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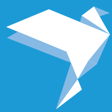
THEMATIC VERSUS GENERALIST INVESTMENT

Why Thematic Investment Strategies Are Stronger Bets

By Dan Conner, founder and general partner of Ascend Venture Capital



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EXECUTIVE SUMMARY

When examining manager perspectives in a comparison of generalist versus thematic investing styles, we uncover a robust investment strategy and an avenue for diversification of a venture capital asset allocation through thematic investments. We found that thematic investment strategies will typically outperform generalist investment strategies. This can be explained by the indispensable process of thesis formulation, testing, and execution typically deployed by thematic fund managers, in which the forces driving widespread transformation inform a central principle dictating investment decisions. This whitepaper asserts that there is a material difference in risk-return metrics and the implications for venture capital portfolio construction, with a stronger case being made for thematic investment strategies.

KEY TAKEAWAYS

- Thematic investing is found to outperform generalist strategies by 1% to 2.5% (α).
- This high performance is underpinned by the practice of investment thesis formulation, testing, and execution.
- Industry, sector, and manager risk diversification can be achieved by allocating among multiple themes.
- Investors should take extra care to select the right themes and managers rather than indiscriminately allocating across thematic strategies.

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INTRODUCTION

When we look back on 2020, we will likely remember the pandemic as a watershed moment that transformed our lives. Seemingly overnight, we found ourselves working from home, managing virtual school, and socializing at a distance. But the wheels that propelled us to adopt these practices were already in motion long before COVID-19; they were simply jolted into high gear by safety-fueled necessity. Sourcing food and goods digitally, banking online, migrating from metropolitan areas — these evolving behaviors were already all around us.

If you had been peering through the right lens, you wouldn't have been surprised when the future arrived. Its approach was perceptible, even measurable. The deep-seated trends were self-evident. The people who pinpointed those trends, formulated an investment thesis to match, and executed a targeted strategy minted their fortunes.

Investment strategy conversations often revolve around approach: growth versus value, active versus passive, commingled versus core-satellite, barbell versus bullet, and so on. Although each has its place in the pursuit of high performance, investment strategies that consider managers' points of view also merit examination given their potential for superior risk-return characteristics — namely those of generalist versus thematic styles.

> Investment managers' points of view merit examination given superior risk-return characteristics

The generalist style of portfolio investment strategy is just as it sounds: Fund managers place investments in an indiscriminate range of industries and sectors, generally focusing on examining growth-driving success factors from the past. You'll usually see this investment strategy at firms with over $250 million in assets under management; this is when it becomes possible to deploy the capital needed to back a volume of deals numbering in the hundreds.

In contrast, in a thematic style of portfolio investment strategy, managers concentrate investments within one or two areas of expertise (usually either industrial, sectoral, or technological). These investment themes rely on specialized background or professional experience, making this a tactical method of portfolio selection. Generally, new managers and micro-venture capitalists favor this strategy.

This whitepaper examines the assertion regarding a material difference in risk-return metrics and the implications for venture capital portfolio construction.

Generalist Versus Thematic Investing: What's the Difference?

Generalist Investing:
A Wide Net of Deals

Summary: Generalist portfolio investment strategies make decisions based on success factors and future growth potential rather than specific industries or sectors.

Who uses this approach? Usually firms with more than $250 million in managed assets.

Key point: Firms with hundreds of deals use returns to feed the machine, so the generalist approach provides a bigger net.

Thematic Investing:
Concentrated Expertise

Summary: In a thematic portfolio investment strategy, fund managers narrow their focus to one or two areas (typically based on industrial, sectoral, or technological themes).

Who uses this approach? Emerging managers and micro-venture capitalists tend to deploy thematic strategies.

Key point: Successfully executing a thematic approach requires extensive expertise in the target area (such as previous professional experience or a specialized background).

