COHEN & STEERS

ESG's Evolving Landscape

Building on COVID Lessons in Real Assets and Alternative Income Integration

Raquel McLean, CFA, Vice President and Managing Research Analyst, Preferred Securities

The corporate sector's response to the global health crisis shows a growing recognition of the effect ESG policies can have in driving sustainable growth and shareholder value. We present a specialist's perspective on how ESG analysis impacts our investment decisions across real estate, infrastructure, natural resource equities, preferred securities and commodities.

The COVID catalyst

Many companies have expanded their focus to encompass all stakeholders in ways that we believe may have long-term reputational and financial benefits.

Integration and engagement

Our four-step approach accounts for distinct ESG factors relevant to each sector, leveraging our resources and scale to unlock potential value and mitigate risks.

Evaluating managers on ESG

As ESG integration can vary widely among managers, knowing common areas of focus may help investors distinguish different techniques and level of focus.

COVID has been an ESG catalyst

A growing focus on stakeholders

Companies and investors have increasingly recognized that environmental, social and governance (ESG) factors can be integral to sustainable business practices, often leading to changes in corporate policies and broader awareness of potential risks. However, it's one thing for companies to implement structural improvements in a thriving economy, and quite another to voluntarily enact costly measures in the midst of a pandemic and unprecedented business challenges.

In other words, the pandemic is revealing companies' true ESG colors. It has also shown that a comprehensive ESG framework must consider not only governance and environmental factors, but also companies' wider social impact, including health, safety and workforce dynamics. As a result, business and investment focus has continued to evolve to further consider all stakeholders, including employees, customers, suppliers and communities.

We believe companies that value stakeholder well-being are likely to experience financial and reputational benefits throughout the recovery and beyond. Those that take proactive steps to help employees, customers and communities are apt to be rewarded with positive brand reputation, greater customer loyalty and higher employee retention. Conversely, those seen as being behind the curve—or worse, putting stakeholders at risk—may be prone to attrition.

As the focus on stakeholder wellbeing has increased, many companies have turned to social bonds to help finance coronavirus response efforts and other actions relating to health care and inequality. Social bond issuance has increased more than 300% over the past year, mirroring the dramatic rise of green bonds targeting climate and environmental projects in 2017–2018.[1]

Government responses impacting ESG

COVID's ESG impact extends beyond company responses, as government aid often comes with obligations to use the capital in ways that are aligned with environmental and social policy goals. For example, in Europe, 25% of the EU Recovery Fund must be spent on measures to fight climate change, state aid packages for airlines are conditional upon CO_2 reduction targets, and aid for the auto industry includes new incentives for electric cars.

For companies that are already ahead in terms of ESG, this focus could position them to benefit even more from future opportunities. At the same time, COVID-related aid may increase the risk of political intervention, particularly for infrastructure businesses that provide a public service. In some cases, such intervention can structurally reduce management efficiency, leading to a lower assigned governance score and potentially having a negative effect on total return. This underscores the importance of ESG integration in assessing both risks and opportunities.

> COVID has created an opportunity for companies to demonstrate their values by expanding their focus to encompass all stakeholders, which we believe could have positive long-term performance implications.

[1] As of July 1, 2020. Source: BNP Paribas. Social bonds are issued to finance specific sustainable development goals with positive social outcomes.

How companies are responding to the crisis

Many firms have taken proactive measures to address the pandemic, such as expanding employee health benefits and work-from-home policies, providing community aid and protecting employment through executive pay cuts. Other actions have been unique to individual asset classes, as noted below.

