How ESG relates to financial performance

A REVIEW OF ACADEMIC EVIDENCE AND INSIGHTS FROM AN INVESTOR

WHITE PAPER

1737
Kempen

JUNE 2020

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Authors

Danny Dekker and Tim Vellinga

Sustainability & Impact team Kempen Capital Management

About Kempen Capital Management N.V.

Kempen Capital Management N.V. (hereafter Kempen) is a specialist asset manager focused on niche investment strategies. Kempen as of December 2019 manages a total of EUR 59 billion in assets, of which EUR 3 billion in private markets, including land and private equity. In every aspect of our business, our commitment is simple: we focus on delivering strong performance in the long run with environmental, social and governance (ESG) criteria fully incorporated into everything we do.

Executive Summary

ESG investing is becoming the new normal. Signatories to the UN-supported Principles of Responsible Investment, for example, have risen six-fold to more than USD 86 trillion between 2008 and 2019.[1] This trend is convincing investors, most forcefully through climate change, and more recently through the coronavirus outbreak, that the long-term viability of the companies in which we invest is inextricably tied to the welfare of their stakeholders. While we cannot predict the full social and financial consequences of the coronavirus pandemic at this stage, we can witness its far-reaching global economic and social impact. We believe that the fall out will further accelerate a paradigm shift that changes markets from purely focusing on shareholder value towards recognising the importance of creating long-term value for all stakeholders including employees, suppliers, customers and communities.

Responsible investors incorporate environmental, social and governance (ESG) aspects into their investment process, of which several ESG approaches can be taken (see the textbox 'Outline of our approach and definitions used' on page 9). Asset owners (institutional & retail) and asset managers are increasingly shifting capital towards ESG investing, including the larger passive managers. As this shift towards ESG investing continues, the question often asked is: *What is the impact of ESG incorporation on the financial performance of investments?*

This whitepaper aims to answer that question.

To do so we have investigated the academic literature of ESG investment funds, alongside academic research on company-level ESG performance. Our focus has mainly been on research related to equities, bonds and real estate in the last five years. We used the extensive meta-study of Friede et al. (2015) as a proxy for the research period until 2015. In this paper we also relate these findings to our own fully ESG-integrated approach as a long term investor.

Our analysis shows seven key findings relating to the performance of equity and bond funds, engagements, green investments (in equities, bonds and real estate) and investor loyalty. Overall, we observed that investors who incorporate ESG approaches in equities, bonds and (green) real estate performed at least as well as non-ESG investors. Furthermore, we found that engagements could both improve returns and reduce risk. And although green equity funds and green bonds showed mixed research results, the EU climate ambition and its accompanying regulation are likely to be a positive development for these investments. The seven key findings are below. We have also added some guidance on 'greenwashing' because, although we did not find an explicit link to it in the literature, ESG investors increasingly need to cope with this phenomenon.

Read more ('Introduction' on page 8}

1 www.unpri.org/pri/about-the-pri

Key findings

1. Equity funds with ESG approaches compete with the returns of conventional funds; and can protect performance during cyclical downturns

Equity funds with an ESG approach do not seem to yield financially different returns compared to conventional funds, based on the sample period of 1988-2014. Hence, ESG investing does not appear to cost returns. Incorporating ESG in the investment strategy (mainly through negative and positive screening approaches), appears to generate competitive returns. These findings are consistent with the findings of previous academic studies and our initial hypothesis. Furthermore, some authors found that equity funds incorporating ESG approaches may offer downside protection during crisis periods. This is largely the result of applying a positive screening approach and focusing on corporate governance issues.

Kempen: This helps confirm our belief that ESG factors must form an integral part of the investment process of a fund to enhance analysis and performance. We believe that for optimum results a full spectrum of ESG approaches should be used including integration and engagement. By combining these ESG approaches, ESG risks and opportunities can become holistically embedded into an investment process and we would expect to see less downside risk. Although it's too early to see, we could expect this for the current coronavirus outbreak too.

Read more on page 10

2. Mitigating ESG risks in credit funds can result in the same or better returns

Although the research on credit funds is relatively scarce, research on corporate and diversified bond funds with ESG approaches suggests they obtain neutral- or outperformance due to avoiding ESG laggards, i.e. companies with high ESG risks and higher default risks. This approach reduces financial losses which, in turn, effectively helps generate excess returns, especially during cyclical economic downturns. This was the case, in the United States and Europe during the investigated sample period 2001-2014.

Kempen: We expected these results as we believe that incorporating ESG considerations into the investment process contributes to long term value – including in credit funds. Although we are of the opinion that a combination of ESG approaches is needed to fully realise the potential for long-term value.

Read more on page 15

3. Engagement can improve performance and reduce downside risk

Engagement with companies could lead to improved performance for investors. Some researchers[2] have examined this ESG approach, during the sample period 1999-2014, and they found indicatively that companies' returns during and after an engagement period had improved. Further research[3] found that engagements could also protect investors' wealth as it reduces downside risk.

Kempen: This result is in line with our conviction. For Kempen, as an active asset manager, engagement is a key element in our ESG approach. We believe that active dialogue with companies that we invest in can lead to win-win outcomes that have real world impact. By encouraging companies to improve their corporate governance, environmental management and social practices, we expect to unlock value.

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4. Investing in green funds historically yields lower returns, but can turn around

Green equity funds experienced either neutral or underperformance compared to conventional funds in Europe and the U.S. during the sample period 1987-2018. Nevertheless, we also observed in some research that financial returns for green funds improved over more recent years relative to conventional funds, and even more so when compared to 'black' (carbon-intensive) funds. Lower performance for green equity funds was due to a low diversification caused by their focus on certain (sub)-sectors and a limited number of available green-oriented investment opportunities. Due to the expansion of green investment opportunities and growing awareness of climate risk, via for example, the EU Emission Trading Scheme (ETS), the performance of green funds has improved over the years.

Kempen: We expect that with the ongoing focus on climate change and the energy transition worldwide the number of investable projects and companies will rise. Especially in the European Union with its ambition to become net carbon neutral in 2050 and accompanying regulation on the agenda. A green acceleration seems to be underway.

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2 *Barko et al. (2018), "Shareholder Engagement on Environmental, Social, and Governance Performance"; Dimson et al. (2015), "Active Ownership".*
3 *Hoepner et al. (2018), "ESG Shareholder Engagement and Downside Risk".*

5. Green bonds: towards a low carbon economy, against a premium?

Green bonds can play an important role in the (re)allocation of capital towards the energy transition and a low carbon economy. With climate change emerging as one of the most pressing ESG concerns, green bonds are becoming increasingly significant financial instruments but are investors willing to pay a premium for this? The results in the literature are mixed and do not offer a definitive answer. Some academics found a premium but others did not find any difference between the pricing of green bonds compared to conventional bonds.

> **Kempen:** The market for green bonds issuance exceeded USD 500 billion by the end of 2018 and had reached a new record of issuing green bonds by 2019. We expect that the number - and related amount - of green bonds, and related SDG-linked bonds, will continue to increase. This is due to increased investor demand for climate-aligned investing and the increasing focus by governments (e.g. the EU Green Deal) on meeting their climate ambition. What this will mean for green bond pricing depends on how investors will act.

Read more on page 23

6. Green buildings appear to have a premium

Buildings account for around 39% of global energy-related carbon emissions. The sector has an important role to play in meeting the climate challenge if it reduces its carbon emissions to cope with increasing climate risks. These include both transitional risks (e.g. regulatory scrutiny) and physical risks (e.g. flooding). Greening buildings could be a sensible strategy in this respect. The assessed academic literature suggested that there seems to be a green premium, different across regions, but no clear outperformance for investors on green REITs (Real Estate Investment Trusts), i.e. listed real estate.

> **Kempen:** We strongly believe that sustainability features can have an important impact on the value of real estate companies. An energy efficient building will incur lower costs, for example in terms of heating. This leads to reduced operational costs for the tenant and an increased willingness to pay a higher rent. The capital expenditure however comes before the return and might explain why the outperformance relationship of green REITs is not always directly visible. In addition, the valuation of green REITs might already have risen as increased levels of ESG fund flows push 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.

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7. Investors in funds incorporating ESG approaches seem to be more loyal

Some indicative results show that investors in funds incorporating ESG approaches appear to be less sensitive to negative performance compared to investors investing in conventional funds in the U.S. and (parts of) Europe during the sample periods 1980-2002 and 2007-2013. This indicative research, although relatively scarce, suggests that ESG characteristics can reduce investors' tendency to shift capital away from less performing ESG funds, compared to conventional funds.

Kempen: We welcome and encourage this trend. We see that investors that take ESG into account tend to have a long(er)-term investment horizon and focus on long-term value creation for clients and other stakeholders. We expect that this development will be further strengthened via (upcoming) regulation and standards, and expect that it will lead to less attention on short-term performance and more attention to ESG and long-term value creation.

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Avoiding 'greenwashing' - time for an ESG unification standard across markets

Although our review of the ESG literature did not yield an explicit link on 'greenwashing' as one of its seven key findings, we recognise the importance of the topic due to the increasing investor interest in ESG. That is why we underline the importance of standardisation initiatives in the market to address the issue and we support the upcoming EU Taxonomy, part of the EU Action Plan on Sustainable Finance, as a classification system to define what is and what isn't sustainable – in order to avoid greenwashing. In the meantime, investors can already take action to avoid greenwashing. At Kempen we have for example developed a comprehensive evidence based scoring framework of managers' ESG capabilities for selecting and monitoring fund managers.

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Introduction

ESG investing has become the new normal and has grown significantly in the last decade. As shown by the PRI[4], the number of assets under management (AuM) of PRI signatories was around USD 13 trillion in 2008, and that amount has risen to more than USD 86 trillion in 2019.[5] The expectation is that the focus on ESG investing will continue to grow due to the increasing societal attention on sustainable topics, of which climate change is probably the most prominent example.

