An Investment Product for the Times:  
The Case for Creating a Real Estate Investment Trust  
That Fosters Sustainable Cities

by

Kevin P. Mahoney

Bachelor of Science, Business Administration, 2006
Georgetown University

Master of Business Administration, 2012 (expected)
Georgia Institute of Technology

Submitted to the School of City and Regional Planning in partial fulfillment of the requirements for the degree of Master of City and Regional Planning at the Georgia Institute of Technology

May 2012

© Kevin P. Mahoney

ALL RIGHTS RESERVED

The author hereby grants to the Georgia Institute of Technology permission to reproduce and to distribute publicly paper and electronic copies of this document in whole or in part.
An Investment Product for the Times:
The Case for Creating a Real Estate Investment Trust
That Fosters Sustainable Cities
by
Kevin P. Mahoney

ABSTRACT
The well-known axiom “location, location, location,” guides real estate investment decisions around the world for developers and owners alike. Yet, investors – particularly retail investors – have relatively limited input into where the primary vehicle for such investments, real estate investment trusts (REITs), invests their funds. REITs generally specialize in a property type (e.g., office or multifamily), and invest in any market whose supply and demand fundamentals suggest a certain minimum return on investment (ROI). While some REITs invest only in individual cities or regions, relatively low-risk markets, including New York and Washington, D.C., capture most investor attention. This paper will demonstrate that investor demand exists for real estate investment options that consider factors beyond ROI. Without necessarily sacrificing ROI, investors can and should enjoy access to REITs that invest in various cities across the country. Moreover, within these cities, REITs should invest in properties that promote sustainable communities characterized by walkability, mixed uses, and multiple modes of transit. Over the long term, such REITs will provide retail investors with the opportunity to both earn a competitive return on investment and help to produce sustainable communities.

This paper will:

1. Analyze the current environment for real estate investing, highlighting trends that will impact the future;

2. Describe how real estate investment trusts (REIT) and socially responsible investment (SRI) can serve as models for better investment options;

3. Consider a new REIT that addresses retail investor demand for sustainable real estate projects.

Option Paper Advisor: David F. Haddow, CRE
Title: Senior Lecturer, School of City and Regional Planning President, Haddow & Company
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>04</td>
</tr>
<tr>
<td><strong>PART I: Problem Identification</strong></td>
<td></td>
</tr>
<tr>
<td>Chapter I – The Current Real Estate Investment Environment</td>
<td>08</td>
</tr>
<tr>
<td>Factors Demanding a New Investment Approach</td>
<td></td>
</tr>
<tr>
<td>Positive Examples Among Current Companies</td>
<td></td>
</tr>
<tr>
<td>Difficulties in Making an Investment Shift</td>
<td></td>
</tr>
<tr>
<td><strong>PART II: Problem Mitigation</strong></td>
<td></td>
</tr>
<tr>
<td>Chapter II – Real Estate Investment Trusts</td>
<td>20</td>
</tr>
<tr>
<td>REIT Overview</td>
<td></td>
</tr>
<tr>
<td>REITs as Owners and Managers</td>
<td></td>
</tr>
<tr>
<td>REITs’ Place in the Investment World</td>
<td></td>
</tr>
<tr>
<td>Chapter III – Socially Responsible Investment</td>
<td>27</td>
</tr>
<tr>
<td>SRI Overview</td>
<td></td>
</tr>
<tr>
<td>Struggles to Define SRI</td>
<td></td>
</tr>
<tr>
<td>SRI Popularity and Performance</td>
<td></td>
</tr>
<tr>
<td>Chapter IV – A New Sustainable Cities REIT</td>
<td>34</td>
</tr>
<tr>
<td>New REIT Operating Principles</td>
<td></td>
</tr>
<tr>
<td>The Hypothetical Investor</td>
<td></td>
</tr>
<tr>
<td>Conclusion</td>
<td>43</td>
</tr>
</tbody>
</table>
INTRODUCTION
As an investment asset class, real estate possesses several unique characteristics that differentiate it from other asset classes. First, real estate contains a tangible quality that many investments, such as bonds, lack. Unlike other tangible investments (e.g., soybeans and copper), however, real estate directly impacts all people – investors and non-investors alike – on a daily basis. In fact, in the first line of his new book, *Cityscapes: San Francisco and Its Buildings*, author and *San Francisco Chronicle* urban design critic John King writes, “A city’s buildings are touchstones of reference and recall that shape our sense of place.”¹ In an April 2011 podcast interview with *Wired* magazine, King added, “Each city has a real physical character unto itself, and that physical character does shape the [city’s] cultural character and the [city’s] social character.”²

On a daily basis, most people rarely think about the built environment that surrounds them. Even so, almost everyone understands on some level that real estate shapes the environment in which they live and many of the decisions that they make. In 2011, researchers from West Virginia University and the University of South Carolina Upstate sought to confirm that good urbanism contributes positively to happiness.”³ In introducing their idea, the authors wrote:

> We hypothesize that the way cities and city neighborhoods are designed and maintained can have a significant impact on the happiness of city residents.

---


² Ibid.

