ZURICH®

BVG Focus Newsletter – Issue: August 2012

Subject:
- Ways out of the interest rate trap

Alternatives to government bonds for Swiss pension funds

Low interest rates and the downside risk of some countries' government bonds are a serious concern for Swiss pension funds. Investments in real assets are attractive alternatives.

Roland Steiner, CFA
Zurich Invest Ltd

Swiss pension funds are in a dilemma. On the one hand, they are expected to deliver certain returns without taking big risks. On the other, central banks' expansive monetary policy has pushed interest rates down to record lows, producing razor-thin yields on safe government bonds. The yield on ten-year Swiss federal bonds has dropped to well below one percent, as the chart below shows:

Yields on ten-year Swiss federal bonds

Source: Zurich Invest Ltd, Bloomberg

According to CreditSuisse's latest pension fund study, Swiss pension plans have invested nearly 40 percent of their assets in bonds, mostly government bonds. They are, however, no longer able to achieve the necessary yields of three to four percent with Swiss federal bonds. Also, bonds are exposed to downside risk if interest rates go up again. The standard Swiss bond indices currently use a duration of almost seven years. At that level, an interest rate increase of two percent would produce a book loss of nearly 14 percent. Foreign sovereign bonds – including several with significantly higher returns – are not an attractive alternative given the issuers' high indebtedness. This has prompted Swiss pension funds to look into asset classes to replace sovereign bonds without taking on too much risk.

Corporate bonds

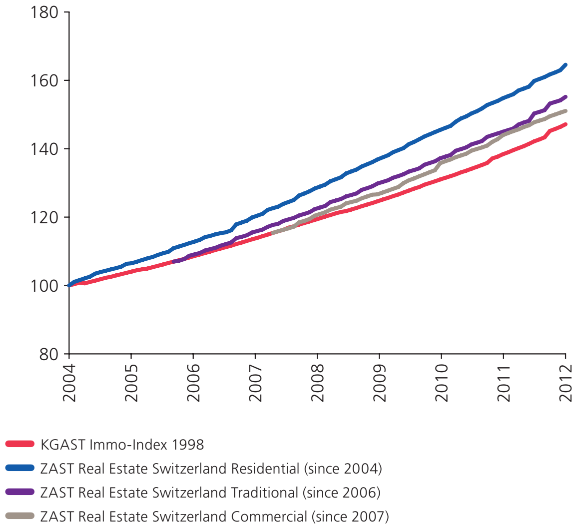
Although many companies are better capitalized than some states, corporate bonds still generate higher yields. Investment grade European corporate bonds currently yield around two-and-a-half to three percent. Yields are higher because investors assume that the probability of default is much higher than the historic average. Their concerns seem misplaced given the companies' solid fundamentals. Investment grade corporate bonds are a true alternative to government bonds. They have shorter maturities than sovereigns, too. If interest rates rose, the book losses would be significantly lower.

Real estate

Another attractive alternative is Swiss real estate, which has generated attractive returns with minimal fluctuations in value in recent years. The real estate portfolios held by the Zurich investment foundation, for example, have been generating annual returns in excess of five percent with minimal fluctuations in value since their launch.

Value of Swiss real estate

Value rebased on 100



Apart from attractive returns, real estate offers another advantage: it is an efficient inflation hedge. With today's expansive monetary policy, inflation protection can play a crucial role in preserving the real value of pensions over the long term. Since the market for direct investments is illiquid and demand greatly outstrips supply, many vehicles are essentially closed to new investment. Alternatively, Swiss pension funds can invest in listed real estate funds and companies. They have also generated solid returns in recent years.

In several Swiss regions, the real estate market is showing more and more signs of overheating. That makes it even more astonishing that only a small fraction of pension funds have begun looking beyond Swiss borders and diversifying their real estate portfolios with foreign assets. Real estate in core European countries, for example, tends to have higher returns, too. This is partly because their real estate mix focuses more on commercial sectors such as office space, sales floors, logistics facilities or industrial properties. When investing in foreign real estate, we recommend working with an experienced partner with the necessary knowledge of the relevant markets.

Equities

At nearly 30 percent, equities represent the second largest asset class for Swiss pension funds. As SPI dividend yields hover above two percent, equities appear to be an attractive alternative to bonds, especially since they provide exposure to real values and thus help to hedge against inflation. However, equity investments have also been extremely volatile in recent years.

Private equity

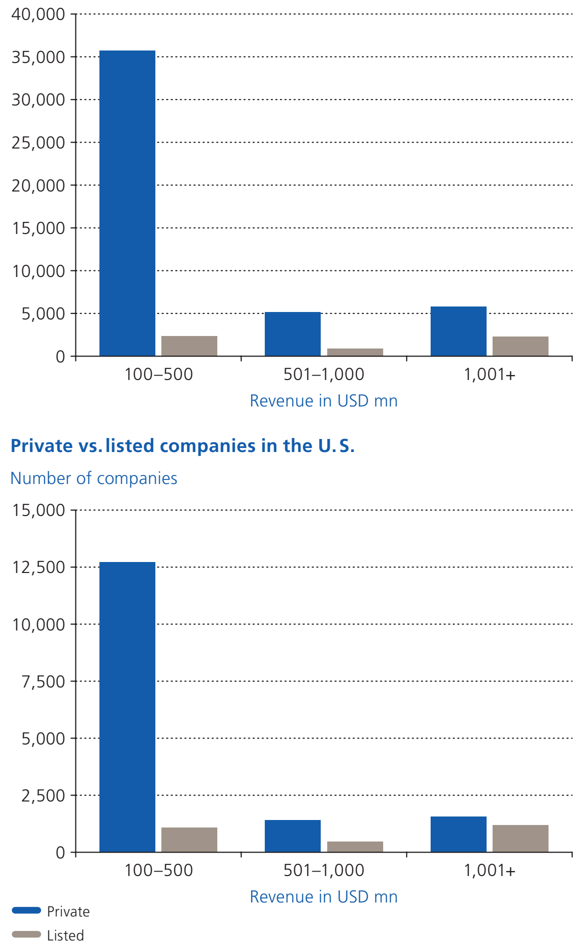
Investments in private companies are another attractive, potentially high-yield diversification option. Most companies are not listed on the stock exchange. Switzerland, for instance, has around 1,100 companies with 250-plus employees, but only 220 are listed. The differences are even bigger in Europe and the United States, as the following chart shows:

