ESG Investing Enticed by Outperformance

INVESTMENT

BY: **Catherine Ann Marshall**

The future of ESG investing in North America will be driven by the carrot rather than the stick during the next few years, but don't discount the possibility that governments may bring out the stick in the absence of tangible progress on climate change.

The carrot is the growing evidence of the potential for outperformance through the integration of materiality and outcomes-focused environmental, social, and governance (ESG) metrics into the investment process. The stick is regulation that forces investment managers to disclose their portfolio's climate risks and how their decisions support greenhouse gas (GHG) reductions.

Climate change risk has become the number one ESG concern in 2019, demonstrated by statements from the Bank of Canada, issues raised in the federal election and, the skyrocketing number of news articles *(See Chart 1)*.

Focus On Material ESG Factors

Cathrine De Coninck-Lopez, global head of ESG at Invesco, says that disclosure of a company's climate change risk exposures will become "table stakes" going forward. Investors need to understand if physical risks (e.g., flood, fire, or drought) and/or transitional risks (e.g., carbon taxes, falling demand, fossil-free alternatives) are material to a company's future profitability.

Other than climate change, "investors only want to know what is material," she says. As a result, the ESG factors for each industry identified as material by the Sustainability Accounting Standards Board (SASB) is an important change. "The SASB reporting is a great initiative," she says. "There aren't hundreds of things that matter in an industry. Likely, there are just 10."

The SASB approach means that investors can get a clear idea of the outcomes produced by ESG investments. The fact that the it covers all industries means that all asset classes, rather than just equities, can report on their material outcomes.

The ESG strategy of investing in firms that score highly on SASB's material factors can drive outperformance in equities *(See Chart 2)*, according to recent research published by Harvard Business School.[1]

Real estate is another asset class where there is a demonstrated relationship between returns and high sustainability scores. The real estate ESG standard is the Global Real Estate Sustainability Benchmark (GRESB) and its material factors – energy usage, GHG emissions, water usage, and waste production – overlap with SASB's real estate factors.

Virtuous Relationship

Recent academic research shows that private real estate funds with high GRESB scores have consistently outperformed funds with low scores, with a return difference of about three per cent annually between the best and worst performing GRESB deciles between 2011 and 2015.[2]

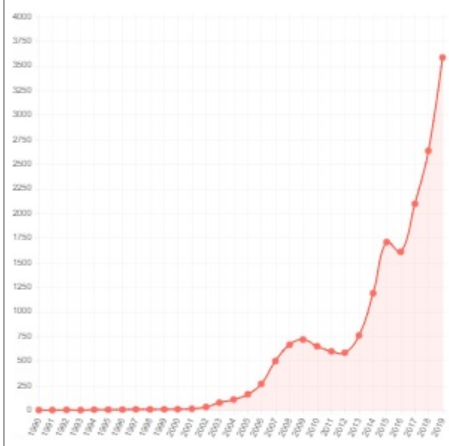
Peter Cuthbert, global head of real estate at Fiera Capital, says initially the ESG program was undertaken in an ad-hoc manner. Now the discipline of GRESB reporting – which quantifies annual reductions in resource use and GHGs – creates a focus on improving metrics yearly. Through improvements in energy use, all the professionals involved in building management can see the virtuous relationship between fighting climate change and driving a profit. "Capital programs in our buildings that reduce energy and other resources result in real savings," he says.

Cuthbert says that because buildings are a major contributor to GHG emissions globally, "greening" buildings means that the private sector is taking the lead on addressing climate change. "The only way climate change is going to get solved is through people and industry – like the kinds of things we are doing in real estate."

Dan Winters, head of the Americas for GRESB, says that many real estate companies are cutting their costs and driving profits as they improve their GRESB score. Good environmental performance helps drive revenue by attracting tenants who are willing to pay above-average rents for efficient, green certified buildings. "Outperformance in real estate is likely driven by the same factors as other asset classes. Companies that are well-managed score well in ESG reporting," he says.

Chart 1

News Stories Related To Climate Risk



Source: Mantle314

Winters doesn't expect participation in GRESB (or any other ESG reporting standards) becoming mandatory in North American in the foreseeable future. While adoption of GRESB is much slower in the U.S. than in Europe, Canada, or parts of Asia, he is hopeful that either investor pressure to report on ESG, or competition between fund managers, will spur increased participation.

Stick Looms Large

In Europe and the UK, politicians have already decided the aggressive GHG reductions required to cap temperature increases at the 1.5 per cent target, or the large and systemic threat to investments of not reaching that goal, require the "stick" of government action.

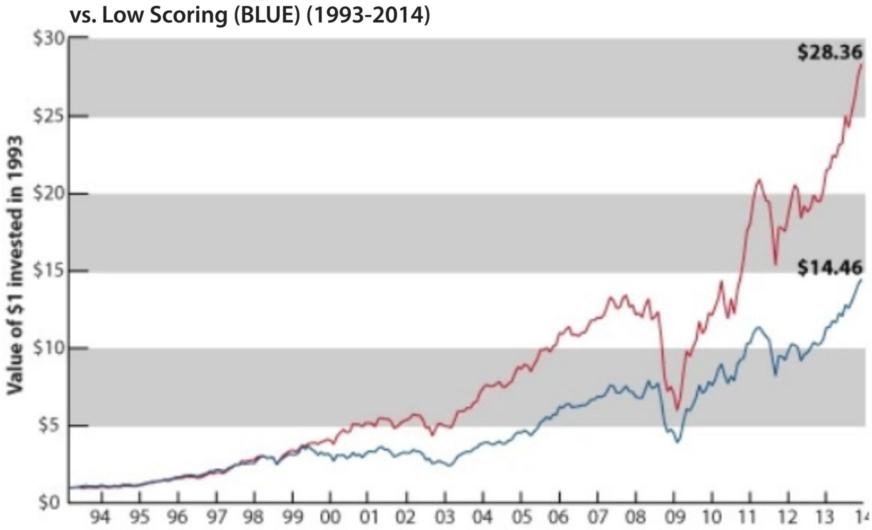
"Although regulation of ESG has not come to North America yet, it is the reality in Europe and the nature of that regulation is still evolving," says De Coninck-Lopez. In the U.S., some city and state governments are leading with regulation to reduce GHGs in the absence of U.S. federal action on climate change, she adds.

A good example of the potential for the "stick" is New York City's 'Climate Mobilization Act.' This new law requires cuts in carbon pollution from buildings by 40 per cent by 2030. This could impact Canadian institutional investors who invest in New York property with U.S. managers, especially those with no ESG program.

Even with broadening support for sustainability programs to increase the focus on 'E' and evidence that sustainability is paying off in the form of returns and results, voluntary ESG going forward likely depends on how well the scale and pace of investments respond to the risk of climate change. **BPM**

Chart 2

Performance of High Scoring SASB ESG Portfolio (RED) vs. Low Scoring (BLUE) (1993-2014)



. Source: Corporate Sustainability: First Evidence on Materiality

Catherine Ann Marshall
is principal consultant at RealAlts.
c.marshall@realalts.com