The key reasons, we suggest, are that places can facilitate human social connections and relationships and because people are often connected to quality places that are cultural and distinctive. City neighborhoods are an important environment that can facilitate social connections and connection with place itself. But not all neighborhoods are the same. Some are designed and built to foster or enable connections. Other are built to discourage them (e.g., a gated model) or devolve to become places that are antisocial because of crime or other negative behaviors. Increasingly, researchers and practitioners have become aware that some neighborhood designs appear better suited for social connectedness than others.”

Ultimately, the authors found that “the design and conditions of cities are associated with the happiness of residents in 10 urban areas. Cities that provide easy access to convenient public transportation and to cultural and leisure amenities promote happiness. Cities that are affordable and serve as good places to raise children also have happier residents.” The current design and conditions of many cities, though, suggest that the individuals and entities who wield the greatest influence have failed to respond to such research.

This paper will argue that much real estate investment over the past several decades has produced communities that discourage connections. The real estate investment industry has operated as if investors only seek an attractive yield, without regard for the built environment that their investments produce. Health, environmental, and economic data suggest, however, that investors soon may

---

5 Ibid.
become more vocal about how real estate companies allocate the funds that they provide. In response, this paper proposes a new REIT that seeks to foster sustainable communities.
Chapter I

THE CURRENT REAL ESTATE INVESTMENT ENVIRONMENT
Factors Demanding a New Investment Approach

In the introduction to his book, *Triumph of the City*, Harvard University economist Edward Glaeser argues that “transportation technologies,” including every mode from trains to elevators, “have always determined urban form.”  

During the mid-twentieth century, the automobile created demand for new, low-density cities and suburbs, which often exchanged sidewalks for “enormous, gently curving roads.” The “undifferentiated urban sprawl” that such a development pattern has generated now appears unsustainable in the United States. Accordingly, investors must view investment in sustainable real estate – characterized by higher density and increased accessibility – across the country with a sense of urgency. Otherwise, the strains that sprawl has created, particularly those related to human health, the environment, and public expenditure, will become increasingly difficult to overcome.

Unsustainable Development Costs

Most noticeably, sprawl has negatively impacted human health. In the journal *Public Health*, Roland Sturm and Deborah Cohen determined that “rates of arthritis, asthma, headaches and other complaints increased with the degree of sprawl. Living in areas with the least amount of sprawl, compared with living in areas with the most, was like adding about four years to people’s lives in terms of their

---

7 Ibid.  
8 Ibid.
health.” More recently, a 2010 study published in the *American Journal of Preventative Medicine* found that the “use of light-rail transit” to commute to work reduced a rider’s bodyweight on average by 6.5 pounds and decreased the chances of becoming obese over time by 81 percent.11

Evidence suggests that car-dependent, low-density development also has harmed the environment. Glaeser points out that while 86 percent of American commuters drive to work, less than one-third of New York residents, who live in the country’s densest city, rely on a car for transportation. Furthermore, “29 percent of all the public-transportation commuters in America live in New York’s five boroughs. Gotham has, by a wide margin, the least gas usage per capita of all American metropolitan areas.” In fact, the city’s density has enabled the entire state of New York to claim the second spot on the U.S. Department of Energy’s list for lowest per capita energy consumption in the country.12

Finally, Todd Litman from the Victoria Transport Policy Institute highlights numerous studies that reveal how relatively unconstrained growth in the built environment places a greater economic burden on society. In particular, the burden most often stems from higher per capita costs for public infrastructure and

---

12 Ibid, p. 37
services. Litman defines “smart growth” as “compact, accessible development within existing urban areas,” which – according to his literature review – “could provide savings of between $5,000 and $75,000 annually per [dwelling] unit for publicly borne development costs (e.g., roads and utility lines).” For “incremental operations, maintenance, and service costs,” smart growth could save $500 to $10,000 annually. In both cases, the extent of the savings would depend on the infrastructure already present on and around the site at hand.

Changing Lifestyle Preferences

As some Americans have become less willing to tolerate the negative consequences that accompany low-density development, they increasingly have adopted alternative lifestyles. After reviewing the most recent U.S. Census data, University of Nevada-Las Vegas urban sociologist Robert Lang revealed in an interview with USA Today that walkable communities now appear to appeal to more Americans. "A few decades ago, all the growth was on the edge," said Lang. “Now, there are city-like suburbs doing well on one side of the metropolis, while conventional suburbs still flourish on the fringe." The 2010 census shows that “close-in suburbs in the 50 largest metropolitan areas added 6 million people from 2000 to 2010, which

---

14 Ibid.
represented an 11.3 percent increase.” The nation, meanwhile, grew 9.7 percent during the same timeframe.\textsuperscript{17}

Washington, D.C., offers a glimpse at how U.S. cities could change in the years ahead, particularly once the economy fully recovers. Between 2000 and 2009, the District’s population grew more than five percent, which reversed a “half-century of decline.”\textsuperscript{18} The population increased another 2.7 percent between April 2010 and December 2011, with 75 percent of the new residents aged 18 to 34.\textsuperscript{19} Meanwhile, Arlington and Alexandria, Va., two of the city’s inner suburbs, experienced double-digit gains over 2000 population figures.\textsuperscript{20} Between proximity to the city and access to extensive public transportation, “there’s been a growing sentiment (across the nation) towards moving closer in the past decade,” believes John McIlwain, a senior resident fellow at the Urban Land Institute.\textsuperscript{21} The Federal Transit Administration even estimated in 2004 that demand for housing within a half-mile of transit would grow from 6.1 million households during that year to 14.6 million households in 2025.\textsuperscript{22}