Asset class	Industry response	Examples
Real estate	• Resources for tenants to take full advantage of federal stimulus programs • Tenant relief funds • Providing hospital overflow space • Government-mandated or market-induced rent deferrals	**Welltower – U.S. health care REIT** • Established a personal protective equipment (PPE) distribution center and spent over $5 million on gloves, face masks, gowns and testing kits • Formed a new partnership for senior housing operators to leverage university medical experts • Trained operators on interfacility transfers, staff screening, safety and testing protocols • Cut $15 million in general and administrative expenses, mainly through executive pay reductions, without employee layoffs
Infrastructure	• Payment flexibility, financial assistance and no-disconnection policy for utilities customers • Temporary relief policies by transportation operators and local governments • Reduced airport landing fees, relaxed slot-management requirements and rent relief for airport retailers • Toll credits for front-line workers	**Enel – Italian electric utility** • Offered a new insurance policy covering COVID hospitalizations worldwide • Change in CEO remuneration policy, with new objectives linked to remote working and increased weight of objectives linked to safety • Contribution to hospitals to purchase equipment, respirators and medicines, and to increase patient capacity • Offered special electricity rates to hospitals and hotels converted into quarantine centers • Employees allowed to donate leave days to colleagues
Natural resource companies	• Acceleration of automated production (especially meat packers) • Enhanced hygiene protocols • Social distancing in facilities • Relaxed absenteeism policies and worker pay during quarantine • "Hero bonuses" for front-line workers • Donations to local communities for health and wellness programs, COVID-19 prevention and treatment, and small business relief	**Maple Leaf Foods – Canadian food manufacturer** • Promoted culture of staying at home when sick • Provided employees with support pay on top of regular overtime pay • Brought in a medical expert advisor to help develop and implement a response plan • Decreased density via staggered shifts • Active COVID symptom screening for employees and enhanced hygiene protocols • Provided emergency food relief across Canada and donated $2.5M to health care professionals
Preferred securities issuers	• Payment deferrals and credit extension for bank consumer and corporate clients • Distribution of Paycheck Protection Program assistance by banks • Refunds of a portion of insurance premiums for auto and small business policyholders • Temporary halt on late fees and nonpayment coverage cancellations	**Liberty Mutual – U.S. insurance company** • Refunded 15% of policy premiums for two months for small business owners • Refunded 15% of personal auto insurance premiums for two months, returning ~$250 million to customers • Temporarily halted late fees and personal auto and home nonpayment coverage cancellations

At August 31, 2020. Source: Company reports, Cohen & Steers.
Companies selected by Cohen & Steers as notable examples of proactive responses to COVID. The mention of specific securities is not a recommendation or solicitation to buy, sell or hold any particular security and should not be relied upon as investment advice. See pages 14–15 for additional disclosures.

Our ESG integration and engagement process

Cohen & Steers' commitment to investment excellence is built upon a culture of continuous improvement, and that includes our approach to ESG integration. We believe our proprietary approach to integration and engagement, combined with the framework established in the Principles for Responsible Investment (PRI), helps to promote transparency and has the potential to enhance our ability to deliver more consistent, attractive risk-adjusted returns.

1. Identify	2. Score	3. Integrate	4. Engage
Determine relevant ESG factors and weights by sector	Generate proprietary ESG scores	Incorporate scores into investment decisions	Gain insight and drive positive change through active engagement

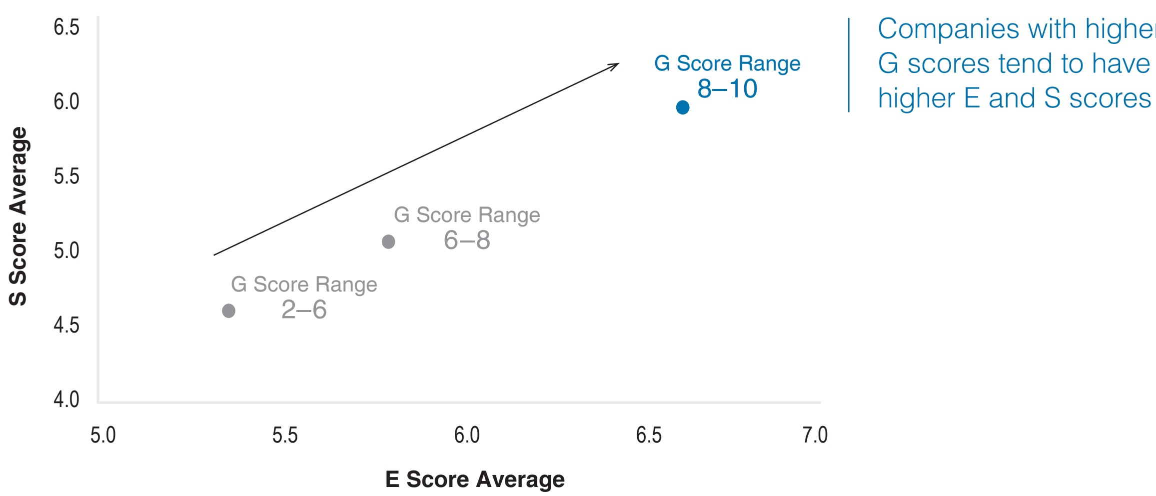
1. Identify ESG factors and assign weights by asset class sector

Different asset classes tend to have distinct “cores” for extracting and realizing value. For example, real estate is a capital allocation business, elevating the importance of governance. By contrast, some industries within natural resource equities and infrastructure can be more operations focused, where safe working conditions are a matter of life and death.

