

## **In Search of Really Ethical Real Estate Funds for Retail Investors**

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# **In Search of Really Ethical Real Estate Funds for Retail Investors**

Just as conventional portfolios benefit from diversification into a range of asset classes, including property; ethically-invested portfolios also benefit from diversification into ethical property funds. While ethical equity and bond funds are reasonably abundant, ethical property funds are much harder to find. A few do exist, but these appear to raise some ethical issues in their own right, in particular, the role of ethical criteria relating to tenants' activities. It would appear that in this respect there is a gap in the ethical product range provided by the fund management industry with a lack of property funds that would meet the requirements of committed ethical investors.

Keywords: ethical, investment, property, real estate, fund, collective, REIT, mutual fund, tenants

## **1. Introduction**

When constructing a diversified portfolio of investments (whether ethical or conventional), it is necessary to have access to a range of asset classes. For portfolios of collective investments, property (or real estate) 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. The benefits of diversification across different asset classes are well established in portfolio construction for reducing risk and enhancing risk-adjusted returns (Markowitz, 1952, 1957), or for a more general discussion see, e.g. Fabozzi (1995), or Rayer (2018).

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 for retail clients in the UK appears much more limited. Some fund managers offer bespoke (individual personalised) ethical property solutions for

high-value investors<sup>1</sup>, but there appear to be few ethical property funds aimed at retail investors. That said there are a small number of ethical retail property funds available – so what would appear to be the issue?

This paper outlines some typical characteristics of the small number of ethical property funds available to retail investors, including some ethical aspects that are considered in such funds. However, there are aspects that committed ethical investors are likely to find less acceptable; this paper focuses on one such aspect, namely consideration of the activities of commercial property fund tenants from an ethical perspective. These can include commercial activities typically involving (or associated with) alcohol, tobacco, gambling, pornography, armaments, nuclear power, and animal testing; as well as sustainability with focus on the environment (including carbon emissions, pollution, fossil fuels and intensive agriculture), social issues (including worker exploitation, modern-day slavery and aggressive tax minimisation strategies) or governance (including excessive executive remuneration, corruption and bribery), see e.g. Rayer (2017).

Some general suggestions are made as to how ethical property funds might be improved before focusing on the issue of whether the activities of tenants could be included in the ethical fund management process. As a practitioner engaged in ethical fund selection on behalf of retail clients, it appears illogical to this author that an ethically inclined investor would avoid investing in the shares of a company involved in

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<sup>1</sup> The author would not wish to promote the services of specific companies offering services in this area, however an internet search based around variants of ‘bespoke property fund’ yields some potential examples.

(say) tobacco production, but be content to earn rental income indirectly from the same tobacco company via investment in a commercial property fund.

The paper goes on to ask whether fund performance might be expected to be impacted by such an approach before exploring how several difficulties in developing a real estate fund with both buildings and tenants managed ethically might be addressed.

The current paper is written from the perspective of a UK investment practitioner constructing portfolios for retail clients using collective investments. Thus it has a primary focus on the UK fund management sector, UK legislation and UK-based legal examples. In some areas examples from other geographic jurisdictions have been included, both because UK examples appeared sparse, and to help other researchers explore similar lines of argument in their own countries. The author is a practicing UK-based wealth manager involved in fund selection using publically-available products for retail clients, and the present paper reports a gap in the UK property fund sector. In this respect, the author represents a client-base seeking a solution in the retail ethical property fund segment which does not appear to be generally available. While the arguments presented may be incomplete, it is hoped they will be sufficient to promote discussion and development in this area, encouraging other researchers to further develop arguments around topics such as the finer legal details and performance benefits of ethical management in relation to commercial property both in the UK and elsewhere. Ultimately the author hopes this will help promote the development of funds that consider not only the sustainability of the buildings but also the ethical activities of their commercial tenants.

## **2. Really Ethical?**

For an overview of ethical investing and the different approaches used see Rayer

(2017). A number of different terms are commonly used, but for brevity in this article the term ‘ethical investing’ is 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 Krosinsky & Robins (2008). Companies are encouraged to promote practices including environmental stewardship; consumer protection; human rights and support the social good (Krosinsky & Robins 2008, Krosinsky, Robins, and Viederman 2012). One focus is on environmental, social justice and corporate governance issues (ESG), see, e.g. Krosinsky & Robins 2008; Krosinsky, Robins, and Viederman 2012, and the UN Principles for Responsible Investment<sup>2</sup>. In sustainable investing, funds are directed into companies with business practices capable of being continued indefinitely<sup>3</sup> without causing harm to current or future generations, exhausting natural resources (i.e., not ‘unsustainable’), and thereby supporting long-term ecological balance. 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 (Bruntland 1987). Although other definitions exist, some commentators have expressed concerns that the concept has been stretched to suit business interests with different agendas<sup>4</sup>. In the context of buildings, sustainability can relate to construction, including materials and labour as well as the on-going use of a building during its lifetime which is the

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<sup>2</sup> <https://www.unpri.org/asset-owners>.

<sup>3</sup> See Rayer (2017) and <http://www.thwink.org/sustain/glossary/Sustainability.htm>.

