CenterSquare
REAL ASSET INVESTMENT LEADERSHIP

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ESG: Making a Difference (and Money) with Real Assets

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The Environmental, Social and Governance (ESG) evolution that has progressed over many years is set to become a revolution. ESG investing, which began as a goodwill movement championed by a few, has today grown into a louder and more powerful structural shift in the way investors think about value creation. At CenterSquare, we have long believed in the case for ESG integration within the Real Asset (global real estate and infrastructure) investment framework as we recognize the return potential from high quality governance, more environmentally friendly assets, and societal contribution. From the investment strategy perspective, it provides a more complete analysis of risks and opportunities associated with each investment. This expanded underwriting is paramount in a world where risks related to the lack of environmental stewardship, social engagement, and strong governance could jeopardize the long-term sustainability of the business itself.

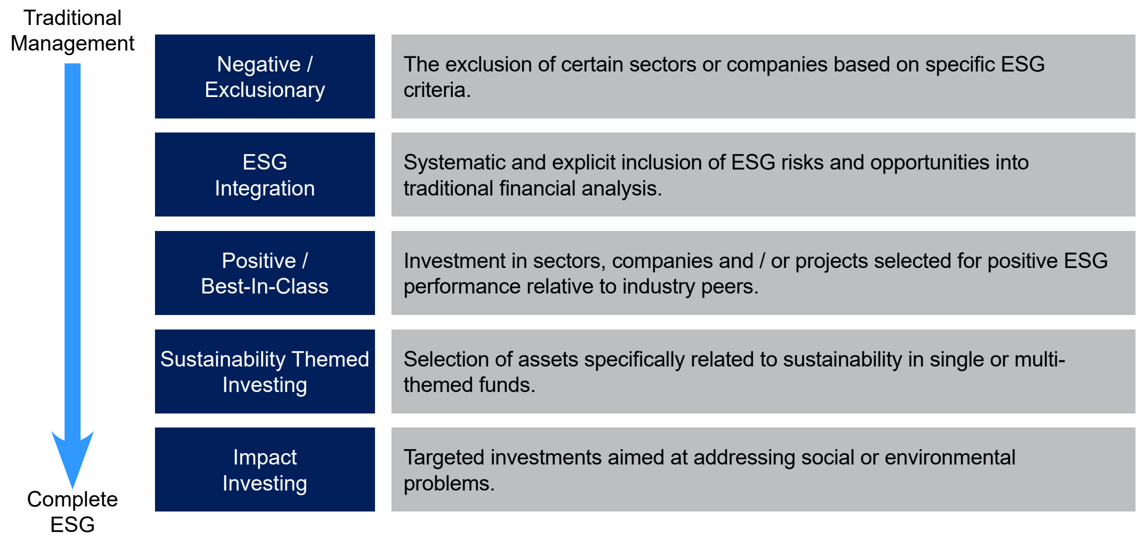
A Value- and Values- Based Proposition

ESG integration for Real Assets is a *value*-based (making money) proposition that allows us to more holistically assess the risks and opportunities associated with any investment. In fact, we find the application of ESG ideals so important that we have undertaken the first comprehensive, quantitative analysis of the efficacy of an ESG perspective for Real Asset investment and share our results here in this paper. However, Real Assets also provide a compelling *values*-based (making the world a better place) proposition for investors seeking to make an impact with their capital. We spend 90% of our time indoors[1], making real estate the cornerstone of how we live, work, and play, and providing for a most efficient avenue for generating an impact on individuals and communities. Real Assets are also one of the largest consumers and producers of energy. Globally, real estate represents 36% of final energy use and 39% of energy and process-related carbon dioxide emissions[2]. Over the next two decades, we expect companies within the Global Listed Infrastructure (GLI) universe will control 68% of all investment related to energy production, transmission, transportation, and consumption[3]. Together, Real Assets present one of the most efficient methods for investors who desire to make an impact on climate change as we move toward the decarbonization of the global economy.

