THE EDGE

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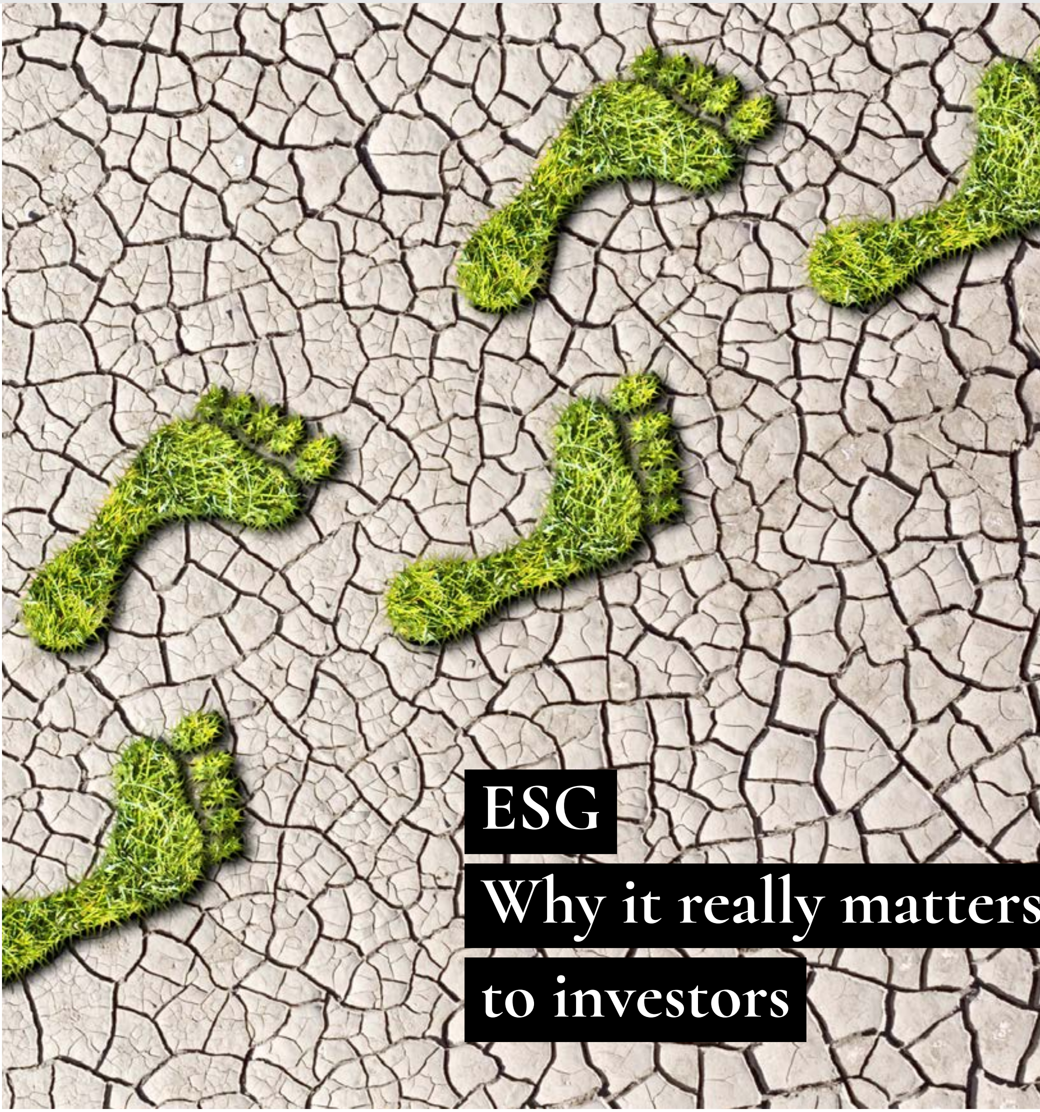

ESG
Why it really matters to investors

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Foreword

Dear Reader,

One thing you notice as an investor is how quickly things change. The Greta Thunberg phenomenon is testament to a collective awakening taking place among the public with regard to the climate-change threat, and this is being borne out through many aspects of our daily lives – from what we eat, to where we shop and even to how we invest. The rise of ESG investing is partly a result of these shifting attitudes, and is the latest incarnation of what can more widely be described as socially responsible investing, which has been around for some time.

ESG stands for environmental, social and governance, and rather than being a type of investment it is actually a set of criteria for evaluating an investment based on the potential risks stemming from these three areas. In this sense, ESG is not only about having a conscience – it's also about hard-headed investment decision making; companies that score very poorly on ESG metrics would potentially open themselves up to a poor share-price performance in future if these risks were to manifest themselves.

It strikes me that ESG as a concept is only likely to become more integral to investing over time. According to a 2006 study called *Cone Millennial Cause Study*, millennials are more likely to trust a company or purchase a company's products when the company has a reputation of being socially or environmentally responsible. It is therefore likely that ESG is going to become increasingly hard for companies and investors to ignore. As ever, it pays to be prepared.

Kind regards

James Faulkner,
Editor

ESG investing is here to stay

By William Sanderson

As investor demand grows for environmental, social and governance (ESG) investment strategies, it is of no surprise that media coverage has followed suit. No doubt you will have already read or been presented with a plethora of informative articles on ESG and responsible investing or you may even have been targeted with 'greenwashing' tactics. Nevertheless, I would urge you to read on and find out about what (the often-overlooked) investment-company industry is doing in this ever-changing space.

As we find ourselves at the dawn of a decade which will supposedly see the European Parliament lead the charge for carbon neutrality while also introducing a new sustainable-finance taxonomy, there is no reason to think that appetite for ESG investing will diminish. Figures support this. According to the Global Sustainable Investment Alliance, sustainable-investment assets under management globally – which includes ESG and impact investments – grew to more than \$30trn in 2018, with some estimates predicting a rise to \$50trn by 2040. Closer to home, the European sustainable-funds universe attracted a record EUR 120bn of inflows in 2019, according to recent research from Morningstar, with assets in these funds closing the year at a record EUR 688bn, up 56% from 2018.

"ESG investing means different things to different people."

Couple this with an insatiable demand to address climate change, and the overall message is clear; ESG investing is here to stay and, more importantly, will play a vital part in financing the protection and welfare of our planet and its population. As the trade body for the investment-company industry, we realise that ESG is of increasing importance.

