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Sustainable Investing

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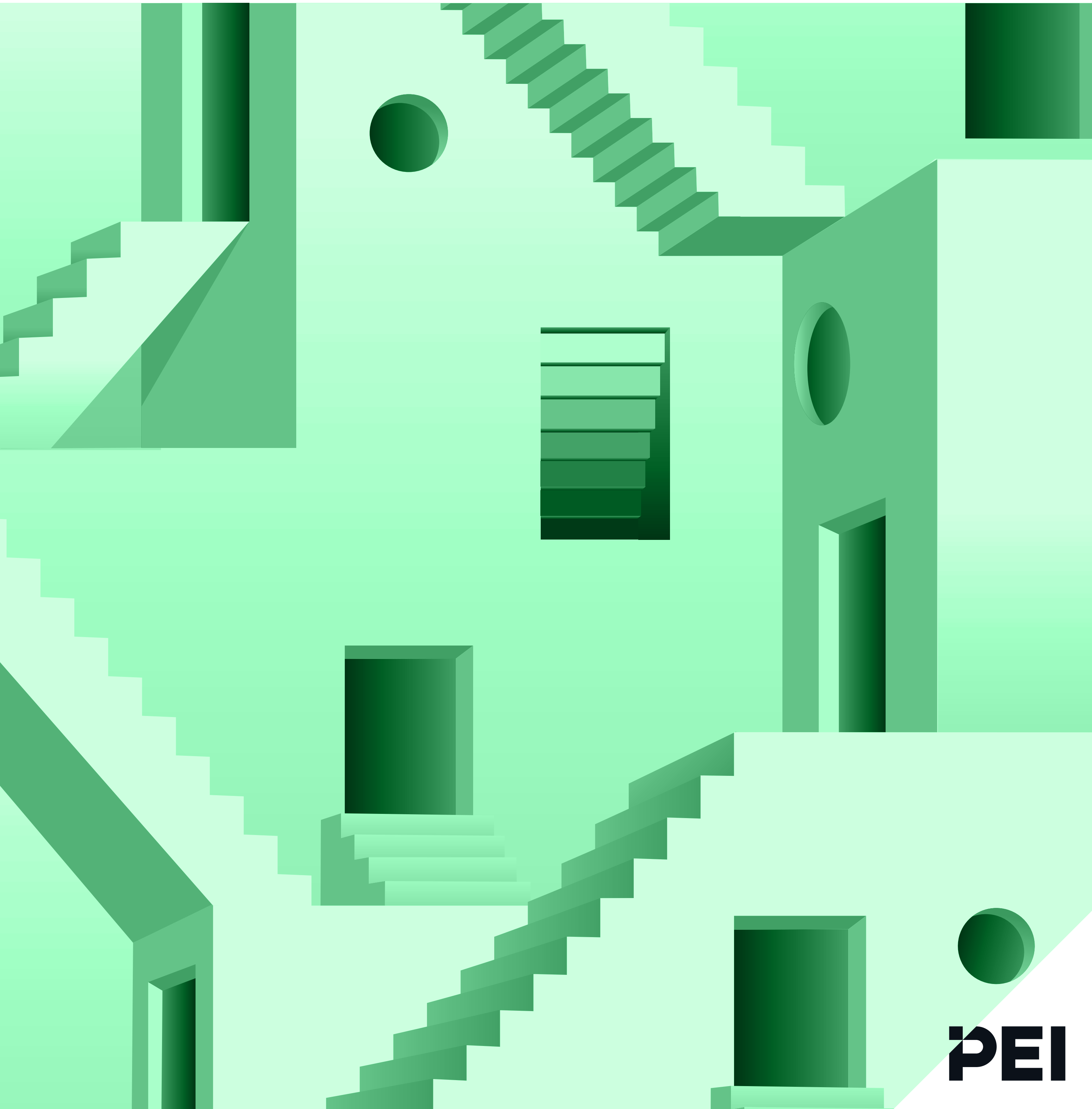

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EXPERT COMMENTARY

Sustainable real estate strategies that work with stakeholder communities are well-positioned to mitigate risks and can also create long-term asset value, argue Manulife's Erin Patterson, Onay Payne and Regan Smith



Social inclusion makes economic sense

As they seek to quantify and mitigate potential downside, institutional investors are increasingly analyzing a varied and complex set of sustainability-related risk scenarios. Environmental factors, including climate risk and sustainability regulations, are firmly at the forefront of this, and are now generally supported by advanced research, data collection and institutional backing.

