MACKENZIE Investments

The Mackenzie Greenchip Team

Houston, we have a problem

On January 10th, scientists from NASA confirmed that 2024 was the hottest year since 1880 when global temperature record keeping began.

For those that believe climate change is mostly related to anthropogenic GHG emissions, reversing the global warming trend looks particularly difficult today. It will require massive energy infrastructure construction (mostly renewable), industrial efficiency plant upgrades, and the expanded mining and processing of green metals and materials. These activities come with great cost, mess, and footprint that intuitively no one wants; targeted economic activity that needs to accelerate today, just as incoming populist governments repeal the "carrots and sticks" policy that support such endeavours. The greatest challenge to mobilizing the capital required, however, likely exists inside capital markets themselves.

> Despite a historic $2 trillion USD investment in clean energy in 2024, it is only half of what's needed to stabilize global emissions.[1]

Progress is hindered by three main forces.

First, the language used to label sustainable investment strategies confuses investors and likely distracts capital from the very solutions willing investors hope to back.

Second, professional investing has developed a fixation on benchmarks dominated by sectors that have little to do with the energy transition.

Finally, both the taxonomy and benchmarks support growing investor aversion to capital-intensive business models.

The taxonomy for environmental investment strategies is overly complex. Labels like "Sustainable", "Climate", "SRI", and "ESG", are used interchangeably, often without clear distinctions.

Only two labels are needed:

1. **Energy Transition strategies:** mobilize capital towards building infrastructure and technologies today, so we have a lower carbon economy in the future.
2. **Low-Carbon strategies:** allocate capital to current low-carbon sectors, potentially locking in higher emissions in the future.

Unfortunately, most strategies labeled with words like "Sustainable", "SRI", and "ESG", are indeed "Low Carbon" strategies. They soak up most of environmentally focused capital at the expense of "Energy Transition strategies".

Benchmarks do little to address label obfuscation. MSCI, a major index provider, offers hundreds of "sustainability and climate solutions" indexes. Almost all of them should be categorized as "Low Carbon", in our opinion. For instance, the MSCI World Climate Change Index and the MSCI World ESG Leaders Index show a remarkable overlap in top constituents, sectors, and country weights with the firm's global standard benchmark, the MSCI World Index[2]. It would be hard to argue that any of these indexes are designed to drive capital allocations to energy transition solutions.

While there are hundreds of low carbon indexes, by contrast investors will find less than ten "energy transition" sector indexes. These tend to be narrowly defined like the S&P Clean Energy Index and the MSCI ACWI IMI Clean Energy Infrastructure Index. They cover *parts* of what's needed for an energy transition.

Mackenzie Greenchip, managing an "Energy Transition" strategy since 2007, believes a broader energy transition index is needed that includes energy efficiency, clean up technologies, water, agriculture, and transportation, as well as clean energy.

While Information Technology, Financials, Consumer Discretionary, and Health Care dominate low carbon portfolios, the Greenchip Universe of around two thousand energy transition companies is largely found in Industrials, Utilities, and Materials sectors. Technology is also well represented; however, energy transition technologies tend to be hardware like solar equipment or analog power management semiconductors as opposed to digital technologies. Unsurprisingly, the Greenchip Universe and other "energy transition" indexes have significant tracking error with broader "low carbon" ones.

In 2008, Russell Investments and Impax launched the FTSE Environmental Opportunities All-Share Index with about 450 constituents, mostly names found in the Greenchip universe. Today the index has over one thousand constituents and somewhere along the line, names were added that seemed less related to the energy transition.

For example, Microsoft is currently the largest constituent. We would argue that eleven of the top twenty names should not qualify as energy transition businesses, yet they account for over 30% of the index by market capitalization, and over half of its 2024 performance[3]. What seemed like a unique energy transition benchmark is increasingly looking like a low carbon index.

Today both the taxonomy and indexes largely support "low carbon" over "energy transition" investment. Why? Because it suits investor preference for low CAPEX business models - low carbon is low capital!

Public equity markets were supposed to be a place companies went to raise capital to invest in and grow their businesses. From 1990 - 2023, S&P 500 dividends and buybacks increased from 42% of capex to over 120%, and now exceed the sum of IPOs, follow-ons, debt issuance and capex. Arguably, public equity markets have become a source of rent on the economy rather than a place to finance growth – or the energy transition.

Climate challenges cannot be overcome without investors embracing capex again, supported by clearer language and dedicated benchmarks.

Learn more about the Mackenzie Greenchip Team here.

[1] IEA, June 6, 2024

[2] MSCI World Climate Change Index, December 31, 2024

[3] FTSE Environmental Opportunities Index Series, December 31, 2024