ESG investing means different things to different people. Are you interested in negatively screening out companies with a harmful impact on the environment or are you interested in the 'best in class' approach, whereby you would be happy to invest in, say, a mining company with good corporate social responsibility credentials? Then we come to impact investing, where the investment must generate a tangible and measurable social or environmental, as well as capital, return.

To throw in an extra layer of confusion, the data that ESG-motivated investors have to rely on is often hard to interpret. There is no clear industry leader in the field of ESG ratings and there is a lack of consistency across the industry. Disclosure is improving, but it is

"The investment-company industry offers a range of opportunities for the ESG-focused investor."

probably fair to say there's more work to do here. Part of this is because regulators seem to be playing catch-up.

Legislation is being proposed to amend the Alternative Investment Fund Managers (AIFM) Directive that will require managers to disclose how they incorporate ESG into their investment approach. A deadline for compliance with these rules has been set for 10 March 2021. Of course, this could change.

ESG and investment companies

Though regulatory frameworks are still being developed, the investment-company industry offers a range of opportunities for the ESG-focused investor.

The Renewable Energy Infrastructure sector, formed in 2013, has raised over £7bn since inception to invest in green-energy projects from solar and wind to battery storage. There are currently 13 companies in the sector with total assets of over £8.4bn. The average investment company from this sector has returned 68% over the last five years. The closed-ended structure, which enables the manager to avoid having to sell assets to meet redemptions and allows investors to access their capital as and when they want, is well-suited to investing in illiquid assets like infrastructure projects. As many investors continue to seek income in this low interest-rate environment, this sector may be an attractive hunting ground. At the time of writing, companies in the sector are averaging a yield of 4.9%.

The Environmental sector is home to three companies with total assets of £863m. The largest and longest-established of these is Impax Environmental Markets, which was launched a long time before ESG was in the headlines, in 2002. Impax has enabled investors to benefit from growth in the markets for cleaner or more efficient delivery of basic services of energy, water and waste.

Venture capital trusts (VCTs) may also be an attractive option for those looking to do good with their cash. VCTs tend to focus on ambitious smaller businesses which can drive economic growth. They have created over 27,000 jobs and generated over £1.4bn of exports since their inception. These vehicles can also invest in new companies and entrepreneurs with business models that, if successful, can and do drive positive social and environmental change.

But are companies outside these sectors taking ESG factors into account and providing investors with ethical options?

The answer, in short, is yes, absolutely.

By way of example, F&C Investment Trust, the oldest investment company, has begun reporting on environmental factors. It now discloses carbon-intensity figures in portfolio updates. Many other investment companies suggest that ESG analysis is crucial during investment selection and research, even if they do not badge themselves as ESG funds. Austin Forey, Manager of JPMorgan Emerging Markets Investment Trust, explained: “ESG considerations are a natural part of our fundamental research and overall approach to investing which focuses on the longer term. It’s embedded in our process. Our fundamental analysis of any company examines what we call its economics, duration and governance.

“A business simply isn't thinking about its long-term future if it's destroying the environment or abusing the community in which it operates.”

Environmental and social issues are part of the consideration of a company’s duration and its economics; a business simply isn’t thinking about its long-term future if it’s destroying the environment or abusing the community in which it operates.”

Mark Mobius’s comment suggests that due diligence on ESG factors may be becoming simply part of being a good portfolio manager, quite apart from any ethical considerations. Andrew Bell, chief executive of Witan Investment Trust, picks up this theme: “Although our stock picking is outsourced to external managers, we monitor and question those managers’ policies in the areas of environment, social and governance effects. We expect our managers to take full account of ESG risks in their assessment of the prospective returns when selecting investments. Whilst our priority is to deliver good investment returns to our shareholders, this needs to factor in the threats and opportunities from the growing body of evidence of climate change and the political and regulatory response to it”. Craig Baker, chairman of Alliance Trust’s investment committee, would agree: “At Alliance Trust we believe that sustainable investment is central to generating successful long-term investment outcomes, and that climate change is a major part of that”.

While there is still a long way to go, the signs are that many investment companies are taking ethical and sustainable considerations on board, both within generalist and specialist mandates. Their closed-ended structure enables investment in a wider range of assets with potential social and environmental benefits, such as infrastructure, renewable-energy projects and innovative unquoted companies which are developing technologies aimed at improving our environment. As we saw last year, the closed-ended structure is the right one for investing in these less-liquid assets.

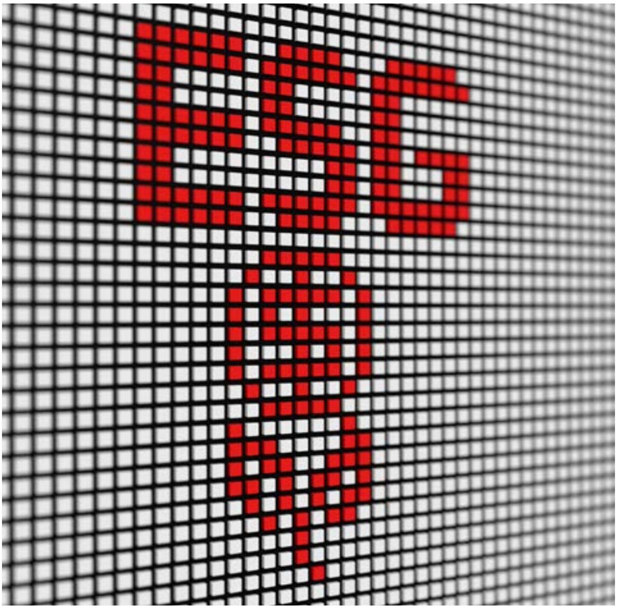
Let's not forget the 'G' part of ESG either. While it often refers to the governance of underlying investments, investment companies themselves have a structure which is designed to protect the interests of shareholders, with the asset manager answerable to a fully independent board.

At the AIC, we realise ESG is increasingly important for many investors. We are helping our members understand the new regulation so they can communicate their ESG approach to investors. Part of our business plan is devoted to ESG; our data team is conducting research into ESG rating methodologies; and our communications team continues to promote investment companies adopting and embracing ethical and sustainable strategies. We hope to see many ESG-orientated investment company IPOs, as well as continued secondary fundraising, in the future.

