Ethical Capital Opportunity ECO Advisors

NEWSLETTER

FUND PERFORMANCE SUMMARY — Q1 2022

PROTEA UCITS II
ECO Advisors ESG Absolute Return Fund

	MTD	QTD	YTD	Since Inception
F Class EUR	1.23%	1.42%	1.42%	8.84%
F Class GBP	1.32%	1.65%	1.65%	10.91%
F Class USD	1.35%	1.62%	1.62%	6.81%
P Class EUR	1.03%	1.19%	1.19%	5.65%

Monthly Net Performance (1YR)	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec 2021	Jan	Feb	Mar
F Class EUR	-0.24%	0.02%	0.12%	1.24%	0.70%	-1.73%	0.17%	2.38%	1.71%	-0.75%	0.94%	1.23%
F Class GBP	-0.20%	0.07%	0.15%	1.29%	0.74%	-1.69%	0.22%	2.44%	1.76%	-0.67%	1.00%	1.32%

Inception dates: F Class EUR and F Class GBP - July 8th, 2019; F Class USD - Oct 1st, 2019; P Class EUR - Jan 6th, 2020
Performance is shown net of all fees. Past performance is no guarantee of future returns. Source: ECO Advisors, FundPartner Solutions Europe (SA)

Gross Performance Summary

PROTEA UCITS II - ECO Advisors ESG Absolute Return Fund

	MTD	QTD	YTD	Since Inception
Gross Return	1.38%	1.78%	1.78%	12.28%
Long Contribution	1.56%	-3.43%	-3.43%	28.31%
Short Contribution	-0.27%	5.16%	5.16%	-16.31%
FX Hedging	0.09%	0.06%	0.06%	0.28%

Above figures are gross estimates of the fund's performance. Components may not sum due to compounding and rounding effects. Source: ECO Advisors

ESG Portfolio Metrics

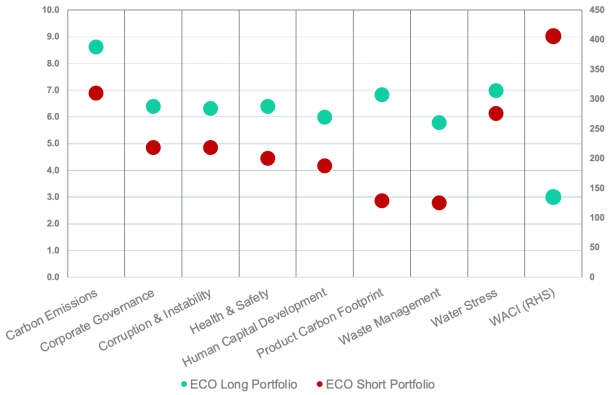
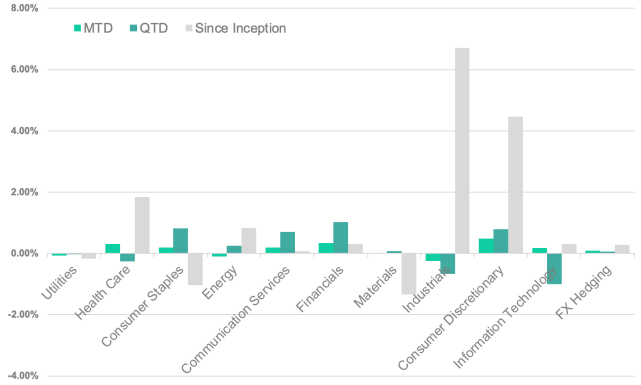


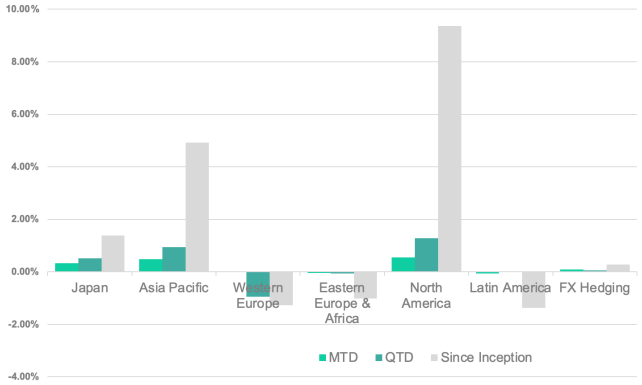
Chart illustrates weighted average score of selected MSCI ESG key issue scores for both our long and short portfolios (LHS). WACI measures portfolio weighted average CO2 emissions <metric tonnes, scope 1&2> per $1m of revenue (RHS). Source: ECO Advisors, MSCI, Refinitiv

Gross Performance Attribution - Sectors



The above figures are estimates, gross of fees. Source: ECO Advisors

Gross Performance Attribution - Regions



The above figures are estimates, gross of fees. Source: ECO Advisors

Performance & Attribution Summary

The Fund gained over the quarter (GBP F class +1.6%, EUR F class +1.4%, USD F class +1.6%). On a gross sector basis, Financials (+100bps), Consumer Staples (+80bps) and Consumer Discretionary (+80bps) contributed, whilst Information Technology (-100bps) and Industrials (-65bps) detracted. Regionally, North America (+130bps) and Asia Pacific (+95bps) contributed, whilst Western Europe (-95bps) detracted. The long book detracted ca. -340bps, whilst the short book contributed ca. +515bps. From a risk factor perspective, ESG stock selection drove the Fund's positive return over the quarter (ca. +290bps), whilst net long residual beta, and net long exposure to Europe both contributed to a headwind (ca. -115bps) from risk factors.

In a volatile quarter, global equity markets declined with the MSCI World TR Index $ falling -5.2%. Global bond markets also sold off significantly with the Bloomberg Global-Agg Corp Bond Index TR $ falling ca. -5.0%, amidst continuing high inflation and hawkish pivots from the Fed and the ECB, who are facing significantly higher inflation than they previously forecast. The US yield curve flattened as shorter maturity bonds reacted most to central bank interest rate signals.

