

# Step-by-Step to Sustainable Property Investment Products

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**Abstract** The interest in more sustainable properties has risen strongly in the recent past. There has been a shift from anecdotal evidence to well-documented case studies and comparative analyses indicating that sustainable building is highly profitable. The development and provisioning of sustainable property investment products and related consulting services offers a major opportunity for property professionals to increase financial returns, as well as their standing within society and the business world. Yet, this opportunity remains largely untapped due to various reasons. This paper sets out a strategy for the development, implementation, and widespread dissemination of sustainable investment products (sustainable property funds) for the property industry. This is seen as an additional and potentially powerful approach to stimulate demand for sustainable buildings.

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## Status Quo and the Way Ahead

The growing acceptance of the idea of corporate social responsibility by organizations, corporations, and other stakeholders across creates a demand for investment opportunities and products that adhere to the principles of sustainable development. This demand is further strengthened by the growing body of academic research evidencing that socially responsible investing (SRI) and corporate social responsibility (CSR) programs do not result in inferior financial performance compared to conventional investment and business practices (UNEP FI, 2007a). In this context, questions arise as to whether there are any sustainable property investment options available for institutional and private investors and whether these investment options are in line with the Principles for Responsible Investment ruled out by the UN Environment Programme Finance Initiative (PRI, 2006), as well as with the responsible investment guidelines formulated by the European Social Investment Forum (EUROSIF, 2007). Besides the products and services offered by a small number of leaders in the field of sustainable property investment and management (UNEP FI, 2007b), the answer to these questions is, especially for the situation in Germany: not yet. In the United States, a manageable number of sustainable property investments opportunities still exist. Regarding their sustainability verification, their investment strategy, and their investment objects, they are following very different approaches.

Planners, construction firms, and facility managers are able to design, realize, and operate sustainable buildings today. However, it apparently requires innovative approaches to increase the demand for buildings that are at the same time

energy-, resource-, and cost-efficient. Furthermore, they should be healthy, resistant to obsolescence, and offer higher aesthetic urban, technical, and functional qualities. Besides informing and influencing authorities and clients of direct property investments, the development of new products for indirect property investments is seen as an additional approach.

In 2007, about €20 billion was invested in 110 public SRI funds in Germany—with a growing trend. Across Europe, more than €1 trillion is invested in this sector. In the United States, assets under management in the SRI sector amount up to US\$2.3 trillion. However, until now property represents an almost entirely neglected asset class within the SRI sector. At the moment, only a very limited number of property investment firms or funds make sustainability an explicit goal; in addition, existing SRI funds in the U.S., as well as across Europe do not offer investors screened and professionally managed property portfolios. If these funds exist, they are simply too hard to find. Given that property improves the risk-return ratio of any mixed-asset portfolio and that an optimal share of property (direct or indirect investment) lies between 10% and 20% (Sirmans and Worzala, 2003; Worzala and Sirmans, 2003), the SRI market as a whole is significantly under-allocated from the perspective of optimal asset allocation. Consequently, the untapped market potential for publicly offered sustainable property investment products is immense. The authors assume that this untapped market potential still exists due to an underdeveloped market for certified sustainable buildings, information and knowledge deficits among private and institutional investors, and a lack of proactive fund developers and initiators. In order to overcome this situation in Germany and for the development, implementation, and widespread dissemination of sustainable investment products for the property industry, the following steps are recommended:

- Description and analysis of relevant constellations of stakeholders;
- Description and analysis of the information and cash flows between these stakeholders;
- Analysis of the interests and motivations on the demand side;
- Estimation of the market potential for sustainable property investment products;
- Discussion of appropriate ‘designs’ and types of investment products;
- Development of suitable assessment, rating, and certification approaches;
- Strategy development for the development of property fund products; and
- Development of appropriate marketing and reporting instruments.

Additionally, first, internationally existing examples should be analyzed. Besides the evaluation of case studies, the following questions should be answered:

- How is the sustainability of buildings proven in the portfolio?
- On which building types do existing examples concentrate on?
- Do the examples concentrate on new buildings or do they also include measures in the building modifications?