William Sanderson is a member of the AIC (Association of Investment Companies) communications team. He works to communicate and promote the benefits of investment companies and VCTs to the media, IFAs and other audiences through various channels.

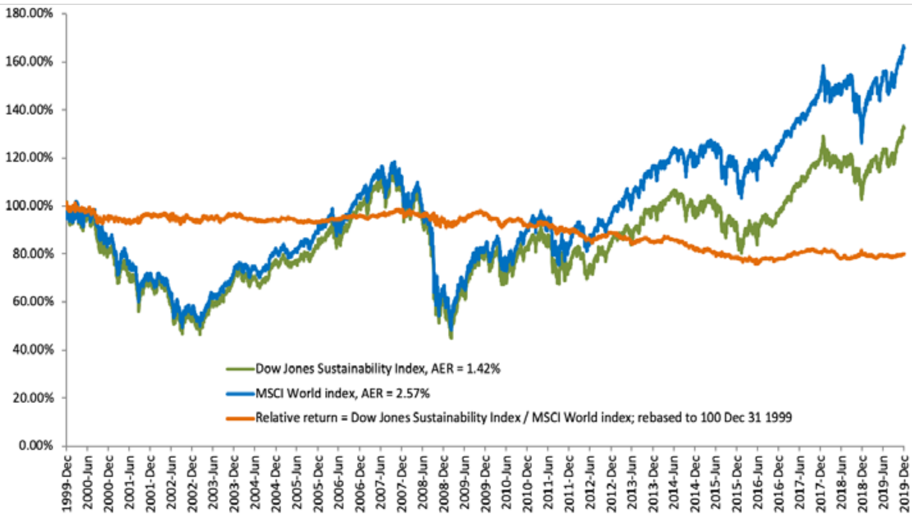
The evolution of ESG

By Lucy Macdonald



ESG has transitioned from a specialised consideration to one that is mainstream and firmly front-of-mind, writes Lucy Macdonald, manager of the Brunner Investment Trust.

Twenty years ago, we launched the Allianz Global Sustainability fund. We hired analysts specialising in the research of environmental, social and governance (ESG) issues, who produced ratings for stocks on this basis. We then constructed a global-equity portfolio using our existing investment process, but also taking these ESG ratings into account to give a positive ESG tilt in the portfolio. This type of activity was viewed with scepticism by most mainstream investors, who could not conceive that they would ever take account of issues such as carbon emissions, labour rights or boardroom diversity in their investment decisions. At the time, this scepticism was to some extent justified by the lack of evidence proving any financial benefit from taking ESG factors into account, and indeed until recently this still appeared to be the case. If we take the Dow Jones Sustainability Index as a proxy for instance, it underperformed the broad MSCI World index for most of the last two decades. However, more recently, in the last three years, the performance has shown a relative improvement.



Source: AllianzGI/Bloomberg as at 5 March 2020

Our own experience of tilting towards ESG factors over the 15 years since launch was better than the passive Dow Jones Sustainability index returns. We tracked the performance and noted that the Global Sustainability Fund and our traditional global-equity portfolios gave very similar returns and that at the very least, adding the ESG tilt did not detract from alpha generation. Therefore, three years ago, we decided to integrate ESG factors more systematically into our fundamental research for all global-equity portfolios, including the Brunner Investment Trust, committing to always be aware of any material issues and explain why we were willing to override any particularly low ESG scores if we bought a stock. For example, when researching a purchase of Estee Lauder shares, if we saw that the governance score was relatively low, we would determine that this was due to the Lauder family's controlling stake and existence of the dual-class share structure; factor this into our assessment of risk and reward; and, if we decided to purchase, explain why we were prepared to do so.

We now think of these factors as a fundamental part of our analysis of the quality of a company, alongside the visibility of its earnings and the strength of its balance sheet. We look for three key factors in any potential investment: quality, growth and a reasonable valuation. Quality companies have a history of generating high returns above the cost of capital, typically thanks to disciplined management. Similarly, a growing company is simply one that increases its revenues and/or earnings consistently, often thanks to a technological or brand advantage. And for valuation, we ensure that we are using analysis techniques that mean we are not overpaying for these characteristics. Integrating ESG into this investment philosophy is relatively straightforward. By looking at a range of non-financial data such as greenhouse-gas emissions, board diversity, executive remuneration or employee engagement, analysts and portfolio managers are better able to build a picture of a company. Crucially, these ESG factors are considered for their impact on long-term company performance; they are not based on subjective morality. We analyse them therefore as part of our quality assessment, alongside metrics like return on investment and financial leverage. Doing so enables us to use these additional details to inform, qualify and interrogate our own financial models.

While accurate information on a company's financial performance is key, it is becoming a less complete story in a knowledge economy where an increasing percentage of a company's

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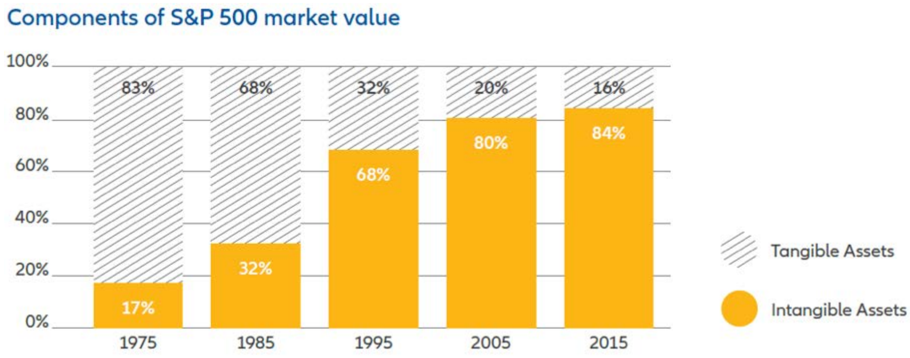

Source: Intangible asset market value study, 2017.

assets are intangible ones that are not shown on the balance sheet. Examples of intangible assets include reputation, human capital, intellectual property, customer loyalty and brand value. Many of these aspects of a business overlap with ESG research and should be assessed to make a fully informed investment decision.

