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NORDIC SUSTAINABLE INVESTMENTS

Round Table Discussion
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insights

THEMATIC STRATEGIES

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a prismatic challenge

Aline Reichenberg Gustafsson, CFA
Editor-in-Chief
NordSIP

Most professional investors are used to looking at their global equity portfolios through a couple of convenient prisms. Sectors and regions have long been the preferred frameworks for allocating money. How do sustainable themes fit into this traditional equation? And is it time, perhaps, to look at allocating money in a more holistic way?

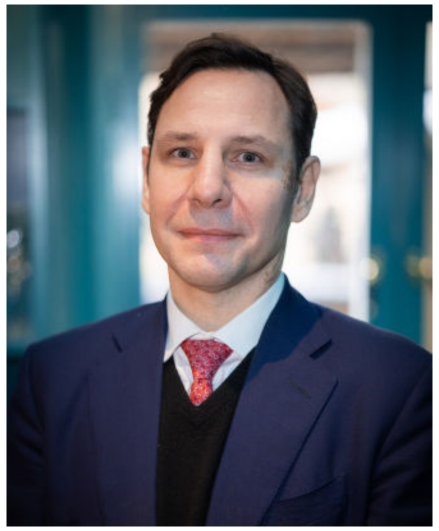
In the spirit of shaking things up and exploring the whys and hows of investing in thematic equity strategies, we gathered representatives from three Swedish institutional asset owners alongside two specialised asset managers for an intellectually stimulating (and delicious) lunch in Stockholm.

While savouring the first course, we tried to dissect the recipe that makes a great thematic strategy, magic ingredients and all. As always, tastes seemed to differ, with some of the guests preferring purity and others opting for mixing things up in a multi-thematic approach.

The discussion heated up as the main course was served. There was a healthy appetite for private market thematic investments among asset owners who were keen to debate equity strategies' potential impact. Offering some juicy arguments, the thematic managers were quite persuasive in demonstrating the various ways they could add value.

From dedicated biodiversity-themed products to new bikes, dessert offered plenty of original thematic thoughts. It may take more than lunch to change the global allocators' prisms but it certainly isn't difficult to see how a thematic approach can lead to sustainable and profitable investments.

who is who?



Bertrand Lecourt
Portfolio Manager, Head of Thematic Investment
Regnan

Bertrand Lecourt leads the Thematic Investing strategy at Regnan. Previously he was a Portfolio Manager at Fidelity International, where he launched and managed the Fidelity Funds. Prior to joining Fidelity International in 2018 Bertrand was a Portfolio Manager at Polar Capital and the founder and CIO of Aquilys Investment Management. Before moving to the buyside, Bertrand was Head of Equity Research, France at Deutsche Bank and a utilities analyst at Dresdner Kleinwort Benson and Goldman Sachs. He holds an MSc in International Finance from HEC School of Management, France, an MSc in Money, Banking and Finance from Birmingham University, UK, and a DEA in Monetary Economics from Orleans University, France.

Anders Landström
Head of Manager Research
Länsförsäkringar

Anders Landström has been the Head of Manager Research for the asset management division of Länsförsäkringar for almost a decade.

The team of dedicated manager selection specialists that he oversees is responsible for sourcing and monitoring the whole range of external products needed to populate the multi-asset portfolio of one of Sweden's biggest insurance companies.

After graduating from Uppsala University, Anders spent most of his career at Lansförsäkringar, dedicating himself to manager research and accumulating an enviable expertise in the field.

Ryan Smith
Fund Manager
Artemis Investment Management

Alongside Craig Bonthron, Neil Goddin and Jonathan Parsons, Ryan is part of Artemis' impact equities team and co-manages global equity funds focusing on positive impact, a field he has specialised in since 2000. Ryan joined Artemis in 2020 from Kames Capital, where he worked extensively on a range of ESG strategies, including the Kames Global Sustainable Equity Fund.

Following an MSc and a BSc, in 2000 Ryan joined what was then Aegon Asset Management as a SRI (socially responsible investing) analyst. In 2002 he was promoted to be Kames' Head of Corporate Governance & SRI; and then from 2015 Kames' Head of ESG Research.

Gabriel Lundström
Head of ESG Investments
SEB Life

Gabriel Lundström heads ESG investments at SEB Life, having joined the team in 2013 as a graduate trainee. Concurrently he sits as a chairman at UN Global Compact Sweden.

Prior to joining SEB life in 2013, Gabriel was a Board Member of Swesif.

Gabriel holds a M.Sc. in Business and Economics with a specialization in Management from Stockholm School of Economics and a B.Sc. in International Business from Uniwersytet Ekonomiczny w Krakowie, Poland.

Marcus Svedberg
Chief Economist
Folksam

Marcus Svedberg joined Folksam in 2022, as a Chief Economist. Prior to joining Folksam, Marcus worked at AP4 as an Investment Strategist. Previous positions include Senior Adviser at Stockholm Sustainable Finance Centre, Adviser to the Executive Director at World Bank Group and Chief Economist at East Capital Asset Management.

