

What are the implications of a falling oil price on a green global equity fund?

The oil price has fallen by 40% since June, which have had a negative effect on the oil industry as well as the renewable energy sector as the incentives for substitution have diminished. We still believe that renewable energy is a strong long-term investment, but are cautious short term. Due to the unconstrained allocation mandate of CB Save Earth Fund, we were able to reduce our exposure to renewable energy to 1% in October in favor of water treatment and cleantech.



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The strong returns of renewable energy, cleantech and water treatment since the summer of 2012 has resulted in an increased interest for environmental investments – which we have always believed is a strong long-term investment – as well as our strategy, the green global equity fund CB Save Earth Fund. On the back of the solid performance of the sector, investors have started to question how/if fossil fuels – primarily in terms of large oil companies, i.e. “big oil” or “oil majors” – fit in a (global) stock portfolio. The discussion has mainly been driven by the concern of “stranded assets”.

The risk regarding “stranded assets”

The concept of stranded assets refers to the risk that oil companies' oil reserves will suffer from great devaluation or even be rendered worthless. There are multiple reasons for this: climate change might cause problems for the extraction of oil reserves due to extreme weather or water shortage; new legislation might prevent oil extraction, for example, there is a contradiction with oil companies extracting all their reserves while the world will at the same time meet the 2-degree target; sharply falling prices on competing energy sources such as solar and wind power give rise to substitution of oil, see Figure 1; social norms and trends such as electric cars and decentralized power generation (the latter is also a threat to electric utilities, cf. E.ON's reorganization).

The history of energy production predicts a paradigm shift

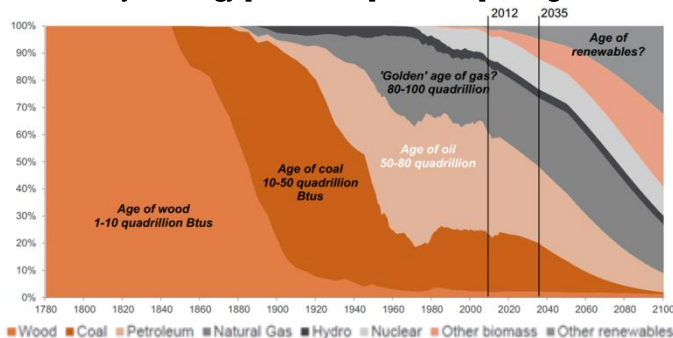


Figure 1. Historically, new technologies have substituted their precursors, not complemented them; old technologies (fossil fuels) are experiencing rising prices and loss of accessibility while new technologies are becoming cheaper and easily available, thus substitution. Source: Citi Research, CB Fonder.

The oil price is falling sharply

A new and current risk is the sharply falling oil price – the second largest the past 10 years, see Table 1 – caused, partly, by increasing supply (primarily as a result of shale oil in the US) as well as a flattening trend in demand. The slow demand is partly a function of weakening growth in China and low growth (at best) in Europe, and partly due to energy efficiency and substitution from fossil fuels to renewable energy. Figure 2 illustrates the price of solar energy since 2007; the price has fallen by roughly 85% and solar energy is now a serious competitor to fossil energy in countries where the majority of the world's population lives, which are highlighted in green in Figure 3.

Another important aspect is that the cheapest unit of energy is the one you don't use; energy efficiency has gained much ground in recent years. For example, the U.S. vehicle fleet's fuel consumption is expected to roughly halve over the period 2000-2020. A similar development is expected in China (International Council on Clean Transportation, 2014).

The price of solar panels has fallen substantially

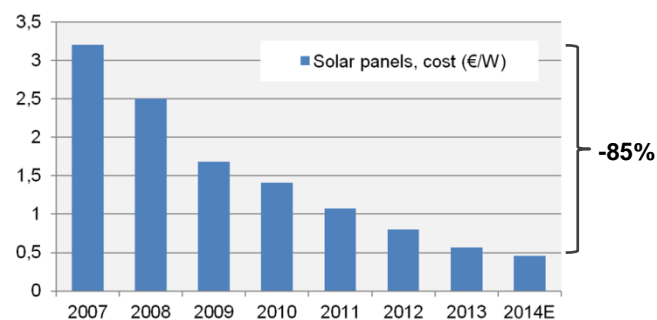


Figure 2. Technical development and industrialization has contributed to a price drop of solar energy of 85% since 2007. Source: UBS, CB Fonder

