REAL ESTATE ISSUES®

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REAL ESTATE ISSUES

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The market for socially responsible property investments (SRPI) is potentially quite large and many institutional investors as well as individuals are expressing an interest in these types of opportunities. SRPI products could take several forms, such as REITs or private funds. They could be new products or existing ones that are certified by some yet

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to be established rating system. A rating system for certifying SRPI products would be needed and could be developed based on models that currently exist in the SRI and green building communities. While there is no systematic research proving the economic feasibility of SRPI products, there is a body of evidence that suggests such products could be competitive with more conventional products. Recommendations are offered for furthering the development of this niche in the real estate industry.

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THE COUNSELORS OF REAL ESTATE, established in 1953, is an international group of high profile professionals including members of prominent real estate, financial, legal and accounting firms as well as leaders of government and academia who provide expert, objective advice on complex real property situations and land-related matters.

Membership is selective, extended by invitation only on either a sponsored or self-initiated basis. The CRE Designation (Counselor of Real Estate) is awarded to all members in recognition of superior problem solving ability in various areas of specialization such as litigation support, asset management, valuation, feasibility studies, acquisitions/dispositions and general analysis.

CREs achieve results, acting in key roles in annual transactions and/or real estate decisions worth billions of dollars annually. Over 300 of the Fortune 500 companies retain CREs for advice on real estate holdings and investments. CRE clients include public and private property owners, investors, attorneys, accountants, financial institutions, pension funds and advisors, government institutions, health care facilities, and developers.

ENRICHMENT THROUGH PEER ASSOCIATION, COLLABORATION, EDUCATION & PUBLICATIONS

Knowledge sharing continues as the hallmark of The Counselor organization. Throughout the year, programs provide cutting-edge educational opportunities for CREs including seminars, workshops, technology sessions, and business issues forums that keep members abreast of leading industry trends. Meetings on both the local and national levels also promote interaction between CREs and members from key user groups including those specializing in financial, legal, corporate, and government issues.

CRE members benefit from a wealth of information published in The Counselors' quarterly award-winning journal *Real Estate Issues* which offers decisive reporting on today's changing real estate industry. Recognized leaders contribute critical analyses not otherwise available on important topics such as institutional investment, sports and the community, real estate ethics, tenant representation, break-even analysis, the environment, cap rates/yields, REITs, and capital formation. Members also benefit from the bi-monthly member newsletter, *The Counselor*, and a wide range of books and monographs published by The Counselor organization. A major player in the technological revolution, the CRE regularly accesses the most advanced methodologies, techniques and computer-generated evaluation procedures available.

WHAT IS A COUNSELOR OF REAL ESTATE (CRE)?

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Editor's Statement

BY HUGH F. KELLY, CRE

THE "BUZZ" IN THE GENERAL PRESS ABOUT THE REAL ESTATE INDUSTRY can be summed up in a phrase: "the bubble." Having experienced a collapse in commercial real estate prices as recently as the early Nineties, and with a wariness honed by the "tech wreck" that triggered the stock market decline precipitated by the dot-com "bubble," the concern is understandable. There is plenty of controversy surrounding the subject; the situation is far from certain. That makes it an "issue," and an apt subject for our journal.

Dr. Damir Tokic's article tackles the question head-on, and concludes that as far as housing is concerned a bubble does exist, and that only low interest rates are preventing price inflation based upon speculation from imploding the market. He specifically looks at the dot-com catastrophe, and warns that "many experts and a few influential academics argued that a dot-com bubble did not exist. Needless to say, billions of dollars were lost as technology stocks plummeted March 2000."

As editor, I commend Dr. Tokic's analysis for your consideration—though I'm personally skeptical about the appropriateness of the dot-com model for real estate. On the housing side of our industry, readers might want to look at a couple of research papers published by the Federal Deposit Insurance Corporation, an agency that has a critical interest in a collapse that would impact home mortgage repayments. The FDIC's website, http://www.fdic.gov/bank/analytical , will bring you to a first quarter 2004 paper entitled, "Housing Bubble Concerns and the Outlook for Mortgage Credit Quality," and a second quarter 2005 paper, "U.S. Home Prices: Does Bust Always Follow Boom?" The first FDIC paper notes at least five key distinctions between the tech wreck and housing appreciation trends: the "utility" of the house (if all else fails, live in your asset!), high transaction costs to sell a home, tax advantages of homeownership, the breadth of homeownership as a stabilizing factor, and the intangible social benefits derived from owning rather than renting. The second FDIC piece notes that past housing booms have more frequently ended in a plateau of pricing than in substantive, sustained price declines, and that "busts" are most often the consequence of local economic shocks—such as the "rust belt" and "oil patch" crises in the 70s and 80s—than in housing price trends per se.

On the subject of "utility," Dr. Alan Winger contributes a thoughtful and thought-provoking article on the changing function of the "home" at the beginning of the 21st Century. He examines the social and business impacts of the digital age, including issues such as telecommuting, and the growing phenomenon of homeschooling. His examination is a bracing reminder that real estate issues are not always simply about cash flow.

That broader perspective is also the theme of Dr. Gary Pivo's examination of the question, "Is there a Future for Socially Responsible Property Investments?" While the "doing well by doing good" theme has been examined for quite a few years in the general finance literature, we have not seen enough specific research in the area of investment real estate, and Pivo's article is a timely and provocative introduction to the subject.

Our "Insider's Perspective" columnists, CREs Ken Riggs and Mark Levine, and CoreNet Global's Chairman Jeffery Elie, keep us attuned to the ferment in the economy and real estate markets that never cease to "bubble along" … in quite a different sense of "bubbling." And frequent contributor Buzz McCoy, CRE, again offers a sage perspective on larger ethical issues in his review of Kurt Eichenwald's *Conspiracy of Fools*, an examination of the Enron and Arthur Anderson debacles.

As editor, I don't feel a particular need to agree with the points of view of each and every article published in Real Estate Issues. I don't believe the reader only wants to see pieces that are "safe" and non-controversial, either. In fact, to the degree that our articles provoke reactions and a feeling of "by golly, I don't think that's right," and prompt either letters or (even better) responsory articles with a different perspective, that is a healthy and mind-sharpening exercise—the very best raison d'etre for our journal.

So I am placed to submit these offerings for your consideration… and invite you to respond as only our talented and experienced readership can.

HUGH F. KELLY, CRE
EDITOR IN CHIEF

Is There a Real Estate Bubble?

BY DAMIR TOKIC, PHD

INTRODUCTION

IS THERE A REAL ESTATE BUBBLE? IF THERE IS, what will be the consequences on the economy as the bubble bursts? Who will be affected by it, and how? These questions reflect daily worries for a significant portion of market participants and general population such as: homeowners, potential homebuyers, homebuilders, real estate investors, stock investors, bond investors, and policymakers.

Unfortunately, less informed participants are not getting the straight answers, thereby risking losing a significant portion of their home equity or incurring other types of financial losses. Is it questionable even if better informed investors or experts really know the answers to these questions?

We would like to refer the reader to the recent dot.com bubble, when many experts and a few influential academics argued that a dot.com bubble did not exist. Needless to say, billions of dollars were lost as technology stocks plummeted in March 2000. Is it likely that the same will happen again? Except this time, instead of tech stocks, real estate values will drop?

This paper uses a think-tank approach to evaluate the broad real estate market and its impact on economy. It is an exercise that every individual can follow and logically arrive at answers that could save someone's existence. First, the paper presents brief literature on "bubbles" and "bursts." Then, it moves to specific questions regarding the real estate markets.

BRIEF LITERATURE ON "BUBBLES" AND "BURSTS"

Generally, a bubble is a period of time when an asset's price reaches irrationally high levels. The bust is an inevitable price correction. There have been many boom-to-bust episodes in different financial markets, throughout the history. This paper will focus on specific studies on housing bubbles.

Studies that compare housing bubbles with equity price bubbles find that housing price busts were associated with the more severe macroeconomic downturns than equity price busts. Also, housing price booms are more likely to be followed by busts. In particular, five factors account for greater severity of housing price busts:

1. Housing price busts have larger wealth effect on consumption than do equity price busts (Bayoumi and Edison, 2003).

2. Housing price busts were associated with stronger and faster adverse effects on the banking system than equity price busts (Eichengreen and Bordo, 2002).

About the Author

Damir Tokic, PhD, is an assistant professor of finance at the University of Houston - Downtown. His publications have appeared in journals such as: the Journal of Investing, the Journal of Emerging Markets, Asia - Pacific Business Review, Journal of Corporate Finance and Accounting and others (tokicd@uhd.edu).

Exhibit 1—What does the construction process involve and what are the effects on the economy?

Stage	Effects
1. Real estate developer borrows from a bank to buy land	■ Bank makes money on interest ■ Lawyers make money on fees ■ Brokers make commissions ■ City makes money on permits issuance ■ Land value increases - Local governments make money on higher property taxes - Local government hires more city workers with increased budget
2. Real estate developer borrows money to begin construction	■ Bank makes money on interest ■ Developer buys raw materials - Price of commodities goes up - Miner companies increase production - Jobs are created in commodity-based industries and countries ■ Developer buys or leases construction equipment - Equipment producers increase production ■ Developer hires construction workers
3. Real estate developer completes construction	■ Buys new tiles ■ New air conditioners ■ New alarms ■ New kitchens ■ New bathrooms ■ Demand for items that go into final product increases, increasing production and jobs in those industries ■ Inspectors make money on final inspections
4. Residential property is sold	■ Real estate agents make commissions ■ Banks make money on interest and fees ■ Lawyers make money on fees. ■ Appraisers and inspectors make money ■ Real estate developer makes profit on sale

3. Housing price busts were more likely to have been preceded by a boom so that there were larger imbalances to be unwound (Bordo and Jeanne, 2002).

4. Housing price busts were more likely associated with generalized asset price bear market than equity price busts (Ito and Iwaisako, 1995).

Exhibit 2—Effects of new home ownership on economy

Stage	Effects
1. Consumer buys residential property	■ Consumer borrows to buy new furniture - Bank makes money on interest - Production of furniture increases, jobs increase - Furniture retailers make money ■ Consumer decorates house - Home décor retailers make money ■ Consumer buys new technology (TVs, entertainment) for the home ■ If condo, consumer pay maintenance fees. Management firm makes money ■ If house, consumer buys lawn equipment or hires maintenance personnel ■ Consumer pays real estate taxes. - City makes money, hires more people - School districts have larger budgets hire more teachers - Police, fire departments have larger budgets, hire more people - Ports and other city services have larger budgets and hire more people
2. As home prices increase:	■ Consumer takes home equity loan -Banks make money on interest -Consumer spending increases with the extra cash ■ Property taxes increase - City, schools, police, fire department, port have larger budgets and hire more (or spend in other ways) ■ Investors and speculators get attracted to real estate returns - Buy properties for quick resale - Buy 2nd or 3rd homes or condos - Property prices increase even more - Banks make even more money on these loans - Real estate agents, lawyers make money as well
3. As interest rates decrease	■ Consumer refinances and lowers the payments ■ Consumers spending increases

5. Housing price busts were associated with tighter monetary policy than equity price busts (Schwartz, 1995).

Exhibit 3—Real estate pricing factors

Real estate demand factors	■ Population growth - Baby boom cycles - Immigration ■ Ability to buy - Good credit - Full time job - Ability to borrow - Savings for down-payment ■ Housing assistance programs - HUD, Freddie Mac, Fannie Mai - Assistance with down-payment - Guaranteed loans for sub-prime borrowers ■ Low interest rates - Interest payments lower - Consumer builds equity faster ■ Trend of fashion - Desire to upgrade - Everybody is buying ■ Speculation - Rising real estate prices. - Low interest rates - Zero down, interest only mortgage products
Real estate supply factors	■ Land constraints -Regional issues ■ Tear down old housing to build new - Prime locations - Sub-prime locations revitalization ■ Townhouses, high-rises, condos, houses closer to each other ■ Interest rates – ability to borrow

Exhibit 4—Reasons behind motivated sellers

1. Foreclosure	■ Lost a job, unable to make payments ■ Divorce ■ Medical expenses ■ Other unforeseen expenses ■ Unable to pay property taxes ■ Home value falls below the total loan amount, stop making payments
2. Relocation	■ Has to move
3. Defective property	■ Previously unknown environmental hazard emerges. ■ Neighbor problems
4. Life changes	■ Marriage ■ Children ■ Larger or smaller family ■ Retirement
5. Speculators	■ Unable to sell a property bought for investment purposes.
6. Inventory liquidation	■ Developers' supply exceeds the demand, must liquidate the inventory
7. Fear that home equity will be lost due to declining prices	■ Declining home prices may trigger even more selling to protect the home equity ■ Especially for owners with 2nd or 3rd mortgage
8. Interest rates increase	■ Borrowers with variable rate mortgages pay higher interest ■ Possible default as payments increase

THINK-TANK EXERCISE

Our exercise starts with an environment where a real estate developer decides to build a housing project. What does the construction process involve and what are the effects of construction on the economy (Exhibit 1)? It seems like the major effect of booming construction on economy is job creation, not only in construction, but also in services that support construction, and manufacturing that supplies the housing industry.

Once the project is completed and sold out, what are the effects of new home ownership on the economy (Exhibit 2)? New home ownership requires further consumption, including home décor, furniture, and technology. Consumption of other goods also increases as consumer wealth increases due to rising home values. In addition, homeowners pay property taxes, which benefits city budgets.

In our perfect environment a real estate developer builds homes and sells them to public for profits. The reality test of this environment will be a function of consumer demand and the ability to satisfy that demand. Excessive imbalance between the demand for housing and the corresponding supply will greatly affect housing prices. If the demand exceeds the supply, home prices will increase. If the supply exceeds the demand, home prices will decrease. Our next exercise discusses the factors that affect the demand for housing and the factors that affect the supply of housing (Exhibit 3). The major demand factor is the ability of consumers to buy a house. Full time employment is a necessary precondition to: save money for the down payment, afford the monthly payment, and to quali-

Exhibit 5—Reasons for slowing demand for housing

1. Population growth slows down	■ Baby boom cycle ■ Anti-immigrant laws
2. Weak labor market	■ Outsourcing of jobs to India, China and other ■ Slow wage/salary growth rate ■ Popularity of part time—temporary employment
3. Low savings rate	■ No money for down-payment ■ Unable to qualify to loan due to lack of savings
4. Increase in personal bankruptcies	■ The combination of high spending, low savings and sluggish job market could increase personal bankruptcies ■ Bad credit—unable to qualify for mortgage
5. Troubles at housing assistance programs.	■ High default rates in sub-prime mortgage market could discourage further housing assistance
6. Declining home values	■ Keep away speculators
7. Higher interest rates	■ More expensive to borrow money ■ Higher interest payments—slower equity building ■ Higher monthly payments—harder to qualify for the loan ■ Keep away speculators

fy for the mortgage. Supply factors are mostly regional, as the availability of land to build differs across regions. However, as long as the demand is strong, homebuilders can find a way to develop a property on limited land, such as build townhouses or revitalize old neighborhoods.

