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Responsible Capital

Annual Report

Summer 2024

Editor's Letter

The global attitude to responsible wealth continues to mature every year. New regulation has clarified what was a previously quite murky delineation of "green funds". Greater clarity has attracted investors, and inflows into the sector continue. With policy moving in the right direction, more capital will follow. Today's responsible investing landscape is brimming with good intention and worth over $30 trillion.

However, there are some bumps in the road ahead. International war and simmering tensions between the US and China have served to heighten global strains. These international divisions do not drive success in any area, including responsible investing. Warring nations create barriers when we should be aggregating global policies and collaborating. Deglobalisation, political uncertainty and tariff wars significantly slow the pace of change. As we reflect on the past year, we see progress in some areas and challenges in others.

But human ingenuity brings us plenty of cause for hope, and investors should remain optimistic in the long run. Artificial intelligence and automation offer amazing potential for future productivity and growth. Our gradual transition to a brighter future will bring enormous benefits to our green energy efforts and sustainable investing more widely.

I hope you find our 2024 edition engaging and insightful.

Charlotte Thorne
Founding Partner, Capital Generation Partners

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Challenges and opportunities lie ahead

Responsible investing's headwinds

Today, over $30 trillion is invested globally in sustainable assets.[1] Putting our savings to work in a way which aligns with our values is becoming increasingly mainstream. But like many global movements, the road travelled is not always smooth. New challenges must be faced and overcome, and responsible investing will be no different. Progress in one area may be a move backwards in another and diverging global attitudes significantly slow change.

But we have cause for hope. Awareness of the issue grows every year and there are many new global and corporate initiatives, all with sincere aims for a better future. With tentative optimism, we try to imagine a future where a responsible attitude to investing is the norm.

Artificial intelligence is power hungry

A shortfall of electricity presents a significant challenge to the global rollout of artificial intelligence (AI). If human thought runs on a decent meal and a good night's sleep, AI thought is powered by a seemingly unquenchable demand for energy.

The data centres behind AI have very power-intensive business models and their ability to access electricity at all times is imperative. That's because there's never any downtime for AI, it's always wanted by someone, somewhere, and that takes a lot of charge. Demand is only set to increase. Even though there are already roughly 600 data centres in the US, estimates suggest we'll need twice that number in the next 3-5 years to meet demand. McKinsey projects a 10%-12% annual increase in global data centre power requirements between 2020 and 2030.[2]

So, where will all this extra power come from? At the moment, the answer isn't very green. Oil, coal and natural gas offer some immediate relief to AI power constraints, and nuclear is also proffered as a solution. But fossil fuels are not sustainable, and many parts of the world are trying to phase them out in favour of more renewable alternatives.

Greener energy options, such as wind and solar, will eventually be rolled out, but they have limitations. Namely, the intermittent nature of wind and solar energy, challenges in seasonal battery storage and increasing resistance from local communities. Storing sustainably produced energy also presents further challenges, as excess energy requires massive batteries, which come with their own sustainability costs. The transition to renewable energy also requires huge amounts of commodities and industrial metals, and mining for them takes a lot of new infrastructure.

The staggering demand for AI will need to be met somehow, and currently, the answer looks like fossil fuel-powered electricity. AI may be driving improvements across many industries, but it undoubtably also presents great challenges for the global transition to more sustainable sources of energy.

We think, however, there's plenty of reason to be optimistic. A total of 173,000 terawatts (trillions of watts) of solar energy strikes the Earth continuously. That's over 10,000 times the world's total energy use.[3] Innovation will help us unlock the potential of renewable energy, and we have already seen production costs reducing dramatically. Areas such as nuclear fusion offer great potential and will be unlocked in time. The benefits from AI, and confidence in human ingenuity should offer a leap forward, even if in the short term, there are challenges to overcome.