As Real Asset specialists, CenterSquare has applied this philosophy to our proprietary ESG scoring methodology, which provides a thorough assessment of the ESG risks and opportunities for our entire global listed real estate and infrastructure investible universe. Herein, we are pleased to share the first comprehensive analysis of investing in global listed Real Assets with an ESG lens over the last decade. Our research demonstrates the alpha generation capability of this investment strategy, resulting in strong risk-adjusted returns versus the respective benchmark, and shows that active investing with an ESG lens can come with additional upside.

The statements made in this paper represent the opinions of CenterSquare and not are guaranteed. Any opinions expressed are as of the date of publication and are subject to change as economic and market conditions dictate. References to returns, risks, and performance describing portfolios in this paper are based on hypothetical analysis techniques (also known as back-testing) and do not represent actual portfolios. Therefore, returns included herein are hypothetical and for illustrative purposes only. ***Past performance, whether illustrative or actual, is not a guarantee of future performance.*** *Please refer to endnotes and important disclosures at the end of this document.*

Figure 1: The ESG Investment Spectrum

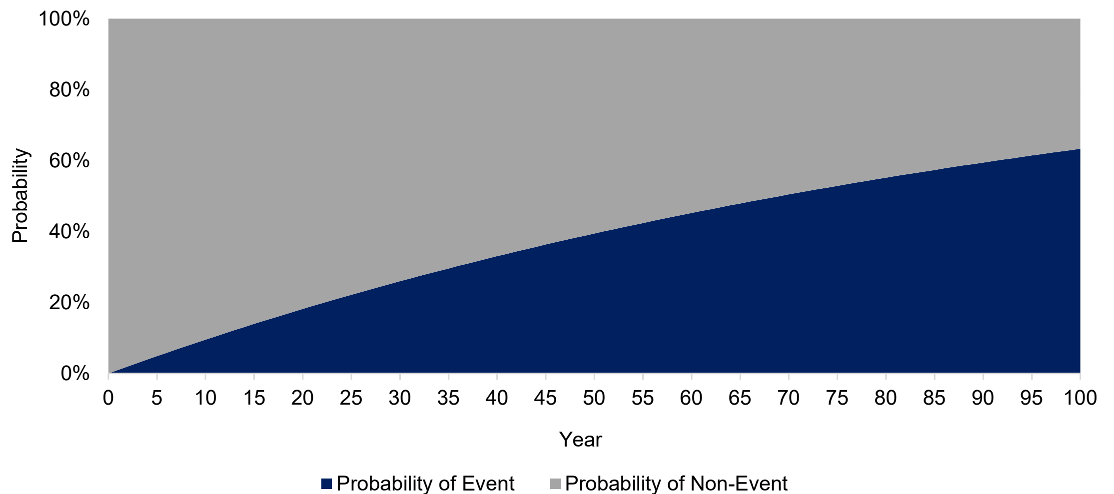


The Real Asset ESG Framework

Environmental Stewardship

This year has been no stranger to "hundred-year" events – extreme weather, historic wildfires, and the COVID-19 pandemic have occupied much of the world's mind space. While many might think such events happen once in a hundred (or five hundred) years, a "hundred-year" event represents a one in one hundred (1%) probability of the event occurring in any given year. As such, the cumulative probability of the event occurring over the course of a hundred years is closer to 63%. With climate change further increasing the probability of their occurrence, these hundred-year events are becoming more akin to seventy-year events and creating an urgency across public and private sectors to address climate change.

Figure 2: Probability of the Occurance of Hundred-Year Event Over Time



Source: USGS website: https://www.usgs.gov/special-topic/water-science-school/science/100-year-flood?qt-science_center_objects=0#qt-science_center_objects

These events, and their frequency, represent a significant risk to the operating environment for most companies. In response, many entities – international organizations such as the United Nations, governments at even the local levels, and companies – are working to create more sustainable business models. They are not only adapting to the changing reality, but also attempting to slow or reverse global climate change to mitigate against these sizable environmental risks.

