Global Megatrends: Capitalizing on Tomorrow’s Trends Today
Introduction

Global megatrends—or powerful seismic shifts—present opportunities to investors with a long-term view and an ability to identify the beneficiaries of these shifts before they become widely recognized. Whether it is the emergence of a disruptive new technology or the rise of a new middle class in emerging markets, we are continuously witnessing the impacts of megatrends as they unfold before us. Investors can recognize and capitalize on these major investment themes by identifying the companies that drive them as well as those that are positioned to benefit from them. In this paper, we discuss why a thematic approach may offer investors a sustainable source of alpha and how to integrate a top-down thematic overlay with a bottom-up investment framework.

“Based on our over-arching view that high quality companies tend to be superior long-term performers, we are proponents of fundamental, bottom-up stock selection that emphasizes quality, value, patience and research conviction. By incorporating a top-down overlay that considers long-term secular themes in a global context, we believe investors can augment that framework: Bottom-up investors can position their portfolio in the most favorable market sectors and industries and mitigate some of the country risk that prevails in emerging markets.”

~ Guido Giammattei
Portfolio Manager
There are four key reasons why a thematic approach may offer investors a sustainable source of alpha:

1. A thematic approach is an unconstrained approach.
   Thematic investing ignores geographical boundaries, style biases and market capitalization, and it transects traditional sector classifications. This provides investors with a distinctive strategic advantage: The ability to look across all geographies to identify emergent and potentially rewarding investment trends. In most instances, thematic investing is global in nature—it is about finding companies that respond to a particular human need, understanding how that need is serviced from factory to consumer, and investing in those companies that are well positioned to take advantage of changing market conditions.

Consider Exhibit 1, which is based on two themes, Digitalization and Health & Wellness. The sample of 13 securities seeking to benefit from Digitalization is dispersed across 8 countries and 3 sectors. Likewise, the Health & Wellness sample of 9 securities is dispersed across 6 countries and 3 sectors. Because few themes are constrained to any one benchmark sector or country, traditional research generally uncovers only part of a major trend. By identifying and understanding relationships across sectors and regions, thematic research can give investment managers an edge over their peers. While many managers use indices to define scope, we believe a thematic approach offers a more flexible way of thinking about how industries and companies work in a global universe.

Reinforcing the view that themes can be effective in adding alpha, evidence suggests that investing along country and sector lines does not offer the potential differentiation or the potential alpha that it once did (Exhibit 2). More mature capital markets have competed away anomalous valuations and excess returns that may have previously persisted at the individual country and sector levels.

Additionally, evidence indicates that investment managers who incorporate themes into their investment process have consistently outperformed the market. Exhibit 3 illustrates that over long-term time periods, thematic investing provides a clear performance edge over the broad market benchmark, the MSCI World Index.

Source: RBC GAM, as of 3.31.14
Thematic Composite: Performance data for thematic managers are based on the performance of an RBC GAM UK-created equally weighted composite. The Thematic Composite was developed by screening Mercer Management Performance Analytics (MPA data) for global equity managers using a top down thematic approach, which identified 8 managers, all of which are included in the composite.
2. Thematic investing exploits a research gap. Nearly 95% of a typical company’s firm value is expected to be produced after the next two years of operations. Yet, because equity market participants have generally shortened their time horizons, many of them have also shifted their focus to the value that can be attributed to just those next two years. This short-term mentality disproportionately emphasizes a forecast period that represents a mere 5% of the expected value generated over the life of the firm.

The fact that so many investors are focused on near-term operations suggests a possible gap in research coverage for longer-term horizons. This increases the likelihood that companies with superior long-term profitability potential could be overlooked for those with superior near-term profitability potential. We believe that a thematic investment approach can effectively exploit this research gap: Themes encourage a focus on long-term ideas, offer perspective, and help to block out surrounding noise, thus allowing us to look beyond the short-term distortions that exist in the market today.

3. Themes support earnings growth. Structural themes act as a tailwind to earnings growth and ensure relative stability, sheltering earnings from volatility and fluctuations in the economic cycle.

Consider our approach, which positions portfolios in industries where there are strong growth drivers to support earnings well beyond the short term. It subsequently provides a powerful roadmap serving to identify the most attractive companies.