The European Green Deal has the potential to transform Europe's economy and society to become climate-neutral by 2050, as it is designed to attract at least one trillion euros worth of public and private investment over the next decade.[6] Central banks are stepping in on ESG and new regulation, such as the EU Action Plan on Sustainable Finance, is underway to accelerate more sustainable investments. And the current coronavirus outbreak can accelerate and boost ESG investing even more. While the full social and financial consequences of the pandemic are difficult to predict at this stage, it is having a far reaching economic and social impact worldwide. We believe that the fall out can further accelerate and boost the take-up of ESG investing worldwide. Such a crisis can accelerate the paradigm shift from the focus on purely shareholder value towards recognising that the long-term viability of the companies we invest in is intrinsically linked to the wellbeing of all its stakeholders including employees, suppliers, customers and communities.

Responsible investors incorporate environmental, social and governance (ESG) aspects into their investment process, of which several ESG approaches can be taken (see the textbox on the next page). Asset owners (institutional & retail) and asset managers are increasingly shifting capital towards ESG investing, including the larger passive managers. As this shift towards ESG investing continues, the question often asked is: *What is the impact of ESG incorporation on the financial performance of investments?*

This whitepaper aims to answer that question.

We have investigated the academic literature of ESG investment funds and complemented this with an assessment of academic research on company-level ESG performance. We focus on academic literature to be as objective as possible. Our focus has mainly been on the research published on equities, bonds and real estate in the last five years. We used the extensive meta-study of Friede et al. (2015) as a proxy for the research period until 2015. In this paper we also relate these findings to our own fully ESG-integrated approach as a long term investor.

Our analysis shows seven key findings relating to the performance of equity and bond funds, engagements, green investments (in equities, bonds and real estate) and investor loyalty. Overall, we observed that investors who incorporate ESG approaches in equities, bonds and (green) real estate performed at least as well as non-ESG investors. Furthermore, we found that engagements could both improve returns and reduce risk. And although green equity funds and green bonds showed mixed research results, the EU climate ambition and its accompanying regulation are likely to be a positive development for these investments. The seven key findings are below. We have also added some guidance on 'greenwashing' because, although we did not find an explicit link to it in the literature, ESG investors increasingly need to cope with this phenomenon.

4 *PRI is the leading advocate for responsible investment supported by the United Nations.*

5 *https://www.unpri.org/pri/about-the-pri.*

6 *https://www.europarl.europa.eu/news/en/headlines/society/20200109STO69927/europe-s-one-trillion-climate-finance-plan.*

OUTLINE OF OUR APPROACH AND DEFINITIONS USED

Overall

- **Academic studies search.** In our structured approach we used key term-based searches on ESG through the Scopus and SSRN database and Google Scholar for academic literature.
- **Funds risk and return.** Based on widely-used financial factor models such as Fama-French three-factor model and Carhart four-factor model.
- **Out-, under- and neutral performance.** Out- and underperformance means if the returns compared to the comparison group are statistically significant (at a 10%, 5%, 1% significance level). Neutral performance means if the returns are not statistically significant.
- **Funds.** The results used are based on actual mutual funds (no hypothetically constructed portfolios).
- **Results from previous years.** The meta-study from Friede et al. (2015) acts as a proxy for findings on financial performance before 2015, where possible.

Range of funds

- **ESG funds:** mutual funds investing in equity or bonds that incorporate Environmental, Social and Governance (ESG) factors in their investment strategy. The ESG approaches may include best-in-class / positive screening, exclusionary screening, active ownership (engagement).
- **Conventional funds:** mutual funds that do not explicitly incorporate ESG factors in their investment strategy.
- **Green funds:** equity mutual funds incorporating environmental factors in their investment strategy and it generally implies investing in companies with strong environmental practices and innovative projects (e.g. renewable energy).
- **Black (carbon-intensive) funds:** mutual funds investing in carbon-intensive equities of companies involved in the exploitation and depletion of our natural resources and natural capital; or black energy funds which invest at least 50% of equity assets in worldwide companies involved in the production, refining, distribution and generation of energy derived from oil, gas, coal, renewable sources, the weight of renewable energy companies being lower than 50% in the portfolio (definition from Ibikunle and Steffen (2017) and Marti-Ballester (2019)). Note that although the name of these funds (and the funds themselves) are not well-recognised in the market, we follow the authors on the names as readers can more easily find the results and we did not know a more suitable name.
- **Diversified credit funds:** a combination of corporate and government bonds.

ESG approaches[7]

- **Negative/ exclusionary screening:** refers to the exclusion of companies due to their involvement in controversial activities (e.g. controversial weapons, tobacco, etc) and due to poor ESG conduct behaviour (called norm-based screening, also seen as a separate ESG approach but also included in this approach).
- **Best-in-class / positive screening:** refers to the inclusion of companies with good ESG standards and performances in a fund's portfolio, exemplified by companies with a high ESG-rating.
- **ESG integration:** ensures that material ESG factors are incorporated in investment decisions.
- **Active ownership (engagement and voting):** initiated by asset owners or managers to address ESG issues with companies through engagement and voting in the interest of a wide group of stakeholders.

7 *Since the term ESG was coined more than a decade ago, fund managers have adopted a range of different ESG investment approaches over the years (e.g. Ayadi et al. (2016), "Typical and Tail Performance of Canadian Equity SRI Mutual Funds"; and Ferruz et al. (2012), "Managerial Abilities: Evidence from Religious Mutual Fund Managers" describe the development of ESG investing during the last decades).*

Detailed key findings

1. Equity funds with ESG approaches compete with the returns of conventional funds; and can protect performance during cyclical downturns

A. ESG incorporation does not appear to cost return with equity funds

Based on the assessed literature, it seems that equity funds with ESG approaches do not yield financially different returns to conventional funds, based on the sample period 1988-2014 of the assessed literature of the last half decade.

The research shows that, overall, ESG equity funds earn similar returns compared to conventional counterparts, across Europe, North-America and Asia.[8] The results are in line with the ESG overview conducted by Friede et al. (2015), which covered 155 fund-related studies and observed mainly neutral performance results.[9] It is worth noting that most assessed research mentioned how ESG funds (i.e. SRI funds) were selected for the research and assessed against conventional funds, but few researchers also mentioned the difference in ESG approaches of these ESG funds.[10] Furthermore, the performance of funds with ESG approaches compared to conventional funds seem not to be impacted due to ESG costs, as net returns were taken into account in the literature.[11]

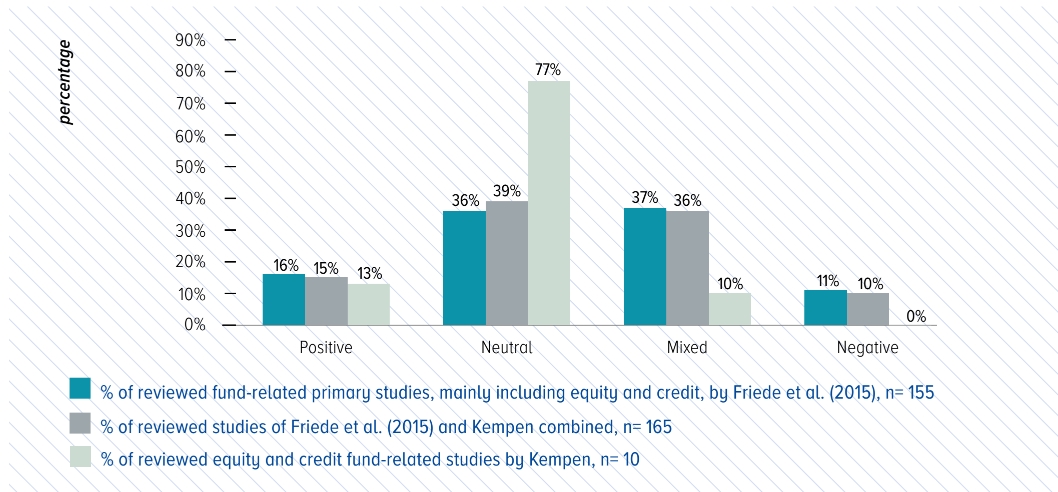
8 *Ayadi et al. (2016); Becchetti et al. (2015), "Socially Responsible and Conventional Investment Funds"; Belghitar et al. (2017), "Importance Of The Fund Management Company In The Performance Of Socially Responsible Mutual Funds"; Kim (2019), "Can Socially Responsible Investments Be Compatible with Financial Performance? A Meta-Analysis"; Leite and Cortez (2015), "Performance of European Socially Responsible Funds during Market Crises: Evidence from France"; Leite and Cortez (2014), "Style and Performance of International Socially Responsible Funds in Europe"; Leite et al. (2018), "The Performance of European SRI Funds Investing in Bonds and Their Comparison to Conventional Funds"; Lesser et al. (2016), "International Socially Responsible Funds: Financial Performance and Managerial Skills during Crisis and Non-Crisis Markets". Note that Ayadi et al. (2016) and Bechectti et al. (2015) took sample periods that started earlier (1988 and 1992) compared to the other studies (from 2000), but all studies found neutral results.*

9 *Friede et al. (2015) also used portfolio-related studies which include hypothetical funds and index funds, as we focus on actual mutual funds. Nevertheless, their results are overall in line with the research we investigated that came out the last five years.*

10 *Leite and Cortez (2014) also assessed the performance of ESG funds with a best-in-class approach versus funds with other ESG approaches in the 2000-2008 period. They found that the performance did not find a statistically significant different performance.*

11 *See e.g. Ayadi et al. (2016); Becchetti et al. (2015); Belghitar et al. (2017); Kim (2019). Note that as Leite and Cortez (2014, 2015) focused on retail funds, they used returns net of operating expenses but gross of any sales charge.*

FIGURE 1: Percentage of reviewed studies on the performance of ESG funds relative to conventional funds.



Source: Kempen, Friede et al. (2015).

