Top themes

Thematic investment ideas from CIO Wealth Management Research

The Decade Ahead

Third quarter themes
Notes on graphics

The visual aids below are used throughout this publication to help categorize themes in the context of portfolio integration and investment time horizon.

Portfolio context

- Non-traditional
- US equity
- International equity
- Commodities
- International fixed income
- US fixed income

Investment time horizon

- Short term: Less than 6 months
- Medium term: 6 to 12 months
- Long term: Greater than 12 months
- Multi-year: Decade themes

Preferred themes are selected based on their timeliness, conviction level, and CIO WMR’s current view on key financial market drivers.

Please contact your financial advisor for copies of reports cited in this publication.
Dear readers,

Since the beginning of this year, we have been using the quarterly edition of this publication to initiate longer-term investment ideas as part of our Decade Ahead series. This quarterly issue is no exception. We are launching a new Decade theme entitled Environmental opportunities. It focuses on the challenges of resource scarcity in the provision of food, water, and energy. We highlight how these challenges are creating investment opportunities in areas such as energy efficiency, alternative energy, water treatment and infrastructure, and sustainable food production. We believe this theme will appeal not only to investors with a focus on sustainability, but also to those interested in capitalizing on key long-term drivers of investment performance. This theme replaces the broader sustainability-oriented theme, Adding value(s) to investing, on our preferred list of themes.

In addition, we are making several other changes to our Top themes universe. First, our equity strategy team has initiated a theme titled Pockets of vulnerability that highlights our least-preferred areas of the US equity market, namely, utilities as well as food and drug retailing. These areas can be used as sources of funds to redeploy into more attractive portions of the market. Second, we are closing the theme Diversify bond portfolios into credit alternatives. The more limited scope for bond yields to rise reduces this theme’s appeal. Within alternative investments, we prefer our remaining themes, such as Exploring the benefits of equity event-driven strategies and Favoring equity hedge strategies. Finally, we are closing the stand-alone theme Water: Thirst for investments, since it is now included within the broader Environmental opportunities theme.

Sincerely,

Stephen Freedman, PhD, CFA
Head of US Thematic and Sustainable Investing Strategy
Turning environmental challenges into opportunities

Stephen Freedman, PhD, CFA

DECADE THEME

Humanity is facing environmental and resource-related challenges on a global scale. Yet, scarcity and the consequent bottlenecks have always been key drivers of innovation and growth. This new Decade Ahead theme highlights how the scarcity in environmental resources, if considered carefully and holistically, can turn into an interesting source of investment opportunities around resource optimization.

Population growth, economic growth, and urbanization as key drivers of resource scarcity

The global population is expanding at a rapid rate. Last year, the United Nations raised its 2050 world population estimate from 9.3 billion to 9.6 billion, up from today’s 7 billion. Population growth weighs heavily on vital resources. This factor is compounded by growth in income per capita, especially in developing countries, and the ongoing trend toward urbanization.

These factors are increasing the demand for higher-quality foods, in particular animal protein sources such as meats. Higher consumption of animal protein worldwide is challenging as it requires a significantly larger amount of land, water, and energy resources to produce compared to plant-based diets. Similarly, economic development and the global phenomenon of urbanization have resulted in a surge of energy consumption and added pressure to existing water infrastructure. These trends only exacerbate the burden on environmental resources.

The water-food-energy nexus

While innovation has always been relied upon to alleviate scarcity in food, water, and energy, the truly global scale of human activity today has created critical interdependencies among the solutions needed to increase the availability of these three critical resources. Much like the arcade game of “whack-a-mole,” addressing one problem in isolation often contributes to exacerbating the scarcity in other areas (see Fig. 1). Consider the following:

Food-water nexus: Increasing agricultural yields requires more water for irrigation. In particular, the higher the production of animal protein, the higher the demands on water resources. At the same time, the widespread use of fertilizers creates runoffs that adversely affect water quality in lakes, rivers, and ground water reservoirs, thereby exacerbating water scarcity.