Q1 saw significant volatility and factor/sector rotations within the equity market. As we alluded to in our last newsletter, high inflation and rising interest rate expectations have historically been associated with increased volatility as well as the outperformance of 'value' segments of the equity market at the expense of 'growth' companies. This could certainly be seen in Q1, both when looking at the performance of global equity style factors as well as the dispersion in the performance of global sectors with Energy, Financials and Materials outperforming IT.

The invasion of Ukraine by Russia in February added to volatility and also exacerbated the rise in commodity prices as significant economic sanctions were swiftly introduced against Russia. After outperforming in January, European equities fell sharply in the wake of the invasion, as the advent of war and the resulting economic shocks from supply disruptions, commodity price rises, and sanctions became clear. The advent of the invasion led to extreme moves in certain areas, especially in Energy, Renewables and Defence sectors, whilst companies with exposure to Russia fell sharply, in some cases over 90%, and many were suspended from trading.

Q1 Earnings season was mixed. The reflationary economic backdrop and continuing strong economic growth, particularly in nominal terms, is clearly still a tailwind for many companies. The ability to navigate high input costs, tighter labour markets and supply chain disruptions whilst maintaining pricing power is proving to be a differentiating factor amidst a wide dispersion in results and earnings guidance.

The Fund's positive return was largely driven by stock selection, particularly from the short book, which significantly underperformed the global equity market. We were encouraged by the strategy's robustness in the face of the challenging market conditions as described above.

There are a number of factors worth highlighting behind the positive performance and stock selection in Q1. Firstly, maintaining a tight rein on net factor/sector exposures, particularly in Energy and Materials, allowed for stock selection to drive performance in an environment where factor and sector rotations had a significant impact. Secondly, our long-held view that ESG leaders are better able to navigate energy input costs, supply chain and labour market challenges continued to be reinforced as we saw a number of names, particularly on the short side, fall during earnings season after citing headwinds in this area. Thirdly, we saw the continued emergence of longstanding underlying political and regulatory 'S pillar' risks impact certain names in the online platform space within our short portfolio (for example, we highlight Meta below). Whilst some of these names have proved to be challenging shorts despite the continuing buildup of such risks, it reinforces our view that companies running with large underlying ESG risks are vulnerable no matter what their perceived growth profile.

As equity markets reacted to the Russian invasion and subsequent conflict in Ukraine, we saw some significant moves in the portfolio. Our net long exposure to Europe, and in particular to Financials was a headwind as the banking sector was hit by uncertainty around sanctions and fears of a growth slow-down. However, our natural long bias to renewable energy focused companies proved to be a tailwind as the geopolitical situation reinforced the importance of the switch towards alternative energy. Finally, in January, our active risk management process identified two companies in the long portfolio which had material revenue and business exposure to Russia, and we proactively removed these positions well ahead of events in February.[1]

Long Portfolio - Significant Movers

> SIMS (+42%), the Australian metals & electronics recycler, gained after reporting strong earnings. The company said net profit and revenue rose in the fiscal first half, as intake volumes grew strongly and approached pre-Covid-19 levels, while margins increased. The company cited a number of structural tailwinds underpinning its business, including infrastructure projects increasing demand for steel, decarbonisation of steelmaking raising demand for recycled metal and an increase in IT component recycling. As well as being exceptionally well positioned with regards to structural trends in ESG, SIMS also stands out as an industry leader in areas such as governance, health and safety, and pollution management.

> HESS (+45%), the US oil and gas producer, benefitted from the rally in the price of crude oil and natural gas. The company posted a quarterly profit on earnings day compared with a year-ago loss, as demand recovered from the pandemic-induced slump and prices surged after the Russian invasion of Ukraine. According to our data analysis, Hess fares well relative to peers on pollution reduction outcomes. The company outperformed its targets to reduce Scope 1 and 2 GHG emissions intensity by 25% and flaring intensity by 50% from its operated assets, reducing GHG emissions intensity and flaring intensity by 46% and 59%, respectively (vs. 2014 levels). The company's oil spill intensity is also notably lower than the industry average.

Short Portfolio - Significant Movers

> SEA LTD. (-46%), the international e-commerce platform operator, declined over the quarter as earnings missed estimates and the company faced headwinds in its digital and e-commerce operations. In March, Sea Ltd. announced it was withdrawing from India's retail market. The company has faced a range of legal, political, and regulatory headwinds which has hampered its operations in what was previously seen as a high growth market. The India withdrawal came weeks after Sea's e-commerce arm, Shopee, said it was pulling out of France. The company lags peers in a number of key ESG areas including governance and labour management. The company has also been involved in labour controversies, particularly around the working practices for couriers working for its e-commerce and delivery platforms.

> META (-34%) declined in February after the company issued disappointing guidance for the first quarter in addition to coming up short on its fourth-quarter profit and user numbers. Daily Active Users (DAUs) on Facebook were slightly down in the fourth quarter compared to the previous quarter, marking its first quarterly decline in DAUs on record. Whilst Meta is no stranger to ESG related controversies, ranging from antitrust, misuse of personal data and facilitating extremist views on its platforms, analysts have cited recent changes to data privacy controls on Apple and Android operating systems as posing a particular challenge to Meta's targeted advertising revenue model.

Outlook & Positioning

The inflationary environment, central bank hawkishness and war in Europe make for a turbulent outlook for equity and bond investors for the remainder of 2022. We believe the macroeconomic and geopolitical backdrop has changed significantly from what many investors have been accustomed to.

We believe that in an environment in which inflation is higher, and labour markets tighter, the role of government and politics is more important and will mean a quite different set of successful investment themes compared to some of the most successful themes seen over the last cycle. Whilst themes such growth, globalisation, asset light business models and ability to take advantage of flexible labour markets were successful themes in the previous macroeconomic cycle, we think it likely that a new set of drivers are likely to be important in the current environment.

