

# The Need for Really Ethical Real Estate Funds

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## INTRODUCTION

When constructing a diversified portfolio of investments (whether ethical or conventional) it is necessary to have access to a range of asset classes. In this context, property funds can be extremely helpful due to their different investment characteristics including lower correlations with other, more conventional, asset classes such as equities and bonds. For background on the benefits of diversification in portfolio construction and different asset classes see [1].

A number of fund management houses collectively provide a decent range of ethical equity funds with a useful geographical spread. Although fewer in number, a reasonable range of ethical bond funds are also available. However the availability of ethical property funds appears much more limited. A number of fund managers offer more bespoke ethical property solutions for higher value investors, but there appear to be very few property funds aimed at retail investors. That said there are a small number of retail property funds available – so what would appear to be the issue?

This paper outlines the characteristics of the small number of ethical property funds available to retail investors, before exploring the aspects that committed ethical investors are likely to find less acceptable. Suggestions are made as to how such funds could be improved, as well as exploring how a number of difficulties in developing such products might be addressed.

## REALLY ETHICAL?

For an overview of ethical investing and the different approaches commonly used see [2]. A number of different terms are commonly used, but for brevity in this article the term 'ethical investing' will be used interchangeably with 'socially responsible investing', 'responsible investing' and 'sustainable investing' except in cases where a useful distinction can be drawn; definitions of these terms are offered in [3]. Companies are encouraged to promote practices including environmental stewardship; consumer protection; human rights and support the social good [3], [4]. One focus is on environmental, social justice and corporate governance issues (ESG). In sustainable investing, funds are directed into companies with business practices capable of being continued indefinitely without causing harm to current or future generations, or exhausting natural resources (i.e., not 'unsustainable'). Sustainability is often defined as ensuring development meets the needs of the present without compromising the ability of future generations to meet their own needs [5].

It appears that retail ethical property funds generally apply their ethical values to 'the buildings' but not in their choice of tenants. Thus the properties themselves are ethically managed, with environmental objectives, energy efficiency and so-forth in mind; but no commitment is made in terms of ensuring tenants are ethical. To be clear an ethical property fund could have an 'ethically managed' building occupied by a tenant operating a company whose business would be unacceptable to an ethical investor.

Since the tenant's rent ultimately makes a large contribution to fund profits, this means that such an ethical property fund could easily be generating returns from unethical practices, which in turn would be passed on to those investing in the fund.

In this context one might ask what managing buildings 'ethically' means? Often this will include energy efficiency and environmental standards etc. However, the efficiency gains and enhanced profitability from these areas may well be what would already be expected from any competent manager with an eye on maximising profits. In this context such management does not appear especially ethical after all.

Some ethical property fund managers may make donations to charities or support local causes. These should not be diminished, they are worthwhile activities, but they may still use profits potentially deriving from a tenant engaged in ethically unacceptable activities.

### Other ESG Aspects

Following the template of sustainable investing with environmental, social and governance considerations, property fund managers should also consider other aspects apart from environmental standards and energy usage.

Considering the social dimension, managing a building ethically should also mean buildings are adapted and accessible for people who are deaf, blind or who have a disability. This would be a genuine social good, particularly if efforts are made to ensure that improvements made exceed minimum standards.

Best practice in this area might also incorporate the following:

- Commitments to formal standards and initiatives for carbon and energy usage.
- Health and safety monitoring, with certification above minimum standards.
- Avoiding geographic exposures to counties with known corruption issues.

Apart from owning properties directly, property fund managers can obtain property investment returns by holdings in Real Estate Investment Trusts (REITs), a form of closed-ended collective investment vehicle that bears similarities with more familiar equity Investment Trusts (for more detail see e.g. [1]). For funds of REITs providers can, of course, complete due diligence on the REITs they select that would also include governance, along with environmental and social considerations.

### THE PRICE OF CONSCIENCE

The steps above may have merit, but they still do not address the issue that tenants may be in businesses that would be unacceptable to an ethical investor.

The argument used by fund providers against placing restrictions on the ethical activities of tenants seems to be that it would restrict the number of tenants available; thereby reducing demand and the rent that could be charged. This seems to be based on the logic that 'profits are king', the sort of argument one might expect from a conventional fund manager.

