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Further Reading: The drawbacks of thematic ETFs

Clean energy names and other thematic names are booming. What's the catch? February 23, 2021
By **Dave Baxter**

- Thematic ETFs are one of the big investment stories of the last year, with major success in areas such as clean energy

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y useful and incredibly boring. A dynamic market – but it does little

These products took in a net €9.5bn in more than half of these inflows

directed at energy transition and connectivity-themed funds. The product set is growing apace: a record 17 thematic ETFs launched in 2020, with more still coming

THEMATIC ETFs LAUNCHED IN 2020, WITH MORE STILL COMING.

As [BearBull outlined last week](#), the appeal is pretty clear: thematic fill portfolio gaps retail investors would otherwise struggle to fill. They are also a pure play on promising trends: why back the whole tech space when you expect the biggest gains to come from cybersecurity shares?

Some of the most popular thematic ETFs have made huge gains. The hugely popular [iShares Global Clean Energy UCITS ETF \(INRG\)](#) made a sterling total return of 132.8 per cent in 2020. But investors should remember that not all niche investments are so successful.

Such is the takeaway from a short Swiss Finance Institute [paper](#), *Competition for attention in the ETF space*, authored by Itzhak Ben-David, Francesco A Franzoni, Byungwook Kim and Rabih Moussawi. The authors note that while the first “breed” of ETFs tracked broad-based indices and charged low fees, price competition in this space prompted the industry to seek higher margins by offering more specialised products. This resulted in thematic ETFs, sector funds and smart-beta products.

As the authors put it, the “obvious conjecture” is that specialised ETFs charge higher fees for better performance. But generally this has not been the case. They found that a portfolio of all specialised ETFs tended, in the jargon of finance, to “earn a negative risk-adjusted performance of 3.1 per cent a year after fees”. This finding reminds us that jumping onto hot trends, via ETFs or otherwise, can sometimes mean buying an asset just as its price, or the factors driving its performance, hit a peak.

The authors put the failings of specialised ETFs down to the nature of their backers. As they put it, “the demand for specialised ETFs comes from unsophisticated investors who chase investment ideas that, in their view, will produce higher expected returns. In reality, however, the underlying assets of these ETFs are overvalued and therefore underperform after issuance”. Experienced or otherwise, retail investors excited by recent trends should remember this warning and think carefully about the longevity of an investment trend.

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The iShares clean energy ETF mentioned earlier has found itself owning big chunks of smaller companies in the sector – resulting in S&P Dow Jones Indices overhauling the index used by the ETF. S&P Dow Jones has raised the cap on how much of the index can be allocated to one stock, from 4.5 per cent to either 9 per cent or five times the company’s liquidity weight.

This allows the ETF to effectively put more money into bigger, more liquid sector constituents, reducing the strain on smaller names.

Separately, Citi analyst Scott Chronert recently identified cases where ETFs collectively owned a big stake in smaller stocks. ETFs recently had a collective 25.5 per cent stake in biotech name **Organovo (US:ONVO)** and 24.4 per cent of life sciences tools and services specialist **Compugen (US:CGEN)**.

Retail investors can roughly check how diversified an ETF is by assessing its position sizes and number of holdings. Unlike a broad equity ETF that may hold thousands of stocks, some thematic ETFs can merely hold tens: the clean energy ETF had just 30 as of mid-February. But this assessment can be a blunt tool.

While an ETF’s underlying liquidity can be difficult (or impossible) for retail investors to gauge, a general risk principle may instead be useful: the more niche an investment, the more care you should treat it with. Niche positions should be sized accordingly.

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