

A STRATEGY FOR INVESTING IN SUSTAINABLE REITS

SIGNATORY TYPE

Investment Manager

OPERATING REGION

US

ORGANISATION

Vert Asset Management

Vert Asset Management is a dedicated ESG asset manager. We believe there is economic value in sustainability: companies focused on the triple bottom line of people, planet and profits, will be better positioned for the risks and opportunities of the future than those focused on profits alone. We work closely with academic experts and portfolio managers to create investment products for the wealth management community. Vert combines ESG research and a rules-based process to deliver funds that strive to achieve investors' dual goals of sustainability and market rates of return.

The Vert Global Sustainable Real Estate Fund invests in publicly-traded real estate investment trusts that, through our investment process, have been identified as companies that are economically committed to sustainability. As of year-end 2018, the fund had \$16 million in assets under management.

THE CASE FOR SUSTAINABLE BUILDINGS

We spend 90 percent of our time indoors, and buildings account for 40 percent of the greenhouse gases (GHG) we contribute to the environment¹. Thus, real estate is a major part of the sustainability challenge – and a major opportunity.

Buildings are large consumers of energy and producers of emissions. There is great potential to improve the performance of buildings in terms of sustainability issues. Buildings present a real opportunity for GHG reduction in cradle-to-cradle design for business supply chains, property investments and resource use priorities². Additionally, addressing sustainability issues could affect the market values of a property or portfolio, providing a price premium, a lower default risk, lower volatility and slower rate of depreciation³.

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- 1 U.S. Environmental Protection Agency (EPA) (2017) "Indoor Air Quality" in EPA's Report on the Environment. Retrieved from: <https://cfpub.epa.gov/roe/chapter/air/indoorair.cfm>
 - 2 Cradle-to-cradle design is a life-cycle assessment philosophy is a concept popularized by architect and product designer Michael Braungart and William McDonough in their book Cradle-to-Cradle: Remaking the Way We Make Things (2002).
 - 3 Fuerst, F. and McAllister, P. M. (2008, July 15) "Green Noise or Green Value? Measuring the Effects of Environmental Certification on Office Property Values." Retrieved from <https://ssrn.com/abstract=1140409>.

According to the UN Environment Programme (UNEP):

“The construction and operations of buildings account for 40% of global energy use, 30% of energy-related GHG emissions, approximately 12% of water use, nearly 40% of waste, and employs 10% of the workforce⁴.”

In the US, real estate investment trusts, or REITs, own a significant share of the building stock. Listed REITs are publicly owned, thus allowing investors to potentially influence management towards integrating more sustainability-focused policies and practices. Many REITs focus on sustainability as a profit driver by 1) reducing costs through energy efficiency upgrades and retrofits, and 2) increasing rents and values, through healthier buildings and sustainable certifications.

SECURITY SELECTION

Globally, there are more than 400 publicly-traded REITs. We use positive and negative selection screens to identify those that qualify for the portfolio.

Our process is summarised in Figure 1 and grouped under the environmental, social and governance dimensions of sustainability. Our selection screens include comprehensive and focused indicators based on our research of important sustainability issues in the property sector and best practices in sustainable REIT management, as well as information sources to evaluate a company's portfolio, policies and management practices.

Figure 1: Overview of ESG criteria in REITs

QUALIFYING CRITERIA	KEY PERFORMANCE INDICATORS
ENVIRONMENTAL	<ul style="list-style-type: none"> Energy and greenhouse gas reduction Green building certifications Biodiversity and land conservation
SOCIAL	<ul style="list-style-type: none"> Urbanism and transit orientation Community impact and engagement Affordable housing
GOVERNANCE	<ul style="list-style-type: none"> Disclosure and reporting Tenant and employee engagement Greenhouse gas policies and programmes
DISQUALIFYING CRITERIA	KEY PERFORMANCE INDICATORS
CONTROVERSY	Bribery, corruption, human rights, displacements and fines
BUSINESS LINE	Fossil fuel and prison industries
CLIMATE RISK	Floods, sea level rise, heat, droughts and storms

Source: Vert Asset Management

Companies that qualify for the portfolio are ranked in our methodology as either Comprehensive or Focused Excellence.

