ENVESTNET PMC

What We Are Hearing And Seeing

Envestnet offers one of the largest asset manager networks in the industry. Given the current environment, we want to share what we are seeing and hearing – perspectives from our trading & operations and Envestnet | PMC teams.

Greg Richards, CFA, CFP, Senior Investment Analyst

Thematic Investing

Thematic investing has become fashionable as evidenced both by the explosion in assets and products over the past few years. Assets in thematic ETFs have ballooned from $27 billion prior to the pandemic to more than $130 billion in June 2021.[1] Headlines have touted phenomenal returns in products such as Cathie Wood's ARK Innovation ETF, the largest thematic ETF. As a result, assets have poured in, and asset managers have responded to the increase in demand with a proliferation of new products. Although the eye-popping returns may be alluring, investors should take a careful look at the pros and cons before deciding if this type of strategy is appropriate for them.

Thematic investing is a top-down investment approach that seeks to identify long-term, macro trends, and then invests in companies that are likely to benefit from these trends. Proponents of this approach believe that this presents an opportunity for superior returns relative to the broader market, and some evidence exists that this may be true. Through July 31, 2021, the MSCI ACWI IMI Innovation Index, which identifies only four themes out of countless possibilities, was up 21.94% annualized since its May 31, 2013, inception. Meanwhile, the broad MSCI ACWI IMI Index was up 10.73% over the same period, demonstrating that superior returns through thematic investing are possible. Furthermore, on a risk-adjusted basis, many of these themes also have shown superior Sharpe ratios to broader market indices. Another appeal to investors may be the diversification benefit offered by thematic investments. In an analysis of excess returns from 2002 through 2015, various thematic portfolios were shown to have excess returns with low correlation to growth and value stocks. This potential for above-average risk-adjusted returns in assets that may offer additional diversification is likely to appeal to many investors.

However, investors should be wary of additional risks. Thematic funds historically have been a bull market phenomenon, attracting assets in periods of high returns, such as today's environment. But, this sets a high bar, and many of the new products ultimately close when they are unable to meet investors' high return expectations. According to Morningstar, 30% of thematic funds that have been created in the last 30 years have subsequently shut down. These investments also tend to be smaller in market cap, concentrated, carry higher valuations, and have cash flows that are often difficult to predict. This can lead to higher volatility that may not be compensated for in short-term return periods. The proliferation of products also can lead to a number of products that border on gimmicky and rely on marketing rather than a clear investment thesis.

Overall, evidence shows that a thematic approach can add value to an overall investment strategy when implemented with a thoughtful, holistic approach and held over the long term. However, investors should be aware of the additional risks inherent with this approach. Many of these risks can be mitigated by considering thematic investing's role in an overall investment strategy, maintaining appropriate diversification, and performing extensive due diligence of asset managers.

Parina Sharma, Investment Analyst

Technology: Amid Earnings, Valuations, and Regulations

After rendering around 20% annualized returns over the last decade and being a leading contributor to the S&P 500 Index, technology stocks finally have experienced some pressure this year. Year to date, their returns have lagged the broader market, and sectors like Energy, Real Estate, Financials, and Communication Services have outperformed, as cyclicals made a strong comeback in 2021.

As the economy reopens, the Information Technology sector may face headwinds from multiple fronts. It is experiencing increased legislative scrutiny that started with the EU's curb on "big tech," followed by additional US antitrust proposals. With China now cracking down on its consumer-facing internet software companies and another EU proposed AI law, this headwind may be here to stay.

Five companies constitute more than half of the Information Technology sector in the S&P 500 Index, whereas the sector itself, the largest in the index, represents 27%. Two of these giants, Apple and Microsoft, drove returns during much of the pre-COVID bull market. However, consumer tech stocks contributed significantly to the index's recovery post pandemic, and their demand may fade in coming months. With their median effective tax rate at around 14.2% for 2020 (according to S&P Global Market Intelligence), the sector is expected to be significantly hit by a reversal of the 2017 corporate tax cuts and a proposed higher global minimum tax rate. Additionally, the valuations are more than stretched above historical averages, and the ongoing global semi-conductor shortage poses a continued headwind.

However, many managers with whom we have been in discussions believe compelling reasons exist to treat any significant tech sell-offs as buying opportunities. Reported earnings and revenues for 2021 have been above estimates. Corporate spending on technology is expected to speed up after its bottom in 2020. Investments in cloud and networking equipment will continue to tread up if the economic expansion continues. Also, 5G technology is likely to accelerate demand for telecommunication components and semiconductors. Many managers have adopted a balanced approach of investing in both long-term tech stocks while also taking positions in Financials and Health Care to ballast this uncertain environment. Investors would be wise to be aware of these market shifts before investing in technology and believing the trends of the past will repeat in the future.