Private vs. listed companies in Europe

Number of companies

Private vs. listed companies in the U.S.

Number of companies



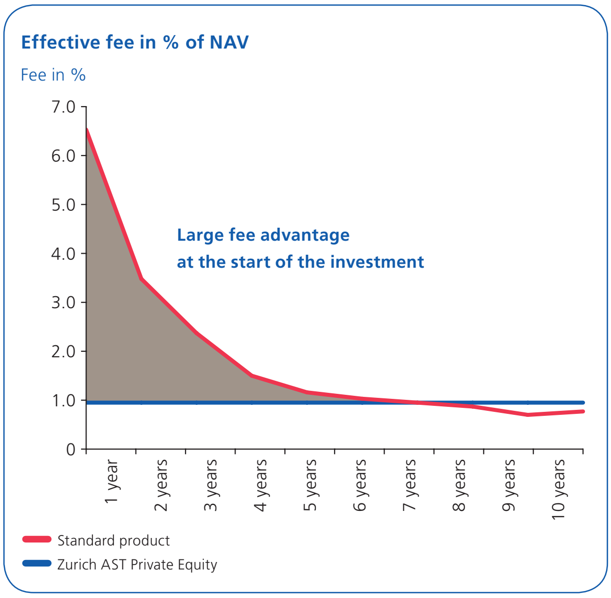
Private companies thus considerably expand the investment universe. Also, several stock indices are highly concentrated. The Swiss Performance Index (SPI) is dominated by three large firms (Nestlé, Novartis and Roche) that make up approximately 50 percent of the index's capitalization. Private equity can be viewed as a true form of active management since the majority owners work directly with the companies to boost enterprise value. This approach has enabled many private equity investments to generate attractive excess returns compared with traditional equities. Furthermore, private equity investments are not traded on exchanges and are therefore not subjected to daily market fluctuations.

To invest successfully, however, fund managers need to follow certain guidelines:

1. They should invest in a well structured product with a long-term investment horizon.
2. The investment or investment vehicle must be broadly diversified across various regions, industries and investment styles.

3. They must take all the costs into account. Unlike the ZIAG solution, most products on offer still charge their costs based on the entire capital commitment, which represents a significant cost disadvantage at the start of the investment.

This is illustrated by the following chart:



Infrastructure

Infrastructure is a broad investment class encompassing roads, ports, utility companies, communication networks and even hospitals and schools. This asset class has seen strong growth in recent years as more and more investors discover its benefits. On the other side of the equation, demand for infrastructure investment has been fueled by governments' budgetary constraints, population growth, urbanization and growing demand for infrastructure among businesses and consumers.

In most cases, these real assets produce steady income hedged by long-term contracts. Since the contracts are often inflation-indexed, infrastructure investments offer excellent protection from inflation. There are also, however, high hurdles for infrastructure investments. They require a lot of capital: the minimum investment in a project is often several hundred million Swiss francs. Very few pension funds worldwide can pony up such a large sum. This gap cannot be filled by the traditional, broadly diversified fund-of-funds model, either, due to the double fee structure and lower expected returns compared with private equity. In addition, investing in infrastructure requires profound subject-matter expertise to navigate the specific risks inherent in these investments (regulatory, political or financing risks). Swiss pension funds are well-advised to partner with an experienced wealth manager who can collaborate with experts and put together an adequately diversified portfolio of infrastructure projects.

Commodities

Investors wanting to capitalize on rising demand for raw materials can also invest in commodities through derivatives. Like real estate or infrastructure investments, commodities represent an efficient inflation hedge. They also facilitate diversification since they are not tightly correlated with the traditional equity and bond markets.

Insurance linked securities

Insurance linked securities, including catastrophe bonds, are another asset class that is gaining favor among investors. Essentially, investors offer the counterparty, usually a (re-) insurer, a type of insurance against massive losses. The investor receives an attractive premium in exchange. These investments are excellent for improving portfolio diversification because natural disasters are completely unaffected by financial market trends.

Conclusion

Swiss pension funds can choose from a broad range of asset classes for diversifying their portfolio and partially compensating for (excessively) low yields on safe government bonds. Many of these investments, however, do not fit into the rigid definitions of traditional asset classes. Pension fund managers would benefit from moving away from inflexible bond and equity portfolios and looking into alternative investments.

Editor: Richard Klaus,
044 628 44 83, richard.i.klaus@zurich.ch

Published by
Zurich Life Insurance Company Ltd
Thurgauerstrasse 80
8050 Zurich
www.zurich.ch

FM70597e-1208