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Using ETFs to Articulate Thematic Investment Opportunities in Global Markets

On September 22, Hubbis hosted a virtual Digital Dialogue panel discussion on Exchange Traded Funds (ETFs) and their rising prominence for the wealth management community in Asia in terms of access to thematics including ESG. The markets across the developed world have slumped this year, and thematic ETFs have also been hit, but there are many who argue that as they offer vehicles to access longer-term disruptive themes that are driven by key emerging trends in our lives, rather than just by growth, thematics will remain in great demand and perform well over time.

There has of course been a rising tide of interest in Asia broadly for ETFs of all types in recent years, and their effectiveness as part of any robust portfolio has been seen even more sharply in the spotlight of the Covid-19 driven market volatility since 2020. Against that backdrop, our chosen panel of experts discussed what key elements make for an interesting thematic ETF, how smart beta can be expressed through ETFs that adapt the asset composition to fit certain key investment trends and themes that their creators have identified, and what types of thematics will likely continue to find strong investor demand.

SPEAKERS

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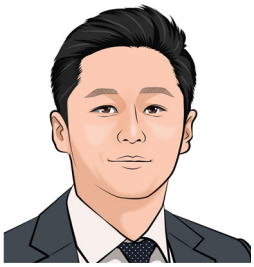

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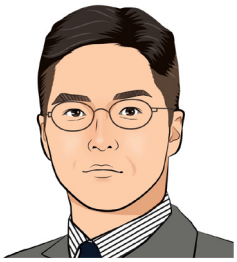

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Setting the Scene

The September 22 discussion ranged over the global rise of the thematic ETF phenomenon, their effectiveness in sophisticated and robust portfolios, their value for self-directed investors and, for the private bankers and wealth advisory community of Asia, to help them roll out more advisory and DPM mandates amongst their private clients.

There are many specific trends that can also be captured through tailored ETFs, such as for example China's technology sector, global medical and healthcare, or perhaps country-specific ETFs such as Vietnam, or perhaps carefully assembled ETFs that aim to selectively capture the towards sustainability and social impact via ESG-centric ETFs. The panel will look closely at how these smart beta ETFs are assembled and discuss the rationale for the broad expansion of thematic ETFs.

And it is not only equity ETFs that will be in focus here; fixed income ETFs have also proven themselves to offer investors both liquidity and performance, especially during the market stresses of Q1, 2020. At that time, many institutions, and very wealthy investors, instead of their traditional approach of buying single bonds, bought into fixed income ETFs due to the liquidity, speed of execution, and transparency.

The discussion was naturally be directed towards the Asian wealth management community, to debate where such ETFs fit into private client portfolios in the region, and how and why they should build a greater allocation towards ETFs, including smart beta ETFs that allow for greater thematic expression in the portfolios.

Why have thematic ETFs become so popular? Answer: access to megatrends affecting all our lives in the future

Thematic ETFs are designed to capture long term structural trends that are set to change the way we live and work. One major house focuses on five key megatrends driving disruption across the world: technological breakthroughs, climate change/resource scarcity, demographics/social change, rapid urbanisation, and changing economic power.

This expert reported that in the past several years, the assets of thematic ETFs globally had grown more than threefold, form roughly USD55 billion before the pandemic to USD200 billion plus by late 2021.

"A major reason behind this rapid growth of thematic ETFs is the acceleration of some of these megatrends, including what we saw during the pandemic around digital connectivity and digital working and shopping and so forth," they reported.