## Steps to Sustainable Property Investment Products

### *Stakeholders, Information, and Cash Flows*

The stakeholders in financial markets in terms of cash flows and value creation regarding financial products can be—in principle—transferred to both, the processes of value creation regarding sustainable property investment products and the relevant groups of stakeholders in property and construction markets. A core element is the linkage between planners and the construction industry on the one hand (the ‘physical side’) and the financial and banking industry on the other hand (the ‘monetary side’). In value creation, the monetary side is responsible for granting the financial capital required for construction. Identifying incentive structures for allocating further investment capital from the financial market to the funding of sustainable buildings creates additional stimulation for the construction industry. A crucial point, however, is that this stimulation is clearly focused on property project that only adhere to the requirements for sustainable buildings (i.e., ‘additional investment capital for sustainable buildings only’). This can create an additional demand for sustainable buildings. The linkages between the physical and the monetary side are provided through financial intermediaries and service providers, such as product developers and suppliers, rating agencies, and institutional funds that collect capital.

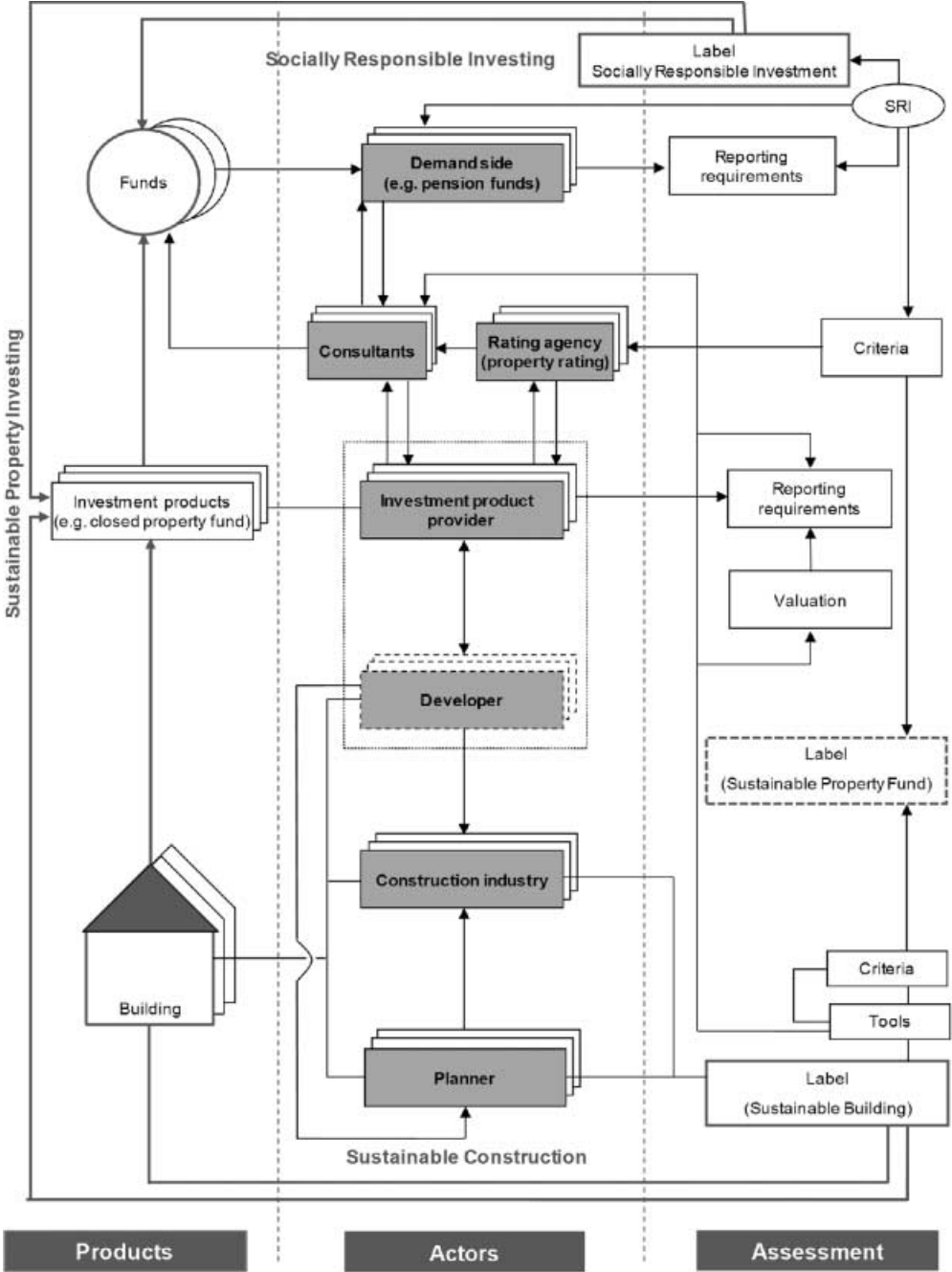
Exhibit 1 provides a simplified description of relevant constellations of stakeholders. The starting point is the demand side (i.e., institutional and private investors interested in SRI products). Stakeholders on the demand side select an appropriate investment product (i.e., a sustainable property investment product) from one of the available suppliers/initiators in the market by relying on consulting service providers and rating results. The supplier/initiator either acts as a property developer or identifies and buys appropriate property assets in the marketplace.