He holds a M.Sc. in Political Economy from London School of Economics and Political Science, and a BA in Politics and Economics from Stockholm University.

From left to right: Julia Axelsson, Anders Landström, Aline Reichenberg Gustafsson, Marcus Svedberg, Julia Roording, Gabriel Lundström, Patrick Aylwin, Bertrand Lecourt, Dylan Watts, Ryan Smith

Sustainability through Thematic Strategies

DoMa
Stockholm

23 November 2022

From global allocation to thematic strategies

Megatrends and growth opportunities linked to secular themes tend to go hand in hand with a fundamental sustainability belief. Could focusing on thematic strategies that capture such trends and target specific positive-impact areas present an attractive solution for sustainable investors who find themselves increasingly beleaguered by ESG sceptics? Is a thematic approach a viable alternative to a traditional global asset allocation and how do such products typically fit in an institutional or individual portfolio? And can thematic strategies really achieve attractive risk-adjusted returns in the long-term beyond the fads of certain sectors? NordSIP gathered representatives from three Swedish institutional asset owners alongside two asset managers specialising in thematic equity strategies to explore the subject in a relaxed and unconstrained manner.

Rising up to the intellectual challenge

"Today's discussion was sparked by a conversation I had with Bertrand Lecourt a few months ago when he was visiting Stockholm," the moderator of the roundtable, **Aline Reichenberg Gustafsson** starts off. "He challenged me by claiming that themes should take a much more prominent role in investors' global equity allocations. Later on, while catching up with Marcus Svedberg, I noticed that he was also intellectually intrigued by the idea. Today we have a great opportunity to explore this hypothesis."

Svedberg certainly recalls the conversation. "Just like for other institutional managers, a thematic approach for us is, normally, secondary to country or sector allocations," he explains. "So, when you [Aline] mentioned this idea of switching the order of priorities, my immediate reaction was to list up all the reasons why this would be very difficult to do. Then I stopped myself and decided to examine the thought properly. If we agree that thematic investments are a good idea, then it is worthwhile exploring how substantial an allocation to such strategies should be," he adds.

What complicates matters is that a thematic allocation often runs across regions and asset classes. Potentially, it also has implications for important metrics in the portfolio. "Confronted with a new thematic strategy, the first thing my colleagues would ask is whether they can fit it within their existing tracking error mandate," explains Svedberg. "Yet if the conviction of management or the strategist is strong enough, you could always adjust the mandate. It is not written in stone."

"For me, designing a thematic allocation is not just an intellectual exercise. I think it is worthwhile to think through how big it should be and what kind of themes we are talking about. From my perspective, it would be easier if the themes are broader," says Svedberg. "I appreciate being part of this discussion and I hope to walk away from here with a few more ideas on how to do it, and how to challenge our organisation's current practices."

"If we agree that thematic investments are a good idea, then it is worthwhile exploring how substantial an allocation to such strategies should be."

Does thematic allocation make sense?

According to **Bertrand Lecourt**, Portfolio Manager and Head of Thematic Investing at Regnan, investing thematically is simply a more efficient way to allocate capital. "For the past four-five years, I have had 1500 meetings in 25 countries with all types of investors and my experience tells me that the way capital is allocated is shifting," he says. "It is a systemic shift away from the traditional market-cap or style-driven allocation. And if you map the direction of this shift, you'll find out that a lot of money is moving towards a more holistic approach, looking along the whole value chain and focusing on sustainable themes."

It is very important how you define thematic investment, according to Lecourt. "I could talk about inflation, or oil price recovery as themes, but this is not what we mean by thematic investment," he explains. "A theme needs to have a few essential characteristics. It has to be global; it has to be broad, and it needs to be a part of a global story. Then there are some magic ingredients, too, such as purity, liquidity, and additionality. Once you've established all of these, then you can narrow a 15,000-stock universe down to 600 or 500 stocks," he adds.

"You need to make sure that your theme adds a significant diversification benefit, that it does not correlate with parts of, or the whole portfolio. You have to check that you are not simply creating another sector fund," advises Lecourt. "Investing in a great global theme which is perpetual in nature means you might have to move beyond benchmarks. You miss the point if you insist on a very low tracking error. A good theme should be a double diversifier, whether your traditional allocation focuses on sector and geography or on value vs. growth."

According to Lecourt, when European institutional investors allocate to thematic strategies, they face the choice of treating thematic investments as a satellite or integrating them in their core portfolio.

Either way, most investors go the multi-thematic course. The approach is gaining traction and such investments have tripled over the last few years.

Going multi-theme

Ryan Smith, who manages a multi-thematic fund at Artemis Investment Management – Artemis Positive Future – agrees with Lecourt's point about a systemic shift away from traditional allocations. "The structural change that we are witnessing is altering the traditional definitions of what comprises a sector, or an industry, or where a company is located geographically," he says. "An obvious example would be how autos relate to energy following the emergence of electric vehicles. There's a blurring of the two sectors and this is happening in other sectors as well. The traditional view of what defines a given sector is clearly shifting."

