Executive Summary:

- Over the last few years, Swiss real estate funds have become much more important. Thanks to their relatively robust distribution yield over the cycle and their low correlation with equities and bonds, they make an ideal addition to an investor’s portfolio.
- Their semi closed-end structure and a relatively active secondary market offer investors opportunities to fine-tune their positions. This structure also allows controlled growth of the products, which is determined by the available investment opportunities and not by liquidity cycles on the financial markets.
- Swiss real estate funds are regulated and monitored by FINMA and offer a high degree of transparency. Standardized key figures at property and fund level are available to investors.
- Investors can choose between over 30 Swiss real estate funds with different degrees of regional diversification and real estate segment strategies. Including theme funds such as logistics real estate or international real estate funds enables investors to diversify their portfolios further.
- Investors are not liable for Swiss income or wealth tax on the portion of the fund’s assets that is invested in real estate in the case of direct real estate funds.
- The performance of real estate funds is based on the distribution yield and price performance. While distributions and NAV changes are influenced by the fund portfolio and developments on the real estate market, premiums typically fluctuate more and are determined by financial market cycles.
Real estate as an asset class has gained in importance over the last few decades. It is virtually impossible to imagine an investment portfolio of an institutional or private investor without it, and real estate is an excellent complement to the traditional equities and bonds asset classes.

In addition to direct investments, Swiss investors can choose between real estate joint-stock companies, real estate investment foundations, and Swiss real estate funds when implementing their real estate allocation.

In this issue of Real Estate Strategies, we take an in-depth look at the Swiss real estate funds segment. This publication is therefore a perfect supplement to our monthly presentation "Swiss Real Estate Funds", which we have been using to provide ongoing updates about developments in this segment for many years now.

History and Tradition

The history of Swiss real estate funds is full of tradition. The first Swiss real estate fund – Swissimmobil Serie D, was launched in 1938. This was a predecessor to today’s Credit Suisse Real Estate Fund Siat, the second-largest fund in the SIX Real Estate Funds Index and the largest residential real estate fund in Switzerland.

As more funds were launched during the 1940s and 1950s, the sector gradually took shape. However, real estate funds led a wallflower existence for a long time. Even as recently as May 2000, the market capitalization of the entire 22 funds was CHF 10.7 billion.

After the turn of the millennium, real estate as an asset class gained in importance among Swiss investors. Between 2000 and 2016, the market capitalization of the sector more than quadrupled. The SIX Real Estate Funds Index currently includes 29 real estate funds listed on the SIX Swiss Exchange – with a market capitalization of over CHF 38.5 billion. In addition, we estimate the volume of the listed and non-listed Swiss real estate funds not included in the index to be over CHF 7 billion.

Semi Closed-End Structure and Secondary Market Trading

Real estate is an illiquid asset class. Processing real estate purchases and sales usually takes several months. In addition, the liquidity of real estate in comparison with other asset classes is limited by relatively high transaction costs. At the same time, investors need to make investments that strike a balance between return, risk, and liquidity. Even if investors have a long-term orientation in their real estate portfolios, they like to be able to make changes or adapt the characteristics of their real estate portfolio to the current market conditions.

The structure of the indirect investment vehicles plays a key role when it comes to the liquidity needs of investors and the illiquidity characteristics of the asset class. Swiss real estate funds therefore offer a good Swiss compromise with regard to liquidity. They have a semi closed-end structure, combined with a secondary market of fund shares.

When raising capital (first issue or capital increases), the fund is opened for investors; otherwise, purchases and sales of fund shares take place on the secondary market, with the majority of funds listed on the SIX Swiss Exchange. Of the 29 real estate funds in the index, the seven larger funds have a monthly liquidity of over CHF 20 million, and more than 15 funds have a liquidity of CHF 10 million. Although this is significantly lower than the liquidity of listed joint-stock companies, it is a clear improvement compared to direct investments and offers investors entry and exit opportunities, as well as the opportunity to fine-tune their positions.

At the same time, this structure enables the typical liquidity cycles that prevail in the financial markets to be managed. Moreover, the growth of the vehicles is determined by investment opportunities.

