Towards a Research Agenda for Socially Responsible Investment in Property

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Change is afoot in the investment world. What is driving it is nothing particularly new – indeed, in the UK, it began with church-based investment back in the 18th century. However, it is gathering pace and is now increasingly entering the lexicon of business. In summary, this 'change' relates to the ways in which corporate entities behave and fiduciaries invest. For an investment manager of the type I work for, both are becoming increasingly important.

Increasingly widespread concern over environmental, social and moral issues is increasing the pressure on companies to operate more like 'corporate' citizens and behave in a socially responsibly manner with respect to the communities they affect and operate within - both for current and future generations.

These expressions of concern are not only manifesting themselves through the ballot box and through Governmental policy and leadership, they are increasingly being felt in the investment world.

As Sir Graeme Davies has suggested, not only are increasing numbers of individuals taking direct action to ensure their own capital is not used to support activities they have concerns about, they are also – often through activist organisations – increasing the pressure on investing institutions to use their power to influence the companies they are investing in, to behave in socially, environmentally and ethically responsible ways.

There have been a number of outcomes from this pressure. First, the scale of investment in 'ethical' or 'socially responsible' investment funds has grown dramatically. Probably the best known fund is Friends Provident's 'Stewardship' fund. But, in what is perceived as a burgeoning new investment market, there are increasingly more vehicles available.

At the last estimate, these funds had a market capitalisation in the UK alone of £120billion – a figure that has more than doubled in the last two years. While investment theory might suggest that artificially constraining one's investible universe in this way might hinder prospects for delivered performance, it is increasingly being argued that, by either avoiding or removing capital from companies that will fall out of favour with customers or which have to invest to meet (or pay fines because they haven't met) increasingly stringent Government regulations - socially responsible investors will see better not worse long run returns.

Second, services are now developing that allow investors to know more about the behaviour of companies in their investible universe. Services like the Ethical Investment Research Service (EIRIS) can be used by investors to appraise company behaviour and performance across a range of environmental, ethical and social issues. A variation on this theme is where companies are admitted to a particular pool (for example FTSE4Good), indicating to investors that they are a company that adopts at least a minimum of standards with respect to their behaviour.

Third, we are increasingly seeing the development of league tables, ranking companies by either their behaviour or by improvements in their behaviour. There is nothing quite like a poor ranking against peers to spur organisations –financial or academic - to action!

So, in the field of corporate activity and in the area of equity and corporate bond investment, issues of corporate social responsibility (CSR) and socially responsible investment (SRI) are increasingly well established concepts – "CSR" relating primarily to how businesses manage the environmental and social impact of their activities and products, "SRI" relating more to how investments are managed. As I said, both of these are proving increasingly important to investment houses generally. Prudential Property Investment Managers Ltd is no exception.

Impact on property

To what extent are these ideas impacting upon or being embraced within the world of real estate? I am grateful to John Holmes and Graeme Newell for talking about CSR earlier and I applaud their vision in developing their interest in these areas.

My observation would be that the bulk of the effort in terms of real-estate related CSR in the UK has been focused on environmental issues and, in particular, creating environmentally sustainable new buildings through the development process and controlling energy usage in, and emissions from, existing buildings.

Less emphasis has been given to the social and community side, but it does exist. Our 'welfare-to-work' scheme - using our shopping centres as routes back into the workplace for youth and long-term unemployed - is one example.

However, what I want to concentrate on today – and why we at Prudential Property Investment Managers Ltd were keen to sponsor this morning's plenary session – is to explore what Socially Responsible Investment might mean for property investors and identify some areas of research which the mighty assembly of brain power brought together in this room today could very valuably drive forward.

My concern is that, with a few honourable exceptions, there is precious little thought being given to the issue of socially responsible property investment. I will argue, in the time I have remaining, that unless we properly conceptualise and ground SRI for property in a clear appreciation of the particularities of property as an investment class, investment houses might well 'thrash around' doing worthy deeds but potentially missing the major opportunities for property investors to contribute to one of the increasingly important issues of our day!. (To give one simple example of what I mean – it is clear that all the work being done on sustainable developments and construction is very important. However, if a business case could be constructed for doing something on the far, far more extensive existing stock of property, the cause of environmental sustainability could take a bigger step forward.

