May 2017

Real Estate Strategies

International Real Estate: New Investment Horizons for Swiss Pension Funds

Welcome to the latest edition of Real Estate Strategies:

Summary

- Real estate investments are becoming popular with Swiss institutional investors. Their international real estate quotas remain low, however. The Credit Suisse (CS) Pension Fund Index for Q1 2017 shows a share of only 1.3% of total assets, compared with the 10% maximum permissible allocation.
- However, the strong diversification effect of international real estate on Swiss real estate and financial assets, the positive situation on rental markets abroad, and the sustained low interest rate environment in Switzerland certainly indicate a higher use of this investment segment in the future.
- Swiss pension funds have already realized this. Surveys carried out as part of the CS pension fund study and a Curem Master's thesis indicate significantly higher foreign real estate quotas.
- Swiss pension funds pointed to their lack of expertise and resource bottlenecks as major obstacles to investing in real estate abroad. Implementation of the foreign real estate allocation via real estate products can mitigate this challenge, because it allows access to expertise and outsourcing of the international real estate value chain to professional and experienced partners.
- Credit Suisse Asset Management offers Swiss pension funds a wide range of international real estate products. These include directly investing global and regional real estate funds, real estate investment foundations, and active and passive vehicles that invest in REITs/real estate equities.

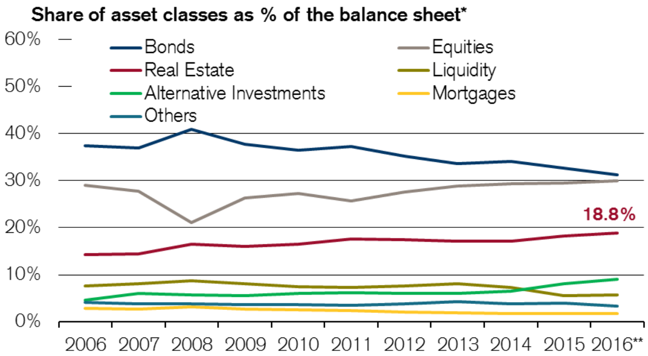
Introduction

This edition of Real Estate Strategies analyzes the role of international real estate in the investment portfolios of Swiss institutional investors. Not only does it provide an overview of the current and future importance of international real estate in asset allocation, it also sheds light on how pension funds view the topic.
This white paper also draws on different empirical results, in particular, a research thesis paper submitted Irene Lo Iacono's for her Master of Advanced Studies in Real Estate at the Center of Urban & Real Estate Management in Zurich, and the 2017 Credit Suisse pension fund study, in which nearly 200 pension funds were surveyed in relation to the central topics of the second pillar.

Pension Funds Increasingly Investing in Real Estate

The share of real estate in the overall balance of Swiss pension funds has risen steadily in recent years and is currently around 19% – almost a third higher than at the start of 2006 (see Fig. 1). The increase in the real estate quota is ostensibly due to the persistent low-interest rate environment and associated restructuring of pension fund portfolios at the expense of bonds. In addition to a more attractive return relative to fixed-income, well-located real estate investments generate stable cash flows. The higher levels of investment in real estate have paid off for the pension funds thus far. According to the Credit Suisse (CS) Pension Fund Index, the positive performance contribution of real estate was the most stable investment of all since 2010.

Fig. 1: Asset Allocation, Swiss Pension Funds



Source: Swiss Federal Statistical Office, Credit Suisse; *Without assets from insurance contracts
**2016 values estimated by Credit Suisse