This is a considerable advantage over other open structures abroad and – in contrast to German or British open-ended real estate funds – makes Swiss real estate funds more resistant to excess liquidity or liquidity shortages, as demonstrated by the robust development during the financial crisis.

However, because the market price can differ from the net asset value (NAV), the funds trade with an agio (premium) or disagio (discount) against the NAV. This is an additional assessment criterion that the investor must take into account upon entry and exit.

Risk/Return Characteristics

Real estate investment strategies can be classed as core, value-added, or opportunistic depending on their risk-return profile.

Core strategies have a defensive, income-oriented focus with limited risk, while value-added and opportunistic strategies are aimed at capital value growth and therefore involve higher risks. Swiss real estate funds mainly pursue core real estate strategies. The focus in commercial real estate is on properties with high occupancy rates and longer-term rental contracts, while for residential real estate, on the other hand, the focus is on established microlocations and macrolocations as well as on high occupancy rates. In addition, the leverage of the funds is limited to a maximum of 33% and the construction project share to 25% by the regulator.

Table 1 compares the risk/return and correlation characteristics of Swiss real estate funds with those of equities and bonds since the beginning of the new millennium based on monthly data.

Table 1: Swiss real estate funds compared to equities and bonds

<table>
<thead>
<tr>
<th>Key figures since 31.12.1999</th>
<th>Swiss real estate funds</th>
<th>Swiss equities</th>
<th>Swiss bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annualized return</td>
<td>5.6%</td>
<td>3.4%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Annualized volatility</td>
<td>6.5%</td>
<td>13.9%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Correlation mkt equities</td>
<td>0.12</td>
<td>1</td>
<td>-0.29</td>
</tr>
<tr>
<td>Correlation with bonds</td>
<td>0.13</td>
<td>-0.29</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Datastream, Credit Suisse, last data point: December 2016

Historical performance indications and financial market scenarios are not reliable indicators of current or future performance.

Swiss real estate funds exhibit a risk level between that of equities and bonds. At the same time, they only have a slightly positive correlation with equities and bonds, which means that...
including real estate funds improves the risk/return characteristic of the whole portfolio.

Their relatively high total returns overall over the last 16 years are certainly also the result of a variety of favorable factors coming together, such as the decline in interest rates and the generally positive economic climate for real estate in Switzerland.

However, the correlations also show that there is a clear justification to include real estate as an asset class in investment portfolios even if total returns become lower at some point in time.

**Large Variety of Investment Opportunities**

Investors in real estate funds are spoiled for choice. The over 30 different vehicles differ in terms of their portfolio characteristics, such as the regional structure, allocation to different real estate segments, fiscal treatment, thematic orientation, and the inclusion of real estate abroad.

Figure 1 shows a categorization of the 29 funds in the SIX Real Estate Funds Index in three dimensions.

The y-axis shows the residential share of the relevant funds. Typically, we refer to funds with a residential share of over 60% as residential real estate funds and funds with a share of less than 40% as commercial real estate funds, with those in between being mixed funds. The distinction between residential and commercial categorization is probably the most pronounced differentiation used at present, and is also reflected in the significant difference in premium levels between residential and commercial real estate funds.

The x-axis shows the degree of Switzerland-wide regional diversification of the fund, calculated using the Herfindahl Index – a commonly used measure of concentration. A lower index indicates good regional diversification while an index of 1 indicates complete concentration on one region. We distinguish between the usual eight regions of Switzerland: Lake Geneva, the rest of Western Switzerland, Zurich, Northwest Switzerland, Bern, Southern Switzerland, Eastern Switzerland, and Central Switzerland.

As an additional dimension, the size of the bubbles reflects the size of the funds, measured based on the market value of the fund’s real estate portfolio.

This categorization allows the funds to be segmented into regionally diversified residential funds, regionally diversified commercial funds, regionally diversified mixed funds, and regionally focused Western Switzerland funds that are typically a little smaller.

This is a simplified representation only. Investors may, if they wish, focus on additional areas in their portfolios, such as the aging of society, the trend toward online shopping, self-storage, or hospitality real estate, by including theme funds in their portfolios.

In addition, real estate funds that invest abroad offer substantially more diversification potential. This is due to the low correlation of returns and the real estate cycles in the Swiss real estate market and real estate markets abroad, which do not run parallel.

