

Steven Falci of KBC Asset Management explores the link between thematic portfolios and sustainability, materiality and long-term investment returns

# Sustainable thematic funds: investments for the future

Pension Fund managers and trustees are increasingly evaluating how to best incorporate environmental, social and governance (ESG) factors into their investments. Many are signatories of the Principles for Responsible Investment (PRI) and are grappling with how to integrate ESG factors into their investment decisions in ways that are consistent with their fiduciary duties as long-term investors.

Thematic funds, with a focus on long-term solutions to our global society's most pressing environmental and sustainable challenges, are an excellent means of achieving this objective.

Thematic portfolios provide a clear link between sustainability, materiality and long-term returns. Whether it is alternative sources of energy, availability of water or climate change, the sustainability



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challenge is clear as are the drivers of long-term investment returns. Fully realising the investment potential of these themes is best achieved through a specialised manager and disciplined investment process.

## Investment drivers

The investment drivers of alternative energy stocks are long-term and sustainable. The demand for energy across the world is forecast to continue to grow for decades to come. With the spectacular rise in oil prices to over \$140 a barrel, renewable sources of energy have become increasingly attractive.

Many renewable sources have become more accessible and cost efficient in their own right, particularly wind energy. Perhaps, most significantly, the global consensus on the imperative to significantly reduce carbon emissions to address the challenge of climate change points to an increase in renewable forms of energy over the next 30 years.

The investment drivers of solutions to fresh water availability are also long term in nature. Water is an essential resource for which there is no substitute. With accelerating industrialisation, economic growth and population growth in developing countries, there is much need for investment in infrastructure to provide adequate water.

In Europe and the US, much of the aged water infrastructure is in need of replacement. An estimated \$1trn (£500bn) in water infrastructure investment will be needed over the next 25 years to assure there will be adequate freshwater available across the globe.

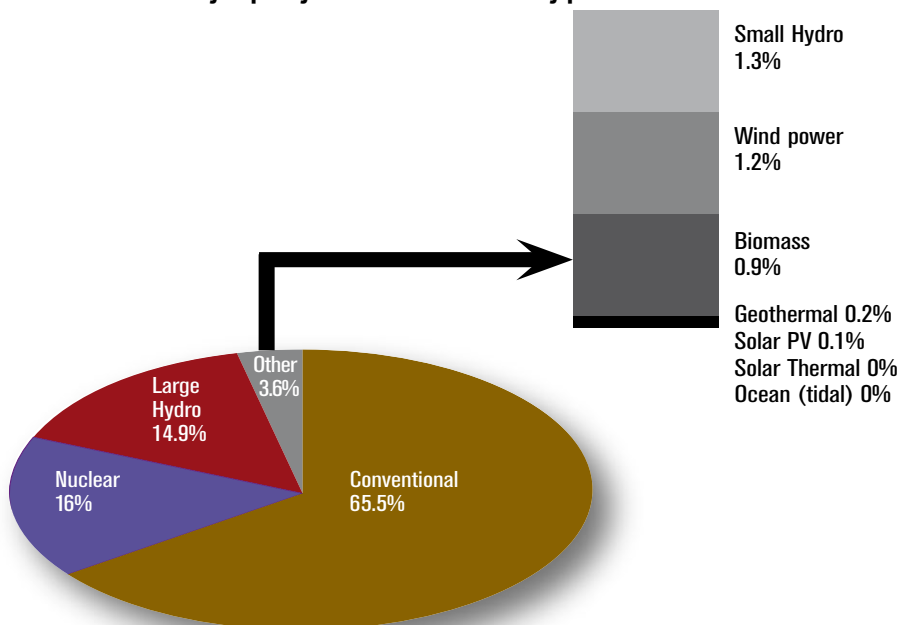
## Climate change

Climate Change is the most significant challenge facing our global society in the 21st century.