Refer to endnotes and important disclosures at the end of this document.

Real Assets are exposed to three main types of risks as it relates to the environment. Physical risks are those associated with the physical effects of climate change such as rising sea levels, increased wildfire frequency, or flooding. Transition risks are those associated with the transition to a low-carbon economy, such as political, legal, or reputational risk. This gives way to regulatory risks associated with state, local, and national policies that are becoming more prevalent and likely to be pervasive across most major markets in the near future. Given Real Assets are meaningfully intertwined with global energy consumption and production, they are significantly exposed to all three of these risks. Understanding them provides a more holistic assessment of our investments' long-term value.

Efforts to mitigate environmental risks also provide opportunities. For example, according to the Climate Bond Initiative, the green bond industry has seen a 65% annual growth rate in issuances since 2013, lowering company borrowing costs for those organizations that reduce their coal footprint on schedule or build a new green development. Additionally, we recognize that more sustainable assets lead to increased profitability. The actual marginal cost of green buildings is less than two percent[4], dispelling misconceptions that sustainable buildings are significantly more expensive to develop. Furthermore, green buildings enjoy meaningful improvements in building performance, including resource efficiencies, that result in cost savings and higher tenant demand. In turn, these factors result in rent premiums and higher occupancy levels[5]. All told, over the long-term, green buildings tend to be, in fact, more profitable.

In the GLI arena, efforts to mitigate environmental risks and promote stewardship have perhaps the clearest positive impact upon the companies themselves. Over the last decade, subsidies in wind and solar have enabled cost competitiveness within the grid, allowing utilities to install cleaner, and cheaper, solutions. Here, global energy policies are going to require up to $35 trillion in new capital expenditures from utilities over the next two decades to support zero carbon generation, usage, and transmission. Combined with secure financial returns and a long-term earnings stream, the cash flows from new solar, wind, and hydrogen installations will serve GLI for decades.

Social Responsibility

From a social perspective, Real Assets serve as the cornerstone of society where people gather, live, and work. As such, awareness of societal needs and the impact of Real Asset development on the local community is vital for the asset's long-term sustainability and value. Real estate, large scale electric transmission, gas pipelines, roads, and airports have a very real impact on local communities, on top of their potential impacts upon the environment. We have historically found companies that are thoughtful and sensitive about local community concerns, and those who spend significant resources on civic engagement, tend to deliver assets into operation faster, with fewer cost overruns, and ultimately achieve better returns of capital with less societal disruption. Moreover, the pandemic has tested the humanity of companies that operate in our communities throughout this year. It has proven the quality of community engagement (or lack thereof) directly influences a company's reputation and impacts its social license to operate.

Additionally, public REITs and infrastructure companies offer investors not just access to the underlying assets themselves, but also strong investment, development, and operating platforms in which human capital matters. Therefore, a company's diversity and inclusion (D&I) policies and practices around hiring, retaining, and developing a quality workforce is paramount. The pandemic and the social justice movement have rightfully highlighted the importance of a more sustainable business model that maximizes value for all stakeholders. We are increasingly seeking diversity metrics across various minority lenses (i.e. race, gender, sexual orientation). Behind this request is a growing recognition that organizations with a diverse workforce are better suited to make decisions that create long-term value. Measuring progress, along with institutionalizing programs to improve D&I, is a critical step in this process.

Strong Governance

Lastly, as a capital-intensive asset class, appropriate governance of Real Assets and proper alignment of interests are key drivers of risk management and value creation when assessing a company's potential for long-term outperformance. Over the years of investing in listed REITs and infrastructure globally, we have observed a clear differentiation between the performance of companies with governance structures that are more aligned with stakeholders and those that are not. Across GLI, for example, we have seen a perpetual discount associated with esoteric corporate structures that consolidate power in the hands of a general partner. Across U.S. REITs, we have seen a perpetual discount associated with external (versus internal) management teams whose fees are positively impacted by growing the asset base, regardless of shareholders' best interest.