I will also argue that there is no simple 'read-off' from SRI in equities to SRI in property investment. As you will see, I believe it is actually more difficult to be a socially responsible property investor.

By identifying some of the differences surrounding the application of SRI in property, it is my hope that I can identify some key research areas which would help the development of SRI in property – where the potential for aiding the cause for sustainability is substantial.

Socially Responsible Investment: the impact of differences between property and equities

Mark Mansley (2000) defined SRI as

> *"investment where social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments, and the responsible use of rights……attaching to investment" (pg 3)*

As we can see from Mark Mansley's definition there are two main strands to the implementation of Socially Responsible Investment. There is one strand to do with the selection of assets for the portfolio. There is another that relates to the use of the powers or rights obtained through the investment process to encourage socially responsible behaviour by the party which has received the investment capital.

These techniques typically go under the names of "screening" and "engagement".

Screening – which can be positive or negative – effectively biases the stock selection process to ensure that satisfactory companies are deliberately included ("positive screening") and/or unsatisfactory companies are deliberately excluded ("negative screening").

"Engagement" is an increasingly important aspect of SRI whereby one might invest in (or at least not disinvestment from) an unsatisfactory company but, rather, one will engage with that company at the relevant opportunities in order to persuade it to change its behaviour.

In practice, according to a recent survey by Deloitte & Touche (2002), two-thirds of investment fund managers currently employ both approaches for the SRI equity funds they run.

Now, I am sure that the construction of an SRI policy for equity investment poses many issues and problems. However, in general, I believe SRI equity investment is made relatively straightforward by the nature of equities as an investment asset. In what follows, I am going to quickly review how property and equities differ as asset classes and how this affects the SRI-related processes of screening and engagement. In both cases, I will suggest that SRI in property is the more complex to implement.

Property versus Equities in SRI terms

At its most basic, share investment is simple. By acquiring shares in a company, one is entering into the part ownership of that entity. In this sense, it is a 'singular' and 'simple' investment. Essentially, one trade's ones capital for a dividend income from the profits of the company and any capital uplifts occurring in the value of those shares.

The equity market is relatively information rich, highly transparent and, most importantly, highly liquid. Analysts can relatively easily assess the performance of companies across a number of dimensions and report, to the investor. If that performance - whether financial, ethical or environmental - is poor, an investor can either liquidate that investment and move capital to a more acceptable company (which in the equities market can be done relatively speedily and cheaply) or, as seems to be increasingly the case, the investor can 'engage' with the company at the AGM or (for the more significant investors) confront directors at face-to-face meetings to express concerns about company performance. The performance of the company can be measured relatively straightforwardly, as can progress over time.

Compare this situation with the more complicated world of property and we will see that the meaning of SRI might well be the same in both markets – but its manifestation in the nature of SRI policy is likely to be very different.

Certainly here in the UK, we are used to thinking and talking about how different property is to other asset classes. Outdoing the old joke about the definition of "academic" – namely, two university dons turning the corner of an Oxbridge cloister and one saying to the other

"and eighthly" – Michael Brett in his book 'Property and Money' lists something like 16 differences that property has with other asset types.

The differences he lists include the usual suspects, namely, large and lumpy investment lot sizes, heterogeneity in location, built structure, tenant quality and lease terms, illiquidity, scarce information, no centralised clearing market, etc.

But, which of these differences make property different to equities in ways relevant to implementing SRI policies? I think there are four. They are all inter-related and they all pose interesting research questions.

Given that my emphasis is on 'direct' property investment, the immediate first difference between "shares" and property is the securitised nature of the former against the unsecuritised nature of the latter. As the name "shares" suggests, the investor becomes a joint or functional owner of the asset in question. This is most usually accompanied by voting rights. As such, the investor and the owner become a conjoined entity.