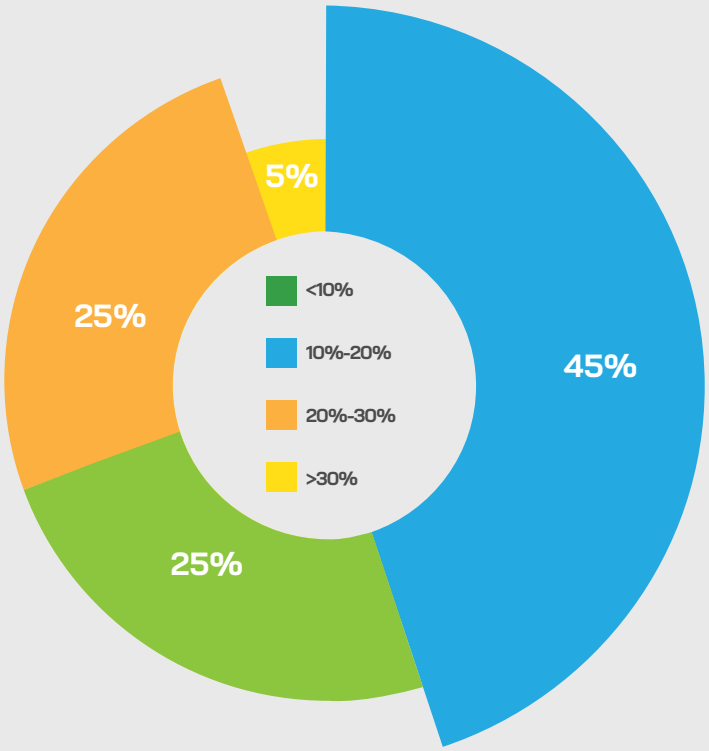
Another guest opined: "Thematic ETFs are gaining traction because structurally they open up tactical opportunities to broader themes, with all the advantages that ETFs have over traditional funds. But also, right now, because of the dispersion in markets which makes thematic opportunities so interesting – the more specific the theme, the more interesting the tactical opportunity."

Three key benefits of thematic ETFs – access, risk management and thematic purity

This same expert explained they see three core benefits. First, access to

The Hubbis Post-Event Survey

WHAT PERCENTAGE OF HNW AND UHNW INVESTMENT PORTFOLIOS IN ASIA SHOULD BE DEDICATED TODAY TO THEMATIC INVESTING?



Expert Opinion

PAUL GAMBLES, Director, MBMG Group

"There is still also considerable interest in fixed income ETFs, but of course in times of rising rates, there are aggregate outflows from fixed income. Nevertheless, once rates peak, we expect huge inflows, and if rates then fall there are great opportunities in US Treasuries, for example. Meanwhile, corporate debt (especially high yield) still worries us though – spreads could easily blow out and there's too much money in corporate debt ETFs for such a relatively illiquid underlying asset class. Actually, ETFs have done a great deal to make corporate debt a genuinely traded asset class but we're not there yet and it will be ugly if we get a blow out before we are. Indeed, spread compression actually indicates to us an accident waiting to happen."