**Breakdown of the Performance of Real Estate Funds**

The performance of real estate funds (price performance and distribution) is influenced by various economic factors. To illustrate the relationships, the total returns of real estate funds are broken down into three factors (distribution yield, NAV changes, and premium changes) in Figure 2.

**Distributions and the changes in NAV show the actual development of the portfolio, while the premium changes are subject to investment flows on the capital markets and are therefore more volatile.**

The distribution is determined by the rental revenues received minus the operating costs of the properties and is therefore a clear, real measure for the investor. The distribution yield provides the relation between the distribution and the current secondary market price of the share and indicates the expected income return on the investment when making an assumption that the distribution remains consistent. As Figure
2 illustrates, the yields were stable and positive over the cycle. This is thanks to a robust cash flow at real estate level and the generally high occupancy rate of over 90% in Swiss real estate funds.

The change in NAV per share is the result of changes in the valuation of the portfolio. The market value of the properties is determined and reviewed on an annual basis by external accredited valuation experts. These valuations are based on discounted cash flow models (DCF models), which themselves are based on assumptions regarding occupancy rates, rental prices, necessary investments, and discount rates.

As Figure 2 illustrates, the NAV changes since 2003 have been consistently positive. This is due to the positive performance on the Swiss real estate market, thanks in part to the lower interest rates, which resulted in lower discount rates for the valuation of properties. However, NAV growth can be both positive and negative depending on the cycle.

The most volatile component of performance is the agio/premium changes: These are subject to the investment mood on the capital markets and may even fluctuate if no new information is available on the fund or market development. This is because they reflect the forward-looking expectations of investors as well as the supply/demand situation of the shares in general.

As shown in Chart 3 below, the level of premiums is also linked to interest rate levels, and changes in interest rates have an effect on the premium changes. In May 2013, for example, when the US Federal Reserve announced the tapering of quantitative easing, premiums decreased, while premium levels increased significantly following the introduction of negative interest rates.

The premium levels also reflect the preference of investors for different segments or individual funds. Investors currently exhibit a strong preference for residential real estate funds, with the focus on these funds’ cash flows, which are robust and rather less sensitive to the economy. However, historically, there have been phases during which residential and commercial real estate funds traded on similar premiums (see Chart 4), and there can be different movements depending on the environment.

**Fiscal Treatment**

In terms of the arrangement of real estate funds, there are two types: direct and indirect funds. The big difference lies in the taxation. The taxation of real estate funds varies according to whether a fund holds real estate directly or indirectly via real estate companies. In the case of direct ownership, funds are only taxed at fund level, while investors are exempt from paying income or wealth tax on the dividends paid. In the case of indirect ownership, the real estate companies held by the real estate funds are subject to income and capital taxation. In addition, investors are taxed on the dividends paid.

**Reporting and Transparency**

Real estate funds are subject to FINMA’s strict regulatory and transparency requirements. FINMA monitors compliance with these requirements on an ongoing basis. The real estate funds publish a semi-annual report and an annual report, the latter of which is reviewed by an audit company. Investors therefore have access to standardized key figures every six months. The basis for calculation of these key figures is specified by SFAMA, the investment fund industry association, thereby enabling comparability between different funds. Typical key figures include balance sheet information such as the size of the portfolio, NAV and net rental income at property level, as well as calculated consolidated key figures at fund level such as the rate of loss of rental income, debt financing level, agios and TER.

As a further aid to decision-making for investors, Credit Suisse Real Estate Investment Management has been publishing a monthly presentation for a number of years now, providing an overview of developments in the Swiss real estate fund and real estate equity market.

The following section looks at a number of charts from this presentation:

**Link to presentation**
Charts: Monthly Overview Presentation

Chart 1: Page 3, overview presentation

Agios and Disagio of the Swiss Real Estate Funds
Month-on-month and year-to-date change

Chart 1 on page 3 of the presentation includes all listed Swiss real estate funds and the unlisted funds managed by CS REIM. It shows the current premium or discount of each individual fund, as well as the premium of the preceding month (red dot) and the premium since the start of the year (green dot) per fund.

