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# How to Invest in the Coming Energy Transition

**By Robert Huebscher**
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*The world is undergoing a dramatic energy regime shift that has been accelerated by recent events, including the COVID crisis, the Ukraine war, and growing concerns about climate change. Harbor Capital Advisors recently introduced the Harbor Energy Transition Strategy ETF (ticker symbol RENW), which is subadvised by Quantix Commodities, a specialist in the development and management of innovative commodity-based investment strategies.*

*Kristof Gleich is the president and CIO of Harbor Capital Advisors. He oversees all investment distribution and marketing and executive office functions at Harbor, and he provides insight while helping lead Harbor's strategic growth plans.*

*Don Casturo is the founding partner of Quantix Commodities. He has 26 years of experience in the commodity markets. He left Goldman Sachs as a partner in 2018 after 20 years in its commodity group.*

*To listen to this interview as a podcast, go here.*

**Kristof Gleich**
President & CIO
Harbor Capital Advisors, Inc.

**Bob: Tell me about the genesis of the idea that led to the strategy.**

**Kristof:** If history has taught us anything, it's that change is constant. We believe the world is undergoing its second large energy transition in the past 200 years. I don't think it's an exaggeration or hyperbole to suggest that the world's energy needs are going to go through the biggest transformation since the phasing out of whale oil in the second half of the 19th century. What we can learn from that transition is that it wasn't a switch that got flicked overnight. It was a phased transition that ultimately took decades. We needed new things to come together to make that happen. Those were human capital, technology, engineering, but also capital flows to be deployed into developing this new source of energy.

On that last point, to help facilitate the transition, we need new benchmarks. Investment products are needed to attract and facilitate the movement of capital to where it's needed. Today's commodity benchmarks are all oriented towards the way commodities are produced and consumed in 2022. They're not how they're going to be produced in 2030, 2040, 2050 and beyond. We decided to partner with Quantix to create a new benchmark for the energy transition and how commodities will ultimately be produced and consumed. We created the Energy Transition ETF (RENW) to make the future needs of commodities available to investors today.

**Bob: Tell me more about RENW. Why is it a timely strategy?**

**Don:** RENW tracks the Quantix energy transition index (QET), which we created to revolutionize the financial products that are available to investors to correspond with what the world is trying to accomplish with the energy transition. We recognized the existing benchmarks were inadequate for that purpose. They were based on the old way the world wanted to energize itself. We're going to transition to net-zero objectives. Financial products need to evolve to make that happen. That results in an index that's more focused on what the world's going to need going forward.

The most notable differences between what we have designed into QET, which backs the RENW ETF, versus the existing commodity benchmarks is the notable lack of petroleum products. Those are the carbon-heavy products, fossil fuels that the world is trying to move away from. We drop those out and replace those with higher weights on base metals, which are going to be very key: copper, nickel, zinc, and lead. They all fit into a world where we'll be much more electrified than burning fossil fuels. Base metals are very important for the battery-electrification process.

The index has a higher weight for natural gas. While that is still a fossil fuel, it's cleaner than coal or oil, and it's going to be necessary to accomplish the transition without reducing the possibilities for growth. We need interim fuels to achieve the transition and gas plays a larger role in our index.

The other element that's included and is unique to QET and doesn't exist in the existing benchmarks is the idea that carbon emissions are going to play a pivotal role in this transition in terms of incentivizing the right flow of capital away from fossil fuels and into alternative energy sources. Governments are recognizing this by having a system that puts a cost on carbon to help make that transition happen efficiently. We've also included two key carbon credit-emission products within our index: Union Allowances in Europe and California Carbon Allowances here in the U.S.

**Bob: Who is the target audience for this ETF? It would seem to resonate with multiple investor types. What are some of the ways that you see it fitting into investor portfolios?**

**Kristof:** Let's start the asset-class level. Commodities are very relevant for investors and advisors building diversified portfolios. Post-GFC (Global Financial Crisis), commodities became the forgotten asset class. I believe it would be a mistake to not consider them when building a diversified portfolio.