RESEARCH-BACKED THEMES VERSUS OPPORTUNISM

A generalist approach typically deprioritizes the formulation process of thematic investments, and therefore often emerges naturally. When managers aren't searching for investments driven by lasting economic, technological, or social tendencies, they tend to drift among opportunities. This type of approach becomes opportunistic and reactive instead of tactical and proactive. It's the difference between going to a supermarket without a list and making impulse purchases instead of planning your list in advance to avoid waste or extra spending.

Even beyond the research needed to identify a thesis or theme, successful thematic investors use a scientific method to manage and deploy their funds. They put the hypothesized theme through the paces of testing, evaluation, and refinement.

Measured inputs of capital are then deployed to test the thesis in live investments. Depending on the target startup stage, this evaluation can stretch from a few quarters to the entire investment period of the fund's life cycle.

This is a pivotal time in the fund family's emergence. Alongside the specified theme, the investment criteria, deal flow, selection, diligence, and portfolio construction processes are also implemented. Thus, it is crucial for this initial fund not to be simply a grouping of hypothetical investments, but rather an active portfolio. In this way, the fund's key systems are also part of the theme's practical evaluation.

> Successful thematic investors use a scientific method to manage and deploy their funds

After the initial fund has demonstrated a positive record of performance, subsequent funds are then raised and deployed in active execution of the thesis.

This staged approach not only lessens the risk of investing in an incorrect theme, but it also allows emerging managers the latitude to build a track record before engaging a critical mass of investors. Furthermore, by only pursuing additional capital after the key processes have been tested, the structures are ready for deployment. In other words, the performance engine has been built — it just needs to be fueled.

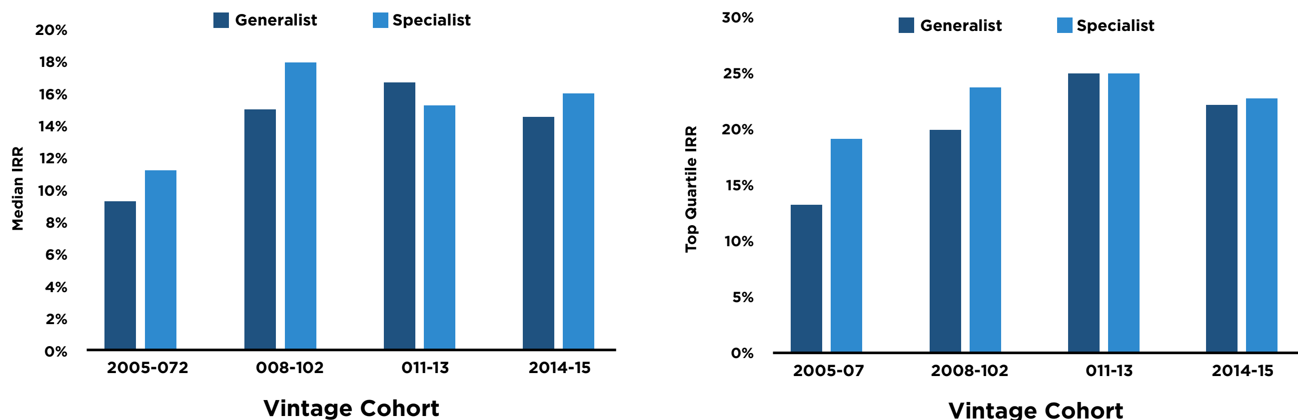
As described above, where the discussion of manager style diverges is the point at which perspective is taken into consideration. Specifically, when crafting a thematic strategy, time is spent developing a philosophy — one that explains a central principle underlying the factors spurring widespread transformation. This results in a heightened understanding of performance-driving factors (think competitive environment, strategic players, and consumer appetites).

FINDINGS

Comparing Returns

The research bears out that thematic investing tends to outperform generalist strategies by 1% to 2.5% (α), due in large part to the aforementioned process of thesis formulation, testing, and execution.

The boost in performance is apparent in the data. Seventy-three funds were analyzed over 10 years, comparing 43 generalist strategies to 30 thematic strategies. Thematic funds were found to perform with an average internal rate of return of 1.2% above generalist funds.



