

Circular Investing

Approaches to sustainable asset management

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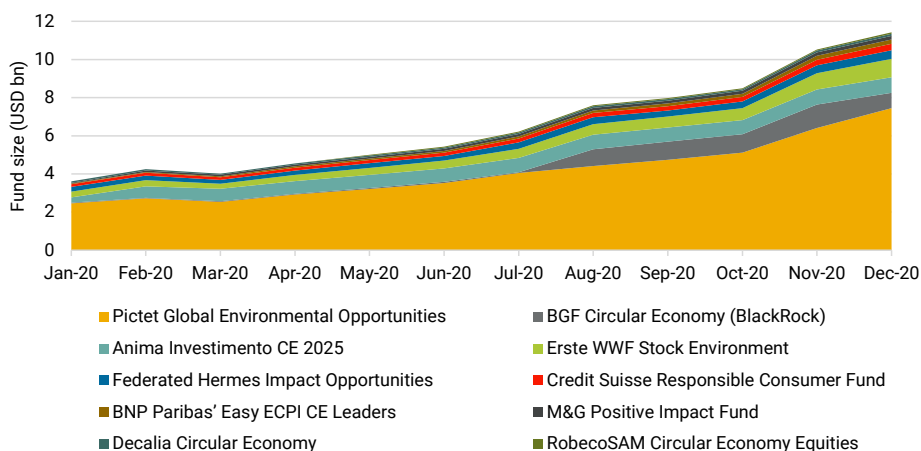
While the previous chapters of this report focused on investment risks and opportunities related to publicly listed companies that contribute directly to the food value chain, this chapter delves into how investors and asset managers can apply the principles of the circular economy (CE) more broadly in their investment strategies. First, we survey the state of play among a sample of 10 CE-themed funds covered by Morningstar Research. Collectively, our sample of funds has grown to USD 11.4bn as of December 2020, more than double the total size since January 2020 (Exhibit 5.1). Excluding RobecoSAM and Anima Investimento (i.e. funds with inception dates in 2020), our sample funds outperformed the FTSE All World (AW) Index on average, by 18 percentage points, in terms of one-year return. Erste WWF had the highest excess return of 77%, though it also experienced higher volatility – roughly 11% more than the FTSE AW.

Next, we consider three approaches that investors and asset managers can apply when developing a CE-themed strategy: 1) portfolio construction, 2) engagement, and 3) financing.

Opportunities in CE investing

While CE funds remain relatively concentrated in certain sectors, investors can achieve a diversified portfolio using strategies such as the core-satellite approach. They can also develop engagement programmes by addressing a set of key risks and opportunities associated with a CE thesis. The rise of green and sustainability bonds suggests companies are progressively incorporating circular activity in their approaches to corporate financing. In 2020, most second party opinions (SPOs) provided by Sustainalytics were for financial institutions and corporate issuers. Sectors exposed to the food value chain accounted for only 13% of SPOs, though we anticipate more interest among companies in this space due to increasing environmental concerns from stakeholders.

Exhibit 5.1: Growth in CE fund market in 2020



Source: Morningstar Direct, Sustainalytics

Circular economy themed funds on the rise

Assessing 10 CE funds

Funds with the stated purpose of investing in CE take a variety of approaches to portfolio construction. Differences include sector and market allocations and the weight of portfolios dedicated to mitigating ESG risks and offering relevant solutions. As outlined in Exhibit 5.2, each of the funds in our sample presents a thesis that aligns with the tenets of CE, which include minimizing waste and pollution, extending the use phase of products and ecosystem conservation. While two of these funds (i.e. Erste WWF and Pictet GEO) have a track record dating back to 2001 and 2010, respectively, the other eight have inception dates within the last four years. This recent proliferation of CE funds is one indication of the growing interest in this topic among mainstream asset managers.