<sup>4</sup> See e.g. <http://www.globalfootprints.org/sustainability>,  
<http://blogs.rochester.edu/thegreendandelion/2013/06/5-definitions-of-sustainability/>,

including Hargroves and Smith (2006).

primary focus of the present paper.

Property funds usually focus on commercial buildings such as shops, warehouses and offices, rather than domestic residential buildings, and so may be called ‘commercial real estate’ funds, although a small number of ‘residential’ property funds do exist<sup>5</sup>. A ‘direct commercial property’ fund will own physical buildings, managing and letting them to generate returns for its investors. Typically, retail property funds focus on the rental and management of existing buildings and do not get involved in property construction.

Funds are often ‘open-ended’ (meaning that the fund size may expand or contract as investors buy or sell units or shares in the funds from the fund manager), but collective investments may also be ‘closed-ended’, which operate with a fixed number of shares so that investors must buy or sell shares from current investors, for more detail see, e.g. Rayer (2018).

For larger investors, with substantial sums to invest (maybe £100 million or more), private (or ‘bespoke’) property investment solutions may be available (see note 1). However, information on such solutions is not readily available since these can be subject to private negotiation between clients and property managers. The issue raised in this paper considers the construction of diversified portfolios for smaller retail clients with sums of maybe only £10,000 or more to invest. In this case, bespoke property portfolios are not a practical proposition, particularly as the property element would only be a small fraction of the total portfolio value.

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<sup>5</sup> See e.g. Bloomberg (<https://www.bloomberg.com>) which lists residential property funds for the UK, Germany and the US among others.

Regarding property sustainability, UK resources include the UK Green Building Council<sup>6</sup>, and BREEAM UK<sup>7</sup>; internationally, two major resources in the US are LEED and BOMA, with BOMA BEST in Canada<sup>8</sup>. As an example, the LEED (Leadership in Energy and Environmental Design) green building system was developed by the US Green Building Council (USGBC) and allows third-party certification of any building type and focuses on seven key areas: sustainable sites, water efficiency, energy and atmosphere, materials and resources, indoor environmental quality, innovation and design, and regional priority (see IIED 2017). Buildings are assessed and points assigned, with certification on an ascending scale of positive environmental impacts and human benefits, from a base level of ‘certified’ through to the highest standard of ‘platinum’. In the latest version, LEED v4, members of the USGBC voted to include ‘cradle to cradle’ certification which will include credits for where building materials are sourced and purchased. The idea is that only materials and processes that can be reused endlessly should be included in product design, with ratings based around the ideas of environmentally safe and healthy materials, designed for recycling or composting at the end of life, manufactured using renewable energy and carbon management, including considerations of water stewardship and social fairness (GreenBiz 2013). BOMA (Building Owners and Managers Association International) is a federation of US associations and international affiliates with a mission to advance the commercial real estate industry which provides information on green and sustainable

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<sup>6</sup> <https://www.ukgbc.org/>.

<sup>7</sup> <https://www.breeam.com/>.

<sup>8</sup> <http://bomacanada.ca/bomabest/>.

building operations and practices, advising on training, best practices and certification for commercial buildings, including LEED and other standards (see BOMA 2017).

Standards such as the above make a valuable contribution to the sustainability of buildings in the commercial property sector. However, 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 business tenants are pursuing ethical activities. 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. Tenant business activities that an ethical investor may find unacceptable are likely to include those mentioned above, such as involvement with alcohol, tobacco, gambling, pornography, armaments, nuclear power, and animal testing: as well as relating to sustainability with focus on the environment, social issues or governance, see the introduction and Rayer (2017).

Since the tenants’ rents ultimately make a substantial 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.

For a retail investor in a commercial property fund comprising a portfolio of pre-existing buildings, one might ask what managing buildings ‘ethically’ means?<sup>9</sup> Often this will include energy efficiency and environmental standards and so forth. However,

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<sup>9</sup> Of course, at the construction stage, energy efficiency also depends on building design, materials and technology used.



the efficiency gains and enhanced profitability from these areas may well be what would already be expected from any competent manager with an eye to 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 be using profits potentially deriving from a tenant engaged in ethically unacceptable activities. Thus to be 'really ethical' it would appear that a real estate fund should manage both buildings and tenants according to ethical and sustainability criteria, with funds doing so here denoted 'really ethical real estate' (or 'RE-RE') funds.

The concept is therefore to avoid commercial tenants engaged in businesses that ethical investors would regard as unacceptable (as described above). Following the logic of ethical investment in other asset classes (see, e.g. Rayer 2017) this provides an avenue for using market forces to nudge businesses away from unethical behaviours. Some of the challenges this is likely to involve are discussed below (perception of loss of profitability in management, practical difficulties, legal issues and investor liquidity requirements). Given that the approach of managing retail property funds in this way with ethical and sustainability criteria applied both to buildings and tenants appears to be a new concept, at this stage evidence is lacking as to how successful it may prove; although, as mentioned, the author represents a class of investor that would like to have access to such funds.

## ***2.1 Other ESG Aspects***

Energy and environmental matters are, of course, important and commercial property is estimated to generate around 10% of the UK's greenhouse gas emissions while

consuming 7% of UK energy (Dixon 2014). However, 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.