\textit{Shrinking Municipal Budgets}

\textsuperscript{17} Ibid.
\textsuperscript{21} Ibid.
Part I: Problem Identification

Despite the increased infrastructure and service needs within cities that changing demographic trends will require, the economic downturn has forced significant budget cuts across the country. According to the Nelson A. Rockefeller Institute of Government, the United States "has lost 668,000 state and local government jobs since the recession hit – more than in any modern downturn." 23 Even in San Jose, a large, growing city in Silicon Valley, the local government has faced "falling tax revenues, rising pension costs, and dwindling state aid." Tax collections in 2012 likely will remain below levels from five years ago, while pension costs “now consume more than a fifth of the city’s general fund budget.” 24 As The New York Times’ Michael Cooper wrote, “It is hardly the image that comes to mind when many people think of a Silicon Valley city where the median household income is $76,794 a year and employers include Cisco Systems, eBay and Adobe.” 25

For similar reasons, the federal government no longer can afford to provide much assistance to ailing cities. As part of a budget agreement to avert a federal government shutdown in April 2011, for example, the White House and Congress cut “at least $3 billion in funds for housing, community redevelopment projects, public transportation and police and fire department,” according to Bloomberg. 26 Greg Minchak, a spokesman for the National League of Cities, said in response, "It’s definitely going to have an impact at the local level. This is going to mean projects

---

24 Ibid.
25 Ibid.
aren’t going to go forward, cities are going to have to reprioritize what they’ve been working on, and we’re going to see layoffs because of this.”27

**Positive Examples Among Current Companies**

Over the past century, governments and real estate developers too frequently have made egregious miscalculations about the role that real estate can play in cities. In *Triumph of the City*, Glaeser asserts, “Too many officials in troubled cities wrongly imagine that they can lead their city back to its former glories with some massive construction project – a new stadium, or light rail system, a convention center, or a housing project.”28 He adds, “Shiny new real estate may dress up a declining city, but it doesn’t solve its underlying problems.”29 Yet, despite their limitations, certain real estate companies – some purposefully, some unintentionally – already help to increase the quantity and quality of dense, accessible communities within a city.

Large, national, publicly-traded companies such as Boston Properties (NYSE: BXP) represent the most basic and conservative end of the spectrum. Like other public companies whose shares trade on a major stock exchange, Boston Properties can access capital from retail investors, defined as “individual investors who buy and sell securities for their personal account, and not for another company or organization.”30 With this expanded capital pool, Boston Properties acquires, develops, and manages high-rise office buildings primarily located in central

---

27 Ibid.
29 Ibid.
business districts, specifically in New York City, Washington, D.C., San Francisco, and Boston. While the average person may only notice Boston Properties’ ground-up development, the company’s interior building improvements and strong property management help to attract the office tenants needed to make an area more vibrant. For example, Boston Properties renovated the lobby in its property at 33 Hayden Avenue in Lexington, Mass., to create the brighter and more modern space that tenants sought.

Most private equity real estate firms also operate nationally, and several share Boston Properties’ investment focus on highly-quality office buildings in the strongest real estate markets. Private equity real estate firms typically raise money from high-net-worth individuals and/or institutional investors, such as pension funds and universities. If these groups’ investment objectives permit, firms such as Atlanta-based Jamestown Properties may diversify their portfolios through riskier, “opportunistic” activities in “24-hour” urban areas. Jamestown, for example, has implemented significant changes at New York’s Chelsea Market and Oakland's Alameda South Shore Center. Such large-scale projects, which people can notice and appreciate without even entering the building, often produce a multiplier effect: over time, the property helps to draw in new companies, residents, and visitors.

The Jonathan Rose Companies, meanwhile, was founded in 1989 as a “mission-based practice,” a rather unique concept among private equity firms. The

---

company's website specifically states that it seeks to “help metropolitan regions become more resilient, competitive, and equitable.” In practice, the goal translates into the company “targeting assets in transit-oriented urban centers of finance, technology, and culture in the United States.” Across the company’s planning, development, and investment activities, Jonathan Rose believes that “smart growth locations in cities that share strong transportation, economic and telecommunication connectors are more likely to prosper.”

The Jonathan Rose Companies serves as a model for purposefully creating dense, accessible communities.

While large local real estate companies, such as Douglas Development in Washington, D.C., and Anasazi Properties in San Francisco, typically maintain less stringent standards than the Jonathan Rose Companies, their commitment to a single area often compels them to pursue projects that benefit the city. Among these companies, some may maintain investment management departments that can raise limited private equity funds. The other companies rely on their own equity and the capital markets, which may involve joint ventures with other firms.