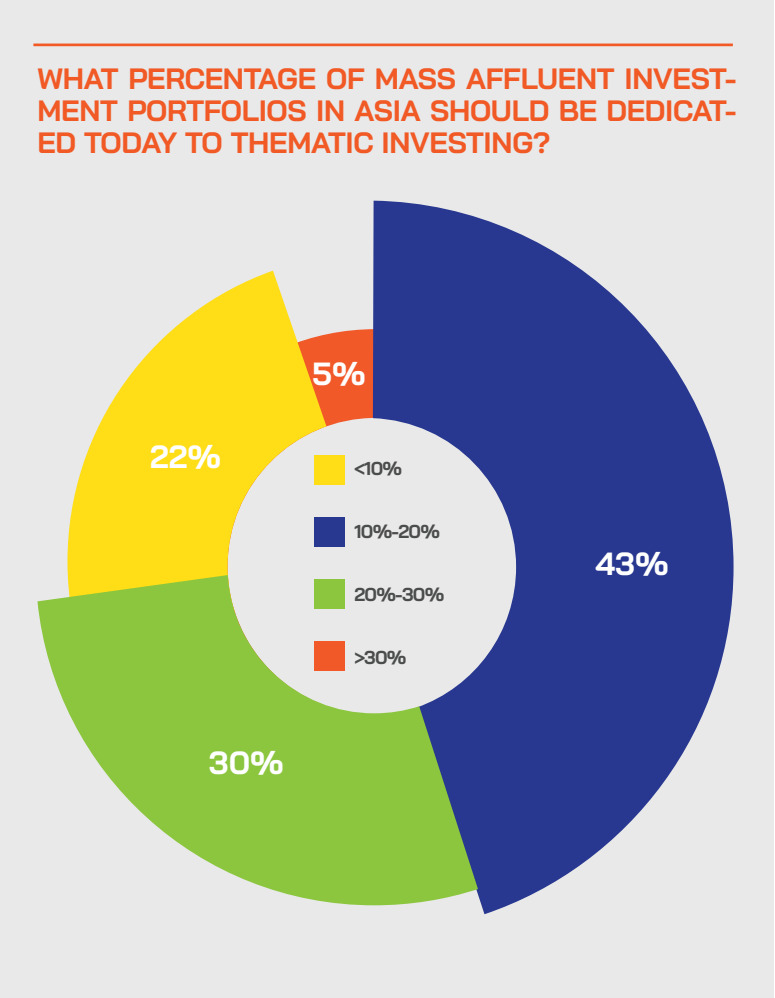
new themes that are not so easy to buy into stock by stock, including themes around neuroscience, Metaverse or cloud computing, which are still in the early stage of the business cycle. "Secondly, thematic ETFs have a broad array of holdings, so that helps exposure and risk management," they reported. "And third, there is thematic purity; well-managed thematic ETFs have very sophisticated index construction methodology and that helps define and select the companies that really are central to the themes expressed."

Thematic ETFs are also becoming more and more specific, and increasingly niche

Another guest expanded on the access, noting that thematic ETFs are getting more and more niche, in terms of geography perhaps, or sub-sectors of EVs, such as global smart driving, or perhaps solar power as a sub-sector of sustainable energy. He pointed, for example to Chinese solar power, which is relatively difficult to access and in which there are many non-mainstream Chinese companies participating. "We provide investors plug and play access without them needing to do any core research," he said.

Another one might be market specific, such as Vietnam, where we can now track the FTSE Vietnam 30 index; we all know how difficult it is to access Vietnam, including currency restrictions, so to provide access to that market through a Hong Kong listed vehicle offers considerable appeal."

He added that such ETFs help investors of all sizes, whether institutional or retail, gain access to interesting opportunities.



ETFs are also ideal for digital investment and robo-platforms, which offer efficient, prescribed and increasingly tailored investment portfolios

A guest explained that their digital platform offers a core asset allocation portfolio, consisting of traditional equities and bonds with geographic diversification and also across different industries. "And we have seen more and more of our investors asking us about the various thematics," she reported, "hence we now offer four different thematics."

She explained these focus on technology driving innovations including artificial intelligence, blockchain technologies. Then there is consumer technology that people can use every day, including FinTech, or Tesla. The third thematic centres on healthcare, where there are numerous technological breakthroughs ahead. And finally, there is the climate related thematic. She explained that by combining stocks and even specific ETFs, they can achieve thematic investments that offer broad access and diversification.

"And for investors, they can also choose their risk level, because we do also recognise that investing in thematics can be very exciting, and actually generate pretty good returns in the long term,

sometimes these are more volatile, especially given the early-stage nature of many of the constituent companies," eh added. "So, for example, if you invest in a blockchain company, given that the technology is still early in the adoption curve, the company tends to be a lot more volatile than, for example, a tech company that's much more developed, for example, Apple."

