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Acclimatising to a new investment

Climate change funds are a new breed of fund, even though some of the ideas and technology in which they invest have been around for a decade or more. Because of this perceived novelty they may be seen as untested funds investing in new technology and solutions that may not have long term staying power.

How true this may be is still up for debate, but the climate change investment houses at least would have us believe that their filters and screening processes ensure that only robust business with successful long term strategies will be included in their investment portfolio.

This newness also means that there are a number of questions to address when considering climate change investment as part of an investment portfolio.

Big boys

The investment houses that have launched climate change funds are all big players in the investment arena. Although smaller companies have launched funds focusing on specific technology areas, such as water or energy, the broad climate change funds have been launched by Allianz, F&C, HSBC, Schroder and Virgin - all big names in investment management and unlikely to start a fund that has not been subject to lengthy and intensive research.

Given the somewhat bandwagon launching of property funds by large investment managers in 2006 and 2007, some will inevitably worry that climate change, likely to be one of the hot investment topics of 2008, will face the same problems as last year's property funds - initial excitement and later problems due to liquidity and pricing exaggeration.

It is reassuring to note that there have been smaller fund launches in more specific investment areas surrounding climate change in recent years as well as the five broader climate change funds that are considered in this guide. The continued success of these smaller funds can be seen as some reassurance that climate change investment will not go the way of the dotcom companies or property funds.

The fact that climate change is being hailed by governments globally as a long term issue that will provide ever more problems, as well as solutions to those problems, and unlike property is not a cyclical investment area, is encouraging in this respect.

Investing in ideas

The climate change funds that have launched so far are, as has already been mentioned, broad funds investing in all the key industry areas affected by climate change.

Each investment house has a number of set categories into which they divide their climate change universe.

Although these vary from investment house to investment house, most companies that are set to benefit from the problems posed by climate change can be divided into the following groups:

- Transport - efficient cars and buses and alternative fuels will mean lower emissions, enabling us to tackle climate change while continuing to benefit from the high speed transport to which we have become accustomed over the past century.

- Water - desalination and water purity testing will become issues with rising sea levels and more stretched water reserves. This is particularly relevant as both climate change and the ever increasing global population put pressure on existing water reserves.

- Waste - recycling and waste reduction means that less energy is wasted in producing new goods as well as tackling the landscape blight of landfill.

- Mitigation of the effects of climate change - new crop varieties, health research and trade routes, among others, are issues that will need tackling as climate change and affects the world around us.

- Alternative energy production - solar, wind and wave powered electricity all have lower carbon emissions than traditional fossil fuel methods. Nuclear power may also fall into this category for some investment houses.

As well as dividing the investment universe into different sectors, it is also possible to invest according to various screens. For instance, one of the investment techniques used by Virgin is to invest 75-100% of its fund in companies that are in the so called lighter 50% of their industry, meaning that they are in the best 50% in terms of pollution. This is intended to have a similar effect to that of positive screening in **socially responsible investment (SRI) funds** in that companies are rewarded for being at the better end of the scale in terms of pollution.

Most of the funds are structured to be relatively unconstrained, meaning that they are not limited to a certain index or maximum exposure to certain areas. This structure enables them to take advantage of the constantly changing face of climate change and maximise opportunities as they appear. This flexibility may add a certain level of risk, as it means that a fund manager who gets it wrong can get it really really wrong, but is necessary if a manager is to be able to run a profitable climate change fund.

Ethical or not?

Investment houses are deliberately not pitching their climate change funds as ethical funds but as funds that embrace the new industry that has risen up from the problems posed by climate change.

They are determinedly not excluding any part of the climate change industry on the basis of how green it is, which can make it appear that these funds are not suitable for investors with ethical interests.

This means that climate change funds can be completely impractical for ethical investors. However, it is important here to consider the exact requirements of the ethical investor before discounting climate change funds.

If an investor's ethical conscience excludes investments such as arms trade or investment in certain countries, a climate change fund would probably not be feasible, as it would be impossible to be certain that the fund would never invest in these things. A fund manager would, for example, be able to invest in an arms producer if it passed the fund's climate change screening process.

If, however, an investor was more concerned about their environmental impact, a climate change fund could be a suitable investment. Because of the nature of the screening processes, an investor would need to be comfortable with the fact that less than perfectly ecological companies would be invested in. Toyota can be seen as an example: because of the Toyota Prius, a hybrid electric/petrol car, Toyota can be seen to be benefiting from the effects of climate change and therefore be a good investment.

However, the Prius business forms only a tiny percentage of Toyota as a whole, and therefore the majority of the investment would not be going towards the environmentally sound aspect of Toyota.

Climate change funds can, therefore, be seen as an option for an ethical investor provided that their priorities lie with the environment and that they understand the investment principles involved in the different funds.

There is little doubt that more climate change funds will spring up throughout 2008. This means that funds will inevitably launch with different constraints, benchmarks and levels of risk, making a fund available for every level of risk tolerance. Whether any self imposed limitations will impact on the ability of the fund managers to run an effective climate change fund will become clear as these funds are launched.

It is likely that a clearer picture of climate change investing will appear over the coming year and answer this question.

It is also likely that, as more funds launch and investors become more comfortable with the concept of climate change as an investment opportunity rather than a hazy problem that requires them to put out their recycling bin twice a month, climate change investment will find a place in many portfolios, ethical and otherwise.