There are multiple structural and cyclical drivers that make the outlook for commodities over the next 10 years look very different from the past 10 years. If advisors are currently not using commodities in any way, shape or form, or haven't considered it, I feel they should go back and test that thesis and consider looking at this asset class.

The energy transition is going to be messy. It's going to be clumsy. It's going to come in fits and starts. It's not going to be a smooth, linear transition. There are going to be times when the old hydrocarbon commodities do well. There are going to be times when the newer commodities do well, and that is where we believe you want to be allocated — and you need diversification within commodities.

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This isn't a product feature, but some of our clients are viewing this with an Environmental, Social and Governance (ESG) lens, which we think is interesting. If you think about commodities and ESG, they don't normally jive together. However, RENW is focused on the commodities that are providing cleaner energy, easy transportation, and helping get the world to net zero.

More broadly, the opportunity ahead for this theme is massive. It's almost impossible to overstate how big it is. We're seeing return-seeking clients interested in this as well.

**Bob: This is the second ETF that you've partnered together on. The first one was HGER. Tell me a little bit about that ETF and the roles that each of you played.**

**Kristof:** Harbor Capital is an asset management firm, but what makes us different is, rather than hiring in-house portfolio managers to select equities, bonds, or commodities, we go anywhere in the world. We look for exceptional, entrepreneurial, distinct investors who have typically spent their career at a larger shop and have decided to hang their own shingle and create their own boutique. We think boutiques produce better outcomes. Don and Quantix are a great example of that. Don had a long and distinguished career at Goldman Sachs. He was the chief operating officer for Goldman Sachs' global commodities division, the largest trading desk in the world.

He spent 20 years there. Then he created his own firm where he creates high-quality investor solutions, synthesizing all his career experience.

Harbor finds people like Don, and there's not many of them. We turn down a lot of managers before landing on these exceptional managers. We bring them to the marketplace in a vehicle — in this case, an ETF that makes sense — and democratize the opportunity for everyday investors. This is our second ETF that we've partnered together. HGER is the Harbor All-Weather Inflation Focus ETF. We brought that out this year because both of our firms had a strong belief that inflation was going to be beyond transitory and was likely going to be persistent and keep surprising to the upside.

We felt there was a gap for investors to have a high-quality, cost-effective inflation hedge. With Don and the Quantix team, we structured an inflation- and commodities-oriented ETF. We launched that and the energy transition ETF. We have two solutions to help cover the inflationary environment we're in now, and the energy transition that we're going towards over the next 30 years.

**Don Casturo**

Founding Partner
Quantix Commodities

**Bob: How does RENW stand out? How would you differentiate it from its peers? What are the advantages of a commodity-based strategy as compared to equity-based ETFs?**

**Don:** QET, the index that RENW is based on, is differentiated from other commodity futures products. It's focused on the full slate of commodities that are relevant to this energy transition. The existing benchmarks are based on old-world technology and the old-world way of energizing the world. This basket is focused on the commodities that are relevant to the energy transition. It does so in a broad way. There are other products that are commodity-only that focus on one sector, like carbon or battery metals, which are relevant to energy transition, but not on the full story.

For the full energy transition to be accomplished – and the world desires it to happen — all those components need to be working together. This is one comprehensive basket that focuses on all sectors.

There are a couple of reasons why it's a better approach than equity investing. We're early stage in this energy change, and it's not obvious what the winning technology is going to be. There are many firms that are trying different approaches. You could build a diversified basket of equities, but by nature you're admitting that there's going to be some losers before you ultimately get it right. There is much uncertainty as to which firms will work and which technology will work. There are a finite number of elements that are available in the periodic table. Whatever technology ends up winning, it's going to be using one of these metals or commodity products that exist in QET.

You don't have to be right about what you're betting on, because we believe it's going to be one of these commodities that are in the QET index. We are not making a bet on management, and we are not making a bet on individual performance of a corporation, which takes research to do well. But that is secondary to the energy transition. That's fundamental management skills. If you want to be pure to an energy transition theme, an investment in the commodities is the most straightforward way to do that.