⁴ United Nations Environmental Programme (2015). The Sustainable Buildings and Construction Programme Retrieved from: <http://www.unep.org/10yfp/programmes/sustainable-buildings-and-construction-programme>

COMPREHENSIVE EXCELLENCE

We use ESG ratings from prominent ESG research firms to qualify companies on Comprehensive Excellence. ESG ratings are composite indicators based on data collected on dozens of items, which are then weighted and combined according to each agency's assessment of their relative importance. No rating agency covers all the REITs, and each uses a somewhat different methodology. Therefore, to strengthen the validity, wholeness and reach of our analysis we average the ratings across three separate agencies. We then identify those companies in the top quartile for each ESG dimension and the aggregate scores. By only qualifying the top quartile, we get a group of about 20 sustainable REITs that are leading the way on sustainability across environmental, social and governance dimensions.

FOCUSED EXCELLENCE

ESG research agencies do not rate every REIT on every dimension, and the coverage of small caps still shows gaps. Some of these under-researched companies are world leaders on certain critical sustainability issues and as such deserve to be included on a list of sustainable REITs. To qualify under Focused Excellence, a company must demonstrate the highest levels of performance by being among the top 10 percent of all companies on selected metrics. About 80 firms qualify on this basis. The 10 issues covered under Focused Excellence are:

1. Affordable housing
2. Biodiversity and land conservation
3. Community impact and engagement
4. Energy/GHG reduction (> 2.6 percent average multi-year)*
5. Environmental/energy policies and management
6. ESG disclosure
7. Green buildings certifications
8. Tenant engagement
9. Transit-oriented and walkable urbanism
10. Water reduction

*According to the International Energy Agency, an annual energy intensity reduction of 2.6% is needed to achieve global climate goals⁵.

The data for these screens come from various sources including our own review of company publications, awards received, selected items from rating company datasets, and datasets produced for Vert by specialised vendors. As investor members of the Global Real Estate Sustainability Benchmark, we make use of the REITs' self-reported data. We also employ Bloomberg for public information.

Finally, the list of companies that qualified under Comprehensive or Focused Excellence are put through negative screens, which disqualify firms for violating certain minimum standards. The screens are:

1. Brown energy or prison businesses
2. Bribery and corruption
3. Environmental fines
4. Low comprehensive ESG ratings (e.g., <50 on a 100-point scale)
5. Climate risk management weakness

The result is a list of companies committed to sustainability as a driver of value in their business.

5 International Energy Agency (IEA) (2016). Energy Efficiency Market Report, IEA, Paris. Retrieved from https://www.iea.org/eemr16/files/medium-term-energy-efficiency-2016_WEB.PDF

PORTFOLIO CONSTRUCTION

Our initial universe consists of all publicly-listed REITs. We only invest in 15 selected developed and emerging markets countries. REITs with a market capitalisation of below \$500 million are not currently considered. We screen out companies with excessive leverage, with insufficient liquidity or with bankruptcy proceedings pending. The benchmark for our strategy is the Morningstar Global Markets REIT Index.

Once the securities have been selected, we construct the portfolio in such a way as to maintain diversification, minimise costs and manage tracking error to the benchmark. We do not overweight or underweight securities based on fundamental financial research. The selected securities are held in roughly market cap weights. The primary benefit of this weighting strategy is that it reduces trading costs. The strategy does not specify targets for country or sector weights; rather, it allows them to adjust with the market. We monitor these weights and may adjust sectors or countries if they fall too far out of line with the benchmark. To maintain diversification, in certain circumstances, we stop purchasing an individual company if its weight in the portfolio exceeds 5 percent.

Portfolio holdings are continuously monitored for any controversies or possible changes in their status as qualified companies. If any security is disqualified on this basis, it will be sold from the portfolio as soon as is practical. At least annually, Vert's investment research group re-evaluates all portfolio holdings, as well as all other REITs in the universe, for qualification and disqualification. Newly-qualified companies will be added to portfolio by the end of the year, and those that have been disqualified will be removed on a tax-efficient basis. This re-evaluation and re-balancing of the portfolio is not expected to incur significant turnover.

KEY TAKEAWAYS

Sustainability means different things in different industries. There is broad consensus among experts in the real estate sector on issues such as energy, stakeholder engagement, disclosure and green building certifications. By carefully selecting relevant and material metrics that reflect those issues, we ensure a strong operational intentionality to sustainable business practices by the REITs. Our stringent security selection criteria, based on robust data, result in a portfolio of REITs that have all made strong ESG commitments.

LEGAL DISCLOSURE

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