

Allocating to Environmental Strategies and Enhancing Global Equity Portfolios

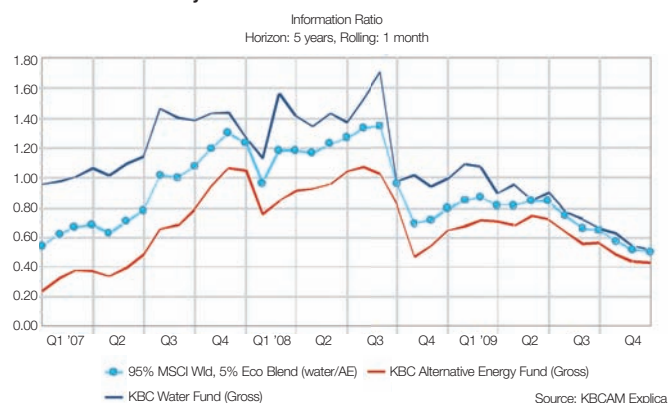
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The search for alpha is a persistent link uniting all equity investors. Sustainability has also recently moved to the fore, as the social and economic consequences of secular trends that challenge the long-term well being of our society are leading many institutional investors to evaluate allocations to thematic strategies that invest in companies that provide solutions to these challenges. These strategies that focus on areas such as renewable energy, water, agriculture, and cleaner solutions that facilitate emission reductions, waste management and recycling came into focus at various points over the last decade and many have provided strong returns to investors who recognised the long-term potential of these themes. More importantly, the drivers of growth underpinning environmental strategies are secular in nature and can continue to provide a unique enhancement to a global equity allocation over the long-term.

The precise place and role that environmental strategies can play in equity portfolios is shaped by the requirements of different investors. Investors have the option of 1) allocating to individual strategies that play a specialist role in their equity allocation, or 2) investing across a number of themes to gain diversified, actively managed exposure across a spectrum of strategies.

Allocating to Individual Strategies

Attractive Risk Adjusted Returns



Return Enhancer/Growth Driver. The predominant rationale is the enhancement of long-term returns. Environmental strategies provide exposure to a unique source of alpha that is not prevalent in many global equity allocations that is driven by 3 global mega trends that are positioned to drive investment opportunities in solutions to sustainability challenges across environmental themes for many years to come.

1. The world's growing population and changing demographic profile
2. The supply/demand imbalance for vital resources of energy, water and food
3. Climate change and the imperative to operate in a carbon constrained world

These three trends are driving investment in solutions to meet the needs of growing population for potable water, food and cleaner energy and encompass a broad range of technologies, infrastructure and services that traditional global equity portfolios may not be exposed to. Historically, using return data for KBCAM's two longest

running strategies, rolling five year information ratio¹ data for our Water and Alternative Energy Strategies demonstrates the potential for strong risk adjusted returns. Viewing them in the context of a global equity portfolio also reinforces this point, as they could have historically enhanced a global equity allocation (as represented by the MSCI World) as evidenced by the favourable information ratio when adding a combined 5% allocation to water and alternative energy strategies². More importantly, we remain confident in the ability of these strategies to deliver strong returns going forward as this alpha is driven by long-term secular trends discussed above.

Diversification. A review of the correlations of 5 year returns of KBCAM's Water and Alternative Energy Strategies to global equities indicates that correlations have ranged from approximately .60 to .85 for Alternative Energy, providing a level of diversification over time, while Water had higher correlation consistently around .90.³ A snapshot at year end 2009 of a Thompson Reuters/Jeffries Agricultural Index shows a correlation of Agricultural stocks to global equities of .80.⁴ Correlations increased during the financial crisis as correlations among most asset classes markedly increased. However, over the long run, we believe investors can obtain a degree of diversification within their global equity portfolio from the unique sources of alpha provided by environmental strategies.

Opportunistic. The unique source of alpha has been viewed by some investors as a longer term component of opportunistic segments of their portfolios. While we firmly believe these strategies need to be evaluated with a long term perspective, a year into the stock markets' recovery, many environmental sectors and stocks continue to trade at valuations that do not reflect their long-term prospects and continue to create an opportunistic entry point for investors who are considering a new allocation to environmental strategies.

Infrastructure. The infrastructure to meet the water and energy needs of a growing global population is substantial and is providing opportunities for equity investors. Population growth in the developing world is driving the demand for new water and waste water treatment infrastructure, while inefficient, leaky, aged infrastructure needs to be replaced in Europe and the US. Booz, Allen, Hamilton estimates that \$22 trillion will need to be invested in water infrastructure from 2005 – 2030 to meet the demand for water globally.⁵ This has driven some investors to include water strategies within infrastructure allocations. Similarly, in order to meet global energy needs, required energy supply investment will need to be substantial – estimated at \$26 trillion from 2007 – 2030.⁶ Infrastructure for cleaner energy generation and energy transmission infrastructure to make renewables more accessible will have to represent a significant amount of energy infrastructure spending if the world is to substantially reduce carbon emissions while meeting energy demand.

Environmental Risk Hedge. While investors evolve to a fully integrated ESG approach across their equity allocation, environmental strategies can provide an implicit hedge to environmental risks embedded in the equity allocation. For example, companies in the equity portfolio that will be negatively impacted by carbon emissions should be offset by companies in environmental strategies providing renewable energy and energy efficiency solutions that will benefit from the demand for solutions to reduce emissions.