The Value of Active Management

At CenterSquare, we have been incorporating ESG considerations into our listed equities investment process for over two decades. As the focus on ESG has continued to evolve, we have continued to

Refer to endnotes and important disclosures at the end of this document.

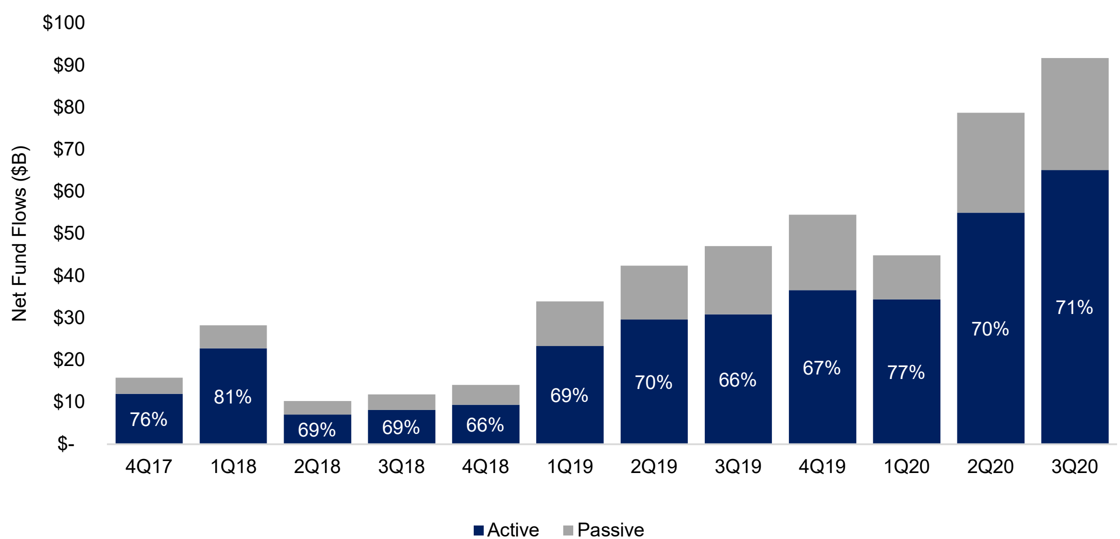
incorporate additional best practices to make our model more robust. Our process today begins by generating a ranking framework to assess a company's ESG score along ten metrics that measure environmental stewardship, social responsibility, and corporate governance, to provide an expanded analysis of material ESG factors that are aligned with the UN Sustainable Development Goals. As industry practices evolve and better ESG data becomes available, we seek opportunities to make this model more robust.

To develop the comprehensive view of a company's ESG practices, we have found active engagement with companies' senior management teams to be essential. While data from reputable and reliable sources (i.e. GRESB, CDP, company disclosures) help inform ESG assessments, data providers generally review ESG practices at a point in time or in the past. Additionally, preparing and submitting disclosures to the myriad of ESG-related data providers tends to require significant resources (i.e. time and money), which disproportionately impacts smaller-cap companies and creates a large-cap bias in most data providers' ESG frameworks. This dynamic is especially true in today's pandemic-ridden environment when resource maximization is critical to most businesses.

At CenterSquare, we have developed a formal engagement process[6], through which we conduct close to 600 ESG-related engagements with senior management and boards at the public companies in which we invest. This approach, which is supported by our long-standing relationships in the industry, allows us to develop a thorough understanding of the ESG practices within the entirety of our global coverage universe. We glean a wealth of information from interactive conversations, which enable a productive dialogue and ensure accountability for continuous improvement of the organization's ESG efforts.

Importantly, we believe ESG engagement for the purpose of influencing change is a key value-proposition brought by active managers who can speak not only with words but also with their incremental investment capital. In an environment where we have seen a sizeable shift toward passive investment vehicles, the incremental value brought by engagement is a major driver for active products garnering greater inflows in the sustainable investment space.

