

White Paper – No time to be passive

The private and public sector need to step up their game.

Over the last several years we have seen ESG transform itself from an occasional afterthought to a main topic of discussion. Despite its hugely progressive, efficient and vastly wealth creating characteristics, the modern capitalist model seems to struggle to deal effectively with externalities. This is nothing new, since the coming of age, we have seen small entrepreneurs, large corporations and everyone in between across many industries find ways to maximize their profits in the short run whilst often spreading certain costs (more difficult to allocate or estimate) to the wider population. The most basic example, of course, being a heavily polluting plant which creates jobs, manufactures a highly desired product, yet often pollutes (sometimes heavily) the adjacent environment without penalties. The revenues are near term for a small group of stakeholders (mainly shareholders), whilst the costs and impact on the health and environment is long term for other stakeholders (wider society and future generations). This mis-match has always needed to be regulated by the governments – which has occurred to differing degrees.

In the appetite to maximize shareholder returns, the firm has every incentive to spread the cost to the wider public. Similarly, in the appetite to regulate externalities, governments can tend to go overboard once they dip their hands into the cookie jar and the thirst for influence and incentives to win votes can have detrimental effects to both entrepreneurialism, economic progress and also ironically public health and the very environment it set out to protect. This is important in the world of real assets as the building sector alone (including construction and operations) contributes c.40% of anthropogenic global carbon emissions¹. Hence, remaining passive in the face of this challenge may be something that future generations may not quickly forgive us for. We need not elaborate in extreme detail on what the planet may look like in our lifetimes and beyond the year 2050 if we do not address these externalities as quickly as possible but it is important we are reminded of the hard facts.

“The slowness of climate change is a fairy tale”²

The 2015 Paris Agreement’s central goal is to limit global warming, more precisely by encouraging to reduce greenhouse gas “GHG” emissions by at least 40% by 2030³ (most recent proposal is for 55% reduction⁴) compared to 1990, yet we are still increasing emissions globally. If we can make that reduction by the year 2030 then we may reduce the trajectory of global warming to no more than 1.5 degrees Celsius.

Unfortunately, with the current investor and consumer passiveness we are very unlikely to reach that target. The ultimate goal of the European Union is to be GHG emissions neutral by the year 2050⁵. This is not something to be taken lightly. By the year 2100, if we continue on the current GHG emissions path, we are projected to reach a +4 to +5 degrees Celsius consistent warming level above the baseline⁶. Today we are at around 1.1 degrees Celsius above the 1900 baseline normal temperature⁷. Last time we had a consistent five degree increase was about 250 million years ago and 96% of living species became extinct⁸, hence needless to say our trajectory is not on a good path as things are changing (for the worse) quicker than scientists were forecasting.

So why does this matter?

In 2020, CO2 emission were reduced by just over 6%⁹ as a result of very difficult global lockdowns causing a seismic shift in behaviour globally. Mathematically speaking, we need around a 7% reduction per annum to be on an effective path. With the sacrifices made globally in 2020, the true surprise is that there was only a 6% impact on CO2 emissions. The climate risks are three-fold for investors: 1) Energy transition risk 2) Physical asset risk and 3) Policy risk. More specifically the first refers to the need to reduce the assets’ CO2 footprint in line with the Paris goals in order to reduce the trajectory of the planet’s warming. It is the magnitude and speed/timing that is of paramount important. It needs to be reduced both on time and quickly

enough. The second risk deals with the likelihood that the real assets themselves end up being damaged due to the effects from global warming (largely via natural disasters). This risk is easy to visualize and we have all seen the news items on the television showing flash floods or wildfires. The final risk we mention is one which is not as simple to visualize. It refers to governments increasing their response to the first two risks via

regulation. As an example, the EU is currently discussing extending the scope of carbon pricing to more sectors (including Real Estate).

What are we doing about it?

At the Real Assets team we scrutinize management teams and their sustainability goals to make sure that there is a climate policy in place and a proper decarbonization strategy. This in itself is not enough as the devil is always in the details. The management team needs to have capital alignment to deal with these issues, it needs mid-term goals and a viable plan to reach 2030 and 2050 targets. It needs to track all scope emissions data and to have a compensation incentive structure at executive and/or board level to ensure that these initiatives do not remain an afterthought. Also the data used for reporting needs to be audited fully to ensure that progress is indeed concrete. We are experts at seeing right through “green-washing” as we have been integrating environmental performance since inception (2011), and never as an afterthought added to the investment process at a later stage. In essence, we are first movers in this space and we pride ourselves greatly on that. Since February of this year all front office staff at the Real Assets team, in combination with our ESG departments, have launched sector-wide engagements where we approach all companies in a real assets cluster with a framework on the tangible actions that need to be taken as a group – given a systemic issue requires a holistic approach.

Initial feedback on the sector wide engagement has been very positive with several companies being quick to take notes and consider implementations sooner than later, and recognising us as partners. The impact, of course, can vary greatly by regions. As data is central to our investment process we have also spent a great deal of time with our quantitative portfolio managers to scrutinize the quality of the data where a lot of work still needs to be done (especially as it relates to the UN’s Sustainable Development Goals “SDG’s”). This is a topic we will elaborate on further very shortly via a white-paper as it warrants its own detailed look.

Avoiding the Problem vs Addressing the Problem – why passive won’t do.