**Bob: You talked a little bit about the composition of the index. It excludes carbon-based or fossil-based fuels. You've got some base metals and some natural gas. What types of commodities are most closely linked to the renewable energy transition?**

**Don:** We have some research available on our website that outlines those commodities that are most important to energy transition and how at this stage we believe the world thinks it's going to happen. It's going to involve much more use of electricity relative to burning of fossil fuels in transportation. We will use different fuels to create that electrification, moving away from coal and moving more towards natural gas. Those are the two most basic premises in terms of influencing our weights. We have much higher weight in base metals, incorporating not only U.S. but global natural gas as that becomes a more important power generation resource relative to coal or even oil. Those get a higher weight.

In determining the relative weight between the two, we look at volume and open interest of these contracts and use that to inform the weighting decision on a monthly basis. The reason we do something that seems relatively simplistic in that way is that it's not obvious what is going to be the dominant and leading technology going forward.

We expect that greater participation in different contracts will start to evolve over time, when we see a signal as to which one of those technologies and commodity resources are in most demand. That will influence the waiting over time.

**Kristof:** There are three buckets. There are commodities needed to construct the new infrastructure. Don mentioned copper, which is the best example of bucket one. Number two is the bridge fuels that are needed to make the world less carbon intensive. The best example of a bridge fuel is natural gas. It's much cleaner than coal or oil. The last bucket is the incentivization structure needed to transition the world to pollute less, which means carbon credits. To put some numbers around it, take copper, for example, and electric vehicles (EV). We can all see the increasing number EVs around us. Every electric vehicle needs eight to nine times more copper than an internal-combustion engine. It means every EV that you see has 100 kilograms of copper in it. That's 0.1 tons of copper in a single EV — a lot of copper.

The world's copper production is roughly 20 million tons per year. If you took the global car fleet and transitioned it from combustion to electric, the world is going to need an additional 10 million tons of copper just for EVs. We have 20 million tons of copper per year. If we get to 100% EVs, we need 50% more copper supply. With no new investments, that deficit means copper is going to be one of the tightest commodities that we've ever seen in history. That's why we feel very strongly that this new investment is needed to bring on new copper supply to help the EV transition.

**Bob: It's only been a few weeks, but how has the performance of RENW been so far? How is it positioned in the market?**

**Don:** It's already had attractive performance. A lot of that has been driven by global natural gas, including European natural gas, which is under a lot of supply stress, given what's going on in Europe. But as we've said in our research, the Ukraine war is not what's driving commodity prices in the longer term. There's a strong structural shift of de-globalization and de-carbonization. De-carbonization is the key feature of this energy transition index that was in place and will remain in place well after the Ukrainian conflict, which hopefully gets resolved soon. Carbon credits are poised for strong performance over the longer term, even if the disruption of Russian gas supply goes away. There's going to be ever-increasing demand for gas and battery products to achieve the net-zero objectives.

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**Kristof:** I believe all investors should take a long-term time horizon. If there's one thing that I could change about investor behavior, it'd be chasing short-term performance. We're focused on building durable, long-term oriented investment solutions to help build high quality diversified portfolios.

**Bob: If there are one or two key takeaways that you'd like to leave with our audience of advisors about the regime shift in the energy sector and the investment opportunity that it creates, what would those be?**

**Kristof:** I am not from these parts; I'm a Brit. I'm having to try and learn my sports analogies. As it pertains to the energy transition, we are in the top of the first inning and there is a long, long game ahead of us. I've taken my kids to baseball and those games last forever. But we're at the top of the first inning. This is going to be the biggest and most dominant investment theme in the rest of our careers over the next 20 to 30 years. It's a theme where many investors may be under-allocated.

It is a transition and not a switch. This is a theme that is expected to become mainstream in the years ahead and we believe will become a core part of portfolios.

Often people look at the energy transition and view it through a technological lens. They think it's going to happen quickly. The iPhone supplanted the Blackberry in a couple of years because it was a better technology. But due to the complexity of this transition, this is going to take 20, 30, 40, or potentially 50 years to play out. Investors need to think about the role that commodities will play in a diversified portfolio and how that's going to be changing.

