

A Pathway Forward

The Canadian energy sector has been the worst performing year to date, although it has made up some ground in the past few weeks thanks to the value rotation that began following the US election.

- As we all know, energy, materials and financials make up the bulk of the S&P/TSX. Getting these three sectors right can make or break a year as a Canadian investor. Expanding our view of the heat map, it reveals that financials are your steady-eddy, go-to sector if you're buying and holding (over the last 10 years) while energy and materials are more volatile, making the decision to participate in any given year more difficult.
- Renewable Energy is often associated with solar panels and wind farms and that's for good reason. Of all new power generation being built around the world nearly 33% is in solar projects while almost 20% is related to wind projects. The use of these types of renewable sources of energy are set for further expansion as the pandemic has only accelerated the transition toward renewables.
- There are a variety of strategies one could use to invest in the renewable energy space and in order to help filter the noise we've listed some fund options worth considering. These products could be used to complement existing energy sector exposure in your portfolio or can even be used to replace traditional fossil fuel energy stocks.
- For a global mandate the **iShares Global Clean Energy ETF (ICLN-US)** is a popular vehicle with nearly US\$2.4 billion in assets under management (AUM). This fund isn't entirely passive, as there is a rules-based approach to selecting the names that go into the portfolio. The process starts with the S&P Global Broad Market Index, which contains over 11,000 names globally, and filters out any companies that do not have significant exposure to clean energy as defined by S&P.
- For those looking for a more US-centric approach to investing in renewable energy there is the **First Trust NASDAQ Clean Edge Green Energy ETF (QCLN-US)**.
- **Dynamic Energy Evolution Fund** was launched only last month the team, process, and philosophy behind the fund are well established. The fund is managed by the Dynamic Equity Income team that collectively manage a suite of mandates including global energy and global infrastructure funds.
- The **Desjardins Societerra Cleantech Fund** offers a truly global approach to getting exposure to the clean tech beyond just renewable energy.

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The Canadian energy sector has been the worst performing year to date, although it has made up some ground in the past few weeks thanks to the value rotation that began following the US election. There's no sugar coating it, the sector faces numerous headwinds that are unlikely to change anytime soon including: pipeline constraints that may be exacerbated by the potential cancellation of Keystone XL may further depressing Canadian oil prices, limited capital inflows as investors place a greater emphasis on ESG factors (heavy emphasis on the E), uncertainty on the global oil demand outlook and over supply issues. Given these long-term headwinds, this is a sector we like to say "we prefer to rent, not own" meaning nimble investors can find opportunities but based on the sector heat map below it is not a space we wish to buy and hold. The S&P/TSX Energy sector has been the worst performing five times (including this year) in the last 10 years. Unfortunately, it has never once been the best performing over this period, although in 2016 it came in second after materials. The value destruction in this space is nothing short of depressing.

As we all know, energy, materials and financials make up the bulk of the S&P/TSX. Getting these three sectors right can make or break a year as a Canadian investor. Expanding our view of the heat map, it reveals that financials are your steady-eddy, go-to sector if you're buying and holding (over the last 10 years) while energy and materials are more volatile, making the decision to participate in any given year more difficult.

