

For Wholesale Investors Only.

BUSTING THEMATIC INVESTMENT MYTHS

Environmental strategies



OCTOBER 2021



BNP PARIBAS
ASSET MANAGEMENT

The sustainable investor for a changing world




INTEREST IN THEMATIC INVESTING HAS EXPERIENCED A MARKED UPTURN IN RECENT YEARS

Interest in thematic investing has experienced a marked upturn in recent years. According to Morningstar, assets under management in thematic funds have more than tripled to USD 595 billion in the last three years¹. While much of this uplift can be attributed to expectations of strong long-term performance, thematic funds often have a strong focus on sustainable investing which has also spurred interest. And with upcoming regulatory changes – such as the integration of ESG² preferences in investor choices under MiFID II, as well as rising demand from more environmentally and socially-conscious investors – the demand for sustainably-orientated thematic funds is only set to rise.

Yet, with over 3,000 sustainable funds available to European investors³, fund selectors face a huge challenge in finding managers and strategies that can deliver on both performance and their sustainability ambitions. In addition, several myths perpetuate around this area of investment that could inhibit fund selectors from making an effective judgement on potential sustainable thematic funds.

We explore these myths to help fund selectors distinguish between those funds that merely say and those that actually do.



THEMATIC FUNDS ACCOUNT FOR

2.1%*

OF ALL ASSETS INVESTED IN EQUITY FUNDS GLOBALLY, AND IS ONE OF THE FASTEST GROWING** INVESTMENT DISCIPLINES.

*Source: data from Morningstar shows that over the three years to March 2021. <https://investors-corner.bnpparibas-am.com/investing/new-survey-confirms-shift-to-thematic-investing> Accessed: August 2021

**Source: <https://www.ftadviser.com/investments/2021/07/30/thematic-investing-grows-by-77-per-cent-in-2020/> Accessed: August 2021



9 out of 10

WHOLESALE AND INSTITUTIONAL INVESTORS EXPECT THEMATIC INVESTING TO BENEFIT LONG-TERM PERFORMANCE

Source: survey conducted by Greenwich Associates and sponsored by BNP Paribas Asset Management. <https://investors-corner.bnpparibas-am.com/investing/new-survey-confirms-shift-to-thematic-investing/> Accessed: August 2021

¹ Source: Morningstar, Global Thematic Funds Landscape Report, May 2021

² ESG: Environmental, Social and Governance.

³ Source: Morningstar, as at end December 2020.





MYTH 1: THERE IS A TRADE-OFF BETWEEN ENVIRONMENTAL THEMATIC INVESTING AND LONG-TERM PERFORMANCE

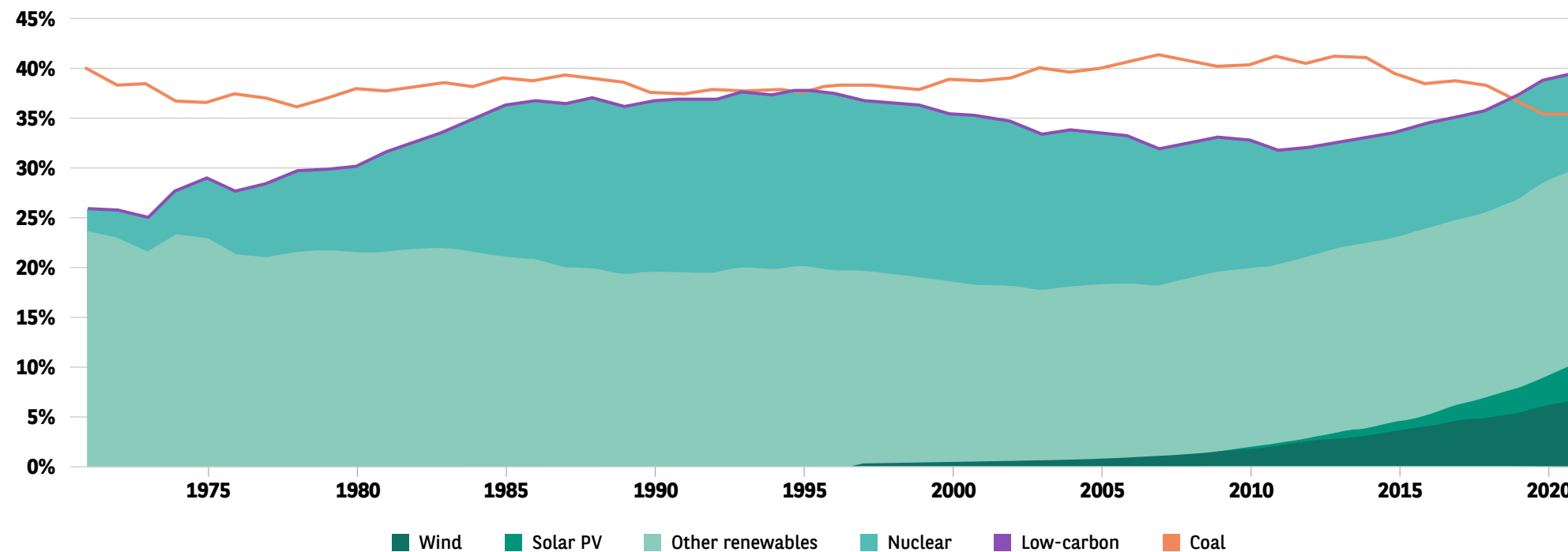
The concept of taking high levels of risk for higher returns is often associated with thematic funds that focus on technology stocks or disruptive trends. To both create alpha and mitigate risk, technological know-how and acumen are absolutely crucial. There is a wide array of opportunities among companies that address environmental challenges which provides the opportunity for both young disruptive companies that are already active in this space alongside more established ones that are tomorrow's winners.

