ROUNDTABLE – ENERGY TRANSITION

Investing into the energy transition

In January, **Tell Media Group**, in cooperation with **Allianz Global Investors**, **BNP Paribas Asset Management** and **Lazard Asset Management**, invited selectors to a roundtable discussion focused on the energy transition. Tell Media Group founder Niklas Tell moderated the discussion.

By: **Niklas Tell**

The discussion, which was hosted digitally, started with Niklas Tell asking the fund managers participating in the discussion to briefly explain how they look at the energy transition and how it influences their investment decisions.

ULRIK FUGMANN: "The energy transition is really quite exciting because I think if you read academic literature, it says there has been a lot of energy transitions, which is really not the case. All we've done is adding new fuels but not really transitioned away from one fuel source to another. We've just kept adding carbon intensity. Now, for the first time ever, we're really trying to transition and actually decarbonise the way that we think about energy. That's why the energy transition theme is so exciting. If you think about energy-related activities, they're responsible for about 70 per cent of carbon emissions today, so it's unsurprising that governments and consumers are so focused on how to decarbonise the energy system. Climate change and energy-related carbon emissions are an existential risk but it's probably also one of the biggest commercial opportunities of our lifetime. That's why the energy transition is not only important for the world but also important for investors that want to be part of this opportunity. We see that solutions are going to be found in three areas. The first is how we decarbonise the energy system, which is about renewable energy production. Secondly, it's also about how we digitalise the global energy system, which is about energy tech, and finally it's about how we decentralise the energy system - so around energy transportation, infrastructure and storage."

PAUL SELVEY-CLINTON: "We have a core investment philosophy where we believe that the negative externalities of greenhouse gas emissions will be increasingly priced in and will appear in company's financial statements going forward. This represents a huge transition risk for those high emitters but it also presents a tremendous opportunity for those companies that are able to provide products and solutions that enable that transition. In terms of how we think about investing, we first identify the key sectors of greenhouse gas emissions as defined by the IPCC. These are power, industry, transport, buildings and agriculture. Over 90 per cent of global greenhouse gas emissions come from those five sectors. Within these sectors we look for two different types of companies. We look for 'enablers', which are companies supplying products or solutions that support the transition to a low carbon economy. You can think about the producers of wind turbines, solar systems or companies producing parts for buildings efficiency or electric vehicles. Those are the enablers and they make up the core of our strategy. We also invest in something we call 'transformers', which are companies with high emissions today but are addressing climate-related risks and re-orientating their business models. These would be companies such as utilities, which might have some coal fired power generation today. However, if they're able to transform within an investable timeline of three to five years and are able to close down the coal fired power stations and invest in renewables which re-orientation the business, we think that presents a huge opportunity for investors."

DAVID FINGER: "What we do is quite similar to what Paul and Ulrik has already highlighted and that shouldn't come as a surprise. Maybe a slight twist to our approach is that we embed this into the SDGs and our SDG-aligned fund range. Climate change and energy are obviously core parts in achieving the SDGs. Many of these issues are now taking a back seat due to the ongoing pandemic but if you look at what's currently being shaped in terms of stimulus around the world, it's clear that energy transition will be a very important part going forward. As the pandemic, fingers crossed, goes away over the next couple of quarters, climate change will be the most important topic going forward. There's therefore the opportunity to position yourself in terms of promising business models going forward."

NIKLAS TELL: FROM AN INVESTOR POINT OF VIEW, ARE YOU LOOKING FOR SPECIFIC PRODUCTS THAT TARGET THIS AREA OR IS IT A MORE HOLISTIC CONCEPT ACROSS THE WHOLE EQUITY PORTFOLIO?

TOBIAS TALLBERG: "I would say that it's a bit of both. We're invested in a sustainable energy fund and have been invested for quite some time. We think this is a very interesting theme and based on the inflows we saw last year, it's clear that there's great value to be found in the transition from fossil fuels to renewable energy. We also see this theme in many of the broader equity funds that we're invested, so in terms of exposure, we have a tilt towards the energy transition in both our dedicated investments in sustainable energy but also through our other holdings."

CHRISTINA BERG: "We did a search for a smart energy fund last year in order to increase the choice on our unit-linked platform. We've seen large inflows into these funds and performance is, of course, one reason for why people have become interested, but we're also seeing a larger general interest. The theme has also become broader compared to some five years ago. There are simply more companies within the theme of smart energy for fund managers to select from."