Exhibit 1 shows a ‘product level’ (left side), as well as an ‘assessment/information level’ (right side). It is clear that both investors (e.g., pension funds) and suppliers/initiators can be subject to so-called sustainability reporting requirements. In this regard, labels for SRI products, as well as for sustainable buildings already exist. However, approaches for the certification of sustainable property investment products are yet missing. Nonetheless, such certification schemes would be the logical consequence if property assets are to play a role within the SRI market. Labels and certification schemes for sustainable property investment products would have to combine assessment criteria from the SRI sector with the sustainable building area. In addition, sustainability issues would have to be integrated into accounting and financial reporting requirements for property funds.

### *Interests and Motivations on the Demand Side*

A major problem in property economic research is the unsatisfactory situation regarding data availability; concerning both, transaction data and information and

**Exhibit 1** | Stakeholders for the Development of Sustainable Property Investment Products



market participants' motivations and goals. Empirical surveys investigating the interests and motivations of selected groups of stakeholders regarding the issue of sustainable building and property investment are rare (Pivo, 2007). So it does not come as a surprise that the situation regarding sustainable property investments in Germany has not yet been subject to investigation and inquiry.

Therefore, a survey assisted by the authors, was carried out among German institutional investors in order to gain insight into their interests, motivations, and level of awareness and knowledge regarding SRI products in general, as well as sustainable property investment products in particular (Schäfer, Lützkendorf, Gromer, and Rohde, 2008).

During September and October of 2007, a total of 848 institutional investors were contacted within the scope of a survey; 116 (response rate: 13%) responded either by telephone interview or through a web-based questionnaire to the following topics: organization and financial structures; importance of property assets in general; importance of socially responsible investing; and the importance of sustainable property investment. Among the 116 participants, 59 were precautionary institutions (such as pension funds and life insurance companies), 34 were non-profit-organizations (including foundations, churches, and charities/aid organizations), and 13 were capital investment companies.

