HAWKSMOOR
INVESTMENT MANAGEMENT

SUSTAINABLE WORLD INVESTORS' REPORT

Autumn 2022

Riding Out The Storm

Welcome to the Sustainable World Investors' Report covering the third quarter of 2022. Each quarter we introduce the sustainability credentials of a fund eligible for inclusion in Sustainable World portfolios, highlight some sustainability items in the news, and on this occasion conclude with a case study.

This quarter's Fund Focus is on SparkChange Physical Carbon, a fund which we added to our private client Buy list this year. This is an exchange-traded product and the world's first physically–backed EUA carbon product. (Please note that exchange traded funds can be held within Hawksmoor's Sustainable World Discretionary Portfolio Management Service, but not utilised within our Sustainable World Model Portfolio Service).

The third quarter of the year provided only a little respite from the bear markets in both equities and bonds, and a notably weak September ended the three months on a disappointing note. It was an especially trying time in bond markets, with the quarter finishing with near chaos in the gilt market. There is some defence that this was unfortunate timing in that the worst of the falls coincided with the quarter end, and the Bank of England has since successfully restored a quantum of decorum.

The dominant feature for our portfolios has been the energy crisis and the knock-on effects for the renewable energy industry. Whist the rotations in Downing Street mean it is not possible at the time writing to say exactly what the UK's energy policy is, it is a truism that the Russian invasion of Ukraine will ultimately force an acceleration of investment into renewables. In the shorter-term, however, the government has to balance the unaffordability of energy bills and an electricity pricing model that is clearly broken, versus the need to incentivise investment. It would be a surprise if they were to come to the right answer first time.

Whilst the legislative flirtations with windfall taxes and renewable price caps have been less than helpful, many of the funds in which we invest have been affected more recently by the volatility in gilt markets. To simplify what are potentially complex arguments, there is a truism that the higher the yield available from buying a gilt (deemed the 'risk-free rate'), the higher the yield investors will demand from other assets, especially those delivering attractive incomes. The higher gilt yields go, the lower the market price of renewable energy assets. Whilst this is an unavoidable short-term nuisance, and one that was a significant factor in the quarter, it should not distract from the importance or the long-term value in renewable energy.

"Heatwaves, drought and floods are happening more often, and more intensely all across the world. Records are getting broken each year, for a grave human and environmental cost… This summer shows us we're living with environmental extremes already… So the question is, how will we act?"

Leah Das, Greenpeace Blog, 16th September.
(Source: https://www.greenpeace.org.uk/news/climate-disasters-summer-2022/)