Source: Credit Suisse AG, Datastream, fund annual and semi-annual reports
Last data point: January 2017

Chart 2: Page 4, overview presentation

Agios and Disagio of the Swiss Real Estate Funds
Close Link between Agios and Longterm Interest Rates

Chart 2 on page 4 of the presentation shows the current premium of the index (red tile), the premium of the preceding month (light blue dot), the premium at the end of 2015, and the premium at the end of 2013 (light green dot). The premium dots are in relation to the long-term Swiss interest rates. In addition, a number of extreme examples from the past (e.g. premium increase of over 25% in the first quarter of 1994 and the financial market crisis of 2008) are listed. These are typically outside of the range (plus/minus 5% of the average).

This chart shows the negative relationship between interest rates and the level of premiums in the longer term.

Source: Credit Suisse AG, Datastream, fund annual and semi-annual reports
Last data point: January 2017

Chart 3: Page 5, overview presentation

Agios and Disagio of the Swiss Real Estate Funds
Development since 1990

Chart 3 on page 5 of the presentation shows the development of the premiums of all Swiss real estate funds since 1990 and the development of long-term Swiss interest rates. The horizontal red line represents the long-term average premium. The chart shows the correlation between premiums and interest rates relatively well. When interest rates fall, premiums increase, and vice versa. Besides interest rates, other factors (demand, relaunches, etc.) also affect the premium.

Source: Credit Suisse AG, Datastream, fund annual and semi-annual reports
Last data point: January 2017
Chart 4: Page 6, overview presentation

Agio Development since November 2008

Development of Commercial and Residential Real Estate Funds

Source: Credit Suisse AG, Datastream, fund annual and semi-annual reports
Last data point: January 2017

Chart 4 on page 6 of the presentation shows the development of premiums of commercial real estate funds (gray line), residential real estate funds (red line), and the entire index (blue line). The two indexes develop either very similarly or very differently depending on the market phase. During a recession, for example, commercial real estate funds suffer much more than residential real estate funds. This is due to increasing uncertainty regarding future rental income despite long-term rental contracts. Residential real estate funds lose more than commercial real estate funds when interest rates are on the increase due to the adjustment of the reference interest rate.

Chart 5: Page 8, overview presentation

Distribution Yield of Swiss Real Estate Funds
Distribution per Share Compared to the Share Price

Source: Credit Suisse AG, Datastream, latest fund annual report
Last data point: January 2017

Chart 5 on page 8 of the presentation shows the direct yield of the individual funds. The average of all funds currently stands at 2.9%. In addition, a differentiation is made between direct funds (blue) and indirect funds (gray).

The taxation of real estate funds varies according to whether a fund holds real estate directly or indirectly via real estate companies. In the case of direct ownership, funds are only taxed at fund level, while investors are exempt from paying income or wealth tax on the dividends paid. In the case of indirect ownership, the real estate companies held by the real estate funds are subject to income and capital taxation. In addition, investors are taxed on the dividends paid.
Chart 7 on page 9 of the presentation shows the direct yield of the Swiss Real Estate Funds Index (red) and the yield of the ten-year Swiss Confederation bond (blue). The gray shaded area shows the difference between the two and therefore the attractiveness of Swiss real estate funds versus Swiss government bonds. Consistently falling interest rates over recent years and the relatively consistent direct yields of real estate funds mean that real estate funds are becoming even more attractive compared to bonds.

Chart 8 on page 11 of the presentation shows the total cost burden as a percentage. This key figure represents the operating expenses of the fund in relation to the average net fund assets. The operating expenses include all regulatory payments to the fund management and the custodian bank, as well as various other fees. The TER NAV is a more meaningful key figure than the TER GAV because the costs are considered in relation to the equity.

Chart 9 on page 12 of the presentation shows the debt ratio as disclosed in the last annual report for each individual fund. Since 2015, the debt financing ratio for real estate funds has been limited to a maximum of 33%. There is a two-year transitional period by the end of which this must be achieved. In the current environment in which debt capital is favorable, it makes sense to have a high ratio.
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Equities are subject to market forces and hence fluctuations in value, which are not entirely predictable.
The key risks of real estate investments include limited liquidity in the real estate market, changing mortgage interest rates, subjective valuation of real estate, inherent risks with respect to the construction of buildings and environmental risks (e.g., land contamination).
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