Embracing the green-tinged premium to futureproof portfolios

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By investing in real assets, pension funds are able to support the economy, create jobs and invest directly in assets that support the climate change transition – all while homing in on the prospects of long-term investment returns. Taken together, this is known as real assets' 'green' premium, explains Ed Dixon head of ESG, real assets at Aviva Investors.

Until recently, environmental, social and governance (ESG) investing has focused on the equity market. But attention is now turning to real assets. This trend is perhaps unsurprising. Real assets sit at the heart of the transition to a green economy, with a large proportion of the £12bn pledged by the UK government under its ten-point action plan for a green industrial revolution[1] covering areas such as real estate, renewable energy, and transport.

The government estimates that the opportunity for investment from the private sector to facilitate this revolution could be three times as large. But this is just the tip of the iceberg, as huge investment will be needed across the world to reach the Paris Agreement goals.

Due to the long-term nature of these investments, real assets represent an investment opportunity for long-term investors, and therefore pension funds too. At the same time, investing in areas such as green real estate and infrastructure could help pension funds meet their ESG commitments and reduce climate change related risks across portfolios.

Recent legislation in the UK mandates pension trustees evaluate and report on climate risks and opportunities. It is likely that pension schemes with over £5bn in assets will have to report in line with the recommendations from the Task Force on Climate-related Financial Disclosures (TCFD) from October 2021. This is particularly pertinent when it comes to real assets, with the investment commitments easily lasting until 2030 and beyond.

"There's a much bigger impetus in real assets investing to look at how ESG is being integrated with current financial products to ensure that the risks are being mitigated, the impacts are being minimised, and the positive outcomes are being supported," says Dixon.

Green premium opportunity

The focus on sustainable investors is only set to grow as asset managers and pension schemes come under pressure to focus on ESG metrics when choosing where to investment.

While renewable energy and wind and solar powered projects have proved popular with investors over the past decade or so, a combination of regulatory pressure and growing concerns about issues such as climate change are now driving interest in broader real assets as well. Dixon believes the asset management industry should be ruthlessly focusing on this opportunity, not least because analysis has proved the existence of a 'green' premium.

One of the attractions of real assets, compared with traditional equities or bonds is the fact you are the owner or lender of the investment in question. Ultimately, ESG is usually ingrained in these investments because managers are so much closer to them and incorporating ESG considerations is a fundamental part of an asset manager's duty to their clients.

For Dixon, his attraction to this sector has been fuelled by a decade-plus long green career. He joined Aviva Investors in 2019 and brought with him a wealth of experience from the private sector. He had held senior sustainability roles at commercial development company Landsec, construction firm Mace and retailer Marks & Spencer. In addition, Dixon is a graduate of the Sustainability Leadership Programme at Harvard. His experience as an in-house sustainability expert has allowed him to see first-hand how the private sector is dealing with the move to sustainable business models, and in many cases is leading the way on largescale goals like decarbonising operations.

Seizing opportunities

The last few years have seen ambitious commitments from large companies, including a pledge from Apple to reduce the impact of its devices to net zero by 2030. Microsoft and Facebook have made pledges of their own to become carbon neutral or even negative (Microsoft) within this timeline.

Similarly, in the UK a significant number of the largest companies have signed up to the United Nations' Race to Zero campaign,[2] while the government has committed to cut emissions by 78 per cent by 2035.[3]

These commitments will filter through to how these companies use their office spaces, their energy use, travel policies and all the way across the value chain. On the flipside, Dixon says that the UK government's push to decarbonise the economy also offers "huge opportunities for investors that are comfortable with looking to new and emerging sectors", which he believes will be "leading the charge" in the years to come. He also sees a "real value opportunity" from searching for the green premium in real estate. The built environment contributes around 40 per cent of the UK's total carbon footprint, with the decarbonisation of existing buildings a huge priority on the road to net zero.

This creates opportunities to invest in improving water and energy efficiency, waste disposal and enhancing the environmental credentials of existing builds, as well as supporting sustainable construction projects.

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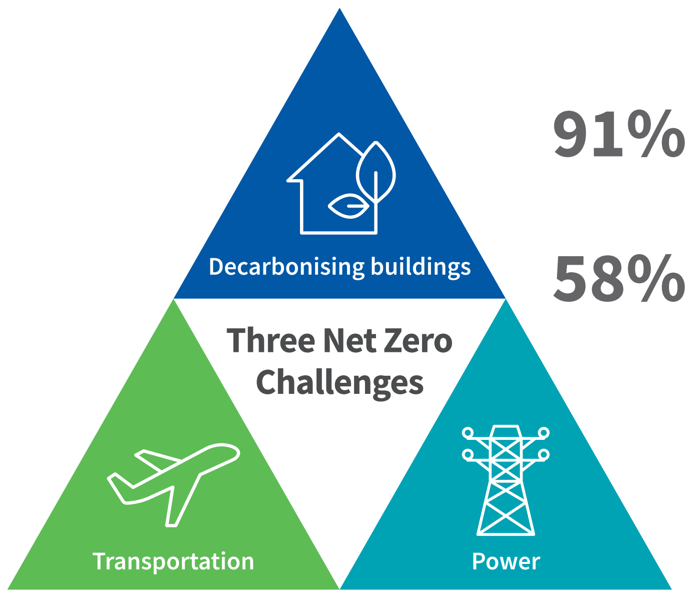
ESG data challenge

However, real asset investing is not without its challenges. Assessing the ESG credentials of less liquid assets, such as infrastructure, or unlisted markets such as private equity, can be difficult due to a lack of data. Dixon says: "I'd like to see more commonality across private markets and real assets in the way that you measure your ESG risks and your impact, both through a transaction in terms of forecasting



91% Percentage of global institutional investors expected to increase ESG real-asset investments over the next five years[4]

58% The percentage that had increased their focus in the previous five years[5]

your impact but also verifying and understanding those transactions over their lifetime."