"We have chosen to approach thematic investing in a slightly different way. Running a multi-thematic fund allows us to access various themes, all related to sustainability. What is exciting about this area of the market is that themes are often demand-led rather than supply-driven. We invest in companies that are providing products and services that people need, that are demand-led, rather than supply constrained. Why? Because supply constraints can be short-term, cyclical and easily revert, whereas demand is typically more structural and long-term." remarks Smith. "We have to be very careful, though, when we define what a theme is. The financial industry has done what it always does with sustainability. It gets hold of an idea and it drives it to an extreme, which probably goes above and beyond what is acceptable. And then the risk of greenwashing arises," he warns.

"Ultimately, we are stock pickers. It is not enough to be exposed to a theme. Often within a theme, there are just a handful of companies that are successful, and even if the main reason they are successful is that they are exposed to that theme, they also need to be well managed, they need to have the right products and services, and the right strategy, etc. otherwise they may not be viable investments. You saw that problem arise in solar energy, for instance, and you are probably seeing it in wind right now. What has been good for society in driving down the cost of energy hasn't necessarily been a good investment. You still need to pick very carefully in the value chain and be mindful of which companies you are investing in," adds Smith.

A theme goes beyond asset classes

Thematic investing has evolved a lot over the years, according to **Gabriel Lundström**, Head of ESG Investments at SEB Life. "It used to be a very blunt, very basic strategy," he comments. "Now we are getting to a point where we need to start working hard, doing the same kind of analysis for this type of investments as for the rest of the portfolio. I think the starting point should be picking long-term strategies. There are challenges in the world that we need to address and there will be companies and projects that will be attractive from that point of view," he adds.

"However, there might be a bit of an over-excitement from investors regarding themes," cautions Lundström. "You need to consider valuations carefully. Green energy is a good example of how extremely positive valuations can suddenly shift. It doesn't mean that it is a bad investment, long term, and we are still quite bullish, but those aspects need to be considered as well."

Lundström lifts the question of investing thematically across asset classes. "When it comes to asset classes, we are quite agnostic. The focus today is on equities, but I see a lot of interesting stuff emerging in the alternative space as well. And I think that the key for us as an institutional investor is what the theme is and how we can invest money accordingly regardless of asset class," he adds.

Digging into the challenges of themes

Anchoring thematic strategies

For **Anders Landström**, Head of Manager Research at Länsförsäkringar (LF), it is important to consider the whole chain of investment decisions when allocating money to themes. "You need to have the macro strategist onboard and the allocator. My role, as manager selector is just the final step in the chain, finding the right products to implement the selected strategy," he says.

At LF, too, investing in a theme goes beyond asset classes. "Climate change, for instance, is a theme that is in focus for our organisation with clear targets going forward. We have been more active in the bond space so far, investing in green bonds," mentions Landström.

"As for equities, we have seen some demand for thematic products from our end clients in the unit-link space, so we do offer such funds. Clients want to have themes as a complimentary source of returns to add to their global and swedish equity exposure. They would often focus on an area that they deem relevant and interesting. It might be water, it might be in renewable energy or it might be broader sustainable solutions." "There are many strategies in the area. Unfortunately, a lot of them have short track records which makes them hard to evaluate," says Landström. "And if you look at a specific theme, like water, for instance, there are many different strategies that are not quite comparable. Some have a narrow investment universe whereas others are very broad in what they invest in. Everyone has their own definitions and benchmarks. For fund selectors, this creates problems when trying to evaluate different alternatives and their future relative performance."

The challenge of scalability

Given the extra effort needed to evaluate thematic managers and strategies, the demand from the organization needs to be strong to overcome the initial threshold. According to **Svedberg,** at least in the Nordics demand is hardly a problem. "It is easy to get excited about a theme like water," he comments. "With sustainability firmly embedded in most institutional investment organisations here in Sweden, everyone is quick to embrace such opportunities, from portfolio managers to CIOs and board directors. The problem is, when you eventually find that great water conservation fund, it is too small to actually make a difference in the portfolio. Or it is packaged as a private equity or debt strategy. In any case, it is often difficult to scale up."

"And if we are talking about going from the current allocation to themes which is probably about 0.1% to integrating themes into the overall equity allocation, which for us is 40%, we need to address the question of scale," says Svedberg. "Large institutions should perhaps consider an alternative solution, to find a suitable ETF. Nowadays, there is an ETF for everything, and if you can't find one, you can perhaps create one to suit your particular needs. You can even build a portfolio of ETFs within the theme."

"We need to start thinking big," says Svedberg emphatically. "I think scalability is one of the hurdles to switching properly to thematic allocation. It is not difficult to buy a small fond, but to be honest, it's not going to make huge difference."

Raising up the ambition level

When it comes to suggesting sustainable themes and thematic products, **Lundström** agrees with Svedberg that there is not much internal resistance in the organisation. His colleagues, the portfolio managers at SEB Life are onboard.