As investors, we have embraced this approach to reflect the increasing role intangible assets (non-physical assets such as power of a recognisable brand and intellectual property) play in determining market value. New generations of consumers and investors are making choices dictated as much by societal impact as they are by traditional factors, fundamentally influencing companies' bottom lines.

As long-term equity holders, we take a three-to-five-year view of a company's prospects and the associated risks. We believe that acting like owners – rather than renters – of companies, is the best means to deliver shareholder returns. Thus, in our relatively concentrated portfolio, with the assistance of our ESG specialists, we constantly monitor corporate developments, documenting any stock-specific concerns we have, as well as our subsequent engagement on those issues.

Meanwhile elsewhere in the industry, asset owners and managers have been increasingly allocating capital to sustainable investing assets, with a growing acceptance that ESG factors should be integrated into investment thinking in order to fulfil fiduciary


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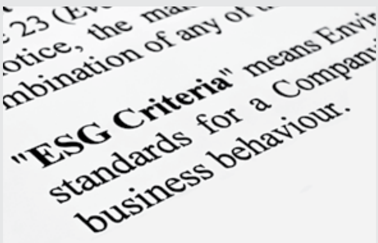
"We now think of these factors as a fundamental part of our analysis of the quality of a company, alongside the visibility of its earnings and the strength of its balance sheet."

duty to clients. According to the Global Sustainable Investment Alliance, at the beginning of 2018 there was more than $30trn US dollars in sustainable investing assets, an increase of 34% over a two-year period. Sustainable investing assets represent more than 25% of total managed assets in the US, and nearly 50% in Europe.

Corporate behaviour is also reflecting the increased scrutiny on ESG factors. Regulatory and reputational pressures, amplified by social media, have invigorated many companies to assess the risks to and opportunities for their business associated with climate change. A tight labour market and increased transparency of corporate culture through internet sites such as Glassdoor has compelled many businesses to place greater importance on human-capital management, to attract and retain talent. Finally, a striking example of changes to governance structures is the evolution of diversity on the board of directors across the globe. The percentage of women on global boards, has gone from 13% at the end of 2007 to nearly 25% at the end of 2019. There is a raft of academic and industry research that finds diverse boards lead to better long-term shareholder returns. As such, possessing the capability to understand these dynamics can contribute to generating alpha in investments while also benefiting broader society.

In summary, ESG has transitioned from a specialised consideration to one that is mainstream and firmly front-of-mind. This has largely been driven



Nicholas Ahonen / Shutterstock.com

by public interest in sustainability over the past two decades, and particularly over the last three years, alongside an exponential increase in related data. There is also a growing body of evidence linking corporate ESG choices to share-price performance, which we expect in time to give clearer proof of the benefit of this approach. In the meantime, those of us who have been investing on this basis for a while can rely on our own empirical experience to assess its value.

To discover more about Brunner, visit www.brunner.co.uk where you can register for regular updates.

Lucy Macdonald is CIO of Global Equities at Allianz Global Investors and is portfolio manager of The Brunner Investment Trust PLC. Brunner aims to provide its investors with growing dividends and capital growth by investing in a portfolio of global equities. Although past performance is no guide to the future, Brunner has paid a rising dividend to shareholders for 47 consecutive years.

The best ESG-based funds

By Nick Sudbury

Funds expert Nick Sudbury uncovers all the best funds and investment trusts operating in the ESG sector.

Socially responsible investing has been around in the UK for about 30 years, but it is only recently that the message has really hit home. Greater awareness of the threat of climate change, pollution and other such issues has meant that a larger number of investors have sought to earn an attractive return while making sure that their money makes a positive difference.

The incidence of extreme-weather events seems to be growing every year and the more widespread recognition of the damage we are doing through TV programmes such as *Blue Planet* has resulted in an unprecedented wave of public demonstrations. Consumer dissatisfaction has reached the point where more capital is being deliberately diverted into businesses with strong environmental, social and governance (ESG) records.

Larry Fink, the founder and chief executive of BlackRock, the world's largest investment fund manager, recently wrote to companies about this very point. He warned them that ignoring the risk of climate change would lead investors to dump their stock, with the result that the share prices would collapse.

The rise in ESG

ESG covers a multitude of different factors that are used to measure the sustainability and ethical impact of an investment in a company. It is now recognised that these criteria can also play an important role in determining the future financial performance of the business.

According to The Investment Association (IA), socially responsible investing, of which ESG is the latest manifestation, accounts for £25.8bn of the £1,275bn of open-ended funds available in this country. This doesn't sound much, but the proportion is increasing quickly and once you factor in institutional investors such as pension funds, the total assets under management in the UK run in this way are likely to be nearer to £1.2trn.

"Socially responsible investing, of which ESG is the latest manifestation, accounts for £25.8bn of the £1,275bn of open-ended funds available in this country."

Influential index provider MSCI has recently urged portfolio managers to incorporate ESG considerations throughout the entire portfolio-management process, including security selection, portfolio construction, risk management, performance attribution and client reporting.

The increase in demand has meant that more fund-management companies are starting to take this area seriously. If done properly, the inclusion of ESG factors into their core investment processes can result in sustainable, successful, long-term returns.

Screening

Implementing these sorts of principles is a subjective process and there are lots of ways that you can do it. Each individual investor will have their own personal view of what's important, which means that they will need to carefully assess the different funds and their providers to find one that meets their requirements.

The first ethical funds used negative screening, a technique that tried to avoid investing in 'bad' businesses like tobacco and alcohol producers, animal testing, gambling firms, oil companies and weapons manufacturers. This sort of approach has the benefit of being effective, transparent and easy to understand, which is why some funds still use it today.

A good example is Rathbone Ethical Bond. It has a high-income target and applies simple ethical exclusions to its security-selection process, namely: no mining, arms, gambling, pornography, animal testing, nuclear power, alcohol or tobacco.

Other funds combine this strategy with a positive screen that actively favours companies with good ESG practices. One such is EdenTree Amity UK that applies a simple and pragmatic ethical screen to its stock-selection process.

Less black and white

Another approach taken by fund providers is known as stewardship, where they actively engage with the companies they invest in to drive change and then report back on the outcomes of these activities. One fund that uses this strategy is BMO Responsible Global Equity where the managers can call on the support of an independent sustainability team to ensure that standards are maintained and backed up by strong engagement.