Now that we understand the housing market pricing factors, we can begin to introduce the discussion whether there is a real estate bubble or not. Our major assumption is that for bubble to arise there has to be a high probability for a sharp decrease in the price. Otherwise, we would not be talking about the bubble. Next, we propose that two conditions would essentially cause the bubble to burst: 1) there have to be motivated sellers (Exhibit 4) and 2) there has to be slowing demand for housing (Exhibit 5). The lethal combination of abundant motivated sellers, with buyers nowhere to be found, is the prescription for housing bust. Real estate speculation is definitely a worrisome activity that can create very motivated sellers, especially if the labor markers are weak and interest rates are rising.

Finally, our exercise ends with the question, if there is a housing bubble, what will be the effects on the economy once the bubble bursts (Exhibit 2). As literature suggests, the consequences of housing bust can be severe for the economy. First, the jobs are lost in construction and in economy wide. Seconds, the wealth is lost as home prices plummet. Both of these are translated into slower consumption. Finally, financial sector suffers as lending activity disappears, and existing loans face defaults.

DISCUSSION—IS THERE A REAL ESTATE BUBBLE?

Our exercise would be worthless unless we are able to answer whether there is a bubble or not. The starting point of our discussion and the major assumption is: for a housing bubble to exist there has to be a significant amount of speculation.

Speculation, in our opinion, can take two forms. First, a real estate developer could overestimate the demand for housing and build an excessive inventory of speculative homes. Second, a homebuyer can speculate by buying properties for investment purposes with the hope to resell them later for profits. These two speculators are very different as homebuilders control supply while speculator buyers control the demand.

The major warning sign for a real estate market is when majority of buyers are speculators purchasing second or third homes for investment purposes. Why? It signals that consumer demand for primary residence is weak due to any reason discussed earlier. If the consumer demand is weak, who is going to buy properties from speculators? Who is going to buy excess inventory from homebuilders?

There has to be a trigger or a tipping point that bursts the bubble. Most likely, that trigger will come either from a home builder liquidating the inventory below the market value, or speculators selling their investment properties bellow the purchasing price. But what would cause such a sell off? Speculators may be willing to hold on to their investments until the cost of holding on to a property increases. Specifically, the prospects of higher interest rates will increase the cost of holding on to investment property and trigger a motivated sell. Declining home values and increasing interest rates will keep away new speculators and further decrease the demand for housing. Excess inventory of new homes and the large number of motivated speculative sales, are likely to cause further decrease of home values.

Exhibit 6—Effect of slow real estate market on economy

1. Less construction	■ Less bank borrowing ■ Less transactions for lawyers and brokers ■ Loss of construction jobs ■ Slowing demand for commodities ■ Slowing demand for construction equipment ■ Slowing demand for tile, kitchen, bath, windows, and other housing products
2. Slower home sales	■ Less bank borrowing ■ Less transactions for lawyers and brokers ■ Lower aggregate commissions for brokers ■ Less business for inspectors, appraisers ■ Less business for management companies and maintenance personnel. ■ Slower furniture sales. ■ Slower home décor sales ■ Slower new technology sales ■ All together, leading to loss of jobs in banks, law firms, brokerages, management companies, retail stores, furniture and construction equipment producing firms
3. Declining land and home values	■ Lower property taxes - Lower budget for cities, schools, police, fire departments, ports… - Loss of jobs and less public spending ■ Foreclosures - Speculators unable to sell investment properties for profit, and unable to sell for loss—no money to close the deal - Loss of jobs associated with slower real estate markets - Higher interest rates for variable mortgage rate borrowers increase payments ■ Loss of home equity, especially serious if home value falls bellow the loan value - Consumer wealth would decrease, affecting the consumer confidence—the wealth effect
4. Stock market downturn	■ Financial sector ■ Construction- and housing-based sectors ■ Commodity-based firms and emerging markets ■ Further erosion of consumer wealth
5. Big picture – the budget deficit problems	■ Loss of jobs, declining property taxes, declining consumer wealth and corporate profits would make it harder to lower the U.S. budget deficit

Slowdown in housing market, as we proposed, would at first cause slowing economy, which would translate into loss of jobs. Homeowners who lose these jobs are likely to miss their mortgage payments and file for bankruptcy. At this point serious consequences would start for the economy as numerous foreclosures further decrease home values and banks feel the increased number of non-performing loans.

In summary, whether there is a real estate bubble or not depends on amount of speculation in these markets. National Association of REALTORS shows that 23% of home purchases in 2004 were by investors. That means that almost 1 out of 4 homes bought in 2004 were purchased only to be resold at the higher price sometime in the future. At the same time, building permits and housing starts continue to grow in 2005 to historically high levels. One only has to take a drive through any U.S. city and its suburbs to notice an abundant supply of newly built condos and single-family homes. One can also notice so many "for sale" signs and "open houses" on existing homes. Isn't this the prescription for a housing bust, as described earlier? In our opinion it is.

There seems to be no data to indicate who are the investors buying second or third homes. However, some analysts suggest that baby boomers have been buying homes for their retirement, which has been the primary demand factor for second homes. Eventually, retired babyboomers will have to sell their primary residences before moving to their new homes. This will only increase the selling pressures and contribute to the housing bust.

Some other analysts see a high level of short-term home "flipping," where speculators invest in a second, third, or

fourth home with the hope to resell them for profits within the short period of time. Sometimes, speculators buy homes/condos while in construction and resell them before the construction is completed.

Another theory is that, after the stock market crash in 2000, baby boomers took money out of the stock market and invested in real estate, hoping that real estate is less risky and more likely to appreciate than the stock market. In addition, a property can be rented out to supplement their incomes in retirement.

Whether baby boomers have been buying second homes to live in them once they retire, or to rent them out to supplement their incomes, or whether other investors have been "flipping" homes for short term gain, a historically high statistic that shows that 23% of homes purchased in 2004 were second home investments is alarming because it indicates unsustainable demand that will inevitably result in bust.

SUMMARY

This paper discusses whether this is a housing bubble or not, and what will be the consequences if such a bubble exists. Using a simple exercise of what happens if, we conclude that there is a housing bubble because speculator investors cause the excess demand, while the speculator homebuilders cause the excess supply. The demand-supply imbalance has to cause the price correction. The only question is for how long speculators will be willing to hold on to their investments, before selling below the purchasing price. We conclude, as long as interest rates are low. Therefore, market participants should closely follow the interest rates as the potential trigger for housing bubble bust.■

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Is the Role of the Home Changing?

Some Real Estate Implications

BY ALAN WINGER

EVERYBODY AGREES THAT THE CHANGES UNDERWAY in the economy are impacting the nation's real estate market and what's happening now is probably only the beginning of what's to come. Most discussions about such matters focus on what our rapidly changing information technologies are expected to do to the business use of real estate. The concern in this article is with possible long-term impacts on the residential real estate choices of households.

While speculations about the long-term future of activity in particular markets are just that—speculations—there are developments underway that suggest the home will, in time, become a more important center of our activities in ways that have implications both for our residential and nonresidential real estate markets. The argument here is worth making because it points to things that should be watched as the future unfolds. Before getting to it, however, I want to review briefly some recent developments in the residential market that suggest this process may be underway.

THE HOUSING MARKET IN THE NEW MILLENNIUM

The housing market has, of course, exploded recently with the sharp increase in the level of single-family home activity both in the new and existing unit markets. While more than a few have expressed concern about a price bubble in these markets, that possibility is not my concern. Rather, my concern is with certain facts that hint at some early housing market impacts of the recent advances in our digital technologies.

The facts of interest are those that show an increase in the size the new units coming on to the market between 1995 and 2003. In 1995, 28% of the units completed and added to the housing stock had floor space of 2,400 square feet or more. By 2003, that figure had risen to 39%. Over this same period there are facts that show a slight decline in the average size of families. The increase in the size of units coming on to the market apparently can't be explained by demographic factors as it has in the past.

WHAT THEN IS THE EXPLANATION?

There are economic models that offer an explanation in terms of what happened to incomes which increased during this period and financing costs that declined sharply. Any self-respecting economist would point to income and financing cost elasticities as factors that could explain the growing demand for more housing space.

These elasticities, helpful though they may be in our interpretation of market developments, are based on calculations that average the relevant experience of the past. While this is an acceptable procedure during periods of relative economic stability, one has to feel a little less comfortable with it during periods of significant economic change. To be sure, we no longer hear much talk about the new economy, but no one doubts that we are living in a period in which our advancing information technologies are generating tons of changes in how the business world

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Exhibit 1—Selected Statistics: 1995 and 2003

	1995	2003
New One Family Homes Completed- % with FloorSpace Greater Than 2400 Square Feet	28%	39%
Average Family Size	3.19	3.13
Median Family Income (In 2002 Dollars)	$47,588	$51,407*
Mortgage Rates (Conventional Mortgages)	7.87%	5.80%

Sources: U. S. Census Bureau, Department of Housing and Urban Development and Federal Reserve.
* Income figure is for the year 2002

operates and, to a lesser extent, in how we live our lives away from our jobs. That this is so has to mean that there are things going on that could be altering our demand for housing space irrespective of what's happening to our incomes or those financing costs.

What things?

THE HOME IN A DIGITAL AGE: THE SOCIAL SIDE

The home has long been at the core of the social life of urban families in the United States. Early on in our history that life for most was largely limited to what were strong cohesive connections with nearby neighbors. This began to change with the coming of the automobile and the suburbanization it brought about. Life in the suburbs, with its mall shopping, TVs, VCRs and neighbors who were not quite so close led to much less contact with those nearby. The social contacts of most suburbanites began to spread over more territory in relationships that, by and large, were weak compared with those of the earlier era. Robert Putnam's *Bowling Alone* provided us with one view of some of the social consequences of these developments.[1]

Enter now into the world of the Internet, the World Wide Web and mobile phones, a world that provides the basis for significant expansion in both the number and reach of our social connections. Those who have become active in this part of the world participate in a social network that allows them to easily increase the number of contacts, some of which are with people located in faraway places. And all of this can be done at different locations.

Some early speculations about the outcome of technologies expected to open up such possibilities had people moving into a more nomadic lifestyle.[2] While some—perhaps even a lot—of our social life would shift into cyberspace, many of the relationships developed in this world, it was argued, would lead to the pursuit of face-to-face contacts giving rise to nomadic movements. Such movement would lead to the need for living space in more than one place, but less space in any one place. With this view of the world, the housing market would become both more dispersed and more concentrated. A nomadic lifestyle would lead to dispersion. Rather than living in just one place, people would have a number of places of residence. But more than one place, given the family budget for most, would mean units with less living space. And the scale economies realized in building such units would lead to geographic concentrations of them wherever those nomads chose to hang their hats. The result would be smaller units clustered in more densely populated areas, units that could be rented or owned in some kind of condominium or time-share arrangement.

There are developments underway that suggest the home will, in time, become a more important center of our activities in ways that have implications both for our residential and nonresidential real estate markets.

Of course, there'd be nothing new in this. Prior to the Internet there were high-density transient residential communities with rental, condominium, and time-share units found in largely in locations where there was warm climate, water, and/or mountains. These were largely the outgrowth of an economy that generated the income and wealth that enabled some people to cover the cost of such space as well as a transportation network that made it economically feasible. What the Internet—and whatever followed—was supposed to do was to greatly expand what the nation's more affluent citizens along with a growing number of less affluent seniors were already doing. The assumption was that increasingly more of the nation's population would have both the wherewithal and mobility to become more nomadic, the result being many more people with more than one place to live—albeit smaller

places. This implied a home life that would continue to recede as a center of activity. While the demand for living space in such a world would continue to be influenced by the demographic and economic circumstances of the household, that demand in particular locations would be diminished by the lifestyle changes that digitization would bring about.

In fact, there haven't been many signs of any such change to date. The Internet is clearly having impact on family social connections in the sense of expanding both their number and reach. When these connections occur in cyberspace, this generates activity that can take place in the home. Whether it does or not, however, is by no means clear for with the growing sophistication of mobile telephony these connections can result in activity outside of the home.

What we do know is that to date most of our important electronic social contacts have been with people who are not too far away—within the same metropolitan area—and that face-to-face contact remains an important part of these relationships. What is different about these activities today is that people are better able to customize what they do. Social life is no longer a matter of choosing to participate in some structured activity like a golf league or Elks meetings. The Internet provides a basis for finding activities that are closer to one's interests or making it much easier to organize an activity by oneself.

Not only does the Internet open up the rest of the world through easy access to global information, it strengthens local contacts and relationships in a way that increases social activity in the home. When those contacts are numerous and involved, as they frequently are, Internet connections via home-based personal computers serve us best given today's technology. As all this has worked out thus far, our social lives in a digitizing world have not really moved us out of the home, but have been pushed back into it a bit.[3] Whether this will remain so as the technology is further developed is, of course, another question. But the technology required to make those wires into the home obsolete will be sometime in coming.

THE HOME IN A DIGITAL AGE: THE BUSINESS SIDE

Work in the home is, of course, something that goes way back. Prior to the industrial revolution, much of what we now call cottage industry activity was housed in the home. The industrial revolution changed all that, moving work into factories, office buildings, warehouses and retail establishments. As we entered the second half of the 20th century, the American home was, by and large, a place for family life and all that entailed.

As we got half way through that second half, speculations about the renewal of the home as a place of work began to surface. Soothsayers began picking up on the expected technological advances in communication at a time when suburbanization was transforming our cities and commuting costs were beginning to balloon. The time became ripe for the notion of telecommuting to work its way into speculations about the future.[4]

Working at home and communicating with others electronically on an as-needed basis was an idea that had a good deal of surface appeal to workers, employers and the communities in which the telecommuting was to take place. For the worker, it meant the removal of what was a growing source of irritation and expense—commuting. It also means more flexibility in accomplishing the work to be done. Such flexibility was of some importance to the two-income family, a family arrangement that was rapidly increasing in number as women began to enter the workforce in large numbers.

Work in the home is, of course, something that goes way back. Prior to the industrial revolution, much of what we now call cottage industry activity was housed in the home.

To the employer, telecommuting had positive cost implications. Workers spared the inconvenience and cost of commuting could be hired at a lower cost. And if the flexibility the arrangement provided to employees worked to their benefit, there could be productivity gains.

To the community in which all this took place, the benefits were reduced traffic flows which lowered the cost of providing and maintaining the needed streets and highways. Less automobile traffic also reduced the dimensions of its pollution problems.

What seemed so promising back in the late 1970s and early 1980s, however, did not materialize in any significant way and didn't initially for a very good reason. The electronic communication gear necessary to create the linkages needed to get most jobs done when workers were

physically separated was not there. Until the development of the Internet, the available means of electronic communication did not really facilitate the kind of interaction between workers and workers and bosses required. And as the technology began to develop, small scale uses of it were expensive, making it unfeasible for much home use. That cost in fact gave rise to the development of a number of places close to where workers lived—teleport centers—places that housed enough activity that made acquisition of the available equipment worthwhile.

Working at home and communicating with others electronically on an as needed basis was an idea that had a good deal of surface appeal to workers, employers and the communities in which the telecommuting was to take place. For the worker, it meant the removal of what was a growing source of irritation and expense—commuting.

The Internet represented, potentially at least, a big step forward. Yet, to this point its potential that has yet to be realized in any significant degree.