Source: PitchBook Data, "U.S. PE Fund Performance by Investment Style"

The results appear to be persistent in the upper echelons of performance; the top quartile of thematic funds outperform the same quartile of generalist funds by an even greater margin of 2.5%.

The high performance makes logical sense. Successful thematic investing requires managers to determine the right investment theme by identifying the next behavioral evolution. They do this by getting a bird's-eye view of widespread trends, and they draw on a mosaic of data points that might include everything from their personal experience to research. The data then informs tailored execution.

Furthermore, emerging managers who attempt a generalist investment strategy are often fated to fall short. Seasoned investors shouldn't choose a public equities index run by fledgling managers, nor should they choose fledgling managers to run generalist investment strategies.

From a competitive standpoint, new managers who deploy capital in a generalist fashion (especially without the backing from an established firm) can end up in troubled waters. Bigger, more established players often block access to popular deals, leading generalist emerging managers to invest in these companies' riskier competitors.

In contrast, a track record for identifying transformative investments early on within a targeted theme (e.g., software as a service, data exchanges, and deep tech) before established players take an interest can also lead to informal scouting relationships with well-known firms. This allows new managers the opportunity to invest with these reputable firms, which can be valuable whether you're an established generalist manager or emerging thematic manager.

Generalist investing also hinges on a slim number of deals returning the bulk of the fund. This increases the pressure of the fund to maximize ownership/return on each winning position among hundreds of underperformers that get ignored. This can lead to unprofessional behaviors with value-destroying potential, including being:

- Harmful to companies.
- Alienating to early-stage investors.
- Detrimental to consumers.

As a result, the most robust strategy for emerging managers appears to be tracking down deals proactively that fit a tactical, well-informed thesis derived from research. It emphasizes hypothesizing, testing, and observation as opposed to pursuing fleeting opportunities in backward-looking pattern-matching.

> Generalist investing also hinges on a slim number of deals returning the bulk of the fund

COMPARING RISK

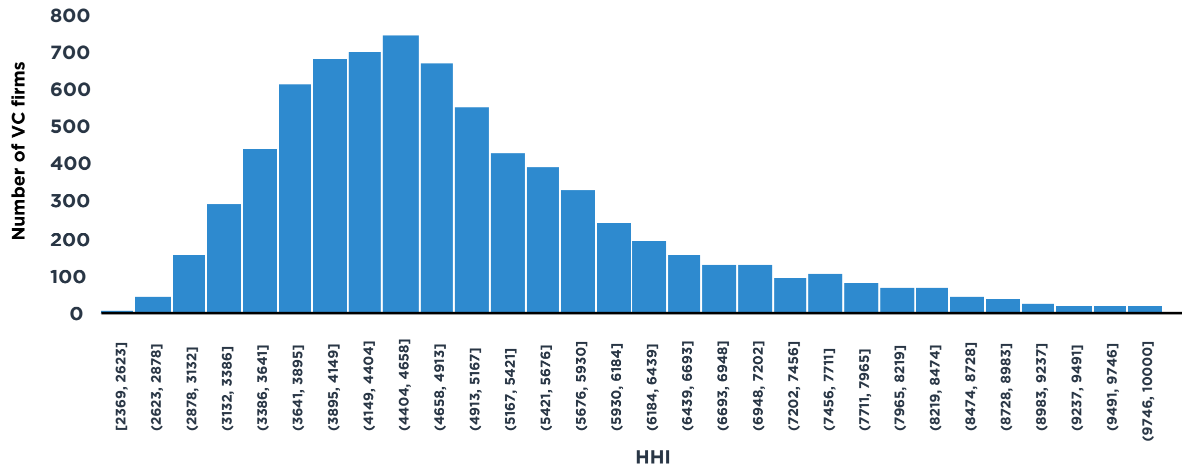
Our research also demonstrates an opportunity for risk diversification for thematic investment managers. This is due to the dispersion of specialized funds and the difficulty of achieving sufficient holdings distribution in generalist portfolios.