S&P/TSX Sector Heat Map – Energy Sector a Tough Trade

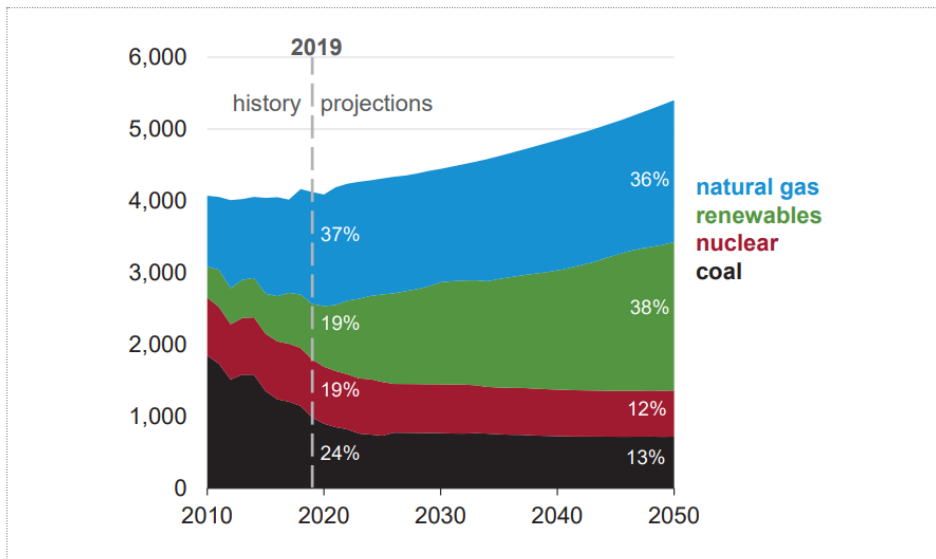
Year	Cons. Disc	Cons. Staples	Energy	Financials	Health Care	Industrials	Info. Tech	Materials	Real Estate	Comm. Services	Utilities
2010	21.8%	8.3%	10.0%	6.3%	50.3%	14.4%	-11.6%	35.8%	26.4%	16.2%	12.6%
2011	-17.9%	4.8%	-12.3%	-6.6%	49.6%	2.0%	-52.6%	-21.8%	1.1%	19.0%	1.6%
2012	18.7%	20.4%	-3.6%	12.8%	24.1%	12.7%	-3.2%	-6.9%	16.2%	6.4%	-0.8%
2013	39.5%	21.4%	9.9%	19.1%	71.7%	34.9%	36.2%	-30.6%	0.5%	8.1%	-8.6%
2014	26.4%	46.9%	-7.8%	9.8%	30.2%	20.0%	34.0%	-4.5%	18.0%	10.5%	11.3%
2015	-3.5%	11.0%	-25.7%	-5.5%	-15.8%	-12.5%	14.8%	-22.8%	3.1%	-1.0%	-7.8%
2016	8.2%	6.1%	31.2%	19.3%	-78.6%	20.7%	4.4%	39.0%	4.1%	9.9%	12.7%
2017	20.4%	6.4%	-10.0%	9.4%	32.7%	17.9%	16.2%	6.3%	5.8%	9.9%	6.2%
2018	-17.7%	0.6%	-21.5%	-12.6%	-16.6%	-3.9%	12.5%	-10.6%	-2.8%	-5.3%	-13.4%
2019	13.1%	12.8%	16.2%	16.9%	-11.4%	23.6%	63.5%	22.1%	17.4%	8.2%	31.6%
2020	9.8%	7.2%	-30.9%	-2.8%	-23.5%	15.7%	55.5%	22.5%	0.2%	-3.0%	13.0%
Best Count	-	1	-	-	5	-	4	1	-	-	-
Worst Count	-	-	5	-	2	-	2	2	-	-	-

Source: FactSet, Raymond James Ltd.

As mentioned, one of the more significant headwinds facing the energy sector is the shift in capital flows. A greater emphasis on ESG has facilitated a move in capital investment away from traditional fossil fuels towards renewables. In fact, of the estimated US\$12 trillion of professionally managed assets in the US with ESG criteria, ~US\$3 trillion is invested in climate change (see Raymond James Financial's [Clean Tech Primer 2021: Climate Mitigation, Adaptation, and Investing](#)). This is a trend that is not going away any time soon, but we know any transition will take decades to wean our economy's reliance from fossil fuels, to cleaner burning sources, and ultimately renewable sources. Many would like this transition to occur faster; many others would prefer not to make the transition or at least slow it down. These two opposing views are often at odds – those in favour of fossil fuels are interested in protecting the significant investment made; those in favour of renewables are interested in arresting

climate change, but they also have financial interests at stake. However, clearly the writing is on the wall as traditional energy companies have begun to expand into the renewable space. In shifting the conversation to transition rather than fossil fuel versus renewable, we can produce an optimal outcome for all involved and the energy transition can occur in a responsible way. Additionally, investment managers that can recognize the value in transition may be able to provide superior returns compared to those that are focused only on one particular silo.

