Investing in Water: Accessing a Compelling Opportunity
At KBI Global Investors, we have been investing in water equities since 2000, applying our specialist skills to a diverse universe of stocks to add value above the MSCI AC World (NR) Index in 12 out of 16 calendar years, with 2.4% outperformance per annum since inception and a beta of approximately 0.99. This paper is intended to shed more light on investment in water equities; defining the investment opportunity, demonstrating how to capture both the beta and alpha and discussing ways water equities can be allocated to investment portfolios. (Returns are net of 85 bps management fees in USD as at 31st December 2016)

The opportunity going forward is equally strong. The supply of water is finite and with water demand forecast to increase by 41% by 2030¹, water is expected to be one of the largest recipients of global infrastructure investment in the coming decades. Specialist active management can best understand how that capital will be deployed and which companies will deliver the dominant solutions.

Delivering strong returns requires capturing both the beta from the water theme and the alpha from stock selection. In order to assure exposure to the beta of water, we believe it is important to precisely define the theme and investment universe in order to create the opportunity set that accurately reflects exposure to the drivers of water solutions. Specialist active management can then add alpha above the returns purely available from the theme by identifying a high conviction portfolio of 40-50 stocks that are best positioned to outperform, taking into account company fundamentals, valuation and the impact of top-down influences.

The water opportunity is broader than a single sector, consisting of a collection of niche companies that are involved in various aspects of the provision of water. Their businesses cover a wide range and include water utilities that manage the infrastructure from source to use and back again, to water infrastructure companies that design, produce or construct water infrastructure to niche water technology companies that produce solutions to manage, conserve and assure water quality.

Companies across these three water sectors have diverse return characteristics. Water infrastructure companies tend to be exposed to cyclical and capital spending end markets. Water technology companies tend to be niche high-growth companies driven by company-specific drivers. On the other hand, low beta, higher-dividend paying regulated utilities can provide a defensive component during more turbulent markets.

For some investors, the challenge that remains is where to allocate to water equities in their portfolio. Water equities are first and foremost global equities delivering a new source of alpha to a global equity allocation in a very risk-efficient manner. They have a place in a global equity portfolio as a source of long term growth and/or as a part of a satellite allocation in a core/satellite approach. Additionally, a closer look at the drivers of growth for water stocks highlights specific investment characteristics that investors are looking for as liquid components of different alternatives allocations including natural resources, infrastructure and real assets. Trying to find a home for water in their portfolio should not cause investors to miss out on its benefits. Wherever it is allocated, we believe it can enhance returns.

Investors with an interest in ESG issues may be aware that today nearly 800 million people do not have access to clean drinking water and 2.5 billion people lack access to basic sanitation². By creatively deploying more sustainable solutions in the water space, $17 trillion in GDP could be preserved, not to mention (more importantly) sparing more than 1 billion people the extreme hardship that lack of adequate water will inflict³. KBIGI’s Water Strategy provides capital to companies providing solutions to this global water problem, while also delivering strong investment performance.
Introduction

Investing in water equities is a multi-decade opportunity sustained by multiple persistent drivers. The long-term case for water has been well documented: water is a finite resource for which there is no substitute and demand for this precious resource continues to grow significantly faster than population. Less than 1% of the world’s water is available for use and this limited supply is increasingly threatened by pollution and depletion of aquifers. Historically, water demand has grown at twice the rate of population and is expected to grow by 41% by 2030.¹

Water is essential to sustaining life and critical to global economic wellbeing as an essential input across many industries. Today nearly 800 million people do not have access to clean drinking water and 2.5 billion people lack access to basic sanitation.² It has been estimated that unless water provision is adequately addressed, 45% of projected 2050 global GDP (approximately $63 trillion) could be at risk. However, if we creatively deploy more sustainable solutions, $17 trillion in GDP could be preserved, not to mention more importantly, sparing more than 1 billion people the extreme hardship that lack of adequate water will inflict.³ Additionally, with 214 river systems shared by 2 or more countries and 273 aquifers also shared across borders, access to water will increasingly pose risk of conflict as this vital resource becomes increasingly scarce.⁴

In order to address the challenges of water scarcity, an estimated $7.5 trillion⁵ investment will be required between 2015-2030. As a specialist manager focused on water equities we see a tremendous opportunity to identify how this capital will be deployed and which companies will provide the winning solutions.

While awareness of the challenges for meeting the demand for water has moved to the fore and despite the strong performance of water stocks over the last 16 years, investors have struggled to see how water may fit in their portfolios. A closer look at drivers of growth that are sought by global equity investors contributes to the compelling rationale for investing in water equities.