On the higher risk side, it is important to remember that many environmental companies are also disrupters. Whether this is part of the energy transition, aiding the shift of power being generated from fossil fuels to renewable energy sources, or the innovation of new technologies that will revolutionise how we live and work in a more sustainable manner.

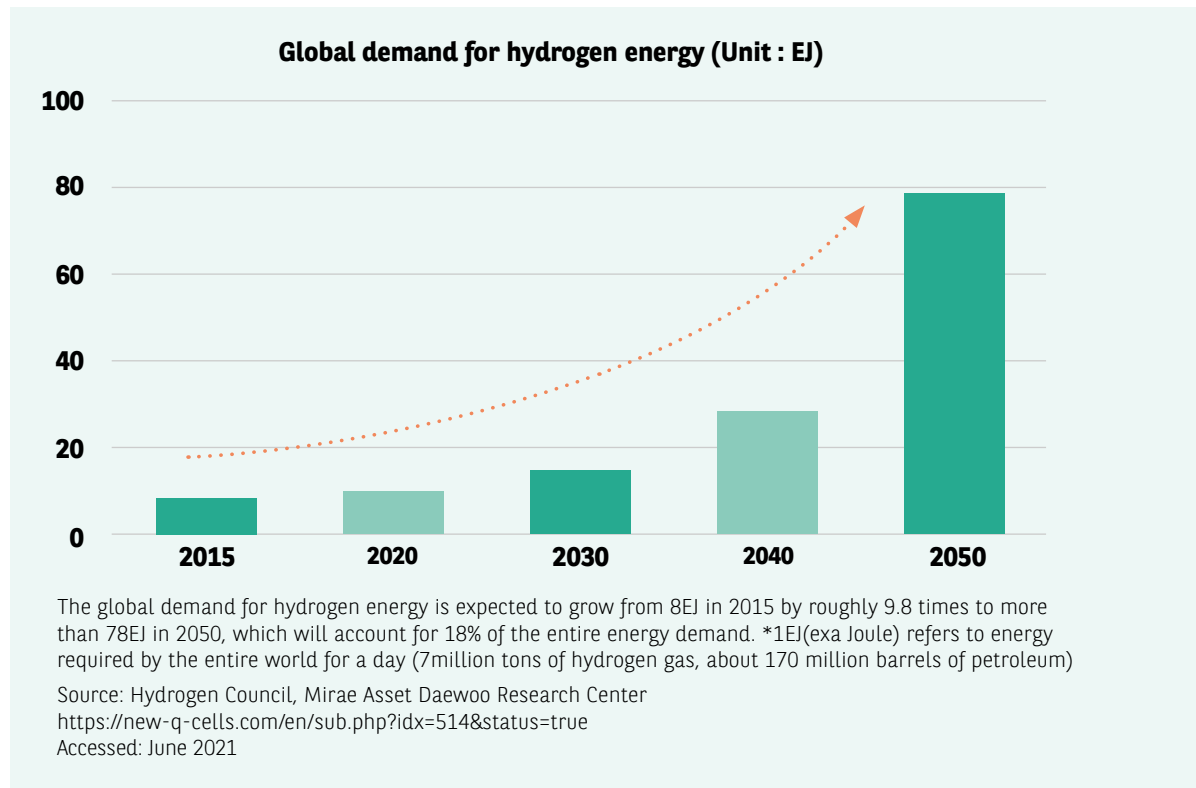
We have already witnessed how innovative technologies in the environmental space offer great investment opportunities. The growth of wind and solar power provide a great example of upcoming industries that have been successful and transformative, as well as experiencing significant growth, and which now are becoming established providers of energy.