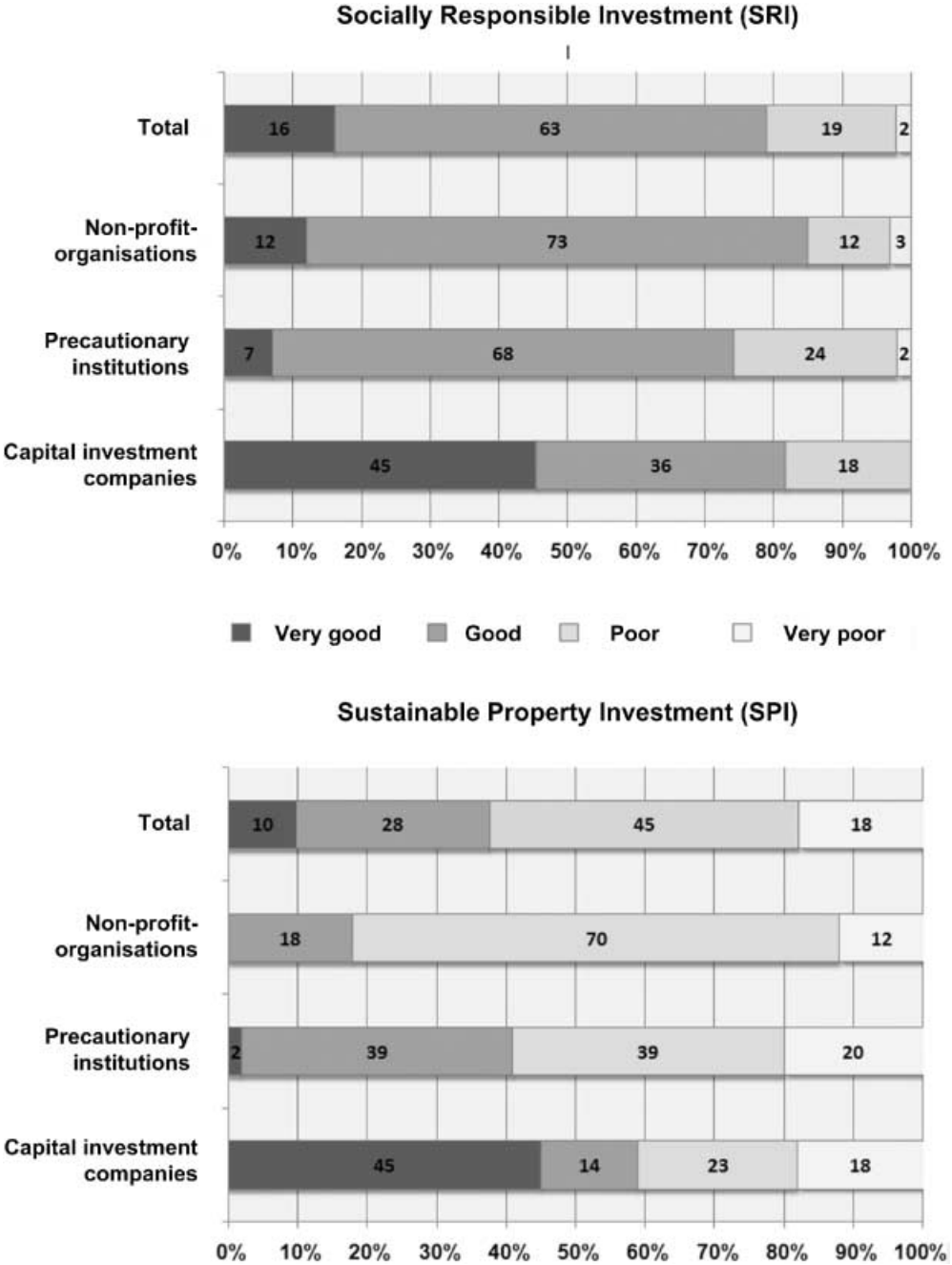
*Importance of Property within the Portfolio.* Capital investment companies usually diversify their portfolios. The survey showed that stocks, bonds, and property make up about one-third of the assets under management each. About 69% of assets under management have a planned holding period of at least five years. The remaining 31% are split between assets with a medium-term (18%) and a short-term (13%) holding period. The inclusion of different asset classes with different holding periods leads to a broad diversification of investment risk, which is typical for capital investment companies. The exact share of property within the surveyed companies' portfolios is 34%.

Regarding precautionary institutions, the survey revealed a risk-averse and long-term oriented investment strategy. On average, bonds have a 60% share of all assets under management. In the case of pension funds and life insurance companies, the share of bonds is even higher: 70% due to legal requirements. About three-quarters of all assets have a planned holding period of more than five years. The share of property within precautionary institutions' portfolios is 13%.

Within the non-profit-organizations, the survey showed that they also have a longer-term oriented investment strategy. The share of property within their portfolios is 16%.

*Level of Knowledge Regarding SRI.* The majority of surveyed investors judged their level of knowledge and awareness regarding socially responsible investments as 'very good' or 'good.' A particularly high level of knowledge was reported among the capital investment companies of which 45% judged their level of knowledge as 'very good' (Exhibit 2). The following relationships have been identified by making use of correlation analysis: (1) The level of knowledge regarding SRI products increases if investors already have SRI assets within their

**Exhibit 2** | Investors' Level of Knowledge Regarding SRI and Sustainable Property Investment Issues



portfolios; (2) the higher the share of SRI assets within the portfolio, the higher the level of knowledge; however, this relationship does not apply to the knowledge regarding sustainable property investments; and (3) the higher the share of property assets within the portfolio, the higher the knowledge regarding sustainable property investments.