Sustainability, with its emphasis on ESG issues (environmental, social and governance) focuses attention on three key dimensions (Rayer 2017):

1. Environmental, including CO<sub>2</sub> emissions, or carbon-intensity; forest and woodland degradation (significant for absorption of atmospheric CO<sub>2</sub>); airborne, water-borne or land-based pollution; usage of scarce resources, including water and living creatures as well as minerals, oil and natural gas; mining activities which generate toxic by-products; over-fishing, intensive agricultural methods and so on.
2. Social, including corporate social responsibility (CSR); child labour; modern-day slavery; payment of non-living wages; hazardous, exploitative and/or coercive working conditions; structures that reduce corporate taxation bills to levels incommensurate with the profits and activities taking place in those countries; anti-social working hours or conditions; displacement of indigenous peoples.
3. Governance; companies with weak internal controls may have management not following company policies, increasing risks of irresponsible behaviours, corruption and bribery. At the board level, weak governance may mean that non-executive directors (NEDs) are unable to hold powerful executive directors in check, with possible damage to the company as well as the owners' (shareholders') interests, and increased risk of excessive executive remuneration.

Regarding commercial property funds, the primary focus of attention has tended to be on the environmental aspects, with emphasis on energy, water and materials. If retail property fund managers were to turn their attention to also considering the business activities of their tenants, this might allow greater emphasis to be placed on the social and governance aspects of sustainability. It would also enhance the ethical 'reach' of environmental aspects, for example, the ethical property fund manager landlord could consider not only the environmental aspects of a building but also the nature of the commercial activities of the tenant. If a prospective tenant was engaged in a business deemed harmful to the environment, as the landlord, they could decline to let the premises to them.

Considering the social dimension, managing property 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, especially if efforts are made to ensure that improvements made exceed minimum standards. Just as high energy efficiency performance standards are an essential part of marketing a property and can potentially enable higher rents (Dixon 2014), it is likewise possible that enhanced accessibility measures and other design aspects that benefit the social uses of a building could make it more attractive to potential new tenants, or generate loyalty from existing tenants, and hence be beneficial to the landlord from a marketing perspective.

Using ESG factors in turn, to help focus on different aspects, motivates the following further suggestions to incorporate into best practice in this area:

- Commitments to formal standards and initiatives for reducing carbon emissions and energy usage.
- Health and safety monitoring, with certification above minimum standards.

- For funds with international property exposures, avoiding, or increasing due diligence, around property investments, or tenants, associated with countries with publically reported corruption issues. Equally, due diligence would have to be carried out into the corporate governance of potential business tenants.

Hedonic regression studies have been used to explore the value added to properties as a result of a range of factors. Stephenson (2012) showed that the EarthCraft House green building certification, with its focus on environmental issues, added an 8.3% property value premium in the US Atlanta area during the period between 2007 and 2010. de Ruggiero et al. (2017) gave a review and showed that for a comparison of flat sales in a condominium in Cetraro, Italy, energy performance made the most significant contribution to the formation of market value. While other studies have explored the impact of issues such as road and rail noise (Andersson, Jonsson, and Ögren 2009), proximity to parks and open spaces (Treg 2010), and links between residential property value, location and health (Coffee et al. 2013), there does not appear to be a literature on the market pricing benefits of socially-focused improvements to buildings, or on tenants.

As well as new developments that meet high energy and water efficiency standards, another approach where fund managers may be able to add value is when older buildings would benefit from the ‘retro-fitting’ of modern technologies. Although the commercial aspects would have to be considered, examples in the context of domestic property include the UK Government’s 2013 ‘Green Deal’ and the more successful ‘Kirklees Warm Zone Scheme’ (Bergman & Foxon 2017).

Although the primary focus of the current work is to the UK, it can be interesting to compare with other countries. Across Europe, Sweatman (2012) concludes that energy efficiency retrofitting activity is below 50% of that required to meet 2020 goals, identifying a need to create mechanisms to stimulate investment of the order of €100 billion per year from both public and private sources, with a significant role to be played by national governments. Within this context, it appears that the UK and Germany have in place structures and policies that are successfully engaging banks and energy suppliers and have the potential programme capacity to meet the funding amounts forecast for their optimal national energy retrofits.

For the USA Bardhan et al. (2013) conclude that significant energy savings appear to be both technologically and financially feasible and review possible market failures that have hampered uptake. They identify two major bottlenecks, imperfect information concerning issues such as products and cost-benefit analysis, and loan market efficiency for providing finance on suitable terms for retrofitting improvements. Regarding financing, they believe that 'on-bill' financing and the PACE (Property Assessed Clean Energy) programmes have significant potential to expand loan access for improvements. They also cite the success of approaches adopted around solar PV installations. While these schemes may be necessary for domestic property owners, property fund managers with interest in improving their building portfolios can consider investment as a commercial proposition. Since Bardhan et al. (2013) concluded that the energy savings were both technologically and financially feasible, but that market financing was the bottleneck hindering progress, although a US example, this implies that there might be a commercially profitable opportunity for a larger-scale professional landlord (such as a property fund manager) to explore.