In property, this relationship between investor and investment is usually very different. In property, the investor will buy an asset and, through a lease contract, let that property to a user. The relationship between the investor and the tenant is, therefore, mediated through a contract where both parties have negotiated rights and responsibilities

Second, at its simplest, the equity investor has only a 'singular' entity to consider – the company. In contrast, the property investor is faced with a 'binary' entity embracing both the building <u>and</u> the tenant. So, in property one could have a good tenant in an environmentally damaging building, or a poor tenant in a good building. Immediately, the problem of investing in a socially responsible manner is more complex for property investors.

Let us now take this further and explore some related differences and their impacts. In equities, the investor has the capacity to terminate the relationship with an unsatisfactory company as fast as the market will allow – which is usually fairly immediately. As such, the relationship between the investor and the company owners has no effective fixity in term. Further support to this liquidity is given by Stamp Duty on equities operating at a level of 0.5% in the UK. As such, there is little financial impediment to transaction and re-investment.

Contrast that situation with property. If a property investor wanted to discontinue a relationship with a tenant then a number of hurdles would exist. If there was a desire to evict the tenant, they are given substantial protection - over a given period of time - by the agreed term of the lease contract and, in the UK at least, the landlord will need to be fastidious about how the tenant is informed of any non-renewal of that lease in order for the tenant not to be permitted to renew.

If a landlord was to consider selling the property to discontinue the relationship with the tenant or because the built structure itself was unsatisfactory in some way discontinue the relationship with the building – then, again, compared to equities, the property investor is disadvantaged. It usually takes around two months to sell the most liquid properties in the UK – high street shops. City of London offices take nearer four months and shopping centres nearer six months. Furthermore, not only is property illiquid but it is also expensive to sell a property and reinvest the proceeds elsewhere in property - with Stamp Duty at 4% and related professional fees adding a further 3%.

Thus, in contrast to the equity investor who can withdraw from an investment cheaply and quickly, it is far more expensive and time-consuming for a property investor to do so.

Engagement

The corollary of this level of tenant protection is that, albeit the property investor can attempt to 'engage' with tenants in much the same way that an equity investor might engage with a company, a landlord has far less power to impact directly on a tenant's behaviour once the relationship is established.

Tenants' rights set out what they can and can't do in terms of their use of a property. As such, the ability of the landlord to control, for example, energy use by tenants is also heavily constrained. A landlord controls the common areas in multi-occupied buildings, but has little control over what happens on the tenant's demise. This is true of both how the tenant behaves and the nature of that business.

Similarly, even when the investor feels comfortable after investing in a good building with a good tenant, tenants in the UK typically have rights to assign their lease. Such a clause will usually be based on a test of reasonableness such that, if the tenant wants to assign the lease to another entity of similar financial standing, the landlord cannot reasonably object. So, a good building/good tenant can quickly turn into a good building/unsatisfactory tenant.

Clearly, the property investor can engage very actively with the built structure – and, it is therefore perhaps not surprising that most thought and action relating to SRI "engagement" in property has been directed at buildings rather than tenants.

Of course, this is all relevant to when the relationship has been established and the investment made. How does the situation for the equity and property investor differ before the relationship and investment is made? Is property different in terms of stock selection screening?

Screening

The investible universe for both property and equity investors, particularly if considered in international terms, is substantial. The FTSE – All Share has 722 listed companies to invest in. The Alternative Investment Market augments this by a further 621 and, of course, overseas one has many thousands of companies to invest in. These companies will naturally present a spectrum in terms of their behaviour and attitudes to CSR issues.

As said earlier, the socially responsible investor increasingly has access to a variety of screening services that give information to investors on the environmental and social performance of these companies. These can be used to negatively or positively screen the investible universe.