A third option is integration, where ESG factors are taken into account in the decision-making process. This ensures that the managers are aware of each potential investment's sustainable characteristics, with a good example being the Liontrust Monthly Income Bond fund. It mainly invests in corporate bonds and uses an integrated sustainability matrix to assess the issuing companies' ESG credentials.

Alternatively there is the thematic approach. This is where funds invest specifically in sustainability-related themes such as low carbon, clean energy or water. One such is Pictet Global Environmental Opportunities, where all the companies in the portfolio must operate 'within a safe operating space' for each of nine environmental challenges and must also actively contribute to solving these issues.

The latest development is impact investing, which is where investors look for companies that aim to generate a positive social or environmental impact alongside a financial return. It is essential that the impact is measureable.

Greenwashing

There is no doubt that some fund providers fully embrace the concept of ESG investing, but there are certainly others that just pay lip service to this, to try and attract some of the 'green' money. This has become known as greenwashing, so it is important that investors look beyond the ESG label that many fund managers use.

In order to make this easier, the IA has recently published industry-wide definitions on responsible and ESG investing in an attempt to create a common language for fund managers

> **"ESG is a lot more nuanced than it used to be, with each fund provider having its own unique way of implementing it."**

and investors to use. If these are widely adopted it should make it more feasible to compare different funds.

The problem is that ESG is a lot more nuanced than it used to be, with each fund provider having its own unique way of implementing it. This could mean that you find yourself investing in an oil company on the grounds that it is engaging with environmental issues. The only real way to find out is to study the literature, including the fund's accounts, which list all of its holdings on the reporting date.

Those who don't have the time or inclination to go into such detail could just stick to the fund providers that make this area a real priority, such as those listed below.

Aberdeen Standard Investments (ASI)

ASI believes that as an asset manager, it can play an important role in helping to address issues such as climate change, pollution, poverty and inequality. In order to do this, it has adopted the idea of impact investing.

The firm uses the UN's Sustainable Development Goals (SDGs) as a framework. This consists of 17 objectives that aim to tackle a range of issues and against which there are 232 indicators to measure progress.

One of its flagship offerings is ASI UK Ethical Equity. It uses the best ideas from the firm's experienced team of investment professionals, while running an annual survey of its investors to make sure it is targeting the main themes and concerns of those with money in the fund. It relies on a 'no compromises', investor-led, ethical-screening system that results in a portfolio of 50 to 100 UK companies.

EdenTree Investment Management

EdenTree is a pioneer in responsible investing and engagement with its investee companies forms a key part of its strategy. Each potential investment is assessed across nine positive screens, against a full range of ESG indicators, to assess its eligibility for inclusion in their funds.

One example is 'carbon footprinting', used in its portfolios for the last three years. This looks at emission trends and how companies are aiming to address this issue through reduction targets, which allows the firm to engage with the higher-emitting companies that it invests in.

EdenTree Amity UK is one of the oldest funds in its field and makes social responsibility the key to any investment decision. It invests a large proportion of the portfolio in small-and-mid-cap companies.

Rathbone Unit Trust Management

Rathbones is another firm that uses the UN's Sustainable Development Goals, but it is also able to call on the expertise of Rathbone Greenbank Investments, a dedicated ethical and sustainable investment division that provides screening services. The fund managers send their stock ideas to Greenbank, which then tests them to see if they pass muster.

Rathbone Greenbank has developed a tool to quantify the carbon footprint of individual portfolios. This is based on the carbon emissions reported by companies, which it then aggregates to determine the amount of carbon 'owned' by a portfolio through its

specific shareholdings. Having this data has enabled the firm to engage with oil and gas companies to accelerate the move towards sustainable non-fossil fuels.

Rathbone Global Sustainability is a global equity fund that excludes companies involved in activities such as alcohol, animal testing and armaments. Each holding must also have at least one positive ESG attribute. It is a high-conviction fund with a bias towards the mid caps.

Other notable funds

Jupiter Ecology is one of the country's oldest environmental funds. It invests in companies that provide solutions for global environmental challenges with the three broad themes of resource efficiency, infrastructure and demographics. The fund has a concentrated and long-term portfolio, but the performance can be more volatile than some of its sustainable global-equity peers.

Baillie Gifford Positive Change aims to generate outperformance, while delivering positive change. It does this by focusing on social inclusion and education, the environment, resource needs, healthcare and quality of life. The fund holds a concentrated portfolio and follows Baillie Gifford's high-growth investment style.

If you prefer investment trusts you could look at Impax Environmental Markets (LON: IEM). It aims to benefit from the growth in the markets for the cleaner or more efficient delivery of the basic services of energy, water and waste.

Nick Sudbury is an experienced financial journalist who has written extensively for a range of investment publications aimed at both private and institutional investors. Before moving into journalism he worked both as a fund manager and as a consultant to the industry. He is a fully qualified accountant and has an MBA.

SDCL Energy Efficiency Income Trust and its ESG credentials

By Jonathan Maxwell

Renewable energy has been an important market for ESG investors for a while. Jonathan Maxwell of Sustainable Development Capital, the investment manager of SDCL Energy Efficiency Income Trust (SEEIT), thinks energy efficiency will be next.

There has been a huge amount of attention around renewable energy, an important asset class in the movement towards a greener planet. While we support and celebrate the shift away from fossil fuels towards renewable-energy production, we would encourage people to consider how this energy is used and look for opportunities to improve efficiency wherever possible.

Forty percent of all the world's energy and carbon use is associated with buildings and, according to the International Energy Agency, 40 percent of the required reduction to limit global warming to 1.5° centigrade needs to come from energy-efficiency measures. Therefore, while renewable production of energy is needed, we must also pursue the opportunities to improve the relationship between energy and its end use; how efficiently is the energy transmitted and distributed? How do buildings consume the energy we produce? And can we reduce energy waste?

While the wider market has paid the most attention to the move to renewable energy, we have been focused on where the energy is used and improving the efficiency of that use rather than the supply of electricity to the grid. It is within this context that we have built an investment programme designed to invest in clean-energy supply direct to buildings (onsite energy generation) and more efficient energy use within buildings through energy-efficiency measures.