Dixon (2014) investigated retrofitting in UK commercial property, concluding that progress in this sector is slow, being hampered by complexity, fragmentation and conservatism (Dixon observes that the sector remains conservative and risk-averse). In this respect, professional management may be able to earn returns addressing these challenges once they have acquired the necessary skill-sets. In commercial property, it appears the key drivers relate to policy, economic factors such as energy costs and market reputation, with a focus on overall cost and value, organisational issues and lease structures. He observes that retrofitting also relates to water and waste as well as energy. Although broader than the usual primary focus on energy, these aspects still only sit within the 'environmental' factor in terms of sustainability and an ESG template.

Although commercial property would not necessarily use the same financing mechanisms as domestic property; property fund managers would be most likely to approach retro-fitting as a commercial proposition viewed through an ethical lens on a building-by-building basis. If ethical real estate fund managers were to retro-fit older properties, this would provide environmental benefits both in terms of efficiency gains with emissions reductions and preservation of architectural heritage. Although, at times, there may be higher gains made in terms of (say) energy-saving by new construction, from a social dimension preservation of historical buildings by making them fit for purpose in a modern environment, can also be considered a benefit.

Similar approaches could also be applied to residential property funds. Interest by ethical property fund managers in retro-fitting would also help stimulate further development in this area.

Retail investors and property fund managers can also gain exposure to commercial property through the collective structures offered by 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. Rayer 2018). 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. A relatively small number of ethically-orientated funds of REITs do exist, although in the wealth management sector these can be limited by smaller fund sizes (say under £100 million in assets under management), which makes them less attractive for retail investment propositions. Regarding investment in individual REITs directly, while some REITs exist that perform above sector norms in terms of ESG factors, specialised due diligence may be required to assess their sustainability credentials, which would likely prove difficult for retail investors. Also, REITs can often be relatively focused property investments making it difficult for retail investors to achieve meaningful diversification without access to collective investment structures.

## ***2.2 Some Existing UK Property Fund Approaches***

While there is no intention to include a survey of the state of the retail ethical property fund sector in the UK, it is helpful to add a brief outline illustrating the sorts of products currently available to UK retail investors seeking ethical direct commercial property funds.

The more ethically-orientated of UK commercial property funds can include both direct commercial property and funds of REITs, with fund sizes ranging from a few tens of millions to tens of billions of pounds sterling. The primary emphasis is on the sustainable management of the physical buildings, including considerations of carbon emissions, energy and water usage, and potentially other issues such as recycling facilities and local biodiversity. This may include energy, carbon and water reduction targets, improvement of properties' energy efficiency and the inclusion of carbon

positive buildings (which produce more energy than they use) within the portfolio. The measurement of carbon impact may also be extended to suppliers. On the social side, during construction or refurbishment consideration can be given to the use of local suppliers and labour, or attempting to measure the social benefit created by the building in the local community.

However regarding tenant interaction, while there may be encouragement to make use of solar energy provided by buildings, or encouragement to engage with local issues; interest in the ethical and sustainable implications of tenant's business activities appears absent. In the case of funds of REITs, of course, the manager owns shares in companies that themselves own a portfolio of properties, making the fund-of-REITs manager a shareholder in a firm which is the landlord to the tenants in question. This further removes the fund-of-REITs manager from the underlying tenants, so that unless the individual REITs selected for inclusion in the fund have ethical policies in relation to their tenants, the opportunity for influence is very much restricted (for further detail see the discussion on REITs and RE-REITs in the section preceding the conclusion).

### **3. The Price of Conscience**

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

In the experience of the author during discussions with UK property fund managers, one argument used by fund providers against placing restrictions on the ethical activities of tenants appears 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 appears 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. In summary, many investors in the financial sector often perceive that ethical investing must reduce the number of investment opportunities, implying a smaller ‘opportunity set’<sup>10</sup> and reduced diversification possibilities, resulting in higher risk, and in risk-adjusted terms, weaker portfolio performance (see, e.g. Langbein and Posner 1980; Knoll 2002).

An overview of some counter-arguments to this position based on the interplay between ethical investing, risk and competitive advantage are explored in Rayer (2017). While it can be difficult to prove that one investment style or another is superior over an extended period, proponents of sustainable investing argue that unethical corporate behaviour and unsustainable practices lead to increased risks (Krosinsky, Robins, and Viederman 2012; Kiernan 2009). Harmful behaviour by companies eventually leads to negative consequences for them, generally having a detrimental effect on growth, profits and share price, leading to market underperformance, thereby running risks that are not well reflected in share price. A number of the statistical analyses of share price reviewed in the section on ‘performance’ below would appear to support this position. By excluding these companies, an investor is removing sources of unrewarded risk from their portfolio. Such practices can increase the likelihood and consequences of

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<sup>10</sup> The investment opportunity set for a portfolio may be considered as the range of risk and return outcomes possible using different exposures to the available set of assets that could be selected. Closely tied with Markowitz (1952, 1957) diversification and the efficient frontier, a larger opportunity set would generally be expected to be associated with the possibility of lower portfolio risk, higher returns or superior risk-adjusted returns.

litigation against a company, cause reputational damage to brands, or make customers and clients decide they do not wish to be associated with the company and take business elsewhere. Examples of other risks may include increased government regulation in response to poor industry standards increasing costs (Helleiner et al. 2009); climate change issues causing carbon permit trading (Stern 2006); ethical behaviour giving a company a 'social licence to operate' avoiding resentment about activities, or its reverse (Kiernan 2009); increased insurance premiums as a result of a poor sustainability track record, increased cost of capital due to investor concerns; and risks associated with emissions and waste discharges. Weber, Scholz, and Michalik (2010) also demonstrated a link between sustainability criteria and credit risk for rating commercial loans, with sustainability having a positive effect on firm performance.