"It is more the case that they are ambitious and want to do it properly," he says. "Which means that the exercise becomes much more advanced. It is not just about screening equity funds based on ESG data. Anyway, the data is of so poor quality that it wouldn't add much value."

"It is more relevant to focus on themes from a returns perspective if you want to do it properly," explains Lundström. "However, figuring out how a theme help you capture returns is a much more difficult job. It comes down to the competence level of the portfolio managers. When you add the fact that we invest in the theme through different asset classes, it puts high demands on the organisation. Picking up speed is a challenge."

Preserving purity

Doing things properly is a top priority for **Lecourt**. "You have to safeguard the purity of the strategy, make sure that you are not greenwashing. If you are managing a water and waste fund, it means you have to design it so that the companies you invest in are at least 90% pure play on water and waste," says the manager. "I am happy not to chase pharma or consumer stocks, for instance, that you could potentially mix in the theme, as it would dilute the concept."

"Yes, a product like this takes a lot of work," admits Lecourt. "When you add to it ESG integration, which is a must in Europe with all the tightening regulation like the taxonomy and the SFDR, you need to exclude a lot of companies that do not fulfil the minimum requirements. That is why we cannot do an ETF here as an ETF is market-driven and difficult to balance once you do the screen on ESG and the screen on purity. We also want to avoid super concentration issues, with everyone chasing the same names that offer growth and impact, as it means that the premium disappears."

"Increasingly, clients want to be able to make sense of their investment. They do want good returns, but they also want to understand where these returns come from," reflects Lecourt. "So, if we haven't done our homework properly to keep the fund pure and ensure the companies that we invest in are doing the right thing, there is a problem. We have to go deeper in our assessment. It is much more work, but once you are done, you end up with a fund that is clearly delineated. It is a new tool that doesn't need to displace everything, it just fits well into your overall mix."

Has ESG been hijacked?

Smith and his colleagues at Artemis have chosen a different thematic approach. The Artemis Positive Future Strategy is managed in a broad thematic style. However, greenwashing and purity of purpose is just as much of a concern to them. "I think the concept of ESG has been hijacked. From the original intention of making a difference it has been reduced to a risk management tool for managing downside risk, and, effectively, to just business as usual," he says. "The way regulation is evolving also indicates that ESG is not different or separate but just part of a good investment process. But that's very different from investing with a purpose."

Smith explains that whilst keeping an eye on ESG factors, it is more important for him as a manager to understand the companies he invests, that there is a deliberate 'intentionality' to solve sustainability challenges. "We need to know who we are investing with, that the people that run the businesses are acting appropriately and the businesses are well managed. The onus has to be on investing in companies that want to and are making a difference. What is it the company does rather than how it operates."

As to purity, Smith disagrees slightly with Lecourt. "I understand where you are coming from, but the companies we invest in tend to be small and have a narrow range of products or services. It makes it easier for us to determine whether they are a suitable investment or not and ensures that we get quite a pure exposure to the theme."

The manager is also mindful of the dynamic nature of thematic success. "Over time, companies tend to copy each other. If one company reduces their emissions, competitors will soon emulate. A sustainable competitive advantage can be short-lived and therefore not necessarily hugely indicative of future success. Businesses are also increasingly driven by intangible factors such as the quality of their internal culture, which some traditional approaches to ESG (which focus on how companies operate) often struggle with."

Do regulatory labels help?

So, how can institutional investors determine which thematic strategy is suitable for them? Does the SFDR classification help, for instance? For **Landström**, whether a fund aligns with Article 8 or 9 of SFDR doesn't seem to matter greatly. "If a fund is easily linked to the SDGs it is a good starting point, but there are many other criteria that need to be fulfilled. We do also see Article 9 products that we do not deem sustainable enough to live up to their article 9 categorisation. As an asset owner, you have to have your own view. Classifications such as Article 9 or 8 should be used with caution as there is a marketing element embedded and the categorisation is done by the investment manager themselves. It is more important to understand what the actual strategy is doing and to follow up on the reporting, the outcomes, specific KPIs that you can measure," he adds.

"It is true that a fund does not need to be Article 9 to be a great thematic strategy, it just has to be well done," agrees **Lecourt**. "Intentionality is important. It boils down to how you define what you want to achieve in the fund's prospectus, and how you follow up that you are actually achieving it. It is about providing a 'user manual' to investors, if you like."

"We do also see Article 9 products that we do not deem sustainable enough to live up to their article 9 categorisation. ."

Looking for alternatives

Thematic alternatives

For **Svedberg**, one area of thematic investments where there is a very positive momentum is in the alternative space. “For a lot of asset owners like us, certainly in the Nordics, alternative investments are a part of the portfolio that is growing both in absolute and in relative terms and it is probably going to grow for years. These investments are illiquid and thus long-term by nature as we are locking in the money. It means we have to be convinced about theme. Alternatives are therefore a first port of call for thematic strategies, at least for us and that is where we see a lot of positive momentum.”

