great economist who comes to mind on the subject of thematic investment is **Joseph Schumpeter**, who was one of the founders of the theory of innovation. To him, “creative destruction” describes *“a process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one”*, which is a cause of economic fluctuations in all forms of cycles. This applies, for example, especially well to the boom in clean technologies (the replacement of fossil

fuels with clean energies, the boom in electric vehicles, the boom in automation and artificial intelligence, which could replace people in certain tasks). .

Perhaps, and more surprisingly, there is **John Maynard Keynes**. One of his great ideas (among many others) is that the state must step in when demand is too weak (during recessions, for example) to support consumption and stimulate investment. The multiplier effects of this expansionary fiscal policy allow the economy to restart on more solid baes. The connection with thematic investment is that “Keynesian multipliers” are very often an opportunity for governments to invest in sectors of the future. During the Covid crisis, a

In illustration, from left to right: Elinor Ostrom, American economist (1933-2012) ; Jean-Baptiste Say, économiste français (1767-1832) ; Joseph Stiglitz, American economist (1943) ; Joseph Alois Schumpeter, Austrian economist (1883-1950) ; John Maynard Keynes, English economist (1883-1946).

significant portion of the Next Generation EU plan covered the energy transition and digitalisation.

Two other economists are **Dennis and Donella Meadows** and other authors of the Meadows report⁵, published in 1972, which already sounded the alert that finite resources created caps on economic growth.

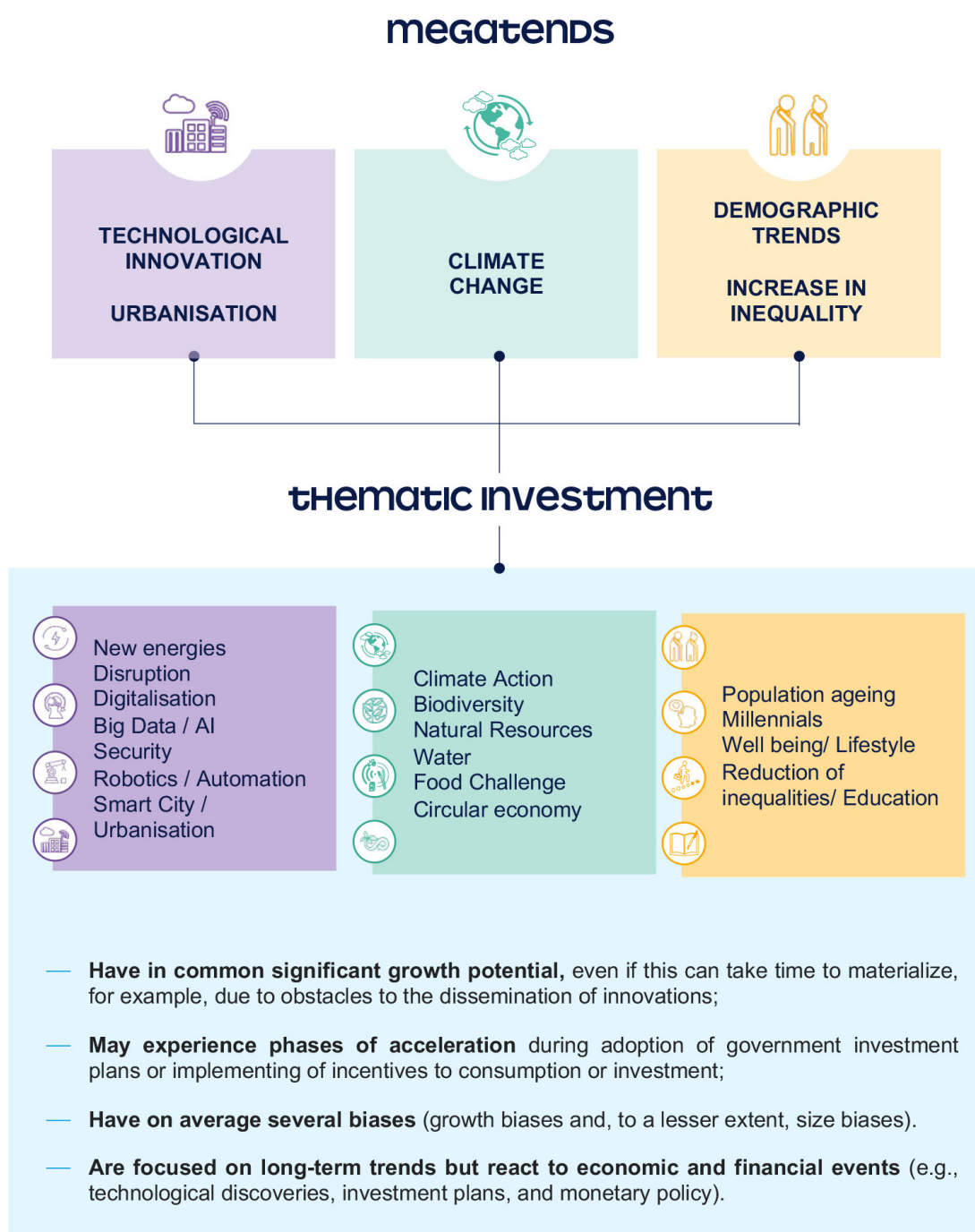
The issue of resource exhaustion is nothing new, but is being felt more and more urgently. The increasing scarcity of resources opens up a number of investment thematics, such as the switch to a more circular economy but also the implementing of independence and sovereignty policies.



