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.

By Ulrich Braun
Real Estate Strategies & Advisory
Credit Suisse Asset Management
Zurich

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 illiquidity. The purchase or sale of a property generally takes several months and is associated with high transaction costs. Investments in indirect real estate investments, by contrast, are highly liquid. As with equities and bonds, certificates can be traded or redeemed on a regular basis. In this case, the transaction costs are comparatively low. Indirect real estate investments therefore result in a higher degree of investment flexibility. Investors are more quickly able to make adjustments to their asset allocation and can therefore respond better to changing market situations and focus on new trends on the markets.

Over the coming years, the trend to securitization of real estate portfolios will continue as the benefits clearly outweigh the disadvantages.

Cost benefits due to scale effects

As in many sectors of industry, scale effects also play a key role in real estate asset management. In other words, the greater the volume of assets, the more efficiently and cost-effectively they can generally be managed. While in the case of small real estate asset managers often just one person will handle all aspects of the business, with large-scale asset managers professional teams are deployed on specific tasks. This boosts efficiency and reduces average management costs. On top of that, major providers have a better negotiating position and greater pricing power than smaller players when it comes to purchasing large real estate portfolios, awarding new construction and refurbishment contracts as well as assigning management mandates – and this also helps optimize costs.

Investment foundations ensure high stability

Real estate investment foundations are the optimal vehicle for securitizing pension fund real estate. They are only open to pension funds enjoying tax privileges under the Swiss Federal Law on Occupational Retirement, Survivors' and Disability Pension Plans (BVG/LPP), because the real estate investment groups of the investment foundations do not have to pay tax on their income.

While equities and investment fund units can be traded daily on the stock exchange, the rights in an investment foundation can be subscribed and redeemed only via the foundation itself. Prices therefore exhibit a high degree of stability.

The real estate investment groups of the investment foundations have grown strongly in recent years, to a great extent due to asset swaps by pension funds. The 16 vehicles represented on the Swiss market had a capitalization of around 13.7 billion francs at the end of 2007. In 2007 the investment group constituents of the KGAST (Investment Foundation Association) real estate index showed an average performance of 4.6% – slightly above the average performance for the past five years. Over the coming years, the trend to securitization of real estate portfolios will continue as the benefits clearly outweigh the disadvantages.

www.credit-suisse.com