The available facts about telecommuting come from surveys, the results of which are wide ranging. Those that come from a trade association (the International Telework Association and Council) suggest there are now more that 40 million teleworkers accounting for close to one third of the nation's workforce.[5] A 2001 survey made by the Census Bureau, on the other hand, indicates that number to be about 20 million.[6] In both instances the reported number includes people who are wage and salary workers taking work home on an unpaid basis, those who were self-employed as well as those who had a formal arrangement with employers to work at home. In the Census Survey, about half of the number of telecommuters were identified as unpaid workers, more than a third were self employed and the remainder (about 15%) were those expressly paid to work at home.

The conclusion to be drawn from the Census data and survey data collected in a number of European countries[7] is that telecommuting in the sense most often used by those who saw it as the wave of the future is still a very small part of the workforce—just a little over 2%. This obviously raises the question of just what is the problem given the potential benefits of such activity.

WHY SO LITTLE TELECOMMUTING?

There are several reasons why telecommuting has not caught on as much as some believed it would a couple of decades ago. One of these has to do with the technology. The telephone technologies that dominated electronic communication until the coming of the Internet and the World Wide Web were limited in what could be communicated between home and the office. While Internet connections, as they have developed thus far, have removed some of these limitations, electronic communication is still in a very rudimentary stage compared with what we can do when we are face-to-face.[8] While disadvantages will diminish as the technology is further developed, there is reason to argue that being face-to-face in business will retain its current importance because of what's happening in the economy.

We are living in an economic world in which there is ever increasing complexity and specialization in the tasks we must perform. This movement into what some characterize as the knowledge economy has given rise to the need for extensive and often very subtle communication among those who are a part of the teams involved in those tasks. The economic world in developed countries has become infused with knowledge-based operations and what needs to be known changes constantly. From science as it has evolved over the past 50 to 100 years or so has come a knowledge base that provides the foundation for much innovation in the economy. And the growing world dominance of markets as the mechanism for economic activity and the globalization of these markets have intensified the competitive pressures on firms to innovate to a degree that competitive advantage in most industries is now achieved through innovative operations.[9]

Innovation, of course, is activity that requires thought that generates something new. In today's world, many of the ideas that give rise to such activity are plucked from the complex subject matter of some science. To innovate today requires high-level competencies and draws upon knowledge not to be found in textbooks. With teams of people involved in interactive ways in much current innovation, there is need for a lot of conversation, discussion and debate. The creativity in this kind of activity is built to

a considerable extent on tacit knowledge—that which is in the mind of the people involved—activity that is now generally believed is most effectively carried out on a face-to-face basis. The emergence of such high-tech centers as Silicon Valley and the Research Triangle in North Carolina is almost always offered as testimony to this point. What this implies is activity that doesn't lend itself to telecommuting. That it has been growing rapidly in importance in the operations of a great many businesses is one of the reasons why telecommuting has not taken off as speculated earlier.

Then there is the matter of how it is that people actually behave. While survival in today's competitive markets requires creative thinking, translating the ideas coming out of bursts of creativity into successful business operations requires rational calculations and choices. It requires the kind of thinking, some of the output of which could be communicated electronically. Yet those who communicate such information are not economic automatons. Those who make those rational calculations and choices bring along emotion when doing so.

No one disputes the fact that our feelings influence the role we play in the economic process. Nor can it be denied that these feelings often create problems that must be dealt with when they occur. Dealing with such problems requires both recognition and understanding. While the feelings we have about something can obviously be made known through language, many in business believe that non-verbal means of communication—body movements, facial gestures, touching, etc.—are more effective. "Going eyeball-to-eyeball" is the typical business characterization of how best to find out what someone really has in mind in communication with others. This, of course, is what we can't do as a telecommuter given the technologies we have today. It is what we can do when we are face-to-face with our colleagues.[10]

WILL IT BE THIS WAY FOREVER?

Some who speculate about the future put forth scenarios that feature technical developments that greatly facilitate substituting electronic communication for much of what we now do face-to-face.[11] If markets in these worlds were to retain their current importance and the globalization process continued, there would be plenty of incentive for businesses to make such substitutions.

But will this really happen? Will those who communicate respond in ways that make any such changes cost effective?

There is good reason to raise this kind of question. Recent research into human behavior has provided insights that suggest communicating on a face-to-face communication might be wired into our behavior. Research in genetics, neuroscience and evolutionary psychology, among other fields suggest the presence of "biological wiring" that reinforces the importance of being face-to-face when connecting with others. The argument, simply stated, is that as a result of the tens of thousands of years communicating on a face-to-face basis in our many activities, we have effectively optimized our biological apparatus to communicate in this way.

We are living in an economic world in which there is ever increasing complexity and specialization in the tasks we must perform.

Precisely how important this wiring is remains a question to be answered. The issue here can be framed as one of nature versus nurture.[12] What the recent studies have done is to elevate the importance of nature. While nobody believes that environment—for example the kind of communication tools we have to work with—is unimportant in how we communicate with one another, what seems clear now is that, given the technologies we have and are likely to have for some time into the future, being face-to-face will remain important. This will be especially so in business settings in which there is need for subtle communication as there is when dealing with complicated matters that have uncertain outcomes—innovation. What this implies is that, over the next decade or two, a great deal of what we do in business will remain detached from any effort to move work to the home to reap the benefits of telecommuting.

Having said this, there are reasons for believing that sometime in the future the importance of being face-to-face in business situations will be reduced—possibly by a good deal. If we assume the technology evolves in ways that allows us to communicate electronically much as we now do when face-to-face, things will be happening that could make people more amenable to its use.

The first of these is the continued growth in the proportion of the population who will feel fully at ease in dealing with the technology and hence more willing to use it if it lives up to its promise. This will not only result from the

aging of the young people now being brought up with it, but will reflect continued success in our efforts to make the technology user friendly.

Second, the nature of work is changing in ways that could, in time, reduce the importance of being face-to-face in business. The boundaries of firms in industries that are on the cutting edge of those rapidly changing technologies are being altered and substantial chunks of the hierarchies of these firms are disappearing. In some of these industries, there are firms that have a core activity, around which there are many independent suppliers providing much of what is needed to carry out successfully what is now being labeled as a business process. There are entrepreneurs coming forth with ideas, organizing a process that encompasses the work of a great many outside contractors—e-lancers as they are sometimes called—and coordinating all these activities with the aid of the tools being provided by our rapidly developing information technologies. Some visualize this process evolving into an operation of talented people getting together on a loosely knit basis, doing their jobs and then disbanding—the so called e-lance economy.[13] Of course, there's nothing new about this. It's a process that now characterizes much of the cinematic product coming out of Hollywood and a number other places. What some of today's soothsayers believe is that it will spread to a great many of our other activities.

While all of this kind of activity can be concentrated in one place with face-to-face conversation dominating the communication of which it is a part—as in what happens in places like Silicon Valley—our information technologies, as they are further developed, will inevitably bring about connections between e-lancers who are more spread out. What this implies is work that is less geographically concentrated. While we will by no means be celebrating the "death of distance," people will have more freedom as to where they carry out their roles in the business process. If there are advantages to being at home in what they do, those e-lancers may well choose to do so.

While e-lancing is currently only a relatively small part of the way in which labor services are provided in business, it's going to grow as our information technologies are further developed. And as this kind of work arrangement becomes more common, there is reason to argue that there will be added incentive to move some of that work back into the home. Some of this will come from commuting costs that will be increasing in part as a consequence of our efforts to deal with our energy problems. These efforts, no matter what they turn out to be, will add to the cost of movement, which means higher commuting costs. These costs will also be rising if we continue to fail to deal with the ever growing problem of congestion in our highways.[14]

HOW WILL WE RESPOND TO SUCH COST INCREASES?

We could, of course, choose move to closer to where we work—back to the city or an edge city—and some will do this.[15] But, in my view, there is good reason to believe that America's love affair with the automobile and the mobility it provides will not disappear. Nor is it likely for many that their desire for a lot of living space will diminish. Yet, moving away from crowded locations as the means of maintaining that mobility and acquiring the needed space will create budget problems, especially if commuting costs are rising. These are problems that could be avoided, however, if we telecommute. If the additions to commuting costs are high enough, more of those who want mobility and space could, technology permitting, decide to work at home or at some teleport near where they live.

While we will by no means be celebrating the "death of distance," people will have more freedom as to where they carry out their roles in the business process.

The economic world is not going to morph into a great mass of cottage industries in which everybody works out of their home connected in a business process, the components of which are linked together through one great big web-like electronic infrastructure. Work out of the home is never likely to become the dominant way labor inputted into a business process if only because of that biological wiring. But its importance is going to increase if competitive markets continue to dominate what goes on in the world economy. In such a setting, businesses will be under constant pressure to look for ways of doing things that result in new products, enhanced productivity, and lower costs. Telecommuting has the potential to contribute to

this search if the technology is there to provide for the kind of communication that is required.

BUT WILL WORKERS RESPOND TO WHAT BUSINESSES WANT TO DO?

History suggest that they will if the benefits from doing so are significant and easily recognized, as they seem to be for telecommuting.[16] We should not expect dramatic increases. Nor will these increases be quick in coming. But there is clearly reason to expect more work at home in the future which is going to impact, at a minimum, the size of the dwellings in which we choose to reside.

THE HOME IN A DIGITAL AGE: EDUCATION

Home-based education of our children in grades 1 through 12 goes way back to our early history. Up until the early 1900s, many children were educated in the home. All that stopped with the passage of compulsory attendance laws that effectively made such schooling illegal. Until the 1960s virtually all of the formal education of our children was done in institutions—both public and private—separate from the home. While there was "home" work, the formal education process was carried out in school buildings staffed with professional educators.

Beginning in the 1960s, growing dissatisfaction with what our schools were doing gave rise to actions that ultimately resulted in the legalization of homeschooling in all 50 states. The movement back home in the sense of acquiring an education at home under the tutelage of a parent or some other member of the family started slowly. From an estimated 13,000 school age students in the early 1980s, the homeschool population rose to a total estimated to be anywhere from 1.1 million up to 2.1 million by 2003.[17] As with those telework surveys, the conservative estimate here comes from a government survey; the more optimistic one comes from a trade association. No matter which number we choose, however, it's clear that the number of children being homeschooled rose sharply during the last two decades of the 20th century. While that growth seems to have leveled off, trade association numbers still show increases during the first several years of the 21st century.

WHO ARE THE HOMESCHOOLERS?

The estimated demographic composition of students include children from larger than average families in married couple homes. These are families with incomes close to the median for the American family. The typical parent has attended or graduated from college. The majority regularly attend a church and have a racial/ethnic background that is predominantly white/nonhispanic.[18]

WHY ARE THESE CHILDREN BEING HOMESCHOOLED?

Surveys indicate three primary reasons, the most important of which is a parent belief that they can do a better job than what is being done in the current school system. Second is a belief that the school curriculum should incorporate certain aspects of their religion aimed at providing instruction in the values they believe to be important. And third, many parents of homeschoolers express great concern about what they see as a poor environment for learning that exists in our institutional school system, e.g. lack of discipline.[19]

The question remains: are homeschooling parents doing a better job? Are they accomplishing what they set out to do?

These were the concerns. The question remains: are homeschooling parents doing a better job? Are they accomplishing what they set out to do?

There are certainly significant advantages accruing to those who do it themselves. The pupil/teacher ratio is one of these. Another is the flexibility that can be built into a home school curriculum, one aspect of which is the greater possibility for more meaningful hands-on experiences in the learning process. The big disadvantage is the probable lack of knowledge and experience of the parent as an educator.

Apparently the advantages outweigh the disadvantages in the case of academic performance studies show that homeschoolers score well on standardized tests which is probably the major reason why most college admission officials now look upon homeschoolers as potential students who will do as well if not better than the traditional high school graduate.[20]

The record in addressing the matter of socialization is less clear. There are a few studies that suggest the homeschooler develops as well and often better than those who attend institutional school.[21] The evidence here, however, is less persuasive. While there is no reason to believe that homeschoolers are socially deprived, they clearly have less exposure to situations believed to enhance social development.

WHAT CAN WE CONCLUDE FROM ALL THIS?
Homeschoolers, despite the recent growth in their numbers, are still a very small part of the total school population. That growth was largely the result of parent dissatisfaction with the nation's public education system. Those with the financial wherewithal had the option to move their children to private schools, and many of them did. It is the dissatisfied families of more modest means with a non-working spouse that took advantage of the option of homeschooling. That interest seems to be holding up probably because the academic part of the outcome is being judged a success.

Is there any reason to believe that homeschooling will make further in-roads into the traditional way we have educated our children?

There are several things that will have bearing on what happens to the homeschool population. One of these is the effort underway aimed at fixing our institutional school problems, including not only public policies but private sector efforts as well. These problems, of course, are nothing new and the results of past efforts to deal with them have not been particularly encouraging. What is new in the current effort is information technologies coming into use that could conceivably bring about changes that result in some real progress in upgrading the learning process in the traditional school system. But improvements in learning tools only touch upon a part of the problem that has given rise to the homeschool movement. Moreover, that technology could provide the impetus for a sizable increase in the homeschooled population if what is forthcoming turns out to be a virtual education program that is both effective and easy to administer.

A second element to consider is the family itself. Homeschooled students are, for the most part, from married couple households with a non-working spouse. A successful outcome apparently requires a major commitment of time and effort by one spouse. It doesn't work out well when both spouses work, as is the case in so many modest income families. That we have so many households with children headed by a single person, along with a great many households with married couples in which both spouses work, puts a cap on the number of potential households who could homeschool their kids if they choose to do so.

That said, there is still room for increases in the number of families homeschooling their children and the development of virtual education, if it works out as some believe, has the potential to lure many of them into the fold. The constraint that will keep this number from ballooning is, as I see it, the social side of the educational experience. The biological wiring that leads us to favor being face-to-face in our communications with others is present in children as well as in adults. Socialization through a group experience provided in an institutional setting is apparently what most kids and their parents want. Whether it, along with the academic experience, is best provided through a public or private institution is how most parents view the issue. The cost of the private school option is a large part of what has and will continue to drive some parents to homeschooling. That cost along with further development of the tools of a virtual education will lead to further increases in the homeschool population of grade 1 through 12, but the probability is that these increases will be much more gradual than they have been the recent past. Yet learning in the home may increase significantly for other reasons.

One of these reasons is what could be happening to the way in which young adults of college age are being educated. The path through virtual education could widen considerably for these people. There has already been some growth in online college education offerings as well as some notable successes.[22] As those inevitable improvements in online offering come in the face of what seems to be never-ending increases in the costs of a college education, more of it could be done in the home.

Then there is the prospect of a work world in which there will be lifetime learning. When innovation is the instrument for achieving competitive advantage and science provides the foundation for innovative effort, there will be a continuous need to keep up with what's going on. While upgrading the human capital we bring to the job has long been a part of what work is all about, it is likely to become much more so in tomorrow's world. And in the competitive market conditions likely to prevail, getting this kind of education through periodic trips to "seminars" at fancy locations will not be as viable an option as it has been, especially if progress is made meeting these educational need through virtual means. This could very easily become work activity best carried out in the home.