Food-energy nexus: Gains in agricultural yield have been, and will continue to be, driven by a greater amount of mechanization and automation (for example, through mechanical agricultural equipment and irrigation technology), which itself requires more energy. Moreover, producing fertilizer is an energy-intensive process. Conversely, the production of biofuels, most notably ethanol, increases the demand for agricultural land and competes with resources available for food and animal feed production.
Addressing one problem in isolation often contributes to exacerbating the scarcity in other areas.

Energy-water nexus: Energy generation, including both power plants and fossil fuel extraction through techniques such as hydraulic fracturing, necessitates large quantities of water. In turn, water purification and treatment, including desalination, require substantial amounts of energy.

Resource optimization and efficiency as elements of the solution
Improving current technologies to make them more efficient, while simultaneously developing more sustainable solutions, is essential to resource preservation. Forward-looking companies are strategically developing business lines that will benefit from these global trends, and, consequently, a variety of environmental opportunities that can be integrated into investment portfolios are beginning to surface.

The path to sustainable energy
While a number of solutions to food and water scarcity problems require more energy, increasing energy supply is no free lunch. Not only does energy use have a monetary price, but all forms of energy also have at least some environmental impact. Most prominently, concerns over greenhouse gas emissions from fossil fuels and their impact on climate change set limits on the extent to which these traditional sources can be relied upon to secure our energy needs into the indeterminate future. This challenge suggests that a transition to a more sustainable energy supply must rest upon two pillars.

First, alternative energy sources such as solar and wind technology have been experiencing significant growth in recent years. While fiscal incentives have been an important driver so far, costs have been declining rapidly to the point where these technologies have started to become competitive against traditional energy sources in some locations. As costs decline further, more widespread adoption can be expected to follow, with associated earnings growth for well-positioned companies. However, even in the more optimistic scenarios, it will be many decades until alternative energy sources can provide for the bulk of the world’s energy needs.

Second, considerable policy and commercial attention is being placed on energy demand management. One of
the cleanest forms of energy is energy never consumed. Innovations leading to energy efficiency gains are particularly interesting in this regard (see Fig. 2). Relevant areas include building technology (such as insulation, energy management systems, efficient water heating, and lighting), industrial processes, transportation (such as fuel economies), electricity generation and transmission (including smart grids), and information technology (such as servers and other hardware).

Water treatment and infrastructure
The scarcity of water resources is likely to become a severe global challenge in the coming decades. In many developed countries, water infrastructure is antiquated, leading to significant leakage (see Fig. 3). For example, the American Society of Civil Engineers estimates that a volume corresponding to 15% of total fresh water supply is lost in the US due to leakage. In many developing nations, basic infrastructure is missing altogether. Large investments in water infrastructure are needed, with an important contribution likely to come from private sources.

The water industry can be divided into the utilities sector, which is responsible for water provision and wastewater treatment, and the industrial sector, which is involved in the production of more efficient water equipment, including pumps, pipes, valves, and metering systems. A number of life-sciences companies are involved in water quality testing and are likely to benefit from water scarcity trends as well.

Food sustainability
Since finding more arable land has become increasingly challenging as a means to grow agricultural supply, the onus lies on increasing yields. A variety of different options is helpful in this respect. More advanced agricultural equipment, efficient irrigation systems, crop protection, fertilizers, and new seed technology can all contribute to increasing agricultural output per unit of land. However, as discussed in the introduction, most of these techniques have costs associated with water and energy use or other aspects of environmental sustainability. Therefore, a careful analysis of their impacts is critical. From an investment perspective, most companies involved in such activities are heavily exposed to the agricultural cycle. At this stage of the cycle, we would advise

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**Fig. 3: Water loss in select US urban networks**
Estimated water loss (non-revenue water) as a percent by volume

**Fig. 4: Animal protein has higher environmental footprint**
Pounds of protein produced per acre
investors to be selective rather than opt for broader participation.

An alternative approach to addressing food scarcity from an investment perspective is to focus on food manufacturers that promote a more sustainable dietary lifestyle, for example, by relying less on animal protein (see Fig. 4), and participate in supportive trends in health and lifestyle, driven in particular by the growing Millennial generation.

**Outlook**
Over the next decade, we expect human ingenuity to help alleviate the various environmental challenges described above. By tracking companies that are the most forthcoming in addressing these challenges through innovative products and services, investors can not only participate in resolving such scarcity problems, but also find solid investment opportunities.