Solar energy is now competitive, even without subsidies, in countries where the majority of people live



Figure 3. In the countries highlighted in green solar energy is competitive to conventional energy, even without subsidies; for the countries highlighted in red, the opposite holds true. The remaining countries have not been analyzed. The yellow boxes show population and the size of the percentage savings with the use of solar energy compared to conventional energy. Source: Bernstein Analysis.

Our allocation in relation to the oil price

CB Save Earth Fund has an unconstrained allocation mandate for investments between the sectors renewable energy, cleantech and water treatment. We have, since fund inception (June 2008), been underweight in renewable energy compared to cleantech and water treatment, which still holds as of today, see Figure 4. Our main reason for underweighting renewable energy has been the lack of competitiveness and thus a high dependence on governmental subsidies. A substantial drop in the price of renewable energy – and hence a reduced dependence of subsidies, see Figure 5 – has given us reason to be more optimistic about the sector during the last 12 months, but as a result of the sharply falling oil price since June we have had to reassess our view, at least in the short term.

Historical sector allocation for the fund, 36 months

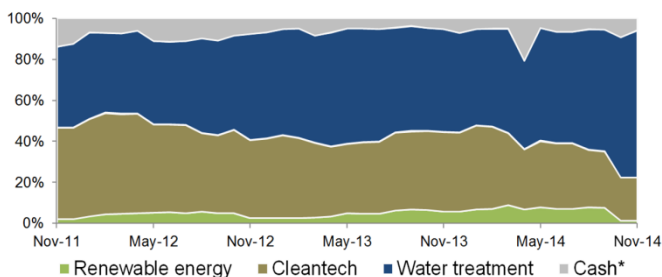


Figure 4. The historic sector exposure of CB Save Earth Fund shows that water treatment and cleantech have been dominant throughout the period. Due to the falling oil price, we chose to reduce our exposure to renewable energy to 1% in October. Source: CB Fonder.

Share of unsubsidized solar energy, 2008-2015E

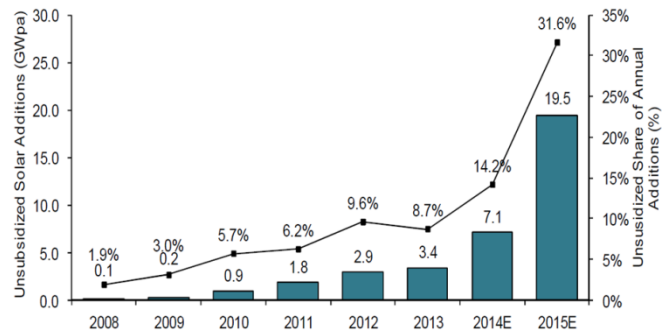


Figure 5. Proportion of unsubsidized solar energy, 2008-2015E; share of annual unsubsidized additions and total additions respectively. Falling prices increase the competitiveness of the sector and allows it to stand on its own feet: in 2008, new additions were almost exclusively subsidized; in 2015, every third solar addition is expected to be unsubsidized. Source: Bernstein estimates and analysis.

Table 1 shows the four largest drops in the oil price, in USD, over the past 10 years as well as how each sector (renewable energy, cleantech and water treatment) have performed relative to the MSCI World index over the same period. The trend is clear: renewable energy has underperformed each time when the oil price has fallen while the water sector has performed in line with the MSCI World index. Although cleantech has had a tendency to underperform during times of falling oil prices, it has always performed better than renewable energy.