Douglas Development, whose “specialty is restoring and preserving mixed-use and retail buildings,” falls in the latter category. Even so, the company “has earned a reputation for revitalizing underdeveloped, emerging areas.” Anasazi Properties, meanwhile, “specializes in the acquisition and development of urban ‘infill’ sites in

---

the San Francisco Bay Area. These sites typically consist of underused property or obsolete buildings.”35 These companies may lack the capacity, market knowledge, and desire to expand their work nationally, but they more consistently improve cities than any other real estate entity. The long-term interest in the market in which they operate and the smaller scale on which they’re willing to work affords them a perspective and understanding that better reflects a city’s true needs and personality.

The opposite end of the spectrum includes small, entrepreneurial local developers such as Philadelphia’s Tony Goldman and Cleveland’s Maron family. Goldman, for example, purchased during the late 1990s about 20 small properties on a “two-block stretch of 13th Street pockmarked with porn theaters and check-cashing agencies.” Today, Philadelphia residents know the area as Midtown Village, which features vibrant street life and offers some of the best restaurants in the city.36 In Cleveland, the Maron family in the 1980s saw potential in a 450-foot-long street that was designated as a national historic district, but featured unremarkable “wig shops, old-style beauty parlors, budget stores, and a shoe repair.” The family spent nearly 20 years making deals with the approximately 300 people who “owned fractional shares of the various buildings and slices of land.”37 Today, the Cleveland Plain Dealer calls East Fourth Street, now home to restaurants, bars, a bowling alley,
Part I: Problem Identification

coffee shop, theater, and nightclub, “the jewel of Cleveland’s entertainment
district.”

Difficulties in Making an Investment Shift

Unfortunately for retail investors who want to invest in sustainable real estate, only
Boston Properties among the companies profiled makes shares available on a public
exchange. In addition, the national companies whose investments generally support
smart growth largely restrict their operations to primary U.S. real estate markets.
As a result, investors who would choose to direct funds to cities other than New
York, Washington, D.C., San Francisco, Boston, Seattle, and Austin have
unsatisfactory options.

Ultimately, however, most companies – particularly those with significant access to
capital – focus solely on investment returns. Accordingly, the culture that pervades
real estate finance values short-term investment horizons, maximum cash flows,
and well-defined investment exit strategies – at the expense of other considerations.
Many real estate companies seemingly disregard the negative externalities,
including physical inactivity, harmful emissions, excessive infrastructure costs, and
social isolation, that their work can trigger. Academic research, demographic
trends, and economic realities show, however, that more real estate companies soon
will need to support sustainable lifestyles. When the transition takes place for high-
net-worth and institutional investors, their smart growth investment funds will

38 Schneider, Keith. "An Enclave of Entertainment in Cleveland." Commercial Real Estate. The
Part I: Problem Identification

assume many forms. For retail investors, though, the solution will lie in a new real
estate investment trust (REIT).
Chapter II

REAL ESTATE INVESTMENT TRUSTS
REIT Overview

History

More than fifty years after their creation, real estate investment trusts have emerged as the vehicle through which retail investors potentially can support more sustainable real estate development. Before 1960, however, commercial real estate as an investment asset class lacked the liquidity and investment vehicle to accommodate small retail investors. Only well-capitalized, highly-knowledgeable entities could invest in large-scale, income-producing commercial real estate. Large financial institutions and high-net-worth individuals essentially comprised the entire market for commercial real estate investments, investing directly in properties rather than relying on publicly-traded securities.39

On September 14, 1960, however, President Dwight D. Eisenhower signed tax legislation that also created an indirect route to commercial real estate assets, which all investors could access.40 Policymakers and investment professionals brought to life the new investment vehicle, called real estate investment trusts, through amendments to the Internal Revenue Code (IRC).

Legal Requirements

The IRC established REITs, according to the National Association of Real Estate Investment Trusts (NAREIT), as companies with at least 100 shareholders for whom

real estate comprises at least 75 percent of all assets and rents or mortgage interest generates at least 75 percent of all gross income. Additionally, the company annually must distribute at least 90 percent of all taxable income to shareholders through dividends. In exchange, REITs may deduct all dividends paid to shareholders from the company’s corporate taxable income. REITs, as a result, often avoid any corporate income tax liability.

Initial REIT Models

The commercial real estate business involves numerous distinct functions, including owning, managing, and financing. The tax code initially required REITs to separate ownership and management activities, which compelled most REITs to focus on mortgage financing alone. In other words, REITs in their infancy either served as direct lenders to real estate owners or provided capital for future loans by acquiring existing loans or mortgage-backed securities. The Tax Reform Act of 1986 eliminated the prohibitive regulation, which empowered new REITs to begin operating as “vertically integrated companies.”

REITs as Owners and Managers

In the years that followed, REITs increasingly began to pursue income from owning and managing, also referred to as the equity side of the business. In fact, “equity

---

REITs” in the early 1990s filed an unprecedented number of initial public offerings, tipping the industry balance toward companies that derive income from rents. NAREIT research indicates that 83 percent of all publicly-traded U.S. REITs currently qualify as equity REITs. The shift in focus required more diverse real estate expertise, since the REITs also became responsible for leasing and maintenance.

Equity REITs managed their new roles through an operating structure that mirrors other publicly-traded companies. A board of directors, appointed by and responsible to shareholders, hires a management team to invest in and manage various properties. In fact, many real estate companies become REITs after previously operating as privately-held companies. In such cases, NAREIT reports, “the majority owners of these private enterprises became the senior officers of the REIT and contributed their ownership positions to the REIT.”

