

Swiss Insights



Real estate investments

Attractive despite changes in conditions

Changes to
circumstances

Advantages of real
estate investments

Various investment
options



Why Swiss real estate investments remain attractive despite changes to conditions



Investors who compare less liquid real estate investments with high-quality government bonds will have noticed that spreads are low in historical comparison. We'll explain to you in this article why real estate investments nevertheless remain attractive, in addition to describing the options that are available for investing in real estate.

Changes in market circumstances

Although concepts like inflation and interest rates had nearly been forgotten in the past decade, we have been reminded of them in dramatic fashion over the last 18 months. Initially kick-started by the pandemic-related supply-chain problems in the fall of 2021, inflation worsened significantly with the outbreak of the war in Ukraine and the associated increases in energy prices starting in the spring of 2022. The central banks – after initial hesitation – responded to this by significantly raising prime rates.

For instance, in the spring of 2022, the Fed took the first of 11 hikes so far and has now raised policy rates in the U.S. to the 5.25% - 5.50% range. The European Central Bank (ECB) followed somewhat later, but it has now also raised the main refinancing rate in the Eurozone to 4.5%. At 1.75%, the current interest rate level of the Swiss National Bank (SNB) is comparatively moderate. This is also due to inflation that is considerably lower compared with other countries.

There are a variety of reasons for this. To begin with, the strong franc absorbed part of the inflationary pressure from abroad. To prevent this pressure from gaining strength, the SNB sought to avoid changing the interest rate differential with other countries. Also, energy has a considerably smaller weight in the Swiss basket of goods, and the share of state-controlled prices is higher in Switzerland than in most other economies.

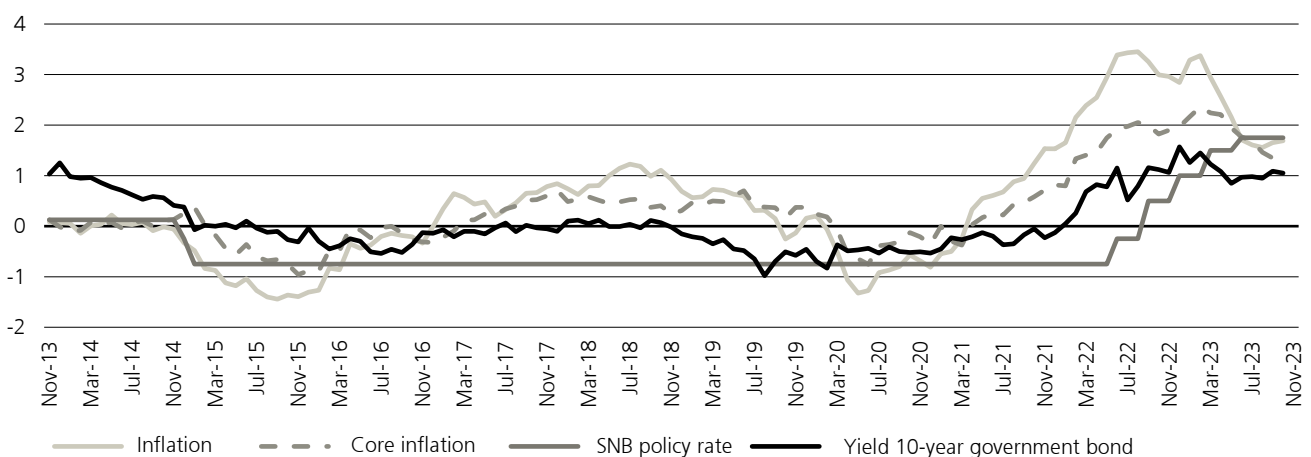
Nevertheless, the current interest rate level of 1.75% means an increase of 250 basis points within 15 months and thus a significant change in the environment for real estate investments (see Figure 1).

Besides inflation, which also has a direct impact on the real estate sector through higher prices for building materials and energy, the situation is particularly marked by the rise in interest rates. First, higher interest rates make it considerably more expensive to finance real estate projects, which in turn reduces returns. By contrast, however, the expectations of investors for returns go up, since other investments, like bonds, have become more attractive again – or in other words, the time of TINA (“There Is No Alternative”) is over. In addition, the higher interest rate environment is having an effect on investment properties through higher discounting rates.