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Funds can use different ESG incorporation approaches. Historically, negative screening has been one of the most used in the past,[12] but increasingly more ESG approaches such as ESG integration and engagement have been used. At Kempen, ESG factors are an integral part of all our investment processes and we combine several ESG approaches (see our website): ESG integration, Exclusion, Active ownership (engagement and voting) and Impact. We believe that as an active asset manager with a focus on long-term value creation, we must take ESG into account in order to get a holistic view.

Based on our assessment of the academic literature on ESG equity funds, we observed that ESG funds do not yield financially different returns to conventional funds. We would expect that ESG funds perform at least as well as conventional funds and probably even better as ESG enhances investment analysis. As mentioned above, our view is that ESG integration enhances investment analysis and performance. Together with the ongoing focus on ESG from more and more stakeholders, including regulators and policy makers, we expect that this will improve the performance of ESG funds compared to conventional funds going forward.

12 *Based on market reviews, Eurosif and Global Sustainable Investment Alliance show that negative screens (exclusions) is still most used as an ESG approach.*

CASE STUDY: KEMPEN SUSTAINABLE VALUE CREATION

The investment philosophy of Kempen's Sustainable Value Creation strategy is based on a long-term focus, sustainable growth and active ownership. Our ESG approach is to select companies that combine:

- low ESG risk;
- contribution to the transition to a sustainable economy with their products and services;
- strong management of ESG issues;
- target to become climate neutral.

In the long run, we have the ambition to outperform the broader market by 2% on an annual basis. In addition to delivering investment alpha, active managers have an important contribution to make by having a continuous dialogue with companies on long-term strategy and in particular ESG. This contribution through active management is to the benefit of all stakeholders. Our view on the added value of active management to sustainable investing is detailed in the white paper 'Active management and sustainable investing'.

A good example of a sustainable company creating value for stakeholders is Novo Nordisk from Denmark. Novo Nordisk aims to drive change to defeat diabetes and other serious chronic diseases like obesity and haemophilia. Their key contribution is to discover and develop innovative biological medicines and make them accessible to patients throughout the world. We expect Novo Nordisk to grow earnings around 4% for the next 10 years at a very attractive return on capital. Total shareholder return has been 16.4% annually over the last ten years while employee growth was 4.1%. R&D to sales has been around 12% and important innovative drugs in diabetes have been launched. Novo Nordisk wants to become climate neutral in 2030 and plans to use only renewable electricity in its global production facilities by 2020. It's the ambition of the company that everyone who needs their essential medicines can access them, at prices that they can afford. Novo Nordisk has availability and affordability programmes in place in over two-thirds of the countries where they operate.

CASE STUDY: ESG EQUITY INDEX SOLUTION FOR CLIENTS

For our (fiduciary) clients we have selected ESG Equity Index funds that incorporate ESG approaches, such as exclusions and best-in-class, in their investment approach. Companies involved in certain activities such as coal, weapons and tobacco are excluded, together with companies that violate UN Global Compact standards. The other companies receive an ESG score based on several ESG criteria with input from a specialist ESG data research provider. Companies need to receive a certain score to be included in the index. These funds show no different risk-return characteristics compared to the non-ESG variants. Therefore by incorporating ESG approaches, ESG Equity index funds can take into account ESG considerations and still have the same return-risk characteristics.

B. ESG incorporation can protect returns in crisis periods

Whether ESG incorporation can protect returns during crisis periods has been investigated by several researchers over recent years. Based on this literature we observed that, although researchers did not find significantly different performance over the whole sample period on average[13], some researchers indicated that ESG equity funds performed better than their conventional peers during crisis periods (i.e. the dotcom crisis in the U.S. and the Great Recession in the U.S., Europe and Asia during the sample period 1992-2012) - although this mainly relates to U.S. funds.[14] The outperformance seems to relate to ESG equity funds that apply positive screening and Nofsinger and Varma (2014) also found that funds focusing on governance issues showed strong crisis alpha. Furthermore, the results appeared to be less favourable for non-crisis periods when the funds experienced the same performance or underperformance. When we look at the ESG approach of the funds used in these papers, it appears that ESG funds using exclusion screening caused underperformance, not the ones using positive screening. A possible reason for this, as mentioned by Leite and Cortez (2015), may be that negative screens are more likely to exclude larger companies from their portfolios, while the best companies in each sector - as used in the positive screening approach - are probably larger well-established companies.

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The academic literature shows an indication that ESG may protect returns in crisis periods, although the results indicate that this is not related to funds using negative screening. At Kempen, we believe that ESG needs to be used in an integrated manner in which several ESG approaches all play their role. Only focusing on exclusion is not the way we prefer to use ESG in our funds. Indeed as one of our investment beliefs is that we prefer inclusion over exclusion, we believe it is in general more effective to bring about change by working with companies instead of excluding them. That is why as an active investor we engage with companies and vote in line with our beliefs. By combining ESG approaches, ESG risks and opportunities are part of the investment process and we expect it to help us – and other like-minded investors – to benefit from less downside risk and to contribute to long-term value creation. Although it's too early to see, we could expect this for the current Coronavirus crisis too.

13 *Becchetti et al. (2015); Belghitar et al. (2017); Leite and Cortez (2015); Lesser et al. (2016).*

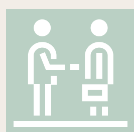
14 *Lesser et al. (2016); Nofsinger and Varma (2014), "Socially Responsible Funds and Market Crises".*

CASE STUDY: KEMPEN HIGH DIVIDEND STRATEGY

We incorporate ESG in our investment strategy via 3 pillars (more details can be found at kempen.com):

Exclusion: We want to exclude as little as possible although we avoid companies that structurally violate ESG criteria with no willingness to improve, and companies involved in controversial weapons and tobacco.

ESG Integration: We want to know and learn as much as possible about the companies we invest in. Therefore we integrate any material ESG issue (positive or negative) into our investment case. We also integrate it into our valuation model if we can quantify it.



Engagement: In our ongoing dialogue with companies we share our observations from an ESG perspective. Sometimes just to create awareness, sometimes to really change the way the company operates.

In our High Dividend strategy we strive for 'triple Ps' which are: Participation (in upward markets), Protection (in market downturns) and Pick-up (in dividend yield). Our thorough understanding of the companies we invest in, including all the relevant ESG issues, has helped us over the years to protect the capital of our shareholders in negative markets. Our investment philosophy is further detailed in our paper 'A proven strategy with regular income from dividends'.

Severstal is a good example of a company that has greatly improved following our engagement for change. This Russian mining company had a severe accident in one of its mines. After this accident we invested in the company, mainly because it is one of the lowest-cost producers of iron ore, has a strong balance sheet and was very attractively valued (including a high dividend yield). During our engagement the company drastically improved its procedures and safety measures. So, going forward, we think the (downside) risk of another accident is significantly lower.

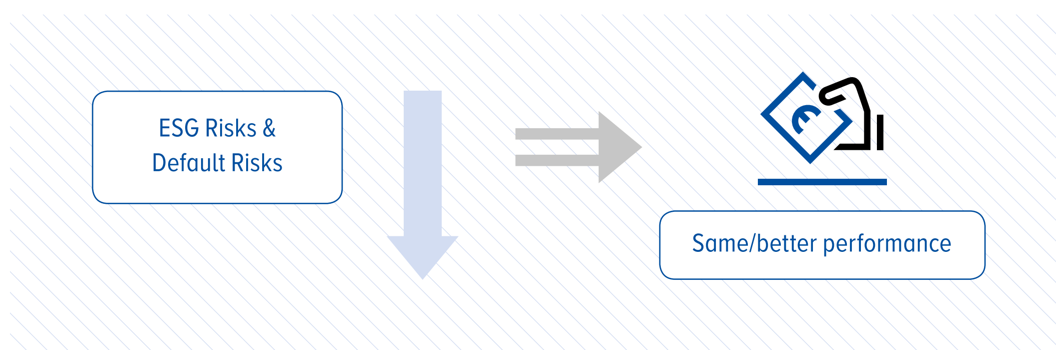
2. Mitigating ESG risks in credit funds can result in the same or better returns

Based on our assessment of the relatively scarce academic literature, we see indicative results that ESG credit funds appear to experience neutral performance or outperformance compared to conventional credit funds in Europe and the U.S. during the sample period 2001-2014.[15]

Whereas Leite and Cortez (2018) found neutral performance for corporate ESG bonds, Henke (2016) found corporate bond funds using ESG approaches outperformed conventional funds (an outperformance of 33 basis points annually in the U.S. and 49 basis points in Europe), on average. The outperformance was achieved by avoiding companies with high ESG risks (i.e. ESG laggards) and companies without a low exposure to default risk. This approach decreased financial losses, which in turn effectively generated excess returns, especially during cyclical economic downturns in the U.S. and Europe.[16]

Leite and Cortez (2018) also investigated European diversified ESG funds (a combination of corporate and government bonds) and showed indicative positive results, where the funds outperformed compared to conventional funds throughout the sample period 2002-2014.[17] The outperformance seemed to reflect mitigation of risks by having a low exposure to GIIPS countries (Greece, Ireland, Italy, Portugal and Spain) that were financially impaired by the sovereign debt crisis in the funds' portfolios. Henke's (2016) results on corporate bonds were in line with his expectation that when funds take ESG risks into account, and act upon it, it leads to a positive financial effect on performance. This can also be seen in parts of the research done by Leite and Cortez (2018), where the performance they found in even the worst case did not perform worse than the conventional funds.

FIGURE 2 Mitigation ESG Risks and Default Risks can lead to same/better performance.



15 Henke (2016), *"The Effect of Social Screening on Bond Mutual Fund Performance."; Leite and Cortez (2018), "The Performance of European SRI Funds Investing in Bonds and Their Comparison to Conventional Funds."*.