Most importantly, ensuring a disciplined positioning with respect to valuation and profit stability factors is critical in this new environment, and indeed this has been a crucial part of our positive returns in recent months. We believe that it is also important to ensure that we are not carrying residual short risk in sectors such as Energy, Materials, and Industrials as they are likely beneficiaries of the environment going forwards as rising energy costs, the Green transition and increased government spending should drive Industrial capex.

We believe that equity market volatility is likely to continue to be elevated, driven by increased political interventions, rising earnings variability in the face of high input costs, and the more limited ability of central banks to increase liquidity or cut interest rates in times of stress due to higher inflation. Furthermore, the risk of a growth slowdown caused by commodity price shocks or central bank tightening also raises the risk of 'stagflation'. We strongly believe that our market neutral, sector and style balanced approach offers a compelling way to navigate what is a challenging environment for traditional equity and fixed income investors.

A common critique of investing through an ESG lens has been its perceived association with certain styles, notably growth. It is certainly true that across the whole global universe, the crossover between high ESG companies and 'growth tilted' companies is higher than to 'value tilted' companies. However, using our peer-relative ESG approach, our process is able to identify no shortage of ESG leaders and improvers with exposure to the value style (i.e., "cheap" stocks) which can also be beneficiaries of the increased capex cycle outlined above. Furthermore, we also find no shortage of expensive 'ESG laggards'. The combination of these continues to allow us to be well balanced in terms of net value/growth style risk.

Some commentators have questioned the efficacy of ESG as an alpha driver, particularly in the wake of a period of outperformance of high carbon intensity companies which we have written about in recent newsletters. We believe that part of this phenomena can be attributed to valuation drivers (see ESG research section below for more details). Controlling for valuation effects, we can see a number of ESG areas as key alpha drivers in this environment. We have already seen examples of 'S & G pillar' drivers come to the fore in recent months and we believe that in periods of increased political intervention, tight labour markets, supply chain disruptions and de-globalisation, issues such as labour practices, supply chain management and corporate conduct will only increase in importance. On the E pillar, the current environment should support more energy efficient companies as well as those with business models geared towards investment in alternative energy and energy saving infrastructure, both of which are key inputs into our 'E pillar evaluation'.

Having cited the importance of valuation discipline in the current environment, in the ESG research section below we explore valuation profiles and potential crowding effects as they pertain to ESG investing across different sectors.

ESG RESEARCH SPOTLIGHT: Is "ESG" Crowded? A First Look

In this Research Spotlight, we aim to investigate a question that is frequently raised by investors: *Is "ESG" crowded?*

The question of position crowding is important for several reasons, most crucially as it pertains to risk management discipline and the future outlook for ESG investment returns. In the discussion to follow, we highlight our approach to monitoring and assessing crowding risk in ESG, and review some of our ongoing research in this area.

Before any analytical assessment of "ESG crowding" can be conducted, it is important to clarify definitions. What do we mean by "ESG" in this instance, and what do we mean by "crowding"? This is not simply a matter of semantics, as definitions are crucial when assessing data and the implications of any analysis. And while it may seem trivial, in fact defining both "ESG" and "crowding" are more nuanced challenges than a simple question suggests.

So, what do we mean by "ESG" in this discussion? As we discuss with investors regularly, ESG can mean quite different things to different people. We know that many equity funds and strategies currently marketed or described as "ESG" or "sustainable"[2] apply some element of exclusionary screening (no tobacco, no thermal coal investments etc.) but otherwise follow a standard investment style or practice. If the majority of ESG investment flows were in such exclusionary approaches, one might hypothesise that the biggest impact might not be "crowded" *long* ESG positions, but rather structural underinvestment or depressed valuations in common names or subsectors subject to such exclusionary screening. Other investment strategies primarily focus on "ESG integration" rather than exclusions (though exclusions are a common part of such strategies as well), with the long-only community owning "good ESG" companies in their strategies.[3] A reasonable hypothesis could be that excessive flows or demand for ESG integration strategies in long-only investing may lead to crowded positions or valuation distortions in certain sectors or particular names that are widely held across a large number of ESG strategies or funds. Finally, one can consider ESG investing from the perspective of thematic investing, where investors are considering investments primarily through the lens of *double materiality*, rather than a focus on companies that excel at managing their E, S and G risks. Thematic ESG investing puts a focus on external societal impact – typically, investing in companies that are focused on some sort of "solution" to a society wide ESG challenge.

While common and popular forms of thematic ESG investing are often focused on the "E" – think clean energy and renewables funds or ETFs – there has also been increasing interest in S pillar thematic funds, for example addressing issues of diversity, or attempting to align investments with the UN SDGs. Together, these three investment approaches (which are not mutually exclusive but provide a useful categorisation) capture the majority of ESG investing with respect to active and passive equity funds and ETFs. So, to answer the question posed above, for the purposes of our discussion here it is the combination of investments in these types of equity strategies that we mean when we talk about "ESG".

There is no doubt that all three flavours of ESG investing described above have become increasingly popular in recent years, with a rapid acceleration in interest and flows beginning in 2018.[4] However, understanding the interplay and cumulative net impact of all investment flows on the market, security valuations and potential future returns is challenging, and we note there are a number of potential techniques to try and assess a degree of "crowding risk".

What do we mean by "crowding"? In principle, investor crowding in an asset or sector suggests that excessive enthusiasm and inflows (or lack of enthusiasm or outflows) creates an adverse situation in terms of forward-looking risk / return for the investments (or a favourable environment for under-owned names or "popular shorts"). This risk could be assessed from a market technical standpoint, looking at price related metrics such as RSI, Bollinger bands, or other tools of technical analysis, in order to determine short term "overbought" or "oversold" conditions. Similarly, one could evaluate differentials in common equity valuation metrics (such as P/E ratio) on an absolute or relative basis, to try and determine if net flows have created valuation distortions that would suggest adverse risk/reward for future returns. In our analysis below, we focus on a valuations-based assessment of crowding, rather than a technical approach.

