Pension funds and real estate – Direct or indirect?

Having a broad risk spread goes without saying these days when it comes to equity and bond investments. Unlike real estate, where many Swiss pension funds continue to keep their real estate investments directly in the local or regional area. This is surprising, as indirect real estate investments offer considerable benefits for pension funds. The securitization of real-estate portfolios in investment foundations, for instance, allows considerably greater diversification at the same time as a higher degree of flexibility.

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Statutory investment restrictions, a high minimum rate of return and ever-growing performance pressures pose major challenges for pension fund investment managers. Since real estate investments are a good way of diversifying, they have once again been attracting the attention of pension funds in recent years. While national and international diversification is now the rule as far as bonds and equity investments are concerned, when it comes to real estate this process is only in its infancy. As the "Swiss Institutional Survey 2005" by Lusenti Partners and Credit Suisse showed, well over 80% of the property investments of pension funds with assets of less than 500 million francs were in the local and regional area – generally speaking in the same canton or a neighboring one.

International real estate

The share of international real estate in pension fund portfolios is also negligible. In 2006, Swiss pension funds had total assets amounting to 581 billion francs. The share accounted for by real estate was 14.0% or 81.1 billion francs. Besides direct real estate investments, this also includes real estate investment funds, foundations and joint-stock companies. Foreign real estate had a share of only 1.1% or 6.7 billion francs of the total assets. Under the law, however, a share of up to 5% would be permitted. This shows clearly that the real estate portfolios of many Swiss pension funds exhibit considerable cluster risk in terms of the geographical spread of their properties.

Securitization of pension fund real estate on the rise

To avoid cluster risk and to benefit from greater flexibility in terms of investments, investors have increasingly been directing their attention toward indirect real estate investments in recent years. That means investing in real estate stocks, funds or investment trusts. Investors' money is not tied up directly in bricks and mortar and instead is traded freely in the form of a security. One method of investing indirectly in real estate which has enjoyed increased popularity in recent years is securitization. Real estate securitization – also known as asset swaps – involves contributing your own real estate to a real estate investment vehicle in return for a unit certificate. This conversion from direct to indirect real estate investments brings considerable advantages for many pension funds.

Diversification in terms of geography and use

A crucial element in optimizing the risk/return of an investment is diversification. Real estate markets function on a very regional basis, even in an era of globalization. Within only a few kilometers, supply and demand can differ massively. For instance, the high vacancy rates in the Swiss office market in recent years were almost entirely a Zurich phenomenon that was scarcely evident in the Geneva/Lausanne region. And while prices in Basel have been stagnating for years, owing to a high level of outward migration, Geneva is bursting at the seams and faced with housing shortages and substantial price hikes. A similar pattern is in evidence when it comes to diversification by type of use: The market cycle for residential properties behaves differently than that of the office or retail sector. Thus developments on the real estate markets are not in step, whether geographically or in terms of the point in the cycle.

If a pension fund wants to minimize the risk of fluctuation in relation to its returns, diversifying the real estate portfolio is therefore key. To spread the risks in an optimum manner, a certain portfolio size and number of properties is necessary. The more a real estate portfolio is concentrated in terms of geography and specific type of use, the greater the risk. In the case of relatively non-diversified portfolios, the higher volatility – that is, the cluster risk factor – should prompt the investment managers to make an adjustment to their expected returns, though this seldom occurs in practice.

High liquidity enables flexible response to market trends

An important characteristic of direct real estate investments is their illiquid-