Given that the overall share of SRI assets within the surveyed investors' portfolios is rather low (capital investment companies: 4%, precautionary institutions: 5%, and non-profit-organizations: 13%), the high level of knowledge reported among investors is, indeed, remarkable.

*Importance of Sustainable Property Investments.* About 50% of the surveyed investors showed a moderate interest in sustainability-oriented open- or closed-end property funds. Among the surveyed investors, the group of capital investment companies showed the largest interest. The remaining half of the surveyed investors stated that sustainable property investment funds are not on their 'radar' or that they are not considering this type of investment respectively. Further survey results are as follows:

- The different groups of institutional investors have different perceptions on what product forms would be of interest for sustainable property investment. The preferred forms are direct property investment and closed-end property funds. Capital investment companies also showed an interest in property stock corporations and real estate investment trusts (REITs). Non-profit-organizations show a tendency to prefer open-end property funds.
- The majority of surveyed investors expect that the rates of return from sustainable property investments are comparable to those of conventional property investments.
- In addition to sustainability certificates for the property assets in question, almost all investors argued that continuous sustainability reporting of fund companies and/or initiators would be an important characteristic of a sustainable property investment product. In this context, it is interesting to note that 31% of the surveyed investors are already subject to sustainability reporting requirements; this means that if those investors would like to engage in sustainable property investments, the availability of sustainability performance information would be a precondition for such engagement.
- Compared to the level of knowledge regarding SRI products and issues in general, the level of knowledge regarding sustainable property investments is judged considerably lower (see Exhibit 2).

In summary, there is moderate interest among institutional investors regarding sustainable property investment options in Germany. Clearly, this interest is greatest among those investors that are already engaged in SRI and that already have larger shares of property assets within their portfolios. However, these investors must be intensively advised and actively provided with detailed information on new SRI options and products in the property sector. This requires the development of appropriate marketing and reporting instruments.

### *Market Potential for Sustainable Property Investment Products in Germany*

The untapped market potential for sustainable property investment products can be estimated by using two different approaches: (1) estimation based on the share of SRI in the total investment universe; and (2) estimation based on optimal asset allocation considerations within the SRI market.

At the moment the share of SRI in total assets under professional management in Germany is roughly 1% (see also Schäfer, 2005). In 2006, the total volume of property assets under professional management of institutional investors in Germany has been on the order of €394.8 billion. Consequently, it can be argued that the market potential for sustainable property investment products is about 1% of the volume of property assets of institutional investors; this corresponds with a market potential of about €4 billion in Germany.

The second approach for calculating the market potential is based on the consideration that from the viewpoint of optimal asset allocation the share of property within a mixed-asset portfolio is somewhere between 10% and 20% (Sirmans and Worzala, 2003; Worzala and Sirmans, 2003). In 2007, about €20 billion was invested in 110 public SRI funds in Germany (Imug, 2007). As a result, the market potential for sustainable properties within the public SRI sector is between €2 and 4 billion.

The figure of €4 billion market potential translates into a floor area of about 3 million square meters of office space; this estimate is based on an average price for gross floor area of about 1,400 €/m<sup>2</sup> for office buildings of average quality (BKI, 2007). For reasons of comparison, the following data are worth mentioning: the market for office space in Frankfurt currently has a size of about 12 million square meters; in Germany, the overall volume for construction works was ca. €237 billion by 2004 and about €5 billion of this sum have been spent for the construction of new office buildings.

### *Existing Market and Discussion of Appropriate Types of Investment Products*

Although a negligible number of sustainability-oriented developments (closed-end property funds with very small volume only) could have been identified within the scope of the research project, the market for sustainable property investment products is virtually non-existent in Germany. Regarding the market in the United States, the Responsible Property Investment Center (see: <http://www.responsibleproperty.net>) provides an overview on existing products and firms. Additional outstanding examples can be found in a recent publication of the UNEP FI's Property Working Group (UNEP FI, 2007b). For the German property market, the following types of investment products are recommended (given that the basic framework for the development and establishment of REITs in Germany is not yet fully sorted, the development of a 'green' REIT appears unrealistic at the moment).