Diversification of Local Risks with International Real Estate

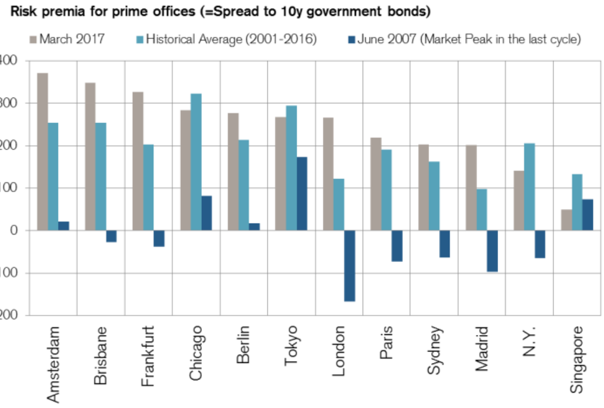
While the benefits of international diversification are undisputed in the case of investments such as equities and bonds, a strong home market bias is still prevalent in the real estate allocation. According to the CS Pension Fund Index (Q1 2017), around 94% of the real estate investment volume is domestic. Measured against all assets, only 1.3% was invested in international real estate investments in Q1 2017. This low quota is not due to regulatory investment guidelines, as defined in Article 55 of the BVV2, in which a maximum of 10% which is permissible for international real estate. International real estate investment could make it possible to use diversification to eliminate local risks, such as local demand and development of the workplace, for example. Cities like Singapore, Berlin or Boston differ in their economic structure. Singapore is a hub for trade and financial services in Asia, Berlin characterized by the presence of the governmental administration as well as start up from companies from the tech sector, while in Boston the global most competitive biotech cluster has emerged. These local differences also lead to differences in the real estate cycle. For example office rents increased in Berlin by 22% but declined in Singapore by 12% between end 2013 and March 2017.
Due to the importance of local factors in real estate values, the correlation between the Swiss domestic and international real estate market is very low and even negative (-0.14, for the period January 2007-December 2016). This is much more attractive from the perspective of diversification than the correlations between domestic and foreign bonds (0.32), or domestic and foreign equities (0.85). The overall risk of the portfolio can be reduced by mixing in foreign real estate. This is particularly important because Swiss pension funds have the highest real estate quota in the OECD comparison.
The high real estate quota implies that a setback in the Swiss real estate market would have a severe impact on pension fund portfolios. Although the demand for Swiss real estate is likely to remain robust as long as the negative interest rates prevail, it will be increasingly difficult to build on the good performance of previous years. Rising vacancies, increasing insertion times, and lower rental rates indicate a downturn in the rental housing market. The progressive decline in immigration is also dampening the demand for rental housing. In office real estate and retail areas, the long-term prospects are unclear, but developments such as automation, offshoring, and online trading are more likely to have a dampening effect on demand.

International Real Estate: Adequate Risk Compensation and Positive Rental Market Situation

After several rounds of quantitative easing by the central banks, and continued low interest rates in Europe, the US and Asia – even if normalization of interest rates has now begun in the US – prices in real estate markets in many countries outside Switzerland have been experiencing a solid recovery since 2014, following adjustment during the financial crisis in several countries, such as the US and the UK. We believe that real estate markets offer further potential in many countries. On the one hand, the risk premiums of real estate are still above their historical average values compared to government bonds.
Fig. 2 compares the current risk premium of premium office real estate as compared to government bonds for a number of major cities worldwide. Premium office real estate is fully let, high-quality real estate properties in the best locations and with typically long rental contracts. In Q1 2017, the income from these types of properties in most cities was 200-350 basis points above the return on 10-year government bonds.

In addition, the comparison with risk premiums at the end of June 2007, when real estate prices reached their high point in the last cycle, shows the fundamental differences between the current situation and that on the eve of the financial crisis.

Fig. 2: Risk premiums that are still above-average



Source: Credit Suisse, PMA; last data point: March 2017

At the time, the net returns from prime office real estate in Sydney, Madrid, New York and London were significantly lower than the return on 10-year government bonds. The valuations resulted from the overheating of the real estate markets, and exaggerated expectations for real estate investments. Further differences between now and June 2007 are the 20-30% lower average leverage for real estate purchases.