Figure 3: Sustainable Fund Flows



Source: Morningstar, as of 10/5/2020.

ESG Performance and Alpha Generation

A long-standing misconception that has hindered the adoption of ESG integration is that such a strategy comes at the expense of alpha. Our research suggests otherwise. At CenterSquare, our proprietary ESG scores[7] enable our investment teams to quantitatively integrate ESG risks and opportunities into our investment process and assess the results.

Using CenterSquare's proprietary ESG scores that span our global listed real estate and infrastructure universe, a high scoring, global Real Asset ESG portfolio[8] measured against its index[9] demonstrated significant alpha generation capabilities across all time periods with lower risk over the last decade.

Refer to endnotes and important disclosures at the end of this document.

Figure 4: Annualized Historical Returns

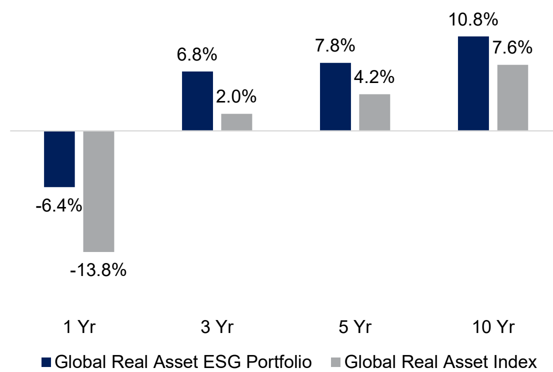
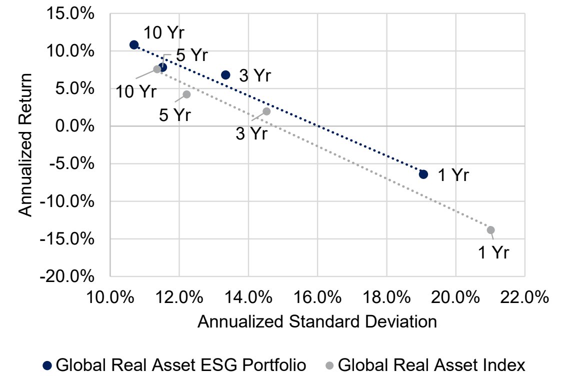
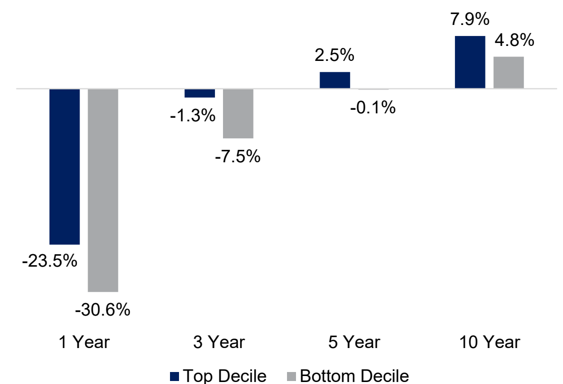


Figure 5: Annualized Risk and Returns Over Time



The portfolio demonstrates alpha generation capabilities, but there is more. By isolating ESG scores as the *only* determinant of portfolio construction, we were able to demonstrate the efficacy of "ESG" as a factor in generating better investment returns across all time periods analyzed.

Figure 6: ESG Annualized Performance By Decile



FIgures 4, 5 & 6: Source: CSIM, as of 10/31/2020. Note: The above is a hypothetical illustration and no representation is being made that CSIM will or is likely to achieve results comparable to those shown, to make any profit, or to be able to avoid substantial losses. There can be significant differences between hypothetical and actual performance results subsequently achieved by any investment strategy. Returns presented are gross of investment management fees and expenses which would reduce investor returns. Please refer to definition of indices at the end of this presentation.