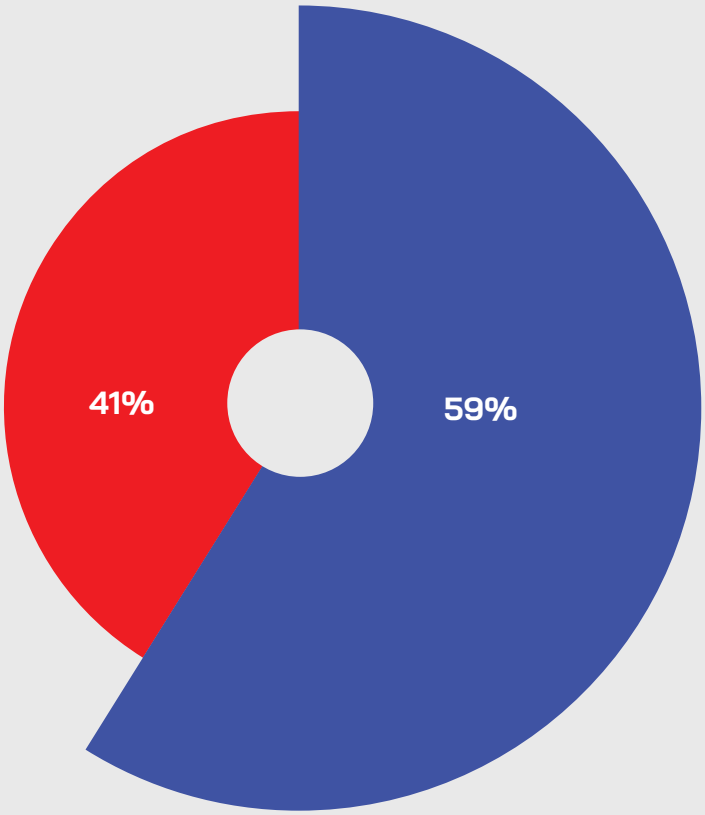
Accordingly, they actually combine these thematic ETFs with safer assets such as bonds, for example. "In this way, investors can actually achieve good diversification, but balanced with safer assets, so they get more stability while still enjoying the long-term upside of a thematic ETF," she explained. "We have gained some good traction with this approach."

In today's challenging market conditions, creators and distributors need to hone their marketing approaches

A guest acknowledged that the thematic space has been hit very hard hit this year, because many of the themes are very exposed to the growth factors. "However," she explained, "there is a misconception that thematics are all growth oriented; for example, urbanisation as a core thematic relates to demographic changes, the need for infrastructure, and these industries that help achieve all that are largely more traditional and value oriented."

Moreover, they explained that clean energy is also value-driven and climate-driven and is one of the key areas that have generated the most inflows year to date. Moreover, clean energy

SINCE THE MARKETS DROPPED, HAS THERE BEEN A SHIFT AMONGST YOUR CLIENTS AWAY FROM PASSIVE INVESTMENTS TO MORE ACTIVELY MANAGED STRATEGIES?



Expert Opinion

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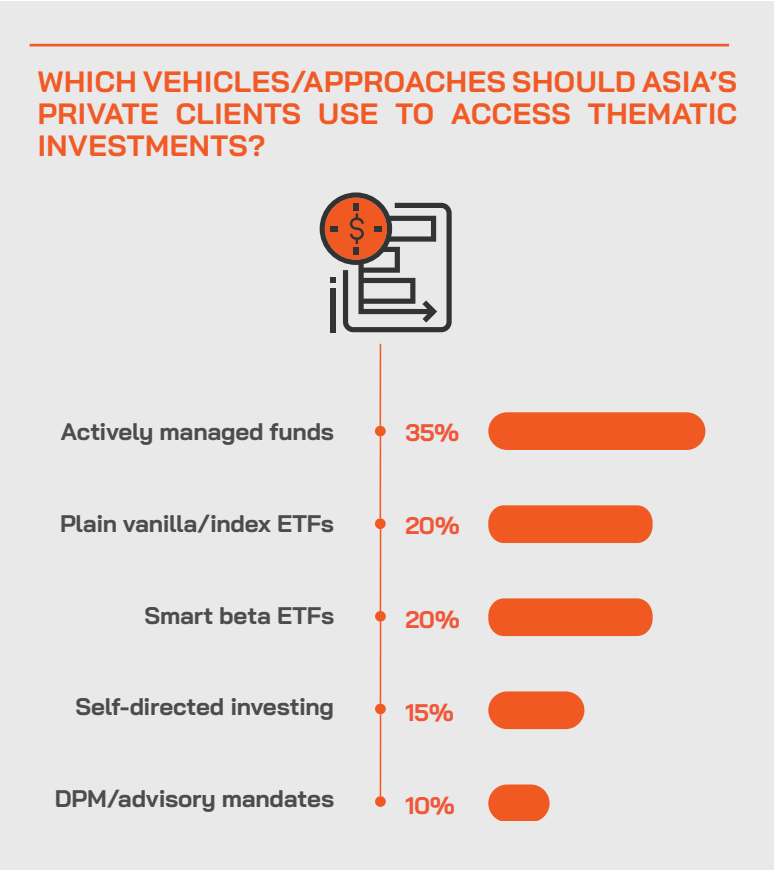
"The greater range of investable assets and strategies and the greater ability to benchmark these through an explosion in index information from data providers has opened the door to a far wider range of investable propositions. First ETFs ate individual stocks (why invest in stocks if you can get an exchange traded basket?). Then they ate funds (why invest in subscription funds when you can get market traded funds?). Then they started to develop a life of their own in specialist markets such as specialist assets like commodities or specialist strategies like long/short and so forth."