Share of Electricity Generated from Renewables to Double by 2050



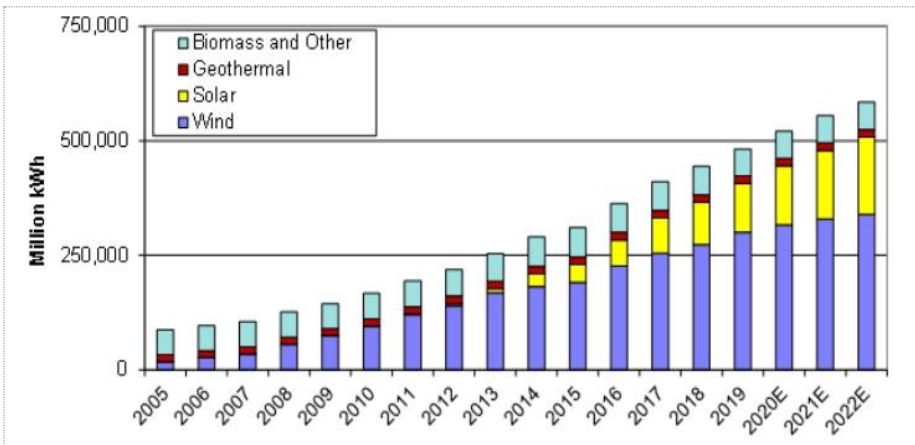
Source: U.S. Energy Information Administration (EIA); y-axis represents billion kilowatt-hours

Ways to Play the Transition

Renewable Energy is often associated with solar panels and wind farms and that's for good reason. Of all new power generation being built around the world nearly 33% is in solar projects while almost 20% is related to wind projects. The use of these types of renewable sources of energy are set for further expansion as the pandemic has only accelerated the transition toward renewables. There are also lesser-known types of renewable power sources growing in popularity including biopower or bioindustrials. Regardless of the types of the renewable energy sources you consider investing in, the opportunities extend far beyond simply the power producers themselves.

For example, investing in solar or wind energy can involve companies across the value chain in upstream or downstream segments, with some larger corporations involved in both. For example, upstream companies or assets might include modules (e.g. solar panels), wind turbines, or power converters while downstream relates to things such as project installation, customer acquisition, or financing. Navigating the evolving renewable energy landscape and being able to separate the winners from the losers can be challenging, which is why gaining access via a basket approach may be prudent.

US Non-Hydro Renewables Power Generation



Source: EIA, Raymond James Financial

Taking a Basket Approach to Investing in Renewables

There are a variety of strategies one could use to invest in the renewable energy space and in order to help filter the noise we've listed some fund options worth considering. These products could be used to complement existing energy sector exposure in your portfolio or can even be used to replace traditional fossil fuel energy stocks. Below we highlight two passive ETFs and two active mutual funds ideal for playing the space depending on your preferred investment approach.

Renewable Energy ETFs

While Canada has a rich offering of ETFs, including more niche products, the best place to look for targeted renewable energy ETFs is in the US. For a global mandate the **iShares Global Clean Energy ETF (ICLN-US)** is a popular vehicle with nearly US\$2.4 billion in assets under management (AUM). This fund isn't entirely passive, as there is a rules-based approach to selecting the names that go into the portfolio. The process starts with the S&P Global Broad Market Index, which contains over 11,000 names globally, and filters out any companies that do not have significant exposure to clean energy as defined by S&P. The fund's focus on clean energy companies includes renewable energy producers as well as those involved in clean energy tech and equipment. An S&P carbon intensity score is then used to rank each name with the 28 lowest carbon-intensity names ultimately selected for the portfolio and weighed by market cap. Each name is capped at 4.5% to avoid any concentration risk.