Investing Across Themes

While investors may allocate to individual environmental strategies to serve a particular portfolio role, there is increasing interest in diversified exposure across themes from investors who:

- recognise the alpha propositions across environmental strategies,
- do not want to choose any one single themed strategy and
- want professional expertise to actively manage allocations across themes

While environmental strategies are all driven by the three long-term trends discussed above, returns can manifest themselves in a diverse fashion within individual strategies. For example, while demand for water solutions are driven by long-term trends they will be supported and impacted regionally, by regulation to address water quality, conservation, and water infrastructure spending designated to address water scarcity. Similarly the long-term trends support increased use of renewable energy and are manifested in regional renewable energy targets and incentives, the drive for energy independence and technological advances and cost reductions across renewable energy technologies.

The differences in the specific returns drivers across environmental strategies point to potential opportunities for diversification of alpha across strategies and for active management to identify varying opportunities over time from both an earnings and valuation perspective.

5 Year Correlations of Excess Returns of Environmental Strategies

	Water	Alternative Energy	Agriculture
Water	1.000		
Alternative Energy	0.446	1.000	
Agri	0.326	0.398	1.000

A review of the correlations of excess returns provides historical support for the diversity of alpha across environmental strategies. Five year correlations of excess returns across portfolios of water, alternative energy and agriculture stocks range from .33 to .45.⁷ Diversification across the sources of alpha available in the different environmental strategies should provide the opportunity to reduce volatility relative to allocations to individual environmental strategies. Moreover, the ability to manage across different environmental strategies enhances a manager's opportunity to maximise returns, evaluating misvaluations and emerging opportunities across the spectrum of environmental sectors.

Capturing the Alpha

While the long-term alpha opportunity across the spectrum of environmental strategies is strong, capturing the alpha is best accomplished through specialist expertise within each strategy and across strategies. The evolving nature of these nascent areas provides the opportunity for specialist managers to add value through an active management process that brings an understanding of the growth drivers of the themes, the stages of development of technology and networks of industry contacts that assist in sourcing relevant information to capture the alpha. A specialist investment process should strive to capture alpha in three areas:



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23 years industry experience,
2 years service with KBCAM

Steven Faldi joined KBC Asset Management in the newly created position of Vice President – Sustainable Investment in 2008 where he oversees the development of KBCAM's sustainable investment business, products and strategic priorities to position KBCAM for leadership in this growing market segment. He has over 20 years of broad experience overseeing investment teams at a large pension fund, an institutional asset manager and a mutual fund company.

Prior to joining KBC Asset Management, Steve was Senior Vice President, Chief Investment Officer, Equities with the Calvert Group where he oversaw the equity and asset allocation portfolios for the largest family of socially responsible mutual funds in the US. Before joining the Calvert Group, Steve was Senior Vice President, Senior Portfolio Manager and Principal at Mellon Equity Associates. Steven has a BS and MBA from New York University, an MA from Pittsburgh Theological Seminary and is a Chartered Financial Analyst

- 1. Clearly defining the environmental theme and the stocks which make up the theme to assure that investors are receiving the themes' unique drivers of alpha.** This requires a precise definition of each environmental theme and criteria defining companies with exposure to the theme to assure alignment between the theme and desired returns.
- 2. Identifying sectors and technologies that are poised to deliver dominant solutions.** Positioning the sector weightings of each portfolio to reflect the key macro thematic and regulatory drivers within each environmental sector, the key technologies where solutions are likely to be forthcoming and the positioning of each of the sectors in terms of the overall value chain for the theme are all crucial to delivering alpha.
- 3. Identifying the stocks within each sector that are best positioned to deliver sustainable growth.** Once the leading sectors have been identified, effort should be focused on finding the stocks which harness the potential within each sector to deliver growth over the long run.

Conclusion

Allocating to environmental strategies continues to provide a strong opportunity for investors to enhance their global equity portfolios. These investments are driven by compelling long-term secular trends that will drive the need for investment in solutions across the environmental spectrum for years to come. While the primary rationale for investors to include an allocation to environmental strategies is alpha generation, individual strategies can play specific roles within a global equity portfolio including diversification, infrastructure and opportunistic investments. Given the evolving, but still nascent-areas that environmental strategies occupy, active management is key to capturing the different sources of alpha available to investors.

1 The information ratio is a ratio of the returns above the market divided by the tracking error. The MSCI World Index is used as a proxy for the market.
 2 The data to construct the information ratio and correlation graphs represents live returns from KBCAM's Water and Alternative Energy strategies.
 3 The data to calculate the correlations represents live returns from KBCAM's Water and Alternative Energy strategies.
 4 Thompson/Reuters/Jeffries CRB In The Ground Global Equity Index, Fact sheet January 2010
 5 Nikko Citi, "Global Infrastructure Investment Growing" September 2009
 6 International Energy Agency, World Energy Outlook 2008
 7 Correlations of excess returns for Water and Alternative Energy were calculated from KBCAM historical returns. The excess returns for the Agri series represents the returns of the KBCAM Agribusiness Fund since its inception in April 2008, with prior returns provided by the Dax Global Agribusiness Total Return Index.

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