On the other hand, there are still many areas of the energy transition that have yet to come close to fulfilling their potential – green and blue hydrogen have long been touted as fuels of the future, but as yet are not widely used; battery storage remains a hurdle for the efficient and effective storage of electricity generated from renewable sources; and many sectors are still considered too hard-to-decarbonise.

Share of low-carbon sources and coal in world electricity generation, 1971-2021



Source: IEA <https://www.iea.org/reports/global-energy-review-2021/renewables>
 Accessed: August 2021



Given the need to transform multiple areas of our existence, the question shouldn't be whether environmental funds will deliver competitive long-term returns, but whether the opportunity cost of not being present in this area could be too high.

So, how should fund selectors navigate the complex and rapidly changing world of environmental opportunities? Companies operating in the sustainability arena are often very specialised. This means technical expertise is a very important part of the stock selection process, as understanding and identifying which technologies are likely to survive over time, which will be the most disruptive, will they be scalable, are there barriers to entry and which could be supplanted as sectors evolve, are all essential questions to consider. When undertaking stock research in this area it is important to recognise the risk factors – don't just talk to the management of companies, but speak with suppliers, clients, engineers, etc, to really understand the technologies behind it.



MYTH 2: SHORTING STRANDED ASSETS ALONGSIDE TAKING POSITIONS IN THE BUSINESSES CREATING SUSTAINABLE SOLUTIONS IS UNETHICAL

Climate change is not only an existential risk, but also one of the greatest commercial opportunities of our time¹. From an investment perspective, the opportunity is not just about finding the winners. There will be fundamental losers in the energy transition as companies with strong environmental credentials are more likely to outperform those that have unsustainable business models and are vulnerable to transition risk.

These so called 'stranded assets' can be capitalised upon by using alternative investment strategies, such as shorting stocks. Such standard investment practices should not be considered unethical even in the context of a sustainable fund. Afterall, by successfully shorting stranded assets a fund manager can recycle these profits into funding other businesses that are creating sustainable solutions.

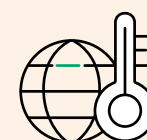
When shorting companies and share prices go down, this effectively increases the cost of equity and as a result, the firms overall cost of capital. As we are trying to promote more sustainable practices, the increase in cost of capital for the firm could affect its ability to continue to raise funds to keep pursuing certain unsustainable practices. Shorting is an important tool to promote price efficiency in financial markets, avoid crowding, unsustainable valuations and that overall helps promote price discovery. Finally, carbon footprints of long positions are netted against short positions opening up for a carbon *negative portfolio*.

Taking advantage of catalysts can also present opportunities from both a long and short perspective – in the de-carbonisation process such catalysts could be sparked by changes to tariffs, industry events and new political initiatives. Relative value positioning – which seeks to take advantage of price differentials between companies within the same sector (i.e. a company with inferior technology versus one of the market leaders) – is another alternative strategy that has the potential to deliver returns.

The steel sector presents a good practical example of how alternative investment strategies could be used in an environmentally orientated fund. The steel industry currently has one of the largest carbon footprints in the world. However, there are 'good' steel firms that use renewable energy and only work with scrap and recycled steel which have a much smaller footprint. Given their contribution to reducing greenhouse gas emissions, as well as their ability to generate higher margins and better potential returns, they can make appealing investments. Against such longs, one could short a traditional 'bad' steelmaking company that uses coal and iron ore and has a much larger footprint. This is not necessarily a case of setting a 'green' company against a 'brown' company, but of aiming to achieve better returns and reduce the overall risk.