A portfolio of water stocks provides access to a number of persistent global themes driving growth that investors are keen to access including;

- Very restricted additional supply
- Steadily rising demand
- Stricter regulation
- Increasing requirement for infrastructure spending
- Need for new technologies

Five Factors Driving Water Investment

Insufficient Supply:
Less than 1% of the earth’s water is available for use, the remaining supply of water is saltwater, polluted, in polar ice caps or otherwise unavailable. Thus the supply of water is finite and this finite supply is increasingly threatened by pollution and depleting aquifers. Water is a resource for which there is no substitute and it is impacted by the same supply/demand imbalances (limited supply, too much demand) putting stress on other vital resources including energy and food.

Increasing Demand:
The demand for clean water is growing rapidly due to growing population, increasingly urbanisation and industrialisation. Water demand is already growing at twice the rate of population growth and is forecast to increase by 41% by 2030⁶. Only 10% of water demand comes from residential use, with nearly 70% of water demand coming from the agriculture sector and 20% from industry, highlighting water’s importance for economic growth⁷. This demand stress takes the form of more spending on water infrastructure for distribution networks, on waste water treatment, on irrigation and to support industrial production.

Increasing Regulation:
Whether it is the European Union’s Water Framework Directive, the Safe Drinking Water Act in the US, or China’s water standards, regulation - both economic and environmental - has been a backbone of support for investment in water. While other areas of clean technology have seen regulatory support wane during economic downturns, the essential need for clean water provides the impetus for continued consistent regulatory support.

Increasing Infrastructure Spending:
The massive under-spending on water infrastructure rehabilitation and replacement in the developed world simply means more pent-up demand for water infrastructure. The US alone has more than 700,000 miles of pipe as part of its water infrastructure, which is 4 times longer than the US highway system⁸. The current replacement rate of pipes of 0.5% per year implies a 200 year replacement cycle. This rate is far in excess of the 50-100 year life of pipes and is clearly unsustainable⁹.

Increasing Technology:
Innovative technologies continue to facilitate the more efficient use of inputs, delivery, quality and provision of water. As a result of the supply/demand imbalance for the vital resource of water, there is and will continue to be significant investment in solutions over the coming decades in areas such as desalination, water recycling, water filtration, and water metering. Further environmental regulations continue to support spending on treatment technologies and testing equipment to encourage compliance with water quality standards.
From a portfolio perspective, water stocks have a place in a global equity portfolio as a source of long-term growth and/or as a part of a satellite allocation in a core/satellite approach. Investors have also utilised water equities in focused allocations that are related to the drivers, including water as a liquid component of an infrastructure, real assets or natural resource allocation.

In this paper, we will attempt to demystify investment in water equities; defining the investment opportunity, demonstrating how to capture both the beta and alpha and discussing ways that water equities can be allocated to investment portfolios.

Overview of the Opportunity

In essence, there is no explicitly defined water sector. In fact, the opportunity is broader than a single sector, consisting of a collection of niche companies with diverse return characteristics that are involved in various aspects of the provision of water. These businesses include more defensive water utilities that manage the infrastructure from source to use and back again, higher growth companies that design, produce or construct water infrastructure and niche water technology companies that produce solutions to manage, conserve and assure water quality.

10 years ended 31 March 2017 (Per annum in USD)

<table>
<thead>
<tr>
<th>SECTOR</th>
<th>10 Years pa</th>
<th>Volatility</th>
<th>Sharpe Ratio</th>
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<tr>
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The Sharpe ratio demonstrates how the return earned compensates the investor for the risk undertaken to generate that return.

Source: KBI Global Investors and Datastream. See disclaimers for description of index information.
Note: All sectors are from the MSCI ACWI Index.
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* The MSCI Real Estate sector classification started in August 2016, before this it was a subsector. Therefore this table links the “subsector” values prior to August 2016 and the “sector” values thereafter to calculate the Real Estate figures.

Water equities have delivered strong performance relative to global equities. While not an explicit sector, a comparison of its returns shows water delivered similar strong performance relative to MSCI ACWI sectors with only the Health Care, Consumer and IT Sectors delivering better returns, over the last ten years. These returns are a reflection of the relatively more stable and diverse end-markets served. The ability to deliver consistent, less cyclical returns is one of the most compelling reasons to invest in water.
Finally, this group of companies that provide diverse water solutions have largely been in existence for a long time. While there are clearly opportunities in new and emerging water stocks, the weighted average age of the companies in a recent snapshot of our portfolio was more than 60 years and nearly one third of the companies trace their origins back to the 1800s. The staying power of these companies is a tribute to their business models, their ability to innovate and the demand for their products, all of which we expect to continue well into the future. Bank of America Merrill Lynch estimated that the size of the global market for water solutions was more than $500bn in 2012 and forecasts that it could be worth $1 trillion by 2020\textsuperscript{11}.