The Future of ESG

ESG integration within the investment framework has been an evolving process for many years, and it continues to develop as data, disclosures, standards, and targets evolve. The momentum behind the focus on ESG, however, has increased quite meaningfully in 2020 alone. Despite the market sell-off, net global inflows into sustainable funds were 72% higher during the second quarter of 2020[10], indicating growing investor interest in ESG issues. Years ahead of its regional peers, Europe continues to lead the space and accounted for over 85% of the global inflows. Meanwhile, the U.S. accounted for less than 15% of the net flows, which provides a significant growth opportunity.

Research indicates there are three groups most interested in investing with an ESG lens in the U.S. – millennials, women, and high net worth individuals[11]. Millennials are aging and will begin to represent a larger proportion of the wealth in the U.S. Women are increasingly becoming heads of households and more involved with investment decisions. These evolving demographic trends in the U.S. alone could result in fund flows of $15-20 trillion into the ESG space over the next two decades[12].

The COVID-19 pandemic has accelerated many behavioral changes, and the focus on ESG is no exception. Within Commercial Real Estate, the pandemic has generated a focus on the healthiness of workspaces through measures of air quality, outdoor spaces, and daylighting. Additionally, as the work-from-home movement blurs the lines between the workplace and the home, similar expectations for healthy spaces are likely to be important for multifamily assets as well. Companies that can get ahead of these imminent needs will be well suited to attract tenants going forward.

In GLI, we see an opportunity for growth in both company cash flows and the investment asset class itself. From the cash flow perspective, GLI is one of the biggest beneficiaries of the environmental stewardship spending boom. Current government policies addressing climate change across the globe imply that Real Asset developers need to increase their spending by 50-100%, to even approach achieving the policies' goals. Given this spend, GLI companies should grow faster than others with the asset class seeing increasing allocations. Here, the positive yield plus growth story along with a natural engagement with environmental stewardship should appeal to that rising cohort of investors for whom ESG commitment is a primary concern.

Refer to endnotes and important disclosures at the end of this document.

Conclusion

The rise of ESG investing is an accelerating movement that we believe will continue to grow around the world as regulations and investor demand continue to propel the trend. With the growth of ESG investing comes some negatives, including the prevalence of "green washing" or only paying lip service to ESG. This behavior is not only viewed cynically and susceptible to punitive regulations, but it is also a lost opportunity to add meaningful value. As Real Asset specialists, we recognize the significant opportunities associated with best-in-class environmental stewardship, social engagement, and proper governance; and we also recognize the significant risks associated with the lack thereof. As such, we will continue to assert that the integration of a robust ESG framework produces a more holistic view of our investments, and as our research suggests, generates strong investment performance.

Endnotes

[1] Environmental Protection Agency - https://www.epa.gov/report-environment/indoor-air-quality#:~:text=Americans%2C%20on%20average%2C%20spend%20approximately,higher%20than%20typical%20outdoor%20concentrations.
[2] UNEP 2019 Global Status Report for Buildings and Construction Sector
[3] IEA 2020 World Energy Outlook
[4] USGBC: https://www.usgbc.org/articles/green-building-costs-and-savings
[5] USGBC: https://www.usgbc.org/articles/green-building-costs-and-savings
[6] Details on our engagement practices can be found in our Engagement Policy
[7] CenterSquare's methodology used to generate ESG scores can be found in our ESG Policy
[8] Global Real Asset ESG Portfolio is a portfolio developed using a 50/50 allocation between global listed real estate and infrastructure. The portfolio is sector neutral versus the index. Stock selection is based on an optimization model with the goal of generating the highest ESG scoring portfolio relative to the benchmark. The portfolio construction also includes a 3% active weight limit and 10% single security limit.
[9] Global Real Asset Index is a market-cap weighted index of the global real estate and infrastructure coverage with a 50/50 allocation between real estate and infrastructure. Please refer to definition of indices at the end of this document.
[10] Morningstar Manager Research, Global Sustainable Fund Flows, July 2020
[11] BofA Global Research, November 2019
[12] BofA Global Research, November 2019

