SWEDISH INSTITUTIONAL INVESTORS: POTENTIAL ROLE IN U.S. REAL ESTATE IN THE NEXT FIVE YEARS

by

FRANK VON ARX ALLEMANN
Ecole Hôtelière de la SSH, Lausanne, Switzerland (1983)

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Signature of the Author ____________________
Frank von Arx Allemann
Department of Urban Studies and Planning
July 23, 1991

Certified by ____________________
Marc A. Louargand
Lecturer, Department of Urban Studies and Planning
Thesis Supervisor
July 23, 1991

Accepted by ____________________
Gloria Schuck
Chairperson
Interdepartmental Degree Program in Real Estate Development
July 23, 1991

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ABSTRACT

The purpose of this research is to consider whether recent deregulations in Sweden will be significant in establishing institutional investors from that country as new sources of capital for U.S. real estate markets during the next five years. To help contemplate the likelihood of this occurring, this thesis examines various factors which are likely to influence the direction of Swedish institutional investments in the future, including the existing structure of the State pension system, the potential effects of an aging population, and the consequences of a unified European market. To provide clues to future investment behavior, the historical investment strategies of two Swedish insurance companies are compared with those of the State pension system. For further perspective, aspects of the investment patterns of British, Dutch, and U.S. institutional investors are discussed, as well.

The findings of a survey of Swedish institutional investors are contrasted with those of a similar study conducted in the United States to identify fundamental similarities and differences in approach to property investment. Finally, this thesis examines some of the reasons foreign investors have historically been attracted to U.S. real estate and considers their potential importance in the decision-making process of Swedish institutional investors today.

Thesis supervisor: Marc A. Louargand
Title: Lecturer, Department of Urban Studies and Planning

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CHAPTER ONE - INTRODUCTION

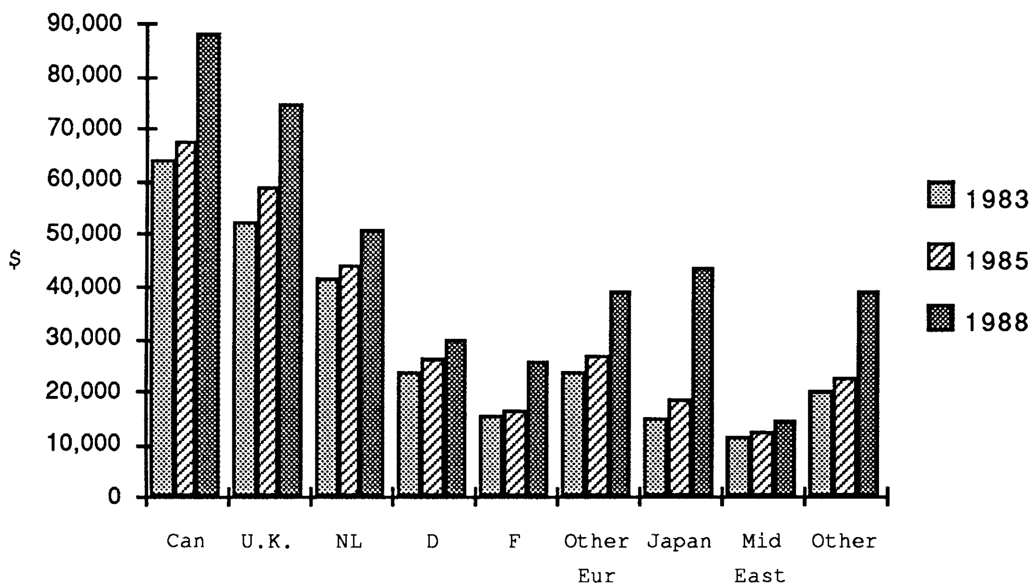
In the last year, investors in U.S. real estate have witnessed the impact of changing capital markets and more stringent underwriting requirements of commercial lenders on the liquidity of the U.S. real estate market. Although U.S. institutional investors may significantly expand their investments in real estate over the long term, it is doubtful this will be the case during the next three to five years. In the interest of analyzing potential new sources of liquidity over the short term, this thesis looks at how the lifting of exchange controls and other deregulations in Sweden might impact the activity of Swedish institutional investors in U.S. real estate investment.

