

Investment Views

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The Case For Sustainability

The third quarter of 2024 was another challenging one for sustainable investing. In the near term the noise looks set to continue and perhaps increase, but this provides an opportunity for investors because the pillars for generating attractive long-term investment returns remain unchanged.

The re-election of Donald Trump as the 47th President of the United States has negative headline implications for the sustainable theme. His administration is expected to roll back a number of important climate regulations, potentially including changes to the SEC's climate disclosure rules and to parts of the Inflation Reduction Act (IRA). The latter is a key piece of legislation passed in 2022, containing substantial provisions aimed at promoting sustainability. These include tax incentives for projects such as renewable energy, significant funding for green infrastructure and support for innovation in sustainable technologies by providing grants and loans. The IRA is intended to not only help accelerate the transition to a greener economy but also to create a "green jobs" bonanza over the next decade. Whilst a full repeal of the Act looks unlikely given the broad support for many of its provisions and the complexities involved in reversing already allocated funds, modifications may well include reducing tax credits and a shift in focus back to traditional energy such as oil and gas. After years of heavy investment in fracking, the US is the world's largest oil producer.

It is not just the US that has witnessed a hardening of political views. In the UK, Opposition leader Kemi Badenoch has a very different mind-set to her predecessor, repeatedly criticising the 2050 net zero target required under the UK's Climate Change Act of 2019, describing it as "unilateral economic disarmament". Whilst the Prime Minister, Sir Keir Starmer, remains firmly committed to the Net Zero target, ministers are coming under increasing pressure to water down penalties for firms that fail to hit targets. The government has already reduced the level of planned fines from next April for boiler-makers who fail to sell enough heat pumps from £3,000 to £500 per unit, whilst electric vehicle makers have warned of an "irreversible impact" on UK car production if they are forced to pay fines if they fall below targets.

Tensions were also on open display during November's COP 29, where around 80 countries vulnerable to climate change walked out of a critical meeting, mainly because the \$300 billion deal for rich countries to help poorer ones fell far short of both the

\$500 billion requested and the \$1.3 trillion economists say is needed for the developing world. Ultimately a deal was reached, but not without some frantic diplomacy behind the scenes and the blockage by Saudi Arabia and Russia of explicit reference to the next steps needed to move away from fossil fuels. It seems that few countries were happy with the eventual deal but were acutely aware that an agreement would be even harder once Donald Trump is in office and with ongoing cost of living pressures in several major Western economies.

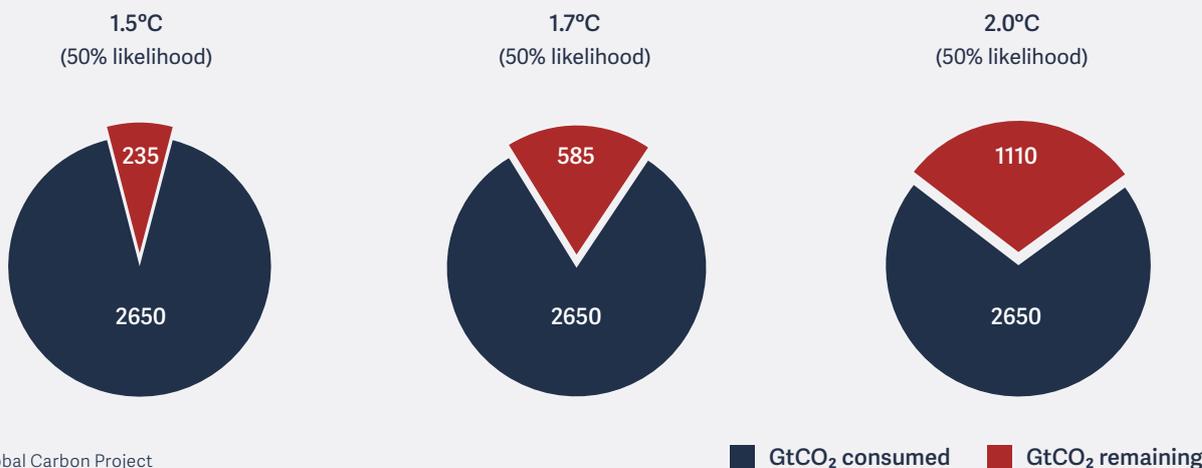
Given all of this noise, why put money to work in sustainable funds now? Why not wait until the opportunity becomes clearer? Here is what Warren Buffett has to say about uncertainty in general - "An argument is made that there are just too many question marks about the near future; wouldn't it be better to wait until things clear up a bit? Before reaching for that crutch, face up to two unpleasant facts: The future is never clear; and you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values."

