

TEMATICA INSIGHTS

ECONOMIC COMMENTARY, EQUITY RESEARCH AND PORTOLIO CONSTRUCTION

SPECIAL EDITION: Why Sector-Based Investing is Dead

If we had a nickel for every time we've been asked the question "which sectors do you like?" ... well, then we would probably be sitting on a beach somewhere a long way from the Washington, DC suburbs where are based.

It seems that at least once or twice per week we are asked, in some form or another, one of the following questions:

- *What sectors do you rate as a buy right now?*
- *Do you like Financials? What about Technology?*
- *What is going to be the next big sector?*
- *What sectors do you think are best in bull markets? And which ones are best for sheltering gains in bear markets?*

Our short answer to any sector questions is simple: ***we like none of them.***

But, at the same time, we also can say ***we like all sectors.*** Or more specifically, we like certain aspects of every sector, while we also dislike aspects of all sectors. Confused? Guess it's not so simple of an answer.

A Smarter Approach Over Sector-Based Investing

Frankly, thinking of investments from a sector perspective is out-dated at best, and fatally flawed at worst.

With our ever-changing technology and the fast pace at which trends are emerging and spreading globally, it's over simplifying to identify any one or two sectors as having the most potential. In any sector, there will be some companies that seize on a new opportunity faster than others as new trends or themes emerge in today's world.

And then there are those companies that will literally jump sectors as a trend emerges — does anyone think of Alphabet (formerly Google) as an auto-company? Well, they very well could be in the next several years if its self-driving project is successful. That's a very big if, however Apple's "Project Titan" and the several hundred employees it has working on creating an electric vehicle at a secret location near its Cupertino headquarters shows just how serious outsiders are about jumping into the auto-sector.

For reasons such as these, and many others, traditional sector-based investing doesn't fit into our mindset at all at Tematica. When we analyze the market landscape, we instead approach it from an entirely different perspective.



ABOUT TEMATICA INSIGHTS

Each weekly edition of Tematica Insights contains in-depth information on real-time developing thematic strategies, economic outlook, investment trading ideas, and analysis of the most pressing developments for the market, as well as forces that drive both our thematic perspectives and thematic recommendations.

Why We Don't Utilize a Sector View of the Markets

Let's use **Apple (AAPL)**, **Alphabet (GOOG)** and **Facebook (FB)** as examples of why we think viewing the markets through a sector-based lens is flawed. We touched on Alphabet earlier, but we chose it, as well as Apple and Facebook for this example not necessarily because their stocks are in the **Tematica Select List of Investments** (some are, some are not), but rather because they are among the largest market-cap stocks with business models that are pretty easy to understand. Plus, all three sort of intersect one another in one capacity or another at some point in their current business models.

In a traditional sector-based view of investing, AAPL, GOOG and FB, would be slotted into **Technology**, **Internet Software** and **Media** sectors respectively. So, an investor could think, "Apple's stock seems to be struggling lately, and so the Technology sector is probably a little over-heated and maybe we should move away from that."

To view Apple as a technology-sector company however, would potentially lead an investor to be overly consumed with simply the latest iPhone sales figures (something that happens to be occurring right now in the fourth quarter of 2015 with the iPhone 6s sales). A sector-based lens would fail to see, let alone understand how Apple isn't just shipping out hardware, but is actually re-shaping the media we consume (Apple Music and AppleTV), the services we are utilizing (through it's billions of app-downloads) and how we are paying for those purchases that we make (Apple Pay).

The same can be said for Alphabet (formerly Google) and Facebook — a sector-based lens would fail to see how these two apparent "media-sector" companies are pushing into retail sales and financial services and are poised to change how we shop, how we pay, and how we save. And then there's the automotive category, mentioned above, where both Apple and Alphabet are beginning to throw their weight around.

