



# Allianz Global Water

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## WATER YOUR ASSETS FOR GROWTH!

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**The Water Investment Theme offers a clear sailing horizon to investors looking for solid returns. Backed by a persistent structural imbalance between water demand and supply, the sector benefits from a huge market potential reinforced by strong long term demand drivers. It might be time to ride the wave!**

The Water Theme offers an opportunity for an active investment approach due to the diversity of the underlying players, and an immunity to political and sentiment-driven volatility given the value of water as a social commodity. A Water-focused portfolio provides exposure to

environmental and social factors, enhancing the appeal of the investment proposition. Alignment with selected Sustainable Development Goals, and an ESG risk-management overlay, make it especially appropriate for sustainability-oriented investors.

### **An investment theme in smooth waters**

Water as an investment theme is neither new, nor does it require lengthy explanation to grasp the basic investment thesis: as static supply meets growing demand for fresh water, inevitable water shortages cannot be expected to fix themselves. The fact that cities such as Cape Town are still unable to secure water supply in periods of even minor drought illustrates the magnitude of the problem and the lack of attention that has been paid to water infrastructure.

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Cape Town, a city in need for long term water solutions

The government of Cape Town warned over a decade ago about the need for new water sources by 2015 – but little has been done since.<sup>1</sup> Today, solutions and technologies exist to connect water-rich with water-scarce regions, or to improve water usage efficiency. Why then, after so many decades of warnings and multiple reports pointing to the growing risk of water shortages, have the necessary infrastructure investments not been made?

## 1 The risk of experiencing actual water shortages builds up slowly over time, making it difficult to predict and easy to ignore.

Water demand is mounting because of multiple factors such as urbanisation and population growth in water-scarce regions, rising water intensity of industrial processes, high-output farming practices and consumer lifestyle changes. These factors are slow and insidious, but in combination they result in a very powerful trend. If left unaddressed, severe disruptions to farming, industry, and everyday domestic life are inevitable.

## 2 Upgrading water infrastructure is costly and requires serious commitment.

The majority of the water network is invisible to the average citizen, who is more concerned with the quality of public services at the point of use than with the entire water cycle. At the same time, politicians fear popularity loss from an increase of water fees to finance long-term projects such as construction and overhaul of waste-water treatment plants, or sewerage filtration technologies. As a result, the upgrade schedule can easily get kicked down the road.

High debt levels and resulting austerity, along with the lack of revenues for many municipalities following the Global Financial Crisis have also contributed to further delays. While the issue of water infrastructure investments is not new, it clearly remains unaddressed, and the problem continues to grow; this slow progress makes Water an under-appreciated and under-addressed – and hence attractive – investment theme.

### Characteristics of Water Investing

**Water is an attractive defensive investment theme with prospects for high growth, that remains protected from the wider political and economic volatility.**

Investing in Water is different from investing in other commodities, as water itself is not a tradeable asset. Water is a commodity with high social value, and one that is extremely sensitive to environmental factors. The relationship between the demand for clean water and the security of its supply is the main reason behind the United Nations' focus on the preservation of and access to water resources within its Sustainable Development Goals (SDGs) framework.<sup>2</sup> Addressing these goals requires significant improvements in infrastructure and technological innovation.

While rainfall comes “for free”, clean water out of the tap does not. Providing a city or a farming region with water requires major investments along the entire water supply chain – this is where the value for investors is generated. Only a few countries have achieved the level of sophistication where water is routinely safe to drink or can be released back into the environment, leaving a lot of investments yet to be completed, especially in emerging markets.

Collection wells, pumping stations, filtration solutions and the treatment of sewage water are only a few examples of the equipment needed to operate the complex system of fresh and waste water. Components that reduce water loss and further improve its quality in the delivery chain ensure that clean, dependable water can be provided at affordable rates for everyone. Companies offering these technologies stand to benefit, and will have a positive impact on the lives of billions of people.

Improving water use practices is also key. Environmental and social pressures force industrial and agricultural users to reduce the amount of water they consume, as well as the level of water pollution and contamination produced. Companies addressing the consumption efficiency challenge enjoy fundamental, secular, social, and political support to ensure ongoing demand for their products and services.



### Why now?

The aforementioned factors make the need for investment obvious, but what evidence is there that we will see investments actually being made over a typical investment time horizon?