### Defining the Investment Universe: Capturing the Beta of Water

Across most equity products, a market index has served as a basic proxy for the investable universe. However, in defining the investment universe for water, there are some unique challenges. On the one hand, the fact that there is no clearly defined water sector means that some investors have chosen to define the universe broadly to include companies that have some (but not necessarily significant) exposure to the provision of water. In such cases, the universe for investment has been described as ranging from approximately 300 to 400 companies. On the other hand, water indices have developed, but only include a limited number of companies due to various index construction requirements including float, size and liquidity. A recent snapshot of three recognised water indices showed constituents ranging from 35 to 60 companies.

Neither of these extremes is optimal. Defining the water universe too broadly dilutes the exposure to the drivers of water solutions and hence the unique source of alpha that water equities can bring to a portfolio. While water indices have developed into reasonable long-term benchmarks...
for water equities, their limited number of stocks and the concentration of stocks in one area (water utilities) make them an insufficient representation of the opportunity set for water investment.

**Defining the Investment Universe**

We believe it is important to precisely define the investment universe in order to create the opportunity set that accurately reflects exposure to the drivers of water solutions and assures exposure to the beta of the water theme. Without constraints related to index construction, a broad array of stocks can be created that provides a sufficient opportunity set from which active management can distinguish superior companies and add alpha above the beta of the water theme.

KBI Global Investors defines the water theme as all manufacturers, service providers and operators across the water cycle. The water cycle describes the flow of water:

- from its origin
- through collection and treatment
- to delivery to end users across residences, industry and agriculture
- through wastewater treatment and remediation back into the environment

KBI Global Investors segments companies working across the water cycle into three water sectors:

- Water and Wastewater Utilities
- Water Infrastructure
- Water Technology

It is also important to note that in order to maintain focus on specific drivers of water solutions, we do not include stocks in our water universe that may appear tangentially related, but are not exposed to those drivers, including hydroelectric power and bottled water.

Having defined water, we want to ensure that the companies that make up each of the sectors of the water universe will be exposed to the drivers of the theme in as pure a fashion as possible. In order to achieve this objective we identify companies from a wide variety of sources and evaluate their exposure to water from a revenue perspective. In order to qualify for inclusion in our water universe, companies must meet one of the following revenue criteria:

- Pure Plays: Minimum 50% revenue from water
- Market Leaders: Minimum 10% of revenues from water and a market leader in their particular product, service or technology

Currently, almost 160 stocks representing about $500 billion in total market cap meet these requirements and make up the KBI Global Investors water universe. This is a dynamic universe that has evolved over our history. New companies are added as our team identifies and qualifies them for inclusion. Companies leave the universe as they are acquired or when their business mix changes and revenues from water fall below our thresholds.

In the early years the investable universe was smaller than today, with approximately half of the stocks in the water utility sector. As the universe grew, water technology stocks became the largest component of the universe. Over the last two years, the universe has continued to evolve with half of the universe now in infrastructure stocks. This is largely driven by the increase in companies involved in industrial water infrastructure and the inclusion of a growing number of companies which are operating in developing countries to meet the accelerating demand for water infrastructure in those markets. The universe has also become more globally diverse, with emerging market companies now representing almost 30% of the universe.
The evolving nature of our universe provides the opportunity for specialist active management to add value. In the early years, the theme was the main driver and the makeup of the universe largely resembled the makeup of water indices today which are dominated by water utilities. With a broader opportunity set now available, specialist active management can add alpha above the returns purely available from the theme by identifying a high conviction portfolio of 40-50 stocks that are best positioned to outperform.

Companies across our three water sectors have diverse return characteristics, providing the opportunity for specialist active management to add value across different market environments. Water infrastructure companies tend to be exposed to cyclical and capital spending end markets. Water technology companies tend to be niche high-growth companies driven by company-specific drivers. On the other hand, low beta, higher-dividend-paying regulated utilities can provide a defensive component during more turbulent markets.

