Global Real Estate

Opportunities and Risks for Swiss Institutional Investors

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1 Introduction

Swiss pension funds invest traditionally not only in Switzerland but also abroad. This is specifically true for equities and fixed income but much less so for properties. Due to the low yield environment, the demand for Swiss properties has grown substantially. This has led to a situation whereby a majority of property investment foundations closed to new investors. As a consequence, liquid property funds have a premium to NAV of 25% on average.

Foreign property is a good strategic option to diversify away from the home market and to target attractive yields and non-residential property segments. Trustee boards should therefore put foreign real estate on their agenda and gain an understanding of the risks, opportunities and available investment vehicles.

This paper discusses the pros and cons of foreign property investments. It also addresses the reasons for the still very low allocation. Finally we show possible implementation solutions.

1.1 Allocation to Swiss and Foreign Real Estate

The Bundesamt für Statistik (BFS) produces a report that details the investment allocation of Pensionskassen (pension funds) in Switzerland. Their results for 2007 and 2013 are displayed below:

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>8,2%</td>
<td>8,1%</td>
</tr>
<tr>
<td>Other</td>
<td>3,3%</td>
<td>4,1%</td>
</tr>
<tr>
<td>Fixed Income (CHF)</td>
<td>25,6%</td>
<td>21,0%</td>
</tr>
<tr>
<td>Fixed Income (Foreign)</td>
<td>11,5%</td>
<td>12,7%</td>
</tr>
<tr>
<td>Mortgages</td>
<td>2,8%</td>
<td>2,0%</td>
</tr>
<tr>
<td>Reach Estate (CHF)</td>
<td>13,2%</td>
<td>15,8%</td>
</tr>
<tr>
<td>Real Estate (Foreign)</td>
<td>1,3%</td>
<td>1,3%</td>
</tr>
<tr>
<td>Equities (CHF)</td>
<td>11,2%</td>
<td>10,2%</td>
</tr>
<tr>
<td>Equities (Foreign)</td>
<td>16,8%</td>
<td>18,8%</td>
</tr>
<tr>
<td>Alternatives</td>
<td>6,2%</td>
<td>6,1%</td>
</tr>
<tr>
<td>Fixed Income % Foreign</td>
<td>31,0%</td>
<td>37,6%</td>
</tr>
<tr>
<td>Equity % Foreign</td>
<td>60,0%</td>
<td>64,9%</td>
</tr>
<tr>
<td>Real Estate % Foreign</td>
<td>9,0%</td>
<td>7,7%</td>
</tr>
</tbody>
</table>


As would be expected, equities have the largest allocation to foreign securities at 64.9% in 2013. Given the high idiosyncratic risk in large capitalization Swiss equity benchmarks, it’s a healthy sign that this percentage has been increasing since 2007. Within the Fixed income allocation, the allocation to foreign currencies is 37.6%. The real estate allocation is invested only 8% in foreign assets and this percentage has decreased since 2007. The results of a December 2015 INREV study below show the higher international investor allocations to real estate:
1.2 Concerns of foreign real estate and their mitigating factors.

Several reasons have been offered\(^1\) for the low allocation of international real estate in Swiss portfolios (with our mitigating points included in italics below):

1. **Good performance of Swiss real estate in the last several years**
   
   *To quote an all too common though no less applicable phrase: “past performance does not guarantee future results”.*

2. **Relatively stable cash-flows in CHF for Swiss investments**

   *Regarding point 1 and 2, we will discuss performance in a later section as well as valuation methods that are quite different from a transactional value.*

3. **Strong knowledge of the Swiss market**

   *A global investment consultant is able to assist to bridge the knowledge gap in foreign real estate.*

4. **Up till 2009, BVV regulations only allowed a small 5% allocation to foreign real estate**

   *The maximum is now at 10%.*

5. **Market entry for smaller Swiss institutions is difficult**

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\(^1\) David Johnson "Internationale Immobilieninvestitionen – Potenzial für Schweizer Pensionskassen" (2012)
Products have been developed that allow small institutions to gain an internationally diversified real estate exposure.

6. There are difficulties in gaining an overview of the market, comparing track records and benchmarking
   Valuation methodologies, the lack of real time pricing, and different benchmark methodologies all contribute to this.

7. Foreign real estate is generally more volatile
   One aspect of volatility is currency movements. These, for a cost of the interest rate differential and trading fees may be addressed via currency hedging. The other aspect is the high volatility in real estate pricing. It can be argued that the seemingly low volatility of Swiss and German real estate can be attributed to nothing other than valuation methodologies.

