

# The highs of low carbon

June Aitken, partner at Osmosis Investment Management, an independent asset management group, explains how to capture returns from the move towards a low carbon economy.



The transition to a low carbon environment is a structural investment and growth story. This topic has evolved from a distant issue to one offering tangible opportunities. Investing in companies with leading-edge technologies that help the world reduce its dependence on fossil fuels, and tackle the problems created by a changing climate, can provide strong returns.

The table below shows returns in low carbon sectors over 1, 3 and 5 years as well as the strength of recovery since the FTSE 100 bottomed in March 2009.

## The shift towards a low carbon environment has already begun.

According to HSBC's Global Climate Change Research, governments worldwide announced last year that they planned to spend \$520bn on low carbon investments. Only \$82bn or 15% was spent in 2009. This means that over \$230bn will need to be spent this year if the proposed stimulus plans are to stay on track. About half of this will be invested in improving energy efficiency (eg smart electricity grids to plug in renewable energy and manage

demand better, or greener buildings), with renewable energy production such as wind and solar receiving the bulk of the balance. Over and above this spending will be new policy measures adding further momentum to the transition. In the UK, for example, the introduction of a new regulation, the Carbon Reduction Commitment, next year will encourage the owners of commercial premises to make buildings much more energy efficient.

In response, a growing number of companies have begun to innovate and provide services and technologies necessary for a low carbon environment. Some have performed well, and are expected to continue to do so, while others will fall by the wayside.

Index performance	Performance period to end Feb 2010			
	From market bottom %	1Y %	3Y %	5Y %
Renewable Energy (Wilderhill New Energy Index)	55.9	46.0	-33.7	14.8
Energy Efficiency (FTSE Env Opp Energy Efficiency Index)	87.4	76.0	n/a	n/a
Water (S&P Global Water Index)	65.5	53.5	-10.7	46.4
Waste (BNP Paribas Global Waste Management Index)	50.5	40.8	-2.0	69.2
Diversified Low Carbon (Osmosis Climate Solutions Index**)	70.5	59.8	-8.6	47.1
FTSE 100	52.5	39.8	-13.2	7.8

\* based on FTSE 100 low on 3 March 2009 \*\* pro-forma prior to Nov 2009

Source: Bloomberg



There is no globally accepted definition of the low carbon sector. Broadly, though it includes renewable energy production (solar, wind, geothermal, hydro, tidal, bio-energy), energy efficiency, water, waste management, and pollution control. Identifying the winners and losers globally is a huge task, made more complex by the existence of over 2,000 pieces of legislation worldwide which could impact companies in different countries. A useful example is how stricter EU agricultural policies negatively affected US biofuel stocks in recent years.

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A good way for investors to participate is through funds, but there are about 50 Exchange Traded Funds (ETFs) and other collective instruments in the low carbon, renewable energy and environmental sectors. Many ETFs track small segments of the low carbon economy, such as solar, wind, biofuels, renewable energy or water. Each sector represents only part of the solution required to shift to a low carbon world so an investor would need a portfolio of these ETFs to get exposure to the whole spectrum of opportunities. The alternative is a single diversified fund.

Another reason for favouring a broad fund is that single segment funds can be very volatile. The sector performance table opposite shows how much further clean energy stocks fell (-34%) when the FTSE 100 declined 13%. A broader fund would have benefited from exposure to the other sectors, all of which outperformed the FTSE 100 during the same period.

Solar is a good example of a volatile single sector ETF. Ahead of Copenhagen, enthusiasm for alternative energy investments saw the Claymore Mac Solar ETF comfortably double to the year's high in November. Post Copenhagen,

### Examples of companies in OCS Index

#### United Kingdom

United Utilities  
Severn Trent  
Eaga  
SIG  
Climate Exchange

#### United States

Cree Inc  
Waste Management Inc

#### Hong Kong

China Water Affairs

#### France

EDF Energies Nouvelle

Source: Osmosis Investment Management

pessimism combined with subsidy cuts in Germany saw the ETF drop 33% from its high before stabilising. A diversified fund like the Osmosis Climate Solutions ETF (OCS ETF) invests in all businesses in the low carbon space and the resulting diversification avoids the pitfalls of putting all bets on any one specific technology.

A diversified low carbon fund makes prudent sense, but choosing a suitable one may not be straightforward. Some funds include stocks such as Siemens or Toyota which may have low carbon businesses like wind turbine gear boxes or hybrid vehicles, but their share price performance is not determined mainly by these activities. Look for funds investing in ‘pure play’ low carbon stocks — those companies whose revenues are mainly derived from technologies, products and services supporting the transition to a low carbon economy.

Some funds allocate investments based on a company's market capitalisation — the biggest stocks get the most money. The portfolio can become concentrated in the largest holdings so investors may not get diversification. Nearly half of BlackRock's \$3.3bn New Energy Fund is in 10 stocks and 5 stocks make up about a third of the EasyETF ET50.

There are two key routes to investment in the low carbon sector: ETFs and unit trusts. ETFs offer easy access, greater tradeability, and lower costs. They incur broking commissions when bought or sold, but management charges are lower and there is no access fee (which for a unit

trust can be as high as 5.25%). Staying on top of an extensive universe of large and mid-cap companies and all global policies and regulations associated with a low carbon economy, poses big challenges for active stock pickers. ETFs track indices which are constructed according to quantitative rules which select companies objectively.

Unit trust performance varies and some of the best, Jupiter Environment and Schroders Climate Change are up about 27% in the year to end January. But the FTSE 100 gained 25% in the same period and a diversified low carbon index such as the Osmosis Climate Solutions (OCS Index) showed double the performance with a 50% increase. Please remember that past performance is not a reliable indicator of future performance and that the value of investments and the income from them can go down as well as up.

The goal of the OCS Index is to provide an objectively constructed, globally diverse basket of 100 low carbon economy companies which perform well compared to major markets and other climate and environmental indices. The index includes only those companies which earn the majority of their revenues from renewable energy production, energy conservation, water and waste management. The Osmosis Climate Solutions ETF aims to track this index and was recently listed on the London Stock Exchange.

As we shift towards a low carbon environment, the sector is emerging as an asset class which should have a place in most portfolios. Strong long term fundamentals supported by government policy and continuing growth in global demand for energy and water can be expected to continue to provide healthy returns and overcome shorter term volatility. For investors looking to participate in these returns, an objectively constructed diversified ETF may appeal more than a single sector ETF or an actively managed fund.

### Interested?

You can buy and sell ETFs and unit funds online via our website at [www.share.com](http://www.share.com) or through our Dealing team who can be contacted on 01296 41 42 43.