This new perspective, or "paradigm shift" — a phrase we

SECTOR-BASED VIEW OF THE ECONOMY



Technology

Alphabet

Internet Software



Media



Another Example of the Flaw in Sector-Based Investing

Lets look at water, oil, and lithium, which tends to translate to **American Water Works (AWK)**, **Exxon (XOM)**, **Royal Dutch Shell (RSH.A)** and **Tesla Motors (TSLA)**. The average investor would see these as a utility, energy, and an automotive company.

From our vantage point however, water, oil, lithium and other key materials are all **Scarce Resources**, a thematic that we track that traces the ebb and flow of supply and demand drivers of key resources of the global economy. Demand for some will be impacted by the **Rise and Fall of the Middle Class** thematic, while others will benefit from the rise of **Disruptive Technologies**, which cuts across several industries.

agree is grossly over and mis-used, but happens to fit well in this situation— is what is called **thematic investing**. It's an investment approach that looks to identify structural changes that are emerging economically, politically and socially around the globe, and then seeks to determine which companies will be impacted by it — both those that stand to benefit from the tidal wave, and those that will be drowned out by it.

A Thematic View of the Market

Going back to the questions at the beginning of this conversation, given this new paradigm, we see far better questions to ask rather than “which sectors do you currently like” would be:

- In today's world where mobile devices are altering the way consumers and businesses interact and transact, which companies or business models are poised to be at the forefront of this movement, and which ones are looking like they will be left behind?

We don't necessarily see the answer being within the Telecom sector.

- With all the data showing that China is shifting towards a more Western diet, what will be impact will be on life-expectancy for the worlds largest population and which companies are poised to gain (or lose) from that, whether its housing, financial services or healthcare? And if the continue to follow the path of the American population, which now boasts 1/3 of its population as being obese, what will that mean for everything from the health complications of expanding waistlines, to the clothes they purchase and the foods they eat?

Is this a healthcare sector issue, a hospitality sector issue or a clothing and textile trend?

- The Cord-cutting phenomenon —an emerging trend where households are moving away from traditional broadcast models of cable or satellite TV, towards on-demand and streaming services — leads us to ask which players in the space are actually creating the most popular content currently being streamed? Which ones are doing the best job of delivering the content? And which types of businesses and services could emerge as the cord cutting occurs and which ones are enabling the trend to even happen?

Over the years of tracking this trend, this has lead us into some sectors most investors would never imagine.

How We Identify Themes

As with all investment strategies, success with a thematic approach ultimately comes down to the underlying principle of investing: identifying which securities within an emerging theme are mispriced or undervalued relative to the business opportunities ahead as a result of the sea change presenting itself through a theme. The thematic approach however makes this process clearer because a theme, at it's core, identifies the underlying drivers of future value (or risk), and thus provides a forward-looking, longer-term lens to making investment decisions, rather than focusing solely on what's happening right now.

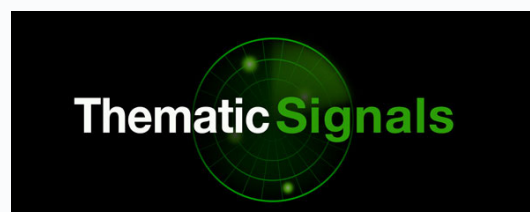
We identify such themes — or **thematics** as we refer to them at Tematica — by looking at the intersection of shifting economics,

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Thematics in the Real World

Below is an hypothetical scenario of how thematics can be interconnected and how they can play-out in everyday life.



DINING OUT

Let's look at where you might choose to grab lunch or dinner. We find that more and more people are eschewing food that is not good for them and instead choosing food that is "healthy", oftentimes taking the form of being "whole", organic or GMO free foods. Think this is media-hype? Compare **McDonald's (MCD)** same store sales over the last several years with **Chipotle Mexican Grill (CMG)** and it's commitment to providing "Food with Integrity". This leads us to ask who's on the leading edge of this thematic — what we call the **Good Foods** thematic — and who are the food producers and suppliers that are helping to make it happen?