Lower demand due to reemerging alternatives, as well as lower willingness to pay due to higher financing costs, are thus having an impact on prices for investment properties, although the extent of this has been less dramatic so far in Switzerland. Compared with the low point in early 2022, net initial returns for prime real estate had risen by an average of 45 basis points by the 3rd quarter of 2023, according to Wüest Partner. Thus, the spread – i.e. the risk premium compared to government bonds – stands again at about 100 basis points.

Figure 1: Inflation, core inflation, policy rate and yield on 10-year federal bond

(%, inflation compared with the prior-year month)



Source: Refinitiv; UBS Asset Management, Real Estate & Private Markets (REPM), November 2023. Past performance is no guarantee of future results.

Inflation has now lessened somewhat around the world, although in most developed countries it is still considerably higher than the target figures. In Switzerland, since June inflation has been back within the target range of 0% to 2% defined by the SNB. As a consequence, the SNB also refrained from further interest rate hikes in September. Despite the fact that inflationary pressure has abated, it is still too early to sound the all-clear. Various factors, such as rent increases and rising electricity prices, are likely to cause Swiss inflation to spike again compared to the fall of 2023. However, this expected uptick in the inflation rate does not necessarily mean that further interest rate hikes are coming, since changes in monetary policy would have no influence on the rise. If, however, other factors (that are capable of being controlled by interest rate policy) lead to upward momentum in inflation again, further interest rate hikes cannot be ruled out.

On the whole, a higher level of interest rates is expected for an extended period, with reductions anticipated in the second half of 2024 at the earliest. In addition to the currently acute price drivers, there are also various structural factors, such as demographic change with increasing aging and migration and the decarbonization of the economy, that are causing prices to rise, also in the long term, and make it unlikely that interest rates will return to the extremely low levels seen in the past decade. In recent years, the market for real estate investments was characterized by a lack of alternative investments. Now, the focus is again increasingly on the characteristics that make real estate an attractive asset class compared to competing investment products.

Advantages of real estate investments

Diversification advantages for multi-asset portfolios

Investing in several different asset classes ensures that a portfolio incorporates different risk-return combinations, which trend in different directions depending on the macroeconomic environment. This means that different asset classes respond differently to changes in their environment. That way, in the case of a

diversified portfolio, possible losses by one asset class can be offset with possible gains by others, which lowers the overall risk. Therefore, through the deep correlation of real estate with other asset classes, such as equities and bonds (see Figure 2), the portfolio's diversification and thus its risk profile improve considerably if real estate is included.

Figure 2: Yield correlation of asset classes

	KGAST	Real estate funds	Real estate equities	Swiss equities	Swiss federal bonds	Global equities	Global bonds
KGAST	1.00						
Real estate funds (SXI Real Estate Funds)	0.02	1.00					
Real estate equities (SXI Real Estate Shares)	0.00	0.46	1.00				
Swiss equities (SPI)	-0.03	0.28	0.48	1.00			
Swiss federal bonds (10-year)	0.02	0.18	0.15	-0.13	1.00		
Global equities (MSCI World)	-0.02	0.32	0.51	0.77	-0.11	1.00	
Global government bonds (FTSE WGBI)	0.06	0.17	0.16	-0.11	0.79	-0.10	1.00

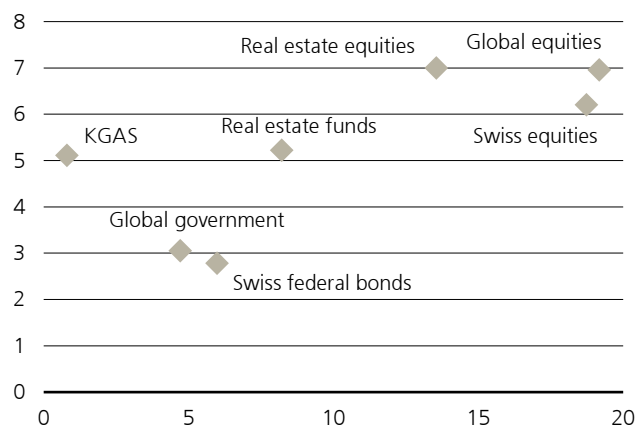
Source: Refinitiv, UBS Asset Management, Real Estate & Private Markets (REPM), October 2023.