¹ Source: <https://www.bloomberg.com/news/articles/2020-11-09/carney-calls-net-zero-ambition-greatest-commercial-opportunity>
 Accessed: August 2021

MEGATRENDS DEFINING THE WORLD OF TODAY AND TOMORROW WILL PROVIDE EXCITING AND DIVERSE THEMATIC OPPORTUNITIES:



CLIMATE CHANGE,
BIODIVERSITY LOSS & FINITE
NATURAL RESOURCES



GROWING
POPULATION



DIGITAL & TECHNOLOGICAL
TRANSITION, HEALTHCARE
INNOVATION



GLOBALISATION VERSUS
DEGLOBALISATION

GLOBAL THEMATIC STRATEGIES IDEALLY SUITED FOR CAPTURING NEW SOURCES OF GROWTH:



FORWARD-LOOKING



POSITIONED TO CAPITALISE
ON GLOBAL MEGATRENDS
SHAPING THE FUTURE



MYTH 3: A SUSTAINABILITY-LED STRATEGY IS AN ESG¹-LED STRATEGY

We consider ESG ratings, but these are not always synonymous with sustainability. We are a sustainability-led group; specifically zooming in on environmental sustainability, which we believe has, benefits for society and the economy too. We strictly only invest in companies that deliver environmental solutions directly aligned with our theme. ESG ratings are embedded into our framework and we leverage a team of 25 people from our Sustainability Centre on ESG, engagement and voting as well as independent environmental analysis and quarterly reporting. However, third party ESG ratings are not relied on explicitly to determine our view of sustainability and here's why.

Fundamentally, ESG has a different definition to sustainability. Sustainability takes a full company view of whether - on net - a company adds or detracts from our environment and sustainability. ESG takes a more compartmentalized approach, judged largely through company disclosure.

This leads to some of the planets most unsustainable companies (coal or oil extraction) having better ESG scores than their clean energy counterparts. This is because ESG is a process based score, rather than a net score - taking account of how a company operates, but not what it does.

ESG scores are vulnerable to inaccurate data; as most methodologies are based on voluntary self-disclosure. Whilst there is talk of regulating ESG reporting, insofar as these statements are unaudited, unstandardized and liable to unsubstantiated claims, widely known as greenwashing. Relying on voluntary disclosure also leads to inherent biases in the results. Larger companies with more established communications can pour more into their sustainability reporting than peers; meaning that an exclusively ESG-led investment strategy has a bias towards larger companies and misses out on the markets young - and often more innovative - sustainability innovators.