PARTICIPANTS

- **CHRISTINA BERG**
  Senior manager research analyst at Länsförsäkringar
- **TOBIAS TALLBERG**
  Product analyst, asset allocation at Handelsbanken Asset Management
- **JOONAS HUTTUNEN**
  Portfolio manager and responsible investment specialist at The Church Pension Fund
- **PAUL SELVEY-CLINTON**
  Portfolio manager/analyst at Lazard Asset Management
- **ULRIK FUGMANN**
  Co-head environmental strategies group at BNP Paribas Asset Management
- **DAVID FINGER**
  Senior portfolio manager thematic equity at Allianz Global Investors

CHRISTINA BERG
Länsförsäkringar
Senior manager research analyst at Länsförsäkringar since 2003. In addition to manager research, she has also worked with risk control, risk budgeting for institutional accounts, done ALM studies for companies within Länsförsäkringar and also done peer-group analyses of Länsförsäkringar Liv.

TOBIAS TALLBERG
Handelsbanken Asset Management
Product analyst at Handelsbanken Asset Management with the main task of identifying the best investment options for fund-in-funds and discretionary mandates within Handelsbanken asset allocation. Before taking on the current role in 2017, he has held several other positions at Handelsbanken.

JOONAS HUTTUNEN
The Church Pension Fund
Portfolio manager and responsible investment specialist at the Church Pension Fund in Finland responsible for listed equity and hedge fund manager selection. Before taking on the current role in 2019, he worked at UBS and Nordea in Luxembourg managing fund-of-funds.

JOONAS HUTTUNEN: "I think on the opportunity side, you can kind of decide on how pure you want the theme to be. A lot of large cap companies are doing something related to the energy transition and you can move up and down that purity scale. On the risk side, I think it's clear that this is something that affects the entire equity portfolio, but a couple of sectors clearly stand out. If you hold utilities, you need to understand the energy mix and, looking at the different climate change scenarios, what kind of energy mix they should have in place in 2030 or 2040 to be Paris-aligned. Are they on the right path with regards to the energy transition? When it comes to companies with fossil fuel reserves, it's clearly a stranded asset risk. However, we must not only look at data describing the current situation but also look at what's happening going forward. You need a more fundamental view or other metrics that might help in deciding whether the companies are on the way to transform. Measures such as green capex can give you an indication of how much companies are spending in order to transition in the right direction. We have been trying to find different metrics in this space as we are currently updating our climate change policy"

NIKLAS TELL: JOONAS MENTIONED PURITY AND MOVING UP AND DOWN THE PURITY SCALE WHICH LINKS TO HEADLINE RISK. IS IT OK TO INVEST IN A COMPANY THAT MIGHT LOOK BAD TODAY BUT IS TRANSFORMING INTO SOMETHING BETTER?

PAUL SELVEY-CLINTON: "We do invest in transformers and there are two pri¬mary reasons. The first is alignment with the Paris Agreement. We need those high carbon-emitting companies to be able to transform and reorientate their businesses if we're going to have the best chance of hitting net zero emissions by 2050. As shareholders, we don't want to deny capital to those businesses that have a realistic chance of being able to execute that transformation. The second point is that it's a good investment. Those companies that can success¬fully address climate change risks, reduce carbon emissions and reorientate their businesses can be rewarded with huge valuation upsides. Take a company like Tesla, which experiences stratospheric share price appreciation. If a traditional manufacturer like Volkswagen is able to reorientate their business, the valuation upside would be huge."

DAVID FINGER: "I would like to chip in with just some thoughts that we had in the product construction phase where we came up with is this dichotomy between footprint and handprint. I think footprint is quite a long-standing concept and there's a lot of products out there optimising the footprint. The question is if this brings us closer to achieving any kind of environmental progress. I think the handprint concept puts a spotlight on this. Think about insulation companies. They make a product that's good for society, so a good handprint, but they have a very bad footprint compared to a software company as insulation is terribly energy intensive in terms of production. We need to have more of a 360-degree view when we build portfolios."

