Exclusions Don't Solve the Problem

Stockholm (HedgeNordic) – Microsoft founder Bill Gates recently told the Financial Times that divesting fossil fuel stocks from portfolios "will not heal the planet and it won't stop climate change." Vidar Kalvoy and Joel Etzler *(pictured)*, the duo managing the recently-launched **Coeli Energy Transition**, agree and emphasize that engagement with management teams is a better strategy.

Launched in mid-August, Coeli Energy Transition is an equity market-neutral energy impact fund that pursues two main objectives. First, capitalize on the high dispersion between energy stocks caused by the energy transition in a market-neutral manner. Second, influence fossil fuel companies to take the right path, reduce their carbon footprints and more importantly, allocate more resources to alternative energy. "Our market-neutral approach to capitalize on high dispersion and the strong commitment to always be net short fossil fuels is what makes our fund different," Etzler emphasizes. "We want to capitalize on and facilitate the energy transition."

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Two-Fold Objective: Dispersion and Impact

As Vidar Kalvoy explains, “stocks in the energy space used to be characterized by very high volatility but low dispersion ten years ago.” In the last five years, however, correlations between oil and sub-sectors in the energy space have declined. “Today dispersion in the energy sector is head-to-head with healthcare and ahead of technology, which used to be the best two sectors for market-neutral vehicles,” Kalvoy emphasizes. The key driver of the high dispersion between energy stocks has been the energy transition. “The energy space has become “sexy” because of dispersion, so our goal is to take advantage of that.”

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Etzler further emphasizes that “the energy transition has fundamentally changed the investment patterns within the fossil fuel space.” The fear of stranded assets has resulted in a big shift from long-cycle investments towards more shorter cycle projects characterized by smaller investments with faster payback time. “This results in shorter oil price cycles or more oil price volatility and has created this fantastic market-neutral opportunity,” explains Etzler. “You will be reluctant to build something in coal or oil that has a payback of 15-20 years when you do not know what the carbon tax or the political landscape will be like,” he argues. “The fossil fuel companies need to change, and not only due to the climate crisis, but also out of economic self-interest.”

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Kalvoy and Etzler are trying to send a loud and clear message: “investments in renewables alone is not enough to save us from global warming.” Fossil fuels account for more than 80 percent of current energy consumption, whereas renewables cover less than ten percent of the energy demand. “The best opportunity to impact and help the world is within the fossil fuel space,” Kalvoy points out. “Although renewable energy might double in the next five years, it is still not enough.” Significant changes need to take place in the fossil fuel sectors to slow down and stop the global warming process.

“The fossil fuel space is also where is the biggest opportunity to profit from the energy transition,” says Kalvoy. According to a report led by researchers from the United Nations-backed Principles for Responsible Investing, the almost $50 trillion global MSCI ACWI Index is poised to lose $2.1 trillion of market value as a result of climate change. This will only partly be offset by an expected $500 billion of value added to green companies. “A market-neutral fund with a commitment to be net short the fossil fuel space at all times makes sense in the long run,” argues Kalvoy.

Impact investing is also affecting the largest fossil fuel companies. Late last year, Royal Dutch Shell announced that they would include so-called Scope 3 emissions in their carbon emissions targets. Scope 3 emissions include the emissions from the burning of fuels sold to customers around the world. In June last year, however, the company had stated that taking responsibility for Scope 3 emissions implied too much litigation risk. The Climate Action 100+, a group of investors with more than $32 trillion in assets under management led by Church of England’s Pension board, were not satisfied and lobbied Shell’s management. Months later, Shell changed course, and today executive bonuses are linked to the emission targets. “Would that have happened if everyone employed an exclusion strategy?” asks Kalvoy. “No. This is a great example of how investors can have an impact.”

Of course, larger investors can assert more pressure on companies. Still, Etzler reckons that “it is not difficult to influence companies even as a relatively small fund.” Raising your hand at conferences and asking fossil fuel companies “why you do this and why you do that” is one way of asserting pressure as a small investor. “If you are a well-respected investor and you start asking questions point-blank, you get companies’ attention and they start listening more carefully,” argues Etzler.

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Being supportive of the management teams embracing the energy transition is another way of facilitating the energy transition, reckons Kalvoy. “Some investors still balk at oil majors investing in renewables with expected IRRs of 10 percent versus fossil fuels’ that are more than 20 percent. We are there to support

management and to highlight how uncertain the fossil fuel IRRs are," he explains. "You are betting on the current framework staying unchanged, which is highly unlikely."

Technicalities

Coeli Energy Transition is an equity market-neutral fund that seeks to generate risk-adjusted returns that are uncorrelated to both the market and commodity price risk. Equally important, the fund commits to maintaining a negative exposure to the fossil fuel industry at all times. To find the long and short ideas for the portfolio, "the first step of the fund's investment process is the idea generation and screening process that consists of a top-down and a bottom-up approach," explains Etzler.

"In the top-down industry analysis, we do a lot of modelling of supply and demand in different sub-sectors," says Etzler. The energy space comprises more than 30 different sub-sectors with very different cycle dynamics. "This is a very asset-intensive industry, and some sub-sectors rely on assets that might last for more than 20 years while others may have assets that last less than five years," elaborates Etzler. The Coeli duo analyzes the supply and demand characteristics of those sub-sectors to find the ones with the best supply-demand dynamics going forward and the ones that are over-supplied and losing pricing power. "Then, we perform a bottom-up analysis to find the best and the worst in each sub-sector, followed by a traditional fundamental company analysis to identify the individual stocks."

The portfolio consists of about 60-80 stocks divided over about ten themes, where each theme is a play on a structural shift in supply or demand. "A theme has to fit into the overall portfolio, where we aim to be neutral in dollar-, market beta- and oil beta terms," explains Kalvoy. "Portfolio construction is as important as picking the right stocks in a market-neutral fund," he ends.