Analysis has also begun to quantify the contributions to climate change from individual nations (Skeie et al. 2017) and companies (Ekwurzel et al. 2017), including changes in extreme event frequencies (Otto et al. 2017). As one example of the potential for corporate consequences, Rayer and Millar (2018) outline how the scientific links between extreme weather events, global warming and carbon emissions by specific companies could imply an approximate 1.5% detriment to their market capitalisations (or share prices) due to damage from the 2017 north Atlantic hurricane season alone, under a hypothetical climate liability regime.

### ***3.1 The Value of Reputation***

For a retail property fund managed according to criteria that include consideration of the ethics of the business activities of its tenants, questions relating to the benefits of a good reputation can relate to the tenant. A business tenant's good reputation may enhance their ability to fulfil their obligations to their (fund manager) landlord, including at the

most basic level, regular payment of rent. There may also be an association between the reputation of the tenant and their physical location.

An honest and trustworthy reputation attracts customers and potential business partners, creating economic opportunities (Boatright, 2009). Does this pay? Business pioneers such as The Body Shop (founded in 1976) and Ben & Jerry's ice cream placed ethical and social considerations deep within their offering (Schwartz 2008). The reputation of an organisation can be regarded as the 'social memory' of its stakeholders which acts as a platform for expectation, with a good reputation being an asset and a bad one a liability (Brady and Honey 2007). They suggest that reputation influences stakeholders and can be wrapped up in personalities (consider Anita Roddick and The Body Shop, Richard Branson and Virgin), and that a company balance sheet does not reflect the total resources available to many organisations, with some directors inspiring confidence and thus encouraging investment.

In this context articulating risk shows not weakness but honesty and realism, while the reluctance to report can indicate denial. Reputation is ultimately a measure of trust, once gone it is difficult to regain, and in some cases its loss is irredeemable. Brady and Honey (2007), suggest five levels of stakeholder reactions to loss of trust from 'disappointment' at activities such as inconsistent behaviour, in which trust is questioned but can be readily recovered, through to 'outrage' at activities such as fraud and illegality resulting in complete loss of trust that cannot be recovered. An aspect of recovery is the confidence to admit error promptly and apologise. In the medical arena, some academic medical centres have adopted a policy of promptly admitting errors, offering apologies and providing fair compensation (Sack 2008). This appeared to satisfy many patients, reduce legal costs and in some cases helped reduce malpractice premiums. Examples given were the University of Illinois where out of 37 cases where

the hospital acknowledged a preventable error and apologised, only one patient filed a legal claim; and the University of Michigan Health System, where existing claims and lawsuits dropped from 262 in 2001 to 83 in 2007 and legal costs fell by two-thirds.

It seems that transparency can also directly benefit company profits. Hayward (2015) looked at two companies that were transparent and engaged with employees, finding they were both highly rated by their employees and enjoyed commercial benefits. In the case of phone operator Three UK, customer numbers and turnover had risen with an improvement in business performance; while TGI Fridays experienced low staff turnover and consistent growth during the recession. Apparently, in these cases, greater openness and honesty brought commercial benefits. An ethical climate within an organisation also helps protect it from unethical or illegal staff conduct, since strong ethical principles help limit abuses by staff who may be tempted to circumvent regulation.

### ***3.2 Performance***

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. The best evidence for this may be the actions of underlying investors, with awareness of ethical investment increasing rapidly. In December 2017 there were £15.4 billion assets under management in UK ethical funds, an increase of £3.0 billion since the previous year (IMA 2018). With this level of uptake in equity and bond funds, it would appear reasonable to suppose that there would be similar interest in the context of ethical real estate funds.

However, from a pure performance analysis perspective, debate remains as to whether this investor confidence is justified. At present studies of ethical performance relative to the broader market appear primarily focused on equity markets with a bias

towards the US, although a few non-US equity examples are included below for completeness. Since concerns that ethically-focused investments are likely to underperform have the potential to be a significant barrier to the development of enhanced ethical criteria for real estate funds, a review of several ethical performance equity studies is included below, to at least challenge this presumption. There remains a need for ethical performance studies to be extended beyond equity markets (with a US bias) to include other asset classes and geographical regions.

Havemann and Webster (1999) concluded that studies of portfolio selection strategies involving excluding even half the market or more, typically resulted in small theoretical losses of less than 0.1% per year, even without considering ethical selection criteria. For investment universes constructed on an ethical basis, they concluded performance was very similar to market indices (although typically with tracking errors in the range 2-4%); their study saw risks and returns broadly similar to the market over an eight-and-a-half year period, despite looking at five different approaches, which resulted in a variety of stocks being selected, the proportion of the market avoided, and the balance of sectors included.