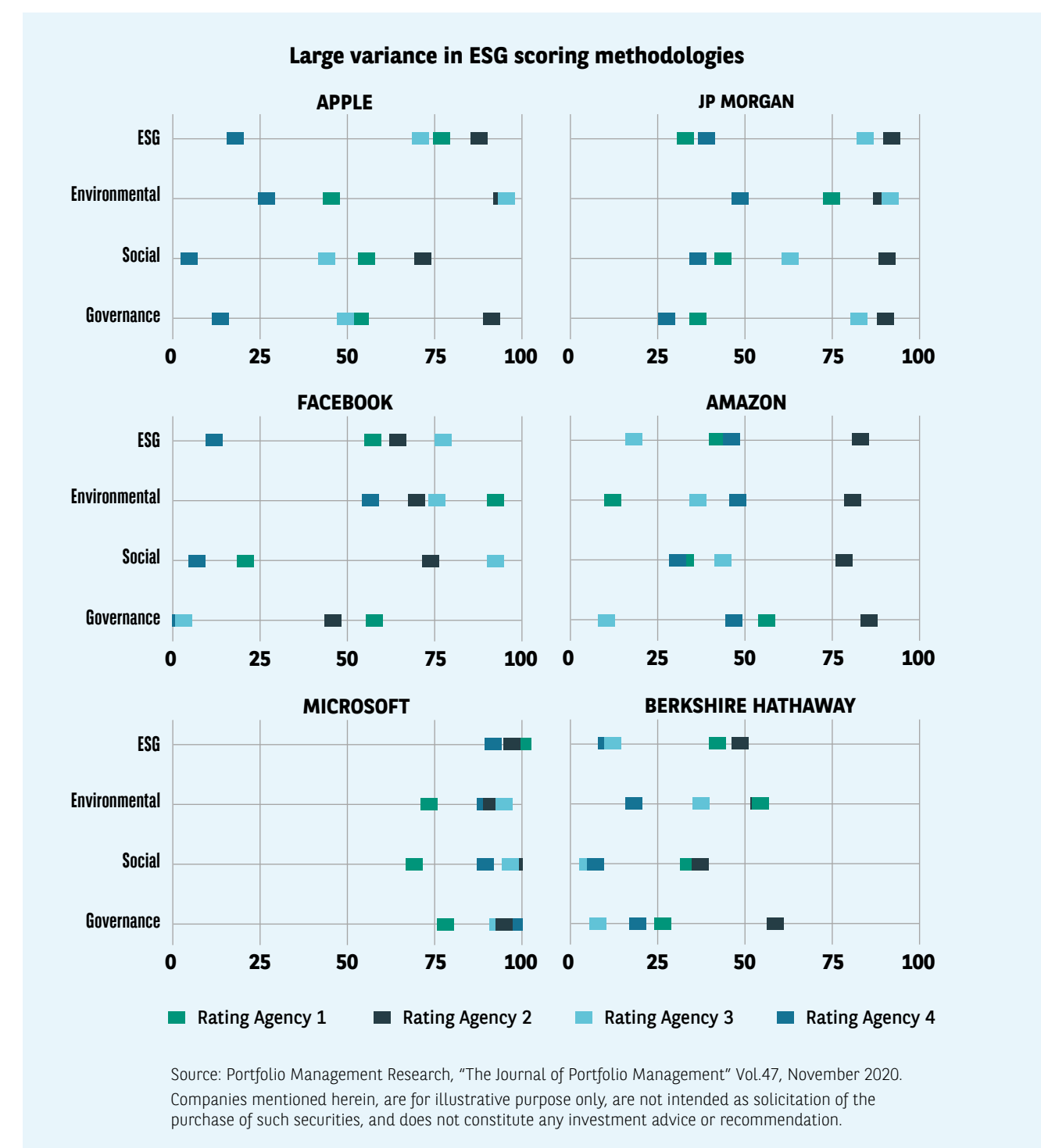
When it comes to size, it is worth noting that with the universe of opportunities expanding rapidly in the thematic environmental space, not all the growth potential will be found in the best-known, largest companies.

¹ ESG: Environmental, Social and Governance.

Often the businesses having the greatest impact on sustainability are small cap innovators, companies that don't have the capacity to focus on getting an ESG accreditation, opting to concentrate on the task at hand: delivering a positive impact on the environment. Therefore, funds that focus solely on ESG criteria may be missing out on those companies achieving true environmental impact and which could be the superstar companies of tomorrow. Fund selectors should look for funds that have an active management style and source opportunities across the market capitalisation spectrum.

The many subjectivities wrapped up in ESG scores reveal themselves in the lack of agreement of scores across rating agencies. The graphs illustrate the massive variances in ESG scores from the biggest ratings agencies across some of the stock markets biggest names. Where a correlation co-efficient of 1.0 indicates perfect correlation, ESG ratings are correlated at 0.54. This contrasts with credit ratings of S&P and Moody's, which is around 0.99.

So, although we incorporate ESG scores into our framework, and we celebrate ESG scores for the great changes they are making to our industry - we do not subscribe to them exclusively. Instead, we combine the analysis underneath the scores with a common sense, sustainability approach. We integrate ESG across portfolios, however, its ultimately the thematic that drives the investment decision rather than the ESG rating itself. Indeed, many companies are either not rated or will have a low ESG rating as a result of lack of disclosure.