WHAT DOES IT ALL MEAN?
There is clearly reason to believe that what we do in the home is changing as a consequence of the information technology revolution. It's not clear at this point exactly

how this technology, as it develops further, will ultimately impact our social life. But right now it's adding to the things we do at home. There are also indications of some shifting of work back to the home as well as some educating of our children. While what has happened to date falls short of what some had forecasted earlier, there has been movement and there is very good reason to expect it to continue and maybe even accelerate a bit. The overall conclusion, in other words, is that there are going to be changes in what we do in the home that impact our housing choices. Those hedonic prices that give us some sense of the importance of the many different characteristics of the home are very likely to change.

We are, of course, not without forecasts of what the information technology revolution is going to do to the home. While forecasting the economic and social consequences of anticipated technological changes is a fool's game, it is one that must be played when the concern is with an item that is as durable and costly to change as is the home. The primary point in this paper is that we have reached a point in the information technology revolution where people in the real estate industry should begin to pay careful attention to those unfolding developments that have a high probability of impacting the kind of homes that people want. I have brought under the microscope several of these that are likely to lead to increases in the demand for more living space. Obviously, the surface here has just been scratched. But it's a start. ■

ENDNOTES

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15. Richard Florida has put together a compelling argument along with some statistical evidence that would have those many "creative" workers in tomorrow's world living in densely populated urban areas. See Florida, R. (2005) *Cities and the Creative Class*. New York: Routledge.

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Is There a Future for Socially Responsible Property Investments?

BY GARY PIVO, MRP, PHD

THE PURPOSE OF THIS PAPER IS TO EXPLORE THE POTENTIAL for a new niche in real estate investing, focused on "socially responsible" property investments. Socially responsible investing (SRI) in general, according to the Social Investment Forum (SIF) means investing "that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis."[1] It focuses on the "triple bottom line" by which investments are evaluated in terms of their financial profitability, social equity, and ecological integrity.

According to the SIF, there were 2.16 trillion dollars in socially responsible investing of all kinds in 2003, including pension funds, mutual funds, foundations, religious organizations, and community development financial institutions. This includes all funds that are professionally managed and using one or more of the core socially responsible investing strategies—screening, shareholder advocacy, and community investing. One explanation for the magnitude of the SRI movement may be the size of the American sub-culture that's been dubbed the Cultural Creatives by author Paul Ray.[2] According to Ray, Cultural Creatives comprise approximately 26% of the American population and include individuals who place a high value on ecology, community, and social responsibility and other strongly held concerns.

Socially responsible investment typically entails 3 strategies that work together to promote sound business practices and societal improvements: Screening is the practice of including, excluding, or evaluating investments on the basis of social and/or environmental criteria. Shareholder Advocacy entails becoming involved as owners of corporate America. And Community Investing provides capital to communities that are underserved by traditional financial services.

Asset flows indicate that investors are finding socially screened funds more attractive than other funds. According to SIF, screened funds attract and retain investor assets longer than non-screened funds and socially responsible funds saw net inflows of $1.5 billion during 2002 compared to a $10.5 billion outflow for U.S. diversified equity funds over the same period.

About the Author

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Like many other investors, individuals interested in socially responsible investing increasingly realize that they should include real estate in their portfolios because it can "enhance the portfolio's returns while helping to diversify volatility and risk."[3] According to one study, an investor that put 10% of his or her portfolio into publicly traded real estate investment trusts in 1992 would have had 7.5% more in his account by 2001, compared to those who stuck with just stocks, bonds and cash.[4] And a recent review of the literature concluded that "real estate has a definite role in the formation of efficient portfolios. There are many works suggesting optimal allocations to real estate of approximately 10% to 20%." [5]

Given this understanding, socially responsible investors want to know whether the various real estate investment products they might select are consistent with their values. They're looking for real estate investments that can "do well while doing good."

If 10% of the more than $2 trillion in socially responsible investing today were in real estate, it would equal nearly 75% of the entire REIT equity market capitalization in the U.S., which was around $300 billion at the end of 2004. Clearly then, the potential scale of a socially responsible property investment (SRPI) market may be very substantial. Yet despite this opportunity, there is no system in place for grading the social and environmental responsibility of various real estate investments and there are virtually no real estate investment funds that are either designed for or marketed to the socially responsible investment community. In fact, interviews conducted by the author with leaders in the SRI world have uncovered the remarkable fact that they are simply unaware of even a single real estate investment product that meets their needs. At the same time, they indicate that there's a great deal of interest in future opportunities, should any arise, that would allow them to invest in real estate in a manner that is consistent with their values.

SRI investors recognize that their acquisition of real estate cannot be satisfied by their simply acquiring conventional real estate investment products. This is because they understand that real estate is not a socially or environmentally benign commodity. Depending on how a property is sited, designed, or managed, it can produce either harmful or beneficial consequences for society and the natural environment. For example, the UN reports that inefficiencies in urban energy use, partly attributable to the nature of urban development, are a primary cause of the rise in greenhouse gas concentrations globally. And the under-investment of real estate investment in lower income, high minority urban areas has long been a concern to social reformers.[6] Given this understanding, socially responsible investors want to know whether the various real estate investment products they might select are consistent with their values. They're looking for real estate investments that can "do well while doing good."[7]

Pension funds, which now hold about 19% of all U.S. commercial real estate equity,[8] also have begun to express an interest in the social and environmental consequences of their real estate investments. California is perhaps the leader in this regard. The state's two large public retirement funds—the California Public Employees' Retirement System (CalPERS) and California State Teachers' Retirement System (CalSTRS)—hold over 200 million square feet of property. They have both set goals to reduce the energy use in their real estate holdings by 20% over the next five years. They also have increased their investment in urban, inner-city real estate to over $2 billion, including $300 million for affordable housing. And California is not alone. For example, TIAA-CREF recently received an award from the U.S. Environmental Protection Agency for their increased use of high-performance building management practices that promote energy conservation.

Given this situation, it is remarkable that SRPI products are either non-existent or impossibly hard to find. For example, despite the fact that there are over 300 real estate investment trusts in the U.S., the author has yet to find a single one that makes social responsibility or sustainability an explicit goal. Moreover, neither the real estate research firms that evaluate real estate funds nor the SRI screening firms that evaluate all kinds of companies collect or distribute information on the social or environmental practices of the many retail or institutional real estate investments that are offered in the USA. This is not to say that no real estate investment firms may be constructively engaged in these issues. But if they do exist, they're simply too hard to find. Of course, one option is to invest in community development investment funds. But these funds typically spread their assets among low income

housing, micro-lending, small business, and community development and may only be open to institutional investors or highly capitalized individuals. While there are a variety of socially responsible mutual funds and a variety of conventional real estate funds, so far there don't appear to be any funds in the U.S. that merge the two and offer both institutional and retail investors a professionally managed socially responsible and progressive real estate portfolio.

Curiously, this is not the case at the international level. For example, Commonwealth Property Office Fund, listed on the Australia Stock Exchange (CPA) and managed by Colonial First State Property Ltd, has adopted explicit policies that commit it to reducing greenhouse gasses, minimizing waste production, ensuring the health and safety of its employees, and benchmarking its progress on various sustainability issues. Commonwealth is just one of several such companies outside the U.S. that have made an overt commitment to these issues.

The total dollars in socially responsible investing of all kinds, including pension funds, mutual funds, foundations, religious organizations, and community development financial institutions—all of which have a current or potential interest in real estate investing—exceeds $2 trillion.

POSSIBLE TYPES OF INVESTMENTS

As with conventional real estate investing, SRPI could take several different forms. One possibility could be publicly traded REITs that seek to own, develop and operate a portfolio of properties that fit certain criteria, such as Energy Star labeled office buildings. A second option might be publicly traded real estate companies that make conservation, urban revitalization and sustainability a key part of their corporate strategy. A third approach could be private funds that are not traded on the public securities markets, but that buy, develop and sell SRPIs. These would be marketed to institutional investors, foundations, and high net worth individuals and could be particularly helpful in increasing the stock of SRPI properties. Closed-ended funds with limited life spans could then transfer their properties to SRPI REITs as an exit strategy. A fourth strategy might be SRPI funds of funds that would acquire interests in multiple private funds. The minimum investments required to invest in a fund of funds is usually smaller than that normally required by private funds, making them a more practical option for individual investors. A fifth possibility could perhaps be socially screened real estate mutual funds, which would buy and sell publicly traded REIT or real estate related stocks that the fund has determined pass certain social and environmental screening criteria.

Each of these types of SRPI investments could be new funds or new companies that are established with the SRPI market in mind. But it could also be possible, and perhaps more practical, to certify existing funds or companies as meeting SRPI criteria. This could be done by independent fund analysts from the real estate industry, the social research industry or the non-profit sector. Likely candidates for certification include public companies that already own a good number of Energy Star labeled buildings or have been recognized by the EPA for their conservation efforts. These would include Arden Realty, Equity Office Properties, Hines, Brandywine Realty, Carr America, Glenborough Realty, Parkway Properties, Prentiss Properties and USAA Realty. Other candidates could be real estate companies that are listed in the various socially responsible investing indices, which screen companies of all kinds for social and environmental issues. These indices include the FTSE 4Good Index, several KLD's indices, the Calvert Index, and the Dow Jones Sustainability World Index (DJSWI). Companies found on such lists today include British Land, Investa Property, Hammerson, Land Securities and The St. Joe Company. A third source of SRPI certified investments might be existing investment funds that are already serving social goals. An example would be the various urban funds that are focused on urban revitalization projects. Current examples here include the American Ventures Urban Fund, the Canyon-Johnson Urban Fund, the CIM Urban Real Estate Fund, and the Southern California Smart Growth Fund. It should be noted, however, that in order to make these funds and companies attractive to the SRI community they would need to be marketed to the community and

certified as meeting certain standards that would make them suitable SRI investments.

SRPI MARKET DRIVERS

As already noted, the total dollars in socially responsible investing of all kinds, including pension funds, mutual funds, foundations, religious organizations, and community development financial institutions—all of which have a current or potential interest in real estate investing—exceeds $2 trillion. But beyond this aggregate view of the potential market universe, there are a variety of activities emerging in the U.S. and abroad that may help drive customers to the SRPI market. Only a few of several will be cited here:

- A group of foundations known as the Funders Network for Smart Growth and Livable Communities has been actively exploring the potential for investing their portfolios in real estate in a way that is consistent with their values. The group includes 29 foundations from the U.S. and Canada that are particularly interested in promoting "better development decisions and growth policies." Members include some of the largest and most respected foundations in North America such as Rockefeller and Ford. This October, the Network will hold the nations first conference highlighting how foundations can support green building and green neighborhood design through their grant-making, investment portfolios, and commercial office choices.

- At the international level, 15 of the world's largest investment companies are currently engaged in a process under the auspices of the United Nations to develop a set of principles for responsible investing. An expert group has adopted principles which are now under consideration and refinement by the institutional members. For real estate and project finance investment the expert group has suggested[9] that detailed environmental analysis should be done before investing, that there should be an accounting of externalities over the entire life cycle of buildings, and that the best practices in the industry should be observed, such as the utilization of eco-efficiency standards. The term 'eco-efficiency' was first used by the World Business Council for Sustainable Development in its 1992 publication 'Changing Course'. It means creating more goods and services while using fewer resources and creating less waste and pollution. The 1992 Earth Summit endorsed eco-efficiency as a means for companies to implement Agenda 21 in the private sector, and the term has become synonymous with a management philosophy geared towards sustainability. The UN expert group also recommends that the Equator Principles be followed, which are industry approaches for financial institutions in determining, assessing and managing environmental & social risk in project financing. They were drafted following a meeting sponsored in 2002 by the International Finance Corporation, a World Bank institution, and have been adopted by numerous financial institutions worldwide including Bank of America, JP Morgan Chase, Citigroup and others. These and related international developments all encourage investors to seek SRPI opportunities.

- This September, at SRI in the Rockies—an annual national gathering of the socially responsible investment industry in the United States—the first ever session will be held on socially responsible real estate opportunities. The meeting will be attended by brokers, investment advisors, financial planners, mutual fund managers, asset managers, and others from around the country and should stimulate further interest in SRPI products.

Growing attention to two other concepts, both related to the demand for corporate and governmental accountability in the post-Enron era, also seem to be increasing the interest in the evaluation of real estate funds in terms of their social and environmental merits.

Growing attention to two other concepts, both related to the demand for corporate and governmental accountability in the post-Enron era, also seem to be increasing the interest in the evaluation of real estate funds in terms of their social and environmental merits. First, funds and companies, and the institutions that invest in them, are expected to report on issues that are material to their performance. This concept is referred to as materiality and its definition appears to be widening to include social and environmental factors. The term comes from the field of

financial auditing and has been defined as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."[10] In other words, something is material and ought to be reported if it has the potential to shape someone's perception of a company. In the context of SRPI, information about the social and environmental characteristics of a real estate portfolio may be material and should be reported in order to allow these consequences of a fund or company to be used when evaluating the company. In some instances, such as the company's commitment to energy conservation, this could have a very real impact on the financial bottom line, as will be discussed further below. In other cases, such as whether the company invests in lower income areas, the impacts may be less financial, but no less important to the judgments formed by investors about the company. And then there is the sharpening concern for fiduciary responsibility, which obligates fund managers to look out for the best interests of their investors. Fiduciary responsibility suggests that fund managers who are investing in real estate should be informed about the social and environmental consequences of their investments, especially if they impact either their investor's financial returns or the quality of their lives. Growing attention to such issues may well increase the demand for SRPI. At the very least, it strengthens the case for more reporting on the social and environmental performance of property companies.

SCREENING SRPI INVESTMENTS

Despite the fact that the social screening of investments is a well established industry, there is no screening process specifically for the real estate sector that is being widely applied in the U.S. One will be required if SRI investors are to objectively determine whether new or existing real estate investment products really do meet their needs.

Two well known systems for rating the environmental and energy credentials of real estate are the LEED and Energy Star programs. LEED stands for Leadership in Energy and Environmental Design and is a "voluntary, consensus-based national standard for developing high-performance, sustainable buildings" that was created and is administered by the U.S. Green Building Council. In the system, buildings can earn points for satisfying various criteria related to topics such as project siting, conservation, and indoor air quality. Various ratings are achieved depending on the total points awarded. The Energy Star program is run by the U.S. Environmental Protection Agency. Under that program, the energy used by individual buildings is benchmarked against buildings with similar characteristics. Those that perform among the top 25% of their peers are awarded the Energy Star label.

The problem with using these systems to evaluate the suitability of a company or fund for SRI investment purposes is that both are focused primarily on environmental concerns and both are designed to be applied to individual buildings. When one considers the fact that the typical real estate investment fund may hold dozens if not hundreds of properties as well as the fact that the SRI community is concerned with a wide ranging set of issues that extend beyond just environmental concerns, it would seem that neither of these systems are immediately useful for guiding the creation of new SRPI products or for certifying existing funds and companies.

Fiduciary responsibility suggests that fund managers who are investing in real estate should be informed about the social and environmental consequences of their investments, especially if they impact either their investor's financial returns or the quality of their lives.