5. In illustration, from left to right: Jorgen Randers, Jay Forrester, Donella et Dennis Meadows, William W. Behrens, 1972, « Limits to growth »

TO SUM UP

Megatrends (i.e., long-term trends that on the whole are decorrelated from economic cycles) give rise to investment thematics that are well circumscribed and transcend traditional classifications. These investment thematics:

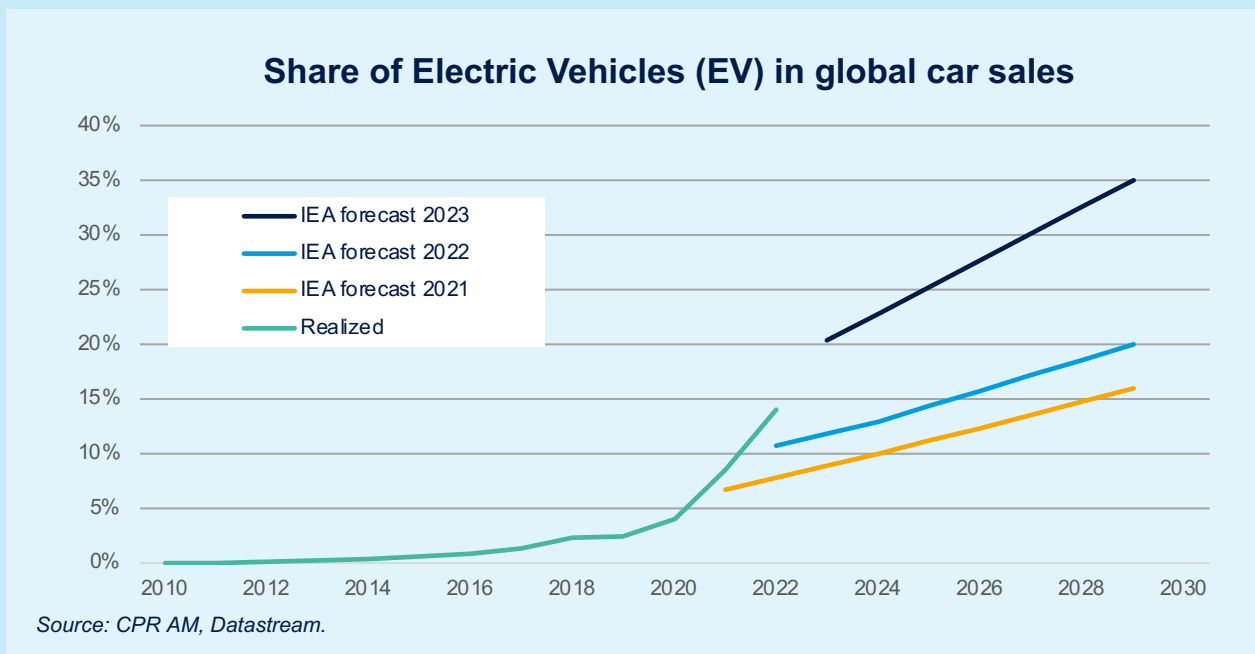


on the LOOKOUT FOR the

« TESLA of tomorrow »

Electric vehicles (EVs) were once rather commonplace in the US early in the 20th century, but over the past century or so have been superseded by internal combustion vehicles. Several US automakers unveiled EV prototypes in the 1990s, but production runs were very limited and often shut down. However,

technological progress and increasing environmental awareness, particularly since the early 2010s, made it clear that EVs would return to favour and achieve extremely strong growth in the following decades (see, for example, the International Energy Agency's forecasts).