16 *Henke (2016).*

17 *The outperformance was (up to) 60 basis points annually, on average.*

Kempen

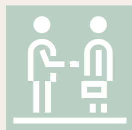
We observed in the academic literature that credit ESG funds obtained neutral- or outperformance compared to conventional funds, one of the main reasons was because they avoided companies with high ESG risks. We are not surprised by this result, as we think that integrating ESG considerations in the investment process contributes to long-term value. Although we believe that to fully embed ESG, a combination of ESG approaches is needed. That is why at Kempen, ESG is an integral part of all our funds and we combine several ESG approaches (see our website): ESG integration, Exclusion, Active ownership (engagements and voting) and Impact. We believe that as an active asset manager with a focus on long-term value creation, ESG must be taken into account to get a holistic view. We would expect that ESG funds perform at least the same as conventional funds and probably even better as ESG enhances investment analysis. As mentioned above, we believe that ESG is a fund's investment process to enhance analysis and performance. Together with the ongoing focus on ESG from more and more stakeholders, including regulators and policy makers, we expect that this will improve the performance of ESG funds compared to conventional funds going forward.

CASE STUDY: KEMPEN EURO CREDIT STRATEGY

As Euro Credit team, we incorporate ESG in our investment strategy through 3 pillars (more details can be found at kempen.com):

Exclusion: We exclude all companies on the Exclusion or Avoidance list (to be found at kempen.com). Companies on these lists are either involved in the production of controversial weapons, derive a significant portion of their revenues from the production or distribution of tobacco, or have been involved in serious controversies.

ESG Integration: ESG criteria are an integral part of the investment process. To form a fundamental opinion on a company, the portfolio managers assess the business profile, the financial profile and the ESG profile. A low score on ESG criteria can result in the demand for an additional premium on the company's bonds and/or initiation of an engagement with the issuer. If ESG risks are deemed too severe, an investment in the company will be avoided and/or existing holdings will be sold.



Active Ownership: We distinguish between three types of engagement. They are i) an engagement for awareness, ii) an engagement for change, and iii) a public policy and/or systemic engagement. Engagement for awareness is aimed at raising awareness on certain issues with a company and/or collecting more information on a specific ESG issue. Engagement for change, which could follow an engagement for awareness, has the goal of achieving a specific 'SMART' goal. We follow the four milestones approach for these engagements. The third form of engagement relates to seeking an improvement in a public policy or a system relevant to wider capital markets.

We started engagement with Volkswagen (VW) in 2018 with the objective of creating awareness at VW regarding the importance we assign to cultural change. We aimed to identify a set of shared KPIs to track and measure VW's progress on improving corporate culture. Kempen requested improved

transparency around: 1) The definition of the cultural change that VW aims to achieve; 2) Clear targets and deadlines; 3) Frequent reporting on the process. We also engaged with VW on compliance with the Paris Climate agreement and its Electric Vehicle development. Over the last two years due to our efforts, alongside those of other engaged investors, the company has made significant progress in changing its corporate culture and has transformed itself into the car industry's most ambitious global Original Equipment Manufacturer (OEM) with respect to development of Electric vehicles and climate goals. Due to this turnaround Volkswagen has improved its financial results and significantly outperformed both on the stock market and the credit market over the last three years.

CASE STUDY: EMERGING MARKET DEBT SOLUTION FOR CLIENTS

For our (fiduciary) clients we have selected ESG Emerging Market Debt (EMD) funds that follow ESG EMD benchmarks. Several ESG methods have been used, namely exclusion and best-in-class approaches. Companies involved in certain activities such as coal and tobacco are being excluded, together with companies that violate UN Global Compact standards. The remaining companies and countries receive an ESG score based on several criteria which are outlined by specialised ESG data research organisations. Countries and companies must receive a certain score to be included in the index. The funds that meet these ESG benchmarks have the same costs as non-ESG variants and show no different risk-return characteristics (some even present slightly lower risk in the long term). Therefore, by incorporating ESG approaches, ESG EMD funds can take ESG considerations into account and still maintain the same costs and return-risk characteristics.

3. Engagement can improve performance and reduce downside risk

Engagement is an important part of active ownership. It refers to the practice of investors entering into dialogue with investee companies to discuss ESG related topics with an aim to increase (long-term) value or mitigate risks; for the company, its shareholder and bondholders, and other stakeholders. Some researchers have investigated whether engaging with companies can lead to improved company performance or lower downside risk. It appears that successful engagements can indeed lead to improved performance and reduced downside risk.

Engagements can generate performance...

Barko et al. (2018) and Dimson et al. (2015) investigated the impact of investor engagements with target companies worldwide during the sample period 2005-2014 (Barko et al., 2018), and for U.S. based companies during the sample period 1999-2009 (Dimson et al., 2015). They found that successful engagements on ESG topics led to positive performance, whereby a successful engagement means that the (ex-ante) ESG goals by the investor were implemented by the engaged company. Shareholders can experience increasing returns both throughout the engagement process and once engagement milestones are achieved. Dimson et al. (2015) found that successful ESG engagements generated up to about 5% (cumulative) abnormal returns over the 12 months following the initial engagement for U.S. companies.[18] Moreover, by applying a buy-and-hold strategy, investors could earn up to 6.8% annual returns by buying equity in the engaged company at the start of the engagement and holding that equity until the engagement is complete.[19] One could say that the increasing return reflects the investors' recognition of the willingness of the engaged companies to improve their ESG practices, and the progress made.

Barko et al. (2018) also investigated investors' response to engaged companies, not just in the U.S. but worldwide too.[20] The academics considered the abnormal returns of engaged companies during and after the engagement period. Their results suggest that engaged companies (whether successful or unsuccessful) earnt up to 2.7% higher (cumulative) abnormal returns than their non-engaged peers over the six months following the engagement case. That said, their outperformance did become somewhat lower (1.9%[21]) once twelve months had passed from the end of the engagement. Furthermore, the researchers found that engagement with firms with low ESG scores led to an outperformance of 7.1% in the six months following the end of the engagement (and 7.5% in twelve months) compared to non-engaged matched companies. Additionally, successfully engaged low-ESG companies outperformed the unsuccessful companies by 6.8% over the twelve month period. This indicates the importance of engaging with lower-ESG rated companies to unlock value by improving their ESG practices.

...and can also reduce risk

Hoepner et al. (2018) examined the risk-reduction hypothesis that engaging on ESG topics lowers downside risk by examining engagements on 296 companies worldwide from 2005 to 2014. They found support of this hypothesis: engaged companies were found to have 11% lower value at risk compared to matched control companies and the effects of ESG engagement on downside risk tended to be stronger for successful engagements. This supports the idea that investor engagement leads to lower downside risk, as well as the notion that companies with stronger ESG practices are less susceptible to adverse events relating to ESG issues.[22] The reverse was found to be the case for unsuccessful engagements, which could be explained by the failure to change ESG policies causing ESG risks to materialise. The researchers also found that risk reductions after

18 *Dimson et al. (2015). Note that the cumulative abnormal returns are market-adjusted returns, calculated as the monthly stock return minus the value-weighted market return.*

19 *Dimson et al. (2015).*

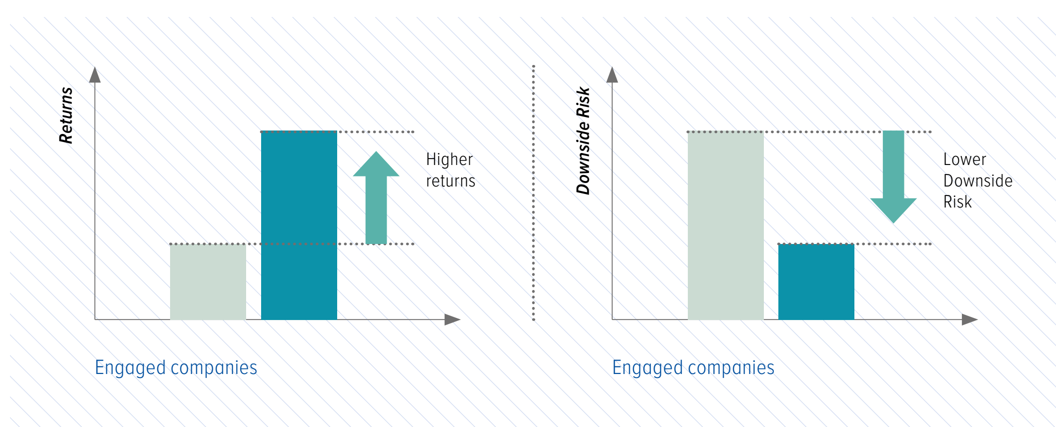
20 *More than half of the targets were from Europe, about a quarter from North America, one sixth from the Asia-Pacific region and the remainder from Latin America or Africa.*

21 *In contrast to the other outperformance figures mentioned in this paragraph, the 1.9% was not statistically significant.*

22 *Krüger (2015), "Corporate Goodness and Shareholder Wealth".*

engagements varied across engagement themes. It appears that more effective engagement (i.e. that which has a stronger relation to risk reduction) occurred when governance or strategy topics were addressed. The same applied when social engagements were combined with engagement to improve governance. It appears that updating a company's social (or environmental) practices without addressing its governance will be unlikely to reduce risk.[23]

FIGURE 3: Engagement can increase performance and reduce downside risk.



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Based on the literature mentioned above, it appears that successful engagements can indeed lead to improved performance and can reduce downside risk. This result is in line with our vision. As an active asset manager, at Kempen active ownership (engagement and voting) is a key element in our ESG approach. We believe in using active dialogue with companies to drive change and real world impact. By encouraging companies to improve their ESG policies and practices, we expect to unlock value through upside performance (e.g. through growth possibilities via new products / clients) as well as by mitigating downside risk (e.g. by reducing costs, improving ESG measures). We have an engagement policy and approach that helps us to select, monitor and report on engagements, including milestones. These are all important elements for driving change, as can be seen in our Responsible Investment report and engagement fact sheets (see kempen.com).

