## ESG newsletter October

# ESG (ratings) on our minds

ESG is on everyone's minds these days. On the news, we see reports on heatwaves, floods and draughts, with impacts on issues ranging from crop yields, to energy prices, to social unrest. These headlines only highlight the great need to take a more holistic, sustainable view of investing. However, increased attention on Sustainable or 'Environmental, Social and Governance' (ESG) investment has come with increased scrutiny.


With a politicised debate in the USA on the value of ESG integration running in the background, we have seen several opinion pieces in newspapers and magazines. For example, The Economist magazine recently ran an article where it made the case for more government action and a unique focus on the 'E' (i.e. Environmental). In addition, there have been numerous academic papers discussing the value of ESG investing and the role of investee engagement (an example of which can be downloaded here).

These discussions are all the more important in the context of the EU's sustainable finance regulation framework, encompassing several measures such as the Sustainable Finance Disclosure Regulation (SFDR), MiFID II, the EU Taxonomy, the Corporate Sustainability Reporting Directive, amongst others.

We welcome this engaged discussion among stakeholders around how ESG factors are integrated across the financial services industry. As an independent private bank and a wealth, fiduciary and asset manager, we are party to the debate and wish to add our voice. It is our view that as an organisation we must deploy the capital that is entrusted to us in a sustainable way, while also considering sustainability risks and long-term value creation.

Embedding ESG factors throughout our business has been part of our culture for a long time, having implemented multiple policies and practices around exclusion and avoidance, ESG integration, and active ownership to contribute to better outcomes. We certainly do not always agree with the arguments of various commentators and often have a demonstrably different approach to making investments more sustainable.

## RATINGS ARE NOT EVERYTHING

When integrating ESG factors into investments, asset managers often make use of 'ESG ratings', attributed to companies by analysts and research agencies with the purpose of scoring how the companies fare on ESG factors and what ESG risks these companies face.

These ratings are one of the most hotly debated aspects of Sustainable Investment. What factors are taken into consideration, how can one measure the plans companies have for ESG risk mitigation, and how do you compare the different ratings from the various rating agencies?
Then there are also differences in how these ratings are used: an assumption is often made that investors simply exclude the worst performers based on their given ratings, or that they may solely invest in the best performers. By doing so, they miss the fact that ratings do not tell the whole story on sustainability performance, nor do they say much on the trajectory (better or worse) that a company is on.

This is not how Van Lanschot Kempen integrates ESG into our investments. On top of the risk score data, we use additional ESG approaches and variables to construct portfolios for our clients, such as a measure of $CO_2e$ emissions, exclusion of companies with severe controversies or poor governance, applying additional Sustainable Development Goals (SDG) tilts, and others. Our aim is to move towards real world impact and a low carbon economy. We also engage with the companies in which we invest to encourage them to make sustainable changes. In other words: our active ownership approach allows us to move well beyond merely excluding companies with poor ESG ratings; we choose a more considered, nuanced, and dynamic approach.

## NAVIGATING THE TRANSITIONS WITH OUR PROPRIETARY ESG RISK SCORE

Our goal is to assist our clients with navigating the important transitions of our time. Therefore, in our core strategies, we focus on finding the future winners and losers of these transitions. Here, current laggards (with low ESG ratings) could happen to be future winners - if they adjusted faster, for example. Since ESG ratings are still part of our evaluation, more forward-looking scores are instrumental for investors. To this end, we have recently developed a new methodology for constructing a proprietary ESG Risk Score, that enables us to incorporate our own views and expertise on the companies involved.

Portfolio managers can now make nuanced and quick adjustments to companies' ESG scores, using their own knowledge and research on companies, thus reducing the dependance on external scores and making the scores more forward-looking. The Kempen Investment teams can then use their scores to better understand ESG risks faced by companies in our portfolios, feeding into our valuation models. The scores can also be used to implement exclusion criteria.

The resulting Kempen Risk scores are absolute, i.e. not adjusted based on the company's performance against its industry peers. Therefore the scores can be used as a comparison of risk between companies and across industries. Portfolio managers can access the scoring system through a specially-built desktop app which provides a high level of transparency on how the score is established.

## HOW IT WORKS

The foundation of the Kempen ESG Risk Score is based on the risk ratings of an external, independent data provider that measures an individual company's *exposure* to 21 material ESG risks and also scores how well these risks are being *managed*.

But while we take the risk *exposure* scores as a given, the Kempen portfolio managers use the external scores and sub-scores on how well ESG-risks are *managed* as default scores which they can adapt and override when they have a differing view on the company. This opinion can originate, for example, from engagement with the company or proprietary research that point towards improvements or deteriorations in ESG status that are not (yet) visible in the default scores.

We put an extensive focus on carbon emissions and corporate governance. Given the importance of these issues, we use a more extensive combination of external data for a refined custom scoring framework based on precisely defined sub-issues. The framework thus reflects the targets the company has set, the way the company manages these targets, and how management is incentivised to reach these targets. This helps us track how the companies in which we invest fare on their decarbonisation ambitions - a direct link to our objective to become a net zero investor!

## WHAT INVESTORS IN OUR CORE STRATEGIES WILL GAIN:

- Clients will benefit from an ESG score that demonstrably incorporates our own knowledge on a given company. We can now correct the externally-provided ESG ratings, if needed, using our own expertise and views.
- The score gives clients a consistent view of the measure we use to set our own exclusion and engagement thresholds for the companies in which we invest.
- The possible outcomes of our engagements with companies can now be incorporated into ESG scores more quickly. This way the scores reflect the current and future situation of companies, allowing for a more forward-looking score.
- The score (methodology) is an reflection and example of how ESG is integrated in our investment processes, demonstrating ESG integration to our clients as part of the SFDR.

*In addition to the Kempen ESG score, we act as active owners through voting and engagement with our investee companies – our **July newsletter** offered some insight on this.*