In a matched pair analysis, Kreander et al. (2005) compared ethical funds against conventional counterparts using data from 80 funds (40 ethical, 40 conventional) from seven European countries over the period from January 1996 to December 1998. Fund matching was by age, country, size and investment universe, and indicated there was no significant difference in performance by ethical funds whether evaluated by Jensen's alpha, Sharpe ratio, or Treynor measure. Further, there was some evidence that the ethical funds were actually less risky than their conventional counterparts in terms of volatility and fund beta, a result that contradicts the conclusion of Langbein and Posner (1980).

In a study of Swedish Socially Responsible Investment funds, Stenström and Thorell (2007) used a screening method to compare conventional funds with replicating portfolios that screened out unethical companies to create equivalent but ethical funds for comparison. They found that the ethical replica funds performed better than their conventional originals, suggesting that certain socially responsible investment practices had a positive effect on fund performance. However, for the funds they analysed, they also concluded that the quality of fund management in adding value was higher for conventional funds than for ethical funds. This last point may be because established conventional funds attract the most able managers. At any rate, this suggests that ethical funds do not underperform, although there is also evidence that they may do rather better.

A number of studies provide evidence that equity portfolios run according to ethical criteria may actually outperform. These cover a range of criteria including environmental (Derwall et al. 2005; Kempf and Osthoff 2007), social (Kempf and Osthoff 2007), employment quality (Edmans 2012) and governance (Gompers, Ishii, and Metrick 2003; Bebchuk, Cohen, and Ferrell 2008) over time intervals of between eight to 27 years with statistically significant outperformance observed. Typically these report the outcomes of long-short strategies, that is to say, the outperformance of a portfolio that is long 'ethical' stocks and short 'unethical' stocks. In addition to market-risk exposure, analyses included mitigation of portfolio style tilts (size, value versus growth and momentum effects) using the Carhart (1997) four-factor model to estimate the average abnormal excess return above the market proxy.

Although a portfolio of short positions may be impractical in the context of property, in all but one case (Bebchuk, Cohen, and Ferrell 2008) the reported results separate the long and short components, so that the benefit of the long-only ethical

portfolio can be isolated. In the case of Bebchuk, Cohen, and Ferrell (2008), the long-only contribution was estimated as half that of the long-short portfolio, which appeared reasonable based on data presented elsewhere within that analysis. The resulting out-performances by long-only ethical portfolios were in the range 1.3-5.2% per annum (see Table 1). It is undoubtedly true that such historical analyses can always be challenged on the basis that they offer no guarantee of future performance. Equally, market conditions may be different looking forwards, and perhaps some environmental, social and governance factors are now better addressed by companies. However, they should give pause for thought for those who are tempted to assume that it is 'obvious' that ethical portfolios 'must' underperform the broader market.

\*\*\*\*\*TABLE 1 HERE\*\*\*\*\*

More recently, simple out-performance by ethical funds may be attributed to weakness in sectors such as mining and oil, which have performed poorly (Jones 2015). Brenchley (2016) makes the point that since ethical funds exclude specific market sectors such as tobacco, fossil fuels and mining, this means they can significantly under- or out-perform their conventional rivals over discrete periods. Despite this, he observes that over the period from 20 October 2006 to 21 October 2016 the UK's ethical FTSE4Good index outperformed the FTSE100 blue-chip index by 3 percentage points. This trend appears to have continued as, over the year to 1 July 2017, UK ethical funds have out-performed their conventional counterparts by 1.6 percentage points (Moneyfacts 2017).

In summary, there appears to be sufficient evidence to suggest there is no reason to conclude that ethical investment must lead to underperformance. In fact, quite

possibly the reverse is the case, as a number of studies have associated portfolios selected using ethical criteria with outperformance, even if the wider investment community has not yet reached a conclusive judgement on the matter.

#### **4. Practical Difficulties**

An argument against placing ethical restrictions on tenants' activities might be that it would be challenging to manage a substantial property portfolio when unethical companies are excluded as tenants. As a thought experiment, let us 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? However, this logic assumes a substantial property fund. As a hypothetical example, consider a commercial property fund owning buildings worth £2.0 billion, with, say, 100 properties in its portfolio (with too many properties the portfolio would become increasingly difficult to manage). This gives an average property value of £20 million, making each individual holding (be it a warehouse, office space or whatever) a significantly large property (or high-value asset), which would, therefore, require a large-sized company as a tenant. In turn, this may limit the pool of potential tenants, making it difficult to turn any potential tenant away from a commercial perspective if the property is vacant. However, do ethical property funds 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. Smaller rental spaces can be occupied by smaller organisations, potentially meaning that a wider pool of tenants would be available, perhaps including local businesses as well as national organisations.



Another aspect is that a fund manager wishing to ensure their business 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 historic buildings or other issues.