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Top themes universe

Our top themes universe represents the full spectrum of investment themes we currently recommend and actively monitor.

**Equities**

**PREFERRED  Capex rising...finally**

We believe that non-energy capital spending is in the midst of sustainable recovery given the aging stock of existing plant and equipment, an improving global economy and strong company balance sheets. Indeed, it is becoming clear that corporations are gaining confidence in the economic outlook and beginning to reinvest in their businesses. We expect to see this trend to continue and disproportionately benefit select technology, industrial, and financial companies.

**PREFERRED  Environmental opportunities**

Population growth, ongoing urbanization, and economic growth are pushing the limits of our environmental resources. Increasing energy and agricultural demand has to be met, while water supplies are growing scarce as a direct result of these activities. These areas of scarcity create opportunities for companies that contribute to alleviating them. We focus on those that provide solutions promoting resource efficiency and optimization, which should help drive their earnings growth in the short and long term.

**PREFERRED  Eurozone comeback**

Investors looking for something outside the US to put into their portfolios might find that Eurozone equities are an attractive choice. We are seeing encouraging signs that the credit crunch is starting to ease, and the European Central Bank’s quantitative easing will provide a tailwind. With support from an economic recovery and a weaker euro, we see great potential for earnings to grow at a robust pace in the years ahead.

**PREFERRED  Major advances in cancer therapeutics**

A new wave of advanced cancer therapeutics is rapidly emerging, significantly improving cancer survival rates and patients’ quality of life. Advances in science, drug discovery instrumentation, and drug design, have already resulted in major advances in cancer therapy. We believe we are in the early stages of realizing the potential of the numerous discoveries in this space. The multibillion-dollar sales potential of these drugs could drive significant upside for select pharmaceutical and biotech stocks.
North American energy independence: Reenergized

We continue to focus on the North America oil and gas business, where we project ongoing growth, and energy infrastructure, where providers continue to catch up to existing demand. These strong operators could emerge from a downturn with an enhanced competitive position. Meanwhile, lower oil prices and an advantaged regional natural gas price are beneficial to North American industrial energy consumers. We also see advances in renewable and alternative energy providing new approaches to satisfy energy demand.

The rising Millennials

By 2025, Millennials will account for more than 25% of the US population, with the older half of this generation just entering their peak working and earnings years. Given its size and spending potential, we believe companies would be well-advised to align their business models with this generation’s unique consumption needs and preferences. In particular, we expect the main beneficiaries to include innovative technology companies, wellness-focused brands, and service-oriented industries.

Pockets of vulnerability

As we near the beginning of a US interest-rate-hike cycle, we believe the utilities and food & staples retailing industry groups will underperform the market, and we recommend underweighting them. During past rate-hike cycles, these industries have underperformed the S&P 500 beginning 6-months prior to the first rates hike until 6-months after. Yield-oriented sectors tend to underperform the broad market as interest rates rise. Additionally, these industries are trading at a premium on a forward P/E basis when compared to their relative valuation history over the past 20 years.

Benefit from reform in Mexico

We believe the passage of structural reforms in Mexico will increase the country’s long-term growth potential which has not been fully priced in by the markets. In the coming months, we expect to see an adjustment as foreign direct investments begin to flow into energy-related infrastructure projects and economic momentum picks up. We expect higher GDP growth in 2015, driven by consumption, and positive ties to industrial activity in the US.

Dividend investing – don’t overpay for yield

Valuations for the highest dividend-yielding stocks remain elevated and vulnerable to rising rates, while equities with moderate yields but historically high and consistent dividend growth are much more attractively valued. Investors should note that although 84% of S&P 500 companies pay shareholders some form of recurring dividend, the payment relative to share price and earnings strongly varies across industries and companies, as does the growth rate of the dividends per share paid.

e-Commerce: Beyond Amazon

As consumers of traditional retail shift their shopping and spending online, opportunities abound for true omni-channel retailers and related companies. We believe long-term positive drivers of digital growth, including the rapid adoption of mobile devices, will continue to hasten market share shifts online. We recommend taking a look at select opportunities in consumer-focused industries that take an omni-channel approach and utilize digital marketing strategies to complement their online efforts.
Top themes universe

**Equal-weight investing**
Cap-weighted index funds have become a standard holding in many investment portfolios. While these funds have some attractive properties, such as low turnover, they also have some drawbacks, such as the tendency to hold overvalued stocks. As an alternative, investing according to an equal-weight approach has shown to exhibit attractive long-term risk and return properties. Moreover, the small-cap bias embedded in such a strategy aligns favorably with our current tactical equity views.