The research results on downside risk did not indicate environmental engagements as a driver for downside risk, but this could be explained by the sample period, which ran until 2014. Since the 2015 Paris Agreement, recent years have seen an increasing engagement focus on environmental topics, mainly those related to climate change. To achieve the Paris goals to stay below 2 degrees Celsius (and preferably 1.5 degrees) of global warming, all parties need to act. Yet it is carbon-intensive sectors and companies in particular that can and must play an important role. We see engagement, on an individual and collaborative level, as a positive method of stimulating companies to move towards

23 Consistent with Monks et al. (2004), who observed greater shareholder support on shareholder proposals which addressed environmental and social issues together with improvements on corporate governance, than shareholder proposals only addressing environmental and social issues alone.

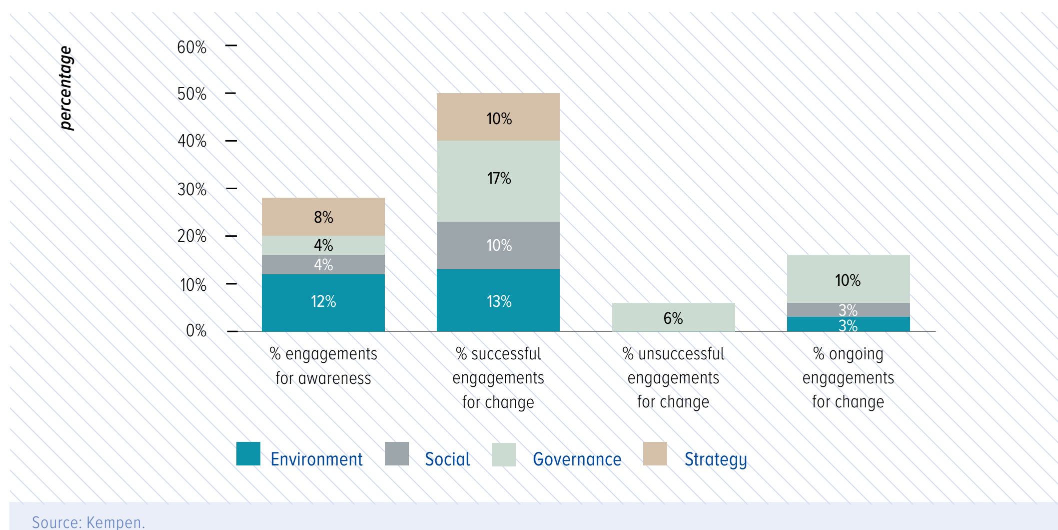
a low carbon economy and to avoid the downside investment risk. As one investor cannot solve this issue on its own, collaborative engagement is often needed. That is why Kempen is an active member of Climate Action 100+, one of the most important collaborative engagement initiatives, where over 350 investors engage with over 150 carbon intensive companies.

CASE STUDY: KEMPEN GLOBAL SMALL CAP

As active investors, we perform comprehensive engagements with our portfolio companies with the objective of unlocking value and reducing risk. Our engagement process defines clear objectives, towards which progress and results are tracked and well documented. If at any stage the company refuses to cooperate, divestment has to be considered. In 2019, we engaged with around 20 companies on strategic, environmental, social and governance issues. An overview of these engagement cases can be found in figure 4.

Exercising our voting rights is also an essential part of our responsible investment philosophy. ISS provides us with voting recommendations based on our own voting and governance policy. Items can then be further analysed on a case by case basis. Often, we inform the company about our voting intentions ahead of the meeting and, where there is a recommendation to vote against management, we ask the company to clarify their viewpoints. After careful analysis, we form our own opinion and vote accordingly.

FIGURE 4: Overview engagement results by Global Small Cap in 2019.



Source: Kempen.

The engagement factsheets of A&F, Kaiser Aluminium and more companies can be found on the Kempen website (www.kempen.com/en/asset-management/esg/engagement-factsheets).

4. Investing in green funds historically yields lower returns but can turn around

Green equity funds incorporate environmental factors in their investment strategy, which generally implies investing in companies with strong environmental practices and innovative projects such as renewable energy. These funds have existed for some time, much longer than green bonds which appeared in 2007/2008 (see finding 5). The performance of these funds has been analysed against conventional and so-called 'black' (carbon-intensive) funds. We assessed the recent academic literature, and overall the research shows that green funds did not perform well compared to other funds. However, it's clear that some research found the performance of green funds to improve in later sample periods. We expect that due to the increasing focus on climate change and the energy transition, the number of investable projects and companies will increase. A green acceleration seems to be underway, in particular in Europe with its net zero carbon ambition by 2050.

Lower returns in the past but some indication of a more positive outlook

During the sample period 1987-2018, we observed that green equity funds mostly underperformed in comparison to conventional funds in Europe and the U.S.[24] Green funds experienced neutral performance against black (carbon-intensive) funds throughout the sample period 1991-2018.[25] Lower performance for green equity funds was due to lower diversification caused by a focus on certain green-related sub-sectors and a limited number of available green-oriented investment opportunities.[26] Furthermore, companies in green portfolios also seemed to struggle with high production and innovation costs during the sample period.[27] Nevertheless, we noticed an indication in some research that the returns for green funds improved gradually over the years.[28] This is likely due to the expansion of green investment opportunities and growing awareness of climate risk, e.g. due to the EU Emission Trading Scheme (ETS) introduced in the EU in 2005. This may have led to more demand for green stocks causing their performance to improve when compared with conventional and black funds.

24 *Climent and Soriano (2011), "Green and Good? The Investment Performance of US Environmental Mutual Funds"; Ibikunle and Steffen (2017), "European Green Mutual Fund Performance: A Comparative Analysis with Their Conventional and Black Peers."; Martí-Ballester (2019), "Do European Renewable Energy Mutual Funds Foster the Transition to a Low-Carbon Economy?"; Muñoz et al. (2014), "Environmental Mutual Funds: Financial Performance and Managerial Abilities"; Reboredo et al. (2017), "Do Investors Pay a Premium for Going Green? Evidence from Alternative Energy Mutual Funds".*

25 *Martí-Ballester (2019); Ibikunle and Steffen (2017).*

26 *Ibikunle and Steffen (2017); Climent and Soriano (2011). Due to the focus on green activities, green equity funds seem to be more focusing on growth stocks.*

27 *Reboredo et al. (2017).*

28 *Ibikunle and Steffen (2017) and Climent and Soriano (2011) found improving performance for green funds compared to conventional and black (carbon-intensive) funds in later periods, although Reboredo et al. (2017) and Martí-Ballester (2019) do still see underperformance of green funds compared to conventional funds in later periods.*

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Some studies illustrated that green funds did not perform well compared to other funds, however some research found that their performance improved in later periods. We expect that with the ongoing focus on climate change and the energy transition worldwide, the number of investable projects and companies will increase. Especially in the European Union (EU) the green revolution seems to be underway. The EU aims to become climate neutral by 2050 and expects that the investments (public and private) needed to reach the interim aim in 2030 (around 50-55% carbon emission reduction) will be over EUR 1 trillion.[29] The accompanying EU regulation to reach these climate ambitions is also likely to drive more investment towards sustainable activities. Furthermore, accompanying policy measures, as can be seen in the Green Deal by the European Commission published at the end of 2019,[30] will help to ensure effective carbon pricing in the economy. This means that externalities coming from climate change will be priced in, as can be seen in the price increase of the European Emission Trading System (from around EUR 5 per tonnes CO_2 a few years ago to around EUR 25 per tonnes CO_2 currently). We expect that the opportunities for green funds, and for green activities, will increase due to these developments.

CASE STUDY: KEMPEN GLOBAL INFRASTRUCTURE

Our investment approach combines fundamental qualitative analysis of a company with a quantitative analysis of relevant data sets. There are three qualitative pillars we analyse; management quality, infrastructure/regulation, and ESG factors. ESG factors make up 25% of the weight in our qualitative analysis, which directly impacts the amount of capital we allocate to an investment. We consider the relevant Environmental, Social and Governance issues for each industry we invest in (for example, social issues may be more significant in pipelines, whilst environmental issues might be more pressing for utilities), and use these factors to either uncover alpha signals, illuminate risks, or highlight engagement opportunities.

There are several uncorrelated themes we are exposed to within the fund. One of these themes is the energy transition required to meet the Paris Agreement goals. For instance, we own shares in Nextera Energy, which is at the forefront of this transition. This company is the world's largest generator of renewable energy from wind and solar. Last year this investment was up by 40%.

Not all companies start off as green as we would like, but fortunately many do show commitment towards changing to meet the challenge of the energy transition. This can present an attractive investment opportunity as the company becomes more sustainable. An example from our portfolio is Xcel Energy, which currently has a blend of fossil fuel-based power generation (coal and gas) and exposure to renewables. The company has an ambition to provide 100% carbon-free electricity by 2050. When we met their management last year, we were pleased to see that their ambitions included medium-term milestones (80% reduction by 2030). These ambitions were integrated into their Long Term Incentive Plans, aligning their rewards with their ambitions. Last year, this investment was up 31%.