Unless a restrictive covenant is in place, on the grant of a new lease, a landlord possessing the freehold of a property would generally be expected to have full discretion over the tenants they select, including based on the tenant's business activities. Further, terms in the commercial lease could be used to address concerns about changes to the tenant's business activities, or sub-letting to tenants carrying out unacceptable activities. The lease could include covenants the tenant must abide by and including expressly stating the tenant's intended uses of the premises, as well as restrictions on whom the tenant could assign or sub-let to. The landlord could also ask potential tenants to 'contract out' of the provisions of the UK's Landlord Tenant Act by following a specific procedure prior to the parties contractually committing to the lease and including a declaration by the tenant to the effect that they understand what rights they are giving up, with the appropriate wording being entered into the lease (Davison 2017). Thus, bearing in mind the UK focus of the current paper, although the UK Landlord Tenant Act 1954 enables the tenant to manage their affairs with quiet enjoyment, i.e. without hindrance from the landlord, if ethical terms (covenants) were written into the commercial lease, it would appear that the Landlord Tenant Act need not supercede the terms of the lease, at least on renewal.

Another approach, where there are concerns about a tenant's activities, would be to let properties on shorter leases. At the expiry of the lease, the landlord can review the

tenant's activities. If these are found to be unsatisfactory, the lease need not be renewed, providing a strong incentive for the tenant to abide by any ethical constraints the landlord specifies. This would admittedly create a higher risk of tenant turn-over, however, if the situation is made clear at the stage of initially accepting the tenant, in practice non-renewal of a lease should only occur infrequently, since it would presumably be an undesirable outcome for the tenant as well as the landlord.

#### ***4.1 The Environmental Protection Act 1990***

In this respect, it is worth asking what evidence is available as to whether a landlord could evict a tenant based on non-compliance with ethical covenants agreed in the lease. There are some sources that suggest this would be entirely possible, including, in the UK, covenants that require the tenant not to be in breach of the Environmental Protection Act 1990 (EPA). The EPA includes a number of provisions that cover aspects of sustainable ESG investing, including part 1 covering integrated pollution control; part 2, waste on land; part 2a, remediation of contaminated land; part 3, statutory nuisances including noise abatement orders; part 4, litter; and part 8 relating to miscellaneous provisions including the burning of straw and stubble.

#### ***4.2 Evidence that Covenants could be used***

Additional evidence that a landlord would be entitled to impose covenants on tenants to restrict their activities arises from the context of derogation of grant. In this situation derogation of grant occurs when a landlord grants rights to a tenant, but then does something that detracts from this grant. Following Sykes (2009), if a landlord lets land for a specific purpose, it is under an obligation not to take steps regarding its retained land that would render the premises unfit or unsuitable for the purpose for which they were let. In the UK courts, this would appear to be long-established, for example, in the

case of *Port v Griffith* (1938) a landlord had let a shop with an express covenant to use it for the retail business of the sale of wool and general trimmings and no other purpose. Subsequently, the landlord let the adjoining shop to another tenant with a tenant covenant to use it for the retail business of the sale of tailoring and dressmaking trimmings and cloths and no other purpose. The first tenant argued that this was a derogation of grant since it frustrated the purpose for which the first premises were let. In this case, there was found to be no derogation of grant. In a more recent case (*Romulus Trading Co. Ltd and Another v Comet Properties Limited* 1996) the judge also considered that there was no derogation of grant.

For current purposes, the point of interest is that neither tenant contested the right of the landlord to impose a covenant that placed very specific restrictions on their activities, for example, ‘the retail business of the sale of wool and general trimmings *and for no other purpose*’. Thus it would appear clear that the landlord was entirely at liberty to specify those goods that the retail tenant was not allowed to sell. Such a covenant could easily be used to exclude products that an ethical landlord might deem unacceptable, such as alcohol, tobacco, pornography or other goods. It would also seem reasonable to suppose that restrictions via such tenant covenants could be extended to non-retail activities.

An example where a breach of tenant covenant allowed effective action against the tenant is provided by *Wilkinson* (1989). In this case, a London property had been let under the terms of the lease for use as a high-class restaurant and nightclub to include music, dancing, cabaret and gambling, with two clubs run from the premises. The landlords had their agents attend the clubs and as a result served section 146 notices on the tenants, to commence forfeiture proceedings. In the words of the judge ‘There is overwhelming evidence that both clubs were used for the purpose of prostitution’, the

judge added that the tenants' breaches were of the utmost gravity and represented a deliberate and continued disregard of their obligations under the lease. Although the situation looked hopeless for the tenants, the judge relieved them from forfeiture for reasons including that the immoral use had ended and was unlikely to resume. From an ethical investing perspective, while the tenants were not evicted, the outcome is entirely satisfactory, in that the landlord was able to enforce the cessation of an unacceptable activity as described under the terms of the lease. Since the landlord would have flexibility over the provisions appearing in a lease, this would appear to provide further evidence that lease terms could be effectively used to prevent unacceptable tenant activities by an ethically-minded landlord.

#### ***4.3 The Ethical Investing Perspective***

Ultimately many ethical investors just 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. The issue that unethical corporate behaviour and unsustainable practices lead to increased risks (Krosinsky, Robins, and Viederman 2012; Kiernan, 2009) was outlined above. To expand on the risks that ethically-careless investors may be taking, these can include an increase in the likelihood and consequence of litigation against a company, reputational damage to a brand, or making customers decide they do not wish to be associated with a company and take business elsewhere. If such companies are tenants of a property in a fund portfolio this may tarnish the fund manager by association, lead to financial difficulties for the tenant, or other problems with the use of the property if the location becomes associated with the negative actions of the occupier. Businesses are becoming aware that supply-chain partners with

unethical practices can tarnish the reputation of a company's brand (Shrivastava and Berger 2010); in this context a tenant clearly forms part of the supply-chain for a property fund manager, meaning that unethical practices by tenants would be expected to tarnish the reputation of the fund manager landlord.