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[1] Global Sustainable Investment Review 2022 | GSIA (gsi-alliance.org)

[2] McKinsey Global Energy Perspective 2023

[3] Vast amounts of solar energy radiate to the Earth, but tapping it cost-effectively remains a challenge (phys.org)

China's quick-fix EVs undermine the market

Electric vehicles (EVs) are an important part of the global green transition, as we slowly shift from combustion engines to battery-powered alternatives. European and US demand for EVs has steadily climbed, and historically, that demand has generally been met by local EV manufacturers.

But China has flooded the market with cheaper EVs, increasing auto exports by 58% year on year to a record 4.9 million units in 2023.[4] There's now oversupply in the European market, which threatens to spread to the US as China attempts to friendshore Mexico. This isn't good news for local economies as Beijing makes a grab for market share.

This rush for market share is also bad news for the long-term sustainability credentials of EVs, as Beijing forces production into a sprint, not a marathon. Today's supply race will press manufacturers to take shortcuts, and that doesn't bode well for the green credentials of EVs. It takes a long time to develop the greenest, most efficient EVs, and China's oversupply will inevitably force manufacturers to cut corners in the competition for market share.

China is able to undercut European and US suppliers because its government heavily subsidises the sector.

In the absence of trade tariffs, competition is unfair. So, in a bid to level the playing field, US President, Joe Biden, stamped levies on $18billion worth of imports of Chinese EVs, increasing the tariffs from 27.5% to 100%. This policy was intended to challenge China's aggressively low pricing and protect American industry, but Beijing has since hinted at tit-for-tat action, as relations between the two countries become increasingly tense.

When it comes to sustainability, China isn't just producing cheap EVs. They pumped more than $130billion into solar in 2023 as they've been busy accumulating manufacturing capacity.[5] This is a worry for the US as Washington tries to build its own production capacity, reduce dependence on China and support its own green transition.

None of this is good news for global sustainability efforts. China is predominately a coal economy, and it's flooding the market with low-cost less green alternatives. Cost-conscious consumers will snap up these cheap EVs, which means European and US manufacturers will lose out to Beijing. The noble efforts to roll out sustainable transport solutions are being hampered by global politics and a drive for market share.

[4] China's green-tech manufacturing boom draws concerns about overcapacity | The Straits Times

[5] ibid

Building walls demolishes change

International trade tariffs, and general efforts to undermine one another's market share, are symptomatic of global economic decoupling. The direction we're heading in looks more like a patchwork of coalitions, as states are joined or divided according to political allegiance. This move is also described as deglobalisation, a reduction in worldwide economic interdependence.

The shift to a more sustainable future is a challenge faced by every country in the world. These efforts benefit from a joined-up approach, where we share innovations and support each other's progress. But deglobalisation creates divisions and barriers where we need open communication, and this will inevitably slow down the pace of change. In this environment, policies should be aggregated, not segregated.

The annual UN Climate Change Conference (COP) was established to unite our global environmental efforts. Goals and targets were optimistically set decades ago, and intentions were sincere. Since then, decoupling and political divisions have made these targets increasingly challenging and the outcomes of the latest COP29 were disappointing. Long-term success depends on shared goals.

Further division is illustrated by the US-China trade tariff animosity. As Europe and the US will probably implement trade barriers to stop the destruction of their domestic industries, China must find a way to navigate this new world. It's likely they will try to grow their economy by stepping up manufacturing, cooperating with the rest of the emerging economies to import unfinished manufactured goods, which will then be finished, refined, and exported to elsewhere in the world. But this does not present a sustainable solution to today's problems.

Political uncertainty presents its own challenges. The contenders for the upcoming US presidential election hold diverging views on the transition towards a more sustainable future. Former US president, Donald Trump, is not known for his environmental sympathies, and the high chance of his return to the White House has put various solar and renewable energy investments on hold. It's rumoured he plans to gut Joe Biden's landmark Inflation Reduction Act (IRA) climate law bill if he does get reinstated.

The IRA was intended to lead to a major reduction in US greenhouse gas emissions and give a boost to renewables, but these changes would likely be curtailed under another Trump presidency. Investors wait patiently, withholding funds until they see what November brings.