To their credit, however, the EPA Energy Star program has recognized the need for a portfolio-level evaluation tool and has responded with the Energy Star Leader program. The program recognizes the management of portfolios that have demonstrated "continuous improvement in energy performance". The program still requires portfolio managers to baseline each building in under their management, however a portfolio management tool is provided to assist them in the process. While this may sound like a challenging process, the approach was formally adopted by the California State Teachers Retirement System (CalSTERS) Investment Board in 2004 for portfolio wide energy auditing by all of its Investment Managers. This approach that uses the measurement of continuous, portfolio-wide improvement in certain performance

measures to confer status on a company, may be a suitable model for a broader SRPI rating system that incorporates other performance measures beyond energy utilization.

Another possible model for conferring SRPI certification on real estate investments is the approach to social investment screening that is currently used by various research firms to evaluate publicly traded companies. Generally, this work is done by independent evaluation firms and focuses broadly on environmental, social, management and human rights issues. Analysts conduct research to determine whether companies have made commitments to monitoring, reporting and achieving certain environmental performance targets, to meeting certain health and safety standards for their employees, to maintaining an independent board of directors and to respecting indigenous people's rights. A case in point is the research done for the Dow Jones Sustainability Index by SAM Research using the SAM Corporate Sustainability Assessment Model. Under their assessment, companies are ranked within their industry group and selected for the Dow Jones Sustainability Indexes if they are among the sustainability leaders in their field. There are 60 different industry groups that are evaluated, including both real estate financial services and construction. Both general and industry specific criteria are defined. Data on firms are verified and externally audited. They are collected from questionnaires completed by participating firms, from company documents, from media and stakeholder reports and from personal contacts with the companies. General sustainability criteria include corporate governance, financial robustness, environmental management and performance, human rights, supply chain management, risk and crisis management, and labor practices. Industry specific criteria have been developed by SAM for the real estate and construction groups but they are not public. However, based on their reports on real estate companies, the criteria probably include topics such as the company's commitment to identifying and mitigating the impacts of development, the resource efficiency of their properties, the use of performance benchmarks for properties, and the degree of engagement with community stakeholders in the development and property management processes.

Analysts conduct research to determine whether companies have made commitments to monitoring, reporting and achieving certain environmental performance targets, to meeting certain health and safety standards for their employees, to maintaining an independent board of directors and to respecting indigenous people's rights.

There are two major differences between the approach represented by LEED and Energy Star and the one represented by the SAM research for the Dow Jones Sustainability Index. The first difference is that the LEED/Energy Star approach focuses on environmental concerns while the SAM approach is broader, covering topics beyond the environmental arena, such as corporate governance and stakeholder engagement. The second major difference is that the first approach uses data on the characteristics of individual properties while the second approach relies on the evaluation of corporate-level policies and behaviors. Energy use per square foot or whether a building is located within walking distance of a transit stop would be examples of property level characteristic. A company's policy commitment to urban revitalization or awards for green building would be examples of corporate level considerations.

Ultimately, any real estate investment aimed at the SRI community will need to consider the full range of issues of concern to SRI investors. However, the degree to which building level vs. portfolio or corporate level criteria should be evaluated is less clear. It will depend on what is both demanded by SRI investors and on what is feasible for SRI analysts to deliver. Currently, SRI analysts focus on corporations' overall records and do not tend to investigate management practices at the level of individual plants or offices, which would be analogous to investigating the performance of individual buildings in a real estate fund. However, it is unclear whether this approach would be satisfactory to investors in the case of SRPI. The LEED and Energy Star programs may already have created an expectation among SRI investors that in real estate, social and environmental issues should be evaluated at and aggregated up from the property level. Furthermore, even if some criteria will need to be applied at the building level, there's the question of whether building design is an adequate measure of performance, as opposed to actual measurable performance results. The LEED approach

gives many of its points for building design features, which might be characterized as building systems inputs, which are assumed to produce certain performance outcomes. The Energy Star program, on the other hand, focuses much more on measurable building system outcomes, particularly energy utilization. Thus, in designing some future SRPI certification system, a variety of issues will need to be resolved including the three mentioned here: the range of criteria considered, the degree to which those criteria are collected at the building or corporate level, and whether inputs or outcomes should be the basis for making evaluations.

Some investors may be willing to accept lower financial returns in exchange for the knowledge that their investments are helping to address leading social or environmental issues of the day. Other investors, however, consider it their fiduciary responsibilities to avoid such tradeoffs.

Another interesting issue that would have to be answered in developing a screening system is whether the real estate products themselves would need to be screened as opposed to merely product performance. In this case, "product" refers to the type and location of a particular building (e.g., urban high rise residential vs. suburban garden apartments or new urban vs. conventional suburban subdivisions). In general, in SRI investing, few companies are eliminated or included in funds or indices because of the products they produce. Exceptions include guns and tobacco. But generally, companies that do a good job with social, environmental and governance issues regardless of their products are included. The focus is on how they do their business and produce their products, not on what products they produce. However, with real estate, companies or funds or trusts can be differentiated both in terms of how they produce their products and the type of products they produce. Moreover, city planning debates that, for example, draw sharp distinctions between urban sprawl and smart growth may have oriented SRI investors to think in terms of the specific types of real estate products being produced. Perhaps properties in cities and denser developments would be considered preferable from an SRPI perspective because they help invigorate cities and reduce urban sprawl. Any system for screening real estate investments will need to come to grips with this issue. Is high rise better than low rise? Is housing better than shopping? Is mixed use better than single use? Is new urbanism better than shopping malls? In other words, are the product types themselves to be judged or would it be appropriate to limit the evaluations to comparing peers, as the Energy Star program does, in order to select "best in class" within each type of real estate investment.

Perhaps it is best to follow the normal protocol found in the SRI industry—to exclude only the worst products from investment; the real estate equivalents of guns and tobacco. Then, all other types of real estate could be SRPI if it was produced or managed according to certain criteria or ranked among the best of its peers. Thus, regional shopping malls could be certified as being socially responsible investments as long as they are managed to conserve energy, follow reasonable employment policies and so on. While this could work, there would no doubt still be those who would not want to invest in low density suburban style office parks, regardless of how well they perform in terms of energy, ecological land planning, community engagement, employee training and other possible indicators. And there will be those who are truly seeking investment opportunities in green, transit oriented, urban developments. In the end, it may be best to evaluate investments in terms of a variety of dimensions or criteria and to offer a range of choices that investors can select among, allowing the individual investors to determine what they consider to be acceptable investments.

One other question raised by the notion of screening is whether there would be enough properties to choose from that meet any established criteria. For example, there are currently less than 200 LEED Certified projects, under the green building program administered by the U.S. Green Building Council. [11] However, there are many thousands of apartments and office buildings located within walking distance of public transit stations, which is known to increase transit use and reduce driving alone.[12] Additional research is required to determine how coarse or fine to make the screens, but it should not be assumed that only the most progressive or "deeply green" projects or funds would be suitable for inclusion in SRPI portfolios. Indeed, many socially responsible mutual funds only screen to avoid tobacco and alcohol-related companies[13]

and so SRPI funds would not have to be particularly restrictive to be in line with SRI industry practice.

MANAGING PROPERTIES: "DOING GOOD BY DOING WELL"

Some investors may be willing to accept lower financial returns in exchange for the knowledge that their investments are helping to address leading social or environmental issues of the day. Other investors, however, consider it their fiduciary responsibilities to avoid such tradeoffs. So what do we know about the economics of socially responsible investing in general and SRPI in particular?

The answer to the general question is that social investing does not appear to require concessions in financial performance. This was the finding of a 2001 study by KPMG Consulting which evaluated the academic literature on the impacts on financial performance when social and environmental criteria are used in the investment process.[14] Their conclusion was that although the existing literature is limited, it nevertheless indicates that financial returns and risk levels are not negatively affected by adding these criteria.

Would the same general finding be true if social and environmental criteria were used to screen real estate investments? We don't really know. But there certainly is evidence that at least certain real estate strategies, which would likely quality as SRPI, can perform at least as well as more conventional approaches.

One of the most promising strategies, from a financial point of view, is placing an emphasis on energy conservation in project design and property management. In fact, of all the possible SRPI strategies, energy conservation may the greatest potential to be a significant value-driver. Perhaps, in more conventional terms, it should be viewed as a kind of value-added strategy or what might be called "environmental repositioning" in which property management skills are used to increase the value and returns of under-performing properties.

According to research done by the EPA drawing on experience from companies that participate in their Energy Star program,[15] a recommended sequence of upgrades designed to save energy costs an average of $2.30 per square foot, reduces energy use by as much as 40% or more, produces an annual savings of $0.90 per square foot, and is paid back in 2.5 years. If this sequence of costs and returns is analyzed for a 10 year period, with the energy savings being capitalized into building valuation and returned at the end of 10 years, then the internal rate of return for the investment would be 41%.

A number of mainstream investors and real estate companies are increasingly aware of the returns that can be earned from energy conservation, as well as the social benefits it can produce. For example, when CalSTERS made its commitment last year to participate in the EPA Energy Star program, it was noted that "a consistent and comprehensive energy audit program…has the potential to increase current cash flow by lowering operating costs, increase asset values by increasing Net Operating Income, (and) promote a cleaner environment...[16] Arden Realty, Inc., which operates 83 Energy Star labeled buildings (out of 217 in the State of California) has also recognized the economic benefits that can be achieved from energy conservation. In fact, they've created Next Edge, a wholly owned subsidiary, to be turnkey provider of fully integrated energy solutions for owners and operators of real estate. And as Next Edge points out, "energy inefficiency impacts your organization's bottom line by inflating your facility's operational costs. The comfort of your occupants and the impact on their environment are critical concerns as well. Investment in energy efficient systems in existing facilities can dramatically lower your operational costs and yield returns from 20% to over 50%, while increasing comfort levels and minimizing environmental impact.[17]

It also appears their forward thinking management may pay dividends in stock prices. A study done by Innovest Strategic Value Advisors for the EPA Energy Star program looked at the relative energy efficiency and energy management performance of publicly traded REITs. "Leaders in energy management achieved superior stock market and financial performance over the two year study period," outperforming below average companies by over 3,400 basis points in the stock market.

Another economic argument being made in support of SRPI in general and green buildings in particular is that it can be a more secure real estate investment because it can reduce the physical and policy risks of global warming.[18] And according Paul McNamara, Head of Research for London's Prudential Property Investment Managers, Ltd., this should lead to lower discount rates and higher prices.[19]

Unfortunately, as of yet, we do not have any systematic research on the financial costs or benefits of socially responsible real estate investing. But until that is done, we

can consider various other pieces of evidence such as the following:

- According to the 2003 Real Estate Performance Report by the National Council of Real Estate Fiduciaries, the 240 central business district office properties in their data base produced an average annual total return of 10.2% over the past 5 years, compared to 7.7% for 915 suburban properties. Downtown office buildings could easily be classified as SRPI because they use less land, generate less driving alone, and provide better access to jobs for lower income households. In addition, the same report shows that high-rise apartments, which by virtue of their higher density help save land, materials and energy, outperformed garden-apartments over the same 5 year period.

- Residential market studies are suggesting there's strong demand for sustainable housing. A 1995 survey found that 21% of all homebuyers embraced new urbanism and its findings were reinforced in 1999.[20] A 2001 study by USC researchers projected a large future demand for housing in denser, walkable, mixed use communities, much beyond what will be available if current development trends continue.[21] The reason is increasing numbers of older households who favor denser, more central locations. Similar findings were reported recently for transit oriented housing. At least 14.6 million households, or a quarter of all new households, are expected to want housing within a half-mile of urban rail transit systems by 2025. That's more than twice the number living there today.[22]

- Up until 2003, The Woodlands was owned by Crescent Real Estate Equities Company, one of the nation's largest REITs. The Woodlands emphasizes the preservation of the natural forest environment and was designed by Ian McHarg, author of *Design with Nature* and perhaps the foremost landscape architect of the 20th century. According to Crescent, the company recognized over $200 million in funds from operations (FFO) and received more than $310 million in gross cash distributions over the approximate six-year life of their investment, which translated into a pre-tax internal rate of return of 43%.

- An academic study assessed the impact of new urbanism on single family home prices. It found that consumers were willing to pay 12% more for homes built in the Kentlands, compared to similar homes in surrounding areas.[23] This demonstrates a consumer preference for living in walkable communities.

- A recent book on infill housing, published by the Urban Land Institute, reached the following conclusion: "Though developers are quick to agree that it's easier to build in greenfields and that infill housing typically costs more to develop…they also agree that when infill housing succeeds, the financial returns for lenders and equity investors are greater over time."[24]

- In the commercial market, "traffic congestion and changing lifestyles impel more mixed use town center developments, urban mixed-use projects, and infill residential," according to Emerging Trends in Real Estate, 2005. Indeed, the prospects for sprawling congested metropolitan areas "hinge on developing successful 24-hour infill environments and integrating mass transportation alternatives to the car."[25]

It may well be time for innovation and leadership in the field of socially responsible real estate. With the current level of interest in socially responsible investing and the rapid growth in real estate investment funds, it is remarkable that there is no mechanism that gives investors the opportunity to own real estate that's been certified as suitable for SRI investors.

Better information could help us understand the economics of SRPI. One solution would be to work with the data on real estate returns produced by the National Council of Real Estate Investment Fiduciaries. The NCREIF data set contains financial performance data on hundreds of properties of various types. Data could be collected on SRPI criteria, such as each property's location in relation to public transportation and energy utilization. Statistical analysis could then determine whether performance on SRPI criteria is correlated positively, negatively, or not at all with financial performance. NCREIF already reports on the comparative performance of different property types and locations. A similar process could be used to report on the comparative performance of different types of properties categorized in terms of certain social and environmental dimensions. An effort of this kind could

help settle the question of whether its possible to "do well by doing good" in a scientific and professional manner.

CONCLUSION

It may well be time for innovation and leadership in the field of socially responsible real estate. With the current level of interest in socially responsible investing and the rapid growth in real estate investment funds, it is remarkable that there is no mechanism that gives investors the opportunity to own real estate that's been certified as suitable for SRI investors. However, there is a potentially large and growing market for such products and it seems inevitable that they will be created. Perhaps the easiest way to achieve this is by certifying existing funds and companies as suitable investments where appropriate. Hopefully, companies will step forward to be recognized as leaders in this emerging field. The multi-trillion dollar SRI investment universe is searching for them and would welcome the opportunity to invest in their products. There may also be opportunities to create new products designed for the SRPI market which perform even better on the triple bottom line—socially, environmentally and financially

In the meantime five key actions might deserve consideration. First, leaders from the SRI and real estate industries should sit down together to explore what's needed and can be done. Second, work should commence on means of evaluating and certifying new and existing investment products. Third, data on the financial, social and environmental performance of properties should be pooled in order to determine the relationships between these outcomes and expand our knowledge of how to maximize all three at the same time. Fourth, companies and funds that are achieving social, environmental and financial success should be identified and rewarded. And fifth, companies and funds should explore how they can make social and environmental goals more central to their strategic planning and how they can report on their performance in these areas. ■

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FOCUS ON INVESTMENT CONDITIONS

Commercial Real Estate Keeps Its Healthy Pace

BY KENNETH P. RIGGS, CRE

ALTHOUGH MANY SIT ON THE EDGE OF THEIR SEAT as commercial real estate continues to provide relatively strong and solid returns, commercial real estate as an investment class is being viewed in a new light and is considered to be an increasingly important asset in the financial world.