“I would agree that the most credible ESG or sustainability strategies and the most credible article 9 funds that I see are in the alternative space,” comments **Lundström**. “There are certainly more question marks around the liquid space. There is a lot of overconfidence, in my view. With regulation improving we might see a lot of Article 9 equity funds downgraded over time. I think the less credible strategies will be washed out as we get more insight and data quality improves. I think that is the positive side of regulatory development.”

Benchmarking thematic success

Meanwhile, manager selectors still have a challenge trying to avoid the less credible thematic strategies. “To evaluate a thematic strategy, you need to understand the theme, in addition to assessing the manager’s philosophy and process,” says Landström.

“You also need to identify a suitable peer group as there are no proper peer group categories or benchmarks. And as for evaluating the actual impact of an impact fund, it is very challenging.”

The issue of benchmarks seems to be a challenge for asset managers, too.

“We have looked at some of the existing impact benchmarks, and it is very difficult for us to manage our strategy against them,” explains Smith. “Some of the benchmarks I have seen have had very large individual positions. If 10% of the benchmark is invested in any stock, be it Tesla or Microsoft, it has significant implications from a portfolio risk perspective. We’d like to measure ourselves against a more sustainable benchmark but currently, they suffer from these sorts of problems and in addition, they aren’t well known to investors, unlike more established, conventional benchmarks.

“ESG criteria are just the basics that need to be met, a hygiene factor. I am, however, more interested in impact strategies as I believe I can add much more value there, both from sustainability and from returns perspective.”

“It is a bit of a test for us, that idea of measuring impact and demonstrating it,” reflects **Smith.**

“But ultimately, it is about authenticity. If I am going to buy this, could I justify it to every underlying investor? Would they think it is impactful and sustainable? Or am I just reverse-engineering some argument to include it in the portfolio? It can be challenging, though, because not everything is easy to explain. A windmill is obvious. It generates this much carbon offset, it is measurable. But a silicon carbide semiconductor which is a revolutionary way of manufacturing semiconductors and will improve electric vehicles’ performance and bring down costs with huge benefits for society, is less obvious and the impact more difficult to measure and communicate.”

Lecourt concurs that investing in truly impactful companies often means going off benchmark. “Take, for instance, a small company like Indian Antony Waste Handling Cell Ltd. They take waste off the street, whereas only c. 50% of waste in India is currently collected in an environmentally safe manner. Then they contain it, they create recycling in the whole system. The company is so small, its weight in index is practically zero, but its impact is massive. Activities like this, take children away from the landfills and put them in school, creating a fantastic social impact locally. Many such companies are, however, not mapped and don’t go through investors’ screens. They don’t fit it in the current system. So, there is much work to be done,” he adds.

Private or public?

Tiny as the company Lecourt mention is, it is still listed on a stock exchange. Venturing into unlisted investments is not part of the manager’s strategy. The asset owners on the panel, however, have the luxury of choosing to implement the themes they believe in through investments in the private markets as well.

Sometimes it is good to work in a small team, according to **Svedberg**, as it allows for certain flexibility. “Once we have established a theme, such as climate transition, we have the flexibility to play it through fixed income, in the listed or unlisted equity space. We could, for instance, invest in Northvolt early on. It is a long-term bet. Maybe one day the company will be listed and then we can take part in the listing. The theme, however, remains the same. You can’t have a theme that stretches over 2023 only. Even if it is a rapidly evolving theme, it has to stay relevant over a long period of time.”

Although he is the head of ESG investment at SEB Life, for the last couple of years **Lundström’s** focus has been much more on impact than on what is traditionally considered ESG. “ESG criteria are just the basics that need to be met, a hygiene factor. I am, however, more interested in impact strategies as I believe I can add much more value there, both from sustainability and from returns perspective. And to be honest, the most credible impact strategies we find are in the unlisted space.”

"Just think back 10 or 15 years ago. You would get the odd sustainability-themed strategy launches and there just wouldn't be enough stuff to invest in.."

Lecourt counters that even if you choose to invest in a theme through the private markets, you still need to consider the listed space to inform you on the pricing of what you are buying. "You need to be able to map the investable universe, to be able to compare apples to apples, which is time consuming," he warns.

"Some themes, like waste and water, for instance, that Lecourt is talking about, are also really hard to get exposure to in the private market," **Svedberg** points out. "Especially waste, I believe, where you need to work with municipalities and local governments which can be quite frustrating. The demand is there, even in developed markets like Sweden, where the average age of a water pipe is just incredible. But how do you source such deals? Still, I believe institutional money should go exactly to such long-term infrastructure projects."

"Where thematic and impact investing meets is exactly at this shared vision," remarks **Lecourt**. "Waste management, for instance, is transforming. We used to put waste in landfills. But if we want long-term solutions, like 'waste-to-energy' or something similar, we need institutional money. To change things within a couple of decades, we need to move away from local, alleged Italian Mafia-type structures to institutionalising the theme, making it investible. And we need to encourage companies to do some of the heavy lifting."