This makes a certain degree of sense, coming in response to the growing magnitude and immediacy of climate risks, the increased cost and decreased availability of insurance for real estate owners and some increasingly pronounced regulation on environmental matters. For example, as many cities work toward reaching net zero by 2050, real estate owners must now evaluate the potential costs associated with addressing the various greenhouse gas emission limits that local and national governments have enacted.

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Putting aside the potential reputational damage associated with non-compliance, it is easy to see that many investors are running the math: is the regulatory fine associated with failure to address New York's Local Law 97 more or less significant than the cost of retrofitting properties to adhere to it? This is just one of many examples of new regulations that investors must analyze and consider within their budgets and business plans.

These trends – increased climate risk, regulatory pressures and new disclosure requirements – are therefore prompting investors to proactively assess their managers' ability to deliver environmentally and socially responsible investments. According to a recent Pension Real Estate Association (PREA) survey, 79 percent of real estate investors are now routinely weighing that question.

However, while most would recognize that the real estate industry has made significant strides toward incorporating environmental considerations within its risk and return analyses – a cursory review of GRESB's ESG performance data and benchmarks, for example, suggests that 50-60 percent of factors typically evaluated relate to the environment – efforts to measure positive social outcomes and impact are less well advanced.

After all, measuring social impact often requires a more sophisticated approach when compared with some of the more familiar, quantifiable environmental factors, such as reductions in energy and water consumption.

As a result, investors are increasingly seeking reliable information on social impact, and frameworks targeted at tracking and standardizing approaches to addressing social impact are gradually taking shape, including growing adoption of the Social Equity Assessment Method (SEAM).

For our part, Manulife Investment Management is working to better understand the connection between our environment and human health through a partnership with third-party certification provider Fitwel, which promotes science-based strategies to help develop healthier spaces. This comes on top of continuing efforts to incorporate material issues such as social impact, nature and biodiversity, and workforce diversity into our investment decision-making processes, wherever those considerations mitigate risk and support our clients' long-term interests.

The economic theory

Indeed, beyond serving as a risk mitigation tool, an 'impact lens' targeting secular environmental and social trends can also be an important means of opening up inclusive economic opportunities.

We have previously posited that deliberately inclusive, non-concessionary real estate investment strategies have the potential to meet the needs of return-seeking investors while also supporting broader socioeconomic outcomes. For instance, there is regenerative potential in the prioritization of human-centered economic development as a corrective to real estate development that unintentionally deepens pre-existing socioeconomic inequities.

And the additional household spending that comes from increased wealth and wealth equity can boost economic growth, driving the consumption of goods and services by the middle class which, in turn, feeds through into demand for real estate.

Additional evidence for this thesis is now coming to light, too: recent research has demonstrated a direct, causal link between increased economic inclusion and stronger GDP growth over the long term. The work of Daron Acemoglu, Simon Johnson and James Robinson, winners of the 2024 Nobel Prize for economics, supports this. As the laureates have noted, "greater inclusivity [has historically] translated into greater long-term growth and prosperity."

"Beyond serving as a risk mitigation tool, an 'impact lens' can also open up inclusive economic opportunities"

Specifically, their work has involved an innovative theoretical framework that demonstrates the link between inclusive economic and political institutions and long-term growth by studying the mortality rates of European colonizers.

In places where the settler mortality rate was high, those colonizers who survived implemented more "extractive" institutions to wrest natural resources from indigenous populations and maximize economic value for the smaller colonizer populations. In places where the mortality rate was lower, the colonizers formed more inclusive institutions to incentivize co-operation among a comparably more populous colonizer base.

The laureates illustrated the importance of these political and economic institutions in fostering prosperity by highlighting the vastly different economic trajectories of Nogales, in Mexico's Sonora region, and the more prosperous Nogales, Arizona. The two cities are separated only by a fence, but the more inclusive institutions established on the US side translated into much stronger economic growth over the long term.

While the US's long-term growth record has been strong, it has stagnated in recent decades as income equity has declined and as the middle class continues to shrink as a percentage of the population. Non-discretionary cost escalations (including housing, healthcare, childcare and groceries) have contributed to that decline, having outpaced wage increases and coming against a backdrop of a shift from manufacturing to service jobs and the corresponding prioritization of increasingly expensive higher education.