Exhibit 5.2: Investing in the circular economy, 10 funds in focus

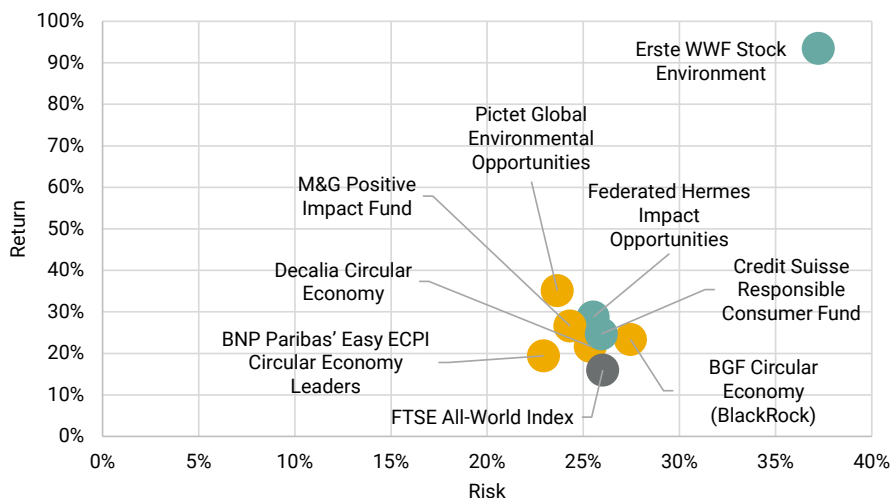
Fund	Inception	Domicile	Thesis
Erste WWF Stock Environment	1-Jul-01	Austria	Invests in water treatment, recycling and waste management, renewable energy, energy efficiency, and mobility.
Pictet Global Environmental Opportunities	10-Sep-10	Luxembourg	Emphasis on holdings assessed to use resources efficiently, minimize waste and limit adverse environmental impacts. Thematic focus on issues of oceanic acidification, land use, chemical pollution, biodiversity, etc.
Federated Hermes Impact Opportunities	1-Dec-17	Ireland	It allocates about 8% to companies within the circular economy theme focusing on resource efficiency and waste reduction. Its other investment themes include future mobility and financial inclusion.
Decalia Circular Economy	1-May-18	Luxembourg	Invests in firms with a CE approach across the value chain: circular supplies, resource recovery, product life extension, sharing platforms, product as a service.
M&G Positive Impact Fund	1-Dec-18	United Kingdom	Invests in firms with circular products and excludes companies that breach the UN Global Compact principles or are involved in tobacco, controversial weapons or nuclear power.
BNP Paribas' Easy ECPI Circular Economy Leaders	1-Apr-19	Luxembourg	Tracks the ECPI Circular Economy Leaders Equity Index that uses a combination of circular economy categories (i.e. circular supplies, resource recovery, product life extension, sharing platforms, product as a service) and ESG ratings.
BGF Circular Economy (BlackRock)	1-Oct-19	Luxembourg	At least 80% of its equities are invested in firms contributing to the circular economy while excluding coal, and oil and gas.
Credit Suisse Responsible Consumer Fund	25-Nov-19	Luxembourg	Invests in firms that are capturing shifting consumer trends in food, urban systems, supply chains, and lifestyle, and are aligned with the circular economy.
RobecoSAM Circular Economy Equities	23-Jan-20	Luxembourg	Groups its offerings into four clusters: redesign inputs, enabling technologies, circular use, and loop resources. It prioritizes resource-efficient business models, including recycled and reused materials, and promoting eco-friendly nutrition.
Anima Investimento Circular Economy 2025	17-Jan-20	Italy	Combines bonds and a "multi-asset" component that gradually builds an exposure to firms with a circular economy focus.

Sources: Sustainalytics,¹⁰⁶ Morningstar

Pure-plays vs mixed funds

Looking at eight of the CE funds in our sample with inception dates prior to January 2020, the funds outperformed the FTSE AW based on one-year returns, with most having a similar level of volatility (difference <5%) (Exhibit 5.3). We characterize the Erste WWF, Federated Hermes and Credit Suisse as "mixed" in terms of combining a CE thesis with other environmental and social themes. The remaining funds are considered "pure-plays" in that they explicitly focus 100% of their investments on supporting CE. Erste WWF is a notable outperformer with an excess return of roughly 77%. Unsurprisingly, its level of volatility over this time frame was roughly 11% higher than the FTSE AW which is likely due to its higher allocation to small-cap stocks. The other mixed funds (i.e. Federated Hermes and Credit Suisse) were similar in terms of volatility to the pure-play CE funds and the FTSE AW. BNP Paribas' level of volatility is about 3% lower than the FTSE AW but still outperformed the benchmark with an excess return of 3%.

Exhibit 5.3: One-year annualized total returns and risk (standard deviation)*



*Orange: Pure play; Teal: Mixed; Grey: Vanguard FTSE All-World UCITS ETF (VWRD); Return (gross) and risk (as measured by standard deviation) in USD from Jan 1, 2020 to Dec 31, 2020. **Source:** Morningstar Direct

Robust CE performance

Overall, our sample of CE funds generated higher risk-adjusted returns than the FTSE AW benchmark over this period. While the timeframe is limited, this finding suggests that investors may not need to compromise on performance when investing in the CE. However, CE funds are generally concentrated, with most funds in our sample holding 50 or fewer companies. This lack of diversification may expose investors to risk that is above their preferred tolerance level.