There is some risk with thematic investing if the thesis is not based on sound research. Because thematic managers focus their investments in one specific area, the diversification of industry, sector, or technology risk is low. That means a fund could be lost to an uninformed or incorrect thesis. (For more information, see the section called “Identifying the Most Promising Funds,” which begins on page nine.)

On the other side of the spectrum, however, generalist funds don’t necessarily solve the risk problem. A risk-conscious fund investor would not be able to reduce asset class risk by increasing the number of generalist funds in their portfolio — they simply end up holding more companies of the same ilk.

In fact, many established venture capital firms that claim to be unique investors tend to invest like everyone else in the cohort; if this were not the reality, the venture capital Herfindahl-Hirschman Index chart below would resemble a normal distribution. Instead, we see a strong positive skew, indicating an industrywide tendency to follow a generalist investment style.

Composite industry HHI distribution of all VC firms with at least 15 deals*



Additionally, with valuations rising across all stages, generalist managers are increasingly unable to deploy capital extensively enough to construct sufficiently diverse portfolios. In 2020, startup investing in the U.S. struck a new high of $130 billion. In this competitive market, generalist portfolios end up with an array of startups in various industries — and that's not sufficient to ascend along the risk-return frontier. After all, you cannot achieve higher portfolio returns or decrease risk by holding more of the same positions. Instead, you need to improve expected returns by targeting outperforming strategies and/or reduce risk through effective diversification.

IMPLICATIONS

Diversify Your Portfolio With Thematic Exposure

When striving for outsized returns, increase allocations in multiple thematic funds, each focused on distinct industries.

This approach is aligned with institutional investing wisdom. When aiming for a thematically diversified venture capital allocation, an emerging strategy for institutional investors is to select four to eight thematic venture capital funds with distinct strategies to invest in per year. This method of portfolio construction offers seasoned investors the latitude to assemble a sufficient number of positions, dispersion across sectors, and diversity of managers necessary to maintain a reasonably derisked exposure to the venture capital asset class over time.

Instead, the prudent investor with a risk appetite suitable for the venture capital asset class in the current environment is left with one robust strategy — to invest in multiple thematic funds to achieve:

- The number of portfolio companies required for a reasonably diversified level of company risk.
- A portfolio of investments dispersed across a sufficiently wide array of sectors to reduce industry risk.
- A diversity of managers to reduce manager risk.

Perhaps this is why for institutional investors, this method of portfolio construction is emerging as a popular alternative to concentrating investments in generalist funds.

Invest in multiple thematic funds to achieve:

- The number of portfolio companies required for a reasonably diversified level of company risk
- A portfolio of investments dispersed across a sufficiently wide array of sectors to reduce industry risk
- A diversity of managers to reduce manager risk

IDENTIFYING THE MOST PROMISING FUNDS

Investing in thematic upstarts that drive the future of industries carries more promise than having a wide index of startups, the majority of which will fail. Outside of the methods that result in managers' successful thematic investment practices, the reasons behind this high performance are also linked to the avoidance of certain pitfalls.

For instance, despite the potential performance boost from increasing thematic exposure, investing in an underdeveloped thematic fund could spell failure. Limited partners should therefore be selective about the themes they're backing.

Here are ways to determine whether the theme is promising:

- Look for perspectives in established publications.
- Research the thesis behind the theme.
- Check previous fund vintages for unicorns and "soonicorns."
- Look for sophisticated family funds that have backed the manager.

Furthermore, if it isn't apparent from the marketing materials, ask your fund manager which theme(s) they are pursuing and why.

However, because of survivorship, the top of the pyramid of successful funds in the cohort of emerging managers is thinner than that of the generalist established pool. So limited partners should take care to construct a portfolio of funds with the correct investment themes. Investing in the wrong economic, tech-driven, or social trends could prove difficult, so be selective about your selections by seeking out emerging managers with vision.

CURRENT THEMES WITH POTENTIAL

If we peer through the right lens, what evolving behaviors can we find today?