Think about inflation. Among commodities, what is the benchmark for headline inflation? It's crude oil, because that sets the marginal price that feeds through to inflation. What does that look like in a post-hydrocarbon world? How do you hedge inflation out? It might be the price of electricity that could be driven by a combination of copper or natural gas, or the price of carbon.

Things evolve and change, and investors need to continue to be forward thinking to stay relevant and produce compelling risk-adjusted returns. We think that RENW can play a part.

**Don:** For this transition to happen, investors need the opportunity to have financial products that are evolving with the energy transition. Part of the reason we have a lack of investment and are not ready to make the transition quickly is we're trying to move away from fossil fuels, and that's being exposed right now. The fact that we have a bit of an energy crisis going on is because we've dropped fossil fuels before we've had a credible supply of alternatives. We haven't had the right financial products to incentivize that. The old indices were incentivizing the wrong things. Creating something like QET to drive RENW gives investors a chance to get in early.

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There is no guarantee that the investment objective of the Fund will be achieved. Stock markets are volatile and equity values can decline significantly in response to adverse issuer, political, regulatory, market and economic conditions. A non-diversified Fund may invest a greater percentage of its assets in securities of a single issuer, and/or invest in a relatively small number of issuers, it is more susceptible to risks associated with a single economic, political or regulatory occurrence than a more diversified portfolio.

Commodity and Commodity Linked Derivative Risk: The Fund has exposure to commodities through its and/or the Subsidiary's investments in commodity-linked derivative instruments. The Fund's investments in commodity-linked derivative instruments (either directly or through the Subsidiary) and the tracking of an Index comprised of commodity futures may subject the Fund to significantly greater volatility than investments in traditional securities. The Fund is non-diversified and may invest a greater concentrate of its assets in a particular sector of the commodities market (such as metal, gas or emissions products). As a result, the Fund may be more susceptible to risks associated with those sectors. Authorized Participant Concentration/Trading Risk: Only authorized participants ("APs") may engage in creation or redemption transactions directly with the Fund. Energy Transition Risk: The commodities included in the Index may become less representative of energy transition trends over time and the Fund's investments may be significantly impacted by government and corporate policies. Foreign Currency Risk: Because the Index may include futures contracts denominated in foreign currencies, the Fund could be subject to currency risk.

Diversification does not assure a profit or protect against loss in a declining market.

The Quantix Energy Transition Index (QET) was developed by Quantix with the objective of providing diversified exposure to the building blocks of the accelerating transition from carbon-intensive energy sources to less carbon intensive sources of energy using commodity futures. Commodity futures that provide exposure to the energy transition theme are considered component candidates for inclusion in the Index. Examples of component commodity candidates include copper, aluminum, nickel, zinc, lead, natural gas, silver, palladium, platinum, soybean oil, ethanol, emissions – European Union Allowances (EUA), and emissions – California Carbon Allowances (CCA). The selection of commodities is subject to periodic review by Quantix Commodities Indices (QCI). Under normal conditions, the Index maintains exposure to at least 10 commodities from its eligible universe in the United States (U.S.), Canada, United Kingdom (U.K.) and other European exchanges. Commodity futures from the component candidates are selected for the Index and weighted based on QCI's quantitative methodology. Under normal circumstances, the Index is rebalanced on a monthly basis. The index listed is unmanaged and does not reflect fees and expenses and is not available for direct investment.

Note about tax-efficiency: ETFs are subject to capital gains tax and taxation of dividend income. However, ETFs are structured in such a manner that taxes are generally minimized for the holder of the ETF. An ETF manager accommodates investment inflows and outflows by creating or redeeming "creation units," which are baskets of assets. As a result, the investor usually is not exposed to capital gains on any individual security in the underlying portfolio. However, capital gains tax may be incurred by the investor after the ETF is sold.

ESG investing is defined as utilizing environmental, social, and governance (ESG) criteria as a set of standards for a company's operations that socially conscious investors use to screen potential investments.

Harbor Energy Transition Strategy ETF Top Ten Holdings can be found here. Holdings are subject to change.

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