ACUITY Insights

Covering Critical Environmental Investment Trends

4th Quarter, 2010

Clean Environment
The Year in Review

Despite well-publicized spending on green infrastructure by governments around the world in response to the 2008-2009 recession (please refer to Acuity Insights Q1 2009 for background), 2010 provided a poor backdrop for environmental investing. Clean tech benchmarks such as the Wilderhill Clean Tech Energy Index and the Bank of America/Merrill Lynch Clean Tech Index were down 5% and down 17% respectively (USD) compared with broader market index gains of 15% for the Standard and Poor's 500 Index (USD) and 18% for the S&P/TSX Composite Index (CAD). Although the performance of the Clean Environment fund lagged that of the broader North American markets, the fund was able to generate a positive return due to its broader focus on four key themes within the Clean Tech universe.[1] The indexes and investable opportunities, however, are heavily slanted towards alternative energy whose poor performance over the past year can be attributed to a number of factors:

- European Debt Crisis: The crisis forced governments to reign in spending plans, including subsidy programs directed at new energy technologies such as solar power. While the profitability of many companies has been largely unaffected due to declining costs for key inputs (i.e. silicon), the negative sentiment has held back most alternative energy stocks.

- Low Natural Gas and Oil Prices: Investor sentiment towards alternative energy stocks improves when the prices of traditional energy sources increase, as the cost of alternatives becomes more competitive. As oil prices have been largely range bound over the last year, and natural gas prices in North America have remained very depressed, energy prices have provided little stimulus for alternative energy stocks in 2010.

- Overcapacity in Key Environmental Sectors; key sectors such as solar and wind[2] have experienced strong growth over the past five years as governments worldwide implemented subsidy programs for green power. This demand has led to significant capacity growth along the solar and wind value chains. These increases in capacity coupled with concerns over subsidy programs for green power in key regions, such as Germany, have created fears in the investment community of overcapacity. Although there are compelling investment opportunities with the low cost providers of various solar components, investors have eschewed the sector in favour of more predictable returns elsewhere in the market.

Table 1: Clean Tech Sector Performance, 2010

Sector	2010 Return	% Mkt Cap
Wind	-33%	30%
Geothermal	-6%	2%
Waste	10%	2%
Smart Grid	-3%	9%
Fuels	10%	6%
Solar	-15%	36%
Water	7%	10%
Storage	-1%	6%
BofAML Clean Tech Index Return	**-17%**	

Source: BofA Merrill Lynch Global Research

Outlook

We anticipate that the factors noted above will continue to hamper the performance of alternative energy stocks in the first half of 2011. However, we view these factors as largely short term given our generally positive view on oil prices longer term and the improving cost competitiveness of key technologies, such as solar power. With solar power approaching grid parity in the sun drenched regions of the world within the next few years, we believe solar adoption will increase significantly even without subsidies. Under such a scenario, the growth rate for alternative energy would be much stronger than for conventional energy sources over the next decade and will eventually draw the attention of mainstream investors.

The Clean Environment fund will continue to diversify across its four key themes and internationally to provide direct exposure to the highest growth environmental technologies and services. Micro themes that we are particularly excited about for the next 12-18 months include new lighting technologies, the deployment of hybrid/electric vehicles, and better waste management processes within the resource sectors. We believe these areas are poised to grow rapidly regardless of government involvement.

Contributors

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1.The four themes are: (i) Energy and Power Solutions, (ii) Water and Wastewater Solutions, (iii) Waste Management and Pollution Control, and (iv) Environment, Health and Safety.
2.Solar and wind energy stocks comprise roughly two-thirds of the total market cap of the Bank of America Merrill Lynch Clean Tech index.

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