Therefore, the first step in our process is to define the key E, S and G factors that are most relevant to sectors within each asset class. We quantify these issues by assigning a sector-specific weight to each factor based on our extensive knowledge of the asset classes, combined with third-party research. This begins with data from MSCI, a leading ESG research provider with broad coverage of the companies in our target asset classes, providing what we view as a good starting point for overlaying our proprietary analysis.

Corporate governance tends to be at the forefront of our fundamental analysis, as we believe strong governance—regardless of industry—is often a foundation for implementing sound environmental and social practices. As shown in Exhibit 1, real estate companies to which we assign higher G scores also tend to rank higher on E and S factors. Due to the critical role we believe governance plays in achieving sustainable business models, we typically weight governance equal to or higher than third-party ESG providers.

Exhibit 1: Governance is correlated with environmental and social policies
Cohen & Steers ESG scores for real estate securities



At July 31, 2020. Source: Cohen & Steers.
See pages 14–15 for additional disclosures.

Key governance issues tend to apply broadly across sectors and asset classes. These include:

- Management acumen
- Transparency
- Board structure, tenure, refreshment, alignment
- Shareholder rights
- Executive compensation
- Audit and risk oversight
- Insider/management ownership and shareholder structure
- Systemically important financial risk (specific to preferred securities and infrastructure)
- Corruption and political/social instability (specific to natural resource equities)

By contrast, environmental and social factors tend to vary meaningfully across sectors, demanding a customized approach to ESG integration across our strategies (Exhibit 2).

Exhibit 2: Key environmental and social factors by asset class

	Environmental	Social
Real estate	• Green building opportunities • Energy management • Green bond issuance • Waste management • Water management • Green leases	• Human capital management • Diversity and inclusion • Health and wellness of tenants (building safety) and employees • Community impact and involvement
Infrastructure and MLPs	• CO_2 emissions, costs of associated credits • Subsidies for green power offtake, risks to environmental policies and regulation • Water stress, land use • Nuclear liabilities	• Human capital management • Customer satisfaction scores, staff training programs and sponsorships • Service interruption, operational safety, employees' incidence rate • Initiatives to support customers in financial need • Data security
Natural resource equities	• CO_2 emissions • Water stress, land use • Toxic emissions and waste management • Opportunities in clean technology • Raw material sourcing	• Human capital management • Employee health and safety • Supply chain labor standards • Community and labor relations • Product safety and quality • Complex political and social issues in developing countries
Preferred securities[a]	• Climate change vulnerability • Financing environmental impact	• Human capital management • Privacy data and security • Financial product appropriateness • Responsible investment • Insuring health and demographic risk • Providing financing to underserved markets
Commodities	• Climate change • Scarcity of finite resources	• Human rights • Working conditions • Impacts on local/indigenous communities

At August 31, 2020. Source: Cohen & Steers.
(a) Environmental and social factors shown for banks and insurance companies, the largest issuers of preferred securities. For non-financial sectors, factors are determined based on assessment of the real estate, infrastructure and natural resource equity investment teams. See pages 14–15 for additional disclosures.

2. Generate proprietary ESG scores

Using the factors listed above, we generate ESG scores for each company relative to its industry. MSCI's ESG scores serve as a starting point, and analysts then adjust these scores where necessary based on our proprietary research. Resources for making these adjustments include other respected ESG research providers (ISS, Sustainalytics, RobecoSAM), sell-side research reports, company filings, Bloomberg metrics and, our most significant driver of scores, our interaction with company management. Scores are typically assessed on a quarterly basis, but may be adjusted more frequently if there are material changes in circumstances.