4. Companies that will benefit from themes tend to be ESG compatible. Responsible investing is focused on the concept of “sustainability.” Sustainability seeks to ensure that current company initiatives do not compromise future ones nor do they negatively affect future returns, investors or society as a whole. Investing along environmental, social and governance (ESG) lines focuses on companies that act to support the environment, society, and strong corporate governance. These companies tend to be positioned in areas that will benefit from long-term trends: There is clearly a move toward cleaner air, energy efficiency and socially positive developments such as diversity and healthier lifestyles—all of which can be captured using long-term themes. Indeed, we strive for every theme in our portfolios to be ESG compatible. As evidenced in Exhibits 5 and 6, companies with stronger ESG factors have delivered higher and more sustainable cash returns over time, as illustrated by comparing company ESG scores* to their cash return on capital invested (CROCI).

*In a 2012 report, Goldman Sachs Investment Research assessed ESG performance based on companies’ management of the environmental, social and governance issues most important to each industry. Publicly disclosed data points were used to calculate scores on each of 20-25 indicators applicable to each sector. Scores may be impacted by the availability, consistency, and/or accuracy of information reported and differences in disclosure levels may impede global comparisons (Goldman Sachs Investment Research; May 7, 2012).
We believe that alpha is best derived from the bottom-up selection of high-quality stocks. In our view, the benefits of thematic investing are maximized when incorporated as a top-down overlay that complements that bottom-up investment framework—it is that top-down overlay that we describe here.

**Stage 1: Development of Global Top-Down View**
The thematic aspect of the investment process begins with a top-down analysis that seeks to identify the broad structural changes that are currently impacting industries and economies. The inputs used to identify these changes—which could eventually become attractive long-term investment themes—are derived from a variety of sources: Meetings with industry experts and consultants, publications, newsprints and annual reports, attending conferences and traveling. Meetings with senior management teams are a particularly powerful source of information used to detect important long-term industry trends.

Occasionally, different forces overlap in terms of their impact on industries and economies, and each major factor is often accompanied by micro factors. The goal at this stage is to understand how the confluence of these forces will change consumer needs on the demand side and the basis for competing in certain markets and industries on the supply side. The changes to look for range from demographic shifts, such as the rise of a new social class, to lifestyle changes such as those that have emerged from the fight against obesity, to technological developments such as digitalization and automation.

**In our view, the benefits of thematic investing are maximized when incorporated as a top-down overlay that complements a bottom-up framework.**
Conclusion

Using a thematic investment approach to capitalize on global megatrends may offer investors a sustainable source of alpha by ignoring traditional biases, capitalization and classification boundaries, exploiting research gaps, and supporting sustainable growth. While it is possible to build a portfolio that is entirely based on these macroeconomic themes, we believe that the benefits of thematic investing are maximized when incorporated as a top-down overlay that complements a bottom-up investment framework. The development of global top-down views and structural themes combined with diligent bottom-up stock selection can be used to identify companies with favorable market positions, experience and strategy. The key is to capitalize on these megatrends and sustainably grow earnings by identifying their potential for accelerated earnings growth before it is reflected in the stock price.

Stage 2: Development of Structural Themes
Once a structural change has been identified, each of its drivers and implications, as well as how they interact, should be analyzed in an in-depth research report. The goal here is to develop investment themes that summarize the new economic environment and that identify industries that will be positively impacted by the changes.

Stage 3: Stock Selection
The final stage of a thematic investment process is designed to identify companies that are either drivers of these macroeconomic changes or well-positioned to benefit from them. In essence, a theme acts as a filter by narrowing down the investment universe to a manageable number of stocks that can be closely examined. It employs fundamental analysis and considers factors such as management quality and vision, brand name, business strategy and valuations. The goal at this stage of the process is two-fold: First, it’s to identify organizations with market position, experience and strategy that will allow them to capitalize on the broad macroeconomic changes and substantially grow earnings; second, it’s to seek those companies with stock prices that do not yet reflect this potential for accelerated earnings growth.

About the Author

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Guido specializes in the Latin America region and leads research efforts for the Emerging Market Equities Investment Team. Before joining RBC GAM-UK, Guido specialized in Latin America as an emerging market equity portfolio manager for Rexiter Capital Management. He began his career in Italy as an equity and derivatives trader and later worked as a securities analyst at HSBC Asset Management. Guido earned a Bachelor of Science degree in Economics from Università Cattolica del Sacro Cuore in Milan, Italy and an MBA from the Carroll Graduate School of Management at Boston College.
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