8. Internal difficulties in the organizational allocation of international real estate investments
   This potentially speaks to the question of how to treat REITs and other real estate securities. In a section later we show the true underlying risks of real estate equity securities.

9. Swiss consultants generally lack experience in this field.
   A global investment consultant can assist to bridge the knowledge gap in foreign real estate.

2 Swiss Real Estate Market

2.1 Current valuations
   UBS publishes periodically a “Bubble Index” of the Swiss residential market. Although the index does not encompass all property segments, it serves as an indication for the current risks of the property market. In the first years after the last deep property crisis in Switzerland in 1990, the index has fallen sharply. However, since 2000 the index has risen to levels close to those seen in the 1990’s.
Swiss Real Estate Valuations

The UBS Swiss Real Estate Bubble index is based on six sub-indices:

a) Residential prices versus rental price
b) Residential prices versus incomes
c) Residential prices versus inflation
d) Debt versus incomes
e) Development versus GDP
f) Mortgage applications for rental properties versus total credit requests for UBS private clients

Although the index is based purely on the residential market, it does offer some insight into the general real estate dynamics in Switzerland. Switzerland’s residential real estate market is currently at “Risk” levels.

2.2 Swiss Investment Options

Institutional investors in Switzerland can invest either in investment funds or investment foundations. Quoted investment funds trade at high premiums to NAV (approx. 25% in April 2016). Most foundations are closed, and when they do temporarily open, they ask for a premium to NAV of up to 8% and are massively oversubscribed. Those that are still open can lack quality assets and/or diversification.
3 Global Property Market

3.1 Return expectations

Most striking is that Zurich offers the lowest yield of the major European cities. Additionally, there are opportunities for higher yield (after taking interest rate differentials between CHF and EUR into account), though significantly higher yields are associated with periphery risk and smaller markets that have a higher illiquidity premium.

European Prime Office and Shopping Center Yields

Prime Office Yields - cyclical peak, low and current.
This graphic above displays that Zurich retail yields are more competitive within Europe than Zurich office yields. Major cap rates according to CBRE in the US for offices are between 4 to 6%. Retail cap rates are between 4.5 to 6.0%. Industrial is from 5 to 6.5%. In Asia, rates for prime office range from 3 to 6%, for Prime retail from 4 to 5.5% and for Industrial from sub 3% to 8%. Suffice it to say, within a global context there is opportunity for yield gain and a reduction in country risk.

3.2 Property Cycles

Different countries are at different stages in the real estate cycle, thereby providing further diversification benefits.

Historical Geographic returns hedged into CHF:
As mentioned in point 1 as to why Swiss real estate investors prefer Swiss real estate, the Sharpe ratio of the returns have been outstanding since 2002. These numbers are presented with caution and are with caveats. Over the last 20 years the Swiss real estate market has been going through a bull market largely propelled by a reduction in long-duration Swiss Government bond yields. Any asset class with high cash-flow will benefit from this. During the 1990’s, the Swiss market experienced a real estate crash that is not depicted in the graph though is strongly alluded to in the Swiss Real Estate Bubble index chart. That Switzerland did not participate in the 2008/09 real estate crash is largely attributed to Swiss valuation techniques that are similar to those in Germany. According to B.S.,

2

real estate funds in these countries are valued with a backward looking, static and in some cases arbitrary method – a weighted average of the “Ertragswert” and the “Realwert”. Anglo-Saxon funds on the other hand value properties based on what would be the likely clearing value in an arm’s length transaction. The result, as can be seen, were very little write-downs in Switzerland during the global real estate crisis of 2007-2009. Any time-series should be called into question if it displays a high level of autocorrelation (the current return being highly correlated with the last).

### 3.3 Benefits of International Real Estate

#### 3.3.1 Reduction in implicit Swiss duration risk

As can be seen from the graph below, listed Swiss real estate’s returns are negatively correlated with 10-year Swiss Sovereign rates – with the exception of one four-year period. The red line represents the growth of the Rüd Blass Market Weighted index. The blue asterisks represent the 10 year CH bond rates.

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2 B.S., – “Eine Uebersicht zu indirekten Immobilienanlagen in der Schweiz”; March 2003
This form of Swiss real estate could be seen in some respects as an additional Swiss bond holding. By increasing the international component vs Swiss listed real estate, this implicit interest rate risk can be reduced.

