Allocating to Environmental Equities

Following the turbulent economic environment of recent years, institutional investors have been reviewing their asset allocations. In particular, as the global economy steadies and developed markets deleverage, many are seeking investment strategies underpinned by long-term drivers that offer superior growth whilst carefully managing risk.

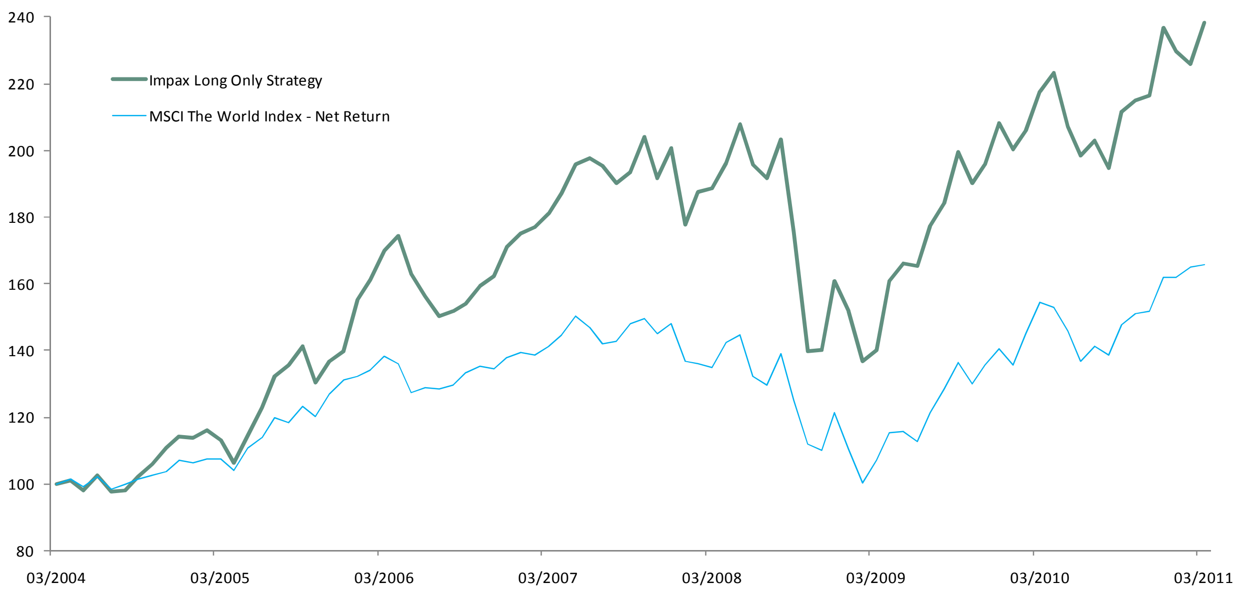
In this context, contemporary equity market fundamentals are compelling and global equity strategies are increasingly attractive. Quoted companies that have emerged from the crisis have done so as leaner businesses, shedding risk-prone management teams and instigating cost cutting measures. Many now have solid balance sheets and strong earnings growth projections. Half of the global manager selections conducted by leading consultant Towers Watson in 2010 were for equity managers[1].

In the post-crisis investment environment, choosing equity strategies underpinned by long term global growth themes is a prudent approach to deriving sustainable returns. Impax's central investment philosophy is based on a number of strengthening, uncorrelated growth drivers that stem from global demographic change and the environmental problems that result. Urbanisation and rising affluence in emerging markets is causing mounting pressure on weak infrastructure and leading to resource depletion and increasing pollution. This is exacerbating energy security and climate change concerns at both the local and global scale and translating into a multitude of environmental legislative targets and investment allocations. For example, there are European Union targets to have increased renewable energy to 20% of the total energy mix, achieved a 20% energy efficiency saving (based on business as usual projections from 2007) and a 50% recycling rate by 2020. China's 12th Five Year Plan is expected to translate into a US$770 billion investment in low carbon energy up until 2020 and South Korea has allocated >70% of fiscal stimulus to green growth support.