Our proprietary overlay is a key differentiator of our approach to ESG integration, as we leverage the depth and scale of our platform and the scope of our information gathering to enhance third-party research. Accordingly, we empower our analysts to make appropriate wholesale adjustments as necessary when using external ratings, focusing on companies' more permanent (versus temporary) actions.

Case study: How our analysis and scoring differ from MSCI

Extra Space Storage (EXR), a leading U.S. self storage REIT, has a relatively low ESG score in MSCI, whereas our proprietary analysis has resulted in a much higher rating. Below, we highlight key ways in which our fundamental research has contributed to differentiated ESG scoring.

	MSCI	Cohen & Steers (CNS)
ESG score	**2.4**	**7.1**
Environmental	MSCI ranks EXR below average, with a negative view on the low number of LEED-certified buildings in its portfolio. The Leadership in Energy and Environmental Design (LEED) certification is a widely used green building rating system.	CNS views self storage as an inherently low-energy-consuming property type and values how EXR minimizes its environmental impact with high solar panel usage, high penetration of LED lighting and/or motion activated lighting, and low water usage at its properties.
Social	MSCI ranks EXR below average, giving it low marks on the low wages paid to many employees.	CNS views EXR as a sector leader in pay and benefits, and values its focus on diversity and its tuition assistance program for employees seeking an undergraduate degree. Proprietary research indicates EXR's culture, brand and reputation within the industry is significantly above average, with very high employee satisfaction scores.
Governance	MSCI grades EXR as average, due largely to the structure of its board of directors—EXR's founder serves as its chairman and is not independent.	CNS notes that EXR separates its chairman and CEO roles and gives stockholders the ability to amend bylaws and vote annually to approve executive compensation, highlighting that excessive pay is not a concern.

At June 30, 2020. Source: FactSet.
Company selected based on the widest differential of MSCI and Cohen & Steers' ESG scores in our real estate investment universe. The mention of specific securities is not a recommendation or solicitation to buy, sell or hold any particular security and should not be relied upon as investment advice. See pages 14–15 for additional disclosures.

3. Integrate scores into investment decisions

Our investment teams incorporate ESG risks and opportunities into the fundamental research process by implicitly and explicitly integrating our ESG scores into investment decision making. Due to the inherent differences in valuation approaches by asset class, ESG scores are integrated in distinct ways, as shown below.

Exhibit 3: Customizing ESG score integration by asset class

Real estate **Infrastructure & MLPs** **Natural resource equities**	• Adjust cash flow forecasts and discount rates to reflect risks
Preferred securities	• Incorporate into relative value analysis, assigning premiums for weak ESG scores and discounts for strong scores • May impact level of ownership and some issuers may be deemed uninvestable
Commodities	• Align with commodities ESG best practices (such as not taking physical delivery and avoiding investment in rare earth or minor metals) to promote well-functioning markets

At August 31, 2020. Source: Cohen & Steers.
See pages 14–15 for additional disclosures.

> Each investment team at Cohen & Steers integrates ESG analysis in a manner that considers the inherent differences of the asset class.

4. Engage companies to gain insight and drive positive change

We take an active ownership and engagement approach with companies in our investment universe, advocating for sound ESG principles that we believe can help optimize investment performance. This engagement is an integral part of our fundamental research process, providing a framework for dialogue between us and our portfolio companies to support, influence or change a company's ESG practices in ways that we believe may have a material impact on its ability to preserve or grow its economic value.

Our engagement process involves four main components:

Individual engagement

Our primary method involves direct dialogue with senior management or boards of directors. This can be a particularly effective tool when we hold a significant ownership position.

Proxy voting

We take an active approach to proxy voting based on our view that our investment professionals—not third-party service providers—have the best insight into our portfolio companies and are best-positioned to vote proxies on behalf of our clients. Our proxy voting decisions take ESG factors into consideration and seek to protect our clients' long-term economic interests.

Collaborative engagement

In certain instances, we may collaborate with other investors and stakeholders, where appropriate and permitted by applicable law and regulation, to ensure that companies protect the rights of all shareholders and consider how actions may impact all stakeholders.

Industry advocacy

To encourage companies to adopt ESG best practices at an industry level, we work with industry initiatives and groups, including:

- Principles for Responsible Investment (signatories since 2013)
- GRESB (formerly "Global Real Estate Sustainability Benchmark," the organization now also covers infrastructure)
- European Public Real Estate Reporting & Accounting Committee

This work fosters collaboration and allows us to discuss and assess ESG matters with industry peers and leading industry constituents.