has actually outperformed the bond market by over 20% year to date. Yes, they explained, traditional energy sector has been the best performing sector year to date, up some 30% since the beginning of this year, but if we look at the time from the Russia invasion of Ukraine, actually, the green energy space has outperformed the traditional energy space, here I am speaking of the largest clean energy ETF currently available, outperforming the MSCI World Energy index.

"With many different catalysts behind it, clean energy is definitely something that within the thematic space is a very strong theme that will not just perform well in the near term, but is a long-term trend," she said. "It is clearly one of the areas that is different from the traditional growth-oriented tech themes that people would usually think of when we talk about thematics."

Another guest agreed, noting that form their viewpoint, ETFs are the most diversified and safest way to invest into the market in general, especially given the current environment with the amount of volatility out there. "ETFs are the easiest way to trade into a diversified portfolio in order to weather difficult market conditions," he said. "Relative to single stocks, we still believe that ETFs are the way to go. Obviously, if you buy into a single stock that performs really well, perhaps the growth will be higher than a basket or index that's sold by an ETF issuer, but we do believe like in terms of risk reward ETFs are the way to go."



Thematic ETFs appeal as under one 'roof' they can span and encompass multiple sectors and different geographies

A guest cited the example of EVs, electric vehicles, noting that such thematic ETFs might include not only the specific, dedicated electric car makers such as Tesla or BYD, but battery makers, lithium miners and also different auto part manufacturers. "Thematic ETFs are different from traditional sectors because traditional sectors can't capture the entire investment opportunity that arise from these themes; the auto sector taps into many different areas of technology and extends to mining and other companies these days. This means such ETFs span different sectors and geographies. That is actually the beauty of thematic ETFs."

Also, on the broad subject of diversification and risk mitigation, another guest noted that although in the past decade, growth has been the dominant factor that investors have chased, thematic investments now offer a longer-term investment horizon and the doorway for investors to look through the impact of the shorter-term interest rate movements and other factors dominating the news. She said that while a lot of the thematic ETF stocks selected are valued on growth still, investors can look to the longer-term and see that over time, these types of companies are growing much faster than, for example, the average S&P stock.