Significant legislation such as this is extending the market opportunity for rapidly evolving technologies within sectors such as power generation (e.g. thin film solar) and transportation (e.g. electric vehicles). This is propelling the renewable energy and energy efficiency, water infrastructure and technologies and pollution control, and waste technologies and environmental support services sectors forward as an expanding set of "environmental markets" that have aggregate annual revenues of ca. US$500 billion and compound annual growth rates of 10-20%[2]. The result is a diverse universe of ca. 1400 stocks that accounts for ca.8% of the global stock market[2] and provides investors with the ideal building blocks for creating global equity investment solutions with long term out-performance potential.

The ongoing complex legislative and technological developments at play within the environmental markets universe means that constituent companies are challenging to value and often mis-priced by generalists. More accurate valuations can be reached by an experienced team of environmental investment professionals that includes scientists, engineers, legislation specialists and regional experts working with a disciplined investment process. Such a team is also best placed to construct environmental investment portfolios that are positioned to generate long term superior performance.

Figure 1: Impax Environmental Long Only Strategy versus the MSCI World Index



*Seven year performance in £sterling as at 31 March 2011. Source: FactSet, WM Reuters

The case for including environmental market equities as a component of a global or regional equities asset allocation is persuasive. Moreover, investors have the opportunity to select from a range of strategies that capture different environmental markets growth themes. These all have a bias towards the industrial, utility and technology sectors and embody a degree of both systematic risk (exposure to power prices and environmental legislation) and non systematic, stock specific risk, which can be minimised by maintaining a diversified portfolio. The strategies are as follows:

- **Environmental Leaders:** Captures the upside from the full investment universe of stocks by incorporating larger companies that are increasing their environmental markets exposure
- **Environmental Specialists:** Offers the highest prospective returns by investing principally in small and mid cap environmental technology companies with a majority of their business in the environmental sector
- **Asia-Pacific:** Offers high prospective returns and long term growth by investing in environmental companies in the Asia-Pacific region
- **Water:** Offers limited volatility and superior earnings growth expectations and benefits from ongoing sector outsourcing and privatisation

Strategy	Annualised Out-performance	1 Year Beta	1 Year Tracking Error	P/E NTM	Forecast Earnings Growth (NTM/LTM)
Environmental Specialists	5.5%	1.2	9.3%	17x	24%
Environmental Leaders	1.4%	1.1	6.7%	15x	20%
Asia-Pacific	2.6%	1.0	4.9%	13x	23%
Water	9.7%	1.0	8.6%	16x	17%

Environmental Specialists: 7 Year Annualised Outperformance (Annualised Excess Return) against MSCI World Index
Environmental Leaders: 3 Year Annualised Outperformance (Annualised Excess Return) against MSCI World Index
Asia-Pacific: Since Inception Annualised Outperformance (Annualised Excess Return) against MSCI AC Asia-Pacific ex-Japan Index
Water: Since Inception Annualised Outperformance (Annualised Excess Return) against MSCI World Index
Forward PE ratios and Earnings Growth Data are based on Representative Accounts for each strategy.
MSCI data is total net return. Source: FactSet, WM Reuters

Solid growth prospects mean that all four environmental markets strategies represent particularly attractive investment opportunities in 2011. Previously low forward power prices are rising and concerns in some countries that public sector spending could remain constrained are being alleviated. This is concurrent with the global industrial recovery, anticipated construction recovery, heightened European and Asian policy momentum and increasing levels of M&A activity. Recent unfortunate global events, notably the Deepwater Horizon oil spill and the Japanese nuclear disaster have acted as additional catalysts for the alternative energy and energy efficiency sectors. These substantial drivers are compounded by historically low portfolio valuations. It is a highly opportune time at which to allocate to the environmental sector.

Choosing an environmental portfolio as a component of a global equities allocation is an excellent means of capitalising on the sector's long term outperformance potential. Prospective returns can be further enhanced by selecting a manager with a specialist team, a proven investment process and a track record of alpha generation.

[1] Towers Watson 2011 Investment Manager Update

[2] Impax Asset Management, 2011

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