Our Framework for Evaluating ESG Crowding

For the purposes of our analysis, we wish to assess the net impact of aggregate active and passive "ESG flows" across an investable equity universe, and so look to determine if:

1. A valuation premium (or discount) is evident across the universe, and more specifically, at the sector level, and
2. For evidence of an increasing (or decreasing) valuation premium (or discount) after 2018, when ESG investment flows accelerated rapidly.

Given the different growth prospects for "high ESG" vs. "low ESG" companies, it is not unreasonable to posit there may be a valuation premium of some sort for "high ESG" companies that is unrelated to the impact of investment flows, if these names can be expected to have better long-term growth prospects, for example (note: this is a hypothesis). Looking at valuations before and after 2018, and the evolution through time, should help provide some insight into whether or not the more recent regime of interest in ESG and increase in ESG fund flows has changed the average valuation profile across "high ESG" and "low ESG" names – i.e., if there is a "crowding effect" that is evident from shifts in valuations between cohorts of stocks based on ESG considerations.

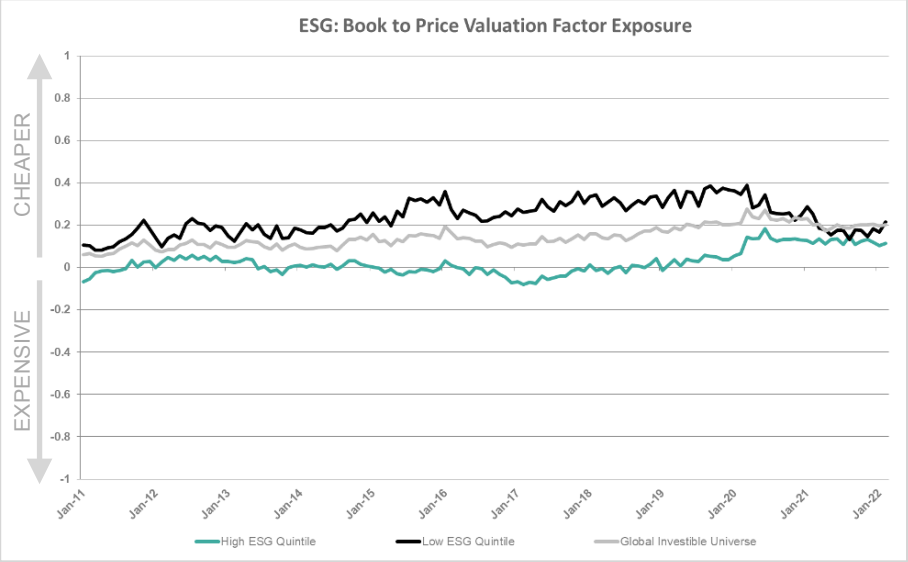
To conduct our analysis, we need to define 1) our evaluation universe of securities, 2) a specific criteria for "high ESG" and "low ESG" names, and 3) relevant valuation metrics.

For the evaluation universe, we utilise our "investable" global equity universe, which we use for our fund's portfolio construction, and which forms the initial stage of our investment process for the ECO Advisors ESG Absolute Return strategy. We note that our investable universe only includes securities where relevant ESG data is available, and excludes small cap and less liquid securities, and is therefore somewhat less broad than the ACWI IMI. As such, it may not be fully representative for all types of investors. However, we believe it provides a sufficiently diverse set of liquid and investable equities across both developed and many emerging markets, and hence a solid foundation for our crowding analysis. While the universe size varies historically (and has grown through time), the current size of the universe we analyse is around 5,000 securities globally.

For our ESG criteria, we utilise MSCI ESG Ratings and scores to examine high and low fractile cohorts of names that rank highly or poorly on MSCI ESG criteria. As one of the largest and most widely adopted sources of ESG data for institutional investors, we feel utilising MSCI's IVA score is a useful proxy to identify "high ESG" and "low ESG" securities with respect to an analysis of ESG crowding, from the perspective of the impact of fund flows, as these data will likely be integrated in some fashion in a significant portion of institutional active ESG strategies.

Furthermore, MSCI's ESG criteria has significance for crowding analysis as the one of the dominant data providers for passive ESG funds and ETFs with the largest market share – which may be more likely to produce a "crowding" effect than actively managed funds. According to research from Goldman Sachs, "roughly 35% of ESG ETFs and *59% of all related AUM today* employs MSCI ESG scoring in security selection, including eight of the ten largest funds globally."[6] Of course, different ESG data sources and methodology in assessing ESG may come to different conclusions, but in the absence of a generally accepted standard for ESG, evaluating through the lens of MSCI ESG seems to us a reasonable starting point for an evaluation of ESG crowding in the market, particularly in light of the market penetration for ESG passive funds using MSCI ESG criteria.

In our analysis, we focus on evaluation of top and bottom quintiles of securities ranked by MSCI ESG IVA score, which forms the basis for MSCI ESG ratings.[7] For our equity valuation metrics, we utilise the Barra Global Equity model, and evaluate the average (equally weighted) factor exposures of our high and low ESG fractile portfolios to valuation factors in the model. We focus our analysis on two key valuation factors in the model for equities, Book to Price (BTOP) and Earnings Yield. The Book to Price factor is straightforward to interpret as a valuation measure; we note in interpreting the charts to follow that a *higher* BTOP score (positive factor loading) represents a more attractive (*cheaper*) Book to Price valuation. The Earnings Yield factor is built from a number of descriptors (factor building blocks) and is a composite of Enterprise Multiple (EBIT to EV), Cash Earnings-to-Price, Earnings-to-Price and Analyst-Predicted Earnings-to-Price.[8] Similarly to the interpretation of BTOP, a *higher* Earnings Yield exposure indicates a *"cheaper"* stock. Finally, exposures are normalised Z-scores based on the overall equity estimation universe for the model; an exposure of 1 can be interpreted as higher than roughly two-thirds of the overall equity model estimation universe.