ULRIK FUGMANN: "I agree that we need to look at both the process and the product. As David mentioned, insulation is a very good example of a company that would receive a very low ESG score because it has got a high environmental footprint. But ultimately, when you look at the life cycle of the product, you actually end up with something that's very much going towards decarbonisation. I think there's a danger sometimes to be led too much by ESG because if you lead your investment towards an ESG score, that will typically give you a bias towards how companies are conducting themselves rather than what they're doing. It's this push and pull between how a company is conducting itself and the effect that the product has on the overall environment. The way we're thinking about energy transition and purity of the mandate is that we're a transition fund and that means we need to allow for companies to be able to transition. We do see, however, a lot of things being invested in under the name of energy transition. I think what we're seeing is a drift in many portfolios towards low carbon companies in the tech sector that are doing very little for the energy transition and that's a very dangerous thematic drift in my opinion."

> "I think CO2 is a very dangerous measure and one that needs to be handled with care"
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> *– Ulrik Fugmann, BNP Paribas Asset Management*

NIKLAS TELL: MANY INSTITUTIONAL INVESTORS HAVE BEEN LOOKING TO REDUCE THEIR CARBON FOOTPRINT. IS THAT THE WRONG TARGET TO HAVE OR IS IT EVEN A DANGEROUS TARGET IF WE WANT TO FIGHT CLIMATE CHANGE?

PAUL SELVEY-CLINTON: "Before I answer that question, I just wanted to follow up on something that Ulrik said on investing in transformers. For us, it's not that we're going to invest in coal or oil companies because they are investing some capex that can reorientate the business on a 20-year time horizon. They need to have a stated plan on how to reduce emissions and reorientate their business in our investable timeline of three to five years. One of the questions we get asked a lot about the transformers is if we will invest in oil companies because they're putting significant amount of capex in the ground today in order to reorientate their business. The answer is no. Yes, a majority of their cash flow going forward will be investing in green technologies but we're talking 2030 or 2035 before they will have repositioned. Coming back to your question about investors and the problem of focusing too much on CO2 emissions. One of the pushbacks we get on our fund is that we invest in a utility company, which absolutely skyrockets the carbon emissions of our fund and takes it above the benchmark. Overall carbon emissions are higher and some investors don't like it. They're investing in energy transition but they also want a low carbon footprint. The weaknesses involved in just looking at carbon emissions on a portfolio level is that it's not forward looking and it doesn't appreciate scope three emissions."

ULRIK FUGMANN: "I think CO2 is a very dangerous measure and one that needs to be handled with care because CO2 emissions can be reported in many different ways. If we take a step back and ask what it is that we're interested in, I suppose we're interested in showing how much CO2 it takes to produce a unit of volume – basically the footprint of the operations of a company. The most commonly used measure is carbon over enterprise value, which is also what regulators use. But enterprise value is a terrible measure because it doesn't reflect the company's actual operation. What enterprise value reflects is just the market cap plus the net debt of the company. If an oil company goes up by 200 per cent because oil prices rally, the company is two times less carbon intensive because the enterprise value is going up. There's simply a lot of detail in there that I think allocators need to dig into and understand and not say, as Paul mentioned, that you will not look at a certain fund because the CO2 is above the benchmark."

TOBIAS TALLBERG: "We think that a company's transition pace is the most important thing. We all know that there have been major inflows into sustainable funds and I think the inflows have highlighted the risk for greenwashing. We've met numerous fund managers that have sustainable funds but when you look at the portfolio, you find that they hold some of the largest oil companies of the world and the transition pace of some of these companies are far away from the Paris Agreement. Similar to many other Nordic investors, we also have exclusions and we don't invest in fossil fuels. However, we do see the investment opportunities in the transition from fossil fuel-based power production and distribution into renewable power production and distribution. That means that when we invest in transition companies with some exposure to fossil fuels, we do so with strict criteria's in place. The first is that the company must have a business plan in line with the Paris Agreement and also that the current investment plan should underline the transition from fossil fuels to renewable energies. Companies that fulfil those criteria are also the long-term winners of the transition and those companies are the ones where we expect great financial and sustainable returns in the future."

DAVID FINGER: "I would just like to add that the market, of course, has this function to allocate capital to different companies and sectors and something such as 'green steel' will never happen if you focus optimising carbon intensity because steel companies would be impossible to hold in such a portfolio. From a societal point of view, it's of course extremely important that we see progress on the carbon-intensive industries as well and you will paint yourself into a corner if you use carbon optimisation across the board."