Table 1. The table shows the four largest drops in the oil price (in USD) over the past decade and the performance of each sector relative to the MSCI World index over the same period. Source: MSCI, S&P, Reuters, CB Fonder

Period	Oil price	Relative performance vs. MSCI World		
		Renewables	Cleantech	Water
1. 2008-07-03 - 2008-12-19	-76.69%	-29.59%	-16.26%	0.39%
2. 2011-04-29 - 2011-10-04	-33.58%	-30.00%	-15.28%	3.62%
3. 2012-02-24 - 2012-06-28	-29.22%	-16.85%	-9.70%	3.27%
4. 2014-06-20 - 2014-11-28	-38.33%	-12.79%	-10.60%	-4.87%

Due to this, we reduced our already low exposure to renewable energy in October (current exposure: 1% of assets under management) and shift our allocation further towards water treatment (72%) and cleantech (21%), see Figure 4. We are overweight in water treatment for several reasons, of which the main ones being: the sector is fairly uncorrelated with the oil price, see table 1; a large part of the water treatment sector consists of water utilities – regulated monopolies that transport water from point A to point B – with very stable performance and dividends, the latter being an increasingly attractive characteristic in the current climate of low interest rates; and that the sector has a historically very appealing risk-return profile, see Table 2.

Energy efficiency dominates our exposure within cleantech, due to the fact that the cheapest unit of energy is the one you don't use, irrespective of the oil price. Unlike renewable energy, the sector is mature and the current technologies often result in significant savings even over short time horizons; companies offer "low-hanging fruit" to their customers.

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Share prices and values may increase or decrease and investments are always associated with a risk of loss. Past performance is never a guarantee for future performance.

Table 2. The table shows that the water sector have performed very well compared with the respective sector within the MSCI World index; it has had the highest return and the third highest Sharpe ratio over the past 10 years. Source: Reuters, S&P, MSCI, CB Fonder

Sector indices	10 years, annually (EUR)		
	Performance	Std dev	Sharpe
S&P Global Water Index	11.4%	14.0%	0.81
MSCI World Consumer Staples	11.2%	10.2%	1.09
MSCI World Health Care	11.1%	11.2%	0.99
MSCI World Consumer Disc.	8.8%	15.2%	0.58
MSCI World IT	8.7%	16.2%	0.53
MSCI World Industrials	7.9%	15.1%	0.52
MSCI World Utilities	7.1%	11.4%	0.62
MSCI World Telecom	7.0%	11.7%	0.60
MSCI World Energy	6.9%	18.3%	0.38
MSCI World Materials	6.9%	18.5%	0.37
MSCI World Financials	2.3%	18.8%	0.12
MSCI World	7.3%	12.5%	0.58

Why CB Save Earth Fund?

CB Save Earth Fund offers a low risk alternative within a segment characterized by high risk. This is made possible by the Fund's unconstrained allocation mandate, where the more mature sectors of water treatment and energy efficiency has made the low risk profile of the fund possible. Figure 6 illustrates the excess return for each sector against the MSCI World index over the past 10 calendar years; none of the three sectors have consistently outperformed the MSCI World index, but each year (with one exception during 2011) at least one of the sectors have outperformed the MSCI World index. "Buy and hold" strategies have proven to perform badly when applied to renewable energy, which is made evident by the current drop in oil price. CB Save Earth Fund provides protection against a falling oil price, but also against what may become a long and cold winter for the renewable energy sector.

Each sector's excess return against the MSCI World index, per calendar year since 2004

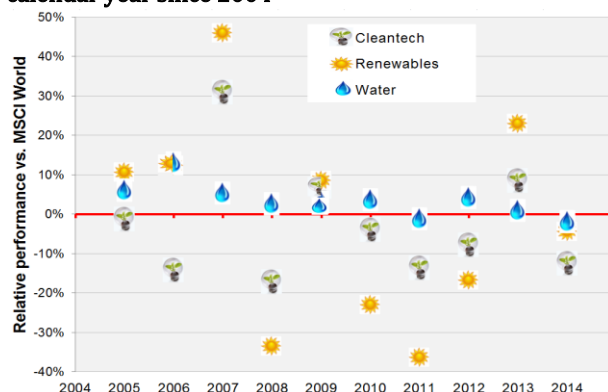


Figure 6. Each sector's excess return against MSCI World Net per calendar year, as of November 2014. None of the three sectors have consistently outperformed the MSCI World index, but each year (with one exception during 2011) at least one of the sectors have outperformed the MSCI World index - thus, the case for active allocation. Source: Reuters, S&P, MSCI, CB Fonder