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Click for full report
 Equal-weight investing

**Restructurings and turnarounds**
Managements rarely aspire to undergo a restructuring, but, in some cases, it is the best path when a company has an urgent need to turn around its fortunes, improve its reputation, or restore its competitive position. A well-executed restructuring or turnaround can transform a company into a strong competitor with dramatically improved financial results. Investors can capitalize on this by selecting companies that are currently undergoing restructurings with a high probability of success.

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Click for full report
 Restructurings and turnarounds

**The sun rises from the East**
We recommend an overweight position in emerging Asia versus the broad MSCI emerging markets index in the next 6 months due to Asia’s macroeconomic resilience, superior earnings growth and profitability, and more attractive valuations. In the current environment of low commodity prices, Asia will likely benefit as a net commodity importer. In addition, Asia’s current account surplus and foreign exchange reserves reduce its vulnerability to US rate hikes.

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Click for full report
 The sun rises from the East

**Transformational technologies**
We believe there are two areas of technological innovation that will be driving forces behind productivity gains during the next decade. The first is the broad set of business opportunities around the explosion of digital data. The second is automation and robotics. Both have the potential to profoundly transform the structure of our economy, disrupt existing business models, but also create substantial growth opportunities for those well-positioned to participate.

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Click for full report
 Transformational technologies

**US technology: Secular growth, on sale**
The US technology sector is attractively valued given its solid long-term earnings growth, improving cyclical outlook, accelerating cash distributions to shareholders, and exposure to secular growth drivers. In the short term, we expect rising demand for IT equipment to drive growth, while in the long term we look to cloud computing, cyber security and e-commerce, among others. Continued labor market gains and rising capacity utilization provide further stimulus to an improving cyclical outlook.

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Click for full report
 US technology: Secular growth, on sale
**Beyond benchmark fixed income investing**

Over the next decade, we believe US taxable fixed income investors will find themselves in a challenging market environment characterized by low starting yield levels, bouts of volatility, and a longer, drawn-out normalization cycle. For these investors, the most widely used benchmark is the Barclays Aggregate Index, which suffers from several flaws, in our view. We argue that investors can circumvent benchmark shortcomings by diversifying bond portfolios beyond a traditional benchmark and adopting a more flexible approach to active fixed income management.

**US senior loans**

Due to their floating-rate character, senior loans are an attractive alternative to more traditional fixed income segments in an environment of rising rates. Although LIBOR floors prevent coupons from resetting upward immediately, we believe individual investor demand should pick up as the Fed moves closer to raising its target rate. Loan prices remain under par, offering an attractive entry point for investments into US loans.

**Mortgage IOs: positive returns when rates rise**

Agency interest only (IOs) are a mortgage-backed securities product that offers investors the opportunity to add yield to their fixed income portfolio, while at the same time mitigating potential losses in a rising-rate environment. When added to a diversified fixed income portfolio, mortgage IOs’ negative correlation to other bond holdings can limit risk and enhance return. Considering that US yields are still at historically low levels, and WMR forecasts they will rise further this year, we continue to believe that this is a compelling time to consider mortgage IOs.

**Opportunities in capital securities**

Financial sector capital securities are likely to continue to outperform the broader investment grade bond market in the coming months, as issuers continue to build capital and liquidity to meet new regulatory requirements, and maintain low leverage. Our view that US interest rates will rise gradually benefits capital securities their attractive yields, while a growing portion of capital securities has floating-rate structural components for added interest-rate risk protection.