This diverse opportunity set enabled us to outperform MSCI AC World in 12 of the 16 calendar years since the KBIGI Water Strategy’s inception; with 2.4% per annum outperformance since inception and a beta of approximately 0.99. (Returns are net of 85 bps management fees in USD as at 31st December 2016)

**Water Utilities**

Water utilities are the linchpin for providing water for residential and commercial use and treating waste water for re-use or remediation back into the environment. As such, they are managers of water infrastructure and the users of technology to filter, treat and measure water use. Regulated utilities are the dominant component of this sector, providing a stable, low-beta safe haven during periods of market turbulence. The sector can also provide the opportunity to participate in growth through non–regulated utilities with more cyclical businesses and emerging market utilities that are facilitating and participating in growth in developing countries.
Regulated utilities benefit from consistent demand that translates into stable earnings. Their business model to meet this demand is one of a regulated monopoly with consistent and compounding growth. Consumer demand for water remains steady throughout the economic cycle and regulators can provide for regular, predictable rate increases. This consistency of earnings can translate into regular increases in dividends, which contributes to both long-term total returns and less volatility during periods of turbulent markets.

Clearly the regulatory environment in which the utility operates is an important consideration for evaluating the consistency of earnings. For example, OFWAT is the regulatory body for the UK water utilities. Every five years, it sets the allowable return for the sector based on the value of the companies’ assets and the cost of maintaining and upgrading these assets for the future. The regulator is motivated to ensure that the rate of return allowed is attractive enough to encourage the utilities to invest adequately without becoming financially distressed, while also ensuring that the consumer pays a fair price for their water. Allowance is made for inflation each year, protecting the sector from its effects.

While regulated utilities provide stability to the portfolio, there is also the opportunity to invest in non-regulated utilities that are more volatile but provide exposure to drivers of higher growth. French company Suez is a leading global player in water, with 2,300 waste water treatment sites and 1,130 drinking water production sites located across five continents, throughout both the developed and developing world. Its revenues are also diversified into higher growth services like waste water treatment and desalination. Exposure to supportive environmental regulation and economic growth in the emerging markets are important drivers of their long-term performance.

Similarly, higher growth can be accessed through local utilities in emerging market countries. These utilities are providing water to a growing population and facilitating economic growth through support of industry. Manila Water operates water and waste water facilities in the eastern part of Manila. It has experienced dramatic growth over the last 15 years as it doubled the number of people in Manila who can access clean water to 6.3 million while simultaneously upgrading the infrastructure to reduce water lost in transport. Water lost in transport was reduced from 63% in 1997 to 11% by 2016.

WATER INFRASTRUCTURE PROJECTS

**New Orleans Flood Control Pump Station.**

After the massive flooding in New Orleans during Hurricane Katrina, the US Army Corps of Engineers built the largest flood control pump station in the world. Central to the effectiveness of this new part of New Orleans’ infrastructure are 11 high power pumps that were custom built by Pentair and are each capable of moving 750,000 gallons of water per minute, the equivalent of completely emptying an Olympic-size swimming pool in less than 5 seconds. This new infrastructure was credited with helping to limit storm damage in New Orleans when Hurricane Isaac struck in 2012.

**Victorian Desalination Plant.**

Located on the Australian Bass coast near Melbourne, the Victorian desalination plant was built to protect Melbourne from water shortages that Australia has been experiencing. The plant, which is managed by Suez’s water treatment subsidiary Degremont, is designed to guarantee the provision of as much as 450,000 cubic meters of water a day. The construction project was extensive, providing opportunity for companies across different areas of water infrastructure and technology; design and construction of the desalination plant and inlet and outlet tunnels, a water transfer pipeline for transport and delivery and energy recovery devices to reduce power use.
Water Infrastructure

Water infrastructure companies include manufacturers of pipes, pumps, valves, fluid control systems and irrigation equipment. They also encompass engineering and consulting firms and construction companies that are involved in the design and implementation of large scale water projects. It is a high beta, long-term growth sector, and will be volatile due to exposure to cyclical variables related to the economic cycle and capital spending. The need for new infrastructure in the developing world and the replacement of aged infrastructure in the developed world will drive growth in this sector for decades.

Water infrastructure companies are constructing large systems in the developing world to transport water from their sources to industrial and domestic end users, as well as constructing plants for wastewater treatment. For example, in China the current five year plan has allocated $763bn to water and related infrastructure. We expect that the next five year plan will contain an even larger allocation. Pollution from industrialisation has led to the next five year plan will contain an even larger allocation. Pollution from industrialisation has led to an urgent need for increased waste water treatment. Chinese companies such as Beijing Enterprises Water are designing and building waste water treatment plants in order to address this significant water pollution challenge in China.

Nearly 20% of global water demand comes from industry. Industrial complexes are handling water for multiple purposes including cooling water, boiling water, process water, cleaning water, fire suppression water, drinking water, waste water, and storm water. Industrial water infrastructure required to run large industrial plants experienced its last wave of investment growth from 2003 to 2008, but was halted by the financial crisis. These projects are several years in process from their initial planning, approval and engineering through to completion and are driven by long-term secular drivers such as population growth and urbanisation. We are currently well into the next investment cycle.