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FUND FOCUS

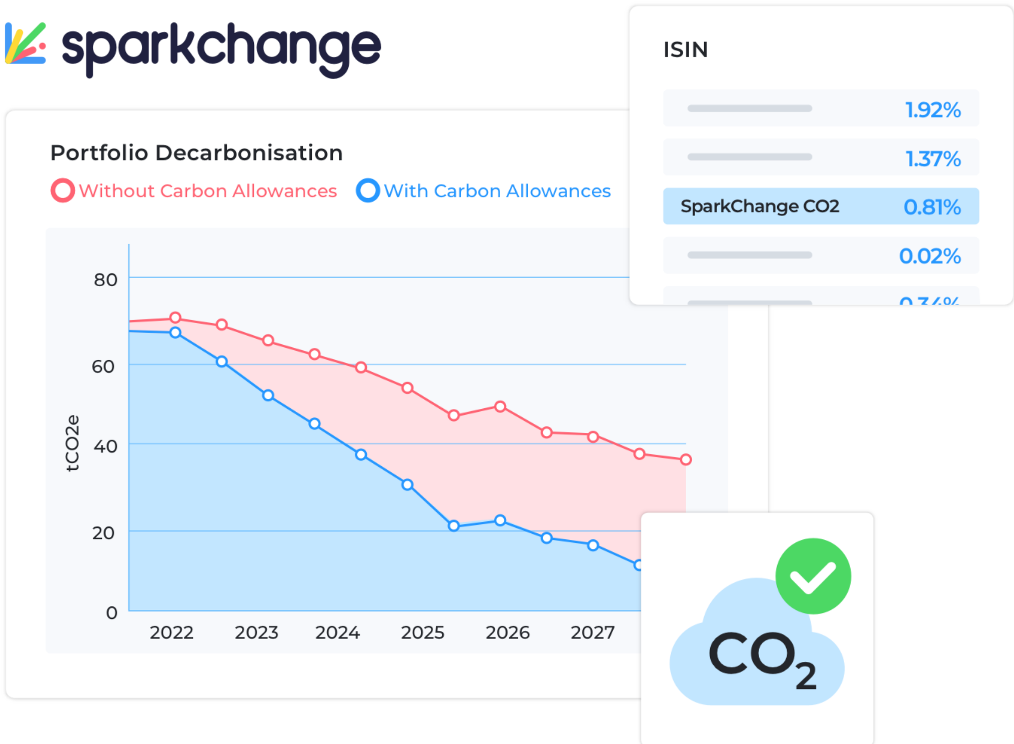
SparkChange Physical Carbon EUA ETC

Unlike many of the funds that are typically used within our portfolios, SparkChange Physical Carbon offers a measurable, positive impact, as well as returns that are likely to have low correlation with both equity and bond markets. It is an exchange-traded product with the purpose of tracking the spot price of European Union Allowances (EUAs), and actually holds the carbon allowances. But before we can get into the nitty gritty of how the product works, it is worth giving a quick overview of what an EUA is, how it works and most importantly why it is an attractive investment opportunity.

By now we are all aware of the pressing need to rapidly decarbonise to combat climate change and reach net zero targets set out in the Paris Agreement back in 2015. Though ten years prior to that was the launch of the European Union Emissions Trading System (EU ETS), which provided a marketplace for carbon credits to be traded. It is the most established carbon market targeting the largest polluters across the 27 EU member countries as well as Iceland, the United Kingdom, Norway, and Liechtenstein. The system used is known as ‘cap and trade’, which essentially means that companies are capped on the amount of carbon they can emit and those that find themselves over the cap will be forced to purchase EUAs or face a hefty fine. Over time, the cap is reduced which creates a financial incentive for companies to cut emissions. Our economic textbooks will also teach us that as supply is taken away, prices rise. The price of EUAs has risen rapidly since 2020.

The beauty of SparkChange Physical Carbon EUA ETC is that it is the world’s first and only physically–backed EUA carbon product. That means it is backed by physical EUAs and therefore tracks the spot price. This comes with a range of extra benefits. Holding physical EUAs takes them out of the hands of potential polluters, making the pace of carbon reduction faster, and an irreversible consequence. Further to that, under EU law, holding an EUA for twelve months or more will trigger additional permits to be cancelled in future years, therefore making the pace of reduction faster. By investing into SparkChange Physical Carbon EUA ETC one is ultimately contributing to a reduction in carbon emissions and creating a more expensive environment for those that are over polluting to do so, thus encouraging exploration of low carbon solutions.

Investing in the physical market, as opposed to the futures market, has another key attraction. Commodity funds typically invest not into physical materials, but into futures contracts. These contracts can carry an additional risk and cost if the price is expected to rise, making each successive contract more expensive than the last. SparkChange, in contrast, actually holds the carbon credits, meaning that performance is protected to that of the EUA spot market, where carbon credits offer an uncorrelated return to common equity/debt markets. All of which is underpinned by the pressing need for the public and private sectors to decarbonise.



(Source: SparkChange Group Limited)

SUSTAINABILITY IN THE NEWS

Within the Hawksmoor Research team's daily internal email we highlight sustainability items in the news along with developments in the sustainable investment universe. Here we present a select number of snippets from the third quarter of 2022.

18th July: Microsoft has signed a 10-year carbon removal deal with Climeworks, a firm specialising in direct air capture (DAC) technology in Iceland. The value of the deal has not been disclosed at this stage, but Climeworks says it is 'one of the largest' in the nascent DAC space and will support the removal of tens of thousands of tonnes of carbon dioxide from the atmosphere. This will contribute towards Microsoft's stated pledge to achieve carbon negative operations and supply chains by 2030. Climeworks develops, builds and operates DAC machines, which when powered by renewable energy or energy-from-waste facilities permanently remove at least 90 out of every 100 tonnes of CO2 captured from the air. Air is drawn into a collector with a fan; CO2 is captured by a filter; when full, the collector is closed and heated to 80-100 degrees centigrade; released CO2 is then collected. At Climeworks' flagship Orca facility in Iceland, the world's largest DAC plant (which became operational last September), partner firm Carbfix then pumps the captured CO2 deep underground – through natural mineralization, CO2 reacts with the basalt rock and turns into stone within a few years. Orca removes 4,000 tonnes of CO2 per year, but in time this will be dwarfed by Mammoth, Climeworks' second commercial facility in Iceland (where ground was broken last month), which once fully operational will capture 36,000 tonnes of CO2 per year. Microsoft is effectively supporting this development (Source: www.edie.net as at 14th July 2022)