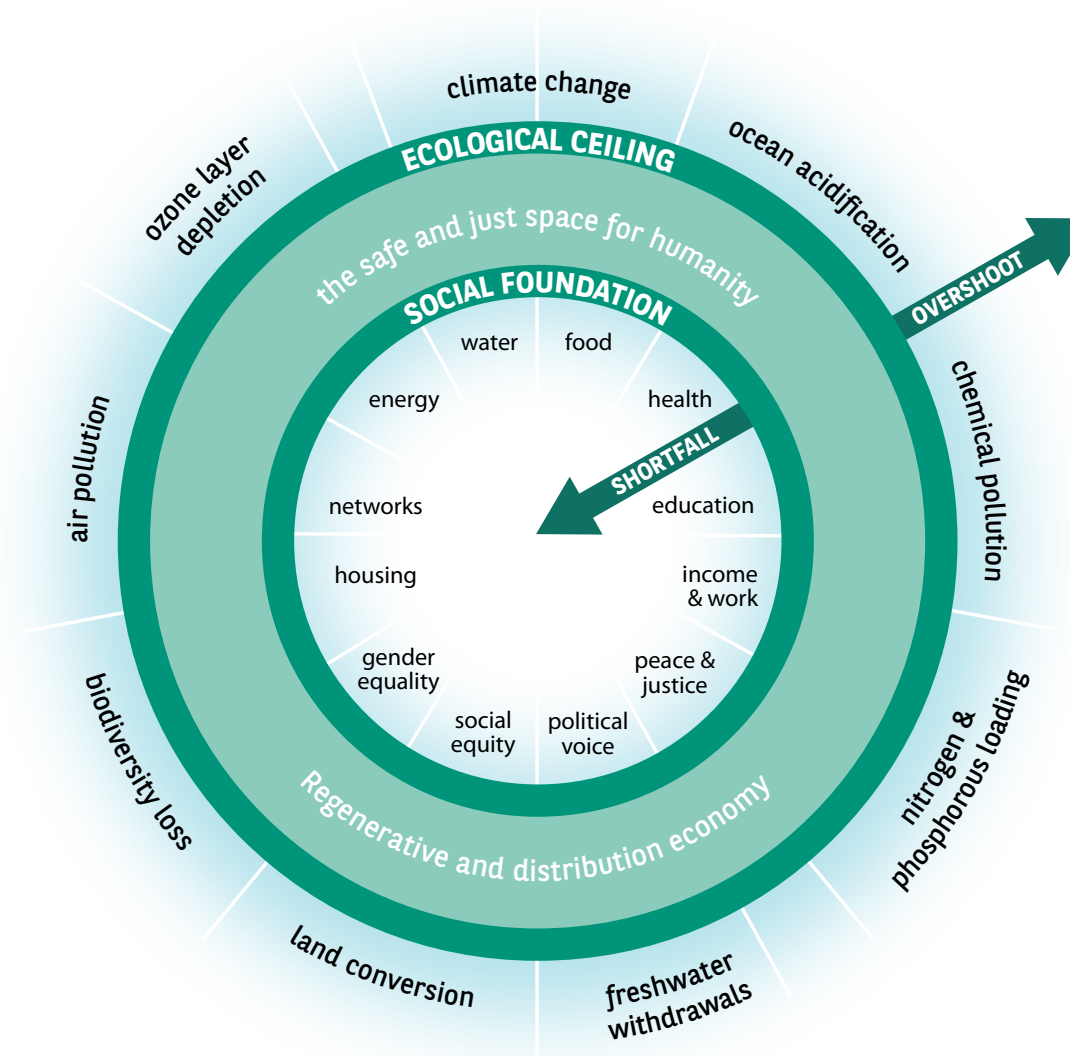
MYTH 4: THE THEMATIC INVESTING UNIVERSE IS NOT DIVERSE ENOUGH TO PUT CAPITAL TO WORK ACROSS A RANGE OF INDUSTRIES

Environmental thematic investing is not just about clean energy. The diversity of businesses that are focused on the provision of environmental solutions is huge. Opportunities in the energy transition alone cover a host of technologies and innovations across a range of sectors, including smart grids, alternative transportation, electric vehicles, industrial energy efficiency, green buildings, LED lighting, hydrogen fuel cells, solar and wind, many utilities.

And that's not including the companies that are focusing on improving the planet's biodiversity, revolutionising food production, conserving water usage and developing solutions to limit our use of plastics. Efforts to establish a more circular economy, that focuses on recycling, repair and regeneration, will also spawn investment opportunities as economies evolve in a fashion that strives to no longer overshoot our planet's dwindling resources.

In short, it's actually a very broad thematic opportunity that will likely impact all industries, to varying degrees.