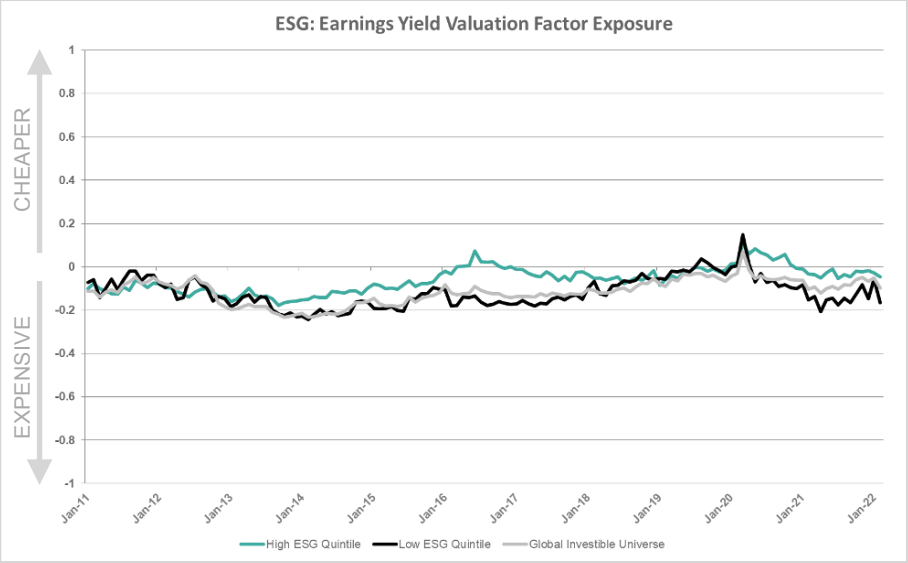


Y axis shows average valuation factor exposure. Higher = cheaper valuations, lower = expensive valuations. ESG quintiles based on MSCI ESG IVA Scores. Source, ECO Advisors, MSCI

ESG Crowding in the Broad Universe

We aim to see if the average "high ESG" exposure to valuation factors has been materially different to the "low ESG" exposure, and if there are any signs that this relationship has shifted before and after 2018, when ESG investment flows became significant. Is there evidence suggesting that a portfolio built from "high ESG" names may be structurally overvalued due to crowding? Or that the increase in ESG fund flows may have shifted historical valuations materially in recent years between "high ESG" and "low ESG" quintiles?

Examining the time series of Book to Price and Earnings Yield since 2012, we see little evidence for a crowding effect becoming evident as ESG has increased in popularity and flows.



Y axis shows average valuation factor exposure. Higher = cheaper valuations, lower = expensive valuations. ESG quintiles based on MSCI ESG IVA Scores. Source, ECO Advisors, MSCI

We do find evidence of a structural and persistent historical Book to Price discount for the “low ESG” quintile, but – in contrast to what would be expected from ESG crowding – this discount has been declining, not increasing, during the last two years. We hypothesise this may be a result of the post-Covid cyclical economic and markets recovery, where we have seen some “low ESG” and particularly more carbon intensive companies in cyclically sensitive sectors (such as Energy and Industrials) undergo a re-rating.[9]

When reviewing Earnings Yield, we find at the universe level very similar average exposures to the Earnings Yield factor, and in fact a small valuation discount for “high ESG” companies, though the magnitude is modest and unlikely to be material. And similar to the trend in Book to Price factor, our “low ESG” quintile has become modestly more expensive over the last two years.

Taken together, we see little evidence in these data for ESG crowding, at the investable universe level. However, there may be crowding effects that are concentrated in certain sectors or industries. In particular, we note the rise of thematic investing during the recent period of ESG popularity and inflows; is “ESG crowding” evident at the Sector level, even if there is little evidence when reviewing high and low ESG securities across a broad investable universe of high and low ESG securities? To answer this question, we extend our analysis to each of the GICS Level 1 sectors in a similar fashion.

Our results are summarised in the below table which continues on to the following page. To understand the table:

- Positive exposures indicate "cheaper" or more attractive valuations, and are averages of quintile factor loadings (Z-scores)
- A more positive value for Difference indicates "ESG cheapness", whilst a negative spread suggests ESG is more expensive
- A trend in Difference through time that becomes more negative (High - Low exposure moves from positive to negative) suggests a potential crowding effect