#### **Social and environmental pressure is mounting:**

One can only ignore aging and inefficient water infrastructure until it creates serious disruptions to industry, agriculture, and everyday domestic life. California is one of the great examples where adopting regulatory standards on reducing indoor and outdoor urban water consumption, as well as water loss due to leaks in water pipes, has helped weather a five-year drought.<sup>3</sup>

#### **Political support building:**

China has made water supply and quality key investment targets. In the US, President Trump has made infrastructure in general a focus area; this includes water supplies, especially after the incident of contaminated water in Flint, Michigan.<sup>4</sup>

#### **Favourable fiscal policies:**

The era of central banks releasing cheap money into the system is nearing its end. To stimulate growth, government policy might have to shift towards fiscal stimulus via infrastructure investments, of which water infrastructure typically constitutes the largest share.

### Water in the investment portfolio

We have been experiencing one of the longest bull markets in history. While there is no clear single reason for this to end, the market is seeing increased nervousness and volatility, exacerbated by political and economic shifts.

Uncertainty is the one thing that equity markets do not like, especially if driven by politics. Over the past three years, global politics has gone through a series of political shocks. The UK is still going through the painful process of negotiating its exit agreement with the European Union. The US market has long been trading on the mood of President Trump's Twitter posts, and experiences even more volatility when some of his sought-after policy changes actually come to fruition – from the nuclear deal with North Korea to the trade war with China and the EU.

At the same time, investors are nervously watching for signs of a global economic slowdown, especially after the US economy, which has been leading the economic recovery, registered its 107th consecutive month of growth in May 2018. While cycles don't die of old age, many signs converge to indicate a slowing momentum in some regions, and the US is expected to eventually follow this trend.

Inflation has been surprisingly low for many years, but, should wages and raw material prices continue to increase, it might return quickly – a scenario best hedged by investing in equities that are able to pass through higher costs.

**Investors seeking growth and stability in these turbulent market conditions may find the search difficult. This is where the Water Theme comes as a solution.**

- The social aspect of water protects it from becoming a political tool, and virtually assures regulatory support for continued investment.
- At the same time, the broader economic cycle plays a smaller role for water-related investments. Consolidated markets and technological leadership of major Water market players allow for stronger pricing power and stable profits.

### Getting the Water exposure right

Investing in the Water Theme is best done by building a concentrated high-conviction portfolio of stocks of companies with highest exposure to the most stable, and cycle- and politics-immune areas of the water industry.

The long-term sustainable solution to water resource management can be distilled to the four Sustainable Development Goals (SDGs), as defined by the UN, that focus on environmental and social impact of products and services from the water angle. An effective Water Theme investment should further integrate ESG factors into the investment process, acknowledging the benefits of responsible investing, and hence further contributing to the long-term outperformance potential of such a strategy.

Meanwhile, stock picking in the Water Theme can allow portfolio managers to further reduce the cyclical and beta of a portfolio. Inclusion of water utilities with inflation pass-through and technology leaders with pricing power act as another inflation hedge. High concentration of investment further enhances the conviction call.



Conceptually, the Water theme is isolated from politics and economic cycles, although general market volatility may still impact the performance through ancillary exposures or a sentiment-driven general sell-off. In such periods, investors should find comfort in the environmental and social alpha generated by investments that show a clear alignment with the SDGs.

Allocating the Water Theme in a broader portfolio offers access to fundamental growth, relative immunity to significant shifts in the cycle or global politics, and exposure to social and environmental returns. Therefore, there are compelling reasons to invest today.



### Summary

After many decades of warning, the necessary investments in water infrastructure and technology still haven't been made. The structural imbalance between water supply and demand remains largely unaddressed, making it a particularly attractive investment theme.

Pressure to make up for the structural imbalance between water supply and demand has been recently mounting for three reasons: social and environmental implications reaching a critical point, a rising political support to the cause, and favourable fiscal policies.

Investing in the Water theme is best done by building a concentrated high-conviction portfolio of stocks of companies with biggest exposure to the stable, and cycle- and politics-immune areas of the water industry.

Water is a defensive investment theme with prospects for high growth, that is protected from the wider political and economic volatility - attractive characteristics for investors under the current tense market conditions.

Water theme offers exposure to social and environmental returns as it is fully aligned with the Sustainable Development Goals of the United Nations. The integration of ESG factors into the investment process, acknowledging the benefits of responsible investing, may further contribute to the long-term outperformance potential of such strategy.

1 The escalation of the water issues in Cape Town was widely covered by the media, for example:  
<https://www.economist.com/middle-east-and-africa/2018/02/15/why-cape-town-is-running-out-of-water>

2 The full background to the UN Sustainable Development Goals can be found at: <https://sustainabledevelopment.un.org/>

3 [https://www.waterboards.ca.gov/water\\_issues/programs/conservation\\_portal/](https://www.waterboards.ca.gov/water_issues/programs/conservation_portal/)

4 [https://www.waterboards.ca.gov/water\\_issues/programs/conservation\\_portal/](https://www.waterboards.ca.gov/water_issues/programs/conservation_portal/)

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