Long/short investing

in a global transition to Net Zero

Panel

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Edoardo
We're going to be focusing on long-short investing in a world transitioning to net zero. And more specifically, investment strategies where sustainability meets alpha generation from an absolute return standpoint.

It's clear that the world is going through a major inflection point, where the cost of energy transition is going to be felt not only by the broader industrial complex, but very much by consumers.

I live in the UK, and the cost of energy, electricity and heating is approaching roughly 10% of the average household's disposable income. This is probably three times what it was just a year ago, so it's an incredible tax on consumers and a massive challenge for governments, not just in the UK but around the world. That is causing some discussion around transitioning to a lower carbon world.

So, to start the discussion, how do you see the path to net zero evolving from here?

Brendan
Governments and corporations generally want to get to the same place, but the path is not going to be linear. Some of the fossil fuels that a lot of the market wants to dismiss need to be around for a little longer than expected. What we're seeing, I think, with the Ukraine-Russia war is really just kind of an exacerbation of that circuitousness.

In Germany, the topic along with the elections late last year was about phasing out coal even faster than the original plan of 2038. People were talking about 2030. Now the conversation has changed to 'Well, we need power, and how do we keep these plants around? And how do we keep prices lower?'

You see the same conversation in Italy where some coal plants have had some life extensions, and we're seeing the same thing in the US, of having to extend coal plant life.

So we are rethinking the process, but we think that the place you're going to is the same.

The US, a predominant supplier, and other places around the globe are trying to fast-track liquefied natural gas (LNG) export facilities to help places like Europe get off their reliance on Russian gas. Those are some investment opportunities.

You've seen various governments take different actions to cope with high energy prices. In France, there were price limits on consumer power. But I think that it comes back to the same place that we'll get to from a net-zero perspective. And I think that the Russia-Ukraine war drives the point home even more. This all creates a lot of dispersion and opportunities in the stock market.

Solar and wind has been a key piece of the transition to renewables. And we've seen missteps there too. For example, Southeast Asia supplies around 97% of solar panels. In the US, trade policy issues relating to antidumping and countervailing duties coming out of that region have effectively put a stop on all imports of solar panels. So the US is trying to move forward with solar, but people can't get the panels. And this is all layered on top of the normal supply logistics issues we've been seeing over the last 18 months.

There's a lot of bumps in the road. There's bridge fuels. There's power bills. It's all making it more complicated. And that creates opportunities from a long-short investing perspective.

Edoardo
We talk about the pace of the transition and that we're going to get more or less in the same place where we want to be, let’s talk about the other biggest contributor to net zero – electric vehicles (EV). What is slowing the pace of EV penetration?

Ryan
The potential for commodity inflation is something that we have flagged since we started the strategy in 2020. The supply and demand imbalances are particularly acute, and we think this is starting to weigh heavily on many sectors, but particularly the automotive sector. So since inception, we've been very positive on this mosaic of EV penetration over the long term, and there are primarily four factors that we've focused on.

The first and most important factor is the very favorable and active regulatory environment. In Europe, we're seeing outright bans of diesel cars over certain time frames. China has subsidies for EVs. And there's been some back and forth in the US, but one common thread is that we've seen consistent momentum from the EPA and from the California Air Resources Board generally rolling in the same direction for fuel economy standards

The second reason that we've been positive on EV penetration for the long term is the abundance of new vehicles, not only from established legacy automakers, but also from a lot of really innovative, new EV makers.

We also anticipate a very aggressive EV infrastructure build-out. We think that's jump-started by infrastructure funds that are going to be released over the next 1 to 2 years, particularly in the US but also in Europe and China.

And then finally, one observation that we've had is an evolving consumer preference for sustainability broadly with the younger generation in particular being very receptive to the climate agenda. We think they will be very interested in buying EVs as a way to vote with their wallets.

While we're very constructive on EV penetration over the long term, we've been increasingly concerned about two dynamics that could create negative revisions to EV penetration over the short term.

The first is what's going on with certain commodities prices, specifically battery inputs such as nickel. We are very concerned about a battery shortage. There is tremendous demand for batteries in a lot of different applications, and the automotive sector is going to be vying for these batteries.

The second near-term concern is high EV prices. We have strong views on EV penetration over the long term, but we are also very cognizant that this path will not be linear. We believe that in order to optimize returns for investors in our strategy, it's extremely prudent to run a portfolio that has both longs and shorts.

And stepping back, we think the automotive sector is a fantastic example of an area that is experiencing the most change it has in many decades with new winners and losers emerging, and an opportunity set that's very rich on both the long and short side.

Edoardo
Do you think the current infrastructure for charging points and everything else is sufficient to sustain the pace of penetration of EV?

Brendan
If you think about the way the grid was set up originally, there were huge central dispatch stations for electrons to flow to the load centers, but now the whole system is being rethought.