If ever one was to ask how the private sector can, with high level government regulation, help deal with externalities which threaten our very existence then this would be it. Whilst investing in ETFs can have upsides in theory, mainly as it relates to the cost, it ends up making the climate problem a lot worse as due to the investment size some ETF hold in certain stocks without informed engaging. This leads to their passive support of managements’ default strategies, and may mean changes to environmental policies are more difficult to bring on-board. Also for a passive index tracker to have a dialogue with a company, comes from a place with fewer degrees of freedom for the passive investor. Passive index allocators often end up exacerbating the issue and make it more difficult to make these very real changes that are necessary to progress towards the common goal, via market practices. A recent innovation from the passive community has been to offer ESG ETFs, where a certain industry will be excluded. Exclusion – whilst positive in terms of signalling and with-holding capital, is not engaging with the company. Given the choice of avoiding vs addressing the problem, our Real Active approach chooses for the latter.

The longer we leave the climate challenge unaddressed, or avoided, the higher the likelihood of seeing more extreme measures by wider society, such as voters through extreme government ideologies or policies which may set unrealistic targets and/or end up damaging the economic system heavily along the way, and still ultimately miss the goals.

Active ESG integration sounds good, but will it create Alpha?

Alpha, in the investment world, has to do with a risk adjusted excess return. Our property and infrastructure investment strategies aim and have achieved the stated annualized alpha targets since inception whilst keeping tracking error predictable in its target range. This means that the information ratio of over 1 has been achieved. We can attribute this to our unparalleled combination of collective high quality data from many sources, processing it in such a way as to make fundamental sense from it and using it to as a bedrock to found our investment models.

The Real Assets team’s sustainable way of investing is not simply about selecting the companies with the best practices at a given point in time. The “real active” way of ESG investing is about anticipating, preparing, engaging, pricing and profiting from the changes that are happening to the planet, improving shareholder alignment and incorporating inclusive stakeholder management to stay ahead of government policy. It is based on cold hard facts and forward looking data points, and is based on active engagement to

push companies to face upcoming high impact issues via smart investments and capital allocation and prepare for certain changes to our planet and our societies. It really is the “new active” way of investing. It is about extracting alpha, for all stakeholders.

A lot on the “E”, what about the rest?

ESG is really three different things although we tend to group them together. In different parts of the investment universe each one can be important. In different investment spaces E and S and G can have different importance. The “E” for offices can be more important as energy labels needs to fit regulation as the assets are generally utilized heavily. The “S” can be more important for residential real estate where aggressively and inconsistently raising rents may not be optimal for a landlord in the longer term, and G is kind of the glue that keeps our whole profession together, without best governance practices, then our shareholder rights and engagements will be worth nothing.

The “E” is the most important elephant in the room, if we don’t get E right then S and G won’t matter. But we can’t do E without proper G (or governance) engagement, and considering a just transition (the impact on S), so there is a natural overlap. The investment industry has organized itself into several initiatives, one of which is the “Climate action 100 plus group” (asset manager wide organization). This initiative targets CO2 reduction not only for several companies to do in the energy sector but for the largest one hundred GHG emitting companies, and jointly engages for maximum collaborative impact. In the spirit of that initiative, the Real Assets team is doing sector wide engagement on all the companies in our universe. Going one step further, we fully integrate the analysis into our valuation framework, which quantitatively affects how much we are willing to pay for a certain investment.

Climate change costs priced in our models

Going forward, we expect the impact of climate risk mitigation and adaptation to increase. With respect to mitigation, companies will have to comply with the Paris Agreement and an increasing amount of data and mandatory reporting should become available to measure progress. In the area of adaptation we see an increasing number of research studies focus on where climate risk presents itself. However, climate risk is not binary. We believe focus should be on the costs to adapt for climate risk. These costs should be incorporated into real estate valuations as we do. In our investment process we believe our estimates for climate risk adaptation will become increasingly accurate. In doing so have sought partnerships with a re-insurance company which allow us a rich data source in natural disaster probabilities, which we then mix in our property scores to be able to project necessary predictive capex right down to the building level. It also allows us to lead more focused and fruitful conversations when we meet with management to gage progress and assess various high impact risks ahead.

Active in real assets means being part of the solution

ESG is an essential component in our investment approach. It determines 25% of our company score, and as previously mentioned, we fully integrate it and price it into the valuation models to systematically reward or punish the valuations of real assets companies. This means that we can invest in a company which at a given point in time isn’t doing too well, but has plans to improve, because we would expect that the stock will re-rate as the company invests in the right initiatives. Aversely, if we judge that an ESG compliant stock is fully priced then there might be times where we don’t own it because although the company is doing well, the price might be well above that. Hence the key is on pricing it, and using our engagements as a driver for change, which then would cause for a rerating and be one of our alpha-contributing factors. This is another example of why we call this approach “alpha by control”. It also helps illustrate why we truly believe that investors really do not have the luxury to remain passive in light of the high probability/high impact events ahead of us.

1. <https://www2.deloitte.com/global/en/blog/responsible-business-blog/2020/decarbonization-of-real-estate.html>
2. ‘The Uninhabitable Earth’, David Wallace-Wells
3. https://ec.europa.eu/clima/policies/strategies/2030_en
4. https://ec.europa.eu/clima/policies/international/negotiations/paris_en
5. https://ec.europa.eu/clima/policies/strategies/2050_en
6. University of Cambridge: Institute for Sustainability Leadership, Business Sustainability Management, Module 1, 2020.
7. University of Cambridge: Institute for Sustainability Leadership, Business Sustainability Management, Module 1, 2020.
8. University of Cambridge: Institute for Sustainability Leadership, Business Sustainability Management, Module 1, 2020.
9. COVID curbed carbon emissions in 2020 — but not by much (nature.com)

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