Besides its tragic effects across the globe, COVID-19 is similar to other historic hardships in that it created opportunities and resilience that companies did not previously understand. As we reorient and uncover COVID-19's impact on business and industries at large, we can also examine the world for potential investment strategies as it rebuilds from ruin.

A wide array of innovations will be traced back to COVID-19, including new capabilities such as the capacity for a flexible workforce. For businesses, this leads us to flexible work schedules; fewer and shorter commute times; and less carbon output that could boost employee productivity, workplace equitability, and overall business resilience.

Additionally, the uptick in digitalization has had a drastic effect on businesses' operations and their subsequent responses to the pandemic. In fact, 85% of executives say technology has accelerated their operations as a direct result of the pandemic.

In the process of adjusting to these developments, society has learned new behaviors such as reliance on e-commerce and online shopping, contactless pickup, and remote work with increased flexibility. These could be here to stay.

85% of executives say technology has accelerated their operations

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Case Study: In-Home Delivery and the Ever-Enduring Value of Convenience

Ghost kitchens, online food ordering, grocery delivery, same-day shipping — the surging popularity of these convenient delivery offerings is all part of a massive boom in the gig economy that wouldn't have existed without the pandemic:

- In 2020, 2 million workers **turned to gig economy jobs** to pay the bills.
- **1 in 3** Americans currently has a side hustle.
- Online grocery orders now comprise **10% of the industry.**

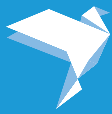
This momentum isn't likely to cease with full vaccine rollout, either. Despite loosening restrictions across states, U.S. consumers are in no hurry to return to pre-pandemic food-shopping habits, and the industry has responded accordingly:

- Walmart launched **two-hour express grocery delivery.**
- Amazon, Shipt, and Instacart have all increased hiring to meet growing digital demand.
- FedEx teamed up with autonomous robotics company Nuro to **offer sidewalk delivery.**

This undeniable arc toward convenience leads to an interesting outcome: precision delivery — with an in-home service option — in which a courier enters your home to put away groceries or plate a meal.

This might sound like a significant logistical burden, but emerging technology is making the process much more seamless. We aren't far from seeing the sky full of **grocery- and food-delivery drones,** and with delivery companies facing cutthroat competition and more established players **charging into the field,** the need for a competitive edge is becoming acute.

Even with the tidal wave of COVID-19 receding slowly, it's clear that convenient food and grocery delivery is now a consumer staple among a host of new and evolving behaviors.



CONCLUSION

In our comparison of manager perspectives, **thematic investing is found to outperform generalist strategies by 1% to 2.5% (α).** This high performance can be explained by the process of thesis formulation, testing, and execution. Specifically, when crafting a thematic strategy, time is spent developing a philosophy — one that explains a central principle underlying the principles driving large-scale transformation. This leads to a better understanding of performance-driving factors such as the overall environment, its players, and customers' needs.

The implications of this explanation also reverberate in portfolio construction. **For those wanting to move upward along the risk-return frontier** by increasing sector exposure beyond a single established generalist manager, additional diversification can be achieved by increasing allocations in multiple thematic funds, ideally focusing on a diversity of industries. However, due to competitive pitfalls, special care should be taken to select the right themes and managers with vision.

Institutional investors are already wisely beginning to allocate and diversify their venture capital holdings to **take advantage of thematic opportunities in this manner**. In the current environment (in which deal volume and activity are reaching record heights), there is clearly immense opportunity in the venture capital asset class. But with ever-enduring levels of risk, a disciplined approach informed by research is still essential.

Learn more about savvy investments by signing up for our newsletter, or schedule a 30-minute chat to meet with our general partner and discuss investing directly alongside our flagship venture capital funds.

ABOUT THE AUTHOR

Dan Conner is the general partner at Ascend Venture Capital, a thematic micro-VC in St. Louis that provides financial and operational support to startup founders looking to scale. Ascend specializes in data-centric technologies that enable the future states of industries. Before founding Ascend Venture Capital, Dan worked on the operations side of high-growth startups, leading teams to build scalable operational and financial infrastructure.