This ongoing engagement helps us understand risks and opportunities and adjust our proprietary valuations to refine our investment decisions. In addition, we utilize engagement to encourage companies to improve transparency and disclosure, as well as make better business decisions. We believe these discussions can lead to strategic decisions that may enhance financial and operating performance, reduce the risk of reputational damage and improve long-term shareholder returns.

ESG integration and engagement in action: Portfolio examples

Identifying potential risks

In early 2018, our analysis of prison REITs led to a reduced ESG score in terms of policy, funding and business model, prompting us to exit our positions. From the start of 2018 through mid-2020, the group has underperformed the broader U.S. REIT market by 22.4% cumulatively. In their current form, we view these companies as uninvestable.

Reinforcing positive investment views

In 2017, our research identified a Hong Kong real estate developer with both strong investment fundamentals and, uniquely, a dedicated sustainability department. Over the past several years, the company has increased its ESG efforts substantially and has communicated a goal of becoming the global industry leader in this area by 2030. Having a better understanding of how this company is approaching sustainability in development practices and mitigating any associated risks has positively contributed to our investment view and related value.

Downgrading investment outlooks

In 2019, we communicated to a Canadian natural resources company our preferences for greater debt paydown and higher capital returns to shareholders. Instead, the company used excess cash to acquire a large, non-core asset. We incorporated its less attractive capital structure and allocation decisions into our investment outlook and lowered our upside/downside base case to reflect the company's elevated leverage profile versus its peers. We downgraded our prior positive investment view, reduced our active investment weight initially and ultimately exited the position.

Aligning compensation with shareholder return

In 2019, we engaged with a U.S. tower REIT on its long-term incentive compensation, which was based on one-third uninvested restricted stock and two-thirds stock options. We discussed our preference for performance-based metrics over time-based vesting to better align compensation with shareholder return. The company eliminated stock options from its 2020 program and incorporated performance targets based on relative total shareholder return.

Introducing a more sustainable dividend policy

In 2019, we pushed for material changes to a regional mall REIT's dividend policy, which was not being fully funded with free cash flow. We also advised the company to limit development and redevelopment spending to help strengthen its balance sheet. The dividend policy recommendations were implemented in 2020 in response to the pandemic, and capital expenditures were reduced.

> Our commitment to the Principles for Responsible Investment and our proprietary ESG integration help to promote transparency and drive our engagement with the companies in which we may invest.

Evaluating manager approaches to ESG

There are many different approaches to evaluating investment managers on ESG criteria. Based on our review of documentation from 11 leading institutional consultants, we note several common areas of focus, which may offer insight when addressing the topic with managers.

What is the manager's level of investment integration?

- Review how ESG factors are identified and integrated into active fund positions as a source of alpha
- Evaluate team member expertise in the respective asset class, as well as data sourcing and scalability
- Consider how ESG-driven views are integrated into portfolio construction, both generally and specific to asset class
- Examine whether investment horizons align with ability to implement ESG views
- Assess firm-level support for ESG integration, engagement activities and transparency

How does it approach active ownership and engagement?

- Evaluate whether the manager demonstrates active engagement through proxy voting (aligned with investment approach) to encourage improvements and mitigate risks
- Consider how the manager collaborates with portfolio companies to improve ESG policies

Are there established firm-level ESG policies?

- Review firm ownership and board structure
- Examine diversity across senior leadership, investment teams, all employees and candidates
- Determine whether there are dedicated ESG personnel or ESG committee structures in place
- Review firm participation in industry-wide organizations, such as PRI

By evaluating these areas, investors can begin to understand a manager's ESG philosophy and process, including how these are incorporated into investment decisions and reflected in the organization itself.

What distinguishes Cohen & Steers' approach to ESG?

Resourcing

We believe the size and experience of our investment teams, together with the frequency and depth of their interactions with companies, enables a deep understanding of management credibility and strategy, allowing us to assess material ESG considerations beyond the scope of MSCI and other third-party research firms.

Scale

Our leadership position in listed real assets and alternative income amplifies our voice and influence when we engage with companies—whether we currently invest in them or not. We believe this helps our ESG advocacy have maximum impact.