3.3.2 Vintage year diversification

An international real estate exposure should be built up over time. A staggered investment approach creates a situation where every year commitments are going out and after several years, yield and principal are being returned, so thereby creating a more liquid asset class out of a generally illiquid asset class. Additionally, it helps protect from lousy vintage investment years. An example of the range of vintage years is described in the Investment Considerations section.

3.3.3 Currency Diversification

If no hedging is done, there is the potential for currency diversification. For those portfolios whose overall return will be less reliant on currency movements (value-add and opportunistic), and are invested over multiple years, a smaller hedging percentage can be considered. For core portfolios that are immediately invested, a high level of hedging is recommended.

3.3.4 Investable universe

There are limited opportunities in Switzerland for Value-add and Opportunistic investments versus what is seen in international markets.
The diagram below shows the current market for closed-end funds that are capital raising. The first graph depicts the total target raise in Millions of euros, the second shows the number of funds. Excluded are funds with vintage years or capital raise starts earlier than 2012 and funds smaller than 100M Euros.

Based on total targeted capital:

<table>
<thead>
<tr>
<th>Region</th>
<th>Core</th>
<th>Core-Plus</th>
<th>Debt</th>
<th>Distressed</th>
<th>Value Added</th>
<th>Opportunistic</th>
<th>Grand Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>880</td>
<td>903</td>
<td>947</td>
<td>-</td>
<td>4.821</td>
<td>7.793</td>
<td>15.345</td>
</tr>
<tr>
<td>Americas</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>478</td>
<td>166</td>
<td>2.920</td>
<td>3.564</td>
</tr>
<tr>
<td>Australasia</td>
<td>-</td>
<td>554</td>
<td>336</td>
<td>-</td>
<td>672</td>
<td>134</td>
<td>1.697</td>
</tr>
<tr>
<td>Africa</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>234</td>
<td>1.349</td>
<td>1.583</td>
</tr>
<tr>
<td>Diversified Multi-Regional</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>147</td>
<td>478</td>
<td>851</td>
</tr>
<tr>
<td>Middle East &amp; Israel</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>253</td>
<td>253</td>
</tr>
<tr>
<td>Grand Total</td>
<td>11.011</td>
<td>7.748</td>
<td>23.862</td>
<td>6.719</td>
<td>47.055</td>
<td>44.836</td>
<td>141.231</td>
</tr>
</tbody>
</table>

Source: Preqin (April 2016)

Per number of funds:

<table>
<thead>
<tr>
<th>Region</th>
<th>Core</th>
<th>Core-Plus</th>
<th>Debt</th>
<th>Distressed</th>
<th>Value Added</th>
<th>Opportunistic</th>
<th>Grand Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>6</td>
<td>9</td>
<td>24</td>
<td>8</td>
<td>88</td>
<td>34</td>
<td>169</td>
</tr>
<tr>
<td>Europe</td>
<td>20</td>
<td>11</td>
<td>13</td>
<td>1</td>
<td>28</td>
<td>12</td>
<td>85</td>
</tr>
<tr>
<td>Asia</td>
<td>3</td>
<td>1</td>
<td>3</td>
<td>0</td>
<td>12</td>
<td>19</td>
<td>38</td>
</tr>
<tr>
<td>Americas</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>9</td>
<td>11</td>
</tr>
<tr>
<td>Australasia</td>
<td>0</td>
<td>3</td>
<td>1</td>
<td>0</td>
<td>3</td>
<td>1</td>
<td>8</td>
</tr>
<tr>
<td>Africa</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Diversified Multi-Regional</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Middle East &amp; Israel</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Grand Total</td>
<td>30</td>
<td>24</td>
<td>41</td>
<td>10</td>
<td>134</td>
<td>82</td>
<td>321</td>
</tr>
</tbody>
</table>

Source: Preqin (April 2016)

The US is raising the largest number of funds followed by Europe and Asia. The strategy of most funds being raised is Value-Added followed by Opportunistic and Debt.

The following graph shows the number of open-ended Core and Core+ funds in the main regions by property type and primary investing location that are open for new investments.