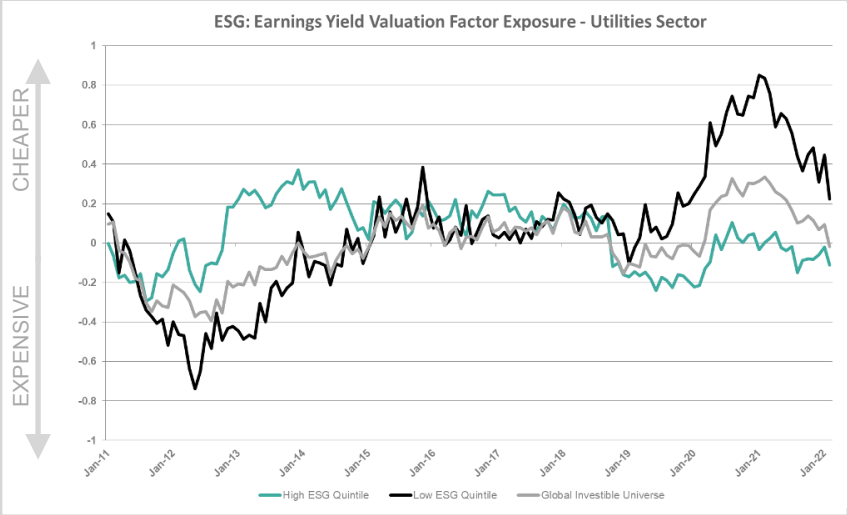
Factor Exposure Summary	Quintile Analysis	Book to Price			Earnings Yield			
	Average Exposure	High ESG	Low ESG	Difference	High ESG	Low ESG	Difference	Comments
Investible Universe	*2012-current*	0.03	0.25	-0.22	-0.06	-0.12	0.07	No evidence for ESG crowding
	2012-2017	0	0.23	-0.23	-0.08	-0.16	0.08	
	2018-today	0.07	0.28	-0.21	-0.02	-0.07	0.05	
	Current (Feb 2022)	0.11	0.21	-0.10	-0.05	-0.17	0.12	
Consumer Staples	*2012-current*	-0.31	-0.30	-0.01	-0.24	-0.41	0.18	No evidence for ESG premium or crowding
	2012-2017	-0.37	-0.31	-0.06	-0.30	-0.45	0.15	
	2018-today	-0.23	-0.29	0.07	-0.15	-0.36	0.21	
	Current (Feb 2022)	-0.17	-0.20	0.03	-0.10	-0.14	0.04	
Consumer Disc	*2012-current*	-0.23	0.09	-0.33	-0.08	0.02	-0.10	Some evidence for ESG BTOP premium; little evidence of crowding
	2012-2017	-0.27	-0.01	-0.26	-0.10	0.01	-0.11	
	2018-today	-0.17	0.25	-0.42	-0.05	0.02	-0.07	
	Current (Feb 2022)	-0.12	0.19	-0.31	-0.12	-0.13	0.01	
Utilities	*2012-current*	0.09	0.56	-0.47	0.07	0.08	-0.01	Evidence for ESG valuation premium and potential crowing effects
	2012-2017	0.16	0.45	-0.29	0.14	-0.10	0.24	
	2018-today	0.00	0.72	-0.72	-0.05	0.34	-0.38	
	Current (Feb 2022)	0.05	0.90	-0.85	-0.11	0.22	-0.33	
Materials	*2012-current*	0.26	0.32	-0.07	0.02	0.00	0.02	No evidence for ESG premium or crowding
	2012-2017	0.25	0.38	-0.13	-0.09	-0.20	0.11	
	2018-today	0.27	0.25	0.02	0.17	0.28	-0.11	
	Current (Feb 2022)	0.27	0.08	0.20	0.29	0.34	-0.05	
Industrials	*2012-current*	-0.12	0.14	-0.25	-0.05	-0.03	-0.02	Evidence for historical ESG BTOP premium; no evidence of crowding
	2012-2017	-0.12	0.08	-0.2	-0.06	-0.08	0.01	
	2018-today	-0.1	0.22	-0.33	-0.03	0.03	-0.06	
	Current (Feb 2022)	-0.07	0.08	-0.15	-0.07	-0.18	0.11	
Energy	*2012-current*	0.57	0.84	-0.27	-0.31	-0.25	-0.06	See next page
	2012-2017	0.49	0.68	-0.19	-0.37	-0.4	0.03	

Factor Exposure Summary	Quintile Analysis	Book to Price			Earnings Yield			
	Average Exposure	High ESG	Low ESG	Difference	High ESG	Low ESG	Difference	Comments
Energy (cont.)	*2018-today*	0.68	1.06	-0.38	-0.22	-0.02	-0.21	Evidence for historical ESG BTOP premium and crowding; however, recent convergence in valuations
	Current (Feb 2022)	0.48	0.52	-0.04	0.07	-0.01	0.08	
Healthcare	*2012-current*	-0.34	-0.31	-0.03	-0.5	-0.84	0.35	No evidence for ESG crowding. Crowding in low ESG innovation/biotechs?
	2012-2017	-0.38	-0.27	-0.11	-0.54	-0.7	0.16	
	2018-today	-0.29	-0.36	0.07	-0.43	-1.05	0.62	
	Current (Feb 2022)	-0.25	-0.27	0.02	-0.55	-1.17	0.62	
Financials	*2012-current*	0.55	0.78	-0.23	0.28	0.29	-0.01	
	2012-2017	0.45	0.68	-0.23	0.18	0.15	0.02	
	2018-today	0.7	0.93	-0.23	0.43	0.5	-0.06	
	Current (Feb 2022)	0.87	0.97	-0.1	0.4	0.36	0.04	
IT	*2012-current*	-0.18	-0.23	0.05	-0.08	-0.28	0.19	No evidence for ESG premium or crowding
	2012-2017	-0.15	-0.21	0.06	-0.05	-0.27	0.23	
	2018-today	-0.22	-0.27	0.04	-0.14	-0.28	0.14	
	Current (Feb 2022)	-0.22	-0.29	0.06	-0.2	-0.34	0.14	
Telco **	*2012- Nov 2017*	-0.24	0.00	-0.24	0.04	-0.36	0.41	
	Nov 2017	-0.36	0.42	-0.78	0.00	-0.14	0.14	
Comm Services **	*Dec 2017 to Feb 2022*	-0.12	0.07	-0.19	0.01	-0.37	0.37	No evidence for ESG crowding
	Current (Feb 2022)	0.00	-0.11	0.11	-0.05	-0.51	0.46	

** Communication Services GICS Sector created in Dec 2017. Telecommunications ceased to be a GICS Level 1 and became a subsector of Communication Services

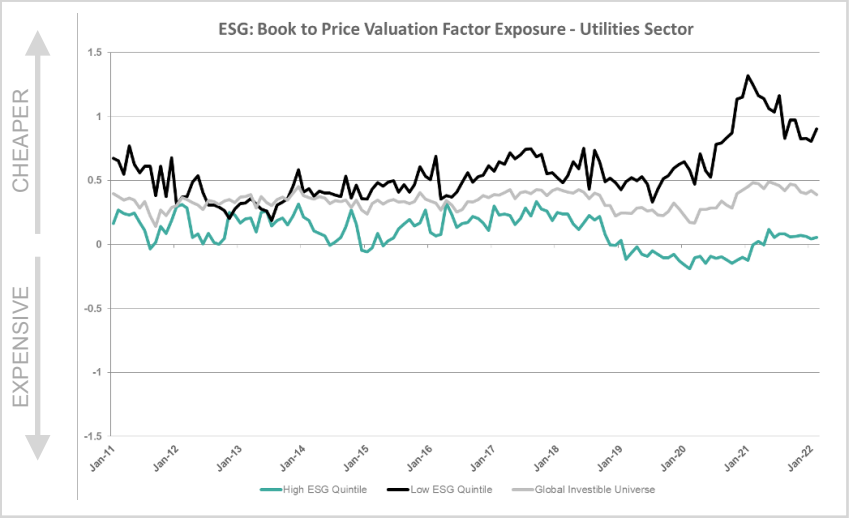
We find a similar story across most sectors that we see at the investable ESG universe level: there appears to be little evidence for shifts in valuations across high and low ESG quintiles that would suggest investor crowding. However, there is certainly evidence in certain sectors – in particular, Utilities and Energy – that an ESG crowding effect has been likely.[10]