Walking the talk: ESG at Cohen & Steers, Inc.

Just as we believe companies with sound ESG practices are better able to sustain long-term growth, we also seek to hold ourselves accountable for effective internal ESG practices. We believe this is essential to delivering consistent investment performance, attracting top talent, building trusted relationships with our clients and enhancing value for stockholders of Cohen & Steers, Inc.

Since our founding, we have sought to be a model of corporate governance—having an active, independent Board of Directors, aligning compensation of senior leaders with client interests and enforcing the highest compliance standards. As we noted previously, we believe strong governance helps to inform sound environmental and social policies.

Our well-ingrained structure includes an ESG Steering Committee, which provides a coordinated approach across the organization. It includes key stakeholders from key functions across the firm to help ensure we are positioned to meet the needs of our global client base. This committee also originates and prioritizes ESG initiatives and oversees three subcommittees dedicated to specific ESG-related areas: investments, product strategy and corporate considerations.

Our ESG Investments Committee supports each of our specialist investment teams in determining the most appropriate way to integrate ESG factors into the research process. It is also responsible for ongoing implementation of engagement tracking and reporting, and evaluates the need for additional ESG research sources and data.

Cohen & Steers is committed to the pursuit of excellence through a culture of inclusion that respects and welcomes employees of diverse backgrounds and life experiences. We believe such diversity brings valuable perspectives that enhance the firm's ability to make better investment decisions for our clients. Our leadership is dedicated to maintaining and enhancing our culture with the same focus brought to our disciplined investment process.

Our strategy for improving diversity and inclusion comprises four pillars:

- **Education** to build awareness about how our differences make us stronger and contribute to our focused approach
- **Leadership** that is accountable for fostering inclusivity and is also reflective of the diversity at Cohen & Steers
- **Recruitment** strategies that provide opportunities for underrepresented groups to join us in the pursuit of excellence
- **Engagement** throughout the firm, driven by employee-led resource groups that advance how we address business and community challenges

> "We believe a culture of excellence and inclusion creates the best environment for employees to make better decisions and achieve results for our clients."
>
> **– Bob Steers, Cohen & Steers CEO**

Conclusion

Global events in 2020 have intensified the spotlight on ESG factors, adding new dimensions and serving as a stress test of companies' commitments to stakeholders, particularly around social impact actions. In our view, companies that have taken positive, proactive measures in this arena are likely to benefit from enhanced business continuity and reputational effects, throughout the remainder of the crisis and beyond.

Although the circumstances may be new, the importance of ESG factors on a security's expected total return is not. That is why ESG standards have long been integral inputs into our security analysis. Our approach includes thoughtful integration into our forecasts and relative value rankings, shaped by the unique characteristics of each asset class, as well as ongoing engagement through active company ownership and industry advocacy.

We believe these efforts can enhance our ability to deliver favorable risk-adjusted returns to our investors, while expanding adoption of ESG best practices.

About the author

Raquel McLean, CFA, Vice President, is a managing research analyst specializing in global insurance companies and Asian banks. She chairs the Cohen & Steers ESG Investments Committee and has 12 years of experience. Prior to joining the firm in 2009, Raquel was an equity analyst at Merrill Lynch specializing in mid- and small-cap banks. She has a BS in Economics and a BA in Finance from Villanova University, and is based in New York.

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Americas

NEW YORK

Corporate Headquarters
280 Park Avenue, 10th Floor
New York, New York 10017

Phone 212 832 3232
Fax 212 832 3622

Europe

LONDON

Cohen & Steers UK Limited
50 Pall Mall, 7th Floor
London SW1Y 5JH
United Kingdom

Phone +44 207 460 6350

DUBLIN

Cohen & Steers Ireland Limited
77 Sir John Rogerson's Quay, Block C
Grand Canal Docklands, Dublin 2
D02 VK60, Ireland

Phone +353 1 592 1780

Asia Pacific

HONG KONG

Cohen & Steers Asia Limited
Suites 1201–02, Champion Tower
3 Garden Road
Central, Hong Kong

Phone +852 3667 0080

TOKYO

Cohen & Steers Japan, LLC
Pacific Century Place, 16F
1-11-1 Marunouchi Chiyoda-ku
Tokyo 100–6216 Japan

Phone +81 3 4530 4710

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