These trends are directly correlated with steep declines in America's socioeconomic mobility, which research suggests is determined by where children grow up and the access they have in their formative years to opportunity conduits, such as stable housing and early childhood education.

Social capital and economic connectedness (in the form of cross-class interactions) have also emerged as key factors in socioeconomic mobility; the more economic connectedness a child experiences, the greater their ability to move up the income scale.

The 'most affordable' multifamily investment strategies yielded higher and less volatile quarterly returns over a 16-year period

	Most affordable (%)	Mid-market (%)	Least affordable (%)
Average return/quarter	1.64	1.42	1.06
Volatility of quarterly returns	2.78	2.87	2.89
Compound average annual return, Q1 2008-Q1 2024	6.54	5.62	4.15

Source: PREA, based on NCREIF quarterly total returns, Q1 2008-Q1 2024

Putting it into practice

Considering social sustainability in real estate investments, then, may be a route to positive economic outcomes for both investors and community stakeholders. Prioritizing mixed- and middle-income housing, for instance, may be a fruitful way to foster economic connectedness as part of a returns-driven strategy.

Many institutional investors have historically shied away from targeting lower- and moderate-income populations on the grounds that the perceived risks derived from servicing them outweigh their potential returns. Concerns include the potential for higher credit loss, increased security costs, maintenance costs and capital expenditures.

Several existing and emerging ideas, though, may help to mitigate these risks, and even produce higher returns.

To begin with, research conducted by the PREA and the National Council of Real Estate Investment Fiduciaries (NCREIF) has shown that investment strategies focused on the "most affordable" and "mid-market" multifamily investments outperformed strategies focused on the "least affordable" investments.

The most affordable strategies yielded higher and less volatile quarterly returns over the 16-year period ending in Q1 2024. Investments in the affordable multifamily range can also satisfy fund mandates across the risk spectrum (whether core, core-plus, value-add or opportunistic), providing diversification within a fund or portfolio.

Secondly, the use of housing choice vouchers (HCVs) may enable US landlords to achieve market-rate rents, minimize credit losses and stabilize net operating incomes when renting to low- and moderate- income tenants. These government-backed vouchers can help to de-risk rental streams, given that up to 70 percent of rents are paid by the federal government.

There is still significant stigma and legal debate around the acceptance of vouchers, and HCVs tend to be associated with high-poverty, lower-opportunity areas, but changes in federal policy could help to incentivize public housing authorities (PHAs) to better support HCV recipients in moving to higher-opportunity neighborhoods with better school systems and lower crime rates. Combined with increased institutional landlord acceptance of HCVs, this could break the stigma and ultimately aid in fostering greater economic connectedness and social mobility over time.

Effective landlord partnerships with the PHAs that administer their vouchers could potentially decrease vacancy rates over time and could also limit re-tenanting and marketing costs. These benefits should in theory outweigh the perceived risks of renting to low- and moderate-income populations.

State-driven initiatives, such as Texas's public finance corporations and housing finance corporations and Florida's Live Local legislation, also incentivize real estate owners to create affordable and mixed-income housing. These programs provide property tax abatements for the development and conversion of housing at specified levels of affordability.

There is still some debate over the extent to which these programs are meeting their desired aims; additional transparency, oversight and accountability measures will likely be required to encourage greater coherence between intention and execution. But irrespective of the controversy around the issues with and potential abuses of these programs, we suggest that these initiatives are a step forward in efforts to address the affordability crisis facing low-, moderate- and middle-income Americans.

The long-term outlook

The ideas discussed here may serve as constituent parts of a holistic effort to reverse the shrinking of America's middle class over the long term. And in the short term, they stand to partially mitigate risks and potentially enhance risk-adjusted returns in inclusive investment strategies employed by returns-driven real estate investors.

This matters because real estate investors have an important role to play in providing adequate standards of living and a healthy living environment for all – something which surely warrants a cohesive and integrated approach, addressing both environmental and social sustainability while driving strong investment performance.

That is why we choose to make inclusivity a fundamental principle of our investment practice. We invite more investors to join us in investing with a deliberately inclusionary lens that first and foremost addresses their fiduciary responsibilities, while also contributing to stronger, more broad-based and longer-term growth for a broader set of stakeholders. ■