Improved methods of irrigation have the potential to save significant amounts of water in the largest market segment of use: agriculture. Currently, the majority of irrigation around the world is done by flooding fields, an incredibly inefficient process where only 25%-40% of the water is actually used by the crops. Using micro irrigation systems (MIS) can lead to 30-70% savings in water vs traditional flood irrigation, and increase yields by up to 45% for wheat, 20% for chickpeas and 40% for soybeans. Jain Irrigation Systems is the largest Indian provider of micro irrigation systems that include both sprinkler and drip irrigation processes. This activity has the potential to have a tremendous impact on water conservation efforts in India where as much as 90% of the water withdrawals go to agriculture and groundwater pumping has led to unsustainable aquifer draw-downs.

Water Technology

Water technology consists of a broad array of niche companies providing both established and ground breaking products and services to meet a variety of needs across the water cycle, including filtration, disinfection, metering and testing. While in aggregate the sector has a beta in line with the market, there are a variety of opportunities to earn extraordinary returns in high growth, smaller cap stocks. These returns can be earned through companies that grow organically or through others that are acquired by larger companies looking for leading niche technologies to complement other capabilities.

Waste water treatment for use in industry and agriculture, which together represents about 90% of water use globally, is poised to be a large component of meeting our increasing global demand for water. Currently waste water re-use meets only a little more than 2% of global water needs, but it is estimated that through use in industry and agriculture it needs to move up closer to 75%. Companies providing products and processes such as desalination components, UV (Ultraviolet) disinfection and chemicals are well positioned to profit from growth in water reuse.

Reverse osmosis is a desalination process that involves filtering waste or salt water through semi-permeable membranes at high pressure, that uses considerably less energy than thermal processes. While desalination plants have been the main users of this technology, in recent years Water Re-Use plants have grown in number, recycling waste water into clean water using reverse osmosis. Danaher provides the ultra-violet treatment which is the final stage of the process, and Pentair sells the microfiltration membranes and vessels for housing the membranes.

UV disinfection is a technology that has been increasingly used to prevent bacteria from multiplying, and assuring quality drinking water. This versatile application will have growing use in a new application - the treatment of ballast water. The International Maritime Organization’s ballast water regulations are designed to prevent invasive species entering foreign waterways. International vessels will need to be retrofitted, with the market for ballast water treatment systems estimated to grow to $21 billion by 2020.
Calgon Carbon and Danaher are UV providers who are developing products to retrofit cargo ships to assure that when ballast water is discharged, bacteria and invasive species are not introduced into the local environment.

Water technology companies play a large role in conservation. Metering companies such as Itron provide tools to manage water consumption and, as the old adage goes, you can’t manage what you can’t measure. Regulation is starting to play a bigger role, with Europe leading the way in this respect, setting a target date of 2020 for automated meter adoption in households, providing the opportunity for much more efficient use of water across Europe. Although estimates vary, some experts believe that smart metering combined with appropriate pricing can potentially reduce water use by 20%.

Specialist Active Management

While the drivers create sustainable, long-term opportunities across all three water sectors, valuation, company and sector fundamentals and conditions across the economic cycle present the opportunity for active management to add value. There will be clear winners and losers, and new technologies and products will continue to evolve that will require expert judgement as to which will be truly disruptive or less likely to gain commercial traction. Winnowing the universe of companies providing water solutions to identify the superior companies should position the portfolio for better returns above those available purely from the water theme. Specialist active management can focus on those companies best positioned to deliver the strongest solutions.

Pure Technologies is one example of a company that we believe has a unique, sustainable product offering that will drive its long-term growth. Pure provides infrastructure diagnostics to help tackle the significant challenge of ageing infrastructure. It has a patent-protected product that uses advanced acoustics to map out a utility’s pipe network, detecting where there are leaks and problems with structural integrity, allowing for cost-efficient strategic repairs that could save significant amounts of water.

Pentair is an example of “best in class” operator with broad water market offerings in pumps, filters, membranes and softeners that has been very successful in strategically growing its water business through acquisitions. The 2011 acquisition of Clean Process Technologies has enabled Pentair to evolve into a leading membrane technology company with expertise in desalination, water reuse, ultra filtration and nano filtration. In 2012, Pentair acquired Tyco Flow, expanding its flow capabilities, diversifying its end-market exposure and adding meaningful opportunities for synergy, all of which we believe should see the group’s earnings trajectory enhanced going forward.