About the Authors

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Ms. Pattarkine is an Investment Strategy Analyst for CenterSquare Investment Management. She joined the team in 2017 and focuses primarily on top down analysis, research and product development, and is an active member of the public side research effort. Additionally, Ms. Pattarkine serves as the Firm's Global ESG Coordinator, engaging both internally and externally on ensuring ESG considerations are embedded into CenterSquare's investment process. Prior to joining CenterSquare, Ms. Pattarkine spent three years in corporate strategy and planning at ExxonMobil in Houston. Ms. Pattarkine graduated from The Pennsylvania State University with Interdisciplinary Honors and High Distinction and holds a BS in Finance with a minor in International Business, BS in Accounting, and Master of Accountancy. She is a CFA charterholder, member of the CFA Institute and a LEED Green Associate.

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The COVID-19 pandemic is rapidly developing globally, impacting the economy and investments for which the duration, scale and severity remain unknown.

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Because the investment strategies concentrate their assets in the real estate industry, an investment is closely linked to the performance of the real estate markets. Investing in the equity securities of real estate companies entails certain risks and uncertainties. These companies experience the risks of investing in real estate directly. Real estate is a cyclical business, highly sensitive to general and local economic developments and characterized by intense competition and periodic overbuilding. Real estate income and values may also be greatly affected by demographic trends, such as population shifts or changing tastes and values. Companies in the real estate industry may be adversely affected by environmental conditions. Government actions, such as tax increases, zoning law changes or environmental regulations, may also have a major impact on real estate. Changing interest rates and credit quality requirements will also affect the cash flow of real estate companies and their ability to meet capital needs.

(Continued)

Disclosure Statements Continued

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Definition of Indices

Global Real Asset Index
Global Real Asset Index is a market-cap weighted index of the global real estate (FTSE EPRA/Nareit Developed Index) and infrastructure (FTSE Developed Core Infrastructure 50/50 Net Tax Index) coverage with a 50/50 allocation between real estate and infrastructure.

FTSE EPRA/Nareit Developed Index
The FTSE EPRA/Nareit Developed Real Estate Index Series covers both the FTSE EPRA/Nareit Equity REITs Index and the FTSE EPRA/ Nareit Developed ex-U.S. Index. Designed to track the performance of listed real estate companies and REITs worldwide, the series acts as a performance measure of the overall market. The Gross benchmark presented is based on total return calculations which add the income a stock's dividend provides to the performance of the index. The Gross benchmark is presented is gross of withholding taxes and investment management fees. The Net benchmark presented is calculated as a total return net of foreign withholding taxes on dividends from an U.S. investor perspective, and gross of investment management fees. The index changed names on March 23, 2009 and was formerly known as the FTSE EPRA/Nareit Global Real Estate Index.

FTSE Developed Core Infrastructure 50/50 Net Tax Index
FTSE Developed Core Infrastructure 50/50 Net Tax Index give participants an industry-defined interpretation of infrastructure and adjust the exposure to certain infrastructure sub-sectors. The constituent weights for these indices are adjusted as part of the semi-annual review according to three broad industry sectors – 50% Utilities, 30% and a 20% mix of other sectors including pipelines, satellites and telecommunication towers. This is calculated as a total return of foreign withholding taxes on dividends and gross of investment management fees.

These benchmarks are broad-based indices which are used for illustrative purposes only and have been selected as they are well known and are easily recognizable by investors. However, the investment activities and performance of an actual portfolio may be considerably more volatile than and have material differences from the performance of any of the referenced indices. Unlike these benchmarks, the portfolios portrayed herein are actively managed. Furthermore, the portfolios invest in substantially fewer securities than the number of securities comprising each of these benchmarks. There is no guarantee that any of the securities invested in by the portfolios comprise these benchmarks. Also, performance results for benchmarks may not reflect payment of investment management/incentive fees and other expenses. Because of these differences, benchmarks should not be relied upon as an accurate measure of comparison.

A direct investment in an index is not possible.

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