<table>
<thead>
<tr>
<th>Region</th>
<th>Diversified</th>
<th>Office</th>
<th>Industrial</th>
<th>Residential</th>
<th>Retail</th>
<th>Hotels</th>
<th>Niche</th>
<th>Other</th>
<th>Grand Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>4</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>Europe</td>
<td>42</td>
<td>12</td>
<td>2</td>
<td>8</td>
<td>12</td>
<td>1</td>
<td>3</td>
<td>5</td>
<td>85</td>
</tr>
<tr>
<td>US</td>
<td>5</td>
<td>2</td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>Grand Total</td>
<td>51</td>
<td>14</td>
<td>2</td>
<td>9</td>
<td>14</td>
<td>1</td>
<td>3</td>
<td>5</td>
<td>99</td>
</tr>
</tbody>
</table>

Source: Preqin (April 2016)

Although by definition more risky, value-add and opportunistic real estate offer the investor the ability to make real estate investments that are less reliant on the capitalization rate and more on the ability of the manager to add value to the underlying. A general comparison between core, value-add, and opportunistic funds are shown below:
As an explanation, liquidity mismatch risk describes the situation whereby the fund is invested in illiquid assets (real estate) but nonetheless guarantees some form of regular liquidity. Problems arise when redemption requests exceed subscriptions and the fund is forced to either sell properties quickly or in a falling market increase LTV and/or halt redemptions.

### 3.3.5 Other benefits

Other benefits of international investing include being able to invest in different property cycles and property types. In other countries there are managers that specialize in niche real estate sectors such as storage, parking houses, hotels, student housing, senior housing, specialized industrial buildings, and even mobile home parks.

### 4 Implementation considerations

#### 4.1 Investment Strategies

##### 4.1.1 Direct Investment vs a portfolio of geographically focused funds

Direct investment in properties is the only option for the largest institutional investors seeking to maintain 100% control of the portfolio. It requires significant depth of portfolio management and operational expertise. To have a well-diversified portfolio would require an AUM of 1.5B CHF+. A portfolio of even 1B CHF would be arguably too small. 32 properties valued at 32M CHF each would be inefficient given the transaction and structuring costs associated with each of the 32 properties. By decreasing the number of properties to 20 for example to get an average cost of 50M would result in each property being worth 5% of the total portfolio – arguably a high level of idiosyncratic risk.

A portfolio of funds on the other hand would reduce the property idiosyncratic risk to negligible amounts and at much smaller investment levels. For all but large institutional investors, external fund selection, tax, and legal advice would need to be sourced externally. In well-functioning markets it still takes 2-4 months to sell a property – currently, core funds can be redeemed more...
quickly on the secondaries market. In difficult markets, liquidity for direct investments and funds both suffer.

4.1.2 A portfolio of geographically focused funds versus a fund of fund strategy

The decision between a portfolio of funds or the utilization of a multi-manager strategy is largely dependent upon the AUM being invested as well as the internal resources available. The fund of fund strategy allows the fiduciary to delegate a large majority of the portfolio management and operational responsibility and essentially leaves one point of contact to manage. This comes at a price of 50-70bps above the fees for the underlying funds (some savings may be achieved with larger AUM). At a certain level of AUM a fiduciary should begin to question whether this could be done in-house or with external advice. Besides the responsibility of portfolio management (geographic, sector and fund selection), operational activities (legal, tax, cash management) would also need to be managed or delegated.

4.1.3 A direct global real estate fund

This option allows an investor to invest in one portfolio of direct investments. One would need to be comfortable with the quality of the assets and the philosophy of the portfolio management team. Redemptions for these types of funds generally takes over a year.

The graph below details the various investment structures and important decision criteria for selecting a structure:

<table>
<thead>
<tr>
<th>Depth of Internal Resources Required</th>
<th>Direct Global Investments</th>
<th>Portfolio of geographically focused funds</th>
<th>Direct Global Fund</th>
<th>Fund of funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Geographic Diversification</td>
<td>Very Significant</td>
<td>Medium</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>Opportunity for higher returns</td>
<td>Low unless significant allocation</td>
<td>Strong</td>
<td>Modest</td>
<td>Strong</td>
</tr>
<tr>
<td>Management fees</td>
<td>High unless significant allocation</td>
<td>Medium</td>
<td>Modest (based on AUM)</td>
<td>Modest (based on AUM)</td>
</tr>
<tr>
<td>Liquidity Profile (in stable markets)</td>
<td>Good</td>
<td>Good</td>
<td>Modest</td>
<td>Modest</td>
</tr>
<tr>
<td>Liquidity Profile (in non-stable markets)</td>
<td>Modest</td>
<td>Poor</td>
<td>Poor</td>
<td></td>
</tr>
<tr>
<td>Pace of deployment of Capital</td>
<td>Slow</td>
<td>Good</td>
<td>Good</td>
<td>Good</td>
</tr>
<tr>
<td>Influence on Gearing</td>
<td>Driven by Client</td>
<td>Steered via allocation to funds</td>
<td>No direct control</td>
<td>No direct control</td>
</tr>
</tbody>
</table>