Buoyed by low interest rates during the last few years, we watched as record-level home sales and new construction, along with loan refinancing, helped pull the U.S. out of a recession. GDP grew, employment grew, and as a result, in 2004, soaring home values and rising stock prices drove the wealth of American households up by 9% to a record $49 trillion, states the Federal Reserve.

With consumers spending even more and businesses growing and finally beginning to occupy more space, record levels of capital flowed to the commercial mortgage markets in 2004. In fact, real estate was among the biggest mutual fund winners in 2004, earning 32% returns on average for the year. This was the fifth consecutive year that public real estate investment trusts (REITs) outperformed the major stock market indices, reported Lipper.

Although private real estate returns are decreasing, real estate returns overall remain less volatile than stocks, and as shown in Table 1, are outperforming those for other investment classes. As such, demand for real estate remains high, with pension funds, endowments, foundations, and individual investors boosting their investment in commercial real estate.

COMMERCIAL MARKETS REFLECT BUSINESS AND CONSUMER TRENDS

The Federal Reserve indicates that it will continue to raise the federal funds rate and to monitor the rate of inflation. The fear is that an increase in interest rates and inflation, along with high fuel rates and a slowdown in consumer confidence, will slow consumer and business spending, and that the real estate recovery—now off to a solid start-will stall. However, real estate's propensity to lag the economy is also one of its most stabilizing features. Since most commercial real estate properties do not move on a moment's notice, there is time for investors to study the fundamentals, evaluate return expectations, and make more informed investment decisions.

One of the most significant findings that Real Estate Research Corporation's (RERC's) second quarter 2005 research indicated was that required pre-tax yield rates

About our Featured Columnist

Kenneth Riggs, Jr., CRE, is chief executive officer of Real Estate Research Corporation (RERC). RERC offers research, valuation, independent fiduciary services, portfolio services, corporate advisory services, litigation support, and other real estate-related consulting services. RERC also provides research, analysis, and investment criteria (cap rates, yield rates, expense and growth expectations, recommendations, etc.) for nine property types on a national and regional level and for 40 major U.S. markets through the quarterly RERC Real Estate Report, *the annual* Expectations & Market Realities in Real Estate, *and the* RERC DataCenter. *(E-mail: riggs@rerc.com)*

Table 1—What Do The Financial Markets Tell Us?

Total Return % as of 6/30/2005

Market Indices	YTD	1-Year	3-Year	5-Year	10-Year
Consumer Price Index	2.15%	2.48%	2.37%	2.43%	2.46%
10-Year Treasury Bond*	4.18%	4.20%	4.13%	4.54%	5.25%
Dow Jones Industrial Average	3.65%	0.66%	5.92%	1.69%	10.58%
NASDAQ Composite	-5.45%	0.45%	12.02%	-12.31%	8.22%
NYSE Composite	-0.45%	9.31%	8.59%	1.21%	8.87%
S&P 500	-0.81%	6.32%	8.28%	1.21%	9.93%
NCREIF Index	9.03%	18.03%	12.18%	10.70%	11.41%
NAREIT Index	4.90%	30.08%	20.34%	20.72%	14.57%

* Based on Average End of Month Returns
Sources: Morningstar, NCREIF, NAREIT

and required going-in and terminal capitalization rates continue to decline for all the major property types except hotels. How much more investors will lower their expectations is unknown, but we believe this further decline suggests that the changes in the financial and commercial real estate arenas are increasingly more structural rather than cyclical, and a larger proportion of this downward shift is here for the long term.

WHAT ABOUT RETURNS ON INVESTMENT?

Office Sector—As for the office sector, RERC's survey respondents indicate that investment conditions have improved quarter by quarter for both CBD and suburban office properties during the last year. Office jobs continue to increase, especially in the financial and services sectors, and little by little, vacancy rates are improving.

As shown in Table 2, NCREIF 1-year returns are averaging above 13% for CBD and suburban properties. However, due to several factors, including high capital expenditures and relatively higher vacancy rates, there is a great deal of uncertainty associated with office investments, which is reflected in the variation in return from this asset. As such, the risk-adjusted returns for the office sector reside in the bottom half of the spectrum. However, what made office properties so risky over the last several years may be investors' biggest ally in generating higher total returns today. Investors are advised to be wary of rising interest rates, as many of our survey respondents believe capitalization rates have bottomed-out, as demonstrated by RERC's relatively high required returns for suburban properties.

Industrial Warehouse—Warehouse properties generally are not the fanciest properties on the block, but their returns are definitely looking good. The risk-adjusted return metric (shown as RAR metric on Tables 2 and 3) for the industrial warehouse sector is second among all the property types, ranking only behind apartments. Demand for industrial warehouse space, especially in port and distribution hub cities, continues to be very robust. As such, the availability rate for industrial properties continues to decline in the near term.

Industrial warehouse properties rarely receive recognition for quality performance, and in the recent past, clearly have been overshadowed by impressive retail sector returns. However, the bread and butter investment characteristics of warehouse properties will allow this investment to offer better risk-adjusted returns for both the short and the long term. Realized capitalization rates cited by Real Capital Analytics are higher for warehouse properties than they are for office properties, while office properties generally exhibit greater risk. One would think this is due to the higher growth potential of office properties and the potential relative under-pricing of industrial properties. But according to Torto Wheaton Research, rental growth for warehouse space is expected to be consistent with inflation and not materially different than rental growth for office properties. Overall, RERC expects industrial warehouse properties to be a solid performer over the next several years.

Retail Properties—Despite increasing interest rates, higher fuel prices, and inflationary trends, consumers thus far have refused to draw down completely. As a result, real estate returns for retail properties have been strong and are expected to continue to perform well throughout 2005. As shown in Table 2, the second quarter 2005 NCREIF index shows that neighborhood/community center top the list with 1-year returns of 24.50%, followed by

Table 2—Rolling Four-Quarter Returns—Second Quarter 2005

Property Type	NCREIF Returns	NCREIF St. Dev.	RAR Metric*	RERC Returns	NCREIF vs. RERC
Apartment	17.12%	2.60%	6.6	9.03%	8.10%
Industrial—Whse	17.31%	3.14%	5.5	9.40%	7.91%
Neigh/Comm	24.50%	5.19%	4.7	9.33%	15.17%
All Property Types	**18.08%**	**3.98%**	**4.5**	**9.80%**	**8.28%**
Power Center	18.52%	4.40%	4.2	9.58%	8.94%
Regional Mall	23.79%	7.35%	3.2	9.13%	14.67%
Office—CBD	15.99%	5.06%	3.2	7.38%	6.61%
Office—Suburban	15.71%	6.74%	2.3	9.98%	5.74%
Industrial—R&D	16.38%	8.71%	1.9	10.20%	6.18%
Hotel	15.24%	10.86%	1.4	12.13%	3.12%

* Risk Adjusted Return
Source: NCREIF, RERC

regional malls and power centers at 23.79% and 18.52%, respectively.

However, given the volatility associated with retail, the risk-adjusted returns for this property type are only about average. Risk-adjusted returns can be somewhat deceptive, given that risk is based on standard deviation or the variation (both negative and positive) of the return around its average. However, the recent run-up in appreciation in this sector has contributed to a significant amount of positive variation, which is good for investors. In addition, Torto Wheaton Research reports an overall vacancy rate of 10.0%, which is expected to increase slowly over the next several years. This, combined with stabilizing rent levels, equates to a stabilizing asset class that will report significantly lower appreciation yields than those we are currently observing, as demonstrated by RERC's required returns. Given our current financial environment, RERC forecasts that retail properties hold the greatest amount of risk of declining returns and downward pricing adjustments. The foundation of this forecast rests on the expectation that increasing interest rates coupled with long-term bond-like leases, along with slowly increasing vacancy levels and stabilizing rent levels, ultimately will result in a downward shift in the investment prospects of retail properties.

Apartments—With 2004 seeing the strongest net absorption of apartments in 4 years and the national vacancy rate declining to 5.9%, there is little wonder that capital continues to flow to apartments. However, the construction pipeline for apartments remains full, and more apartment and condo conversion completions are expected in 2005 alone than during the last 2 years combined. With continued low interest rates, apartment occupancy is not expected to improve much more until 2006, despite increased hiring and strong household formation.

Even so, we all need a roof over our heads, and as such, apartments have proven to be the least volatile asset class with respect to risk-adjusted returns, both over the short and long term, as shown in the risk-adjusted returns metric in Tables 2 and 3. RERC's going-in capitalization rates for apartments are 6.8%, the lowest point in all the years RERC has been tracking these rates, and the expectation is that they are about to begin heading upward. This is consistent with trends from Real Capital Analytics that new product is being brought to the market at higher capitalization rates. With their low volatility, apartment capitalization rates are typically a leading indicator among the various real estate sectors. As such, during the next few quarters, RERC expects to see the capitalization rates of other real estate asset classes show signs of bottoming out or even increasing.

Hotels—According to the Commerce Department, travel is back, with 46.1 million international visitors traveling to the U.S. in 2004. These visitors spent $93.7 billion, an increase of 17% from the previous year on lodging, transportation, and other expenditures. All signs point to continued growth in the lodging industry this year, due in part to the strengthening tourism industry, but also to increasing business travel.

However, as anyone who has spent much time in hotels this year can attest, the cost of an overnight stay has gone up. The question for investors is whether the income streams from hotels provide enough return on their investment to compensate for the degree of risk. As shown

Table 3—10 Year Average Returns—Second Quarter 2005

Property Type	NCREIF Returns	NCREIF St. Dev.	RAR *	RERC Returns	NCREIF vs. RERC
Apartment	11.96%	2.60%	4.6	10.63%	1.33%
Industrial—Whse	12.07%	3.14%	3.8	10.77%	1.31%
Power Center	12.99%	4.40%	2.9	11.29%	1.70%
All Property Types	11.47%	3.98%	3.0	11.20%	0.27%
Neigh/Comm	12.60%	5.19%	2.4	10.99%	1.61%
Office—CBD	11.64%	5.06%	2.3	11.08%	0.56%
Office—Suburban	11.85%	6.74%	1.8	11.30%	0.54%
Industrial—R&D	13.37%	8.71%	1.5	11.38%	1.99%
Regional Mall	11.20%	7.35%	1.5	10.96%	0.24%
Hotel	13.60%	10.86%	1.3	12.91%	0.69%

* Risk Adjusted Return
Sources: NCREIF, RERC

in Tables 2 and 3, 10-year returns on hotels according to NCREIF are higher than the other property classes, but NCREIF returns for the last year show a different story, with industrial R&D properties as the only property type earning lower returns than hotels. Furthermore, the risk-adjusted returns for hotels are lowest among all the property types tracked, while RERC's required returns for hotels remain at more than 12%, the highest percentage among all the property types for a 10-year period. Despite their risk, hotels provide a good investment alternative for those who are prepared to ride the ups and downs of the travel industry.

WHAT CAN INVESTORS EXPECT?

Commercial real estate continues to garner very high respect among investors—both institutional and retail—as they search among the investment alternatives and recognize the diversification benefits and solid risk-adjusted returns. The challenge rests with the pricing side of the commercial real estate equation—it is not cheap at this point in the investment cycle. Unless interest rates increase sharply and capitalization rate increases follow, real estate prices likely will remain high. Even with high prices, RERC expects commercial real estate to remain a relatively attractive investment and to be considered a solid performer, with the following points in its favor:

■ Low 10-year treasury rates will help to keep capitalization rates low with little pressure from alternative investments.

■ Since the stock market remains volatile and is moving sideways, investor demand for commercial real estate is likely to continue to put upward pressure on prices.

■ All property types are seeing improving space fundamentals with lower vacancy rates, which is beginning to drive rental growth and ultimately will support price increases.

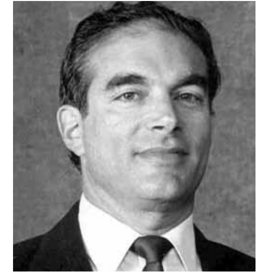
■ Despite recent stellar performance, retail properties stand the greatest risk of a downward adjustment in prices.

■ Apartments historically have been classified as low-risk, but low capitalization rates are beginning to create risk with apartments being priced for perfection.

■ The industrial sector is generally expected to perform well over the next several years, as demand continues to increase.

■ Hotels are an attractive investment alternative with strong upside potential, as business and consumer spending continues, and solid income returns with lagging appreciation returns are reported. ■

FOCUS ON THE ECONOMY



Budget Deficit, Trade Deficit, Savings Deficit and Monetary Policy Deficit: "Are We OK?"

BY DR. MARK LEE LEVINE, CRE

INTRODUCTION

IF IT IS TIME FOR THE UNITED STATES to have its annual "physical," it may be worthwhile to focus on the "Fiscal" issues, including any potential maladies.

I. U.S. TRADE DEFICIT

The U.S. budget deficit has been the focus of discussion, particularly in the last few years, as a result of huge U.S. trade deficits with other nations.

The U.S. trade deficit and the weaker dollar are of great concern. The report in *The Economist*, p. 96 (January 2005), stated: "The falling dollar has so far failed to reduce America's trade gap." It was thought by many commentators and political pundits that with the weaker dollar there was a "silver lining in the cloud;" it was the possible good news that there would be more exports; other countries would find that purchasing U.S. goods was less expensive. However, notwithstanding this logic, the weaker dollar has not produced the level contemplated; the U.S. trade deficit has grown!

The article in the Report, *The Economist* (January 2005), indicated that the U.S. trade deficit on goods and services widened to $60.3 billion in November 2004. The oil imports increased in price. (Crude oil was over $56.00 a barrel in March 2005. Of course, now the price per barrel has been in the high 60s, with projections for much higher prices coming for the winter of 2006.) U.S. exports of U.S. goods sold to other nations declined in that same month. As a result of these events, the U.S. trade deficit on goods, without considering other categories, as reported by *The Economist*, rose to $654 billion for the 12-month period ending November 2004. (This was an increase from the $547 billion for the prior year of comparative measurement.)

Lest one assume that this deficit position is common throughout the western world, the German trade surplus rose to close to $200 billion for the same time frame noted, November 2004!

Given the weakened dollar and market considerations, a comment in *Business Week*, page 30 (January 24, 2005) noted that many pundents and economic analysts were shocked by such increased U.S. trade deficit and trade gap.

About our Featured Columnist

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Because U.S. imports purchased from other countries are about 50% greater than U.S. exports sold to consumers in other countries, based on the *Business Week* numbers, there is additional concern that the U.S. will have a very difficult time avoiding an increased trade gap, with huge deficits.

As pointed out in the *Business Week* article, the U.S. dollar has fallen against the Euro and Japanese yen, but it has not fallen to the same extent with many other countries that trade with the United States. It is clear that a lower dollar value position will not cure, by itself, the trade gap in the U.S. Rather, the U.S. needs to lessen U.S. imports and increase U.S. exports, by, in part, creating demand by other nations for U.S. goods.