The stock-market run of the EV manufacturer Tesla, which was founded in 2003 and has been listed since 2010, shows that success, even in a promising investment thematic, is not a given, but also that valuing growth companies is challenging, as some traditional metrics do not apply (price/earnings ratios,

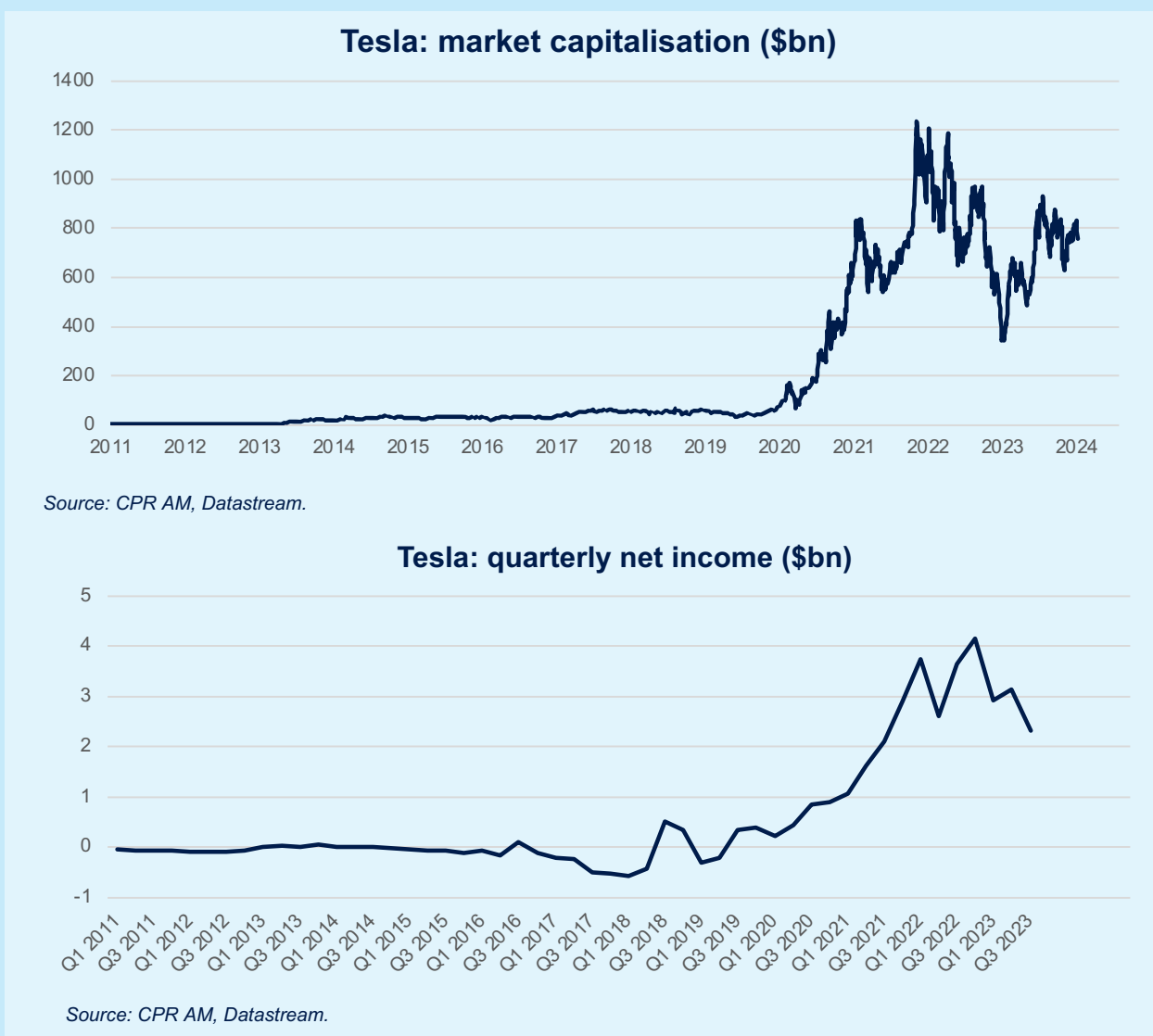
for example, make no sense for companies that are not yet profitable). Not until a number of years did Tesla become profitable (it didn't truly become so until mid-2019) and that was when its stock truly took off. Sales took off on the heels of aggressive government policies in major countries, buttressed by infrastruc-

ture plans adopted during the Covid crisis, including the Inflation Reduction Act in the US.

Prior to 2019, Tesla had mostly reported from 2015 to 2018. As of the end of 2019, Tesla's market cap was just \$75bn. In October 2021 it hit \$1000bn for the first time and it is now one of the world's largest market caps.

Tesla's share price rose by 743% in 2020. Good for you if you had it in your portfolio. Simply put, one of the objectives of thematic investment is to identify the "Teslas of tomorrow".

But this example also shows that the stock market success of thematic companies depends closely on the ground on which they develop.



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