foundation & endowment money management

Investors Warm To Climate Change, Energy
- 12/27/2007

Approximately 31% of 100 university endowments recently surveyed by the **Sustainable Endowment Institute** said they would be making investments in renewable energy funds in 2008, a huge spike from the 9% who said they would in 2007. Renewable energy and climate-related investing are set to become mainstream allocations, but what is the appropriate investment structure for nonprofits? *FEMM* recently spoke with **Michael Murray**, head of the foundation and endowment group at **UBS Global Asset Management**; **Neil Suslak**, managing director at **Braemar Energy Ventures**; **Mikan Van Zanten**, a partner at **Robeco Private Equity**; and **Mark Nydam**, a managing director at **Pacific Corporate Group Asset Management**, about the future of climate change and renewable energy investing.

FEMM: *What is most compelling today about climate-related investing, and what has changed most at the level of institutional thinking?*

Mark Nydam

Nydam: The real impetus from the institutional side is the belief in a fundamental shift caused by climate change that will influence performance across industries and economies. Many investors believe they need to be exposed to the space to maintain their fiduciary responsibility. In terms of business fundamentals, it is no longer a world in which oil prices will likely ever again reach a floor of $20-30. The floor is now $45-50 for oil. That has changed the game in energy investing and makes alternative energy much more attractive.

Murray: There are three things driving this: increased awareness about sustainability; increasing demand from shareholders and trustees; and the fact that investors have the tools to overcome what was largest of the objections, the idea that they gave up returns when investing in a sustainable way.

Mikan Van Zanten

Van Zanten: The growth of wealth around the world and the resultant consumer demand is much higher than oil saving, and the production of oil in the Middle East is close to limits. Oil companies can always try to take more

out of the ground, but as they have said, at some point the production costs will increase significantly and pricing can't go back down. We don't believe oil prices can ever revert to low enough levels that would stall the development of clean technology. Even if oil prices drop a little, renewable technologies will remain cost competitive.
Given that 50 to 80 renewable energy funds are being raised a year, investors have time to orient themselves. Even if they don't make that one fund that comes through the door at any given time, they can afford to take an extra six months if they need it.

FEMM: *What are the unique risk factors in this asset class?*

Nydam: There are still relatively few funds-of-funds in existence that package together clean technology funds which, on their own, may have too high a risk profile. At the level of direct investing in funds, few managers already have one or two clean energy funds under their belt. There are a very large number of venture funds coming to market in the near future, but from an institutional investor's perspective, it is hard to make the case to invest in first-time funds. That said, we are now entering a point in the sector's cycle where the early stage risks related to whether some technologies would even work or whether the market will accept these technologies have been mitigated.

Van Zanten: I don't think investors intrinsically run different risks with a clean technology portfolio than in any another type of private equity portfolio. In private equity, a key risk is not being diversified. The ultimate driver of the clean technology space is the number of people on the planet and increased wealth leading to more energy consumption. That is not highly correlated with drivers in other venture capital and private equity markets, such as information technology and biotechnology. Clean technology should perform better during periods of resource constraints while other private fund sectors generally slow in terms of growth.


Neil Suslak

Suslak: The biggest risk is a manager not appreciating the dynamics of the energy sector. Regulation is also a big issue, not so much at the company level, but it can shift corporate spending and customer response. There isn't a long history of track records, either. Valuations have also crept up across a range of opportunities in the energy sector, and that is something to pay attention to, though for the most part valuations are still fairly reasonable. We are focused on energy, which sounds narrow, but the industries we are targeting are some of largest in the world, including the power industry, and the fuel side and transportation side of power delivery.

FEMM: *How should institutions access climate change strategies and what level of allocations being made?*

Nydam: For smaller institutions, the fund of funds approach might be best because clean technology is such a broad space, and can be subdivided into eight or nine sectors, each a complicated space to play in. A fund of funds also allows the investor to diversify between growth stage and venture stage companies in the sector, so a portion of returns will have the profile more typical of venture capital, while also remaining risk-diversified, and diversified in terms of the liquidity profile of portfolio holdings. Fund of funds can also selectively pick higher-returning, co-investment opportunities.

Van Zanten: Most institutions view clean technology as part of their private equity portfolio, and allocations depend on what extent they are comfortable with the sector. If you look at the overall venture space, clean technology is 12% of dollars being put to work. To some investors, that is already sufficient. However, others believe that because the return drivers are so strong for clean technology, investors need to take on more than what they would gain from a 12% slice of an overall venture capital investment bucket. We believe clean technology returns will compare favorably to the wider private equity market.

Suslak: We've been in energy technology since the early 1980s, and historically it was large energy companies that provided the venture capital money. It is only in the last few years that institutions have also seen the opportunities to make lots of money in these funds. Our most recent fund had a high level of institutional interest, all from institutions that are traditional players in the venture world. Not all have committed to the sector yet, but all are actively looking. Foundations and endowments have been a little longer in their review process than pensions, and our most recent fund was raised so quickly that many nonprofits could not make the decision to invest in time. But many foundations and endowments are reviewing the sector actively.


Michael Murray

Murray: The portfolio diversification available through sustainable investing is evolving rapidly. Most nonprofit institutions are still interested in making maiden investments in a core equity asset class, whether it be domestic or global. Our primary focus has been in the area of long-only equity funds, but we are examining expanding these offerings. Going forward, our climate change effort may include not just long-only, but large-cap, small-cap, fixed-income, and some hedge fund portfolios and private equity. The benefit of non-correlation in all of those asset classes is very well established inside modern portfolio theory. What is new is the ability to execute in all those

areas on a sustainable basis. The bottom line is that there are enough investment opportunities on the horizon to meet most risk/return profiles.

FEMM: *How should investors weigh the balance between investing for pure returns and investing as part of social policy?*

Nydam: Institutions need to think of this story from the financial return standpoint. Investors can still get double bottom lines, and in our funds we measure the environmental benefits from a quantitative standpoint; that is a secondary, however, to the primary focus of generating healthy returns. We are at what I would describe as the commercialization phase for many clean technologies. Many companies' new technologies have been proven, and these companies now need growth capital. The institutional investor universe could be an important source of pre-IPO capital. It could be a nice marriage between what the clean tech space needs in terms of capital to build plants, and what institutions are used to providing in the hundreds of millions of dollars, and ultimately, the returns that these investments can generate.

Suslak: In the venture capital world, what has changed dramatically is the range of institutions looking at this as a pure investment opportunity and a way to outperform existing portfolios, as opposed to helping society. That has opened up the category to virtually any institutional investor in the world. There are some very large global companies focused on sustainability, and while institutions may support the view that stock prices may do well as a result of a focus on climate change, they also tend to believe that the dramatic performance will be among smaller companies finding solutions to big issues in the private fund format. We are expecting the upper end of venture returns over the next five to 10 years.

Murray: Investors should use three themes as the blueprint from sustainable investing, whichever asset classes they employ. These are climate change, water, and demographic changes, including nutrition, health and education. We've seen outstanding returns in public equities. Our *Eco Performance* large-cap portfolio is up 9.87% for 2007 through November, and our smid-cap *Innovators* portfolio is up 42.74%.