A sea of opportunities, and some constraints

"Private equity firms are, of course, aware of the transformation that is underway and are snapping up many of the deals," adds Lecourt. "Eventually, many of the companies IPO. But as a long-term asset owner, you don't have to wait for it. You can co-invest in infrastructure projects through the private markets, through debt or credit thus diversifying across asset classes and adding liquidity and exit strategies to your portfolio. In the inflationary world that we have entered, physical impact stories like waste management are where you should be allocating resources. And this is just the beginning," adds Lecourt.

Smith shares his optimistic view of the increasing opportunity set for sustainable thematic investors. "Just think back 10 or 15 years ago. You would get the odd sustainability-themed strategy launches and there just wouldn't be enough stuff to invest in. Even if your principal idea was sound, you honestly couldn't create a suitably diversified portfolio. That has fundamentally changed. The opportunity set is growing, and the funding of this area is just enormous. The amount of money getting funnelled to provide solutions which underpin technological development is amazing. Especially in developing markets, despite some pushback in globalisation, and anti-China sentiment," he says.

The transition theme

"There is so much more to invest in nowadays, and you are not wedded to a handful of stocks as you would have been just a decade ago. Given this, however, I find that there is a bit of a disconnect between the sea of opportunities available and what is on offer for the end fund investors. You look across Article 9 and Article 8 funds and you see that a lot invest in the same stuff. To me, this doesn't make sense. How can you make the argument that the opportunity set is growing and yet everyone invests in the same things or that they are investing to make a difference?" wonders Smith.

"This is crazy indeed," agrees **Lecourt.** "I believe regulation is forcing managers to invest in the same kind of assets. Climate mitigation regulation, for instance, is really pushing us to invest all in the same thing. I think we need to break this," he adds.

Transitioning vs. business as usual

"I like the idea of ESG delta, or ESG improvers," comments **Svedberg**. "For a thematic strategy it is crucial to be able to show that it is actually driving change. I don't mind that the manager is investing in brown companies, as long as I can see that these are improving, becoming whatever shade of green they are aiming for. And I think that there is also a financial delta attached to this. The manager can sell the company when it becomes green enough and start again with another company that needs help to improve. But then we must be convinced that the company

or the fund manager are being very rigorous and take all the necessary measures, like community stewardship, etc."

Smith, however, has a slightly different opinion about this. "I used to think like you, but I have come to think that it has to be either-or," he says. "We position ourselves at the pointier end, investing in companies that are trying to do something very different, to shake up their markets, to push for change by driving established businesses to catch up or do something very different. And I'm increasingly of the view that the middle ground is this grey area, of business as usual dressed up as sustainable."

"That said, I realise that at the other end we need to do something about the biggest emitters. There are not that many and yet they are a huge part of the problem. In terms of where the emissions come from, they come from certain sectors and businesses. Driving change in these businesses makes a lot of sense. But it is also difficult to affect change. You need to join forces with people that are like-minded to drive development forward and make a difference. Unfortunately, it is relatively easy to launch a strategy in this space and talk nobly about it while in practice just continuing with business as usual. You just happily invest in the same old companies. So, I think, whilst it's not impossible, this is a tough space to invest in authentically. Our rationale is that if the disruptive companies we invest in are successful, these guys will have to change," concludes Smith.

" In a way, ..., it doesn't matter who drives the change as long as it happens."

Svedberg shares some conflicting thoughts on the matter. "A while ago, we made a strategic investment in SSAB, one of the biggest polluters in Sweden. We are quite convinced that the company's ambition to develop green steel is important and credible. Our challenge, however, is to explain what our role is, how our stewardship could help drive this change. And I think there are two ways to influence the development. For one, we can be loud about it. It is, after all, a Swedish company, it is close to home. Also, we have singled out this particular investment so we can be quite active even if our share is limited. So, yes, in specific cases you can do this. In a way, though, it doesn't matter who drives the change as long as it happens. We as a team are convinced that SSAB is on track, we just think that the market hasn't priced it fully yet. Ultimately, there is a financial rationale behind the investment," adds Svedberg.

The best way to generate positive impact

"Yes, we find it very challenging to look at the transition theme in the listed equities space," agrees **Lundström.** "If a big private company comes to us claiming to have a transition strategy, we set environmental targets and so forth and we plan for achieving the transformation in a few years' time. The case needs to be credible, of course, management has to show that they had made progress before and that they are able to transform companies. But when it comes to listed equities, I find it much harder to understand how you as an investor can impact these companies while just participating in the secondary market."

"Similarly, I see a much more direct effect when we put money into infrastructure that ends up contributing to a significant change than when I invest in listed equities. This is my opinion at the moment, you are welcome to try and convince me otherwise," he invites the other panellists.

"If you expect to get similar impact from a listed equity fund, you have to work super hard. You might find a fund that seeks out exposure to companies raising money to achieve a specific positive impact, but it is difficult."