This challenge is being addressed, with the development of industry ratings and benchmarks, such as the Global Real Estate Sustainability Benchmark (GRESB) for real estate and infrastructure. GRESB provides standardised sustainability data — on property companies, developers, infrastructure funds and assets — to institutional investors. These standards can provide investors with more certainty that their portfolio of real assets is meeting their sustainability objectives, as well as delivering attractive long-term returns. This increased transparency will help demand for ESG real assets to grow, particularly as pension funds are starting to realise the long-term potential of this asset class.

Using ESG to futureproof portfolios

ESG integration has become a crucial ingredient to futureproof portfolios. Yet the key is not just choosing investments but staying invested and – most importantly – staying engaged.

Real assets are at the heart of the three-pronged challenge in transitioning to net zero: decarbonising the heating and cooling of buildings, transportation, and power. As such, pension funds must be aware of the climate change risks their real asset portfolios are exposed to and have concrete strategies in place to mitigate these.

Dixon says that ESG considerations in real estate also include wellbeing factors, such as "how cheap that building is going to be to operate compared to another building down the road, the quality of the build, and whether it's going to be affordable to maintain over its lifetime".

Meanwhile, bringing a real estate portfolio in line with net-zero targets will have profound implications on the investment market itself.

It will mean investors are more focused, only buying assets where there is full confidence they can be decarbonised in time, as well as refurbished and redeveloped. Or, alternatively, disposing of everything else in your portfolio that isn't managed in line with the pathway to net zero.

The idea of using ESG to drive better quality investments and 'futureproof' portfolios is only increasing, and long-term pension fund schemes are beginning to realise this. The key trends such as climate change transition, that are transforming the way industries grow, mean pension funds are keen to not miss out on a largescale economic shift and investment opportunity.

Driving engagement

For asset managers to ensure such investments stand the test of time in a portfolio, more work is being done after an investment has been made in terms of ongoing engagement and campaigning for change.

For example, once the investment is made, a constant process of engagement and improvement is necessary to ensure the assets continue to meet rigorous criteria. In real assets, this is particularly important since their assets and liabilities can sometimes be as long as 50-60-years.

Dixon explains that engagement is a key element of the transaction process. From his point of view, engagement is about delivering ongoing benefit, not just a short-term positive impact, and this means "really baking it into the very fabric of the transaction". He gives an example of a transaction Aviva Investors conducted with a listed REIT, which involved three key performance indicators (KPIs) to incentivise the company to deliver on ESG targets by promising a cheaper cost of debt in return.

He explains that "if they deliver all of those things after year one there's an opportunity to agree another set of KPIs which can become more aspirational and increase the ambition on both sides. Again, they would benefit from a cheaper interest rate."

In the private debt market, Aviva Investors positions itself as a responsible lender and launched a Sustainable Transition Loans Framework which includes a commitment to originate £1bn in sustainable transition real estate debt by 2025. One of the ways to do this is by providing loans with a covenant forcing the borrower to commit to ambitious targets and report on their progress over the lifetime of the loan.

Downside protection

For long-term investors such as pension funds, this creates an opportunity to marry their long-term liabilities with their sustainability goals, particularly given the rigorous reporting requirements on climate risks coming into force in the UK.[6] The engagement approach can help pension funds mitigate future ESG risks resulting from climate change, public controversies, and regulation. Dixon says the "huge amount of forthcoming regulation" in the real estate market "is causing poorer quality assets to be less attractive and perhaps even illegal in some cases to rent thanks to EPCs and the MEES legislation".

"We need to be protecting ourselves against downside risk, looking at those poor-performing assets from a financial and a non-financial perspective, and exiting from those to maintain performance for our clients," he says.

An approach that combines divestment from legacy assets that can create a drag on performance, while simultaneously positioning the portfolio to take advantage of future trends, such as the move to renewable energy sources or electrification of vehicles, could ensure strong reliable returns and downside protection for long-term asset holders.

FOOTNOTE

1 The ten-point plan for a green industrial revolution - GOV.UK (www.gov.uk)
2 Third of UK's biggest companies commit to net zero - GOV.UK (www.gov.uk)
3 UK enshrines new target in law to slash emissions by 78% by 2035 - GOV.UK (www.gov.uk)
4/5 Macquarie Infrastructure and Real Assets (MIRA) ESG Survey 2020 - Macquarie Asset Management (www.mirafunds.com)
6 UK government presents pension fund climate risk governance, reporting regs - IPE (www.ipe.com/news)

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