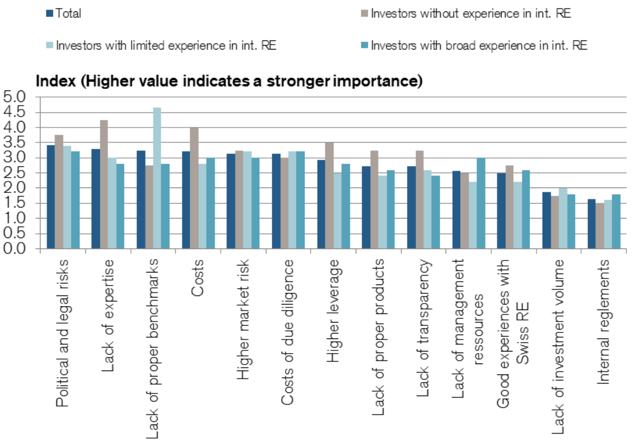
On the other hand, an important decision-making factor in our analysis is supply and demand in rental markets. We follow local developments in more than 80 cities around the world in order to be able to seize any opportunities in a timely manner and identify any risks at an early stage. A positive factor at the moment is not only the recovery of the global economy, which is expected to support further demand for real estate, but also the ongoing low expansion of supply in many cities, such as Sydney, Munich, Amsterdam and Boston. In other words, supply is currently lagging behind demand. This leads to a decline in vacancy rates and rising market rents. Over the next two years, we expect rising rental prices to be on average between 2% and 3% p.a., in all regions (North America, Asia Pacific and Europe).

International Real Estate from the Perspective of Swiss Pension Funds

The hesitance to make use of international real estate quotas, and the continuing good market outlook, raise the question as to what makes Swiss pension funds reluctant to invest more in international real estate.

Fig. 3 shows the findings from expert interviews with 15 Swiss pension funds with an investment volume of CHF 165 billion, taken from the Master's thesis by Irene Lo Iacono. The pension funds invested CHF 21.5 billion in real estate in Switzerland, and CHF 3.2 billion in real estate abroad. In addition to the aggregated representation, the figure displays the responses organized into three clusters: Funds with extensive international experience, funds with some international experience and funds without any international experience.

Fig. 3: Obstacles to real estate investment abroad

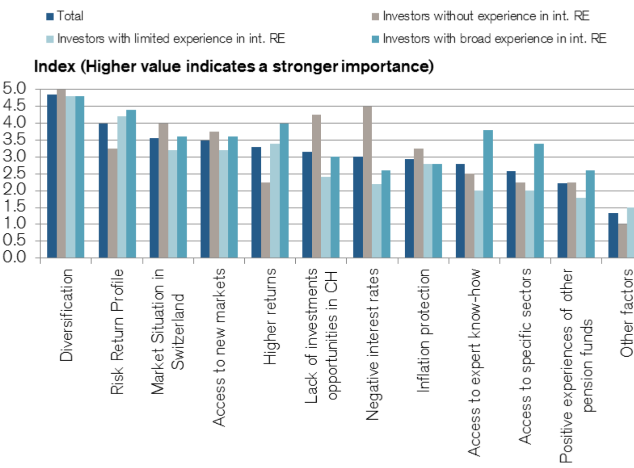


Source: Curem Master's thesis Irene Lo Iacono, last data point: September 2016

All three segments mention political and legal risks, their lack of expertise, the lack of appropriate benchmarks, and the cost of investing abroad as being the main obstacles to exposure abroad.

Pension funds with little experience regard their lack of expertise, the high costs, or typically, the slightly higher debt financing levels, as the major obstacles. On the other hand, in the case of pension funds that are already invested abroad, the decisive factor is mainly internal resource bottlenecks, such as a lack of management capacity or the cost of the due diligence when selecting funds.

Fig. 4: Motives for real estate investment abroad



Source: Curem Master's thesis, Irene Lo Iacono,
last data point: August 2016

All three investor segments however recognize the strong benefits of portfolio diversification resulting from the low correlation between international real estate and Swiss real estate, and financial assets, such as equities and bonds (Fig.4).

For investors without any international experience, the focus is mainly on push arguments, such as the investment crisis in Switzerland, the tense situation in the home market, or the negative interest situation. For investors with international experience, on the other hand, the focus is on return or developing new segments.