**Yield pickup with kicker bonds**

Municipal kicker bonds are callable, high-coupon munis that sell at a premium and are priced to a specific call date. However, the actual yield realized will “kick up” if the call is not exercised by the borrower in a timely manner. If rates do rise, kicker bonds are less likely to be called, thereby increasing the duration as the effective maturity is extended beyond the investor’s expectation. We see a yield opportunity in 5% coupons versus AAA non-callable bonds with comparable redemption dates.
Exploring the benefits of equity event-driven strategies
Executives are under pressure to stimulate organic growth prospects through M&A and significant corporate events in order to promote shareholder value after a sustained period of multiple expansion. Accordingly, we find special-situation investing and merger-arbitrage strategies as attractive ways to capitalize on these corporate transactions. Opportunities for special-situation investing include corporate events such as spin-offs, breakups, tender offers, and asset disposals, among others.

Favoring equity hedge strategies
We think the current environment is conducive for stock-picking and it is likely to remain in place for the foreseeable future. We expect higher intra-market return dispersion, which is positive for this style, to enable managers to generate excess returns. Furthermore, we expect performance to increasingly be dictated by company-specific fundamentals and developments, rather than broad market movements and shifts in risk perception.

Financial industry trends & wealth management strategies

**PREFERRED** Liability optimization
The current market environment presents an opportune time for investors to “optimize” their liabilities in order to add potential alpha to their balance sheet. Liability allocation is a custom household decision to be made within the context of tax situation, time horizon, and asset allocation. Liability optimization can potentially impact a household’s net worth as the benefit is accrued and compounded over years and decades, thereby enhancing returns.

Adding value(s) to investing: sustainable investing
Concerns about sustainability are rising among consumers, employees, civil society, and the investment community. Whether investors seek to align portfolios with personal values, achieve a positive environmental or social impact with their investments, or believe that sustainability considerations affect securities’ values and returns, sustainable investing is on the rise and the number and sophistication of related investment solutions are growing.
US Thematic Investment Committee

The themes selected for the top themes universe are selected and actively monitored by the US Thematic Investment Committee (TIC).

Members of the US Thematic Investment Committee

All members are analysts or strategists working for CIO Wealth Management Research Americas (CIO WMR):

- Michael Crook
- Sally Dessloch
- Leslie Falconio
- Andrea Fisher
- Stephen Freedman (Chair)
- David Lefkowitz
- Barry McAlinden
- Tom McLoughlin
- Brian Nick
- Mike Ryan
- Jon Woloshin
- Jeremy Zirin

Top themes universe

CIO Wealth Management Research actively recommends and monitors a range of investment themes that we believe an investor should consider in light of current or anticipated financial market trends. Thematic drivers include but are not limited to emerging growth opportunities, misvaluations in capital markets or foreseeable developments in public policy, demographics, society, environment, and technology.

All themes originate from analysts within CIO Wealth Management Research. Among the top themes universe a subset is deemed “preferred.” Themes with the “preferred” designation may change from month to month and are determined based on factors such as conviction, timeliness, implementability, and our current WMR Chief Investment Office’s view on key financial market drivers.
Emerging Market Investments
Investors should be aware that Emerging Market assets are subject to, among others, potential risks linked to currency volatility, abrupt changes in the cost of capital and the economic growth outlook, as well as regulatory and sociopolitical risk, interest rate risk and higher credit risk. Assets can sometimes be very illiquid and liquidity conditions can abruptly worsen. WMR generally recommends only those securities it believes have been registered under Federal US registration rules (Section 12 of the Securities Exchange Act of 1934) and individual State registration rules (commonly known as “Blue Sky” laws). Prospective investors should be aware that to the extent permitted under US law, WMR may from time to time recommend bonds that are not registered under US or State securities laws. These bonds may be issued in jurisdictions where the level of required disclosures to be made by issuers is not as frequent or complete as that required by US laws.


Investors interested in holding bonds for a longer period are advised to select the bonds of those sovereigns with the highest credit ratings (in the investment grade band). Such an approach should decrease the risk that an investor could end up holding bonds on which the sovereign has defaulted. Sub-investment grade bonds are recommended only for clients with a higher risk tolerance and who seek to hold higher-yielding bonds for shorter periods only.

Nontraditional Assets
Nontraditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments; there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

• Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-US securities and illiquid investments.