At 31st December 2001, IPD recorded 11,940 properties (worth c£99billion) on its database – a big number. However, if one took two vague rules of thumb - namely that around only 2 per cent of the UK built stock is new each year and that environmentally responsible attitudes have only been prevalent amongst developers for, say, a decade, we might expect a maximum of 20 per cent of the stock would be of a standard acceptable to a choosy SRI investor. But, even in these more environmentally conscious times, probably only a quarter of the buildings built over that period would adhere to the highest standards. This suggests that there might only be 5 per cent of the existing built stock in the UK that would immediately "pass muster" for a dedicated SRI investor. I suspect it is even less than that. Properties are largely legacy assets, relatively few will be without blemish and most will be expensive to make them fully acceptable.

Furthermore, over and above the vast majority of the existing stock being from a vintage when ideas of sustainable construction had not been thought of, it will also, in the vast

majority of cases (one hopes) have tenants already in occupation. As in the equity market, these will form a spectrum from the socially acceptable to the socially unacceptable.

Clearly, the screening services used in the equity market could help socially responsible property investors think about who occupies their prospective investments. However, the more localised nature of property means that many prospective tenants – especially in smaller more secondary assets will be relatively unknown entities, requiring substantial case-by-case investigation in order for their credentials to be checked.

So, even at the investment stock selection level, the socially responsible property investor might have to work harder to screen his or her universe than an equity-oriented equivalent to find acceptable buildings and tenants.

Towards a research agenda

So, where does this all leave the property research community and what does it have to do with us? Well, first, I would say suggest that we as a community are expected to have something to say about these issues. There is mounting pressure to embrace these concepts, there is no straight read-off from equities and, therefore, a number of research requirements are immediately generated – which few others have the knowledge to address.

I would say at the outset that there are some key questions that we need to be addressing and that, as a collective, property researchers have a lot of answers in some areas but almost none in others.

Let me first list the questions and then review what work has been done and what still requires to be done. If SRI and CSR are not 'things' in their own right but, rather, ways of doing things, then I would expect them to have resonance and relevance for us all. For me the main research questions are

- What are the characteristics of a socially responsible property investment?
- How might socially responsible property investments perform?
- What are the most appropriate measures to monitor the performance and progress of socially responsible property investment?
- What should policy-makers and others be doing to best progress socially responsible property investment?

What are the characteristics of a socially responsible property investment?

This is the area where property researchers are strongest. We have done a lot of work on the use of green materials in building use and construction, identifying sustainable development and best construction practice at site and urban design levels. In related disciplines, there have been a terrific amount of work done on energy and emissions management.

On the social dimension of property portfolios, I haven't seen much work. However, EIRIS and other types of screens could clearly be evaluated for their relevance and transferability for use in a property investment management context. There would clearly be great benefit in someone exploring what scope exists, and what ways are best, for engaging with tenants.

I would certainly like to see a lot more work emerging on the most cost-effective actions landlords can take to move their existing stock towards being more socially responsible investments. In the short term, a small improvement on the 97% of buildings that constitute

the existing built stock will far outweigh any improvements through radical changes to the development process. We and policy-makers should rightly be interested in both areas.

Looking at what positive things property investors can do, again most existing literature is environment focused. The work done on reviewing the investment case for urban regeneration is very important in this respect. Much could be done to review the community work of property investors and provide analysis and information to help develop and share best practice between investors. All of these key areas would be valuable to feed back into the educational process.

How might/do socially responsible investment perform?

Having developed a reasonable view of what a socially responsible investment might look like, investors - aided by researchers - need to understand how they might and do perform in comparison to less responsible property investments. If these asset characteristics were to be deemed important over time and begin to be included in investors' appraisals of asset worth, then over time they will also filter through into market pricing, influencing delivered performance on the way.

For example, what added risk premium is appropriate for what level of contamination in land? Are contaminated land sites currently mispriced? What adjustment might be made to one's rental growth estimates for an asset that is a long way from a public transport node in a world of rapidly increasing real costs of fuel – are business parks and retail warehouses currently mispriced and, if so, by how much? What risks and return implications should appraisals include relating to air-conditioned offices?

The list is endless – but, to what extent are any of these current and future risks included in current valuations? Does this mean assets are currently mis-priced and to what extent? Is there any evidence to suggest that such features have already begun to influence asset and fund performance?