Note: Correlations based on monthly data from January 2000 to September 2023. The KGAST Immo-Index tracks the performance of direct real estate investment groups that are members of the Conference of Managers of Investment Foundations (KGAST). The SXI Real Estate® Funds Broad Index comprises real estate funds that are listed on the Swiss Exchange and invest at least 75% of their assets in Switzerland. The SXI Real Estate® Shares Broad index considers real estate equities with a listing on SIX Swiss Exchange and at least 75% of their assets invested in Switzerland. The SPI is considered the overall market index for the Swiss equity market. The MSCI World Index comprises large- and mid-cap companies from 23 industrialized countries. The FTSE WGBI measures the performance of fixed-rate, local-currency, investment-grade sovereign bonds from 20+ countries that are denominated in a variety of currencies.

As can be seen in Figure 3, the risk-return profile for real estate investments lies between the one for bonds and the one for equities. Swiss real estate funds generated an average return of 5.2% over the past 23 years, which were initially influenced significantly by the increasing professionalization of the sector. Their total return was thus fewer than 100 basis points below that for Swiss equities, with considerably lower volatility. The return calculated on the basis of valuations is also less volatile due to the lower frequency of the valuations. Over the same period, real estate equities posted a return of as much as 7%, but with considerably higher volatility, which is also attributable to the fact that they are more strongly affected by fluctuations on the exchanges than is the case for funds and direct investments.

Figure 3: Total return and volatility

(2000-2022, %, p.a.)



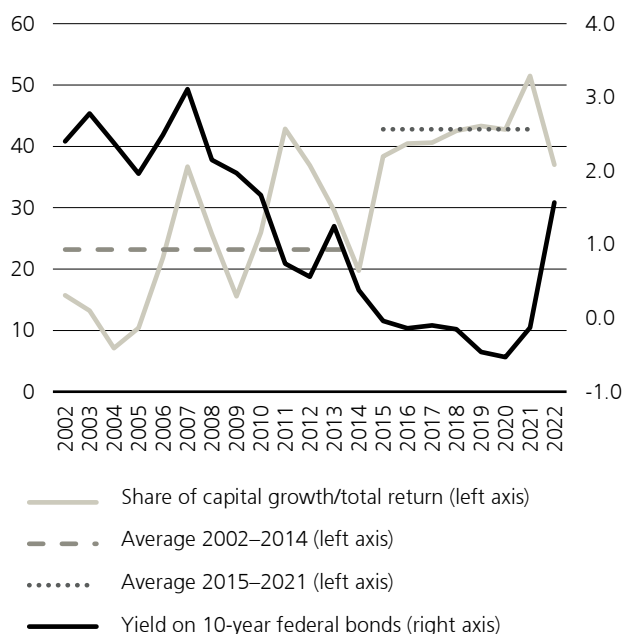
Source: Refinitiv, UBS Asset Management, Real Estate & Private Markets (REPM), October 2023. Past performance is no guarantee of future results.

In general, real estate investments benefit from the high share of income in the total return, and they offer protection against inflation, at least in part, due to the indexing of rental income. For instance, the income return between 2002 and 2022 amounted to 4.1% p.a. on average, which was significantly higher than average inflation of 0.5% p.a. In the area of core real estate, a ratio of about 70-80% income return to 20-30% appreciation return is assumed on average. The resulting lower volatility of real estate investments thus reduces the risk profile of the portfolio, particularly in more turbulent times.

Appreciation

Nevertheless, the ability to benefit from capital growth was quite high during the past period of low or even negative interest rates, which triggered significant investment pressure. As mentioned above, the share of capital growth in the total return of Swiss real estate over the past 20 years was 30% on average, with a sharp distinction between the years 2002 to 2014, where the average was 23%, and the negative interest years of 2015 to 2021, with an average of 43% (see Figure4).

Figure 4: Share of capital growth in total return



Source: MSCI/Wüest Partner, Refinitiv, UBS Asset Management, Real Estate & Private Markets (REPM), October 2023. Past performance is no guarantee of future results.