However this argument appears very similar to an argument that has been used against ethical investing in the equity arena. It sounds very much like a variant on the 'price of conscience' argument used around ethical investing in other sectors. Investors often perceive that ethical investing must reduce the number of investment opportunities, with the smaller 'opportunity set' reducing diversification possibilities, resulting in worse returns, higher risk, or weaker portfolio performance. A number of counter-arguments to this position based around the interplay between ethical investing, risk and competitive advantage are explored in [2]. Overall, it might be worth noting that the 'price of conscience' argument does not

seem to put off ethical investors in the equity and bond arenas, so there is little reason to believe it would in the context of real estate.

### Practical Difficulties

An argument against placing ethical restrictions on tenants' activities might be that it would be extremely difficult to manage a substantial property portfolio when unethical companies are excluded as tenants. Suppose a 100,000 square foot space when the only potential tenant is a multinational corporation wanting a 20 year lease, but the corporation is engaged in unethical activities – can a manager in good conscience not lease the space? But this logic assumes a very large property fund. Do ethical property funds really need to be that big? A £500 million property fund would permit 50-100 buildings in the £5-10 million range, quite small by real estate fund standards, and far less likely to face the problem outlined above.

Another aspect is that fund managers wishing to ensure their tenants are ethical will need to decide on the criteria to use. This could involve screening along the same lines as identification of ethical companies (particularly in the case of corporate tenants), but could also include additional requirements, perhaps relating to the readiness to accommodate factors relevant to the properties in question, such as preservation of historical buildings or other issues.

Ultimately many ethical investors simply do not believe in the price of conscience. Indeed, often based on experience, they suspect it is the reverse argument that is true. It may be the ethically-careless investors who are (or will be) losing out on performance due to the sustainability benefits and competitive advantage that ethical investing brings.

### WHAT WOULD REALLY ETHICAL INVESTORS WANT?

If an ethical individual were to purchase a commercial property directly, how would they select their tenants? They would probably exclude tenants they deemed unethical. Fund managers could put themselves in the shoes of such an individual when selecting tenants.

In the equity and bond markets, ethical investors are prepared to use the indirect means of market capitalism to direct companies – making ethical development capital cheaper by either more highly valued shares (new capital raising from share sales), or more valuable bonds (lower interest rates). So from an ethical investor's perspective, why would they not want to use the direct influence that a landlord has to select tenants to encourage ethical behaviour? That may mean ethical tenants benefit from cheaper rents or greater availability of rental units, but it may also mean that landlords do not suffer from knock-on problems that less ethical tenants can generate. In this respect the arguments may mirror those surrounding the returns from ethical investing in other areas.

### LIQUIDITY ISSUES

As a new subset of an asset class, liquidity may be a problem for ethical funds in direct property. In this context, it is possible that REITs may offer a partial solution. As a closed-ended property investment vehicle REITs may reduce immediate liquidity concerns for investors, since there would be no fear of the potential lock-ins experienced by some investors in open-ended property funds.

However, for better property diversification one might prefer an open-ended fund of REITs. This would have to await the appearance of a sufficient number of really ethical REITs (here denoted RE-REITs), with ethically approved tenants.

In this context a fund of RE-REITs would seem an excellent solution, even if such a thing might be some way off. In the meantime a reasonably diversified RE-REIT would be a good starting-point for an ethically-minded property investor.

## CONCLUSION

Ethical investors seeking retail ethical property funds may find that available solutions are limited, and that those that can be found only manage their buildings ethically, whilst tenants may be engaged in businesses they would deem unethical. This seems deeply unsatisfactory.

The arguments against really ethical property funds, with ethically approved tenants as well as ethically-run buildings appear to involve the 'price of conscience' essentially mirroring similar arguments used against ethical investing in other asset classes. Arguments that are disputed by ethical practitioners.

For the ethical investor it appears that there is a significant gap in the market, with a notable lack of really ethical real estate (RE-RE) funds available for retail investors – whether in the form of open-ended RE-RE funds or closed-ended RE-REITs. This being the case, ethical investors would benefit if fund providers were to launch a number of really ethical real estate funds which would also provide benefits in portfolio construction for diversification as well as being useful investment vehicles in their own right.

## REFERENCES

- [1] Q. G. Rayer, *Portfolio Construction Theory*, 4th ed., London: Chartered Institute for Securities and Investment, 2017.
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