PAUL SELVEY-CLINTON: "We shouldn't underestimate the ability for institutional investors to be able to engage with company management teams. One of the things we use on the energy transition fund is something we call the climate transition assessment, which measures companies in

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Lazard Asset Management
Portfolio manager and analyst. Prior to joining Lazard in 2014, he worked in a predominantly European focused fund at SAC Global Investors. Before that, he was an equity analyst and partner at Occitan Capital. He began working in the investment field in 2006 as an equity analyst at Brevan Howard Asset Management.

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Co-head environment strategies group. Before joining BNP Paribas Asset Management in 2019, he was chief investment officer and co-founder of North Shore Partners. He began his career at Goldman Sachs in London, where he spent 11 years investing thematically across energy, materials, agriculture and industrial companies globally.

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Allianz Global Investors
Senior portfolio manager thematic equity. He joined Allianz Global Investors in 2006 and became part of the European research department in 2008 after working as an executive assistant to the global chief investment officer. He started his career by covering the materials sector and later assumed responsibility as a portfolio manager.

terms of strategy, governance and risk management metrics and targets around climate. That interaction, based on the climate transition assessment, can help push companies in the right direction, including in terms of carbon emissions."

JOONAS HUTTUNEN: "I just want to take a step back and comment on what was said earlier about the transition pace. I know we have different ways to measure emissions and I know that they're backward looking. However, as more and more companies start to provide carbon reduction targets in different forms, we will also be able to see if they're able to hit those targets. Then I think we can start to use these CO2 numbers, regardless of how they are calculated, as an indication of the credibility of the transformation of the company."

NIKLAS TELL: SOME COMPANIES ARE TICKING ALL THE BOXES FOR DOING THE RIGHT THINGS AND BEING WINNERS IN THE ENERGY TRANSITION BUT MANY OF THEM ARE ALSO SHOWING STRETCHED VALUATIONS. HOW DO YOU FIND THE SWEET SPOT IN THIS AREA?

PAUL SELVEY-CLINTON: "I think you're exactly right. You only need to look at the exponential rise in ETFs in this space and the amount of capital that's going into them. However, a lot of this is focused on the power segment and in terms of the total greenhouse gas emissions by sector, power is about 25 per cent of that. It's still receiving the majority of invested capital and this is causing some very steep share price movements. The way we tackle that problem is that we don't just look at power. We look at industry, transport, buildings and agriculture as the other big sources of emissions and we think these are areas that policies and regulations will target going forward."

ULRIK FUGMANN: "Most observers would have looked at the space and seen some fairly punchy returns being made in 2020 and I get this question all the time – is this time to take a breather? Nothing continues into the oblivion and this space is subject to the same supply and demand balances as any other sector. It's going to see disruption like any other sector. However, valuations are something that are really tricky because you take traditional valuation metrics and applying them to those companies that are operating within technologies in areas fairly nascent in markets that are expanding very rapidly. Being systematic, fundamental and screening on earnings growth and high cash-flow generation is going to take you into quality companies. It's going to take you into certain style factors and it's going to take you into large caps. As a result, the biggest risk we see at the moment is that large-cap valuations are getting lofty. As an all-cap fund we have an even distribution between small-, mid- and large-caps and I really think that's helping to de-risk our mandate. It means that we can avoid crowdedness and it means we can sidestep companies with unbelievably high valuations in the large cap space, which are household names for most sustainable investors."

DAVID FINGER: "I think we should also look at traditional companies that might be in the sweet spot from a cyclical point of view as well as from an energy transition point of view. We will still need a lot of materials going forward and that's a sector that has been overlooked but might be lifted by the recovery after the pandemic. This is what we've done. We've shifted some of the gains from the racier part of the market into other niches. I think investors need to be prepared for volatility going forward as things may not go as smoothly as over the last couple of quarters. It's still important to not put all your eggs in one basket."

NIKLAS TELL: WHAT ABOUT REGULATION? WE HAVE, OF COURSE, THE EU TAXONOMY COMING BUT ARE THERE MORE REGULATION ON THE WAY? WHAT ARE THE OPPORTUNITIES FROM THIS AND WHAT ARE SOME OF THE POTENTIAL CHALLENGES?