It is staggering that in the UK, combined losses from generation, transmission and distribution, and equipment-inefficiency losses can represent over 60% of the energy produced. Onsite energy generation is potentially a more cost-effective and a more carbon-efficient

"It is staggering that in the UK, combined losses from generation, transmission and distribution, and equipment-inefficiency losses can represent over 60% of the energy produced."

way to deliver energy to buildings. Rather than using energy directly from the grid, we can use cheaper, cleaner and more reliable energy-generation solutions delivered directly at the point of use for buildings, avoiding losses and the carbon costs associated with the energy system. This can be achieved for commercial, industrial and public buildings through solutions such as roof-top solar panels or combined heat and power plants fed by anything from waste flue gases generated from industrial processes, to natural gas (which can be well over twice as efficient than when used to supply to the grid), to sustainably sourced biomass and other efficient and sustainable feedstocks as appropriate. These solutions significantly reduce reliance on the far less efficient and reliable grid.

"These solutions significantly reduce reliance on the far less efficient and reliable grid."

We took SDCL Energy Efficiency Income Trust (SEEIT) to market in December 2018 and introduced a unique investment asset class to the public market. So far there has been huge appetite from investors for our offering, and since initially raising £100m in our IPO, we have gained an additional £230m in subsequent fundraisings from a broad range of investors.

With the proceeds, we have acquired a diverse portfolio of energy-efficiency assets that are providing cheaper, cleaner and more reliable energy. For example, our onsite combined heat and power plant in St Bart's Hospital provides energy at an efficiency level of over 80%. If drawn from the grid, the efficiency level could be below 40%. Similarly, we have an agreement with Tesco to install rooftop solar-power panels across its estate which deliver onsite power directly to the end user.

SEEIT has also invested in a North American cogeneration industrial portfolio, where waste flue gases and heat from steel production that would otherwise be polluting the atmosphere, are recycled into turbines that produce power for the steel mills and the surrounding site. This project generates around 298MW of energy, but its renewable energy certificates are equivalent to 536MW of solar power production, due to its waste reduction.

Often overlooked, is the challenge of providing heat as well as power to buildings. In countries such as the UK we require as much heating as we require power. Green-energy investment has typically focused on electrification. However, the thermal side of the system is also hugely important. Therefore, for energy supply, we also focus on heat alongside power production. While the heat generated by traditional power plants supplying the grid is often released at the point of production, onsite generation can capture this heat and repurpose it to more efficiently provide for the thermal requirements of buildings and industrial sites, significantly improving the efficiency levels in comparison. This is extremely useful for sites such as our cogeneration plant at St. Bart's Hospital or our project which provides both power and cooling (through heat convection) to Citi's Riverdale Data Centre in Lewisham.

Our next area of focus is around what happens inside the buildings once the energy has been supplied. We recognise that a tremendous amount of energy has been wasted due to suboptimal demand systems, whether it be lighting, heating, ventilation or any other inefficient use of energy within a building. As such, we invest in technology which significantly reduces energy demand, providing buildings with efficient LED lighting; improved insulation, heating and ventilation systems; better air conditioning; or updated building controls. These projects can, in turn, reduce energy demand by a further 25% or more. An example of this in our portfolio would be the provision of lighting to Santander's entire UK estate of branches and offices, initially 800 buildings, with over 90,000 efficient LED lights, dramatically reducing its energy consumption and carbon footprint.

These two big opportunities to significantly reduce overall primary energy losses in the system are the investment thesis for SEEIT. We have acquired a diversified portfolio of energy-efficiency projects which deliver lower-cost, cleaner and more reliable energy solutions to end users in return for long-term contracted revenue streams.

This is a different concept to wind or solar power providing energy to the grid. It is about the interface between energy and the built environment, and it has a considerable benefit from an environmental, carbon-footprint perspective, while relying to a lesser degree on public subsidy. This benefit comes hand-in-hand with long-term, uncorrelated income.

SEEIT is targeting an attractive total return for shareholders of 7-8 percent. per annum.

Jonathan Maxwell is CEO of Sustainable Development Capital Limited (SDCL) and has over 20 years' experience in international finance, infrastructure and private equity. Since establishing SDCL in London in 2007, the group now operates across the UK, Europe, North America and Asia and has launched energy-efficiency project investment funds in the UK, Ireland, Singapore and New York with a net IRR target of over 10 percent. In December 2018, SDCL floated SDCL Energy Efficiency Income Trust (SEEIT), the first UK-listed investment trust to invest exclusively in energy efficiency, for £100m. SEEIT now has a market cap of around £350m.

Clean meat and ESG

By Laura Turner

Global investor interest in environmental, social and governance issues, and the global agricultural production system has reached a tipping point.

"On an industrial scale, raising animals for food is inefficient and unsustainable – regenerative farming, organic farming and improved crop management alone will not provide enough food in the future for a more affluent global population."

On 12 December 2015, parties to the UNFCCC, including some of the largest global carbon emitters in the world (who account for a combined 55% of global greenhouse-gas emissions), signed the Paris Agreement. Nearly five years later, the efforts to curb the warming of the planet to below +2°C by 2050 and combat climate change have proceeded, but not as much as hoped. A transformation of key industry polluters – energy, transportation, industry and agriculture – is necessary if we intend to sustain 10 billion people on the planet.

Since 2001, 18 of the 19 warmest years on record have occurred, 20% of species are facing extinction and COVID-19 is a prime example of global epidemics becoming more frequent and more severe.

ESG investing, a term which has only been in existence for the last 20 years or so, allows investors to seek out businesses with a positive impact on the environment, society and governance, with the potential for positive returns and a long-term impact on those three criteria. Climate change is a major priority for ESG issues, and today there are many opportunities available for investors to shift towards a lower-carbon global economy, with disruptive technology.

Disruptive technology has the potential to transform major polluting industries. Aside from the digital revolution of the 1990s and the shift in energy generation and automotive production, technology is entering new supply chains such as food and material production.

Food production currently accounts for 20% of global greenhouse-gas emissions. The food-production system alone exploits more than 70% of the world's land and 30% of the food we produce is wasted before it even reaches the consumer. On an industrial scale, raising animals for food is inefficient and unsustainable – regenerative farming, organic farming and improved crop management alone will not provide enough food in the future for a more affluent global population.

