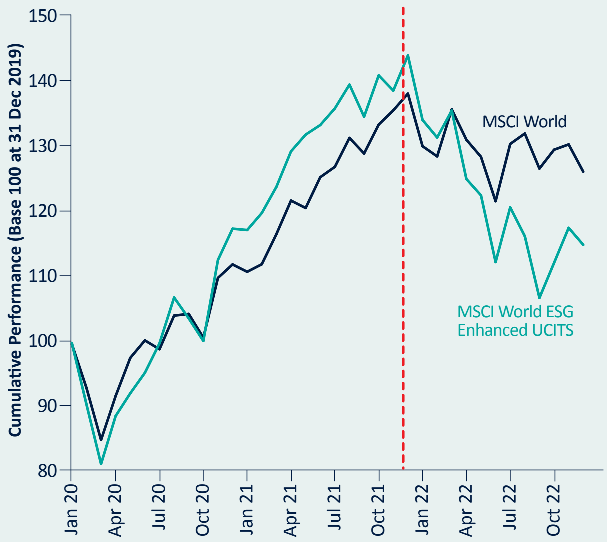
Sustainable Investing

This is the fourth year in which Sustainable Investing (SI) has featured as one of a small number of our core investment themes. We have evolved the scope of this theme over these four years to increasingly focus on two core areas under the SI heading: the global energy transition and diversity. SI includes our ongoing manager engagement efforts to see ESG factors fully integrated into their investment processes alongside traditional fundamental financial analysis where it makes sense to do so. SI also includes our investments in impact companies mostly found in the healthcare and education sectors. Diversity (this term subsumes inclusion and equity) translates into a widening of our manager screening funnel to include a larger proportion of diverse asset managers. It also includes our manager engagement activities focused on firm diversity and the incorporation of diversity into investment processes as managers examine and engage with their portfolio companies. Focus is generally required for excellence in any field and, at this moment in the evolution of our SI theme, we are most focused on the energy transition and diversity and will devote this short description of our SI theme to our progress on the energy transition.

Investment Industry's View on Sustainable Investing. Over the last couple of years, we witnessed a strong backlash against the ESG investing mega-trend with critics underscoring the unmanageably wide scope of the concept, the vast array of different definitions and approaches and greenwashing claims. The greatest backlash perhaps was the attack on fossil fuel exclusion policies which may have achieved the desired effect of reducing the investment in new oil and gas production in the face of a heightened need for energy security following Russia's attack on Ukraine. In the US, this backlash has resulted in many oil producing states divesting from asset managers who have been particularly vocal about ESG. Furthermore, during 2022, so-called ESG investment funds underperformed against broader indices. In many cases, these funds were underweight defense and fossil fuel companies which performed strongly during 2022 but retained overweight allocations to fast growing technology and healthcare sectors which performed poorly in the face of rising interest rates. This is illustrated below in Exhibit 1, which shows the relative outperformance of an ESG variant of MSCI World vs. the vanilla index during 2021, before sharply reversing in 2022. The institutional investment world is now torn between not owning companies and sectors which are perceived to be poor ESG performers and owning companies where investors feel the company or sector is likely to see meaningful improvements in ESG factors, regardless of whether the investor takes an active role in influencing the positive change.

Exhibit 1

MSCI World ESG Enhanced UCITS outperformed MSCI World in 2020 and 2021 before the trend reversed sharply in 2022



***Source:** MSCI*

The backlash has been far from universal. An increasing number of institutional asset owners and asset managers continue to embrace net zero goals. Today 20% of US endowments have net zero goals and 11% of pensions as measured by assets.[1] So far, of our 100 largest clients, 15 have a net zero goal in place. Our attempts, and our clients' attempts, to detail investment plans and policies for achieving this goal have been complicated by the myriad potential energy transition pathways, with some seeking to exclude investments in fossil fuels and others continuing to invest in fossil fuels despite their desire to achieve net zero emissions.