Equity REITs invest in all property types, from office buildings and apartments to health care facilities and warehouses. For example, like the aforementioned office REIT Boston Properties, Vornado Realty Trust (NYSE: VNO) is “one of the largest owners and managers of commercial real estate in the United States,” with a core business that includes “New York office properties, Washington, D.C., office properties, retail properties, and merchandise mart properties.”

Ventas, Inc. (NYSE: VTR), meanwhile, is “the leading seniors housing and healthcare real estate

---

investment trust in the United States, with a highly diversified portfolio of over
1,300 seniors housing and healthcare properties in 46 states, the District of
Columbia and two Canadian provinces.” The Westfield Group (NYSE: WDC) “has
interests in and operates one of the world’s largest shopping centre portfolios.” The
company is a “vertically integrated shopping centre group” that “manages all
aspects of shopping centre development, from design and construction through to
leasing, management, and marketing.” Conversely, Public Storage (NYSE: PSA),
“operates over 2,200 unique and diverse company-owned [self-storage] locations in
the United States and Europe, totaling more than 141 million net rentable square
feet of real estate. …Based on number of tenants, Public Storage is among the largest
landlords in the world.”

Equity REITs as a group have fared well compared to other asset classes. From
January 1978 through December 2010, equity REIT performance according to
NAREIT “exceeded both the broad equity market and other forms of real estate
investment by more than one percentage point per year, producing an average
annual return of nearly 12.3 percent.” Over rolling five-year periods from January
1976 through September 2011, equity REITs enjoyed 100 periods “during which
their average annual total returns exceeded 20 percent.” The REITs also
experienced 85 periods during which average annual total returns finished between

47 "Investment Performance." REIT.com. National Association of Real Estate Investment
15 and 20 percent.\textsuperscript{48} Sustained success over both the long-term and brief periods indicates the value that REITs have added over time to investment portfolios.

\textbf{REITs' Place in the Investment World}

Due in part to their well-documented success, REITs have proliferated, with Internal Revenue Service records indicating that 1,100 U.S. REITs have filed tax returns to date. NAREIT reports that, as of January 1, 2011, 153 REITs had registered with the U.S. Securities and Exchange Commission (SEC) to sell shares on a major stock exchange, primarily the New York Stock Exchange.\textsuperscript{49} The remaining companies either have decided against selling shares publicly or do not engage in activities that require registration with the SEC.

REITs have contributed significant liquidity to the real estate investment market, greatly expanding retail investors’ options over the past few decades. Today, listed U.S. REITs collectively represent $389 billion in equity market capitalization, with an average daily trading volume around $4 billion. Unlisted REITs, meanwhile, manage more than $70 billion in assets, adding another $7 billion to that figure each year. Internationally, REITs and other listed property companies contribute another $700 billion in market capitalization to the total.\textsuperscript{50}

\begin{flushright}
\textsuperscript{48} Ibid.
\textsuperscript{50} "50 Years of REITs." \textit{REIT.com}. National Association of Real Estate Investment Trusts. Web. 29 Feb. 2012.
\end{flushright}
As a result, a given individual now can purchase shares in the real estate investments that support his or her broad investment goals. Moreover, the real estate investment process now operates more seamlessly than ever, with REITs appearing on investment menus alongside traditional “core” asset classes such as stocks and bonds. Acceptance from the financing community culminated in 2001, when Standard & Poor’s agreed to add REITs to several closely-tracked S&P indices, including the S&P 500. Since funds worth hundreds of billions of dollars track the S&P 500, the move officially legitimized REITs as the leading real estate investment option for retail investors.\(^5\)
Chapter III

SOCIALLY RESPONSIBLE INVESTMENT
SRI Overview

“Socially responsible investment” (SRI), which has survived criticism and shifting criteria over several centuries, offers both a precedent and model for how a REIT can generate competitive returns while also fostering sustainable cities.52 The investment principle began, however, several hundred years ago with mission-based religious groups, who sought to direct money to causes that reflected their values.53 Their decision-making process revolved around “negative screening,” which eliminates entities that “do or make things” that the investor does not like. Quakers, for instance, refused to invest in slavery or war, while Methodists avoided organizations that sold tobacco and liquor, now known as “sin stocks.”54

Even with SRI’s historical roots, however, The Wall Street Journal credits pension funds with “setting the foundations for today’s SRI industry.”55 During the 1980s, pension funds “boycotted firms employing sweatshop labor or doing business with oppressive regimes,” such as South Africa’s apartheid government.56 In recent years, investors’ negative screening has expanded to include human rights violations, pornography trafficking, and animal product testing. Altogether, the negative screening process determines investment decisions “in five to 10 percent

———
53 Ibid.
54 Ibid.
56 Ibid.
of socially-screened fund assets.” According to the Social Investment Forum, “tobacco remains the most targeted product, with more than 88 percent of the total assets in the universe of socially screened funds” invested in tobacco-free companies.

Struggles to Define SRI

Even more recently, positive screening, or “actively seeking out companies that operate in a way that supports your political beliefs or at least meets your standards for good corporate citizenship,” has become a popular alternative or addition to the traditional “do no evil” SRI model. Now, SRI funds can invest affirmatively, supporting “sustainable business practices, stakeholder relations, climate change, and corporate governance.” The modified approach has satisfied investor demand, but also has challenged investors and analysts to accurately define and track SRI.