29 https://ec.europa.eu/commission/presscorner/detail/en/ip_20_17
30 https://ec.europa.eu/info/sites/info/files/european-green-deal-communication_en.pdf

5. Green bonds: towards a low carbon economy, against a premium?

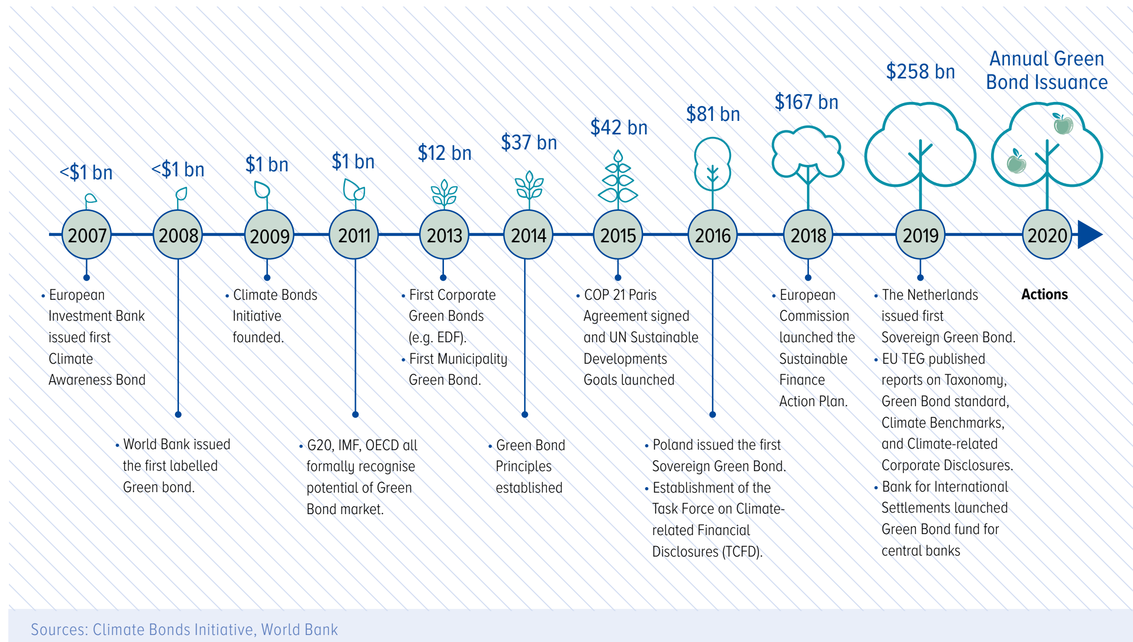
Green bonds can play an important role in the (re)allocation of capital as part of the energy transition and the shift to a low carbon economy. With climate change emerging as one of the most pressing ESG concerns, green bonds can be used as financial instruments for managing the challenge of climate change. The growing importance of green bonds is reflected in the growth of the green bond market. This market was started in 2007/2008 by supranational organisations (European Investment Bank, The World Bank). Just a decade later, at the end of 2018, the accumulated green bond issuance was over USD 500 billion and the global green bond issuance had reached a new record of USD 258 billion by 2019 (which was up by 51% from 2018).[31]

With green bonds playing an important role in pathways to a low carbon economy and the market for these bonds continuously increasing, the question arises as to whether investors will be willing to pay a premium for them? In recent years, emerging green bonds have been analysed by several researchers who examined the performance of these bonds against conventional bonds in the sample period 2007-2017. The results are mixed, as some researchers found green bonds with prices at a premium (i.e. lower yield for green bonds) and others didn't find any difference in pricing.[32] Baker et al. (2018) and Karpf and Mandel (2018) found a green bond premium when examining U.S. municipal bonds during 2010 and 2016. Zerbib (2019) also found a small premium (2 basis points) when analysing green bonds against conventional bonds during the period 2013-2017. On the other hand, Hachenberg and Schiereck (2018) did not find evidence that green bonds traded significantly higher than their counterparts. They looked at the daily spreads of the labelled green bond population between October 2015 to March 2016. Tang and Zhang (2018) found a similar result for green bonds in 28 countries during the decade 2007-2017. They found that stock prices responded positively to green bond issuance but they did not find a green bond premium, indicating that the positive stock returns weren't driven by the lower cost of debt. Hyun et al. (2019) also did not find any significant yield premium or discount on green bonds, based on the sample period 2010-2017.

31 *https://www.climatebonds.net/files/reports/cbi_gbm_final_032019_web.pdf; https://www.climatebonds.net/files/reports/2019_annual_highlights-final.pdf*

32 *Baker et al. (2018), "Financing the Response to Climate Change: The Pricing and Ownership of U.S. Green Bonds"; Hachenberg and Schiereck (2018), "Are Green Bonds Priced Differently from Conventional Bonds?"; Hyun et al. (2019), "The Price of Going Green: the Role of Greenness in Green Bond Markets"; Karpf and Mandel (2018), "The Changing Value of the 'Green' Label on the US Municipal Bond Market"; Tang and Zhang (2018), "Do Shareholders Benefit from Green Bonds?"; Zerbib (2019), "The Effect of pro-Environmental Preferences on Bond Prices: Evidence from Green Bonds". Note that most papers look at a premium in the secondary market, although also include issuance (Tang and Zhang, 2018).*

FIGURE 5 Growth green bond market



Sources: Climate Bonds Initiative, World Bank

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The research discussed above is based on sample periods that date to 2017. A question remains regarding the future pricing of green bonds, especially in Europe since the EU is aiming to reach net carbon neutral by 2050. The accompanying EU regulation for financial markets, the EU Action Plan on Sustainable Finance, also plans to (re)allocate more capital towards sustainable activities to achieve Europe's ambition. We expect that the amount of green bonds, and related Sustainable Development Goals (SDGs)-linked bonds,[33] will increase due to the increasing focus, especially by the EU, on climate ambition. Furthermore, so-called Transition bonds have recently been issued.[34] What the increasing demand for green-related bonds will mean for green bond pricing depends on how investors will act. If investor demand increases and 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).

33 *SDG-linked bonds are bonds which explicitly link the Sustainable Development Goals to their company, not to specific activities as with green bonds. For instance, Italian utility Enel issued in September and October 2019 an USD and EUR denominated SDG linked bond (c. USD 1.5 billion). The interest rate of the bond is directly tied to the achievement of the company's strategy, which is related to the contribution to the Sustainable Development Goals (SDGs 7 and 13 relate to the SDG linked bond issue).* https://www.enel.com/content/dam/enel-common/press/en/2019-September/SDG%20bond%20ENG%20(003).pdf

34 *Transition bonds are, just as SDG-linked bonds, relatively new bonds that could help the transition towards a low carbon economy, but focus on carbon intensive industries (e.g. oil production and coal mining) to finance their shift to cleaner ways of doing business. The risk here is that finance goes to activites with few environmental benefits. Therefore the International Capital Market Association, the organisation behind the Green Bond Principles, has set up a working group Climate Transition Finance that considers providing guidance for potential future issuances.*

CASE STUDY: KEMPEN EURO CREDIT FUNDS AND KEMPEN EURO GOVERNMENT FUND

Kempen Euro Credit

As part of our process for credit investing, we strongly believe that incorporating ESG factors into our fundamental view of a company leads to superior investment returns rather than purely selecting green bonds in a portfolio. A company's progressive or regressive ESG profile will therefore generate a stronger or weaker fundamental opinion. We aim to reach a position based on this fundamental opinion and valuation, irrespective of whether the issuer has issued a green bond. Though if a green bond has the same risk-return characteristics as a 'normal bond', we have a preference for holding the green bond.

Currently, we have found that 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. We think this is the result of additional demand from Green Bond Funds that seem to have lower price sensitivity and trading frequency. With the advent of the first SDG-linked bond issued by Enel, we have noted that these bonds trade at a higher spread than the green bond equivalent. This can be explained by the missing green bond label, and therefore ineligibility for Green Bond Funds. However, there is also a technical difference that explains the higher spread level, since the coupon step format prevents the ECB from buying the bond within the Corporate Sector Purchase Programme (CSPP). There is also a possibility that the rules for CSPP will be changed soon to make SDG-linked bonds eligible for the CSPP program.

Within the sustainable finance bonds space, we've recently seen the first examples of companies issuing of Transition bonds. The latest example of this is a planned transition bond from Cadent Finance, the biggest gas distribution company in the UK. This is a new field of bonds, which we anticipate will experience lower additional demand in comparison with green bonds and SDG-linked bonds. This is mainly due to the fact that proceeds will be spent on projects that do not meet the EU green bond taxonomy criteria. In the case of Cadent Finance, proceeds will mainly be used to replace iron gas pipelines with Polyethylene pipelines. However, we do believe there is a place for these transition bonds within the bond market, as they will act as an incentive for companies to increase investment in projects that improve the CO_2 footprint or any other pre-set targets within the scope of ESG topics. If the intentions of the issuer are credible, we anticipate that issuing a transition bond will strengthen the continued positive behaviour of the issuing company and management. We do expect these transition bonds to trade at a slightly wider spread than SDG-linked and green bonds.

Kempen Euro Government

We are an active investor in the green bond market and therefore have a preference for green bonds over 'normal bonds' if the risk-return characteristics are equal. For most funds and mandates we do have an explicit green bond target (ranging between 20% and 25%). For all funds and mandates we manage, we report on the percentage of green bonds, the breakdown of types of project that are financed and the $C0_2$-reduction. In the sub-sovereign, supranational and agency area, green bonds often outperform normal bonds after issuance. KFW and the European Investment Bank are good examples of green bonds trading a few basis points tighter (i.e. a premium) than normal bonds. This is caused by an increasing demand for green bonds, as well as the buy and hold approaches of investors that buy these green bonds.

The Dutch government issued a green bond in May 2019, though it was issued at too high a price in the primary market. For that reason, we did not participate on behalf of our clients. A few weeks later, the bond cheapened somewhat, after which we bought it. The market for sovereign bonds is growing. An example is the German green bond, read our view on that bond kempen.com.

6. Green buildings appear to have a premium

Buildings account for around 39% of global energy-related carbon emissions.[35] The sector has an important role to play in the challenge of climate change to reduce its carbon emissions and to manage increasing climate risks, both in the form of transitional risks (e.g. regulatory scrutiny) and physical risks (e.g. flooding). Greening buildings could be a sensible strategy in this respect. In the academic literature we analysed, there appears to be a green premium, but no clear outperformance for investors on green REITs (Real Estate Investment Trusts), i.e listed real estate. In our opinion, the impact on total returns from capital expenditure can play an important role in explaining causal relations.

Green premiums for residential and office buildings

We also found that, based on our assessment of the recent academic literature, there appears to be a green premium for residential and office buildings, although the premium differs between regions. The recent meta-study by Cespedes-Lopez et al. (2019) explored whether housing with energy performance has a positive premium in the sales price.[36] Having examined 66 studies on the impact of having, or not having, an energy performance certification (EPC) in the sample period 1995-2017, it was found that housing with an EPC had an overall price premium of 4.2%, and this result seems to be in line with earlier similar meta-studies.[37] The average premiums obtained were higher in North America (5.4%) and Asia (4.8%) and lower in Europe (2.3%). In Europe, the premiums were lower but more stable (i.e. less variability), possibly due to the mandatory adoption of EPC labels via regulation in EU countries (called the 'ABCDEFG qualification' certification system).