Portfolio construction

Achieving diversification

Investors can adopt a variety of strategies to maintain a diversified portfolio that promotes a CE thesis. Common approaches include implementing a core-satellite portfolio and applying ESG-informed tilts to underlying companies.

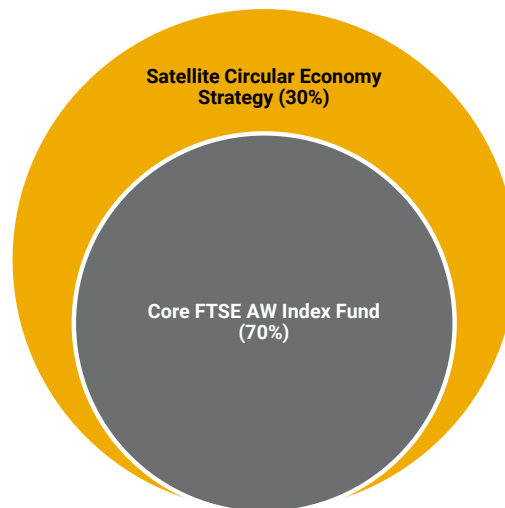
Developing a core-satellite portfolio

The construction of a core-satellite portfolio can take many forms but generally uses a combination of active and passive strategies. The “core” component of the portfolio may consist of semi-active and/or index funds targeted at maintaining market exposure to a given benchmark. Active strategies are considered the “satellite(s)” of the portfolio, where stock selection may generate value through higher risk-adjusted returns. The satellite(s) often have a greater potential return than the core but typically carries higher risk (i.e. standard deviation). Its benchmark can also differ to reflect specific mandates, such as a focus on certain sectors or geographic region.

An illustration

Exhibit 5.4 illustrates the concept of a core-satellite portfolio. In this hypothetical example, the index fund represents 70% of the overall portfolio, comprising the core of the portfolio, and is used to track the performance of the FTSE AW. The remaining 30% is the satellite strategy, which in this case relates to the circular economy and acts as a potential alpha driver.

Exhibit 5.4: Hypothetical core-satellite portfolio



Source: Sustainalytics

Weighted tilting

While a CE strategy may include holdings in multiple sectors, this report focuses on companies in the materials (agricultural and specialty chemicals) and consumer (defensive and cyclical) sectors. Exhibit 5.5 summarizes key ESG and financial datapoints about the companies profiled in earlier chapters. A weighted tilt can be applied to individual holdings in a satellite portfolio based on ESG risk ratings and a combination of financial metrics, such as price-to-earnings (P/E), earnings per share (EPS) and return on assets.

Exhibit 5.5: Sample ESG and financial metrics for profiled companies*

Company	Subindustry	ESG Risk Rating (Qualitative)	Highest Controversy Level	P/E	EPS	Return on Assets %
Yara International ASA	Agricultural Chemicals	Medium Risk	Category 1 - Low	17.3	2.4	3.9
Novozymes A/S B	Specialty Chemicals	Medium Risk	Category 1 - Low	31.9	10.9	15.4
Koninklijke DSM NV	Specialty Chemicals	Low Risk	Category 1 - Low	39.8	3.5	4.3
Archer-Daniels Midland Co	Agriculture	High Risk	Category 3 - Significant	17.9	2.8	3.7
Olam International Ltd	Agriculture	High Risk	Category 3 - Significant	8.0	0.2	2.6
Bakkafrost P/F	Packaged Foods	Medium Risk	Category 2 - Moderate	34.5	12.3	6.7
Leroy Seafood Group ASA	Packaged Foods	Medium Risk	Category 3 - Significant	21.2	2.9	5.7
Danone SA	Packaged Foods	Low Risk	Category 2 - Moderate	18.5	2.9	4.1
Tesco PLC	Food Retail	Low Risk	Category 3 - Significant	21.9	0.1	2.0
Starbucks Corp	Restaurants	Medium Risk	Category 3 - Significant	135.4	0.8	3.8

*P/E, EPS and Return on Assets are trailing 12-month values as of December 31, 2020.

Sources: Sustainalytics, Morningstar Direct

Measuring ESG performance

ESG data can be integrated into this type of strategy by, for example, overweighting firms that contribute to CE and demonstrate outperformance on key management indicators or material ESG issues (MEIs), such as those related to carbon emissions and resource use. Alternatively, companies that underperform on these measures and those involved in frequent or high impact ESG incidents can be underweighted.