Specialist active management also plays an important role in overall portfolio structure. Consideration of the bottom up fundamentals and valuations of the companies that make up each sector along with the impact of top-down macro influences on those fundamentals guides optimal portfolio structure. Over the long run, we would expect to maximize exposure to higher growth companies in the infrastructure and technology sectors, but during periods of cyclical slowdown and economic uncertainty we have the option of adding more stability to the portfolio through regulated utilities.

There are times when valuation disparities between sectors provide the opportunity to add value. This is very much bottom-up driven, and specialist active management can identify clusterings of companies within each sector that have become under or over valued and identify the fundamental reasons for the valuation disparity. For example, during the European economic crisis in the summer of 2011, many water infrastructure stocks were sold off well beyond their intrinsic value. The more defensive regulated utilities outperformed in this sell off, and many were viewed as fairly valued, providing the opportunity to reduce exposure to utilities and access outstanding opportunities in many undervalued infrastructure companies. This shift proved beneficial to the performance of the water strategy, as infrastructure stocks significantly outperformed in 2012.
Water Equities: Capturing the Opportunity in Asset Allocation

While a better understanding of drivers, sectors and stocks that encompass water equities may provide some clarity regarding the opportunity to deliver consistent performance, the challenge that remains for some investors is where to allocate water. Water equities are first and foremost global equities delivering a new source of alpha to a global equity allocation. Additionally, a closer look at the drivers of growth for water stocks highlights specific investment characteristics that investors are looking for as components of different alternatives allocations.

Global Equities

Water equities provide exposure to new sources of growth and unique sources of alpha that are not prevalent in many global equity allocations. Currently, the stocks in the KBIGI Water Strategy represent approximately 0.50% (as at 31st December 2016) of the weight of the MSCI AC World Index. They have a place in a global equity portfolio as a source of long-term growth and/or as a part of a satellite allocation in a core satellite approach. Combining water with other equity strategies can provide more diversified, risk-efficient returns. The low or negative correlation of the excess returns of water to growth-oriented strategies is demonstrated in the table below. Specifically, the table looks at the correlations of excess returns of water above MSCI AC World Index relative to other areas of the market where investors look for growth:

- MSCI AC World Growth Index, a proxy for the universe of growth managers
- Information technology and pharmaceuticals/biotech, two areas where investors have traditionally looked for growth
- Agribusiness

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<th>Ten Year Correlations of Excess Returns above MSCI AC World</th>
<th>MSCI AC World Growth</th>
<th>S-Network Water</th>
<th>Dax Global Agribusiness</th>
<th>MSCI ACWI Info Tech.</th>
<th>MSCI ACWI Pharma &amp; Biotech</th>
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Source: KBIGI Global Investors, Datastream as at 31st December 2016. See disclaimers for description of index information.

The table below demonstrates the alpha and diversification benefits of incremental allocations to water. Over the last 10 years, adding modest 5% increments to a hypothetical global equity allocation would have provided very strong results. Using the MSCI ACWI as a proxy for a global equity allocation, a basic allocation strategy adding 5%, 10% and 15% allocations to water would have added incremental cumulative return without increasing risk. The Information Ratios (which provide a measure of the outperformance generation per unit of risk) for these three incremental allocations to water are very strong, confirming that the excess returns were delivered in a very risk-efficient manner.

<table>
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<th>10 Years ended 31 May 2017</th>
<th>MSCI ACWI RI ($)</th>
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<tr>
<td>Annualised Return</td>
<td>3.6%</td>
<td>3.7%</td>
<td>3.8%</td>
<td>3.9%</td>
</tr>
<tr>
<td>Volatility</td>
<td>17.0%</td>
<td>16.9%</td>
<td>16.8%</td>
<td>16.8%</td>
</tr>
<tr>
<td>Beta</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Information Ratio</td>
<td>n.a.</td>
<td>0.3%</td>
<td>0.3%</td>
<td>0.3%</td>
</tr>
<tr>
<td>Tracking Error</td>
<td>0.00%</td>
<td>0.32%</td>
<td>0.64%</td>
<td>0.96%</td>
</tr>
</tbody>
</table>

Source: KBIGI Global Investors, Datastream, Returns in USD. See disclaimers for description of index information.
Rather than arbitrary 5% allocations, managers of global equity allocations can allocate to water in ways that optimise their risk/return objectives for their entire global equity portfolio taking into account:

- targeted levels of expected return
- targeted levels of beta and volatility
- active/passive mix
- maintenance of size and style allocations

Implementation could range from “dipping your toe in the water” to being part of a larger transition in global equity strategy. Funding can be done in a measured fashion; either investing new cash or reducing existing equity holdings in a manner that would result in the final allocations across all equity strategies achieving the desired aggregate equity characteristics.