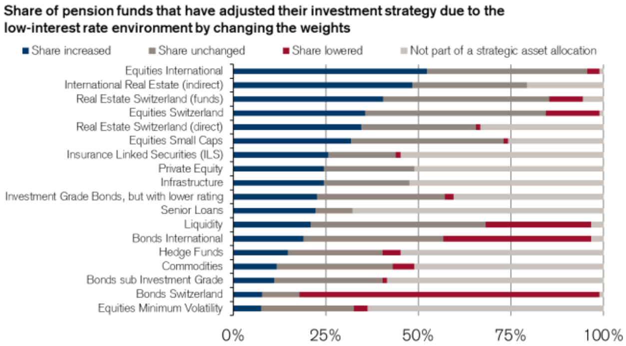
International Real Estate as an Extension of the Investment Spectrum

Price gains on bonds as in recent years will be very unlikely over the next few years. Coupons and payable bonds will also have to be reinvested at much lower rates. As laid out above real estate investments still provide a substantial additional yield compared to government bonds.

This is why we believe that an adjustments to the investment strategy are required. For real estate, international real estate investments offer an interesting fixed investment.

Even though the proportion of international real estate remains low, according to our survey of nearly 200 Swiss pension funds for the latest pension fund study, a trend towards a higher rate of international real estate investments can be observed. In terms of the pension funds surveyed that have made adjustments to the asset allocation by changing the weights, 48.3% have increased the share of indirect international real estate, and none has reduced the proportion of international real estate (see Fig. 5)

Fig. 5: Adjustment of the investment strategy in response to a sustained low interest rate environment



Source: 2016 Credit Suisse Pension Fund Survey

The interviews in the Master's thesis further support these results: All three clusters envisage high growth potential for international real estate in their portfolios. 70% of respondents said they would increase the international real estate quota over the next two years. When aggregated, the pension funds show a maximum quota of 9.4% as a total of investments. This would correspond to an increase in the international quota of 6.9% compared to the current international quota of 2.5% for the study sample. Even groups that do not yet have any international investments are also seeing a significant increase to a maximum of 9.3% of their investments.

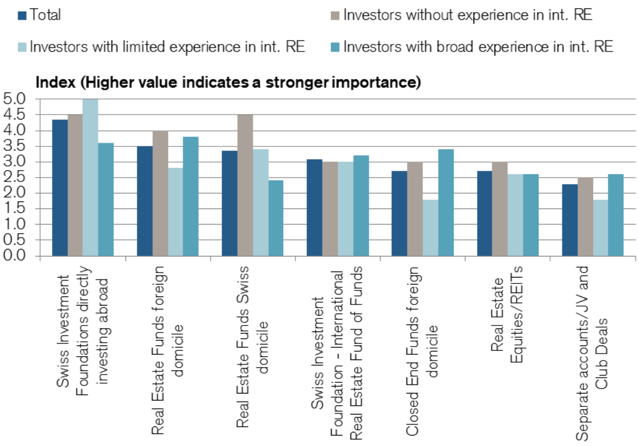
Different Implementation Options

How can the targeted higher international real estate quotas be implemented in practice? Fig. 6 shows an overview of the preferred implementation options for the pension funds surveyed. All investors surveyed said they would implement their foreign allocation in future via real estate investment vehicles, as opposed to direct investments, which continue to play a major role in Swiss portfolios.

This indirect approach is also a logical consequence of the above obstacles; Typically, the lack of expertise in international real estate or resource bottlenecks are what led pension funds to stay away from foreign real estate thus far. International real estate products can mitigate these problems, because they allow access to expert knowledge and outsourcing of the international value chain to professional and experienced partners.

However, as expected, real estate funds investing directly in the pension funds under Swiss law, direct investment foundations, or foundations implementing a multi-manager approach, are relatively ahead in the desired implementation of the foreign real estate allocation.

Fig. 6: Preferred options for implementation in practice



Source: Curem Master's thesis, Irene Lo Iacono, last data point: August 2016

There are differences between the three groups of investors here too: Investors without any foreign real estate experience stated in an interview that international real estate funds under Swiss law should be preferred, while investors with broad experience can also imagine investing in real estate funds domiciled abroad.

This strategy is also understandable. As a first step towards exposure in international real estate, globally diversified products predominate. These mainly have Core and Core+ strategies. After establishing an initial global allocation, the real estate allocation can be further refined using focused regional strategies or higher return strategies, such as value-added funds.