With positive screening in mind, The Wall Street Journal defined socially responsible investors as “those who look for profitable investments in companies mindful of larger social purposes.” Meanwhile, the MSCI KLD 400 Social Index, one of the oldest SRI stock indexes, simply selects U.S. companies that have “positive

58 Ibid.
59 Ibid.
environmental, social, and governance (ESG) characteristics." In the company’s index description, MSCI notes that it “analyzes each eligible company’s ESG performance using proprietary ratings covering environmental, social (community and society, customers, employees, and supply chain), and governance and ethics criteria. MSCI seeks to include in the index companies with positive ESG performance relative to their peers and in relation to the broader market. Companies that MSCI determines have significant involvement in the following businesses are not eligible for the index: alcohol, tobacco, firearms, nuclear power, military weapons, and gambling.”

Perhaps no investment decision better epitomizes the constantly evolving SRI definition than Domini Social Investments’ evaluation of fast-food chain McDonald’s. Domini Social Investments is an “investment firm specializing exclusively in socially responsible investing.” The company manages “funds for individual and institutional investors who wish to integrate social and environmental standards into their investment decisions.” According to Domini’s website, two “fundamental principles” determine the funds that it offers to investors: “the promotion of a society that values human dignity and the enrichment of our natural environment.” Domini views “these twin goals as crucial to a healthier, wealthier, and more sustainable world.”

63 Ibid.
Part II: Problem Mitigation

In a 2007 article, *The New York Times* pointed out that Domini had added the international fast-food company to its SRI watch list. While many people would not associate McDonald’s with social responsibility, the company earned Domini’s attention based on a “best in class” approach to SRI that rewards socially responsible leaders within each industry. “It’s horrific how we raise chickens in this country,” acknowledged CEO Amy Domini, “but McDonald’s, while still horrific, is less horrific. You have to keep your eye on the ball. It’s hard to argue that they haven’t made progress at McDonald’s.”66 The example, however, lends credence to critics’ claims, among them “longtime environmental advocate” Paul Hawken, that SRI has become “so broad it is meaningless.”67

**SRI Popularity and Performance**

Nevertheless, SRI recently has grown at a “faster pace than the broader universe of conventional assets under professional management.” As of 2010, “professionally managed assets following SRI strategies stood at $3.07 trillion, a rise of more than 380 percent from $639 billion in 1995.”68 According to the Social Investment Forum Foundation, the “broader universe of assets under professional management increased only 260 percent from $7 trillion to $25.2 trillion” during the same period. The trend even held during the economic downturn, when the universe of assets

67 Ibid.
remained flat as SRI assets continued to grow at a “healthy” rate.\textsuperscript{69}

Most investors traditionally have shied away from SRI due to fears that the restricted investment pool will limit returns. In 2011, though, AP7, an organization that manages Swedish pension assets, hired a Stockholm School of Economics professor, Dr. Emma Sjostrom, to review “21 peer-reviewed academic studies, published between 2008 and 2010, on the topic of the investment performance of SRI products.”\textsuperscript{70} In her report, Sjostrom wrote, “Of twenty-one studies, seven conclude that SRI investment products have similar performance relative to their conventional peers. Five studies report that SRI outperforms conventional investment. Three studies find that SRI generates inferior performance relative to its conventional peers. Finally, six studies report mixed results – for example, the performance of SRI may vary” with each fund type (for example bond funds vs. balanced funds), time period, and SRI criteria.\textsuperscript{71}

The review, while narrow in scope, has contributed to the body of evidence that SRI can simultaneously generate competitive returns and accomplish social goals. Such evidence has steadily increased demand for SRI options, suggesting that the approach will survive long enough for investment managers to hone a general strategy that satisfies multiple investor objectives. Up to this point, real estate investment managers have not felt similar pressure. As mentioned previously,

\textsuperscript{69} Ibid.
\textsuperscript{71} Ibid.
however, real estate impacts individual people unlike any other type of investment asset. This more personal investment relationship suggests that the SRI model may achieve even greater acceptance among real estate investors. The first companies to firmly establish this model in the real estate industry, therefore, have a unique opportunity to serve as a galvanizing force for significant positive change.
Chapter IV

A NEW SUSTAINABLE CITIES REIT
This paper has demonstrated – via academic research, demographic trends, and economic realities – that, going forward, real estate investors must expand, if only for social reasons, the criteria applied over the past several decades. Accordingly, a REIT that fosters sustainable cities has become a critical investment option to help counteract the negative health, environmental, and economic legacies that recent development patterns have left. Given the non-discriminating way in which those legacies impact people, a sustainable cities REIT likely would appeal to a large audience and generate competitive returns.

Yet, the real estate investment industry seems to dismiss this sorely needed product, while also indicating that any such investments only can take place in primary markets. As a result, aspiring smart-growth investors who seek diversification through real estate currently must choose among an outdated menu of options that likely fails to reflect their values and interests. If smart-growth investors ultimately decline to invest in this sector, real estate companies lose out on additional capital.