Rather than trying to change Lundström's mind, **Lecourt** agrees with him that direct investments are the best way to get real impact. "If you expect to get similar impact from a listed equity fund, you have to work super hard. You might find a fund that seeks out exposure to companies raising money to achieve a specific positive impact, but it is difficult," he says.

"Let me give you an example of how we, as thematic investors with deep expertise, can add value even in the case of large, listed companies," continues Lecourt. "I was recently meeting the management of Veolia, one of the biggest water and waste companies in the world, trying to assess what they are doing in terms of climate mitigation and climate adaption. Because I follow many similar companies, I am aware of the risks involved in operating landfills in a global warming scenario. Look at what happened in Australia, for instance. Due to torrential rains, a local company's landfill was filled with water that swam over and caused massive pollution. They had to pay an enormous fine. Now that extreme weather occurs much more frequently, you have to do something about this exposure."

"Suddenly, as an investor knowing what is going on worldwide, you can have a meaningful conversation about Veolia's exposure to climate change. Apart from helping them assess the financial risk, if you have the knowledge, you can help them gain advantage, this sustainability edge could be a source of revenue. Does that count as being impactful though? It is an incremental improvement, and it is difficult to quantify, of course. Nobody would know that we have been doing that, but it is the kind of thing that we as specialised investors can contribute with," adds Lecourt.

Impact through stewardship

Speaking of stewardship, **Smith** has a similar view. "You would hope that the businesses we invest in are run by people that believe in what they are doing and want to do the right thing," he says. "These people are entrepreneurial; they are often quite young. Philosophically they are quite aligned with the ideas, the need for sustainability, the need to appeal to younger investors, the need to make the right disclosures, etc. But they don't necessarily have the time and the skillset to do everything. Hopefully we can help them in that regard."

"You could, of course, question the validity of ESG ratings, but companies do place a value on meeting the criteria. They know that doing so brings them onto the radar of other

"Pension money is long-term and our investors have a very long investment horizon. Naturally, we do not judge the performance of a strategy in one year only. It might be challenging in the short term, as we need to explain ourselves, but as long as we understand what is behind the underperformance it is not a problem."

investors. So, there is a role for investors like us in guiding them to achieve higher ratings by doing the right thing. Not that we would want them to play the system by any means, but you can encourage them to make the correct disclosures, or frame what they are doing in an appropriate and honest way. We think this is really impactful. There is definitely a role for investors who have seen many companies in similar situations and at the same stage of maturity," adds Smith.

"Most of the companies you are talking about are smaller," agrees **Lecourt.**

"They are often mono-product companies. If you take a big conglomerate, it is difficult to achieve the same impact. There is definitely a lot of value in looking at these smaller companies, talking to them. Sometimes they don't have sustainability experts in the management team, or the reporting tool to measure all the things we need. 85% of these companies that we look at, are not even covered by the big banks' analysis teams. They go completely under the radar. And I am not even talking about ETFs. For ETFs, I believe the 15 biggest stocks are 80% of the value driver. You have to look at the tail and that is why most of what you do is difficult, because you need to pinpoint these companies, monitor them, understand the way they are evolving. Engagement with these companies is really important," he concludes.

The proof of the engagement pudding

"That is definitely what we intend to do," responds Lecourt. "Engagement needs to be monitored. We send letters to all our companies; we give them six months or one year to reply and if they don't, we check what is going on. Sometimes they are doing a good job, just not publishing the results, it is not a priority for them. But then compliance comes to us and sometimes we are pushed out of a good investment because they are just not good at communicating what they are doing," he complains.

"Yes, it is rather easy to focus on what your own needs are as an investor," confirms **Smith**. "About a quarter of the companies in our portfolio have some form of net-zero target, a quarter have other emissions targets that they measure, another quarter measure their emissions but don't have targets, and the last quarter doesn't do anything. What we expect from portfolio companies has to reflect their size and maturity and things like that. I believe it would be unfair if we were to hold them all to the same standard."

Should we focus on CO_2 emissions?

"We do believe that there is a need to measure your emissions, even if you perhaps do not consider yourself a huge emitter," continues **Smith**. "One reason for this is the war for talent. If you want to be an attractive employer, these are the sort of soft issues that you need to address to attract the very best people. The example I'll

quote may be slightly dated now as he has been sacking everyone in the company he has recently bought (!), but there were three million individuals applying to that famous electric car manufacturer in 2021. Companies want young people, talented people. And intelligent people want to work in companies that are solving humanity's big problems, which is an enormous tailwind for these companies. That they are attracting this talent also makes these companies more attractive as investments," he adds.

Lecourt sounds a bit sceptical about the one-dimensionality of current measurements. "The story now is CO_2 emissions. We mention water and waste management and people say no, it is too complicated to measure, we just want one thing," he laments. "As if climate change adaptation or a 1,5-degree goal could be reduced to measuring one parameter, CO_2 emissions. Climate change impact is difficult to quantify, too. You need to have diversification in your sustainability angle, you need to consider social issues alongside the environmental goals."