If every third home has an EV inside that's either pulling more electrons or, in fact, maybe even pushing electrons back out to the grid, or if you have rooftop solar, that creates the need to rethink how that grid works. And in a lot of places the grid is quite old, and it's not cheap to fix.

Another factor is that this energy transition has a lot to do with the climate. We've seen the floods in Germany and the wildfires in California, for example. So they have to re-retrofit all of these grids for these conditions. In northern California they're looking at undergrounding 10,000 miles of line, which is a huge undertaking and a big opportunity for some of the infrastructure funds that we look at. There's a lot of different pieces of the investment horizon across utilities, industrials, engineering, a lot of different places where companies are going to take advantage of these investments that need to happen.

This all ties back to what you brought up at the very beginning, which is the bill, right? And so when we look at the consumer's bill and people paying for this, this is becoming a bigger piece of the wallet, a bigger percentage of their disposable income. Everyone wants to do this and wants to do it as fast as they can for energy transition, but there's a pretty significant cost here. For most of the consumer bills, the commodities that we talked about earlier go straight to the consumer, and that takes up an even bigger piece of the bill. That ties back to our 'not linear' thesis.

Edoardo
As you look at investment opportunities, where do you find the best opportunities that can marry, if you like, security and sustainability at the same time? What other areas are we thinking about?

Brendan
Ever since Fukushima [the 2011 earthquake-triggered disaster at Japan's Fukushima nuclear power plant] everyone has said 'I don't want nuclear.' About 50 miles outside of New York, the Indian Point nuclear power plan has been put into the process of retiring, and that supports probably 50% of the load for New York City. But today, nuclear has seen a revival of interest.

We have seen support for small modular reactors, something that's been around a long time, that you could put in very rural areas to provide very clean, cheap, long-term power for places that aren't necessarily connected to the grid. We're seeing a revival of interest in nuclear power across the globe.

Edoardo
That makes sense. So changing gear for a second to higher inflation and the impact of deglobalization and reshoring of supply chains, a process that really started a while back and accelerated with the COVID-19 lockdowns. And now geopolitical tensions are accelerating the process. Do you think this presents a once-in-a-generation opportunity to decarbonize supply chains and therefore have a major impact on the speed of reaching net zero, at least from an industrial production point of view?

Ryan
We believe that decades of underinvestment in company-level CapEx and infrastructure have contributed to today's supply chain issues. And decarbonization policies across the world have just amplified the need for a significant amount of CapEx over many years.

More importantly, there's an interest in not having certain countries controlling either key inputs or goods. Battery manufacturing is an example. Today, it's controlled by Asia, and both Europe and the US have a strong desire to reshore battery manufacturing.

One of the most important observations is how easy it is to underestimate the CapEx associated with battery manufacturing when you not only include the battery factories, but also the upstream mining, the refining, the modernization to the grid that's required, that Brendan has outlined, the EV infrastructure that's required, and then the battery recycling facilities that are also required in that entire ecosystem. We strongly believe that we're on the cusp of a battery CapEx supercycle, and on top of that we think that there's an incremental trillions of dollars of CapEx that's associated with this confluence of reshoring, decarbonization, and repairing and improving supply chains that you've hinted at.

In our strategy, we generally look for less obvious ways to express these views. One area that we're currently very excited about is the group of companies that are operating on the front end and enabling this green CapEx. We believe that companies that are deeply involved in engineering, in environmental permitting and consulting for green CapEx are poised for very strong organic growth, margin upside with limited change in capital intensity leading to significant free cash flow generation over many, many years. And it's a group that's not very well covered by Wall Street. I think it's a confluence of reshoring, decarbonization and supply chains, and we have very creative ways to express that view in our strategy.

Edoardo
The final topic is your research focus. When you look at industrial production techniques and innovation, give us an example of some of the most interesting advancements you see today.

Ryan
One key pillar in our strategy is a focus on energy efficiency, which is among the lowest cost means to reduce emissions and should be an essential part of any net-zero scenario. A good case study is HVAC, heating, ventilation and air conditioning. HVAC equipment represents the largest energy pool in a commercial building, and commercial buildings represent a huge percent of global emissions. Innovations there can often drive a

significant improvement in our pursuit of net zero. And we see a lot of really interesting innovations in HVAC, such as new refrigerants, new high efficiency heat pumps, and digital solutions in terms of building controls that can drive a wholesale improvement in energy efficiency for commercial buildings.

In the manufacturing arena, historically there's been a lot of focus on automation driving energy efficiency. For the most part, this has meant automating one or two lines in a factory. We think the next phase is automating multiple lines in a facility, connecting those lines, and then connecting factories. And that's facilitated by digital solutions that include sensors, connectors and software, which has been facilitated by rapid advancements in connectivity, such as 5G, data gathering, real-time data processing, supercomputers and cloud computing. Energy efficiency is a key investment pillar in our strategy and there's numerous ways that we can express that in the portfolio.

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