GETTING TO WHERE THE ACTION IS

To continue on, if you are headed out for a night on the town, maybe you're catching a ride from **Uber** or **Lyft**, two companies among a growing number, include **Airbnb**, **Etsy (ETSY)**, **Shopify (SHOP)**, **InterDigital (IDCC)**, arguably **Qualcomm (QCOM)** and others that have little to no physical or manufacturing assets, but play a major role in today's economy. We categorize those companies as **Asset-Lite** thematic companies. They are businesses that exist without any hard assets, instead relying solely on either virtual market places they create — operating simply as brokers bringing buyers and sellers together — or in managing intellectual property rights through patents, trademarks and copyrights.

We expect to see far more of these type of companies — some will succeed, and other won't be as fortunate, but it's a trend that is unraveling before our eyes.

SOCIAL NETWORKS = ANTI-SOCIAL

No matter where you end up — a restaurant, a club, the mall — notice how often people (adults as well as kids) are picking up their smartphones to check-in, answer a message or post a selfie — all part of our **Connected Society** thematic. For that matter, watch a baseball game and notice the number of fans behind home plate and how much more attention they are paying to their devices than the game unfolding in front of them.

Obviously there are the manufacturers and component suppliers that are putting those devices in people's hands to look to for investment opportunities; but there are also the companies that are building the pipes and managing the constantly expanding flow of web traffic to those devices to look at well.

And then of course, whose producing all that content we're looking at? That's part a different thematic, **Content is King**, which we'll cover next.

WHERE ARE THE CROWDS?

Later in the evening, you might head to the movie theatre, where the lines may not be as long as you expected. That could be because of two things: either the **Cash Strapped Consumer** decided to stay home and stream a movie or TV series on **Netflix (NFLX)** or **Amazon Prime (AMZN)** instead of paying the creeping cost of tickets and snacks, which can set you back almost \$100 for a family of four; or they bought the tickets through an app on their mobile device, downloaded the tickets and just walked into the theatre showing a QR code on their phone — that's an example of what we call **Cashless Consumption**, and there are a number of players each playing a role in that transaction.

demographics, psychographics, technologies, mixed in with regulatory mandates and other forces. **To put it more simply, we look at the real world that companies are operating in, and try and understand what's happening and why.**

By examining these thematic tailwinds, our goal is to identify mispriced securities relative to the business opportunities ahead and avoid those that are overly valued and or staring into the face of significant headwinds. In our experience, the most attractive opportunities can be found when the business model for a company cuts across multiple themes that converge and reinforce one another.

Going back to Apple, Google and Facebook, at Tematica we see each one as a player in our **Connected Society** thematic — each in their own way shaping the landscape of how we as a society interact and engage electronically with one another, as well as with businesses. Those three same companies are also having a profound influence on what we call **Cashless Consumption**, which is the electronic payment world with services such as Apple Pay, Android Pay, and Facebook buy buttons that are in testing.

Some businesses will adapt to these new realities, while others will leap frog ahead, riding these thematic tailwinds to profits and significant share price movements. And sadly, there will be those left floundering too.

For every Apple, there is a Palm and Blackberry.

For every Facebook, a MySpace or Friendster.

For every Tesla Motors, a Hummer.

For every Netflix, a Blockbuster.

The list goes on and on, across all sectors and categories. But it's only when we look at the landscape through a thematic lens that we are able to see whether it is company A or company B that has legs, and then it's within the stock fundamentals of each that drives us to identify the risk-to-reward ratio and determines whether we rate each one as either a buy or sell.

How we started utilizing a Thematic Approach

We came to this point of view of the world after decades of analyzing industries and companies combined with our Wall Street equity research experience. We realized that the shortcoming of industry or sector-focused thinking is that it leads to investing with blinders on. It fails to understand the underpinnings of why certain companies are poised to explode, while others are ready to implode.

To put it simply, why did MySpace crash and burn and why not only is

EXAMPLE THEMATICS



At the intersection of computing, broadband, mobility and the Internet, we have a new set of devices — Connected Devices — that are changing the way we live and thus creating **The Connected Society**.