Unlisted or directly investing vehicles also currently appear to be more favored by investors than vehicles listed on the stock exchange, such as REITs and real estate equities. This is probably due to the lower volatility and deeper correlation of non-listed vehicles with other financial assets, and corresponds to the needs of investors to achieve a significant level of diversification for their other financial assets. REITs/real estate funds typically show a higher correlation with financial assets than real estate equities and real estate investment foundations. In contrast, however, they offer better liquidity than the latter. The choice of vehicle ultimately also depends on the interaction of the triangle of return, risk and liquidity. Investors must decide how to balance these three factors according to their individual needs and preferences.

Credit Suisse Asset Management International Real Estate Products

Credit Suisse Asset Management offers investors a wide range of international real estate products (see Table 1 on the next page).

The products range from structures regulated and domiciled in Switzerland, such as the directly investing global real estate fund, an investment foundation that invests directly in the German real estate market, and a CSA 2 investment foundation, which implements a global multi-manager approach using a Core+ strategy. This is complemented by the offer of two funds domiciled in Luxembourg. The first is a carbon-neutral real estate fund that invests directly in European core strategies strongly geared to environmental sustainability. The second has a European "value added" strategy and is interesting for investors that want to somewhat increase their risk-return profile. Another option is active and passive vehicles that invest in REITs/real estate equities.

Accordingly, Swiss pension funds are able to increase their international real estate exposure according to their needs. For more information on the product offering we recommend to contact your Credit Suisse relationship manager. The authors of this study are also happy to provide more assistance if needed.

Table 1: Credit Suisse Asset Management international real estate products (organized by assets under management)

Vehicle	Form	Description	AuM in million
Credit Suisse Real Estate Fund International	Real estate fund under Swiss law, directly investing, not listed	Global directly investing real estate fund, invests in over 10 countries worldwide, foreign currency exposure is largely hedged; first and largest Swiss real estate fund investing globally	CHF 2,974 million
CSA 2 Multi-Manager Real Estate Global	Investment foundation, open ended structure multi-manager approach	Investment foundation investing in non-listed real estate funds globally and implementing a Core+ investment strategy; Pricing at NAV; foreign-currency exposure is largely hedged	CHF 411 million*
Credit Suisse Real Estate Fund Global	Real estate fund under Swiss law, direct investment, listed on SIX	Globally diversified, directly investing real estate fund, foreign currency exposure is largely hedged;	CHF 382 million
CSA Real Estate Germany	Investment foundation, open ended structure, directly investing	Directly investing investment foundation with a focus on commercial real estate in Germany	CHF 347 million
CSIF III World ex CH Real Estate Index - Pension Fund	Umbrella fund under Swiss law of the type: "Other funds for traditional investments"	The fund tracks the reference index FTSE EPRA/NAREIT Developed ex CH	CHF 295 million
CSIF (CH) Asia Real Estate Index	Umbrella fund under Swiss law of the type: "Other funds for traditional investments"	The index fund tracks the reference index FTSE EPRA/NAREIT Developed Asia	CHF 159 million
CSIF (CH) Europe ex CH Real Estate Index	Umbrella fund under Swiss law of the type: "Other funds for traditional investments"	The index fund tracks the reference index FTSE EPRA/NAREIT Developed Europe ex CH.	CHF 132 million
CS (Lux) European Property Fund II	Non-listed closed-end real estate fund (LUX)	Directly investing European value-added fund with a focus on generating higher returns in selective investment themes with potential.	EUR 70 million*
Credit Suisse (Lux) European Climate Value Property Fund	Non-listed open real estate fund (LUX)	European directly investing Core real estate fund with a focus on sustainability, climate-neutral investment	EUR 66 million*
CS (LUX) Global Property Total Return Equity Fund	Investment fund 2 domiciled in Luxembourg	Global fund invested in listed real estate investments with a total return approach	EUR 18 million

* based on capital commitments

Source: Credit Suisse; last data point: April 2017

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Publication Date
May 2017

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