Why the new ethical investing is blossoming

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Whether you've heard of it or not, ESG (Environmental, Social and Governance) investing is already big business. Bank of America claims it has doubled in the past few decades[1] and the US$1.3tn Government Pension Investment Fund of Japan intends to more than triple its portfolio allocation to ESG investments from the current 3%.

ESG investing is a form of ethical or socially responsible investing. Based on an assessment of environmental, social and governance factors, the ESG process measures the sustainability and ethical impact of a company or product.

This was once a niche but is now growing rapidly. According to the 2006 Cone Millennial Cause Study, the millennial generation is more likely to trust a company or purchase its products when it's considered socially or environmentally responsible.

You may not care what millennials think but the finance industry does. Standing to inherit $59 trillion by 2060 in the US alone, millennials will demand tailored ESG investment products. Naturally, the industry is keen to provide them.

This shift is already underway. In Australia, most superannuation funds offer ethical investment options. Phillip Vernon, Australian Ethical Investment managing director, believes that up to 10% of the Australian investing public, or 1.5 million people, let their ethical convictions drive their investment behaviours[2]. If it isn't already, ESG investing is about to go mainstream.

The impact on the commercial property sector is likely to be substantial. If the millennial generation's ethical beliefs determine their investments, why wouldn't it also affect the places they choose to work, shop and play?

On a recent trip to Singapore I toured CapitaGreen, a key asset of APN's Asian REIT Fund that embodies ESG principles, to see what the future might hold.

The CapitaGreen building, Singapore
Image source: CapitaLand Commercial Trust

With a double-skin façade and greenery on 55% of its perimeter, heat gain is reduced and natural lighting floods into the spaces. Rainwater is harvested to feed the vertical greenery and a cool void at the centre of the property permits airflow through the building, topped by the rooftop red petals you can see in the image above. With column-free internal office space and high ceilings, this is a highly awarded building targeted at tenants that want to attract millennial employees.

The big question for property investors is whether buildings like CapitaGreen are able to charge a premium rent. There's no doubt tenants find it attractive. In Singapore's competitive leasing environment CapitaGreen's occupancy rates are high. But there's no sign (yet) of rental premiums for its impressive green features.

That may be about to change. In 2012, Deutsche Bank published Sustainable Investing: Establishing Long Term Value and Performance. It examined over 100 sustainable investing studies, finding that high ESG ratings correlated with a lower cost of capital in 100% of the studies. It also found that in over 85% of the studies, high ESG ratings were correlated with market and accounting-based outperformance[3].

In another study of more than 10,000 mutual funds by the Morgan Stanley Institute for Sustainable Investing, sustainable equity funds were found to have met or exceeded median returns of traditional equity funds during 64% of the time periods studied[4].

There are two powerful trends pushing ESG investing, one relating to performance, the other to demand. Younger investors want more ESG investing options while the research indicates that there's a performance bonus for choosing them.

With the green building movement gaining momentum after the 2000 Sydney Olympic games, the property industry is well aware of these trends. In 2009, the Global Real Estate Sustainability Benchmark (GRESB) was launched by several large US pension funds and is now standard practice for the world's largest real estate companies. It has increased engagement on ESG issues, driving the development of buildings like CapitaGreen in Singapore.

APN's own Industria REIT is also very much focused on these issues. A few months ago, Industria announced a partnership with GEM energy to install 1 megawatt of solar panels across six of their business park buildings in Brisbane – one of the largest such installations in the country. This investment by Industria not only reduces its power bills, it also allows Industria to generate more than 40 per cent of its energy on site at the technology park – a big boost to sustainability.

At APN, we have long embraced ESG as an explicit part of our investment process because it matches so well with our strategy of investing for sustainable income with lower risk. We believe that companies with good ESG practices should exhibit lower volatility (or risk) over time. Accordingly, they deserve a premium in their valuation. The Singapore REIT that owns CapitaGreen is a case in point.

Property valuers can't yet attribute a specific valuation premium to green buildings, but we can and do incorporate it in our valuation and investment process. And whilst we can't attribute the APN Asian REIT Fund's outperformance (relative to its benchmark) solely to the ESG component of our investment process we do think it helps. Our millennial investors seem to like it, too.

If the future is one of green buildings and ESG investing beating traditional benchmarks I'll be happy with that, as should our investors.

1 Boston College Center on Wealth and Philanthropy, http://www.afr.com/personal-finance/shares/ethical-investing-comes-of-age-20170518-gw7kuc
2 http://www.bc.edu/content/dam/files/research_sites/cwp/pdf/Wealth%20Press%20Release%205.28-9.pdf
3 https://www.db.com/cr/en/docs/Sustainable_Investing_2012.pdf
4 https://www.morganstanley.com/sustainableinvesting/pdf/sustainable-reality.pdf

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