So perhaps the real question is not how to time the moment when the negative sentiment will change, but whether the long-term investment case for sustainability remains on track? The answer to that question is yes, for the reasons stated below.

First, there is a genuine problem to be solved that is simply not going away. In fact, it keeps getting worse. By some measures, in just over six years the goal of limiting the temperature increase above pre-industrial levels to below 1.50C will have been passed, as the chart below shows.

If that happens, we risk reaching a number of tipping points that, as the FT's Martin Wolf puts it, would leave us "in a new and very dangerous world": collapse of the Greenland and West Antarctic ice sheets; abrupt thawing of the permafrost; death of all tropical coral reef systems; and collapse of the Labrador Sea current. The obvious conclusion is that whether we like it or not, we have to start doing far more, not less.

The remaining carbon budget to limit global warming to 1.5°C, 1.7°C and 2°C is 235 GtCO₂, 585 GtCO₂, and 1110 GtCO₂ respectively, equivalent to 6, 14 and 27 years from 2025. 2650 GtCO₂ have been emitted since 1850



Second, there are identified solutions available, primarily a clean energy revolution across the globe but in emerging and developing countries in particular, as they are generating all the rise in global emissions.

Third, the solutions all involve spending a great deal of money, a sum that continues to rise. McKinsey argues the world must spend \$9.2 trillion per year to reach net zero by 2050. Hence the focus during the UN Climate Change Conferences (or COPs) on richer countries taking action themselves but also agreeing to provide emerging economies with the money to do what we all need them to do. As a member of the Indian delegation at COP29 complained, the \$300 billion agreed “is a paltry sum” in view of the huge commitments really required.

Fourth, the electorate, who politicians represent and are accountable to, are unsurprisingly overwhelmingly in favour of doing what is required to save the planet. A YouGov poll in July found that 74 per cent of the UK public support the Net Zero target, up from 69 per cent in April. That figure was the same in America in a Pew Research Center survey last year. Younger investors in particular are more likely than ever before to incorporate ESG principles into their investment decisions. This translates across to investment firms, where 80% of institutional investors globally expect assets in sustainable funds to grow over the next two years (source: Morgan Stanley Sustainable Signals Survey covering more than 900 institutional investors across North America, Europe and Pan Asia). Reasons for the expected increase include exposure to growth opportunities and the maturity of sustainable investing as a strategy.

It is difficult to think of another investment idea with so many structural factors in its favour: a clear and urgent problem to solve, significant sums to be spent, regulatory change in support and electorate demand for action in the face of unrelenting news flow about the consequences of not doing so.

The issue for investors on the ground is that the sustainable landscape is so broad that investment returns vary very widely indeed. Too many funds have been launched to capitalise on the anticipated flood of money, many of which have invested solely in high growth “jam tomorrow” sectors that now face extensive overcapacity, including the EV and solar industries. The challenge is therefore in separating the wheat from the chaff.

The most sensible way to do that is to invest in generalist funds that focus on high quality companies with strong earnings growth and reasonable valuation multiples across several sectors. That way you avoid getting trapped in one or two industries that fail to deliver. In our core mandates, we hold the Ninety One Global Environment fund, a well-run generalist fund where many of their holdings have demonstrated extremely strong operational performance yet have seen their share prices detach from fundamentals for much of 2024 as negative sentiment increased. As we review the fund’s holdings today, there is certainly no cheery consensus, no very high price to pay; indeed, on a look through basis, we own companies such as Sungrow and CATL whose earnings have increased significantly and whose share prices will follow suit eventually. In the short term the market is always a voting machine; but in the long term, value wins out.

For larger, standalone sustainable mandates, we invest the bulk of funds in several generalist sustainable funds, supplemented by a smaller allocation to specific specialist opportunities where deep dive research provides a higher level of understanding and greater confidence that the upside far outweighs the downside. The lower portfolio weighting to these opportunities reduces the impact on returns if we are wrong.

We have no way of knowing when sentiment will change but we remain confident that it will. Trying to time that moment is futile, as markets are forward looking and complex, with the

bulk of gains occurring on a very small number of days. Missing those days significantly reduces returns.

In summary, the sustainable investment landscape now has plenty of revenue generating, earnings growing, cash producing companies whose valuations have been unduly impacted by the headlines. Whilst this may remain the case for some time to come given the new US administration, a long-term allocation continues to make sense, whether as a theme within multi-asset portfolios or as a standalone sustainable mandate.

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