Environmental Markets: A Compelling Investment for 2011

Environmental markets offer investors a compelling opportunity to tap into superior growth over the next decade and beyond. Strong sector drivers, a broad, diverse investment universe and a high prevalence of stock mis-pricing create multiple opportunities for alpha generation. Impax believes that the application of a disciplined investment process across a number of carefully designed environmental investment strategies can result in sustained outperformance.

Strong drivers of growth

As the world population approaches seven billion and rises in affluence, concerns about resource scarcity, pollution, energy security and climate change are escalating. Policy makers and investors worldwide are increasingly facing up to the need to develop global resources in a sustainable manner.

Across the EU there are targets for 20% renewable energy and a 20% improvement in energy efficiency by 2020, and in the US a majority of states have set standards specifying that electric utilities must generate a certain amount of electricity from renewable or alternative energy sources. China is expected to invest US$770 billion in low carbon energy up until 2020, South Korea has allocated more than 70% of its fiscal stimulus to green growth support, and India has targets for 10% renewable energy by 2015. In 2010 total new investment in clean energy alone is estimated to have reached $243bn, up 30% from $187bn in 2009.[1]

Broad, diverse investment universe with high prevalence of stock mis-pricing

These compelling targets are leading to a wealth of opportunities across a broad range of environmental companies that are classified by FTSE Group into 21 diverse sub-sectors spanning alternative energy, energy efficiency, water treatment, pollution control, waste technologies and resource management.

The dynamic legislation propelling these sectors works in combination with rapid technological developments, particularly in areas such as smart grids, electric vehicles, light emitting diodes and thin film solar. This makes for a rapidly expanding set of markets that now includes ca. 1400 listed stocks and accounts for ca. 8% of the global stock market[2]. Environmental markets have aggregate annual revenues of ca. US$500 billion, compound annual growth rates of 10-20%[2], and are characterised by high levels of corporate activity. This results in a complex range of diverse companies that are challenging to value and are often mis-priced by generalist investors.

Experienced, disciplined investment process can generate alpha

Impax believes that accurately valuing environmental markets companies and constructing optimal investment portfolios requires a team of specialist investment professionals (including scientists, engineers and legislation analysts) and a disciplined investment process (that combines a study of macro-economic trends and environmental themes with detailed stock analysis and valuation). By successfully following this approach Impax has succeeded in creating sustained alpha at volatility levels similar to mainstream indices.

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

*Five year performance in £sterling as at 31 December 2010

Investment portfolios complement global equities allocations

Rapid growth of the environmental markets universe has resulted in the opportunity to create a small range of carefully designed investment strategies, all of which demonstrate a bias towards the industrial, utility and technology sectors but which offer a range of risk/return options.

Impax has developed two principal strategies that capitalise on the global environmental investment opportunity. The first of these, “Environmental Specialists”, invests only in companies with a majority of their business in the environmental sector, and provides the highest prospective returns along with a tracking error (to a typical basket of global equities) in the region of 8 to 10%. In contrast, the “Environmental Leaders” strategy captures the upside from the full investment universe of stocks by additionally incorporating larger companies that are increasing their environmental markets exposure, and provides a more diversified investment portfolio with a tracking error of 5 to 8%.

The impressive speed with which the Asia-Pacific economies have embraced the environmental markets opportunity has presented an additional opportunity to create investment portfolios that capture the superior growth of companies in this region. This strategy has generated strong early performance with a modest tracking error and volatility, and has attracted a range of investors seeking a new way of tapping into potential future outperformance in the Asia-Pacific region.

Figure 2: Impax Listed Equity Strategies

Strategy	Outperformance of benchmark	Volatility	Tracking error to benchmark
Environmental Specialists	6.2%*	18.0%	8.4
Environmental Leaders	2.6%**	17.5%	5.4
Asia-Pacific	12.8%**	14.7%	5.3

Benchmark for Environmental Specialists and Environmental Leaders strategies is the MSCI World Index. Benchmark for Asia-Pacific strategy is the MSCI AC Asia-Pacific Index. Volatilities and tracking error are both over one year to 31 December 2010.
**Five year annualised performance in £sterling as at 31 December 2010. MSCI indices are net total return.*
***Annualised outperformance in £sterling as at 31 December 2010 since inception in March 2008 (Environmental Leaders) and October 2009 (Asia-Pacific)*
Source: Factset

Environmental sector attractively valued

Strengthening growth drivers, an expanding universe of innovative companies, a proven investment process and a track record of alpha generation creates a compelling case for environmental markets investing. Growth of environmental markets in 2011 is expected to continue at a high rate, catalysed by the continued recovery of debt markets, and supported by escalating IPO activity (ca. 54 IPOs in 2010), an increasing number of M&A transactions (ca. 30 in 2010)[2], and the $130bn of further government stimulus funding that has been allocated to the sector world-wide. Furthermore, company valuations are at 10 year lows and high growth forecasts mean that price earnings to growth (PEG) ratios are as low as 0.5[2], rendering the sector a strong value proposition.

[1] Bloomberg New Energy Finance, 2010
[2] Impax Asset Management, 2011

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