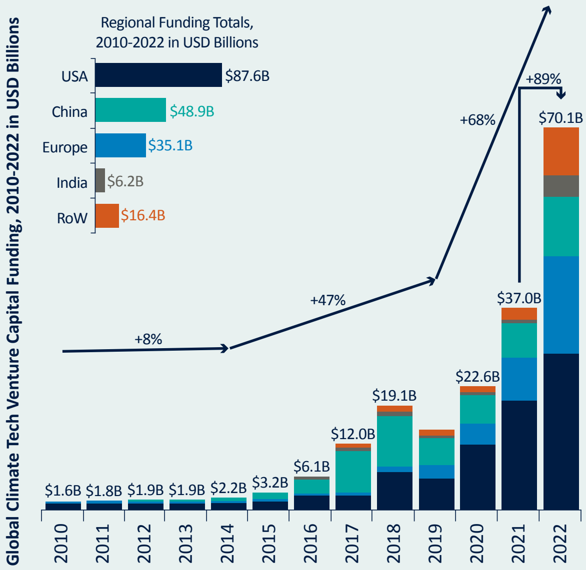
Backlash or not, we are seeing significant growth in Sustainable Investing generally, and in the energy transition specifically. Most of the growth in energy investing is accounted for by large public companies across utilities, oil and gas, automotive, materials,

1. Pensions and Insurers Data from Net Zero Asset Owner Alliance. Endowment data from Intentional Endowments

industrials and agricultural sectors. However, as estimated by the International Energy Agency and Imperial College London, the amount invested in renewables infrastructure via private equity infrastructure funds has more than doubled in the 5 years 2016-21 from $60B to $125B. Below, in Exhibit 2, you can see that climate technology investments totaled $70.1B in 2022, which accounted for approximately 16% of total venture capital investments in 2022.

Exhibit 2

Climate Tech Venture Funding nearly doubled to $70B in 2022



Source: *HolonIQ*

In Insights 2022, we summarised the essence of our 64-page Partners Capital Global Energy Transition Investment Framework into a one-page summary of our conclusions which are still valid today.

Global CO2 emissions today average approximately 40B metric tons per year. Power generation and industry (steel and cement, in particular) account for 62% of current global emissions, with transport, agriculture and building accounting for the rest. China, US and Europe account for 60%.

Today, 80% of global GDP is located in countries that have a net zero ambition, up from 50% at the beginning of 2021. For example, the US, the second largest emitter but the largest on a historic basis, has set a target of cutting net greenhouse gas emissions by 50% below 2005 (peak) levels by 2030.

In pursuit of these ambitions, renewable energy is clearly the dominant contributor (50%) to emissions reduction between now and 2050. However, it will also require meaningful contributions from carbon capture, hydrogen, battery technology and increases in our natural sinks like forests.

In order to achieve net zero by 2050, experts suggest it will require an incremental $2.3-3.8T of average annual investment out to 2050, an increase of over 100% from the estimated $2.2T that was invested annually towards net zero between 2016 and 2020 (for a total annual capex of $4.5T to $6.0T).

Due to the future reliance on wind and solar power and the intermittent nature of those two power generation sources, we believe that large scale renewable energy storage is the most significant hurdle to the goal of achieving net zero emissions. Continued improvements in existing technologies (e.g., grid-scale lithium-ion batteries and hydrogen electrolysis) will be commonplace during the transition. Green hydrogen is a likely feature of this future, but it will take at least a decade to achieve meaningful scale.

Carbon capture technology will likely be crucial in decarbonising more difficult to abate emissions from heavy industry from 2030 onwards, although the technology is currently nascent.

Based on the long-term climate objectives and the shorter-term technological constraints, we believe that natural gas and nuclear, where available, will likely bridge the gap for the next decade until batteries and hydrogen storage technology reach the point of wide scale utility. At that point, renewables will come to dominate the power grid, supported by a combination of nuclear and natural gas plants fitted with carbon capture technology. Batteries will support day-to-day grid management, and hydrogen will support the grid for seasonal management of surpluses and deficits.