For those looking for a more US-centric approach to investing in renewable energy there is the **First Trust NASDAQ Clean Edge Green Energy ETF (QCLN-US)**. To create the underlying index First Trust collaborated with Clean Edge Inc., a US-based company that specializes in creating thematic indices related to clean energy. Investments are eligible for inclusion if they operate in at least one of four specific sub-sectors as determined by Clean Edge: Advanced materials (i.e. materials and processes that enable clean energy), energy intelligence (e.g. smart meters, LEDs, superconductors), energy storage and conversion (e.g. advanced batteries, electric vehicles, hydrogen), or renewable electricity generation (e.g. solar, wind, geothermal). Once a company is determined to derive more than 50% of its revenues from the above sub-sectors and meets certain minimum thresholds for market cap and trading volume, it is included in the portfolio. Much like the iShares product, this fund is market-cap weighted and

has a ceiling on how much weight a stock can have in the portfolio for the sake of diversity.

Renewable Energy Mutual Fund

While the **Dynamic Energy Evolution Fund** was launched only last month the team, process, and philosophy behind the fund are well established. The fund is managed by the Dynamic Equity Income team that collectively manage a suite of mandates including global energy and global infrastructure funds. In recent years the team has been ramping up exposure to renewable energy investments in their broader portfolios on the back of what they see as attractive fundamentals and secular tailwinds in the space. The team looks to invest in companies supporting the global transition to renewable energy on both a residential and commercial scale. It does this by setting target ranges for various parts of the renewable energy space. In particular, the fund aims to have 30-40% allocation to renewable power, 40-50% allocation to emerging renewable energy solutions, and 10-15% allocation to new energy innovators (e.g. sustainable finance). When evaluating investments the team uses a QUARP (quality at a reasonable price) philosophy, which essentially means having a focus on companies with strong business models, a history of increasing cash flows, and have a clear visibility of future sustainable cash flows. In true nature to the team's income investing approach the funds targets a 2% annualized distribution.

Broad Environmental Themed Mutual Fund that Incorporates Renewable Energy

The **Desjardins Societerra Cleantech Fund** offers a truly global approach to getting exposure to the clean tech beyond just renewable energy. For example, themes that the fund invests in are energy efficiency, water infrastructure, waste management technologies, renewable and alternative energy, and pollution control. The fund is managed by UK-based Impax Asset Management, which may not be a household name in Canada but has a global footprint with over C\$30 billion in AUM. While the Desjardins product is just a few years old, Impax has been running this same strategy for nearly 20 years. The fund differentiates itself from some others by targeting small and mid-cap companies, predominantly those with a US\$2-10 billion market cap. Furthermore, while most global equity mandates have a majority exposure invested in the US, this fund enjoys more than 50% exposure outside the US. The fund goes beyond simply investing in the most fundamentally attractive companies that fit the renewable energy theme. The team at Impax spends as much time performing granular fundamental research on specific companies as they research specific clean tech themes. In conducting research into themes, they evaluate at least 23 sub-sectors (e.g. solar energy generation equipment, biofuels, and buildings energy efficiency) based on market conditions for that sub-sector, the state of legislation and policy, relative valuation, and relative earnings momentum. The result is a portfolio with fundamentally solid companies that fit broader environmentally friendly themes that are expected to benefit from macro tailwinds.

Bottom Line

The renewable energy sector has been growing rapidly and the combination of policy responses and macroeconomic drivers stemming from the pandemic will only work to continue that trend. There are many companies across geographic and market cap spectrums that not only produce clean energy but provide inputs and ancillary services. With rapid growth, there will undoubtedly be winners and losers in the space so having a dedicated manager navigate the space comes highly recommended.

Funds Mentioned

Name	Product Type	Currency	Symbol	MER
iShares Global Clean Energy ETF	ETF	USD	ICLN-US	0.46%
First Trust NASDAQ Clean Edge Green Energy Index Fund	ETF	USD	QCLN-US	0.60%
Dynamic Energy Evolution Fund ^{1,2}	Mutual Fund	CAD	DYN3460 [Series A]	N/A
			DYN3461 [Series F]	N/A
Desjardins SocieTerra Cleantech Fund	Mutual Fund	CAD	DJT00168 [Series A]	2.61%
			DJT03968 [Series F]	1.45%

Source: Fund Company Documents; 1. Series F version also available in \$US; 2. MER not available as fund is less than 12-months old

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