"Over time, the earnings growth power will actually outweigh the valuation changes," they explained. "If you're a long-term investor,

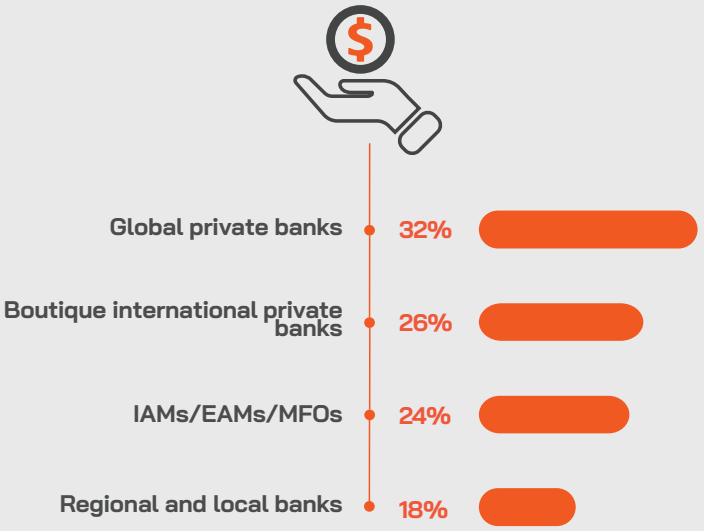
then these are thematic portfolios that you can hold for a long time, offering satellite holdings to your portfolios to help generate a higher return in the long term. But just be prepared and aware that in the short term, the environment is not the most conducive for growth companies, so you do need to have a bit of patience."

Some argue that ETFs are benefitting from their transparency, compared with the ongoing 'mining' of elevated fees in parts of the wealth industry in Asia

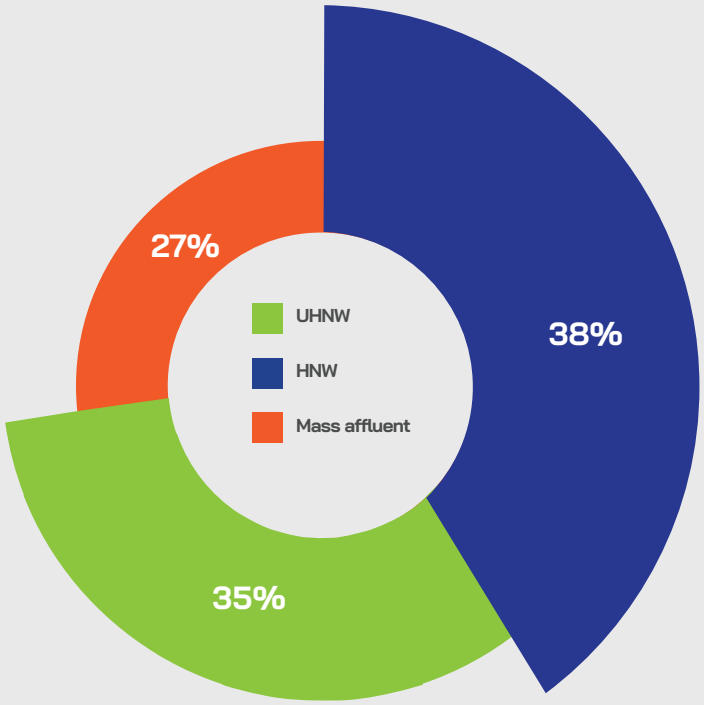
An expert stated: "It has been no surprise to see some low fee passive ETF providers being successful in developing a leading ETF market presence, but what's been more impressive in some ways is how we've seen the likes of other big names develop hybrid models offering combinations of passive and active of mutual funds/ unit trusts and ETFs, and others are trying to follow."

He said the new platform providers and the most progressive private banks have also started to face this reality and also a few niche advisors who have developed remuneration models based entirely around fees and without trailer fees or similar. "But the wealth management community is clinging still to their ability to influence clients and hold on to the older remuneration models rather than direct them towards the more transparent fee modes," he cautioned. "Nevertheless, I believe that better client understanding of fees and stronger regulation will ultimately see the demise of these old habits in Asia, just as they die a death in other regions. ETFs have been the death knell of trailer fees and retrocessions in other markets."

IN TERMS OF THE INVESTMENT PORTFOLIOS OF THE NEXTGENS, AS A BROAD GENERALISATION, HOW IMPORTANT IS ESG AND IMPACT INVESTING TO THEM IN THEIR INVESTMENT PORTFOLIO FORMATION?