With this backdrop, our investment strategy will follow our long-running sustainable investment framework:

1. Favour those managers best able to assess the degree to which companies will be affected by the energy transition, regardless of their industry
2. Allocate capital to those companies and sectors which sit in pivotal positions on the path to net zero emissions.

Here in Insights 2023, we want to highlight the evolution of the investment industry's views on investing in the energy transition and the progress we have made with client portfolios in 2022.

Partners Capital Progress in Investing in the Energy Transition. Virtually every one of our public equity, private equity and credit focused asset managers are investing in the energy transition today, to the extent that the companies they own will all be evolving their businesses in the direction of lower greenhouse gas emissions in the years ahead. It is our job to help those asset managers that need it, to appreciate and understand how any one of their investments is likely to be affected by the energy transition, and in some cases, for us to encourage these asset managers to engage with company management on how best to prepare for and exploit this mega-trend to the benefit of their investors and the environment.

We cannot be of any help unless we have a deep understanding ourselves of what the greatest challenges are to the global energy transition. To this end, over the last few years, we have invested in developing our own in-house domain expertise in the energy transition and sought ways to transfer this understanding to our asset managers through our research publications and day-to-day interactions with them. This starts with educating our asset class teams in the energy transition which is an ongoing process at Partners Capital. In our engagements with the asset managers that we partner with, we go further than simply asking table stakes questions like "do you have an ESG policy" and "do you integrate ESG factors into your investment process?". We have engaged with our asset managers on ESG investing through our Asset Manager ESG integration Survey since 2016. However, we are most impactful in our face-to-face engagement with our core asset managers on specific topics under the sustainable investment heading by, for example, supporting managers in the development and implementation of their ESG materiality assessment frameworks or their approaches to achieving a net zero goal in their own portfolios. In 2022 we published our *Global Energy Transition Investment Framework* and distributed that to all of our asset managers, many of whom have made it mandatory reading for their research teams. Several dozen of our largest managers have engaged with us on its content to swap investment insights.

Additionally in 2022, we continued to dig deep into the investment world to find more active investment managers across asset classes who have deep energy transition domain expertise and who have demonstrated an ability to generate significant investment outperformance from this expertise. In most cases of Energy Transition or ESG managers we have approved and invested in, their sustainable investment "lens" is not sufficient as the sole source of alpha generation but is married with other fundamental research-based and value adding investment skills that together we believe can generate significant outperformance in the future. But very occasionally we are finding managers exclusively focused on investing in the energy transition where their insights appear to be delivering material outperformance on their own. This had us approving a new public equities manager, a private debt manager and two new energy transition focused private equity managers in 2022. Our dedicated impact private equity pooled vehicle, which was launched in 2021, is now approximately 45% deployed, having committed to six managers and one co-investment. We also continue to allocate to and upgrade the quality of talented managers focused on investments in impact sectors such as healthcare and education.

As of the end of 2022, our model portfolio had approximately 10% of its portfolio allocated to primarily sustainable investments and impact strategies.[2] As we add more managers with dedicated energy transition capabilities to our platform and clients allocate more capital to capitalise on these opportunities, we anticipate that this figure will grow.

Today, we estimate that, on a capital weighted basis, 79% of the active manager universe that responded to our Asset Manager ESG Integration Survey in 2022 is comprised of asset managers who fulfil our minimum requirements of firm wide ESG integration. This represents an increase from 75% in 2021.[3]

Your capital is at risk and you may not get back the full amount invested.

2 The 10% allocated to primarily sustainable investment strategies and impact strategies includes that subset of managers within our current model portfolio for institutional clients who qualify as "ESG leaders". These are managers whose investment strategies we believe to be significantly influenced by their insights on how ESG factors affect company performance. This 10% also includes managers focused on investing in what we define as impact sectors, which includes renewable energy, healthcare and education.

3 We have received responses from 93 managers to date (representing $23.7B of capital, or 53% of AUM) to our 2022 Asset Manager ESG Integration Survey. This compares to responses from 128 managers in 2021 (representing $20.7B of capital, or 47% of AUM as of June 2021). More information on our Asset Manager ESG Integration Survey can be found in our 2022 Sustainable Investing Report.