With over a $600 billion trade deficit—and growing—U.S. trade deficit problem will not be an easy item to correct. An interesting statistic noted in an article in *Business Week* (February 28, 2005) was that for each $1 dollar spent on consumer goods, disregarding the automobile, 45 cents (45%) of that dollar will go to imports (U.S. purchasing goods from other countries). That figure increased from 25% in 1997!

Notwithstanding that the U.S. dollar has fallen approximately 15.4% in the past three (3) years, as noted by Chairman Greenspan in the *Business Week* article (February 28, 2005), the falling dollar does not cure the U.S. trade deficit. Citing Ms. Catherine Mann, a Senior Fellow with the Institute of International Economics, it was asserted that as the U.S. dollar falls, those foreign interests that have invested in U.S. assets will also lose value in the U.S. assets. As such, there is concern that foreign investors may not desire to continue to invest in U.S. assets.

A multiplicity of factors will impact the U.S. economy and the export-import trade gap issue.

II. BUDGET DEFICIT

In addition to the U.S. trade deficit, there is constant concern with the fiscal/budget deficit in the United States. As I have indicated in many articles, the U.S. fiscal deficit continues to grow on a monthly basis. The size of the overall budget deficit continues to break records.

The excess of payments or expenditures by the U.S. government, as opposed to revenues received, makes it clear that this imbalance situation cannot go on indefinitely. If it continues much longer, it will have major, negative, impacts on numerous financial markets and the U.S. economy in general. Such position was noted in an article by Cynthia Saltzman, "Federal Budget Deficits: It's Not If, But When They Matter," *Journal of Financial Service Professionals* 22 (March 2005). Dr. Saltzman noted concern with the Federal budget deficit. She was careful to cite the leading commentator on this issue, Federal Reserve Chairman, Alan Greenspan. Mr. Greenspan has warned, noted Dr. Saltzman, in November 2004, at the European Banking Conference, that there will be economic problems for the U.S., if the U.S. does not take steps to address the issue of current budget deficits and the total U.S. fiscal budget deficit, overall. Increased spending by the Federal government, with less monies coming into the FISC, make it clear that the U.S. is not in a favorable international financial position.

Related economic issues will also create financial burdens on the government and will continue to place pressure on the U.S. government relative to the fiscal deficit. These issues include, among others, decreasing tax rates and, thus, decreasing tax revenues, advocacy to further decrease and make permanent the tax changes of the past few years (which further reduce U.S. tax revenues), potential Social Security funding problems, a negative trade balance position, Homeland Security issues that have financially drained local and national economies, recent losses from Hurricane Katrina and Rita, etc.

III. TAX CONSIDERATIONS

The overall economic tax consideration for the U.S. economy is the simple fact that the revenue stream for the U.S. Federal government has been reduced (as is true in many states), yet the demand for services from the U.S. government has remained strong.

Included in the U.S. deficit under its fiscal policy is the consideration by President Bush to make permanent many "temporary" tax changes that were made over the last few years. This concern with "permanency," and how to fund the same, will cause billions of dollars in additional deficits, unless offsetting positions can counterbalance the drain on the government and tax revenues when these "temporary" tax changes become "permanent," if such events occur.

Congress also recently mandated that Reports be given to Congress on a regular basis to analyze activities of the Internal Revenue Service, highlight major problems involved with the tax system, and make recommendations and propose other legislation to reduce or eliminate those problems. Consistent with these mandates by Congress, the Internal Revenue Code of 1986 (The "Code"), as amended, under Code Section 7803(c)(2)(B)(ii), requires

the Reports indicated. Following the mandates, National Taxpayer Advocate, Nina Olson, released the *National 2004 Annual Report to Congress and Executive Summary* (January 11, 2005), consisting of 2 volumes of over 700 pages. This Report, which was given to Congress under I.R.-2005-7 (January 11, 2005), stated the need to also reduce the complexity in the tax system. Therefore, there is the desire to provide for "permanency" of prior "temporary" tax changes, as well as to provide a strong voice for simplification of Federal income tax laws.

Federal Reserve Board Chairman Alan Greenspan has warned for many years that making cuts in the income tax stream, without allowing offsetting support for those cuts, would create problems within the Federal government. Chairman Greenspan recently advocated that he favors extending some expiring tax cut positions, for a "permanency" position, but he is concerned with any changes that are not "pay as you go." (Chairman Greenspan's successsor will likely have the same concerns.)

This issue was raised in an article by Dustin Stamper, "No Tax Cut Extensions Without Offset, says Greenspan," *Tax Notes* 887 (February 21, 2005). In this article, Mr. Greenspan said: "I argued a year ago that my support for the tax cut is in the context of a pay-go rule...."

The need to provide for revenue, the desire by some in Congress and the President to extend many tax cuts from "temporary" status to a "permanent" position, and the attempt to eliminate some complexity that now exists within the Internal Revenue Code, affect the U.S. economy. (However, as I have noted in many articles, when Congress attempts to "eliminate" complexity and to "simplify" the tax law, it seems that the Code and supporting materials usually become longer and more complex!)

The additional issue of Social Security overlaps with general economics issues. It has been addressed vociferously by the President and members of Congress. This subject will continue to be debated. It is far from being resolved. What is certain is that any "solution" requires "funding."

IV. MONETARY POLICY

As to monetary policy, the big concern has been, and will continue to be, the issue of interest rates. Although the short-term interest rate has increased slightly in the past months, with many indications that the rates will continue to be increased, the concern focuses on how "substantial" these increases in the interest rate will be in the short term. For example, a sudden increase in the interest rate, such as 2% (200 percentage basis points), would substantially impact most areas of our economy; it will impact the ability to make other positive changes in U.S. tax law, trade deficits, budget deficits, the housing market, and much more.

A related issue is to examine how actions by leaders from other countries might impact U.S. and international monetary policies. Major foreign investors may determine that the sliding value of the U.S. dollar lessens real property values in the United States; terrorism remains an important concern in all areas, including its impact on economics; rising oil prices have damaged the hope for a trade balance; and other issues could potentially cause major upward changes in the interest rate. In such instances, one could reasonably expect strong, negative impact in many areas, such as in the housing industry.

This slowing of the economy, because of increasing interest rates, would have additional adverse effects that would substantially, and negatively, impact the U.S. economy, along with possibly the economies of many other countries.

For an overview of the issue as to interest rates and the impact of the same on home sales, and much more, see the note, "Real Balance," *REALTOR* magazine 26 (January 2005). This article noted issues as to interest rates and the equilibrium in the marketplace, along with questions on the rate of inflation, gross domestic product (GDP), unemployment rates, interest rates in general, and housing prices, among other issues. These topics were examined by David Lereah, chief economist for the National Association of Realtors (NAR); Paul Merski, chief economist for Independent Community Bankers of America; Mark Dotzour, chief economist for Texas A&M University; Frank Nothaft, chief economist for Freddie Mac; Doug Duncan, chief economist for Mortgage Bankers Assn (MBA); and Steve Bunn, the chief economist for C.B. Richard Ellis, Information Management. All of these economists and prognosticators clearly emphasized the concern with interest rates and the impact of major changes in the rate of interest charged.

There were five (5) interest rate increases in 2004 by the Federal Reserve, moving the Federal Funds (interest rate) to 2.25%. At the time of the writing of this article, this rate has moved to 3.75%. There is additional concern with continuing, rising interest rates and the effects on U.S. and world economies.

V. OVERALL ECONOMY FACTORS

As mentioned, the U.S. economy is influenced and impacted by many factors, such as the U.S. trade deficit, tax laws, monetary policy, etc. Many additional important areas must be considered within the economy, as noted below:

SOCIAL SECURITY

Many debates have developed on the issue as to how the U.S. government should address the apparent shortfall in funds necessary to pay for Social Security benefits, currently and in years to come. With rising medical costs, people living longer, and more people retiring (especially those among the "baby boomers"), there is great concern that the "insufficient funds" with Social Security will not be able to meet the rising demand. The "best means" to address the Social Security issue is not the intended focus of this article. But, the timeliness of properly addressing this issue will impact the economy.

An article by Howard Gleckman, "The Real Retirement Time Bomb," *Business Week* 72 (January 31, 2005), summarized concerns with amounts of Social Security paid out today, and what could be paid out in coming years if changes are not made in the Social Security system. See also the article by Pete Engardio, et al, "Now, the Geezer Glut," *Business Week* 44 (January 31, 2005). This article focused on the baby boomers throughout the world affecting U.S. and world economies in general. The attempt to fund retirement for aging workers shifts the financial burden onto existing workers to fund some of the monies required for Social Security needs.

HOUSING

It is clear that the housing market has supported the U.S. economy for many years. Whether the housing market can sustain its position, which most economists agree cannot be the case, and when such markets will change, are additional, important economic issues. An article by Jeff Opdyke, "Hot Housing Markets Face New Risks," *Wall Street Journal* D2 (Wednesday, March 2, 2005), focused on the risks in the housing market. One risk is the inability for the housing market to continue to produce sales at the same sales rate as existed in years 2002-2005. Of course, part of the demand was a function of the lower interest rates. Lower interest rates will probably continue in the short term, but the long-term forecast is for increasing interest rates. Thus, housing will be impacted. With higher rates, many potential buyers will be placed outside the area of affordability for the purchase of a home. Refinancing will also slow.

There is also concern that many housing markets are overpriced, because of growth in the housing market over the past few years. The "B" word is coming up again—the "Bubble." A housing bubble may break. The Opdyke article noted that the riskiest U.S. housing markets were in ten metropolitan areas, which have greater risk of a housing bubble bursting. Six out of the ten areas are in California. Several markets of concern included: Boston, New York, New Jersey, Michigan, and Rhode Island. The article commented that there was a 16.1% chance of decline, overall, of the national housing market in the top 50 metropolitan markets in the United States.

For more on the issue of the housing market and areas of concern, such as mortgage rates, housing starts, inflation, affordability, and so forth, see the monthly report produced by Meyers Housing Market: Key Indicator Alert, which can be found on the web at: http://www.meyersgroup.com.

OIL

The price of oil recently rose to over $65.00 per barrel. Consistent, rising demand for oil has a negative impact on the U.S. trade deficit position. As oil prices continue to increase, and demand does not lessen, a negative impact on the U.S. economy results. The rise in heating oil prices, gasoline for travel, and other uses of fuel affect both private and commercial activities.

STOCK MARKET

The U.S. stock market has been fairly strong over the last year. However, the general consensus of economists seems to express concern for this market, especially as to segments involving the housing market, oil and gas prices, monetary and fiscal policies within the United States, budget issues, interest rates, and a myriad of other factors.

POPULATION

The baby boomer issue relative to Social Security, as well as changing population demographics in many countries, affect all economies. The rise of the hispanic population affects the U.S. markets. There are more immigrants into the U.S. Also, the overall increase in U.S. population, approaching almost 300 million, educational levels of the population, and aging considerations influence overall world economies, too. For an examination of many of these issues, see the broad look at the industry addressed

in a major article in *Business Week*, p. 88 (January 10, 2005).

VI. OTHER ISSUES

Other issues need to be addressed for positive development of the U.S. economy. Transportation, aerospace, general construction, auto production, pharmaceuticals, and environmental issues are only a few examples of those areas which impact on the U.S. economy. Continuing conflicts in the Mideast and other locations substantially impair the ability of the U.S. and other countries to perform positively, on an economic level.

VII. CONCLUSION

Many factors must be considered when looking to the overall posturing of the U.S. economy. This includes trade surpluses and deficits, tax (fiscal) policy, monetary policy, housing, Social Security, the stock market, petroleum, population mix and much more.

Changing world markets, particularly the growing markets in China and India, are shaping the direction of economies throughout the world. Major conflicts or major settlements between countries, such as conflict issues in Middle Eastern countries, certainly impact world economies. A lack of consumer confidence and a concern for the direction of the country (U.S.) are additional intangibles that raise the level of concern for our economy—and our country.

With all of these variables, it appears that a "wait-and-see" position for 2006 will be important for many markets. Maybe we need another good physical? ■

FOCUS ON CORPORATE REAL ESTATE

A Taxing Decision: Here, There…Everywhere?

BY JEFFREY L. ELIE

DR. SEUSS WROTE DOZENS OF CHILDREN'S BOOKS that tell us the world is not necessarily logical, nor does it always work the way we expect it to. That's why when the Sixth Circuit Court of Appeals struck down the longstanding and widespread practice of states giving businesses certain kinds of tax incentives to create local jobs, corporate real estate professionals could have been forgiven for turning Seussical with exasperation. To quote *One Fish, Two Fish, Red Fish, Blue Fish*: "From there to here, from here to there, funny things are everywhere."

The quote seems particularly apt because, for the moment, the court ruling has left us in limbo—uncertain about where or when or how the tax incentive decision will come into play. Among the possibilities:

- Now that the U.S. Supreme Court has accepted the Cuno case, a decision affirming the Sixth Circuit ruling would make it the law of the land; a rejection of the Sixth Circuit reasoning would bring us back to where we were when the case started.
- The decision could be limited to Ohio, Kentucky, Michigan and Tennessee, the four states covered by the Sixth Circuit Court, which has stayed the implementation of its ruling until appeals play out. The full appeals court has refused to reconsider the issue, leaving the U.S. Supreme Court as the next level of appeal. If the Supreme Court refuses to take up the matter, the decision will stand—but only for the four states.
- Congress may render the court process moot. Bills have been introduced that will specifically empower states to offer these types of tax incentives. A GOP-dominated legislative branch and a business-friendly executive branch may well see this as the best solution.

How did we get to this point? The story begins in 1998 with the state of Ohio, the city of Toledo and two school districts using tax incentives to entice DaimlerChrysler to build a new vehicle assembly plant near its existing facility in Toledo. DaimlerChrysler estimated it would spend $1.2 billion on the project and bring several thousand new jobs to the area. The city and school districts agreed to forego collecting all property taxes on the project for 10 years; the state kicked in a 13.5 percent investment tax credit to offset DaimlerChrysler's state corporate franchise tax, based on the purchase of new manufacturing equipment and its installation in an Ohio plant. The combined tax incentives were valued at $281 million.

There was little unusual about the package, except perhaps for its size. Across the country, cities, counties and states engage in similar deals to demonstrate to businesses that

About our Featured Columnists

Jeffrey L. Elie is chairman of CoreNet Global, an association of 7,500 end user, service provider and economic development executives who manage more than $1.2 trillion worth of corporate real estate. Elie is also Vice President of Global Real Estate and Facilities for Kaplan, Inc., supervising the corporate services infrastructure for Kaplan's more than 500 locations.

the jobs and economic stimulus they bring are valued. And in this case, Ohio seems to have struck a bargain that worked. The plant opened in 2001, employing about 3,800 workers.

The package was challenged in a lawsuit initiated by then-presidential candidate Ralph Nader, who said he opposed the use of subsidies and incentives by state and local governments to attract or retain businesses and jobs. Formally filed by a dozen taxpayers and three small businesses, the suit—Cuno v. DaimlerChrysler—argued that both the tax credit and the property tax abatement violated the Commerce Clause of the U.S. Constitution by favoring in-state over out-of-state business expansion.