Other issues may include poor industry standards increasing business costs to all involved in the sector (Helleiner et al. 2009), with those organisations that have invested least in meeting, maintaining or raising standards being the most affected as they are forced to improve. Climate change may place restrictions on carbon emissions, or require carbon permit trading (Stern 2006; Helleiner et al. 2009), with potential to affect both landlords and tenants depending on buildings' standards and activities involved. Meeting new standards may incur costs associated with process redesign or technology retrofitting. The ethical behaviour of a tenant company gives them a 'social licence to operate' as a valued community asset (Kiernan, 2009), unethical behaviour can result in resistance from communities, government and NGO opposition can upset projects and damage brands. Poor sustainability records can increase insurance premiums and increase the cost of capital whether by raising the cost of debt or lowering the value of equity. Energy inefficient processes and failure to minimise waste indicates sub-optimal corporate processes, increasing costs, although, in terms of buildings, better commercial property fund managers appear to be addressing energy and waste issues. However, tenants with unsustainable practices may also suffer from historical and contingent liabilities that could threaten their balance sheets (Kiernan 2009), have unanticipated capital costs relating to pollution control or be involved in intrinsically unsustainable business activities, which could undermine their ability to meet rental commitments.

The above points illustrate that ethically-careless property investors could easily find that the tenant cash-flows underlying rental payments, or else the costs associated with managing their property portfolios could prove to be far less robust than had been anticipated, with the potential to undermine investment performance.

## **5. 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 have already demonstrated a willingness to use the indirect means of market capitalism to put pressure on companies by selectively investing in those they deem ethical and avoiding or selling out of holdings in companies they regard as carrying out unacceptable activities. This has the effect of making development capital cheaper for ethical companies by increasing demand for their assets and either raising the value of their shares (supporting new capital raising from share sales) or raising the price of their bonds (providing loan capital at 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 the knock-on problems that less ethical tenants can generate. The suggestion is that since the risks associated with unethical tenants may not be effectively priced into rentals, the costs (or loss of earnings) associated with the activities of unethical tenants might be more than compensated for by the reduction in problems associated with such

tenants. In this respect, the arguments mirror aspects of those surrounding the returns from ethical investing in other asset classes.

## **6. Liquidity Issues**

For retail investors seeking to invest in property funds that manage their tenants according to ethical criteria in addition to sustainability issues in terms of physical buildings, from the author's experience, even should fund managers launch such products, in the first instance the availability of such funds is likely to be extremely restrictive from a portfolio construction perspective. In effect, just as ethical equity funds form a restricted subset of conventional equity funds, ethical property funds would form a new and restricted subset of conventional property funds, especially when the additional ethical criteria for tenants are also included.

At early stages, since there will be very few commercial properties managed according to these enhanced ethical criteria (involving both buildings and tenants), the creation of collective retail funds of this type will be challenging. For direct commercial property funds managed along these lines, since there may be a relatively small market for sales and purchases of such buildings, liquidity may also be more restricted.

In this context, it is possible that suitably managed REITs may offer a partial solution, since these could be based on a smaller number of properties, with funds of REITs made available to retail investors. 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. 'Lock-ins' may occur during periods when a lack of confidence in property causes a large number of investors to wish to sell their property fund holdings.

Under these circumstances, a manager of an open-ended property fund would have to sell physical buildings to raise the cash to repay the investors wishing to sell. Since property sales can be lengthy to complete, the manager may have to lock investors into the fund (not permit them to sell out of the fund) for a period while they arrange the sale of buildings and attempt to achieve a fair market price. Although this avoids immediate liquidity problems since no property sales would be necessary, in a REIT the share price would adjust to balance investor sales and purchases. Therefore, the sale would be possible, but likely at a much-reduced price.

However, for adequate property diversification, a better initial solution might involve an open-ended fund of REITs, with each REIT holding a small number of commercial properties managed according to ethical criteria that include both tenants and building sustainability. This would have to await the appearance of a sufficient number of 'really ethical' REITs (here denoted 'RE-REITs'), with both buildings and tenants managed according to ethical and sustainability criteria. 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.

## **7. 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 and sustainably, while 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.

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Alpha, per year	Period Analysed	Ethical Criteria	Sources
1.3-4.0%	1995-2003	Environmental	Derwall et al (2005)
2.3-3.6%	1992-2004	Environmental, Social	Kempf and Osthof (2007)
2.3-3.8%	1984-2011	Employment quality	Edmans (2012)
3.5%	1990-1999	Governance	Gompers, Ishii, and Metrick (2003)
3.7-5.2% (estimated)	1990-2003	Governance	Bebchuk, Cohen, and Ferrell (2008)

Table 1: Long-only outperformance by ethical portfolios according to ethical criteria.