Some existing REITs certainly will continue to ignore the evidence and reject these arguments. Investors, however, only need a few innovative firms to accommodate their more thoughtful approach to investing. The sustainable cities REIT proposal does not seek to remake the entire REIT industry, but rather seeks to address a new, unfilled niche. In turn, the entrepreneurial firms who respond will capture untapped capital and perhaps even steal some market share from their less adaptable competitors.
Part II: Problem Mitigation

New REIT Operating Principles

A new sustainable cities REIT would revolve around two fundamental principles. First, the new REIT would invest according to smart growth theory. REITs no longer can receive a blank check to pursue developments that merely offer the desired return over the investment time horizon. Such investments fail to account for the longer-term costs and impacts on the people who live in the surrounding area. Accordingly, the REIT will only consider projects built within a half-mile of a subway or light rail station. In cities with limited public transit options, the funds would consider investments with central access to bus stations, bike lanes, and mixed-use developments. Moreover, the surrounding area must provide sound infrastructure for pedestrian traffic, including well-maintained sidewalks, street furniture such as benches, and ample lighting. At a building scale, the REIT would upgrade or install environmentally-friendly features and amenities, including a heat-island-reduction roof, water-efficient landscaping, and bike racks. This criteria will play a small, but important role in improving health, minimizing environmental impact, and reducing public costs associated with real estate development.

Secondly, the new REIT would make possible direct investments in less prominent – often referred to in the industry as “secondary” – real estate markets. Essentially, the REIT would recognize that certain investors want to attach personal values to the real estate investments that they make. When an individual invests in Apple Inc. stock, the contributed funds theoretically may help to support development for a product, such as the iPhone, that can change lives around the world. When an
individual invests in real estate, however, the funds primarily will impact people in one specific location. For instance, when Boston Properties in 2011 developed 2200 Pennsylvania Avenue, a 10-story, Class A office building in Washington, D.C., the project impacted a finite group of individuals, such as building tenants, the nearby George Washington University, neighborhood residents, and the District of Columbia. The new sustainable cities REIT, however, would appeal to a hypothetical investor in Center City Philadelphia who has no interest in supporting commercial real estate development in Washington, D.C., but would rather support a new mixed-use development on Philadelphia’s formerly industrial Callowhill Street. This ability to invest in specific cities suggests that the REIT could expect even local universities and civic organizations to allocate some of their reserve funds to such a customized investment product.

To achieve a competitive return on investment, this REIT would contain multiple funds, which would remain open concurrently. The primary fund, called Baseline Fund I, would exist to generate the minimum return that investors would expect for this type of real estate investment. The secondary funds, meanwhile, would exist to allow investors to invest in specific cities that currently receive insufficient attention from national, publicly-traded REITs.

Baseline Fund I would invest in the relatively safe first-tier markets that currently attract REITs such as Boston Properties and Vornado. Just as notably for this fund’s purposes, first-tier markets also offer the smart-growth characteristics, due to high population density and pre-automobile street grids, that other markets lack. The
sustainable cities REIT would mimic Boston Properties and Vornado’s activities in these markets, investing in stabilized, Class A office buildings for their relatively consistent, low-risk cash flows. Only the secondary funds would venture into other, riskier product types. In accordance with the REIT’s first operating principle, the office buildings in Baseline Fund I all would need to qualify for Leadership in Energy and Environmental Design (LEED) certification. In order to generate the previously-mentioned minimum return, the REIT would strongly encourage investors to invest some capital in this fund. Risk-seeking investors could choose to opt out, though.

The secondary funds would embrace the higher risk and return profiles that often accompany second-tier markets to provide investors with access to those cities. Multiple secondary funds would exist – for example, the REIT might operate three secondary funds at one time, one each for Chicago (i.e., Chicago Fund I), Miami (i.e., Miami Fund I), and Philadelphia (i.e., Philadelphia Fund I). These funds would require more patient capital, since sound investment opportunities likely would become available at less frequent rates than in first-tier markets. Even after this consideration, the investments still would present many challenges that Baseline Fund I typically could avoid. New secondary funds (e.g., Atlanta Fund I) would open as sufficiently large demand emerges. Even when investor demand for a new fund exists, however, the city in question still would need to possess solid market fundamentals, such as relatively low unemployment and foreclosure rates, to receive consideration. The sustainable cities REIT’s management, for example,
Part II: Problem Mitigation

currently would reject any investor requests for a Detroit fund due to the significant economic issues that plague the city’s real estate market.

Despite its unique focus, the REIT largely will operate like other REITs currently in existence. Most notably for this type of work, any development activities that the REIT undertakes will occur through a separate entity, which then will transfer the asset into the REIT after stabilization occurs. Such a model will avoid encumbering the development process with REIT-specific restrictions (e.g., 75 percent of income must derive from rent payments) that offer no benefit during the development phase.

This paper acknowledges that the new REIT offering may not appear attractive to investors immediately. Amid ongoing U.S. economic and political turmoil, many investors, including large investors such as pension funds, remain risk-adverse in the face of significant losses over the past few years. Until the economy significantly improves or private funds demonstrate success with this strategy on a smaller scale, REITs may encounter trouble attempting to raise funding for these types of investments. However, as the economy improves and data continues to support the rationale behind this approach, more investors likely will demonstrate a willingness to participate in the fund offerings.