**Alternative Allocations**

Specific drivers of growth derived from providing solutions to resource scarcity combined with greater liquidity relative to private equities has led water to be considered for a role in various alternative allocations:

**Natural Resources.** While water is arguably our most vital resource, it has been largely ignored by natural resource investors in part because it does not trade as a commodity. With less than 1% of the earth’s water available for use, water is indeed a scarce natural resource and investment in companies providing solutions to water scarcity is driven by the same supply/demand dynamic that drives investment in other commodity-based resources like oil, gas and grains. Water can bring a new, diversifying element to natural resource allocations that are currently dominated by investments in energy, minerals and grain related investments.

**Infrastructure.** The water strategy is very much driven by the significant need for water infrastructure spending globally over the coming decades. As noted above, water is expected to be one of the largest recipients of global infrastructure spending through 2030. The water strategy gains direct exposure to infrastructure through regulated assets (utilities), which are often behind classic infrastructure funds, as well as through more cyclical engineering, construction and manufacturing firms that are involved in the manufacture, design and construction of infrastructure projects and their components. Water technology companies also provide components to enhance infrastructure and its use ranging from infrastructure diagnostic and repair technology to metering.

**Real Assets.** Some investors have included the water strategy as a liquid component of a real assets allocation. Publicly traded equities in water offer both exposure to infrastructure and a degree of inflation protection that real asset investors desire. Water infrastructure can be an important element of real asset allocations because it provides both inflation protection and capital appreciation potential. Water utilities, whether regulated or contract based, are protected from inflation in several ways – operating and cost of debt pass-through, allowed equity returns, and recognition of actual capital spent.
Impact of Water Investing

Water is essential to sustaining life and critical to global economic wellbeing as an essential input for agriculture, in homes and across industries. Today nearly 800 million people do not have access to clean drinking water and 2.5 billion people lack access to basic sanitation. It has been estimated that unless water provision is adequately addressed, 45% of projected 2050 global GDP (approximately $63 trillion) could be at risk. However, by creatively deploying more sustainable solutions in the water space, $17 trillion in GDP could be preserved, not to mention (more importantly) sparing more than 1 billion people the extreme hardship that lack of adequate water will inflict.

Many investors, including those with an interest in ESG issues, have long been aware of the highly robust investment case for water companies that are providing solutions to the global clean water shortage. However, we are witnessing the emergence of a growing number of ‘ESG Impact’ investors, who prioritise the achievement of environmental, social or governance benefits from their underlying investments. KBIGI’s Water Strategy has been able to satisfy both camps by delivering strong performance (the KBIGI Water Strategy has outperformed the MSCI ACWI in 12 out of 16 calendar years, net of fees, in USD as at 31st Dec 2016) from investing in a portfolio of forward-looking companies that are having a positive Impact on the world’s most important natural resource, water.

Below we have provided four examples that represent high impact investments from our water portfolio.

**High-efficiency irrigation:**
70% of all water use globally is agricultural. Historically farmers employed flood irrigation to water crops. This method of irrigation is highly inefficient and wasteful of water. We invest in an Indian irrigation company that supplies irrigation equipment for use in agriculture, which helps to reduce water consumption and increase agricultural yields. Using the company’s micro irrigation systems (MIS) can lead to 30-70% savings in water vs. traditional flood irrigation. Yields of crops can increase up to 45% for wheat, 20% for chickpeas and 40% for soybeans. And it’s a growing market, as the global MIS market is projected to grow at CAGR of 18.3% from 2016-2021.

**Water re-use technologies:**
Increasing the supply of water in areas where it is scarce is potentially the ‘holy grail’ in the water space. Desalination is one technology that grabs many headlines in relation to this topic, however waste-water recycling for re-use is the real game changer for this issue. It is far less energy-intensive and much more portable then desalination (of course desalination can only take place at/near a salt water source). We invest in a French Utility company that provides a low-cost source of sustainable incremental water supply through its water re-use technologies. Currently only 2% of waste water worldwide is recycled. Through improving regulation and public perception the water re-use market is expected to grow by 20% over the coming years.

**Infrastructure diagnostics:**
The average water leakage rate globally is 15-20%. Think of how much water stress could be alleviated by reducing or eliminating that waste in a cost effective and targeted way. We invest in a Canadian water tech company that employs ‘smart ball’ technology that travels through water pipes and acoustically tests the integrity of these pipes for any potential weakness or fractures. This technology saves significant costs for Utilities, allowing a pre-emptive approach to addressing potential water leakage problems. Industry experts say it can cost 3 to 10 times more to make an emergency water-line repair than to make repairs and replacements that are planned in advance.