35 Of the building carbon emissions, 28% comes from operational emissions (e.g. energy needed to heat, cool and power) and 11% comes from manufacturing building materials and products (e.g. steel and cement). IEA. Global Status Report For Buildings And Construction 2019. IEA, Paris, 2019, https://www.iea.org/reports/global-status-report-for-buildings-and-construction-2019; https://www.worldgbc.org/news-media/bringing-embodied-carbon-upfront

36 Cespedes-Lopez et al. (2019), "Meta-Analysis of Price Premiums in Housing with Energy Performance Certificates (EPC)".

37 The authors refer to the outcomes, with premiums ranging between 3.5-7.6%, of the meta-studies by Ankamah-Yeboah and Rehdanz (2014), "Explaining the Variation in the Value of Building Energy Efficiency Certificates: A Quantitative Meta-analysis"; Brown and Watkins (2016), "The Green Premium" for Environmentally Certified Homes: A Meta-Analysis and Exploration"; Fizaine et al. (2018), "Does the literature support a high willingness to pay for green label buildings? An answer with treatment of publication bias".

To avoid variability, which reached between -2.5% and 14.3% in America, the authors recommended mandatory labels to be used. This is also in line with suggestions coming from similar meta-studies, since it is understood that voluntary labelling tends to lose value over time.[38]

The meta-study of Ankamah-Yeboah and Rehdanz (2014) examined research into residential and office buildings to explore whether energy performance had a positive premium in sales and rental prices at those buildings.[39] Based on their review of 30 studies they found that residential and office buildings labelled energy-efficient received a premium of about 7.6% (rental or sales), whereby the residential sector does not generally differ from the office sector. Furthermore, the meta-study of Kim et al. (2017) focussed on 9 studies related to rental pricing in office buildings and also found a significant premium in the rental prices (14.7%). They also mentioned that other characteristics besides certification that influenced the rental prices of green buildings were their location, building characteristics, and lease contract features.[40]

Green REITS and shareholder returns

Do we also see a positive relationship between green real estate and shareholder returns? In their large meta-study, Friede et al. (2015) mentioned that in the relatively young green real estate research field, five out of seven studies showed a positive relationship between green performance and corporate financial performance, and two studies showed neutral results. The results seem to be mainly positive, although the authors don't mention the specific research, nor whether the financial performance relates to only shareholder returns. Looking at the research before 2015, Eichholtz et al. (2012) seem to be the first scholars to investigate the relationship between return performance of REITs and their green component. They investigated U.S. REITs on their green performance between 2000-2011 and found that the greenness of REITS was positively related to operating performance (e.g. return on assets), but did not find a significant relationship between the greenness of property portfolios and abnormal returns.[41] The authors also mentioned that the latter suggested that stock prices already reflect the higher cash flows deriving from investments in more efficient buildings. Sah et al. (2013) also investigated the greenness of U.S. REITs in relation to their operational performance and shareholder returns between 2005-2010, and found a higher return on assets and operating performance for green REITs as well as a higher shareholder return (over 5%).[42]

More recent (although relatively few) studies indicate less conclusive results where there is no outperformance found by green REITs. Coen et al. (2018) also compared the financial performance of green and non-green U.S. REITs between 2010-2016. They found that non-green U.S. REITs tended to perform better during that period.[43] As a possible explanation for this, they mentioned that the returns of green REITs might have already reflected the higher cash flows deriving from investments in more efficient buildings. Without a 'surprise-effect' investors should not expect outperformance. The above research focussed on U.S. REITs; Mariani et al. (2018) addressed this gap and examined the greenness of European REITs (via green certifications) and their opera-

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38 Ankamah-Yeboah and Rehdanz (2014); Fizaine et al. (2018).

39 Ankamah-Yeboah and Rehdanz (2014).

40 Kim et al. (2017), "Green features, symbolic values and rental premium: systematic review and meta-analysis".

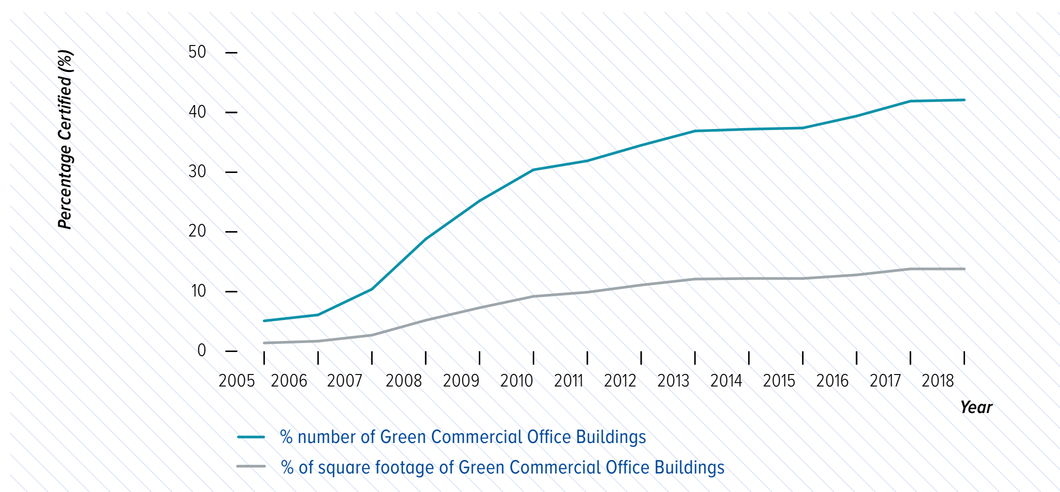
41 Eichholtz et al. (2012), "Portfolio greenness and the financial performance of REITs".

42 Sah et al (2013), "Are Green REITs Valued More?".

43 Coen et al. (2018), "THE FINANCIAL PERFORMANCE OF GREEN REITS REVISITED".

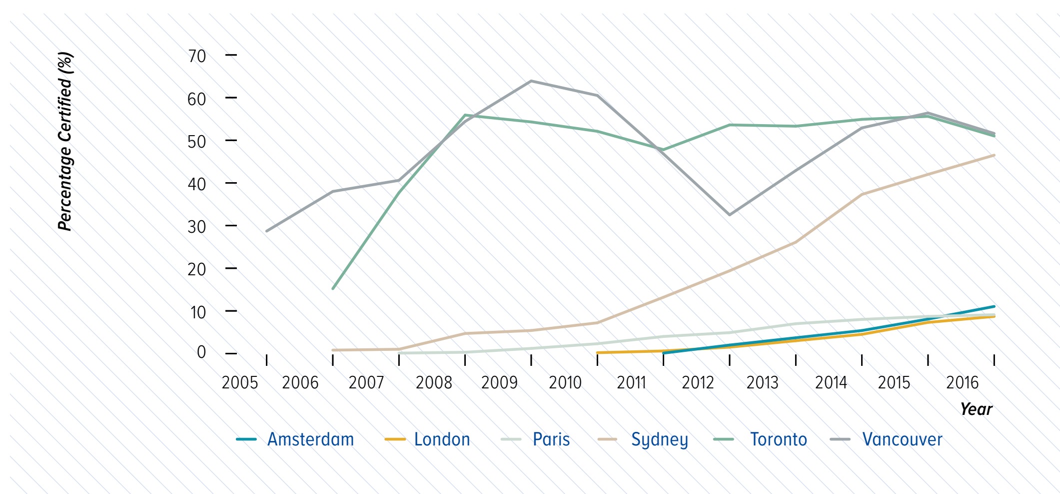
tional (e.g. return on assets) and shareholder returns between 2010 and 2016.[44] They found that the greenness component had a negative impact on the operational and return performance of green REITs, in contrast to the results found by e.g. Friede et al. (2015), Eichholtz et al (2012) and Sah et al. (2013). A main reason for this impact according to Mariani et al. (2018) could be the incremented capital expenditure related to the refurbishments and adjustments processes needed to obtain the green certification.

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

FIGURE 7 Growth of green certifications across commercial office markets of cities in (Western-)Europe, Canada, Australia



Source: CBRE. International Green Building Adoption Index 2018.

44 *Mariani et al. (2018), "Green Real Estate: Does It Create Value? Financial and Sustainability Analysis on European Green REITs".*

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At Kempen, ESG criteria are incorporated into our investment framework as part of our Real Estate investment strategy. ESG determines 25% of the warranted valuation that we calculate.[45] We strongly believe that sustainability features can have an important impact on the value of real estate companies. An energy-efficient building will incur lower costs for heating, cooling, lighting and ventilation. This leads to reduced operational costs for the tenant and an increased willingness to pay a higher rent in contrast with a less green building.

In addition, tenants increasingly require modern and sustainable office spaces to attract and maintain a young and highly-educated workforce. Energy Performance Certificates (EPC) labels give a good indication as to the capital expenditure we should model in our real estate valuation to achieve greener buildings. The increased capital expenditure levels should be balanced by higher long-term rental growth prospects and higher occupancy levels ultimately driving higher total returns for investors. However, the capital expenditure comes before the return (as is often the case) and might explain why the outperformance relationship of green REITs may not always be directly visible. 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 clients' capital to the most optimal risk/reward investment opportunities.