*Development of Smaller Closed-End Property Funds for Private Investors.* An appropriate strategy for new fund initiators is seen in the development of closed-end funds. These can comprise one or more property assets that have been certified



with the national sustainable building certification scheme. As this certification scheme is still under development, the idea of developing and marketing ‘hot-topic-funds’ appears attractive: the possibilities include ‘climate-protection property funds’ and ‘energy-efficiency property funds’ comprised of net-zero-emission buildings. The typical fund volume for closed-end property funds in Germany is between €5 and 250 million; the duration usually is between 10 and 20 years.

*Development of Special Open-End Property Funds for Institutional Investors.* Due to distinct reporting requirements towards investors and the possibilities for active portfolio management, the investment type of special open-end property funds particularly lends itself for the development of sustainable property investment products. With this type of investment, the number of investors, duration, and volume is unlimited; typically the volume is at least €250 million. Given the lack of comparability between different sustainability assessment and certification schemes, it is recommended that properties be selected from regions within the coverage of one certification system only (questions concerning comparability and acceptance of different certification systems are currently intensively discussed in Europe).

### *Investment Strategies*

Sometimes it is argued that one problem for the development and establishment of sustainable property investment products lies in the difficulty of identifying an appropriate number of property assets that would qualify for such treatment. However, the following investment strategies can be applied.

1. *Project Development.* If there is a shortage of sustainable buildings in the marketplace, fund developers/initiators can act as a project developer and guarantee the way that the property assets are designed, constructed, and subsequently managed according to the requirements of sustainable building.
2. *Improving Sustainability Performance of the Existing Stock.* Investments into the existing building stock can extend or restart the lifecycle of buildings and improve their environmental and social performance. In Europe, carrying out extensive revitalization works is partly regarded as superior to building new.
3. *Fostering More Sustainable Communities and Cities.* This strategy comprises investments in community projects such as affordable housing and urban revitalization in order to foster a more sustainability society.

Pursuing the aforementioned strategies leads to additional demand for more sustainable planning and construction works. An additional investment strategy without this effect is:

1. *Portfolio Optimization.* Comprises the purchase and/or disposal of property assets (e.g., for portfolio selection or portfolio optimization purposes) that meet/do not meet preset minimum environmental and social performance requirements. It also includes active portfolio

management to develop the existing stock towards a more sustainable asset. Almost certainly the quality of the applied management practice will become—besides the quality of the buildings within the portfolio—a criteria for assessing and certifying sustainable property investment products.

### *Reporting: Requirements & Possibilities*

An essential feature of a sustainable property investment product is the availability and regular updating of a sustainability report. This is because many institutional investors (in particular, pension funds) are already subject to sustainability reporting requirements. For example, in their statement of investment principles, trustees in the UK must give (according to the Occupational Pension Schemes Regulations) information about (a) the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention, and realization of investments, and (b) their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to investments. Similar reporting requirements apply in Germany.

Sustainability reporting is a critical area as there is a general ‘ethical, social and environmental reporting-performance portrayal gap.’ This gap has been identified by Adams (2004) and by Hummels and Timmer (2004). It is argued that current ethical and social reporting practice does not provide investors and other stakeholders with appropriate information to assess the material consequences of company activities and behavior in socially or politically sensitive areas. “Until reports that compare sustainability performance are freely available, as ubiquitous as financial reports, we will remain lost in the quagmire of intriguing anecdotes, unable to determine who performs better [...]. In a world with comparable reports, sustainability reporting can fulfill its true potential: providing concise, transparent information that clearly reflects the reality of environmental and social issues, allows for benchmarking, highlights long-term risk and opportunities, and contributes to improved levels of public and investor confidence. [...] Otherwise sustainability reporting will remain an exercise in creative writing,” (Rogers, 2005, p. 39).