According to the FAIRR initiative, a global network for ESG investors, meat production has increased by 370% since the 1960s and dairy production by 140%. Given that 70 billion animals a year are currently processed for consumption, capacity of production in the conventional system is already being breached.

In August 2019, the United Nations recommended a global shift towards a vegan diet to combat the worst effects of climate change. However, the likelihood of changing eating habits for the bulk of the population is a challenging task, and viable technologies exist allowing us to continue to consume meat. We have not reached peak global meat consumption: the US is eating more beef than ever before, not less; and despite African swine fever, China's pork consumption is rising and the demand for poultry is increasing across multiple regions. It is a myth that white meat 'is better for the environment and health' than red meat. While chicken is the most efficient energy converter of feed to meat (with a ratio of 9 to 1), this is still not a good conversion mechanism, and chickens are perhaps treated most inhumanely, force fed and killed in bulk.

Currently, meat substitutes such as products from Impossible Foods, Beyond Meat, Quorn, Vivera and the Meatless Farm Co, account for less than 1% of the global meat market. It is plausible that plant-based meat substitutes could replace up to 10% of beef production, but they will never provide the transformation necessary to improve the efficiency and productivity of the food-production system.

Cellular agriculture, 'clean meat' or 'cultivated meat', labels used to describe meat grown directly from cells (without the need for slaughter), is a prime solution for this transformation, without requiring a major change to the consumer's plate.

The nascent sector of cellular agriculture contains 35 companies, all working to provide healthy, sustainable meat at scale and to eradicate factory farming and shift the global society to a more holistic meat-production system. It is not coincidental that these companies fit neatly within the criteria for positive ESG investing. A focus on minimising environmental impact is of paramount importance and the sector is looking to create production facilities that can be carbon neutral. Current estimates of life-cycle analysis for cultivated meat provide promising reports of 48% less energy used than when farming conventional beef, 97% less greenhouse-gas emissions produced, 96% less land and 98% less water. The reduced need of inputs for food generation – absence of animal feed, antibiotics, herbicides and pesticides for the feed; water for the feed; and water for the animal and reduced land requirements, among other factors – allow the E of the ESG investing primer to be achieved.

The use of antibiotics in animals began in the 1940s, with the purpose of therapeutic and preventative treatment for the livestock. Currently 70% of global antimicrobials are consumed by animals, and usage within agriculture will continue to increase – a major concern for the risk of antibiotic resistance. It has been strongly recommended that the agriculture sector reduces its usage of antibiotics; however, this is sometimes an impossible task, given the intensive and unsanitary living conditions animals are placed in. To meet the societal ESG criteria for investing in the cultivated-meat sector, investors and customers alike could be satisfied with acknowledging the absence of even the need for antibiotics in cultivated meat production. This could have a widespread benefit for society by stopping a superbug catastrophe.

Given cultivated meat allows for meat to be produced in the modular sense – from the cell up – it can be tweaked and tailored along the way, to have a specific nutritional profile. For instance, by containing no cholesterol, or with reduced saturated fat or higher protein content, these products could improve health, by reducing both obesity and malnutrition.

It cannot be denied that the financial requirements for creating a new production system are vast, but that in itself allows for investor access. Funding in the sector will likely triple in the next year, from $140m in 2019. A single production facility could cost around $50-$100m to build, requiring around 70 employees to maintain and operate. Given the facilities could theoretically be built anywhere, with weather and climate not a concern (a hot, dry climate could actually be beneficial, as it would allow for a solar-powered production facility), self-sufficiency within countries currently heavily reliant on imports is possible and food security will no longer be a concern for many nations. The concept of a decentralised food system can engage local labour forces and allow for job and community creation around the facilities.

Thought leadership and strong governance at board level of companies within the cultivated meat space is already evident and admired. For example, Aleph Farms, a cultivated beef company based in Rehovot, Israel, announced in February the launch of a "Z-Board", a Generation Z global advisory board programme, focused on encouraging the younger generation towards 'conscious consumption'. Given that millennial investors are twice as likely to invest in companies

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with specific social or environmental outcomes, the generational following is likely to continue the impact investing trend, as they seek companies with high-quality ESG practices.

Take, for example, the work of Lou Cooperhouse, president and chief executive at BlueNalu, the cellular aquaculture™ company based in San Diego. As well as creating a diverse and highly experienced team, he has also established a global advisory board with an array of expertise across regulatory policy, consumer interests, marine conservation and sustainability. BlueNalu has also sponsored Eat Blue™, the educational platform and community dedicated to conserving ocean biodiversity and promoting sustainability.

These companies, all less than a decade old, are leading the way in generating accountable businesses. Many are working with governments and forming coalitions to educate the public about cultivated meat or are engaging with existing retailers and manufacturers to diversify existing practices. The absence of government funding in the sector is notable. Governments need to invest more in cultivated meat and ignore the meat-industry lobbyists for a transformative societal impact.

Laura Turner is an analyst at the AIM-listed investment company Agronomics, which focuses on life-science investments such as the emerging alternative food technology sector. She graduated from the University of Oxford, with a Master's degree in Chemistry.

ESG and smaller companies

By Derren Nathan

ESG investors risk missing out on some of the most innovative developments in sustainable technology, writes Derren Nathan.

Small-cap companies are feeling the squeeze from all angles. More granular disclosure standards, transparency and investor-engagement levels are of course desirable criteria for investors, but of course so are outstanding returns. Smaller companies by their very nature have the capacity to create new product categories and outperform their larger industry peers. But to achieve this they need access to growth capital, the freedom to be agile and not to be suffocated by red tape.

Recent years have seen a raft of regulations, rule changes and standards that have increased the cost of doing business for a UK smaller company and impacted on its ability to raise capital. In terms of capital markets, MiFID II has driven a reduction in research coverage of smaller companies. Also, RDR (the Retail Distribution Review) has seen a fall in genuine advisory stockbroking and a flight from risk towards model portfolios and index trackers. Changes to the EIS and VCT rules have narrowed the universe of companies who can qualify for these tax breaks.

Finance departments are already grappling with new accounting standards such as IFRS 16 (leases) and IFRS 15 (revenue from contracts with customers), and in some cases the 'department' may just be the finance director alone. Indeed some smaller quoted companies will not even have a full-time finance director.