Good intentions are repeatedly hampered by geopolitics, with divisions rife. Today's deglobalisation is unlikely to drive the unified change we need to transition to a more sustainable future. Widespread uncertainty breeds a world sitting on the sidelines, waiting for the change which never arrives. Instead, all efforts should be expediated and aggregated.

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Reasons to be optimistic

It isn't all completely doom and gloom. Sustainable investing is becoming more mainstream as awareness of the subject has grown exponentially over the past decade or so. This means there have been significant inflows into strategies where ESG is now fully integrated into decision making.

These inflows are partly thanks to policies introduced in 2021. The EU articulated Articles 8 and 9 under their Sustainable Finance Disclosure Regulation (SFDR) to create greater delineation between light green versus dark green funds. It was a move towards transparency in previously murky territory, and this clarity has attracted investors. Policy is moving in the right direction, and it's usually just a matter of time until investors follow.

Further progress is evident in the growth of the responsible investing community, represented by the UN Principles for Responsible Investment (PRI).

Signatories to the UNPRI rose 10% year-on-year (22/23), reaching 5,391 by 31 March 2023.[6] After several years of very rapid growth in sign-ups, growth is starting to slow simply because saturation point has been reached in the most highly developed responsible investing markets. Everyone interested is already fully engaged and making great efforts to drive sustainability initiatives. If nothing else, there is certainly plenty of great intention, and that's where a lot of change starts.

Investors should remain optimistic in the long run. Human ingenuity is immense. AI and automation offer amazing potential for future productivity and growth. We have plenty of challenges, but challenge leads to opportunity. The energy transition and sustainable investing should be seen as an opportunity to benefit from the transition to a brighter future for humanity.

Robert Sears
Partner, CIO

[6] UN PRI 2022-23 Annual Report

Our approach to
responsible capital

Responsible investing with a commitment to driving change.

Impact and engagement

We believe it's our responsibility to use our influence for good, both as significant fund investors and as facilitators of direct client investments. To that end, we work closely with the funds we invest in to help them enhance any outdated ESG processes. We also help our clients make long-term investments in sustainable technology solutions such as waste water treatments, electric vehicles and fuel cells.

Investment excellence

We maintain the highest standards of excellence across our ESG investment approach and aim to deploy capital as thoughtful, patient and discriminating.

Every investment is evaluated through a detailed ESG process which incorporates quantitative and qualitative data. Environmental and social risks are considered at every stage.

Today's evolving economy offers many opportunities for sustainable investors, as solutions are constantly sought for the challenges we face. We carefully scan the investment horizon to make sure we capture any great new businesses.

The right qualifications support this excellence, so every member of the investment team is required to hold the CFA certificate in ESG Investing.

Collaboration

We are proud signatories of the UN Principles for Responsible Investment and the TCFD, the Task Force for Climate-related Financial Disclosures.

Our Responsible Capital Committee is chaired by Sustainability Economist, Dimitri Zenghelis. Dimitri has advised governments, financial institutions, and international organisations on economics, sustainable growth, climate transition and innovation. The Committee meets regularly to allow us and our clients a space to discuss various ESG perspectives and challenges.

Key facts

3/8 partners are female	Diverse team with multiple nationalities represented and Spanish, French, Portuguese, Mandarin, Cantonese and Italian (among others) spoken	We are accredited Living Wage Foundation Employer	We work with Carbon Footprint in our target to become carbon neutral