In the Utilities sector, we find historically (pre-2018) a Book to Price discount for "low ESG" Utilities, and similar Earnings Yield exposures. However, a significant valuation spread forms from 2018-2020, peaking in early 2021, and converging over the last 12 months. While the valuation gap has reduced significantly from its peak in early 2021, it remains wider than long term historical averages. It is reasonable to hypothesise investors have increasingly required a significant valuation discount to hold "low ESG" utilities, which became extreme in late 2020 / early 2021. Given the growing regulatory risks, increasing costs for carbon emissions over time (see prior Research Spotlights for a discussion of global ETS developments), and long term growth prospects for "greener" providers, some valuation premium for "high ESG" names in the sector is not surprising. The size of the valuation spread, however, does suggest ESG crowding may have been a factor in driving valuations.

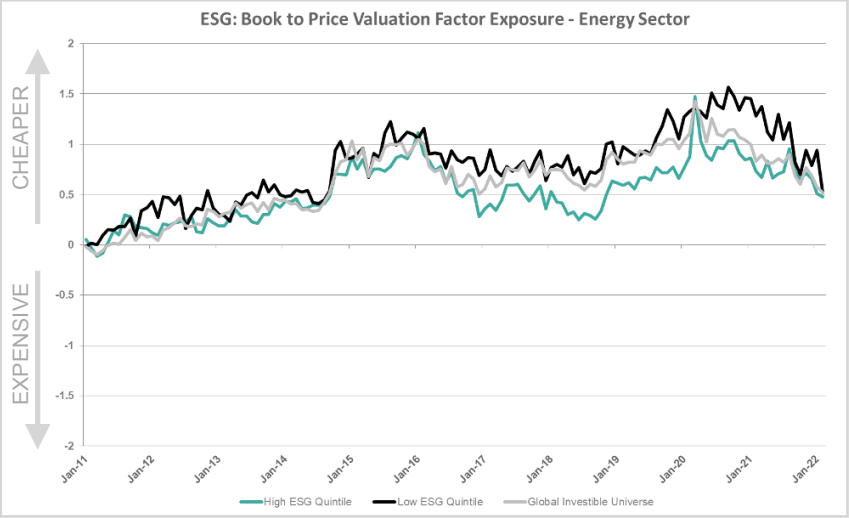


Y axis shows average valuation factor exposure. Higher = cheaper valuations, lower = expensive valuations. ESG quintiles based on MSCI ESG IVA Scores. Source, ECO Advisors, MSCI.

In the Energy sector, we see a Book to Price valuation premium emerge after the 2015 Paris Agreement, and a similar Earnings Yield premium emerge for "high ESG" energy companies. Similar to the Utilities sector, we observe a decline in the "high ESG" valuation premium occurring over the last 12 months, to such an extent that as at February the valuation spread has converged.



Y axis shows average valuation factor exposure. Higher = cheaper valuations, lower = expensive valuations. ESG quintiles based on MSCI ESG IVA Scores. Source, ECO Advisors, MSCI. Note



: Y axis shows average valuation factor exposure. Higher = cheaper valuations, lower = expensive valuations. ESG quintiles based on MSCI ESG IVA Scores. Source, ECO Advisors, MSCI.

In conclusion, our analysis suggests an observable ESG premium and potential evidence for historical crowding effects in these two "E" focused sectors, which appear to have peaked in Q1 2021. We are not entirely surprised by this result; anecdotal evidence for "excessive" retail enthusiasm for clean energy in 2019 and 2020, and the excitement around the Democratic "Green Deal" were widely discussed by investors and market practitioners at the time. Importantly (for our investment process and outlook), we find little evidence of "ESG crowding" in other sectors or at the broader universe level, as well as a significant contraction in the valuation premium in the Energy and also to some extent in the Utilities sectors in the past few quarters. Given the long term outlook and prospects, some valuation premium for "high ESG" in these "E focused" sectors is not unexpected.

Our work suggests a more constructive outlook for ESG-focused investments in these two sectors than we had one year ago, and little reason to fear a more general "ESG crowding" across a broader range of sectors. Furthermore, the results indicate that while the "E theme" may have become crowded in 2019 and 2020, the broader universe of "high ESG" has not exhibited convincing evidence of crowding effects.

