Changing Climate. Changing Portfolios.

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Introduction

Hurricanes, typhoons, droughts, wildfires, and other extreme weather events are causing record damage. Increasingly, climate change is impacting the economy and our daily lives and has come into focus as an existential threat to the world as we know it. We are rapidly approaching a time when the world will be forced to act aggressively in an attempt to overcome decades of inaction. As return-oriented investors, we see this effort providing the backdrop for decades of secular growth in the climate change sector, along with the potential for strong returns.

Opportunity

For those paying close attention to the science, the climate situation has been alarming for decades. In the past decade, however, climate change mitigation technologies, such as wind, solar, and electric vehicles, have made impressive progress and are now cheaper, in many cases, than their conventional alternatives. And in the past couple years, the world has started to recognize the urgency with which we must address climate change, as the United Nations, the World Economic Forum, and governments around the world have identified climate change as perhaps the biggest risk to global prosperity.

We believe the dire environmental situation combined with the improving economics for clean energy and a growing sense of urgency will support secular growth in the climate change sector for decades to come. Interestingly, despite strong long-term growth prospects, we find many climate change-oriented companies trading at a discount to the lower growth broad equity market. Investors should be excited by the strong return prospects implied by buying growth-oriented companies at a discount.

Beyond strong returns, we believe a climate change strategy (for our purposes, a strategy investing in the sector) may offer other significant benefits as well. We expect these to include diversification, protection from climate risk, and inflation protection. We also believe the climate change sector is particularly inefficient with many opportunities to add value through stock selection.

Approach

In designing a climate change strategy, we first have to identify companies that benefit from efforts to combat climate change, either through mitigation or helping the world adapt to climate change. Relevant industries include wind, solar, electric vehicles, batteries & storage, energy efficiency, agriculture, and water. In considering companies for our investable universe, we examine the purity of their exposure to climate change, and as a general rule, we look for companies with at least fifty percent of their business tied up in climate-related activities.

We also believe it's important to look up and down the value chain for opportunities. If we're considering the electric vehicle industry, we don't just focus on the electric vehicle manufacturer. We look at semiconductor companies that service the electric vehicle industry, lithium ion battery manufacturers, and raw materials that are inputs into either the batteries or the vehicles themselves. We want as much breadth as possible without sacrificing our exposure to climate-related activity. This gives us a better chance of finding strong investment opportunities.

We also carefully consider the industry dynamics for the companies under consideration. Secular growth is irrelevant if a company can't monetize the growth within its industry into the profitability that equity investors benefit from. Solar panel manufacturing, for example, while a clear mandate fit, is rife with undesirable industry dynamics, including low barriers to entry, little product differentiation, and lots of competition. Due to the industry dynamics, we've excluded 75% of the solar companies that we've analyzed from our universe. The few solar companies that have made it into our buyable universe either have a unique, patented technology or benefit from increased activity in the solar industry (installers, developers, companies that manufacture equipment used by the solar panel manufacturers, etc.).

Once our investable universe has been established, we believe it is critical to incorporate valuation in positioning the actual portfolio. Every company is worth a price based on expected growth in fundamentals, but the market often gets ahead of itself. While the climate change sector as we've defined it is generally trading around market levels, we've seen hype and lofty valuations in some areas. In particular, the electric vehicle manufacturers, Tesla and BYD, and the meat alternative companies, Beyond Meat and Impossible Foods, have traded at levels that we believe are hard to justify and leave little margin of safety. In order to fully capitalize on the opportunities in the climate change sector, we feel valuation is paramount.

Portfolio Fit

The prospects for strong returns, diversification, and inflation protection are exciting, but how does a climate change strategy fit into a broader portfolio? After all, very few investors have a climate change bucket! There are a few different ways of framing this sort of allocation. Our favorite framing is to position the portfolio as a global equity alpha play with diversification benefits. We believe there's money to be made in this sector.

POTENTIAL PORTFOLIO FITS

- **Global Equity Alpha**
- **Real Assets**
- **ESG, Impact, or Sustainability**
- **Insurance Against Climate Risk**

Outside of global equities, the most natural home for a climate change strategy for many portfolios may be in the real assets allocation. There's also a growing trend toward making specific allocations to ESG, impact, and sustainable investments. A climate change strategy would be a candidate for these types of allocations or for investors who favor thematic investing more generally.

Perhaps the most interesting framing, however, may be to think of this type of strategy as insurance. As already discussed, the experts expect climate change to have a major impact on the economy. Even with the uncertainty surrounding such projections, one must acknowledge that there's a significant risk that climate change will have a considerable, unpleasant economic impact. It seems reasonable to think that investors would want to protect themselves from this risk, and investing in a climate change strategy would be a good start.

Conclusions

Allocating to a climate change strategy is not standard operating procedure for investors, but for those willing to think outside the box, we expect the rewards to be significant. Not only should investors be intrigued by the potential for returns, diversification, and inflation protection, but a well-designed climate change strategy should also help protect a portfolio from a major risk to the economy. There are a variety of ways that such a strategy could fit into a portfolio. It's up to investors to figure out how a climate change strategy fits into their particular investment process, but we expect it will be worth the effort.

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