In a more robust economic period, a proposal with such civically-minded objectives might qualify for certain state or federal tax breaks. Due to REITs’ tax-favored structure, however, the same incentives offer little benefit. Accordingly, if and when
the strategy gains traction, government officials should consider alternatives to tax breaks that would incentivize REITs to invest specifically in historic properties and low-to-moderate-income areas. For example, Congress in 2000 created the New Markets Tax Credit (NMTC) Program to “spur new or increased investments into operating businesses and real estate projects located in low-income communities.”72 Yet, under the current tax credit structure, even the popular NMTC serves little purpose for REITs, which are a big source of capital in the real estate investment and development business.73 To start, officials may want to consider property tax breaks, offer subsidies through a public-private partnership structure, or agree to fund infrastructure improvements.74

The Hypothetical Investor

In describing the new sustainable cities REIT, this paper previously mentioned a hypothetical investor who lives in Center City Philadelphia. To better understand the REIT’s value, this section will elaborate on how this investor might approach such a new investment opportunity.

Born and raised in a Philadelphia suburb, the investor has lived since college in the city’s densest and most vibrant area. Today, he is in his early 30s and falls into an upper-middle-class income bracket. He takes the subway to work, and on weekends, he walks with friends to local restaurants, theaters, and parks.

73 E-mail exchange with Michael Grupe, NAREIT
74 E-mail exchange with Lawrence J. Longua, New York University
Up until this point, the hypothetical investor has invested in Boston Properties to diversify his retirement portfolio. Boston Properties, in turn, has rewarded the trust that he has placed in the company’s management and the sound markets (e.g., New York, Washington, D.C., San Francisco, and Boston) in which it invests. Since his initial investment, Boston Properties has produced returns that have met his financial objectives for the real estate investment category. Yet, the hypothetical investor has longed for an opportunity to contribute to his own city’s real estate development, while still receiving similar returns. Unfortunately, Philadelphia’s commercial real estate market continues to confront several issues (e.g., moribund office demand and a high city-wage tax) that have generated excessive risk for most publicly-traded REITs. In addition, the hypothetical investor isn’t thrilled about Boston Properties’ investment in Princeton, N.J., which fails to reflect the values associated with his Center City lifestyle.

The new sustainable cities REIT appears to satisfy the hypothetical investor’s investment preferences. As part of his investment, the investor will contribute approximately 70 percent of his dedicated real estate capital to the REIT’s Baseline Fund I. In other words, the investor will continue to invest predominantly in markets such as New York, Washington, D.C., San Francisco, and Boston. In this case, however, his contribution only will support projects that reflect smart growth principles (e.g., walkability) and environmentally-friendly building design. The REIT’s management has indicated to the hypothetical investor that, with prudent decision-making, he can receive a return from Baseline Fund I that mirrors the
return that he received from Boston Properties. The investor then will invest the remaining 30 percent of his dedicated real estate capital in the REIT’s Philadelphia Fund I. The fund largely will seek to acquire and redevelop office and industrial buildings on Center City Philadelphia’s fringe, in areas such as Callowhill and Northern Liberties. Unlike with Baseline Fund I, the investor will pay a penalty for divesting from the fund before five years pass, in order to provide the REIT with sufficient time to identify promising investment opportunities and execute any significant redevelopment plans. The hypothetical investor gladly will accept these terms, however, for access to a REIT that – for the first time – recognizes the preferences that he and many of his peers bring to the real estate investment market.
CONCLUSION
In summary, the real estate investment community must acknowledge and continually remember that real estate, which possesses tangible qualities that directly impact all people on an ongoing basis, is unlike any other asset class. Many people think about and can appreciate how real estate shapes their daily behavior. Yet, even as awareness of this influence has grown in recent years, the investment options available to real estate investors have failed to change accordingly – despite the fact that the appropriate investment vehicle (REITs) and a model for the newly desired investment type (SRIs) both exist.

This paper has argued that the real estate investment industry needs to pursue sustainable opportunities that create connections between people and places. This is not just a call for another alternative investment vehicle. Rather, this change is necessary to improve the health, environmental, and financial conditions in cities across the country. Given real estate’s unique characteristics, the real estate investment industry’s exclusive focus on return on investment has always been short-sighted and irresponsible. Real estate companies, however, could avoid accountability for their role as long as investors and the market at large expressed indifference or demanded additional supply. Now that these preferences have begun to shift, the same companies must act just as quickly to provide investment opportunities that maximize the benefits that real estate can offer.

A move by the real estate investment industry toward investment options that promote sustainable communities and facilitate connections among people can produce significant benefits for the companies themselves. Companies that respond
now to the growing demand can capture profit, build a reputation as a leader, and accomplish important social objectives. Meanwhile, the companies that ignore the current health, environmental, and economic data may lose market share as well as the chance to build expertise in a still emerging area of real estate and investing. This changing reality suggests that a new sustainable cities REIT, built upon the SRI model, is the most logical vehicle to achieve profit for companies, competitive returns for investors, stronger finances for municipalities, better health for individuals, and a more livable environment for all.
BIBLIOGRAPHY