Achieving CE goals through active ownership

Active ownership

Active ownership has become one of the leading strategies in addressing ESG issues because it can enable investors to encourage their portfolio companies to adopt practices that mitigate material risks. In this case, active ownership refers to shareholders using their rights and ownership position to encourage and help a company transition from a linear “take-make-dispose” model to a CE model. Such engagement and voting activities can be applied in conjunction with the portfolio approaches noted above.¹⁰⁷

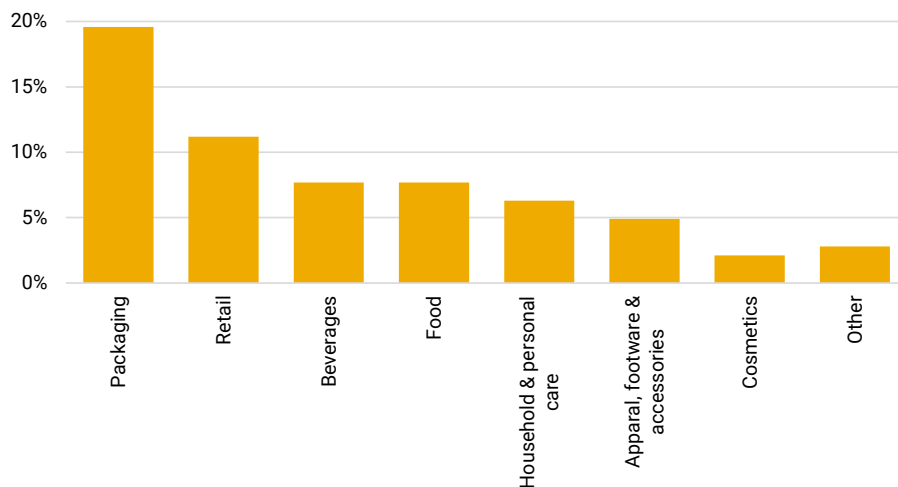
Proxy voting and engagement

The term “proxy voting” generally refers to the aspect of active ownership that involves exercising the voting rights attached to shares. In recent years, plastic pollution and sustainable packaging have been addressed by several shareholder-sponsored resolutions at large US companies. On the other hand, engagement involves ongoing dialogue between the investor and the company. Engagements may be undertaken individually or in collaboration with other investors. They often aim to encourage investee companies to sign onto industry-level, market-wide or global commitments.

The Global Commitment

The Ellen MacArthur Foundation and UN Environment Programme, for example, released the New Plastics Economy Global Commitment (Global Commitment) in October 2018 to create a circular economy for plastics. Since its release, the Global Commitment has attracted over 500 signatories consisting of companies that are part of the plastic packaging value chain, governments across five continents and financial institutions with a combined USD 4tn of assets under management.¹⁰⁸ In 2019, roughly 62% of reporting signatories came from the consumer sectors, with 20% in packaging, as shown in Exhibit 5.6.¹⁰⁹ While we expect packaging companies to be engaged in reducing plastic waste, the beverage and food industries combined account for less than one-fifth of signatories. This gap provides a potential focus area of engagement for investors and asset managers to encourage wider adoption of the Global Commitment.

Exhibit 5.6: Percent of reporting signatories in the consumer sector in 2019*



*Based on a sample of 143 business and government signatories

Source: Ellen MacArthur Foundation¹¹⁰

Investor engagement in plastic waste

Several organizations have used the Global Commitment as the basis for helping investors better understand plastic waste while also addressing associated risks and opportunities. The UN Principles for Responsible Investment (PRI) established a Plastic Investor Working Group that consists of 29 global investors with USD 5.9tn in assets. The purpose of the group is to build a holistic understanding of plastic.

Thematic engagements

In January 2019, Sustainalytics launched a three-year thematic engagement on *Plastics and the Circular Economy*, which encourages companies to improve their recycling practices, shift strategic focus towards redesign and innovation, as well as increase the reusability of their products. The programme has so far found that companies in exposed sectors are increasingly committed to addressing plastic waste issues and have started to incorporate circular principles within their business strategies more explicitly.¹¹¹ Other relevant engagements include *Feeding the Future* and *Responsible Cleantech*, which explore solutions for food waste reduction and cleantech production.¹¹²