## Current market share expected to grow

International Energy Agency:  
30% of all energy related investments in next 30 years will be in renewables

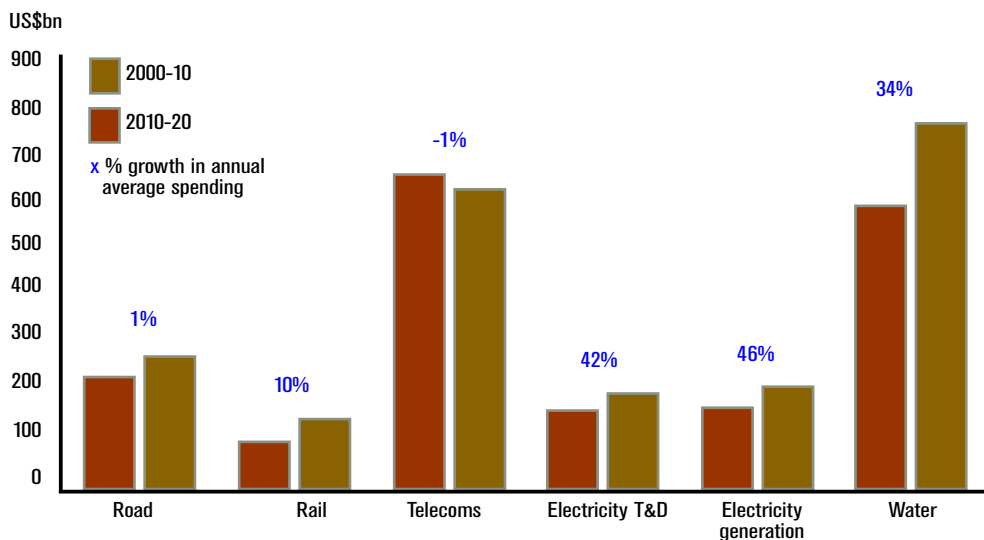
## Renewable electricity capacity share of 2005 electricity production



Source: Renewables Global Status Report 2006 Update, REN 21

## Water investment likely to be the largest area of infrastructure spending

### Average annual infrastructure investment by decade



Source: OECD, Goldman Sachs Research

Climate change poses risks to companies, to a lesser or greater degree depending on the sectors in which they operate, but it also presents opportunities – astute companies are already taking advantage of new technologies, products and services and investors are increasingly seeking out those companies that are providing innovative solutions to reduce carbon emissions and mitigate some of the negative impacts of climate change.

Renewable energy sources, clean technology, energy efficiency measures and carbon emissions trading markets are the most obvious examples of these opportunities but climate change is also creating challenges and opportunities for investors in related themes such as water and agribusiness.

### Investment focus

While these thematic strategies are supported by long-term secular trends, fully capturing their long-term potential requires a specialised investment focus.

This focus will use fundamental and quantitative insights to add value at two levels:

- Identifying the component

themes or sectors, within the larger theme, that are positioned to provide the dominant returns over the long term; and

- Selecting the stocks within each theme that are best positioned to deliver solutions.

Defining component themes within the broad theme, their constituent stocks and establishing strategic targets to each component theme is an essential foundation for positioning the thematic strategy for long-term performance and defining the investment universe as a de facto benchmark to guide portfolio construction.

A specialist focus is essential in bringing together the top-down and bottom-up fundamental insights that are vital in the construction of a thematic universe such as alternative energy or climate change – where innovation and new technologies are significant sources of alpha.

Once established, identifying better relative value among the component themes and identifying undervalued stocks best positioned to provide long-term leadership within these themes should be the focus.

Investing across a number of component themes, within disciplined constraints for sectors and holdings, can lead to an appropriately diversified portfolio that has the potential to deliver significant long-term returns.

Thematic strategies are sound and intuitive means of integrating sustainability into pension fund investment strategies. Given the long-term secular drivers to these themes, they provide strong potential to enhance long-term returns while contributing to solutions to global sustainability challenges.

Additionally, they can also bring a degree of diversification to a global equity allocation that has yet to gain exposures to these emerging strategies. Pension fund managers have the ability to prudently introduce them into their equity allocations in a manner that is appropriate to their individual plan's risk profile.

**A specialist focus is essential in bringing together the top-down and bottom-up fundamental insights that are vital in the construction of a thematic universe**

