

Investment

Resource efficiency a marker for investment performance: Osmosis

BY [RACHEL ALEMBAKIS](#) | THURSDAY, 21 JUL 2022 4:51PM

Companies that are more resource-efficient, including efficiency in managing environmental factors, are more likely to provide stronger risk-adjusted returns, according to Osmosis Investment Management.

Osmosis uses its in-house research process to standardise unstructured corporate environmental data, enabling the construction of a sustainable investment factor which the firm demonstrates through their research as being uncorrelated to other common factors. When applied to a diversified portfolio, it results in a tilt towards the most resource efficient companies and has evidenced stronger risk-adjusted returns.

"What we see is that our Resource Efficiency factor has been performing, very consistently over time across regions and sectors," said Tom Steffen a quantitative researcher at Osmosis. "Analysing 17 years of data, going back to 2005, there were 15 years where the signal worked really well and only two years where it wasn't rewarded by the market."

After five years of running the strategy, the information ratio for the strategy ex poste fees is "above 1.1, which means for every unit of risk, we've been more than compensated with a unit of return while delivering in excess of 50% reduction in carbon, water and waste footprint relative to the benchmark," said Osmosis chief investment officer Robbie Parker

Osmosis manages both fossil fuel free portfolios as well as portfolios that hold companies across the economy including in the fossil fuel sectors. In [December 2020](#), Commonwealth Superannuation Corporation announced it was partnering with Osmosis Investment Management to launch an environmentally sustainable equity strategy.

CSC, the \$50 billion fund for government employees, will partner with Osmosis to launch a Resource Efficient Core Equity Portfolio (ex-Australia). The portfolio will aim to mitigate environmental risks while targeting a better risk-adjusted return.

Fossil fuel divestment falls into three camps, those investors who believe that the sector will suffer significant value destruction and those that from an ethical or environmental perspective have elected to divest from the sector and those that believe in both. They are not necessarily mutually exclusive.

"From a returns perspective however, excluding the sector creates real challenges for investors," Parker said. "Recent events have shown that carbon-based fuels play an important role in the world economy, either through increased demand or supply side shocks. Recently, taking a binary approach to divestment has negatively impacted fossil fuel free portfolios performance, largely as a consequence of rising prices. Forecasting the price of fossil fuels in the future with an increasingly volatile geopolitical landscape is incredibly challenging."

Our approach focusses on the risk bought into portfolios via divestment, and smartly allocates that risk towards resource efficiency companies within the sector, such as renewables, with the additional risk budget allocated to resource efficient companies across the rest of the economy. This approach allows us to deal with the supply side of fossil fuels through divestment but importantly through targeting resource efficient companies across the broader economy, deal with the demand side as well. And you shouldn't address one without the other

"Our argument is that it's all very well divesting from the sector, but if your issue is divesting from assets that are stranded, for example, the only reason they're going to be stranded is if all other sectors are stopping using them. "In that case, active risk just becomes risk."

ESG strategies have performed well since 2018, but thus far in 2022, ESG benchmarks have underperformed because they are underweight energy and overweight tech, Steffen said.

The challenge for ESG funds is that the longer the outperformance of fossil fuel-based energy stocks, the bigger the active risk bet for investors in ESG strategies, Steffen said.

"That's where the concern would be - if you see a doubling of energy to represent 6% of the MSCI World, that will become a large portion of the active risk," he said. "If this deep value rotation continues, that could be a real problem. While historically it hasn't been a real issue, it's

something that can become a problem, and from an ex-ante perspective, that tracking error will rise and become slightly problematic."