ESG newsletter

July 2020

How does ESG affect financial performance? 5 key takeaways of our whitepaper

Danny Dekker, Vice President Environment, Social and Governance Advisory

With over 3,000 institutions signed to the UN-supported Principles of Responsible Investment and a record $31 trillion of assets apparently managed in a sustainable way, ESG investing is becoming the new normal. But what is the impact of ESG incorporation on the financial performance of investments, both in normal times and in times of crisis such as the one we are currently experiencing due to COVID-19?

The extensive research done for Kempen's latest White Paper helps answer that question.

We investigated a comprehensive range of academic studies, with a focus on equities, bonds and real estate in academic publications over the last five years. We also applied Kempen's own practical experience to the findings throughout the paper.

You can read the full paper here, but for those short on time, here are five of the key findings:

1. ESG funds hold their own compared to conventional funds

Our research shows that in both equity and credit funds, ESG approaches can compete with conventional funds in the good times, and can offer protection during cyclical downturns.

In equities, funds with an ESG approach over the sample period consistently yielded competitive returns and - in some but not all cases - also offered downside protection during crisis periods. The latter is largely the result of applying a positive screening approach and focusing on corporate governance issues. While it is too early to tell if this is case in the current market downturn, performance so far suggests this theory is proving true.

Our research also looked at credit funds, especially corporate and diversified bond funds with ESG approaches. We found they achieve neutral- or outperformance compared to conventional approaches, mainly due to avoiding ESG laggards (i.e. companies with high ESG risks), for studies of the United States and Europe during the sample period 2001-2014.

These findings help confirm Kempen's belief that ESG factors (and a combination of ESG approaches) must form an integral part of the investment process of a fund to enhance analysis and performance. Our Sustainable Value Creation strategy, for example, looks to invest in companies with low ESG risks and

Kempen

contributing to the transition to a sustainable economy, and at the same time aims to outperform the broader market by 2% on an annual basis.

2. Stewardship is linked to improved corporate performance

At Kempen we believe in engaged shareholdership that benefits all stakeholders. You can find plenty of engagement examples in our recently-released Annual Stewardship and Responsible Investment report. Based on our White Paper's academic review, we see that engagement with an individual company can lead to improved performance after an engagement period had ended. A study by Dimson et al. (2015) for example, found that successful ESG engagements with US firms generated up to about 5% (cumulative) abnormal returns over the 12 months following the initial engagement. On the risk management side, Hoepner et al. (2018) examined engagements on 296 companies worldwide (from 2005 to 2014) and found those firms had 11% lower value at risk compared to matched control companies.

3. The jury is out on a green bonds premium

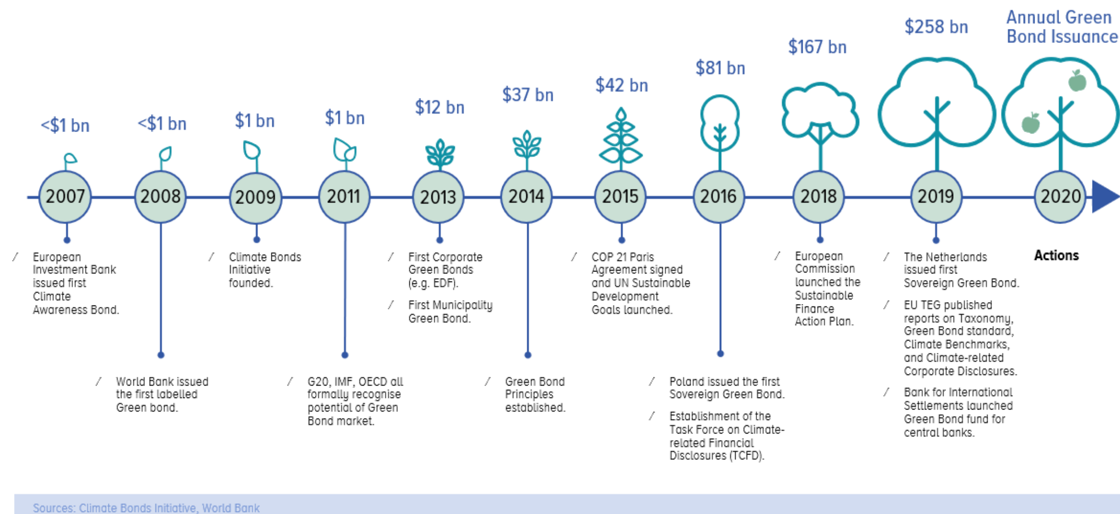
As shown in the graphic below the market for issuing green bonds has boomed in recent years, passing $500 billion by the end of 2018 and reaching a new record in 2019. With regulators such as the EU pushing for more, this is a trend likely to continue.