In many ways, these diverse questions can be summed up as a general assessment of the business case for SRI in property.

I am pleased to say that this is an area we at Prudential are particularly interested in and we are working with Sarah Sayce at Kingston University, Louise Ellison at Portsmouth University, and a host of others (including the USS, IPD, Drivers Jonas, Boots, Forum for the Future, IPF and the DTI) on a major research project into these areas.

What are the appropriate measures to monitor the performance and progress of socially responsible property investments?

Following on the same theme, what measures might best monitor performance and progress in terms of socially responsible property investment? Albeit with some differences and particularities, we can - in the UK - measure the investment performance of our property portfolios in much the same way as we do our equity and bond portfolios.

But – and I'm not sure the equity sector is very far ahead of us in this respect – we have little currently available that allows us to monitor the environmental and social performance of our property portfolios.

The challenge exists – and presumably relates in large part to identifying the features of socially responsible property investments – to find simple mechanisms by which individual properties can be scored in terms of their social and environmental 'impact'. Some thought from organisations like the Building Research Establishment is going into this issue – but it is mainly being driven by construction technicians more than investment and valuation professionals.

What sort of simple measures can be developed that are reasonably robust for the task in hand yet can be applied with ease, *en masse*, to the built stock of our countries? If such a mechanism can be defined and data gathered in sufficient quantity then, I believe, SRI in property and our industry's contribution to the sustainable development of our globe would take a massive leap forward.

With such a measure, we could score, benchmark and rank bothinvestors' and occupiers' portfolios. We could identify and rank how different portfolios are 'improving' in this respect over time. We could correlate the environmental and social performance of portfolios with investment performance. With these building blocks, we could further examine the business case for socially responsible investment.

What should policy-makers and others be doing to best progress socially responsible property investment?

Not really a key driver for this paper, but an obviously corollary of its contents, is whether or not there are lessons in the above for policy makers.

Policy makers at central and local government level are clearly moving the property industry towards the greater goal of 'sustainability.' Much of this policy simply impacts property as part of its impact on all industries. Carbon taxes, energy and emissions regulations are of this type. There is also policy which is more deliberately environmentally focused. Sometimes this is aerially-based, to either encourage or protect areas from development, sometimes it will be more general.

All of this is valuable but I can't help thinking that, if policy-holders were given a better understanding of how the microeconomics of property ownership and occupation work, and how policy measures of different types might impact on the economic, environmental and social performance of a property, then they would be much more able to fine-tune policy and regulation to obtain the best impacts for the public good, whilst minimising any impact on investment performance.

For example, would the encouragement of fully serviced leases help energy management in buildings by bringing it fully under the single control of the landlord – who in turn could be incentivised to reduce usage? Should local property or other taxes be modified in some way to reward energy efficiency? Should carbon dioxide emissions be treated as externality effects from buildings and, thus, become a legitimate concern for local planners? Etcetera, etcetera. The list could be long – but could be prioritised in ways sensitive to how property occupation and investment actually work.

Conclusion

So, I would conclude briefly by re-iterating that SRI is here to stay and it requires our attention

SRI in Property exhibits many differences - in terms of its operationalisation - to that witnessed since the mid-1990s and before in equities. These differences can be traced directly to the different characteristics property possesses as an asset class – in particular, its illiquidity, its socially and economically determined contractual basis and its essentially binary nature as an investment.

These differences mean that there is no ready "read-off" from equities to property with respect to SRI. This, therefore, means there is a plethora of property research questions being raised for which answers are increasingly urgently required.

I am sure my list of questions is woefully lacking. But I lay them before you simply to tempt you to get involved in, what I feel certain, will be a burgeoning area of research. Because, as I have said, SRI is not a thing in itself but, rather, a way of doing things, I hope it will be of relevance to us all going forward.

I can't think of a better group to speak to that can rise to the challenges posed.

References

Mansley, Mark (2002): Socially Responsible Investment, *Pensions Week*, March 2000
Deloitte & Touche (2002): Socially Responsible Investment Survey 2002, Deloitte & Touche