With the yield on government bonds having returned to positive territory in 2022, values like those seen in the years 2002 to 2014 should become the norm again. This means that active asset management and a selective portfolio strategy will become significantly more important again, since no longer will every property – irrespective of location, fit-out and energy-efficiency status – see a rise in value, as was the case during the times of TINA. Instead, location, property quality and sustainability standard will, as indicators for the rental income situation, become much more significant again.

Protection against inflation through stable rental income

In addition to potential appreciation in value, real estate investors primarily benefit from the cash flow generated by rental income. For instance, much like fixed-income products, real estate investments offer the ability to benefit from steady cash flows. In the current (interest rate) environment, the focus is once again on cash flow, which is in fact the core element of real estate.

Since rental income normally rises in lockstep with inflation, real estate offers a certain degree of protection against inflation. In Switzerland, this protection exists in the commercial segment as well as the housing area. On the one hand, about 80-90% of commercial rental contracts are inflation-indexed, i.e. rents rise with the inflation rate. On the other, the statutory cost-of-living adjustment and the "reference mortgage rate" provide investors with protection against inflation in the housing area.

The reference mortgage rate determines the possible rent adjustment on the basis of the trend in the volume-weighted average interest rate for domestic mortgages. The reference interest rate was raised on 1 June 2023 for the first time since introduction of the concept, with the next increase expected on 1 December 2023. The rise in the reference interest rate by 25 basis points makes it possible to raise rents by 3% in the case of rental contracts that are based on the current reference interest rate level. In addition, there is the regular inflation adjustment, which enables landlords to raise rents by up to 40% of the increase in the cost of living since the last rent adjustment and pass on general cost increases (insurance, management, taxes). Thus, in mathematical terms, two interest rate hikes result in a potential rent increase of about 10% for existing rental contracts.

In addition to the ability to raise existing rents, the significant scarcity on the Swiss housing market is moreover resulting in a strong potential for higher asking rents. The scarcity, which is caused by high immigration and negligible expansion of housing stock, as well as by a certain shift in demand currently from

an owner-occupied housing market to a renter-occupied one, can be seen in a significantly falling vacancy rate. Between 2021 and 2023, the vacancy rate fell from 1.54% to 1.15%. Given that since 2018, construction activity has declined and – with barely 33,500 housing units approved for construction in the past year – literally collapsed, a vacancy rate of less than 1% can be expected until 2024. According to the economic laws of supply, demand and price, scarcity should lead to stronger growth in rents in the future as well.

In addition, stable or rising cash flows are relevant particularly for investment products with a certain debt component. Their income situation comes under pressure through higher financing costs. It is not possible to give a blanket answer as to whether rental growth, which increases income, or debt financing, which increases costs, will outweigh, since both tenant and financing structures are product-specific and thus vary highly at times. However, the effect of higher debt costs can at least be attenuated.

Various options for investing in real estate

In Switzerland, there are various options for private as well as institutional investors to invest in real estate. They vary highly in a number of respects, from the amount of minimally invested capital and their liquidity to the correlation with alternative asset classes and thus the diversification potential, but also in terms of the risk-return profile. Various investment options, as well as their characteristics, will be described in the following.

Purchase of one (or more) properties

Probably the most common way to invest money in real estate is by purchasing it directly. Sustained high demand on the Swiss market results in stable appreciation in value, whereby with both alternatives, the possibility exists to benefit from appreciation in the event of a sale.

In addition to potential appreciation upon sale, letting also offers the ability to generate regular cash flows in the form of rental income. Sustained high demand moreover results in stable appreciation in value. A further advantage of direct ownership is the greatest possible independence from movements on the exchanges, with the diversification potential being significant in this case.