REFERENCE FOOTNOTES

1. As at 31st March, no company in the long book has material business exposure to Russia (according to analysis of the portfolio using data from Bloomberg).
2. The question of "ESG integration" and "sustainability" definition is also challenging and non-trivial, but beyond the scope of this Spotlight.
3. Of course, there are many forms of ESG integration, and recently more emphasis has been placed on either companies that are improving on their ESG credentials, or in more extreme cases an activist approach, which focuses on investment in poor ESG performers and agitates for ESG improvement at the corporate level. While these approaches to integration complicate any analysis, the most common form of ESG integration remains focusing long holdings on companies with a favourable ESG profile.
4. This assertion is supported by flows analysis from our Prime Brokers, as well as sources such as Morningstar. See, for example https://www.morningstar.co.uk/uk/news/216474/sustainable-assets-are-teetering-on-the-%244-trillion-mark.aspx for an illustration of the substantial increase in flows from 2018 through 2021.
5. According to data from MSCI as of September 2021.
6. Goldman Sachs research, "Exclusions in ETFs: A Sign of Things to Come?", Jan 2021
7. As part of our research, we have also evaluated groups of securities by MSCI ESG rating (AAA and AA, CCC and B) as an alternative to fractiles. We find a fractile approach more robust in ensuring a similar number of names in each cohort to form a representative average, whereas the number of securities in each ratings bucket can vary over time. For this reason, we prefer the fractile approach; we note our broad conclusions remain robust to choice of grouping methodology in any event.
8. N.B. We have also looked directly at the factor descriptors as part of our analysis; our broad conclusions on crowding remain unchanged. We focus on BTOP and Earnings Yield factors in this discussion for tractability.
9. See our discussion in prior Research Spotlights on performance of Carbon Intensity as a factor, for a more detailed discussion.
10. Of course, we are not the first or only firm to highlight evidence for crowding related to the clean energy thematic. See, for example, https://www.msci.com/www/blog-posts/the-pressure-of-the-crowd/02505396213 where MSCI researchers applied MSCI's own security level crowding model to various thematic indexes, and found a level of crowding in "Efficient Energy" that was similar to what was observed in US tech in 1999. Our approach is different, but the results are corroborative.

DATA APPENDIX

GICS Sector Exposure	Long	Short	Net	Gross	Long Portfolio WACI	Short Portfolio WACI	Net Portfolio WACI
Communication Services	6.7%	-4.8%	1.9%	11.5%	3.1	-0.7	2.4
Consumer Discretionary	9.1%	-12.9%	-3.8%	22.0%	5.7	-11.0	-5.3
Consumer Staples	7.1%	-2.9%	4.3%	10.0%	11.1	-4.3	6.8
Energy	3.0%	-3.1%	-0.1%	6.0%	27.4	-29.8	-2.4
Financials	10.8%	-6.3%	4.5%	17.2%	0.5	-0.3	0.2
Health Care	9.0%	-6.2%	2.8%	15.2%	2.1	-1.6	0.5
Industrials	13.0%	-9.1%	3.9%	22.1%	5.6	-23.2	-17.5
Information Technology	8.5%	-4.9%	3.7%	13.4%	4.8	-3.2	1.6
Materials	7.8%	-6.8%	1.0%	14.6%	36.9	-76.5	-39.6
Utilities	2.2%	-3.0%	-0.8%	5.2%	7.3	-93.0	-85.7
TOTAL	77.3%	-60.0%	17.4%	137.3%	104.5	-243.5	-139.0

Regional Exposures	Long	Short	Net	Gross
Japan	8.0%	-8.2%	-0.2%	16.2%
Asia Pacific	10.2%	-7.4%	2.9%	17.6%
Western Europe	17.2%	-6.0%	11.2%	23.1%
Eastern Europe & Africa	0.0%	-0.3%	-0.3%	0.3%
North America	39.7%	-35.3%	4.4%	75.0%
Latin America	2.2%	-2.9%	-0.7%	5.1%
Total	77.3%	-60.0%	17.4%	137.3%

Strategy Key Metrics (weighted average)	Long	Short
P/E (1FY)	13.4	12.2
P/B	2.0	1.7
Net Debt / Equity	2.7	3.7
Dividend Yield	2.5%	2.9%
Free Cash Flow Yield	4.0%	5.0%
Return on Equity	13.7%	12.7%
Beta Adj Exposure (vs. MSCI World)	0.08	
Ann. volatility (ex-ante)	3.5%	
1 day VAR (99% monte carlo)	-0.53%	
1 month VAR (99% monte carlo)	-2.5%	

	Long Portfolio	Short Portfolio	MSCI ACWI
Normalised WACI	135.1	405.9	162.9

Annual Carbon Emissions (mt)	Long Portfolio	Short Portfolio	Net
Scope 1 & 2 Emissions	1,255,958	(3,133,349)	(1,877,391)
Scope 3 Emissions	6,280,144	(7,079,652)	(799,508)

Key Portfolio Metrics	Long	Short
No. of positions	125	156
Largest position size	1.08%	-0.71%
Top 10 positions wgt	9.4%	-6.3%

Source: ECO Advisors, MSCI, Bloomberg

KEY FUND INFORMATION

Terms	PROTEA UCITS II - ECO Advisors ESG Absolute Return Fund
Management Fee (M) share class	1.1% management fee
Performance Fee (P) share class	0.60% mgt. fee, 15% perf. fee *(HWM + rate hurdle)*
Founder's (F) share class	0.60% management fee
Administration & other fees	0.39%
Investor liquidity	Daily
Share class currencies	EUR, GBP, CHF, SEK, USD
Domicile	Luxembourg
Launch date	July 8th, 2019
Vehicle	Protea UCITS II SICAV
Distribution type	Accumulation
Service Providers	
Administrator	FundPartner Solutions (Europe) S.A.
UCITS management company	FundPartner Solutions (Europe) S.A.
Depositary	Pictet & Cie (Europe) S.A.
Prime brokers	JP Morgan, Goldman Sachs

Other Information	
Corporate engagement	ESG driven voting & engagement for longs
Fund AUM (EUR)	€191.8m
ESG long book exclusion policy	Tobacco, weapons, adult entertainment, gambling, thermal coal, tar sands, arctic drilling, nuclear energy, UNGC violations
Morningstar category	Alt - Market Neutral - Equity
SFDR category	Article 8

Share Class	ISIN	Hedged
F Class EUR	LU2002381171	n/a
F Class GBP	LU2002381254	Yes
F Class USD	LU2002381502	Yes
P Class EUR	LU2002382492	n/a
M Class EUR	LU2002381684	n/a
M Class GBP	LU2002381767	Yes
M Class CHF	LU2002382062	Yes

German, UK, Austrian, Belgian tax reporting available upon request.

The Key Investor Information Document and Prospectus are available at www.ecoadvisors.eu and investors should read these documents prior to investing. F Class shares are open for subscriptions from existing F Class investors only. P & M Class shares are open to subscription from new investors.

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