Moving forward, regulation will be a key driver with increasing impact. For example, in England and Wales, it was made illegal in April 2018 to let buildings with an EPC label of F or G. In the Netherlands, legislation was passed last year stating that office buildings with a D energy label or lower will be illegal to let as of 2023. Investments are needed to support the Real Estate industry in its transition to become more sustainable and move towards a low carbon economy. At Kempen, we feel a fiduciary responsibility to encourage companies in this transition. We do not exclude companies that own lower-labelled buildings from our universe since it is precisely those companies that need the investment and support the most to refurbish the buildings they own. It is therefore those companies that could experience the biggest upside from improvement. Most value can be unlocked for all stakeholders by identifying where the largest upside lies, and then engaging with companies and encouraging their management to start their journey. Allocating capital only to those companies that already own highly sustainable buildings is, in our opinion, irresponsible as it incentivises companies to sell less sustainable buildings that need upgrading and buy newly developed sustainable buildings. For more details about our approach, see our website (strategy and publication).

45 As the correlations between data vendors are rather low and we feel most data vendors currently lack the ability to judge materiality of issues, we combine our own observations from meeting management, raw data from different data vendors and our forward looking views on what we believe will become increasingly important, to determine the ESG score of each company.

7. Investors in funds incorporating ESG approaches seem to be more loyal

Investors that value ESG incorporation will focus not only on financial returns but also on environmental, social and governance aspects. We expect that such investors will invest for longer in ESG funds compared to investors in conventional funds. We consulted the academic literature that focussed on this ESG investor loyalty, described as the fund 'cash inflow-outflow sensitivity' relationship of ESG funds compared to conventional funds. Though the literature is relatively scarce, we found some indicative results in line with ESG investor loyalty.

Investor loyalty

Investors' preference for ESG seems twofold: investors can generate financial competitive returns whilst also contributing to social, governance and environmental-friendly aspects. This 'twofold preference' argument mentioned by Bollen (2007) can be found in the research we assessed. Since ESG is one of the two 'preferences', this can explain why some investors may be less likely to shift their investments away from poorer performing ESG funds. We found an indication, based on the relatively scarce literature, of this loyalty in equity funds (in the U.S.) and pension funds[46] (in Spain) incorporating ESG. These funds tend to experience lower outflows in response to negative returns compared to their conventional counterparts.[47] Equity funds and pension funds experienced no significant outflows to (lagged) negative returns in the U.S. and Spain. On the other hand, their conventional counterparts experienced approx. 0.49% and 3.12% outflows for every 1% decrease in (lagged) negative returns throughout the assessed sample periods of 1980-2002[48] and 2007-2013[49], respectively. These indicative results show that ESG investors appear to value ESG and can be more loyal than other investors. Additionally, these investors' loyalty could also lead to lower liquidity risk for ESG funds in contrast with conventional funds, since outflows could be lower and the AuM of funds incorporating ESG could be protected by ESG in the event of negative returns.

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In the academic literature on this subject, we found some indicative evidence that investors that value ESG appear to be more loyal than other investors in relation to the cash inflow-outflow sensitivity of a fund and its performance. This is in line with the 'twofold preference' argument mentioned above. We both imagine and encourage that this trend will become more prevalent among investors moving forward. Investors that take ESG into account tend to have longer-term investment horizons, such as

46 Pension funds can exists of a pool of different securities such as, equities and/or bonds, or the combination of both (Martí-Ballester, 2015).

47 Bollen (2007), "Mutual Fund Attributes and Investor Behavior"; Marti-Ballester (2015), "Investor Reactions to Socially Responsible Investment"; Renneboog et al. (2011), "Is Ethical Money Financially Smart? Nonfinancial Attributes and Money Flows of Socially Responsible Investment Funds".

48 Bollen (2007).

49 Marti-Ballester (2015).

pension funds and insurers. They also tend to be more likely to focus on long-term value creation for clients and other stakeholders, when ESG considerations are an integral part of the investor's investment beliefs, process and decisions. We expect that this development will be further strengthened via (upcoming) regulation and standards.[50]

Avoiding 'greenwashing' - time for an ESG unification standard across markets

With growing demand for ESG-linked financial products and the absence of a coherent standard for sustainable products, the market tends to give rise to heterogeneous methods of incorporating ESG in funds. These different methods and the lack of one single standard bring ambiguity about what exactly can be deemed ESG investing. Investors run the risk of 'greenwashing' and need to be aware of this, and ask themselves which ESG approaches would relate to their investment beliefs and preferences. An ESG framework could help investors to embed ESG into their investment process, as we will describe in the next paragraph. From a broader market perspective, a unified classification system for sustainable activities can help to create greater transparency and more clarity to avoid greenwashing. The upcoming sustainable classification system from the EU Action Plan for Sustainable Finance, i.e. the EU Taxonomy, is a welcome initiative in this respect.

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Kempen selects and monitors external managers on behalf of its institutional clients. To combat the issue of greenwashing, we consider ESG issues in all steps of the manager selection process from initial shortlisting to formal due diligence and regular monitoring. Our default position is that Kempen expects all managers to have a responsible investment policy and to integrate material corporate governance, environmental or social risks and opportunities into their research, portfolio construction and investment decisions, as well as engaging with companies when they see room for improvement. To ensure that all the funds we invest in on behalf of our clients meet our minimum requirements, we have developed a comprehensive evidence-based scoring framework of ESG capabilities for managers.

The framework assesses managers' commitment to sustainability and responsible investment, the breadth and depths of their policies across asset classes as well as their ESG integration and active ownership efforts in specific funds that we are invested in. Furthermore, we look for evidence and transparency in how these policies are applied to portfolios in practice. To meet our clients' minimum requirements and ensure compliance with their principles, a number of key requirements must also be met, such as the exclusion of controversial weapons and tobacco or the 'comply and explain' principle regarding companies that fail to comply with internationally recognised norms such as the UN Global Compact.

50 *Such as IORPII, SRDII, the Dutch governance code and the UK Stewardship Code where a long-term focus and value creation is encouraged.*

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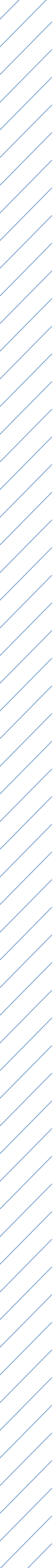

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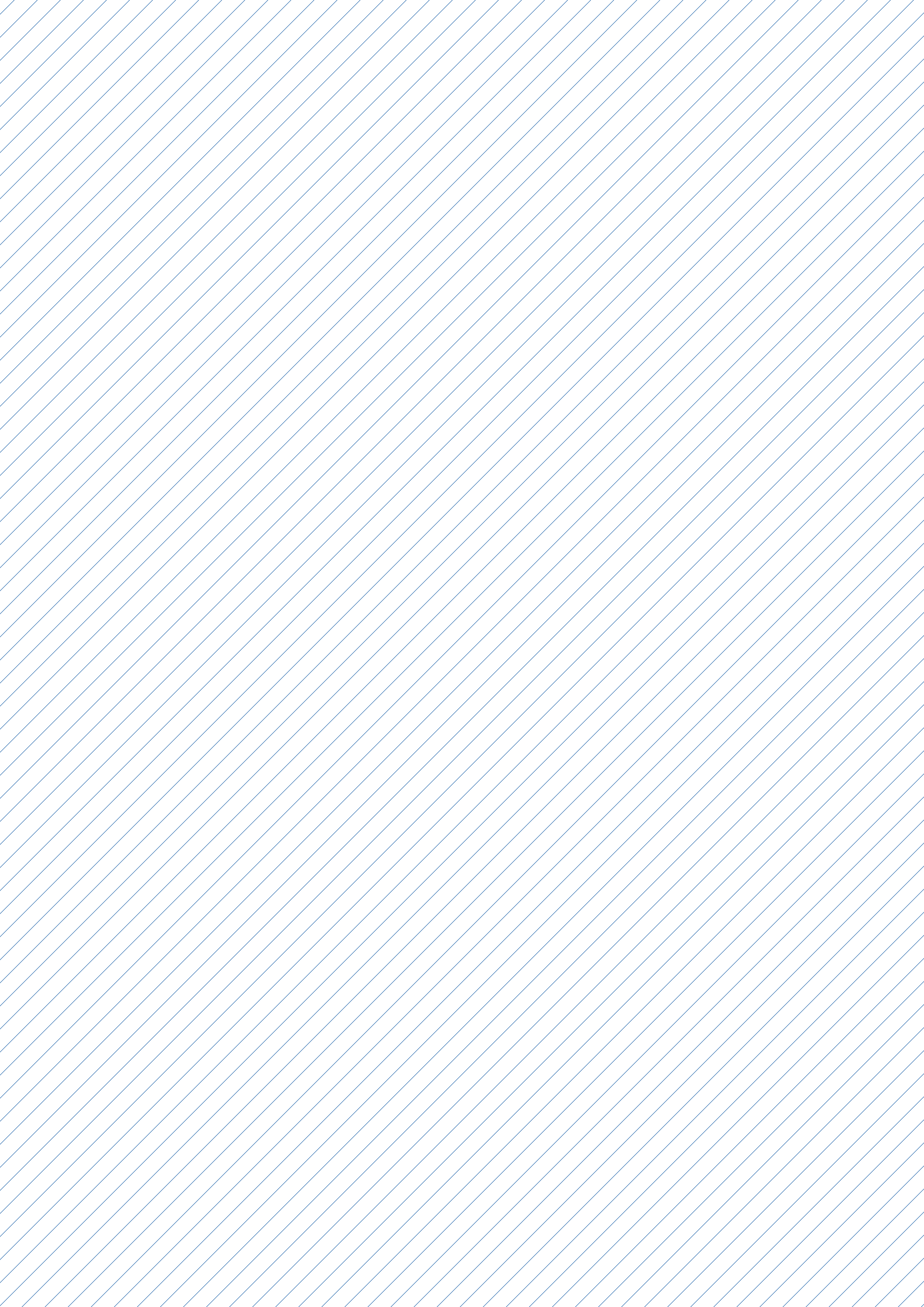

Kempen
Asset Management

Beethovenstraat 300
1077 WZ Amsterdam
The Netherlands

P.O.Box 75666
1070 AR Amsterdam
The Netherlands

T +31 (0)20 348 8700
F +31 (0)20 348 8750

www.kempen.com

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