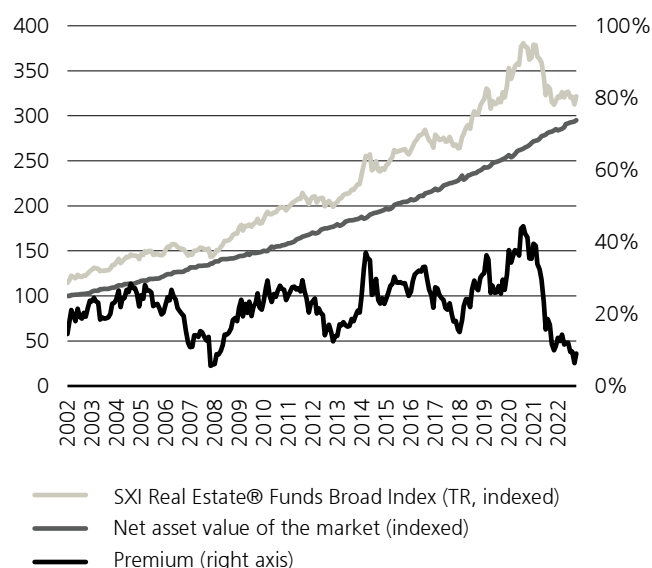
At the same time, there is a considerable single-asset risk, since diversification with multiple properties is expensive and complex. In addition, the invested money is tightly tied up due to the relatively low liquidity and high transaction costs.

Real estate funds

Real estate funds collect the capital of multiple investors and invest it in a portfolio of properties. This significantly diversifies the risk for investors compared with direct ownership of a property. Their returns consist of rental income from the properties contained in the portfolio and the appreciation in the value of the real estate. They assign management of the properties to a company with expertise in all aspects of the real estate value chain. In this regard, real estate funds are subject to the Collective Investment Schemes Act (Kollektivanlagegesetz) and are thus supervised by FINMA.

A distinction is made between open-ended and closed-ended real estate funds. They differ in whether a return of capital is possible and thus also whether the term is open or fixed. In Switzerland, moreover, there is a distinction between listed and unlisted funds. Funds that are traded on the exchange are open to private as well as qualified and non-qualified investors, and they have higher liquidity and lower transaction costs than both direct investments and unlisted real estate investments. At the same time, they are also more strongly dependent on fluctuations, since the exchange price reflects the appetite of investors and not necessarily the underlying value of the real estate portfolio.

Figure 5: Index of the total return of real estate funds, net asset value and premium (in %)



Source: UBS Asset Management, Real Estate & Private Markets (REPM), September 2023. SXI Real Estate Funds Index, Bloomberg, real estate fund financial statements Past performance is no guarantee of future developments.

For that reason, the resulting difference between the exchange price and the underlying net asset value (NAV), i.e. the premium, was very high in past years due to investor pressure. Last year, exchange prices for funds fell sharply with the upheavals on the capital markets (see Figure 5), whereas real estate values largely remained stable.

This means that investing in real estate funds has thus become significantly more attractive again, since following the corrections last year, these funds are being valued in a considerably more attractive manner than direct real estate and thus offer attractive dividend yields.

Investment foundations

Investment foundations are a special form of collective investment. They are limited to tax-exempt occupational pension institutions (i.e. monies in Pillar 2 or Pillar 3a) and manage their capital under the oversight of the Occupational Pension Supervisory Commission. With minimal exceptions, they are similar to an investment fund in terms of their characteristics.

Real estate equities

In addition to making a direct acquisition and investing in real estate funds, investors also have the option of investing in companies in the real estate industry. This makes it possible to benefit from growth opportunities, while at the same time the stock certificate is highly liquid. However, high liquidity is also associated with high volatility, particularly because returns depend not only on the real estate market itself but also to a great extent on the individual performance of the respective companies.

Other investment options

In addition to those mentioned above, there are other options for investing in real estate products. For instance, investments in a 'fund of funds' are suitable for the purpose of broad diversification. A 'fund of funds' invests in several other real estate funds instead of directly in real estate assets and thus makes it possible to take a broad position on the real estate market with just one investment.

Because of the increased liquidity expectations of financiers in the wake of the 2008/2009 financial crisis, the 'real estate debt' instrument has become more popular. A 'real estate debt fund' collects capital and then lends money to potential property buyers, developers or similar owners of real estate assets. The fund investors receive regular interest payments on the lent capital, as well as mortgage collateral. Similar to crowdfunding with companies, concepts have now popped up in the real estate sector for 'crowd investing' or for 'real estate club deals'.

These involve investors forming a group, usually via an online platform, to invest collectively in a real estate project. If the planned financing need is achieved by a certain cut-off date, the project is carried out, and depending on the term, investors receive a participation in rental income and/or their share of the corresponding sale proceeds. The project developer benefits here from the mezzanine capital of crowdfunding, which is considered equity by the bank.

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