DAVID FINGER: "For this particular product category that we're talking about, I would see this as an opportunity because I think financial markets are clearly pushed into this direction and capital is allocated into this niche."

ULRIK FUGMANN: "The bottom line is that I think the EU taxonomy is good. It's 440 pages so it's a big mouthful and it's a massive undertaking for portfolio managers because you have to be very precise around how to do your taxonomy-aligned analysis. There's a lot of detail and some of it is relatively clear, whereas other areas are very much open to interpretation. It's certainly a step in the right direction but at the same time, one can always worry a little bit when regulators are starting to sort of create the direction of travel for how and where one should invest in order to get a certain label."

TOBIAS TALLBERG: "I can't say that I know all of the details of the 440 pages but I do have an optimistic view that it will make it easier for us as fund selectors, or for us as sustainable funds selectors. In the dialogues that we have with different companies, it will become easier if we can say that we're interested in funds that are article eight or article nine etc and this is what we want you to pitch to us. We talked about greenwashing before and I think the new taxonomy will lower the risk for this as everybody will follow the same rules. You can't just label your fund sustainable and then go and buy every brown company in the world. It doesn't work that way so I have an optimistic view."

CHRISTINA BERG: "Today we need to review each fund company separately because everyone has their own view on what ESG is. Hopefully this will help us to see where the funds are positioned. We haven't seen it yet but I'm cautiously optimistic."

NIKLAS TELL: LOOKING BACK JUST A COUPLE OF YEARS, THERE ARE DIFFERENT ESG RATINGS FROM A RANGE OF PROVIDERS THAT ALL HAVE THEIR OWN METHODOLOGIES. WILL THIS JUST BE ANOTHER ONE AND THEREFORE JUST ADD TO THE NOISE?

CHRISTINA BERG: "There are not that many different ESG-ratings on funds, so I hope the taxonomy will help in classifying if a fund is sustainable or not using the same framework."

PAUL SELVEY-CLINTON: "On the question of regulation and measuring carbon emissions we have, as discussed earlier, sometimes suffered because we invest in transforming businesses. We've therefore developed what we call a net green revenue score. We asked all our analysts one simple question: in a move to a greener world, what's the effect on revenue growth for each sub sector? For each company, we're able to weigh the revenue exposure by the sub-sector in order to gain a net green revenue score. It provides us a way to communicate with investors when regulatory measures, such as carbon emissions, don't give you the full picture."

ULRIK FUGMANN: "There's a lot of debate around ESG ratings and the taxonomy and if you look at ESG ratings and do a scatter plot, you can see that the correlation is pretty much zero correlation. I think that's a good thing. As a portfolio manager, I want to value companies and hopefully do that better than my competitor and I think it must be the same for fund selectors and asset allocators. There seems to be a discussion where everyone wants to use the same way of looking at companies for ESG. Doesn't that lead everyone into the same stocks and doesn't that increase crowdedness and volatility?"

TOBIAS TALLBERG: "If we look at ESG data today, we all know that the data isn't always correct. That's especially the case for smaller companies, which don't always have dedicated people working with ESG reporting. For us, sustainability is very important when we do our due diligence on a fund and the sustainable metrics are one the tools that we use and the metrics need to improve. However, you can't just look at the individual numbers. You also need to understand why the figures are the way they are. The metrics are getting better and more and more companies, even the smaller companies, have sustainable groups working with these types of things already, so I think we're moving in the right direction."

DAVID FINGER: "We've talked about the EU taxonomy quite a lot but what's crucial in this regard is to highlight what's happening in the US because we need to be able to compare companies across the globe and we need a level playing field. With the new administration in the US, there are hopes for this to happen. The EU taxonomy is one important pillar but it's just one, so it's not a quick fix for all the issues we have."

NIKLAS TELL: WE'VE TALKED ABOUT DATA IN GENERAL AND PROBLEMS WITH CO2 MEASURES. HOW IMPORTANT ARE CARBON METRICS AND IS THERE DATA THAT YOU WOULD LIKE TO HAVE ACCESS TO BUT ARE LACKING TODAY?

PAUL SELVEY-CLINTON: "The lack of data is one reason why we developed net green revenues, which is our own proprietary way of being able to test if a company is really exposed to the energy transition. We can use this as a source of investment ideas to see which companies are exposed to sustainable and green revenues. We're also able to use it as a data source for our investors to look at and for us to prove that we're investing in the energy transition."