Our values as investors

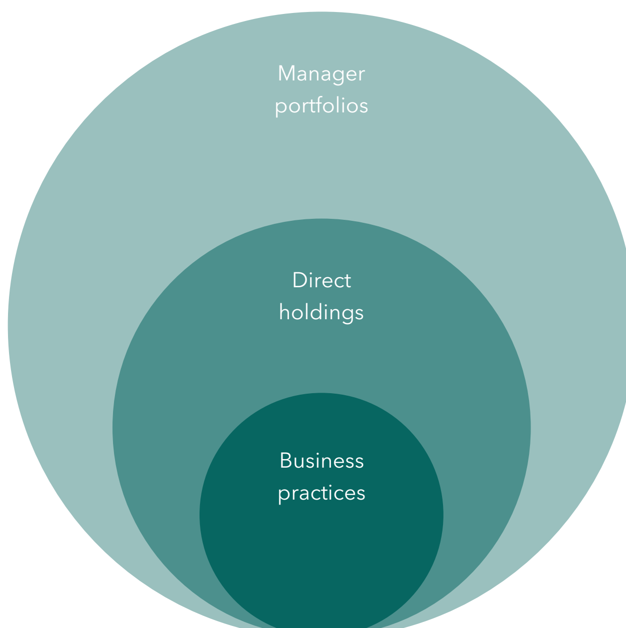
We firmly believe the allocation of capital is one of the single most powerful forces in driving change in the global economy. From the day we launched Capital Generation Partners, we knew that we wanted to help families make the most of the power of their capital. We wanted to help them actively put it to use in a way that is lasting and sustainable.

Our values as business owners

It's our responsibility to act as thoughtful stewards of capital on behalf of our clients. That ethos shapes the way that firm is structured – independent and partner-owned – the way we invest, and the way that we conduct ourselves in our day-to-day practices.

Our sphere of influence

We ensure our principles as responsible investors and business owners are reflected across our practices.



Manager portfolios

Where we have influence, we wield it to drive positive change.

We have instructed managers to sell out of positions where they have not met our ESG requirements.

Direct holdings

Where we can help our clients make an impact, we do.

We facilitate the acquisition and ongoing management of ESG-related businesses, allowing our clients to have a major impact on the companies they invest in.

Business practices

Where we have full control, we seek to lead by example.

For instance, we have specifically targeted ourselves with becoming carbon neutral.

Our manager selection

Manager selection

We wield our influence as fund investors to drive change within our industry, helping shape the capital allocation of hundreds of billions worth of investment around the world. As we typically allocate large sums of capital and forge close relationships with our managers, we can have considerable influence in the funds that we invest in.

For example, we have persuaded funds to become UNPRI signatories, helped them integrate ESG in their investment processes, and worked side-by-side with lower scoring managers to help them improve their scores across all key metrics. We have also worked closely with our buy list managers to help them improve their responsible investing practices.

We conduct an annual managers survey which offers detailed insights into their progress in terms of ESG integration, resourcing, external affiliations (e.g. TCFD) and more.

Every fund we invest in goes through our proprietary ESG framework. Although managers don’t have to achieve a perfect ESG score to warrant a place on the buy list, we do want to see evidence of their ability to improve. We see it as our responsibility to help them do so.

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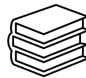
We scrutinise, score, and engage with managers on six key metrics:

Active ownership

- Do they demonstrate consistent voting practices?
- Are they a leading force in active engagement?
- How have they voted in the past?

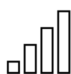


Capability and resources

- Do they have ESG-dedicated staff and systems?
- Have they made a major capital investment in ESG and responsible investing?
- Are they planning to invest more in this respect?

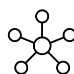
Policy

- Do they have detailed and thorough responsible investing policies?
- Are they signatories or supporters of responsible investing initiatives?
- Is their sustainability approach consistently applied?



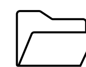
Reporting

- Do they fully adopt industry reporting best practice e.g. INREV, ILPA?
- Is the ESG value-add clearly delineated and evidenced?
- Are specific metrics consistently shown in reporting?



Integration

- Do they have an established, proven sustainability model that's fully embedded?
- Do they have examples of ESG factors applied in practice?
- Are ESG factors considered throughout their investment process?



Portfolio

- Do they show material positive contributions to UN SDGs?
- Is sustainability a prominent and meaningful component of portfolio management?
- Which sustainable investing themes are they geared towards?

