SRI Tackles Climate Change

By Maggie Shea, Financial Correspondent
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CHICAGO (HedgeWorld.com)—Although the idea behind socially responsible investing—doing well by doing good—isn't new, the definition of SRI continues to incorporate new areas, the latest being global climate change.

Global energy consumption is rising, Peter Fusaro, chairman of Global Change Associates Inc. in New York, told attendees at the Managed Funds Association Forum in Chicago on Tuesday [June 12]. And that means more carbon emissions, but also a profitable investment opportunity.

The United States produces 22% of global carbon emissions, with China close behind at 18%. Worldwide oil consumption stands at around 85 million barrels of oil per day, 9.7 million of which will be consumed in the United States each day this summer. "The environment is now a fiduciary, not just a goodwill issue," Mr. Fusaro said. "Consumers are now wanting green power. There are over 600 green power corporations…. This is the carbon year."

He added that the $5 trillion value of the global energy business makes it the world's largest, yet most under-funded industry. Last year, every energy company in the United States spent a combined $4 billion on research and development, he said, citing figures from British Petroleum plc. Mr. Fusaro compared that amount to U.S. automotive manufacturers, which spent around $30 billion on research and development in 2006 and the U.S. government, which spent $7.5 billion. However, he said, the $830 billion carbon market, trading at six to 20 times its physical size, is potentially a $3 trillion market, "and will grow." He added that carbon is the first global commodity market to develop worldwide since oil, and the United States could be a significant player.

"We invented cap-and-trade in America. It came from Wall Street," Mr. Fusaro said. He cited examples such as trading sulfur emissions, which helped combat acid rain in the 1990s, as well as nitrous oxide emissions trading, which helped reduce urban ozone levels. "We're going into the third tranche of reductions on [sulfur] credits—another 70% reduction, and a 60% reduction on urban ozone," he said. "These financial instruments for the environment have proven to work. We're going to do the same thing on carbon."

A cap-and-trade system first establishes greenhouse gas emission limits for a designated group of polluters, such as power plants. The amount is then divided into individual allowances, and distributed by either direct allocation or public auction. Companies can then buy and sell those permits depending on their emissions needs.

There are 35 regional emissions markets in the United States, and the Chicago Climate Exchange is North America's only legally binding, rules-based greenhouse gas emissions allowance trading system. California and 12 Northeastern U.S. states have implemented long-term emissions reduction goals, targeting the automotive and electric utilities industries. Around 575 hedge funds, mostly micro-cap stock traders, are environmentally focused, and 40 of those trade emissions.

This U.S. carbon market is just emerging, Mr. Fusaro said. "It's got a lot of chaos and anarchy and triple-digit margins. It's got a lot of opportunity, but a lot of this is going to be technology- and market-driven."

The main problem facing this emerging carbon market is a lack of regulatory and market design, he said. The public policy and capital market arenas hold two different mindsets—one side understands the cap, the other the trade. Currently nine climate change-related bills sit in Congress, one of which would exclude carbon from greenhouse gas emissions. The federal government can't seem to reach a consensus on a clear-cut framework for what will eventually be a mandatory market, Mr. Fusaro said. "The bottom line is we're probably not going to see legislation [on climate change] until late 2009 or 2010." He added that as most corporations are multi-national, different environmental standards across different country lines are "ludicrous" because markets work on simplicity and replication.

Mr. Fusaro said the key is to take a longer-term view. "This is a worldwide problem that's going to take a century to solve. We need a long-term regulatory framework developed by the business community … because that gives the industry time to invest in the plants and equipment and change processes," he said, citing the success of the 40-year anti-acid rain program, now in its 12th year. Furthermore, due to the global nature of the climate crisis, technological innovation in so-called clean tech should be sought on a global scale, he said. "Don't underestimate the power of engineers—there's technology from Israel, South Africa, China," he said.

The money to fund this will come from the private sector, Mr. Fusaro said. "Blackstone, [Kohlberg Kravis Roberts & Co.], Carlyle all are putting together some massive funds," he said. "Some of the macro hedge funds … are moving into project finance. And venture capital, which resides mostly in Silicon Valley, is starting to realize that this is not a quick IT fix—this is four- to seven-year lead times."

He added that while there are only a handful of venture capitalists in the world, they are the ones who will put capital at risk to invest in clean technology innovation on a global scale. "Clean tech … has got an investment appetite which is amazing. And clean tech resonates with SRI."

Sandy Selman, managing director of Asia West LLC, also speaking at the MFA Forum on a panel about SRI, said that since 2000, clean tech has become mainstream. In 2006 U.S. venture capital invested almost $3 billion in clean tech, half of which was in energy supplies, he said. He also said that while regulation drove environmental change in the 1970s and early 1980s, a shift occurred in the late 1990s to the "economic carrot"—which posits that there is value to be captured from investment in renewable energy projects, biofuel technologies, energy storage, bio-based materials and energy efficiency. And solar cell initial public offerings and trade sales make up for most clean tech exits.

The Changing Face of SRI

Global climate change, while it may be today's SRI opportunity, is not the only issue SRI fund managers are tackling. Poverty, obesity, the aging population and water are among the world's problems that represent attractive, sustainable opportunities for investment, said John DeSantis, president of Civic Capital Group LLC, also speaking at Tuesday's SRI panel. Civic Capital spends a lot of time examining companies' annual reports to find out what investment opportunities they're "bragging about," Mr. DeSantis said. "We see shifts in where the opportunities are. In the 1980s it was all about consumption … and how to build consumption. In the 1990s it was telecommunications. Five years ago, companies were bragging about opportunities in China. Now the number-one theme is global climate change."

The historic notion behind SRI was screening out the universe of "bad" stocks investors want to avoid, such as tobacco companies and casinos, said Peter Fell, vice president of the Kenmar Group Inc. "Around 10% of professionally managed money is somehow involved in SRI, mostly through screening," he said

Mr. Selman said socially screened funds, shareholder advocacy funds and community investing funds—or what he called "classic" SRI funds—are a big asset class, now accounting for around $2.29 trillion in the United States. Socially screened funds make up around 68% of that.

Each investment manager at the MFA Forum offered a slightly different definition of SRI as it applies to his fund. Mr. DeSantis said Civic Capital found "there are profits to be made by investing in companies helping solve the world's problems." He emphasized that the investment strategy is not one of screening out things, but rather finding opportunities for sustainable and visible demand, for profits and to benefit society at large. Some opportunities include microfinancing securitized loans, healthy eating and assisted living for the elderly, he said.

Mr. Fell said Kenmar's portfolio is more of a sector fund. Part is a broad representation of sustainable global equities, and the other portion focuses on centers where capital is moving, such as waste management, water and the environment. "There is a large constituency of investors that want to put their money to work in a socially responsible way and want higher returns," he said.

Asia West looks to capture value lost from industrial processes through investment in companies that "upcycle," or convert waste materials into useful products. The firm invests in companies—such as MBA Polymers, which recovers engineering plastics from computers and appliances—that produce finished products that compete with incumbent materials. "If our companies have a sustainable, competitive advantage, the markets we're going after are global and huge," Mr. Selman said.

All of the panelists forecasted that clean tech would move further into the mainstream in the coming years as a viable SRI opportunity. Mr. DeSantis added that the feel-good SRI strategy itself would become more popular as well. "It's a very sticky business. I haven't lost one client. It's a niche moving toward the mainstream…. And my mom loves what I'm doing."

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