But as green bonds become an ever-more significant financial instrument, are investors willing to pay a premium for them? The findings of our White Paper on this key question are mixed. Some academics found green bonds do have prices at a premium (i.e. lower yield for green bonds), but others did not find any difference between the pricing of green bonds compared to conventional bonds.

From Kempen's perspective the answer is clearer. Our Euro Credit fund for example, has found that, in general, green bonds tend to trade at a lower spread (i.e. a premium) than normal bonds of the same issuer. The difference is somewhere between 5 and 10 basis points.

What the increasing demand for green-related bonds will mean for green bond pricing will depend on investors. If investor demand increases and shows it is prepared to receive a lower yield, green bond yields can become lower than conventional bonds (i.e. a green bond premium). On the other hand, if demand does not increase, then the additional cost for those that issue green bonds could lead to green bond issuances at a discount (i.e. higher yield on green bonds).

FIGURE 5 Growth green bond market



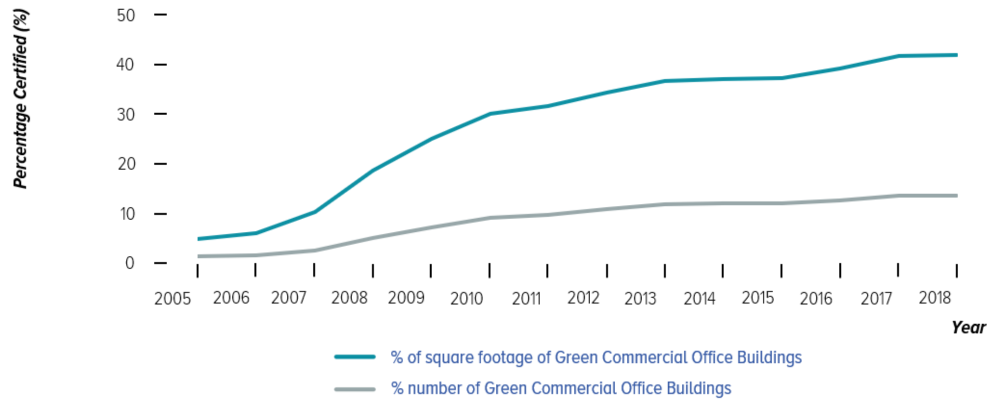
Sources: Climate Bonds Initiative, World Bank

4. Sustainable property has already priced in the extra value

Buildings account for nearly 40% of global energy-related carbon emissions, so the property sector has an important role to play in meeting the climate challenge. There are also clear financial opportunities for doing so – as energy efficiency leads to reduced operational costs for tenants and an increased willingness to pay a higher rent. Greening buildings could also be a sensible strategy to manage the climate risks they face including both transitional risks (e.g. regulatory scrutiny) and physical risks (e.g. flooding).

The research for our White Paper suggested that while there *does* seem to be a green premium in the property sector, different across regions, there is *not* clear outperformance for investors on green REITs (Real Estate Investment Trusts), i.e. listed real estate. This might be explained by the fact that additional capital expenditure needed for greening buildings comes before the return. In addition, the valuation of green REITS might already have increased as increased levels of ESG fund flows pushes up valuations for sustainable investments. As long-term stewards of capital we need to take current valuations into account as well in order to allocate our client's capital to the most optimal risk/reward investment opportunities.

FIGURE 6 Growth of green certifications across the 30 largest commercial office markets in the U.S.



Source: CBRE. Green Building Adoption Index for Office Buildings 2019

5. Time to better define ESG to avoid greenwashing

As my colleague Narina Mnatsakanian wrote in her blog on the subject earlier this year the wide adoption of ESG investing across global markets is not all good news. Different investors apply different methods that they call 'responsible investment' and the lack of one single definition or standard brings ambiguity and runs the risk of 'greenwashing'.

On the back of our White Paper we believe that to combat the emergence of greenwashing in global markets ESG frameworks, such as the EU taxonomy, can clarify what should and should not count as sustainable activities and help create greater transparency and more clarity in this critical area.

This Kempen Capital Management N.V. (KCM) document is provided for informational purposes only and does not provide sufficient information to enable you to make any investment decision. The information in this document is incomplete without the oral explanation given by a KCM employee.

KCM has a license as manager of various UCITS and ABIs and is authorised to provide investment services and as such is supervised by the Dutch Authority for the Financial Markets (AFM).

Nothing in this document can be used without prior permission by KCM.