25th August: The UK's department for transport has announced that 9 UK councils will receive £20m of government funding to improve local electric vehicle charging infrastructure. The Local EV Infrastructure (LEVI) scheme aims to improve accessibility to charging points, which research has shown is a major barrier to people moving to electric vehicles. Different councils will explore different ways of installing the rapid EV chargers, some will install them on streets and others will look into installing charging hubs, much like a petrol station where people will visit the hub to quickly recharge. This is a pilot scheme, which aims to enable the supply of around 1,000 EV charging points, with plans to roll it out further by the end of the year. The scheme will also runs alongside the On-Street Residential Chargepoint Scheme (ORCS) which is funding around 2,869 EV charging points already (Source: www.edie.net, as at 25th August 2022)

5th September: Supermarkets have begun removing best-before dates from hundreds of fresh fruit and vegetable lines and some own brand diary lines, with the aim to reduce food waste in customers' homes. Tesco adopted this approach in 2018, and Marks & Spencer earlier this year, with Asda, Sainsbury's and Aldi following more recently. Foods which have a high food poising risk are required to have use-by dates under rules by the Food Standards Agency, however best-before dates are used as guidelines for when is best to eat the foods. Studies have shown that consumers often confuse the two and throw away food after its best-before date. Sainsbury's calculated that it could prevent up to 11,000 tonnes of food waste each year through this change. The Waste and Resources Action Programme (WRAP) research has estimated that around 8-10% of global annual emissions is caused by food waste. With around 70% of UK food waste being caused at the consumer stage this could be a big step forward in reducing waste and emissions. (Source: www.edie.net, as at 5th September 2022)

21st September: Amazon has announced a further 71 new renewable energy generation projects, now totalling 379 projects globally. There are now 25 on-site solar projects in the UK, including the 7 added today. Amazon will operate 18MW of on-site solar capacity in the UK once these have been installed. The addition of these projects strongly aligns with Amazon's goal of powering all operations with 100% renewable electricity by 2025. The company is part of the Clean Energy Buys Institute and is the world's leading corporate purchaser of renewable energy. (Source: www.edie.net, as at 21st September 2022)

ESG: Companies vs Government Policy

We often hear about how 'governments need to do more to combat climate change'. This is clearly true. It would be farcical to suggest otherwise. But it would be equally farcical to suggest progress depends solely on politics.

Most democratically elected governments suffer from short-termism. Why sow the seeds of a successful policy when its benefits may coincide with your political foes being in office? Much better persevering with sticky plaster policies that deliver results just in time for the next election. It's a disturbing, but perhaps unsiurprising, truth that relatively little has come out of environmental summits since the Paris accord of 2015. Admittedly, between 2016 and 2020 there was another rather unhelpful political headwind. There is very little overlap between list of things The Donald believes about climate change and what the president of the USA should. He's still blustering about in the twittersphere somewhere, and some even fancy him for another run in 2024.

Yet the progress from corporations has been, in many cases, extraordinary. From a peak in 2015, Apple has cut emissions by 40%. This is despite growing revenue by over 50%. There is no question this was led by investor pressure. Only a few years ago, slides on ESG were a rarity in company presentations, and to query environmental, social and governance matters during a call was seen as a waste of valuable Q&A time. These days, management scramble to spouse their virtues and upgrade their policies. This does, unfortunately and inevitably, bring about the problem of greenwashing. To combat this, we hope an agreed set of standards will emerge. Sustainable metrics matter far too much for this not to happen. The FCA has got the ball rolling, and we applaud it for doing so.

But good ESG practices are about more than window dressing. Just listen to Larry Fink, CEO of BlackRock (which has $8t under management). He explains the increased focus on ESG factors as not about being 'woke', but about robust long-term stewardship. He's right. Only sustainably run companies will survive. We accept sustainable flows were boosted by bandwagon-jumpers seeking to capitalise on a strong performance run. With that in mind, there is no guarantee it'll be a one way ticket from here. However, the absolute truth that only sustainably run companies can survive in the long run should ensure public market engagement with ESG principles trends upwards over time. If it doesn't, it'll be left to the politicians. And we can't afford that to happen...