**‘Point of Use’ (POU) residential water treatment:**
80% of all illness in the developing world is water-related. Installing low-cost counter-top or under-sink treatment equipment in developing country homes, where water pollution is endemic, provides critical protection from contaminants for the end user. We invest in a water equipment maker providing residential counter-top or under sink water treatment in developing countries, ensuring clean drinking water for millions of people. About 80% of groundwater in mainland China’s major river basins is unsafe for human contact, let alone safe to drink! At current growth rates, the company’s residential water treatment business is growing by more than 15% per annum in China every year.
Integrating Publicly Traded Water Equities into Impact Investor Portfolios

The provision of clean, fresh water is a central sustainability challenge that many impact investors are increasingly embracing.

The supply/demand challenges facing our most critical resource are well documented and as a result water is becoming an almost intuitive impact allocation.

So how are water companies providing solutions to the water crisis? We have taken a deeper dive into our own water portfolio and below is a snapshot of some of the positive initiatives that are being undertaken.

<table>
<thead>
<tr>
<th>Water Issue</th>
<th>Solution</th>
<th>Impact Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residential water treatment (POU)</td>
<td>Counter-top or under sink water treatment for clean drinking water.</td>
<td>High - particularly in developing countries where this provides critical protection from contaminants.</td>
</tr>
<tr>
<td>China industrial water and sludge</td>
<td>High priority for the government to clean up industrial related waste.</td>
<td>High</td>
</tr>
<tr>
<td>Cooling water towers</td>
<td>Efficient equipment meaningfully reduces environmental impact and energy consumption.</td>
<td>Medium</td>
</tr>
<tr>
<td>Infrastructure rehabilitation</td>
<td>Retrofitting and upgrading existing water treatment facilities and pipe networks.</td>
<td>Medium - enhances the sustainability of the infrastructure while ensuring environmental compliance.</td>
</tr>
<tr>
<td>Dewatering - muni (sewer bypass)</td>
<td>Pumping water/wastewater for municipalities, a sewer bypass option may be required during routine maintenance periods or at times of flooding.</td>
<td>High - critical in times of flooding and for infrastructure maintenance &amp; repair.</td>
</tr>
<tr>
<td>Efficient irrigation - agri</td>
<td>Crucial to manage water use and increase yields.</td>
<td>High - helps reduce water consumption and increases yields.</td>
</tr>
<tr>
<td>Water reuse technologies</td>
<td>Technologies to enable wastewater to be cleaned and re-used.</td>
<td>High - a low cost, low impact source of sustainable incremental supply.</td>
</tr>
<tr>
<td>Infrastructure diagnostics</td>
<td>Technology to assess and measure water related infrastructure for targeted maintenance.</td>
<td>High - by identifying leaks and pre-emptively addressing potential problems, it saves significant waste and costs.</td>
</tr>
</tbody>
</table>

Conclusion

Investment in water equities can provide strong, consistent returns over the long run, contributing in a significant manner to an investor’s asset allocation. The long term drivers of the theme which include natural resource scarcity, emerging market growth and infrastructure spending can largely provide the beta from the theme. However, specialist active management, which can identify which companies are best exposed to the drivers of growth, have the strongest product offerings, and are undervalued relative to their prospects, has the potential to add value above the return purely available from the beta of the water theme. Water equities are most logically allocated to global equities but some investors may choose to use water equities as liquid components of alternatives allocations. Trying to find a home for water should not cause investors to miss out on its benefits. Wherever it is allocated, we believe it can enhance returns.
End Notes

5. WHO and UNICEF, “Progress on Drinking Water and Sanitation.” 2012
11. Manila Water Investor Presentation, March 2017
12. Manila Water Investor Presentation, March 2017
15. Bloomberg Intelligence “China Water Industry Topic Primer” 2017
22. The MSCI AC World Growth is an aggregate proxy for active growth managers, but managers of global equity allocations can look at other growth strategies/managers in their portfolio and how their excess returns correlate with water
23. Information ratios of .50 are considered good, .75 very good and 1.00 outstanding
30. Indian Irrigation Company Annual report 15/16
31. French Utility company website report
32. The World Bank, KBI Global Investors analysis
35. Water equipment maker Q4 earnings report
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S-Network Global Water Index: The S-Network Global Water Index covers 60 global companies that derive 30% or more of annual revenues from participation in the water sector.

Dax Global Agribusiness: The Dax Global Agribusiness Index represents the performance of global companies generating more than 50% of overall turnover from the agricultural economy.

MSCI ACWI Growth: The MSCI ACWI Growth Index covers more than 1,300 securities across large and mid-cap size segments exhibiting overall growth style characteristics in 23 developed and 23 emerging markets.

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