The continued growth of online and mobile shopping coupled with the growing pervasiveness of smartphones, means that around the globe more and more people will be scanning and swiping instead of writing checks or paying with cash.



The companies that are developing the products, services and business models that are pushing aside existing players in an industry and transforming how consumers do everything from shop, commute, travel, work, play, relax and even do things such as purchase energy.

Facebook still here, but poised to be around for a long, long time.

That's a taste of how we think about the world. If you're thinking there is a lot to look at, let's just say we're not apt to be lying by the pool eating bon-bons. Well, at least not without a laptop or tablet reader pouring through financial filings, company as well as industry reports and all sorts of articles looking to piece together the puzzle of a current or emerging theme.

Thematic thinking is very much like that of the best hockey player of all-time, Wayne Gretzky, who famously said, "A good hockey player plays where the puck is. A great hockey player plays where the puck is going to be."

Who wants to be just a good investor?

About Tematica Research

As the leader in Thematic Research we are committed to providing financial advisors, broker-dealers, and RIA's with independent equity research, economic insights, and investment ideas based upon our proprietary thematic perspective of the world and markets.

In our view, if we can provide independent financial advisors with specific and actionable insights into how we see things unfolding in the general economy, the markets themselves and ultimately in specific individual stocks and exchange traded funds (ETFs), then you can focus your time on what you do best: working with your clients to develop financial plans and strategies to help them achieve their individual goals and aspirations, while also having the time to attract new clients and assets.

Tematica Insights: Independent Research for Financial Professionals

Financial Professionals that subscribe to **Tematica Insights** receive in-depth information on our latest thematic thinking, providing specific recommendations across individual stocks and exchange traded funds (ETFs) along the way as we build out the **Tematica Select List of Investments**. The content in **Tematica Insights** is available exclusively for financial advisors and financial professional (CPA's, Broker-Dealers, etc.). Here is a look at some of the resources we currently provide to subscribers:

- **Tematica Insights Newsletter:** This weekly publication comes straight from Chief Investment Officer Chris Versace and his team, and contains in-depth information on thematic strategies, economic outlook, and investment management process.
- **Tematica Insights Hotlines:** Because the markets, economic conditions and company news is constantly shifting, as news and market conditions warrant, we share what we see as the most pressing developments for the market as well as forces that drives both our thematic perspectives and thematic recommendations.
- **Select Investment List:** Direction on how to execute investments in our thematics with investments in Stocks and ETF's, or Options for advisors looking for more aggressive strategies.
- **Conference Calls:** these quarterly confernece calls allow for an opportunity to engage directly with Tematica Chief Investment Officer Chris Versace and his team to dive deeper into issues — whether its gaining more perpspective on a specific theme or stock in the Tematica Select Investment List, or to discuss other economic conditions or other themes you may see emerging in your every day life.

Interested in seeing how thematic investing can help you and your clients?
Contact Us today and we'll set up an information session.

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Companies Mentioned

Alphabet (GOOGL)

Amazon Prime (AMZN)

American Water Works (AWK)

Apple (AAPL)

Chipotle Mexican Grill (CMG)

Etsy (ETSY)

Exxon (XOM)

Facebook (FB)

InterDigital (IDCC)

McDonald's (MCD)

Netflix (NFLX)

Qualcomm (QCOM)

Royal Dutch Shell (RSH.A)

Shopify (SHOP)

Tesla Motors (TSLA)

read carefully the entire research report, which provides a more complete discussion of the analyst's views.

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Analyst Positions

At the time of publication, Mr. Versace, Chief Investment Officer of Tematica Research had no positions in the shares of companies mentioned in this issue.

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Investment opinions are based on each stock's 6-12 month return potential. Our ratings are not based on formal price targets, however our analysts will discuss fair value and/or target price ranges in research reports. Decisions to buy or sell a stock should be based on the investor's investment objectives and risk tolerance and should not rely solely on the rating. Investors should