4.2 Vintage Year Risk

In a global context, sector and regional decisions are an important decision in real estate investing, though arguably more important are vintage year risk, leverage, and manager risk. The chart below with data from Preqin shows the IRRs for Value-Add and Opportunistic real estate managers per year, the median manager return, and the dispersion between the first and third quartile managers.
When looking at the median IRR, it has been as high as 22% and as low as only 0%. The range of up to 22% between the years shows the importance of dollar cost averaging one’s real estate allocation over at least 4 years. The range of returns within years (between the 1st and 3rd quartile) has been close to 21% in some years. It’s not a huge stretch to maintain that manager selection and due-diligence are extremely important. One of the main underlying questions is if the manager is only sourcing real estate beta and overlaying leverage, or if there is fundamental real estate talent within the organization in the areas of portfolio management/strategy, business relationships (sourcing and to a lesser extent dispositions), asset management, redevelopment and development, and leasing. Those investment consultants / manager researchers with backgrounds in real estate investing are best positioned to assist in this task.

4.3 First funds vs. Established Manager

To further demonstrate the importance of manager selection, a widely believed myth is that by investing in a manager with a long track record, a safe choice is being made. The following chart from Preqin presents some interesting observations.
The first notable observation is that the majority of first funds (52%) perform above the median. Funds 3 and 4+ only perform above average 45% and 49% of the time respectively. This begs the question, why would a stable, experienced real estate manager not be able to beat less experienced first time funds? Generally, first time funds are run by experienced real estate professionals that have left larger shops to start their own firm. They are also responsible for investing in far fewer deals given their smaller capital commitments. With less money to invest and still looking at a similar number of deals, they are going to be very discriminating in the deals they invest in as the large share of their remuneration comes from performance fees. Some of the largest funds are able to generate substantial fees from asset management alone – sometimes a major difficulty they have is just finding a place to invest their capital.

Experienced real estate fund due-diligence is required for all funds, even those funds represented by managers that have a long history in the market.

4.4 Liquidity

One of the first questions in determining any real estate strategy is the level of required liquidity. Some investors view REITs and other real estate securities as a proxy for real estate that they can use for the purposes of liquidity. We would strongly recommend against this strategy. As seen from the graph below, international real estate securities have a very high correlation to the overall equity market. There was one period where the high correlation went negative - during the alignment of two different macro-economic phenomenon: rapidly dropping interest rates and the blow up of a tech bubble. Going forward in the near and medium term, the confluence of these two factors is highly unlikely.

A level of manageable liquidity is better achieved by dollar-cost averaging into the asset class and redeploying returning capital in a disciplined manner which is best done through the use of capital allocation tools where assumptions are made for annual deployments and return of capital after accounting for future return expectations (based on the current portfolio) and fees.
4.5 Currency hedging

A manager’s performance and performance fee are calculated in the currency of the investments. Most real estate managers do not offer currency hedging services. Generally, the more focused the real estate is on income generation, the higher the hedging position should be. With that said, currency exposure should always be considered in a total portfolio context, not just within the investor’s total real estate commitment.

4.6 Taxation and Structuring

Even tax-exempt investors investing in foreign real estate are exposed to foreign real estate taxes. Depending on how the investment is structured, foreign tax filings may be required. Some investment vehicles are better than others for minimizing tax leakage and reporting requirements; though this depends on the legal entity of the client, hence no generic advice can be given and each investor should avail themselves of legal/tax advice prior to investing.

In the case of an investment in a portfolio of geographically focused funds, an international tax and legal provider with staff in Switzerland familiar with private equity structures is absolutely necessary to insure a suitable investment wrapper is developed for each fund investment that minimizes the necessary tax outlay.
4.7 Fund Selection / Geographic and Sector Allocation

Only an international investment consultancy is able to offer the depth of resources to review and conduct in-depth investment and operational due-diligence on the hundreds of funds raising capital in the marketplace.

Through a global presence, an investment consulting firm is able to stay up-to-date on the real estate developments in the main real estate markets and offer informed advice on the best opportunities available globally.

5 Conclusion

Swiss investors invest a far smaller percentage of their portfolio in foreign real estate than investors in other countries. The allocation amounts to 1% of total portfolio, respectively 8% of total property allocation.

A higher allocation would substantially improve diversification and would lead to better return/risk characteristics as the Real Estate cycle is not uniform in all markets. It is important for the pension representatives to understand the characteristics of different investment vehicles. Based on the size of the investment, the structure can vary greatly. Only with an independent expert can an investment be recommended.
Disclaimer

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