Funds need to look beyond specific asset classes or established sustainable technologies and be more thematically led to truly uncover this vast array of opportunities. Fund selectors should seek those funds with a targeted approach that shift away from broad-brush strategies and focuses attention on business cases, in-depth knowledge of the underlying assets and active engagement as the investible universe is broad enough to create alpha through stock selection, as well as mitigating risk through well-diversified exposure.



Source: <https://doughnuteconomics.org/about-doughnut-economics>
 Accessed: August 2021

BNP Paribas Energy Transition Investment Universe

RENEWABLE ENERGY PRODUCTION

DECARBONISATION - production of renewable and transitional energy

- Biofuels
- Clean Fuels
- Combined Heat & Power
- Fuel Cells & Hydrogen
- Geothermal Power
- Hydro Power
- Ocean & Tidal Power
- Renewable Project Financing
- Solar Power
- Waste to Energy
- Wind Power

ENERGY EFFICIENCY, TECHNOLOGY & MATERIALS

DIGITALISATION - environmental technologies, energy efficiency and green enabling materials

- Advanced & Light Materials
- Battery Materials
- Emission Efficiency
- Energy Optimisation & Controls
- Green Minerals & Metals
- Industrial Automation
- IT Software & Process
- Power Storage
- Recyclable Products & Materials

ENERGY INFRASTRUCTURE & TRANSPORTATION

DECENTRALISING - smart power infrastructure, networks and alternative transportation

- Power Infrastructure & Networks
- Alternative Bus & Coach
- Alternative Shipping
- Alternative Trucking
- Alternative Vehicles
- Bikes & Bicycles
- Electric Vehicle Batteries
- Power Infrastructure
- Railway Transportation
- Alternative Aviation & Aerospace

Source: BNP Paribas Asset Management Environmental Strategies Group
 Accessed: June 2021



MYTH 5: YOU SHOULD ONLY INVEST IN FUNDS THAT HAVE AN ESTABLISHED TRACK RECORD


Sustainable and environmentally focused-investing is still a young investment discipline while being a rapidly growing area with new funds being created all the time. As a starting point, a team's track record can be a useful indicator of how they have performed in the past. But as the regulator likes to remind us, past performance should not be considered an indicator of future returns.

There are actually very few investment management teams that have a long track record in understanding these industries. Firstly because this is a multi-sector opportunity, and the manager needs to be aware of markets that are starting to blend together. But also because the skill set required (understanding the industries and technologies that make up the investment universe) is still quite rare.

So what should fund selectors focus on in this space? First and foremost, it's important that every company in the portfolio is fully aligned with the theme that the fund is trying to pursue. Clearly equity-based investment portfolios are well suited to identifying those companies across the globe that, through their products, processes or services, address environmental challenges across sectors. The construction of a tightly risk-managed portfolio, that is diversified across styles and geographies is also essential. The incorporation of companies with a more defensive nature, that have proven their ability to weather a crisis, can be particularly beneficial as the progress of the transition to a more sustainable, environmentally friendly world will not be immune to episodes of volatility and turbulence.

Top-down considerations are just as critical as bottom-up stock selection. The macro, political and regulatory themes will be powerful drivers in making sure this transition moves forward at the needed pace. Whether it is the EU green deal, fit for 55, EU taxonomy, China net zero 2060 target, the US\$ 3.5tn infrastructure package, or the upcoming COP26 conference, there are many top-down factors that are driving forces for companies in this space that need to be monitored. For example, in the US, President Trump's highly publicised opposition to climate change initiatives did not prevent many American states and municipalities from establishing and implementing their own alternative energy policies during his administration.

And while investments related to the sustainability agenda clearly have an ESG angle, it's important to focus on the E in ESG. Clearly social (S) and governance (G) issues have merit and should be considered, but targeting environment solutions (E) is the priority. This is where the most investment, growth, and tech enabled innovation is taking place and this is where the world faces its greatest challenges.