While requirements such as streamlined energy and carbon reporting (SECR) and gender pay-gap reporting can be relatively easily absorbed by larger companies, this is a disproportional burden on smaller companies, despite certain exemptions. All companies on the Main Market of the London Stock Exchange must comply with the SECR framework, unless they can confirm their energy use is low – 40MWh or less over the reporting period. Those on AIM or the NEX Exchange will need to comply should they meet any two of the following criteria:

- a turnover of £36m or more;
- a balance sheet of £18m or more; or
- 250 employees or more

Similarly, companies with fewer than 250 staff are exempt from gender pay-gap reporting, but some would like to see this threshold come down. The European Union's non-financial reporting directive currently only applies to companies with 500 employees or more.

With ESG becoming of increasing importance across investment mandates (in the UK alone some $9trn of assets under management are under the guardianship of signatories to the United Nations Principles for Responsible

Investment (PRI) according to the PRI website), smaller companies risk being increasingly overlooked. They simply do not have the bandwidth to compete with larger companies when it comes to attracting the favour of the ESG ratings agencies. Indeed, our review of some of the better-known agencies that provide ESG ratings suggests that companies listed on AIM barely feature at all, with some providers not giving ratings to any AIM stocks.

The confusing landscape on ESG reporting makes this a daunting subject area for non-specialists. Choosing which sustainability framework to use is in itself an onerous task, given the lack of unified standards. It is no surprise that the management of smaller companies are to some extent ignoring ESG reporting and the 2019 Investor Relations (IR) Society Survey, *Insights into current ESG reporting practices*, reported that only a small proportion of small-cap companies amongst the IR Society's membership responded with any feedback, suggesting that many smaller companies are not ready or resourced to consider their approach to ESG within investor relations. However, a little bit of thought goes a long way and rather than ignoring the issue, the boards of listed companies can now relatively quickly benchmark their ESG disclosure performance against their peer group by completing the London Stock Exchange's online ESG disclosure-assessment tool.

We believe that those who want to deploy capital into companies who can make a real impact on sustainability need to look beyond just ESG ratings, and in doing so will find that smaller companies are a hotbed of technologies that can reduce our footprint on the planet. Indeed, of the London Stock Exchange companies awarded the new Green Economy Mark last year, we estimate that some 60% of the companies (approximately 60 excluding investment funds) are on AIM.

We highlight a handful of companies who achieved this designation below.

Symphony Environmental Technologies (LON:SYM), a corporate client of Hybridan LLP, is a leader in biodegradable plastic technology, and its lead brand the d2w masterbatch currently converts around 200,000 tons of plastic into a biodegradable material. The company has recently added a compostable resin to its range, positioning itself as a partner that can handle the full plethora of increasing regulatory challenges facing plastic producers worldwide. Its business model is highly scalable and it has the potential to drive significant volume and margin improvement.

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Tekmar Group (LON:TGP) is a leading technology provider of subsea protection systems for the global offshore-energy market. HY September 2020 revenue more than doubled to £17.1m, with a record order book up 23.3% to £15.9m at the period end. The company enjoyed a £0.8m profit before tax in comparison with a previous corresponding loss of £2.6m.

Impax Asset Management (LON:IPX), is a well-established asset manager whose strategies use the firm's specialist expertise in understanding investment opportunities arising from the transition to a more sustainable economy. The shares are up by around 90% over the last year and the recent Q1 December 2019 AUM (assets under management) update reported a 7% increase to £16.1bn despite the challenging equity markets.

Last year was the quietest year for London initial public offerings (IPOs) in a decade, according to EY's latest IPO tracker, and despite a general improvement in sentiment, and the resolution of some political uncertainties, 2020 has started slowly. With that in mind, the fact that the first post-Brexit IPO to come to the London markets, Calisen, has also been awarded the Green Economy Mark, is a sign that the 'green pound' will be an increasingly deep pool of capital for some time to come. Calisen, an owner and manager of energy infrastructure assets, raised £300m on admission.

Derren Nathan is Head of Research at Hybridan. Derren has over a decade's experience of broking and researching smaller quoted companies. He has had exposure to nearly every sector at some stage, and also had an 18-month spell as an analyst on a prominent leisure sector desk. He continues to be amazed at the energy and innovation found in entrepreneurial businesses but realises this must be coupled with prudence and operational excellence to satisfy investors. Prior to working in equities Derren spent several years in the Investment Funds Group at PwC having started his career at a leading insolvency practice, a helpful introduction to how not to run a business.

Investor Events Diary

EVERY WEDNESDAY | 12:30
Event: SR Live webinar
Organiser: SyndicateRoom
Place: Webinar
Tickets: www.syndicateroom.com/events/sr-live

EVERY THURSDAY
Event: FinecoBank open house
Organiser: FinecoBank
Place: FINECO HUB, 19 Great Winchester Street, London EC2N 2JA
Tickets: Not needed, drop in

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2 APRIL | 0900-17:00
Event: UK SPINE Annual Conference 2020
Organiser: UK SPINE consortium (led by University of Oxford)
Place: Jurys Inn Birmingham, 245 Broad Street, Birmingham B1 2HQ
Tickets: www.kespine.org.uk/events/conference-2020-free-flow-knowledge-accelerate-innovation-healthy-ageing

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22 APRIL | 13:30-18:00
Event: The Essentials of All Trading Success
Organiser: FinecoBank
Place: FINECO HUB, 19 Great Winchester Street, London EC2N 2JA
Tickets: https://finecobank.com/uk/public/corsi-e-education/corsi

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30 APRIL | 08:30-10:30
Event: EISA Spring Seminar 2020
Organiser: EISA & hosted by PWC
Place: More London, 7 More London Riverside London SE1 2RT
Tickets: https://eisa.org.uk/events

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11 JUNE | 19:00-21:30
Event: Chairman's Reception / EISA Awards
Organiser: EISA
Place: TBC
Tickets: https://eisa.org.uk/events

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25 JUNE | 18:30-00:00
Event: Small Cap Awards 2020
Organiser: Small Cap Network
Place: The Montcalm Hotel London, 2 Wallenberg Place, Marylebone, London W1H 7TN
Tickets: www.eventbrite.co.uk/e/small-cap-awards-2020-tickets-79392449955?aff=ebapi
Or https://smallcapnetwork.co.uk/events