"We have this very big Swiss client, for instance, where the CEO tells us they have now committed to net zero. Now he needs to come to the market and show that he is doing something about it," continues Lecourt. "And so, even though he says he loves our fund, he can't invest in it because it doesn't fit in the net-zero slot. We need more flexibility; we need to be realistic and give companies some space if we are to reach net zero."

Performance issues

Thematic impact strategies generally have not had a stellar performance recently. For **Landström**, this is not a huge issue. "Our clients have a much longer time horizon," he comments.

"Pension money is long-term and our investors have a very long investment horizon. Naturally, we do not judge

The long term in mind

the performance of a strategy in one year only. It might be challenging in the short term, as we need to explain ourselves, but as long as we understand what is behind the underperformance it is not a problem."

"I suppose you would expect us to say that the valuations are much more attractive right now," laughs **Smith**. "But seriously, they are! Valuations were crazy before and now they are not. These are large demand-led markets, and the structural trends are there. Our conviction remains, but it has obviously been very challenging. But to be fair, we have always been very clear to our clients regarding the style of our investment, our focus on growth. They understand which slice of their portfolio we fit in, and they have other components which they also invest in. The most dangerous thing for us in this environment would be to style drift. We have consciously avoided that, driven by our philosophy. We do not think you can get the same kind of impact by shifting around," he says.

"I think we all agree that these are long-term strategic themes, and they should be evaluated accordingly," comments **Svedberg**.

"This doesn't mean that you can never throw things out. And just because you have decided you want to buy into a theme, doesn't mean that you must do it immediately. Maybe there has just been a boom, and everyone likes hydrogen, or whatever technology, suddenly. Then you should perhaps bide your time investing in hydrogen. Hard as it is, for some exposures you can use the short-term tactical ups and downs. Entry points matter for your performance, and you may as well use them. This is a whole lot easier to say than do, but if you have done your long-term analysis properly, then you are always ready to act."

"Years of experience have taught me to do this exactly," agrees **Lecourt.** "Within the theme that we manage, we map everything. We know exactly where each company in our investment universe is, valuation-wise and we track them over time. That is how we can avoid buying into overpriced stocks. Knowing where you are relative to the trend all the time is very important to do," he says.

Wrapping up the lively discussion, the moderator gauges everyone's expectations for the future of thematic strategies."So far, we have mostly done direct thematic investment, primarily through green bonds, in our institutional portfolios" says **Landström.** "We do realise, however, that we can also achieve impact if we go into the liquid space by offering impact fund solutions to our unit-link clients as they usually cannot access illiquid strategies. They need liquid sustainable thematic products with good risk-adjusted returns. We have seen younger clients who are really determined to go for specific strategies rather than traditional global equity funds, whether broader environmental themes, or water or whatever their top interest is."

(Thematic) Christmas wishes

"What we wish for is perhaps more differentiation among thematic products," continues Landström. "Funds that go down the market cap space can achieve this more easily, but otherwise a lot of the funds have rather similar profiles with investments in the same companies. If I am to pinpoint one theme we will be focusing on, it is biodiversity. That will be something to watch out for."

Speaking of wishes, **Smith** jokes that you should be careful what you wish for. "I was wishing for a shakeout of sustainable investments a year ago. I even asked Santa for more regulation in this area and as I am getting my wish now it will be interesting to see how it all lands. Ultimately it should be a good thing. I am optimistic that there will be more focus on the authenticity of these strategies, what it is that they invest in, what it is that they do. Once that has come to pass, I would like a growth rally. And I'd like a new bike for Christmas," he adds, laughing.

At the top of **Lecourt**'s Christmas list is the opportunity to design and offer new thematic investment tools to his clients. "I look forward to continuing the dialogue with investors and assessing their needs. I want to make sure that the products we design are fit for purpose, only then can we manage them well," he says.

"I do believe that themes need to become the foundation of our equity investments going forward," shares **Lundström**.

"We invest in equities through funds, and I think I will be looking at thematic strategies much more in the future, searching for funds that have credibility and know-how. I believe the sustainability space is becoming much more complex and advanced and people with general ESG titles, like mine, should give way to more narrow specialists. We are seeing those roles emerging in all kinds of areas. It is part of the reason I think themes will have to provide a foundation, areas of specialisations."

Summarising the discussion, **Svedberg** sounds cautiously optimistic. "I am not sure that we are at a point where thematic strategies are about to replace traditional allocation, but they are certainly moving towards becoming mainstream investments. A strong underlying sustainability focus in these themes could perhaps help us reach part of the end customers who have not completely bought into the story yet. I am thinking about certain US investors in particular, but also about men my age here in Europe. You look at the polling data from the Swedish election and it turns out that for a large group of Swedish middle-aged men the climate issue is at the bottom of their list of priorities. I believe we need to reach out to these men and I think this may be a good way to do, through specific, well-managed impactful thematic strategies," concludes Svedberg.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