DAVID FINGER: "I would say it's a double-edged sword. More disclosure and more data would be great to really be able to compare different companies and also products if you're talking about fund allocators. However, if everything is efficient and available, then we don't have an active market anymore. It would benefit the quants or the passive side and that's of course not something we would like to see. I think we will mostly stay in this middle ground for the next couple of years and I think that's where we can make the difference."

> "It's important to understand which businesses are self-reliant and which are helped by subsidies"
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> *– Paul Selvey-Clinton, Lazard Asset Management*

ULRIK FUGMANN: "I fully agree with David. We need to keep some of the idiosyncratic signals and I think ultimately it's up to us as fund managers to provide fund selectors and asset allocators with the resources and data they need to gain insight into the portfolio. I also think it's important for fund selectors to not just use hurdle rates and instead really look into portfolios to understand what's going on below the surface. Because if we set hurdle rates, the danger is that we all end up greenwashing. We just make sure that we reach the hurdle and then we can say that we're green. That's not what we want to do. I hope that this is an area that's going to continue to develop Again, ESG is biased towards how a company is conducting itself and focus less on whether the product it provides is actually helpful for society. I think it's so important to have a common-sense approach when you look at a portfolio."

NIKLAS TELL: AS INVESTORS, DO YOU FIND EVERYTHING YOU'RE LOOKING FOR WHEN TRYING TO INVEST INTO THE ENERGY TRANSITION?

CHRISTINA BERG: "I was doing a search for renewable funds last year. We saw a lot of fund companies providing funds labelled 'renewable energy' but when you start to look at the positioning in the fund, you see that it looks more like an environmental fund. I think it's important that they stay true to the theme and don't venture out too much. We also appreciate information about the investments they make and what effect the investments have on the environment. I see that the impact reports have become much better from almost all the managers but there's still more to be done."

TOBIAS TALLBERG: "I would say that I can find everything and whether asset managers are doing the right things or not is up for us to evaluate too. A tip from my side would be that asset managers really need to find and communicate what makes them unique. Given the development over the last five years, we've had so many fund launches within sustainability and given the return we saw from the energy transition theme in 2020, I think we will see a lot of new funds coming to the market."

NIKLAS TELL: JOONAS, YOU DID A SEARCH IN THIS SPACE LAST YEAR. WHAT WERE YOUR FINDINGS?

JOONAS HUTTUNEN: "A lot of products have been launched in this space, so we did a wide search that focused broadly on environmentally-themed funds to get a better picture of the product universe. The first screen included anything from funds that owned mega-cap tech names all the way to smart energy or clean energy funds. We added a fund that was somewhere in the middle of this spectrum in terms of focus. Overall, I would say that there's enough supply of products and it seems that I receive almost an email per day about a new fund launched in this area. I think the tricky part is to find a team that combines the real environmental insight with skills and experience in portfolio management."

NIKLAS TELL: IF YOU LOOK AHEAD, WHAT ARE YOUR MAIN WORRIES?

ULRIK FUGMANN: "As a portfolio manager, I'm always wor¬ried. I'm never not worried. I go to bed worried and I wake up worried. I would mention three risks that we focus on. The first is commoditisation. We really try to avoid being in technologies and areas of the energy transition that we feel are being commoditised. We want to make sure that the companies that we're investing in have real moats and have high barrier to entry. A second risk is interest rates as a lot of investments have moved into this space and even a smaller rise in interest rates could actually have a large effect. The third is the value versus growth debate as I think a lot of environmental funds have a very high growth exposure. We've created a long value exposure in our portfolio, which helped our portfolio in the latter part of 2020 and also at the start of this year."

PAUL SELVEY-CLINTON: "One thing that we're focused on is technology disruption. In some cases, there are businesses that are being priced today as if they're going to be the dominant technology for the next few decades. But there's always a risk of new technology displacing over time and you're seeing a lot of innovation in some of these areas. Another thing we're focusing on is timing. I think everyone on this panel will appreciate that there's a long runway of growth but we have to recognise that in some pockets, we're still exposed to some subsidies. It's important to understand which businesses are self-reliant and which are helped by subsidies." ●