Financing the principles of the circular economy

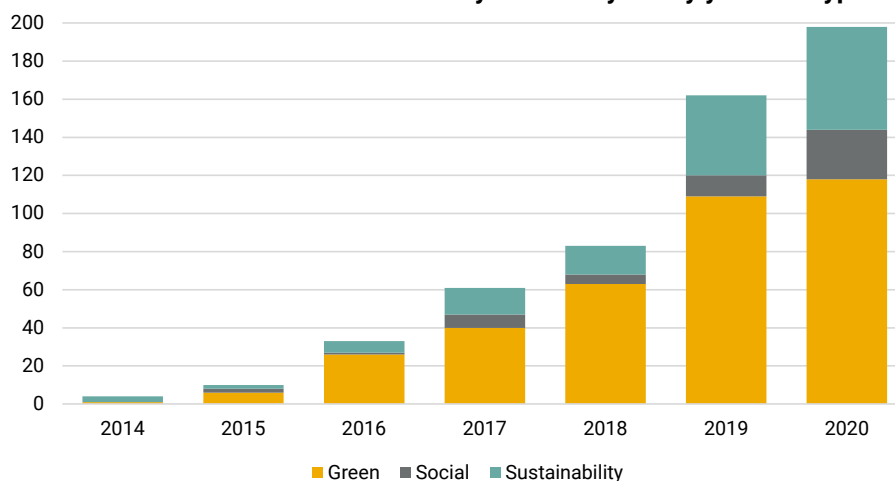
The rise of green bonds

In 2019, the global green bond market reached USD 258bn, a 51% increase compared to 2018.¹¹³ Despite representing a small portion of the USD 100tn global debt market, the large inflow of green bonds suggests increasing opportunity for investors to gain CE exposure through other asset classes besides public equity. Green bonds are debt instruments used to finance or refinance environmental initiatives. Similarly, sustainability bonds are also on the rise which are used to finance both environmental and social initiatives.

Increased transparency

Roughly two-thirds of issuers commission SPOs from external review providers. This increases transparency to stakeholders over the use of proceeds.¹¹⁴ In total, Sustainalytics has delivered more than 500 SPOs to date using a similar scale to the International Capital Market Association’s (ICMA) Green Bond Principles. The ICMA framework covers several CE principles, including eco-efficient products, pollution prevention and renewable energy.

Exhibit 5.7: Number of SPOs delivered by Sustainalytics by year and type



Source: Sustainalytics

Rising demand for SPOs

Between 2014 and 2020, Sustainalytics saw average growth of roughly 103% in the number of SPOs published annually (Exhibit 5.7). Since 2015, green bonds have accounted for more than 60% of the SPOs provided by Sustainalytics. However, we have observed a rise in SPOs for the other two types of bonds in recent years. In 2020, Sustainalytics saw a significant increase in SPOs for social bonds – more than double the number prepared in 2019. Sustainability bonds accounted for at least one-quarter of the total number of SPOs in the past two years. For instance, Sustainalytics provided an SPO for Alphabet’s Sustainability Bond Framework, with part of the proceeds allocated to circular activity. Alphabet’s USD 5.75bn issuance is the largest sustainability or green bond issued by a company to date.¹¹⁵ It also suggests emerging opportunities in different sectors, such as technology and healthcare, to engage in CE principles. While sectors exposed to the food value chain (i.e. materials and consumers) accounted for less than 15% of SPOs, we anticipate more interest from companies in this space as environmental concerns from stakeholders continue to rise.

Emerging Markets

From a geographical perspective, the highest number of issuers came from the US and Japan between 2014 and 2020. Overall, European countries (excluding the UK) accounted for at least 30% of the total number of SPOs delivered within this timeframe. While most issuers were from developed markets, several SPOs were delivered to issuers in emerging markets in Asia and Africa. Given that emerging markets may face resource constraints, the rise of SPOs in these areas suggests potential opportunities due to the rapid urbanisation and industrialisation underway there.¹¹⁶

The upside with CE investing

An influx of circular activity

While the CE concept has roots outside the field of responsible investment, it has inspired an influx of activity in the public equity and debt markets. Despite a limited track record, CE funds have demonstrated robust performance in 2020, suggesting investors can generate competitive returns while tackling pressing sustainability issues. However, fund performance over a longer timeframe and further research are necessary to thoroughly assess CE investing. Investors can also engage with companies in adopting circular approaches to achieve mutual environmental goals. The 103% growth in SPOs for green, social, and sustainable bonds over the past five years suggests that companies are increasingly recognizing the value-add of ESG-linked loans.

The next frontier

While the food value chain has been the primary focus in this report, other sectors, such as technology and healthcare, are certainly exposed to related risks and opportunities. Investors looking to develop a CE thesis will find ample opportunity to innovate strategies across a wide range of industries and markets.