THE MESSAGE

ESG INVESTMENTS

Repower EU: art. 8 vs art. 9 SFDR

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Nowadays they speak of sustainable or ESG investments as if they were something very different than the market as a whole. In the ESG world there's a range of instruments, some of which are so similar to the overall market that it's difficult to understand the difference, if any.

Let's have a look for example at Europe, where ESG and sustainability are much more advanced: by comparing the Stoxx 600 versus the Stoxx 600 ESG in the last two years we can see no performance difference. Only 15 out of the 600 stocks of the main index are excluded by the ESG index.

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The flood of investments into ESG vehicles pushed all companies to pay more attention to environmental, social and governance factors to avoid being excluded by the investors' portfolios. As a result, what a couple of years ago was an ESG European equity fund is slowly morphing into a common European equity fund, and this can be guessed also by the number of existing vehicles that 'change' to ESG: one may think that their investment strategy is not changing substantially after all.

Is this what an investor would expect when we talk of sustainability? Or would he expect something about solar, wind, hydrogen energy sources, electrification, batteries, waste recycling, digitalization, building renovation, gender and diversity parity, etc? Perhaps we should make an effort to differentiate more the generalist funds that include ESG principles (so-called art. 8) from the specialist funds that aim to make an impact (so-called art. 9) according to the SFDR.

After the Russian invasion of Ukraine one of the topics was the comeback of sustainable investments; however we have seen that the Stoxx 600 ESG followed closely the Stoxx 600. Even more selective benchmarks such as the MSCI Europe ESG Leaders have behaved similarly to the generic MSCI Europe, while some difference can be seen in one of the most selective indexes, the MSCI Europe SRI. Still, these are small differences compared to those themes that will help us attain the net zero objective by 2050, such as alternative energies, well represented by the S&P Clean Energy index.

	Performance 24 Feb - 9 Mar 2022
MSCI Europe Index	-4.12%
MSCI Europe ESG Leaders	-3.66%
MSCI Europe SRI	-1.84%
S&P Clean Energy	23.54%

Source: Bloomberg

The alternative energies theme is the heart of the energy transformation chased by Europe, and that has become a priority with the invasion of Ukraine as it's the only way for our continent to reach independence from the Russian oil and gas and, at the same time, reduce CO_2 emissions. But it's not the only theme. Other sectors, such as the building renovation, didn't perform as well in the period shown in the table. On the contrary, one could say that while renewable energy has dropped on average by 50% from January 2021 to the invasion (as measured by the S&P Clean Energy), the building renovation companies has seen an extraordinary 2021 with average performances of +50% thanks to the incentives of the Next Generation EU program, which aims at trebling the renovations from 1% to 3% p.a.

Today the huge difference between MSCI Europe and S&P Clean Energy is almost halved, while building renovation dropped by 25% in 2022. The reasons are the same that are affecting all companies in these times of market turbulence: increase of commodities (energy in particular) prices, rising rates, supply chain issues and delayed projects delivery. And those multiples inflated in the wake of reform euphoria get deflated by the fear generated by all these issues.

As we highlighted more than once, art. 8 and art. 9 funds tackle the issue of energy transformation at different speed, but the former are slowing down versus a broad market more and more ESG-aware and compliant. The latter, on the other hand, continue on their path driven by specific themes, which however may rise and fall at different times.

With the new **Repower EU** program unveiled on May 18th, Europe keeps pushing on energy transformation: a**dditional investments for 300 bn** to step up the targets already upsized with the Fit for 55. The three main targets involve short term needs (diversification of gas sourcing), medium term goals (pushing on renewable energy) and one that will depend on the habits of European citizens and their ability to use energy more efficiently. Lacking this voluntary effort, the possibility of an energy rationing could prove a more powerful incentive.

While the short-term goal is to reduce Russian dependency by two thirds by the end of the year, the medium-term goal is to be completely independent by 2027. This will be achieved **by increasing the target for renewable energy from 40% to 45%**, that for **green hydrogen electrolyzers to 17.5 GW by 2025** (the original Green Deal target of 6 GW looked already ambitious), and with a **greater energy efficiency coming from building renovations and transports electrification** (more details here).

For an art. 8 ETF that follows a generalist index is difficult to follow all these themes: hydrogen and solar pure players, for example, are small and medium sized companies not included in the Stoxx 600 ESG. There are of course ETFs that follow some of them, with the added issue of managing the volatility in the various market environments. The alternative is to invest in actively managed funds, that can be themselves art. 8 or art. 9 with different shades of green.

According to Morningstar, less than 5% of mutual funds were art. 9 at the end of 2021, while art. 8 funds represent almost 40% and some of them, as we discussed in the past, have simply “migrated” their prospectus from their pre-SFDR life.

It’s up to the investor to choose the theme(s), the vehicle(s) and the shade of green.