THEMATIC FUNDS CAN LOOK BEYOND ESG RATINGS - WHICH CAN BE BIASED TO LARGE-CAP COMPANIES - TO CAPTURE THE BEST SUSTAINABILITY OPPORTUNITIES


Source: <https://www.institutionalinvestor.com/article/b1s06tm9knt763/There-s-a-Blindspot-in-ESG-Investing-Here-s-How-to-Fix-It>
Accessed: August 2021



3/4

WHOLESALE AND INSTITUTIONAL INVESTORS ARE USING THEMATIC FUNDS TO ACCESS STRATEGIES WITH A FOCUS ON SUSTAINABLE INVESTING

Source: survey conducted by Greenwich Associates and sponsored by BNP Paribas Asset Management. <https://investors-corner.bnpparibas-am.com/investing/new-survey-confirms-shift-to-thematic-investing/>
Accessed: August 2021




EUROPE IS THE LARGEST MARKET FOR THEMATIC FUNDS, REPRESENTING

51%

OF GLOBAL THEMATIC ASSETS

Source: data from Morningstar shows that over the three years to March 2021. <https://investors-corner.bnpparibas-am.com/investing/new-survey-confirms-shift-to-thematic-investing/>
Accessed: August 2021





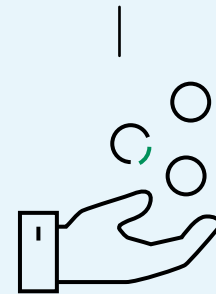
MYTH 6: YOU CAN'T ACHIEVE IMPACT THROUGH A PUBLIC INVESTMENT VEHICLE

There is a common belief that true investment impact can only be achieved through venture capital, private equity or via direct project finance. While these investment types are a powerful way to achieve impact, they are also harder to scale, very niche and harder to access. For this reason, we also have an all cap approach to our investment universe. This also means that we can achieve significant impact by investing and engaging actively with younger and promising companies in the environmental space, by providing them with capital and advice to further their presence in the markets that they operate in.

To truly succeed, environmental themes must be accessible to all investors – after all it is investors and the wider civil society who are driving the growth of ESG and sustainable investment products.

In actual fact, some environmentally themed funds already participate in primary placements, such as initial public offerings, primary offerings and private investment in public equity (PIPEs). In doing so, funds are providing a large amount of investment dollars for companies to put to work, enabling them to accelerate their growth, hire more people, build facilities and conduct research and development.

The environmental opportunity is significant and has capacity for many forms of investment to deliver an impact.

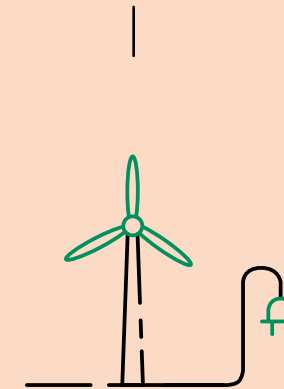


OUR UNIVERSE FOR THEMATIC ENVIRONMENTAL INVESTMENTS IS BROAD AND DIVERSE, REPRESENTING AROUND

2,000

COMPANIES GLOBALLY

Source: BNP Paribas Asset Management Environmental Strategies Group
Accessed: August 2021



THE MARKET OPPORTUNITY FOR ENVIRONMENTAL SOLUTIONS REPRESENTS

US\$4 tn

Source: FTSE Russell. Investing in the global green economy report: https://content.ftserussell.com/sites/default/files/research/fr_investing_in_the_global_green_economy.pdf
Accessed: August 2021



ASSETS UNDER MANAGEMENT FOR THEMATIC FUNDS HAVE MORE THAN TRIPLED TO

US\$ 595 bn

Source: data from Morningstar shows that over the three years to March 2021. <https://investors-corner.bnpparibas-am.com/investing/new-survey-confirms-shift-to-thematic-investing/>
Accessed: August 2021





ARE YOU READY TO INVEST WITH A PURE THEMATIC APPROACH?

There is no denying that the search for greener solutions to power and protect our planet will be a significant investment opportunity, but the speed with which these solutions are evolving creates a challenge for fund selectors. As well as the well-known incumbents, there will be small nimble, innovative companies aiming to make their names and any of these companies could become the superstars of tomorrow. Finding effective, environmentally themed funds will take research and an open mind as well as having the conviction to invest purely and as a result with an unconstrained approach.

At BNP Paribas Asset Management, we have developed a range of thematic strategies which proactively invest in companies that champion greener policies, environmentally positive practices, as well as the energy transition. Our portfolios are constructed carefully and are risk aware by building in robust layers of diversification across geographies, sizes and styles and incorporating ESG considerations.

We believe fund managers, fund selectors and investors alike have an opportunity to use their position and influence to shape a better world. We all can and should play our part by investing in a greener future.



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