AMONGST ASIA'S PRIVATE CLIENTS, RANK WHICH CATEGORIES OF INVESTORS ARE MOST INTERESTED IN THEMATIC INVESTING?



Is active management more in demand now that the receding market tides are lowering nearly all the asset prices?

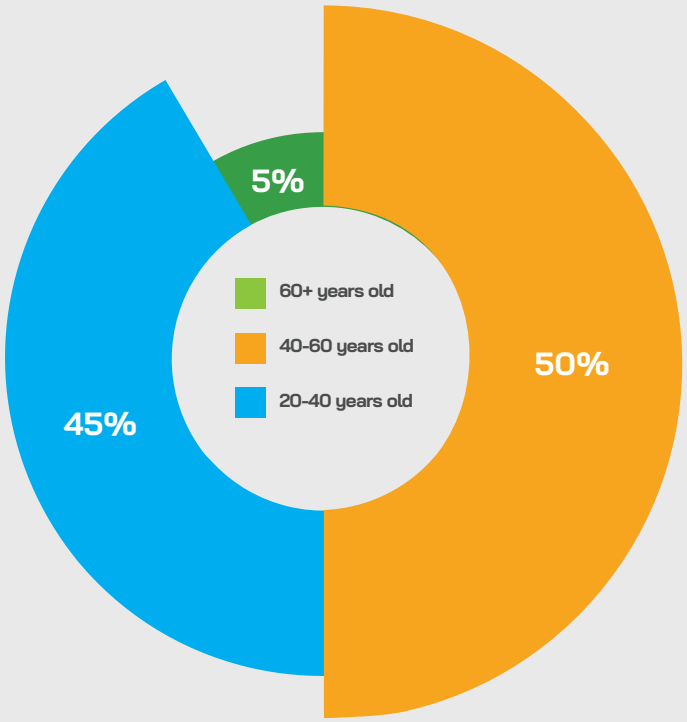
An expert whose firm delivers both active thematic funds and also passive thematic ETFs said there were several considerations for investors in their choice of the active or passive fund model.

"First of all, the investment universe for active is generally broader, versus passive or ETFs that are usually more niche," she explained. "For example, you can have a sustainable energy active mutual fund, but usually for ETFs, you can have more niche exposure within the sustainable energy space, for example, solar, for example, hydrogen, or clean energy. We need flexibility for the active fund manager to be able to pick and choose his or her preferred companies, but for ETFs, we don't really need to have such broad universe, we need to provide investors with more niche exposures that are typically not tracked by active managers."

Another factor is that when an investors buys an active mutual fund, they are trusting the fund manager, whereas for ETFs you need to look at the index construction. "If you want to know whether the ETF is really picking the right companies that are really relevant to the theme, you need to make that assessment, and it is generally based on rules for our ETFs, that is our approach."

And she pointed also to active mutual funds charging higher fees compared to ETFs. "Low cost is definitely a big advantage for ETFs," she said.

AMONGST ASIA'S PRIVATE CLIENTS, RANK WHICH AGE GROUPS OF INVESTORS ARE MOST INTERESTED IN THEMATIC INVESTING?



Expert Opinion

PAUL GAMBLES, Director, MBMG Group

"As to how clients should use ETFs within their portfolios, they should start from their asset allocation – asset type, investment strategy etc and work out the best way to achieve exposure. For plain vanilla assets/strategies, it will nearly always be ETFs, for idiosyncratic beta, it might not be possible for ETFs to achieve perfect replication. For tactical exposures and specialist assets it will usually be ETFs."

ETFs must be viewed from the perspective of robust portfolio formation, not simply as standalone holdings, said another expert, who said we must consider ETFs from the perspective of portfolio function. "I am an advisor, looking at creating balanced portfolios for clients, so we purely look at the ETF from a functional point of view, as to what they do when added into the mix and what correlations there might be to other holdings," he explained. ■