In fact, the reporting requirements for an innovative product with which the market is unfamiliar with are even harder for already established investment products. In this regard, it is important to realize that acceptance of and trust in new property investment products will only be achieved by striving for the highest degree of transparency possible and, in doing so, not only delivering attractive products to investors but also the information necessary to meet investors’ reporting requirements. Thus, a sustainability report for sustainable property investment products should, at least, contain information on the following issues:

- Impacts on the environment through emissions; expressed through the CO<sub>2</sub>-equivalent;
- Energetic quality/energy efficiency;
- Amount of drinking and waste water during occupation;

**Exhibit 3 | Sustainable Property Investment Opportunities**

Company	Type of Company				Type of Building											Type of RPI							Verification of RPI		Certification	Indices									
	Developer	Fund Manager	Institutional Investor	Private Equity Funds	REIT	Homes/Multifamily	Commercial	Office/Retail	Industrial/Warehouse	Distribution	Hotels	Schools/Universities/Life Science	Hospital	Theme Parks	Ranches	Parks/Neighborhood	Urban Revitalization	Environment Protection	Local Citizenship	Corporate Citizenship	Brownfield Redevelopment	Smart Growth and Transit Oriented	Green Building and Maintenance	Affordable and Workforce Housing		Fair Labor, Responsible Contracting, and Workforce Development	Historic Preservation	Own approach	Certification by Third Party	Dow Jones Sustainability Index	FTSE4Good	Australian SAM Sustainability indices	Domini 400 Social Index		
Cherkeze Investment Partners				X													X					X	X				X	X							
EBL&S Development	X																						X					X							
Genting Edlen	X																																		
Hines CALPERS Green Development Fund				X																			X					X							
Kennedy Associates																																			
Melaver	X																																		
Noisette Community Protogis	X																																		
The Bond Companies	X																																		
The Schuster Group																																			
United Fund Advisors																																			
Volcan Real Estate																																			
Windmill Developments	X																																		

- Waste volume;
- User satisfaction; based on post-occupancy evaluations;
- Existence of local risks through flooding, extreme weather, large-scale catastrophes in adjunct industries, etc.; and
- Extent and manner of regular inspection and maintenance works.

It has to be noted that this information refers to the property assets only; more general reporting requirements for the fund companies/initiators are laid down in detail here: AccountAbility (2003) and GRI (2006). The information on the property-related issues should be expressed (1) in absolute values, (2) as a trend, (3) in comparison to selected benchmarks, and (4) by indicating appropriate reference values (such as m<sup>2</sup>, m<sup>3</sup>, number of occupants/employees, etc.). The annual sustainability report of the UK-based fund company Hermes serves as an outstanding example in this regard (Hermes, 2007).

### *Analysis of Existing Sustainable Property Investment Opportunities*

The authors analyzed a number of existing international samples. Exhibit 3 shows only an extract of a larger table, which was developed with the support of the Responsible Property Investment Center (RPI List, 2009). Exhibit 3 shows all of the companies that have a trust in a certification for sustainable buildings.

The results of an analysis of Exhibit 3 can be summarized as follows:

- A standardized method for the evaluation of the sustainability of complete portfolios of buildings, as well as the quality of the management of funds has not developed yet.
- The predominant assessment system used is LEED but BREEAM and Casbee are also featured.
- A range of different types of properties are invested in. Housing construction is an area of key focus.
- The companies investigated, responsible property investment focuses on “Urban Revitalization” and “Green Building and Maintenance.”

With regard to a standardization of the evaluation of buildings, it is recommended to actively pursue the developments in the international and European standardization (ISO TC 59 sc 17 and CEN TC 350), as well as the activities of the SB Alliance.

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## Conclusion & Outlook

The interest in socially responsible investment and corporate governance issues has risen dramatically in recent years; and so has the availability of SRI products. However, this trend has not yet been matched with corresponding developments within the property industry. This assertion applies to both the demand side (investors) and the supply side (fund developers and initiators). As a consequence, the current challenge lies in aligning the goals and motivations of socially

responsible investing with efforts to increase the share of property assets within investment portfolios. This will create a demand for sustainable property investment products and thus strengthen the demand for sustainable buildings in general. Meeting with this challenge requires (1) increasing the awareness level of such investment products through systematic marketing; (2) delivering more scientifically robust evidence regarding the economic advantageousness of sustainable property investments; and (3) purposefully serving investors' existing sustainability reporting requirements.

Research carried out on the situation in Germany revealed that institutional investors that are already engaged in the SRI market represent a most promising target group for sustainable property investment products. But even though there is market demand and the untapped market potential can be estimated, most existing property fund providers/initiators are reluctant to develop appropriate investment products. As a result, there are opportunities for both fund initiators aiming to enter the property sector, as well as for established property fund initiators to successfully extend their product range. These opportunities are major and they have to be taken advantage of.

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