Cuno was rejected by the first court to hear it. However, on October 19, 2004, a three-judge panel of the Sixth Circuit Court of Appeals overruled the lower court with regard to the tax credit. The judges agreed with the lower court and rejected the plaintiffs' argument on the property tax abatement issue, finding such a subsidy constitutional since it is well established in law that a state may use its collective wealth to benefit the local economy. This form of tax abatement is an enticement that can be offered to any business, whether they are within or outside the state.

But the tax credit offset for DaimlerChrysler is seen by the court as completely different because it reduced the company's existing franchise tax liability. That meant DaimlerChrysler could only reap the benefit if it developed its facility in Ohio, making the investment tax credit an inducement that hindered expansion of trade outside of the state. Such a tax credit was not equally available to in-state and out-of-state business expansion.

Since the Sixth Circuit ruling, experts have weighed in on each side. Some find the decision a completely rational determination of the issues ("The decision of the Sixth Circuit in Cuno is well-reasoned and is consistent with Supreme Court precedent applicable to discriminatory taxation…The focus should be on encouraging local businesses and out-of-state businesses to invest in the state by giving them an exemption from a new tax liability on land or personal property that will be used in their in-state business or a direct subsidy from their in-state businesses paid from general funds."). Others see angels dancing on the heads of pins when the court applies one set of reasoning to direct subsidies such as the allowed property tax abatement and a different one to indirect benefits such as the tax offset ("Making a distinction between subsidies and tax incentives seems highly formalistic since subsidies can, in practice, discriminate against interstate commerce in precisely the same manner as tax incentives… Federal courts certainly have a role to play in protecting interstate commerce from state intrusion, but curtailing the ability of states to raise or cut taxes, indeed to compete for business investment, is antithetical to the spirit of the Commerce Clause itself.").

One overriding point: we're not on corporate welfare, contrary to popular claims. Most states have required "call back" programs where companies that do not meet projected employment and investments levels must pay back the incentives. There are many examples of these on the books nationally, especially in weaker economic times.

From a real estate professional's point of view, the legalities and final outcome are in other's hands. The concern that the decision raises, however, is that there is no longer certainty about the rules of the game. That has a ripple effect not only across the United States but also globally, as businesses strive to remain competitive in a worldwide market. CoreNet Global, an association of 7,500 executives who manage more than $1.2 trillion worth of corporate real estate, has already begun to examine the unintended consequences.

In an informal survey conducted in early 2005, the CoreNet Global membership predicted an impact not only on existing facilities with similar incentive packages but also on future projects already in the pipeline. According to the survey, 35 percent say they plan to ask states and localities to refine their incentive programs so they can withstand a court challenge; 29 percent say their companies may re-evaluate location decisions for upcoming projects; and 32 percent say their plans will go forward unchanged, with factors other than incentives playing a larger role in the decision-making process.

That adds up to nearly two-thirds of the membership who see an adverse impact if and when the ruling takes hold. With state incentives responsible for a massive amount of economic development, the potential impact is immense. Possible effect: an increase in the rate of outsourcing of jobs and functions overseas. All-but-certain outcome: a huge increase in the cost of expanding operations in the United States.

The proof is in the statistics. Statements from Ohio officials indicate that more than 16,000 companies have applied for the investment tax credit since 1995, claiming more than $1.9 billion in credits. By some counts, roughly

two-thirds of the states in the nation offer some type of investment tax credit, each of which may or may not be affected by a final decision on Cuno, depending on how they are structured. The cumulative impact is difficult to determine—but it is not inconsequential at a time when businesses reckon their costs carefully before proceeding with expansion.

Furthermore, Cuno raises questions about a whole host of other incentive programs, including:

■ The Keystone Opportunity Zone (KOZ) in Pennsylvania. Since the program began in 1999, more than $5 billion has been invested, 43,000 jobs have been created or retained—all the result of the waiver of millions of dollars in state and local taxes. In addition, PECO is offering reduced electrical rates to businesses that move into a KOZ from outside the state or outside existing PECO territory—an incentive not available to businesses already PECO customers.

■ The Michigan Economic Development Corp. awarded $128 million in single-business tax credits last year through the Michigan Economic Growth Authority (MEGA). Some critics of MEGA, which they say discriminates against the many businesses that do not receive tax relief, believe the program is so similar to Ohio's that MEGA would be eliminated; others believe that the program would be permissible.

■ Pennsylvania's Research and Development Tax Credit is offering businesses that expand their research and development function within the state a credit against their tax liability that carries forward to the next year.

■ In Kentucky, a plant manufacturing stainless steel products has agreed to a $75 million expansion there, with industrial revenue bonds issues by the state a key incentive for the decision.

The International Economic Development Corporation has weighed in on the issue, cautioning that in our globally competitive world market, the states are not just competing against themselves for business. Their official statement: "The opportunity to offer tax incentives to businesses looking to grow or relocate is a valuable economic development tool. Tax incentives allow states, regions and communities to vie for business in our globally competitive world market."

There remain many unanswered questions. So as Dr. Seuss no doubt would say, let us end where we began. From there to here, from here to there, funny things are everywhere. Despite the uncertainty reflected in our whimsical Seuss quote, real estate professionals will continue to move forward, helping their companies make location and expansion decisions that are based on tangible benefits: the lowest capital investment costs, the broadest labor availability, the best quality of life—and the most competitive, legally solid package of incentives they can bargain for. While the courts and politicians consider where to go with Cuno, the strategic real estate advisor will simply add this taxing decision to the already complex set of factors that need to be considered. ■

RECOMMENDED READING

Conspiracy of Fools: A True Story

by Kurt Eichenwald (2005, Broadway Books, New York City, 742 pages)

REVIEWED BY BOWEN H. "BUZZ" MCCOY, CRE

THE MOST COMPLETE STORY OF THE ENRON SCANDAL to date has been written by Kurt Eichenwald. a seventeen-year *New York Times* veteran. A two-time winner of the George Polk Award for excellence in journalism and a 2000 finalist for the Pulitzer Prize, Eichenwald has based his account on more than a thousand hours of interviews with over a hundred participants in the events, as well as a review of tens of thousands of confidential corporate and government documents, including FBI notes and testimony before federal grand juries.

The book is written as a narrative, and Eichenwald manages to build suspense, along with incongruity, even though we all know the final outcome. The Enron scandal did not burst out, fully grown, in a matter of days. Widespread corner cutting, steadily falling standards and compromised financial discipline had been festering for close to a decade. Warnings about funny numbers and unrealistic expectations went unheeded, and investors celebrated reckless or incomprehensible business strategies that helped the stock price defy the laws of gravity.

Eichenwald depicts the Enron scandal as not simply the outgrowth of rampant lawbreaking. The true story was more complex and more disturbing. Crime was just one ingredient, along with shocking incompetence, unjustified arrogance, compromised ethics, and an utter contempt for market judgment. It was Enron's tragedy to be run by people smart enough to know how to maneuver around the rules, but not wise enough to understand why the rules had been written in the first place.

No single person was responsible. It took the shortcomings of a handful of executives along with a community of bankers, lawyers and accountants eager to win the company's fees, a government willing to abide absurdly lax rules and a class of investor more interested in quick wealth than long term rewards. The impact was broad, including the destruction of Enron, the demise of Arthur Anderson, the termination of the chief of the Securities & Exchange Commission and the passing by Congress of the most onerous corporate compliance legislation since the Great Depression.

Eichenwald depicts most Enron executives as wanting to do the right thing. Robert Jaedicke, outside director and chair of the audit committee, was concerned about Arthur Anderson being appointed both auditor and consultant to Enron. As early as 1987 a pair of renegade oil traders at Enron was shut down by CEO Kenneth Lay, who was quoted: "I promise you, we will never again risk Enron's credibility in business ventures without first making sure we thoroughly understand the risks."

President Jeffrey Skilling helped push Arthur Anderson to change Enron's accounting from a customary accrual basis to "mark to market" where up to twenty years of future earnings could be recognized at a discounted value in the current year. Such accounting, among other matters, caused a "snowball" affect whereby Enron had to book increasingly huge amounts of future revenues in order to depict year to year growth to investors. Chief financial officer Andrew Fastow, swore that Enron was shielded from interest rate risk, failing to take note of the elemental financial fact that the rate utilized to discount future earnings was itself a risk related interest rate calculation by Enron of the likelihood of achieving the earnings predicted many years in the future.

About our Featured Columnist

Bowen H. "Buzz" McCoy is a retired investment banker and former President of the Counselors.

Such inflated earnings gave a misleading picture of the firm's financial condition, misleading all the senior executives and the board of directors as well. The harsh fact was that such inflated revenues were not backed up by cash. The assets were puffed up and borrowed against. The borrowings represented cash which had to be repaid, and the bulk of the revenues did not produce cash in the early years. To compound the problem, Fastow played the yield curve, borrowing huge amounts at low rates, financing the imputed value of long-term contracts with overnight money represented by bank borrowing and commercial paper, which could be pulled at the discretion of the investors.

One justification given for moving to "mark to market" accounting was that the company was moving from a regulated pipeline business to a short-term commodities trading business. That was true in part, but the company was also investing in a series of gigantic long-term asset plays including a multi-billion dollar energy plant in India and a United Kingdom waterworks business. Those international executives who brought in large long-term billion dollar projects which would take years to build and generate cash were paid huge up-front cash bonuses.

Fastow and others preoccupied themselves with building their personal wealth illegally while concocting crazy financial deals for the company. They arrogantly portrayed themselves as financial geniuses and disparaged all traditional pipeline and financial types, including those who wrote business plans, purchased insurance, calculated honest investment returns or kept track of cash and debt maturities. Enron began pursuing wildly contradicting strategies. One (pre-booking future years' revenues) brought in large earnings but little cash; the other (long-term power projects) consumed large amounts of cash and produced next to no earnings for years. This potentially put Enron's liquidity and credit rating at risk. The company was on a collision course with itself, and none of the senior officers or directors had the faintest idea what the net result could be.

For several years Arthur Anderson's practice group in Houston and New York stated categorically that Enron's accounting was incorrect, but the Arthur Anderson account manager in Houston over ruled them. In similar fashion, younger executives within Enron who raised critical issues were given unattractive assignments, penalized in their annual reviews and bonus payments or terminated. Excess ran wild. Swagger became more important that substance. The usual controls over expenses, risk positions and financing constraints were not imposed. First class travel, or utilization of corporate jets, became standard. There was no control of purchasing. Businesses were added on with no unifying strategy, running from trading to pipelines, to water companies to broadband to rental videos. Enron was creating and trading financial derivatives to protect customers from the business effects of bad weather.

There was a great need to fill the gap between reported earnings and cash flow. Fastow's group did this by figuring out ever more complex ways of borrowing. Bank loans were structured to look like gas trades, known as prepays, and were reported as operating cash flow. Off book deals were assembled to funnel in other money from banks and outside lenders. The tax department structured deals that created future tax benefits, which Enron claimed all up front.

Fastow utilized a "thin capitalization" rule to put debt off balance sheet, with equity contributions as low as three percent. He even cheated on that, having the equity put up by related parties (including the gay partner of an Enron executive), or even, with subterfuge, by Enron itself, thus voiding all the deals. These deals carried about half the debt of the company, made Fastow about $45 million one year, were unreported to the board of directors, and were unsupportable by Enrons' cash flow. Meanwhile, Eichenwald reports, Fastow was not particularly smart, and he did not understand accounting or treasury operations. When he finally had to divulge his financing self interests to the board, the board waived Enron's code of conduct, based upon lies Fastow told them about the arrangements he had made. His deals were named Jedi, Chewco, LJM, Raptor and Braveheart, among others.

On the final day of 1999, in a few hours, Enron generated more than 40 percent of the $1.2 billion in operating cash flow it would report for the year, almost all of it in money that would be returned to Citibank in a couple of weeks, with interest. Thus Enron emulated the very worst of the savings and loans from the previous cycle of scandals. Enron traders exacerbated the California energy crisis. In one case, through lies and illegal maneuvers, they increased congestion costs on the California power grid, netting an additional $30 million in profits for Enron.

While all this was going on, financial publications such as *Fortune* and *Business Week* lauded Lay, Skilling and Fastow. *The Wall Street Journal* got closer to the truth.

Ken Lay, seemingly totally ignorant and obtuse about what was going on in his company, hob-nobbed with Bush I and II, Cheney, Greenspan, and anyone else who might be useful to his purposes. Eichenwald reports that Lay's infor-

mation about the business was usually several years out of date.

A senior partner at Arthur Anderson complained that Enron was a high-risk, maximum exposure client who dictated to their accountants what their quality control measures should be. Once again he was overruled at the local level.

The under-reported off balance sheet transactions finally sank the company. There were triggers in the deals which called for debt repayment if the Enron common stock price fell below a certain trigger point or if Enron's bonds were to be accorded a less than investment grade rating. Both events happened, almost over night, catching the financial community and many executives at Enron, and the board, totally off guard. There were Enron executives and Arthur Anderson partners who had warned of this for months, but they were arrogantly dismissed as "not understanding the business." Yet, when the chips were down, the financial staff of Enron could not produce a balance sheet, a cash flow statement, or a debt maturity table.

Arthur Anderson, which had signed a consent in the Waste Management case, forbidding the firm, by permanent injunction, from ever deceiving anyone in the future, began shredding documents. Meanwhile Lay, still seemingly in total ignorance, told the employees their stock in the employee savings plan was safe, while selling Enron stock himself to pay off bank loans. At one point a senior executive yelled at Lay, "*The Wall Street Journal* knows more about what is going on in this company than you do!" Lay announced later, "The only reason our share price has fallen so far is because of short sellers and the media." A merger with competitor, Dynegy, was terminated when Lay reported the wrong stock exchange ratio to his board. Had it gone through, Lay was entitled to a $61 million severance package. Another executive announced: "You have to understand. I am working for a delusional chairman who thinks all the company has is a PR problem that can be solved with a press release."

The trials and verdicts are still ahead for Jeffrey Skilling and Kenneth Lay, but Eichenwald has provided us with a thoroughly researched, carefully documented and solidly written account of the Enron tale up to this point. Once again we are reminded of the difference between doing deals and building a business, and of our own personal responsibility as business leaders to know the difference and act kpon that knowledge.

Whether or not Lay and Skilling can argue their way out of jail, they have already been convicted at a level much deeper than the machinations of the law. They are guilty of the deep sin of pride and hubris—the sin that Dante in the *Divine Comedy* placed in the lowest reaches of Hell. They, like Ulysses, are false counselors who betrayed the trust that was a part of their leadership positions.

The Creator gave us the free will to choose between good and evil. The Creator also gave some the gift of leadership, and we should be able to rely on the goodness and wise judgment of our leaders to show us the way. Such true leaders do not claim that they "did not know." They can be relied upon to take ultimate responsibility and to help us find deeper meaning for our lives in the workplace.

In causing the demise of Enron as they knew it, as well as Arthur Anderson, and in being the catalyst for the imposition of onerous and bureaucratic regulations on all public companies, the former senior officials at Enron have decreased the level of trust that is basic to American business, thereby causing grave harm to our way of life. ■

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