Our annual Responsible Capital Fund Manager survey

Every year, we send our Responsible Capital Survey to the fund managers on our buy list. This thorough survey requests information on various areas of conduct, including ESG processes and reporting, and more day-to-day business practices, such as carbon offsetting and diversity, equity, and inclusion policies. Any weaknesses are addressed as part of our desire to elicit change for good.

Here are the main takeaways from our 2023 survey results:

11%

of managers have made improvements to reporting.

41%

of managers have a formal stewardship policy.

11%

of managers have made improvements to their ESG training.

1. **Reporting has great potential for improvement.**

   Managers answered 'yes' to 55% of all reporting-related questions (where 'yes' indicates progress). This tells us that many managers could clearly be doing much more when it comes to reporting. But some have made a good start, with 11% notifying us of some improvements.

   We were pleased to note that transparency is becoming the minimum standard for managers, not the exception, and the breadth of responsible investment reporting does generally continue to trend upwards.

2. **Most managers do not have a stewardship policy.**

   We were surprised only 41% of managers answered 'yes' when asked 'do you have a formal stewardship policy?' and 'do you participate in collaborative engagements to influence issuers?'

   Our sense is that managers may be reluctant to collaborate on engagement with other managers as they are in competition with one another. They may also be concerned about the formation of concert parties when participating in collaborative engagements (i.e. groups of shareholders so influential that they effectively take control of companies without mounting a formal takeover). The formation of concert parties may have regulatory consequences. This will certainly be an area of focus for our future engagement activities.

3. **There have been some improvements made to ESG training.**

   We found it encouraging that 11% of managers reported improvements made to their ESG training in the past year. Enhanced training could be an early indicator of future ESG improvements in these firms.

4. **DEI has taken steps backwards.**

   4% of managers said they no longer have a diversity, equity, and inclusion (DEI) policy. We think this is probably due to some backlash seen against this type of policy and a recognition that, if poorly done, these can misfire.

5. **Alternative strategies are trailing.**

   Hedge fund managers answered 'yes' to just 44% of questions (where 'yes' indicates progress), which is a lower figure than the other three asset classes surveyed. However, this is an improvement on last year, where hedge funds replied 'yes' to just 33% of questions.

   We note there has been less ESG development and integration in discretionary macro and CTA strategies (commodity trading adviser). As several of the hedge fund managers surveyed follow these strategies, we think this lack of clarity is to blame for the lower ESG engagement. This will also be an area of focus for our ESG engagement activities.

Our responsible business practices

We invest in many funds and individual projects, but crucially, we invest in our own business. CapGen is 100% privately owned by the partners of the firm, so we have complete control and accountability for the way that it is run, and the impact it has on the wider community. That is a privilege and a source of great responsibility we take very seriously.

Diversity and employment

When it comes to hiring, we seek diversity of representation and diversity of thought. We are then committed to building careers not jobs. To that end, everyone has their own career progression plan, and our mentor program offers support from outside line management structures.

- 3/8 partners in the business are women
- We are a Living Wage Foundation employer
- We support interns from disadvantaged backgrounds through the Access Aspiration initiative
- We work with Girls Are Investors (GAIN) to help open up the financial services industry to young women and girls, providing internships and work experience

Environmental responsibility

As a services business, we have a relatively small carbon footprint. Nevertheless, we still do everything in our power to reduce it to a minimum. We also work with Carbon Footprint to estimate our annual emissions, which we then round up and pay to offset.

We are cloud-based, we limit plastic and food waste in our office, and we use a green energy supplier.

Charity

We believe in supporting and partnering with local charities that actively support the communities in which we operate as a business. For many years, our charity efforts have focused on supporting organisations that drive positive social change, through education, tackling food poverty and more.

We tend to prefer committing to charities for multi-year donation programs, often supporting smaller charities at earlier stages in their growth.

Our charity partnerships include:

- Access Aspiration
- Makaton
- The Felix Project
- Young Minds

We are signatories and supporters of:

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