Monica Sengelmann, CFA, Investment Analyst

The Evolution of the Emerging Markets Equity Asset Class

The MSCI Emerging Markets Index (+0.2%) is essentially flat for the year and significantly trailing both developed international markets (MSCI EAFE: +9.7%) and US markets (S&P 500 Index: +18.0%) through the end of July. This is somewhat surprising for an asset class that usually performs well during economic recoveries. For example, after the 2008-2009 Global Financial Crisis (GFC), the MSCI Emerging Markets Index climbed 79% in 2009, whereas the S&P 500 Index rose only 27% and the MSCI EAFE Index was up 32%. This leads us to the question: What is going on in emerging markets (EM) in 2021?

The first and most straightforward answer is the slow and uneven recovery seen in certain EM regions. A second item affecting the asset class would be China's recent announcements concerning new regulations around the education industry. With China representing 37% of the overall EM index, it is obvious that the recent volatility in the country has affected the asset class.

However, this is a recent development that has exacerbated the headwinds that EM was already facing. The third and more interesting item here is the changing dynamics of the EM index's sector and regional composition. During the post GFC recovery, the EM index was much more heavily weighted to cyclical sectors (i.e., Energy and Materials) and cyclical countries (i.e., Brazil, South Africa, Russia). This boosted performance of EM after the GFC, as cyclical companies had a strong rebound in 2009. Fast forward to today, and a different make up of sectors and countries exists in the EM index. North Asian countries (China, Korea, Taiwan) have grown rapidly, and they now comprise roughly 65% of the EM index (up from only ~43% of the index in 2009).

With this comes an increase in weighting to the Information Technology sector, as the growth of internet services, smartphones, and other technology has exploded over the past 10 years, especially in emerging Asia, due to young demographics and a huge IT focused talent pool. The IT sector now makes up 20% of the index (up from 11%), while other internet related sectors also have increased. This has come at the expense of cyclical sectors, which now make up only 44% of the index (down from 63%). This index composition has acted as a headwind to the EM asset class since the COVID-19 vaccine announcements in November 2020 that spurred a sharp cyclical and value-led rally.

All this goes to show that EM investing is no longer just a cyclical play but is much more nuanced. It can provide investors with exposure to major structural growth themes like the rise of the emerging middle class and rapid technological innovation. Although these stories have been out of favor in EM so far in 2021, and have hampered returns versus developed markets, the themes are backed by long-term growth drivers that will continue to develop.

Daniel Homan, CFA, Investment Analyst

China's Regulatory Environment and Implications for US Investors

Regulators in China have taken an increasingly antagonistic stance toward certain sectors in the country. In particular, they have targeted the tech giants and, more recently, the education sector, with varying degrees of severity. During July alone, the MSCI China Index dropped by 13.8%, dragging its year-to-date performance down to -11.8%. The situation is complicated and nuanced, with implications abound for investors in both China and emerging markets (EM) as an asset class.

First, the importance of China to the EM asset class cannot be understated. China currently makes up 37.5% of the MSCI Emerging Markets Index, by far the largest single country in the index. With A-share market inclusion, the importance of China in the broader index will only continue to grow. With that in mind, it is critical to understand whether we are at the beginning of an increased regulatory regime by the Chinese Communist Party (CCP) or these are more one-off actions.

The first inkling of trouble dates back to November of 2020 when the Ant Group withdrew its IPO, in order to maintain the stability of capital markets. Further, in April of 2021, regulators levied a $2.8 billion fine on Alibaba (China's largest online retailer) for antitrust violations. Tencent (a gaming/music/chat platform) was fined earlier this year, and has announced new gaming restrictions for youth and suspended registrations for WeChat to upgrade security technology. Didi, China's Uber, listed on the NYSE in July against the behest of the CCP, and is now under investigation for data security breaches.

Although all these measures might seem draconian, the CCP saved its most heavy-handed action for the for-profit education industry, which was worth some $100 billion in market value. In late July, the CCP announced that the entire tutoring industry would be moved to a not-for-profit model, essentially killing the industry.

These actions are significant, but they are far from indicative of a new paradigm of interference in private capital by the CCP. Ultimately, the managers we have spoken to were not concerned that we were heading into a period of interference by the CCP into private business. The CCP is much invested in businesses being the economic engine that will transition the Chinese economy from the world's low-cost production center to one built on domestic consumption. Few of our managers were materially affected by the killing of the tutoring industry, with some having minor positions in the leading companies. However, most EM managers had only varying exposure to Alibaba and Tencent along with broader China, emphasizing that an active manager is crucial to navigating the regulatory environment in China.

As markets have reset and China's equity risk premium has risen, the country's collective pricing of earnings is now 20% to 30% below that of its developed markets counterparts. Perhaps, in a country where the rule of law is tentative, investors should be compensated with an increased risk premium to balance higher regulatory risks.

[1] Source

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