Shifting Capital Market

The integration of the world's economies and financial markets, facilitated by advances in information technology, has significantly increased the awareness of worldwide investment alternatives. In the past several years, the world has seen huge international flows of capital, indicating an acceptance by foreign investors of this expanded universe of investment alternatives. Having the option to choose, foreign investors have invested enormous sums in the U.S. economy, either through portfolio investments or direct investments in U.S. industries, including real estate.

Chart 1, Foreign Direct Investment in the U.S., reflects the gross value of property, plant, and equipment of U.S. affiliates of foreign companies, in all industries. Canada, the U.K., and Japan showed the most dramatic growth throughout the 1980's.

Chart 1: Foreign Direct Investment in the U.S. (in millions)



(U.S. Department of Commerce, Bureau of Economic Analysis)

Some of the reasons these foreign investors have been attracted to the U.S. include high rates of return; a large and diverse market offering investments ranging from U.S. Treasury bonds to regional shopping malls; a deep market that ensures an abundance of buyers for almost any investment held for future disposition; a stable government; a highly skilled labor force; and a less onerous tax system.[1] Other external

1 Foreign Investment in U.S. Real Estate: The New International Landlords, p. vii

influences which have contributed to the increase in foreign investment are exchange rate differentials working in favor of investors holding other currencies; the U.S. trade deficit, which has produced tremendous liquidity for some countries to fund U.S. acquisitions; and a loosening of restrictive foreign investment regulations by some nations.[2]

This inflow of foreign capital has had important implications for U.S. real estate. Like all other categories of foreign direct investment in the U.S., foreign real estate holdings have grown rapidly in recent years. According to the National Association of Realtors (NAR), between 1982 and 1989, the value of foreign direct investment in U.S. real estate more than quadrupled, from $11.4 billion to $46 billion.

Nonetheless, other forms of domestically generated investment grew even faster, so foreign investment's market share actually declined between 1982 and 1988, from 22.2% to 16.3%.[3] There is evidence that continued shifting of capital market flows such as this will bring about important changes in the area of U.S. real estate investment. For example, there are signs that foreign investors are backing away from the U.S. as the automatic repository for their money. In the first half of 1990, offshore investors sold a net $7 billion

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2 Dalton & DeMoss, pp. 14 - 17

3 McMahan, John, Real Estate Issues, Fall/Winter 1990

of U.S. stocks and spent just over $10 billion on direct investment, a quarter of what they invested a year earlier.[4]

Furthermore, within the United States, injudicious lending on the part of commercial banks, S&Ls, and insurance companies during the past ten years has resulted in serious crises in each of their industries and a sudden demureness as players in the capital market. More specifically, some of the major sources of capital behind the real estate boom of the 1980's have been seen to be retreating. As of July, 1990, institutional investors were looking to withdraw more than $1.9 billion from open-end commingled real estate funds, amid fears that the appraised values of the underlying properties were inflated.[5]

A more recent trend triggered by the declining real estate market shows several pension funds actually liquidating their property investments and reducing allocations to real estate in favor of other asset classes. Two examples of this growing trend are a reduction of the real estate allocation of Xerox Corp.'s pension fund from 10% to 7% and an asset allocation study for the New Hampshire Retirement System recommending a sharp reduction in the funds' current 10% target for real estate.[6]

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4 Kahn, Management Review, March 1991

5 Hemmerick, Pensions & Investments, August 6, 1990

6 Hemmerick, Pensions & Investments, March 4, 1991

Life insurance activity in real estate has slumped as well. New commercial mortgage commitments by the twenty largest companies declined from a high of $24.1 billion in 1986 to roughly $22 billion in 1989, and dropped a further 36% to $14 billion in 1990.[7]

The Japanese, one of the largest sources of foreign capital in the U.S. real estate market in the late 1980's, have also started reducing their investments in this sector. According to the accounting firm Kenneth Leventhal & Co., Japanese real estate investment in the U.S. dropped $13 billion between 1988 and 1990, a 27% decrease.[8] One of the main reasons for this shift is a requirement for higher yields brought about by an increase in the cost of capital in Japan, which jumped from 2.5% in 1988 to over 6% in 1990. Significant declines in the Japanese stock market, the increasing allure of European investment, and poor market conditions in the U.S. have also caused the inflow of Japanese capital to ebb.

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7 American Council of Life Insurance, Washington D.C.

8 Yamaguchi, Yuzo and Carey, Conán, "The Burst Bubble Blues", Economic World, June 1991, p. 23

Investments by Deregulated Foreign Funds

The investment behavior of a few institutional investors in Sweden provide compelling evidence that capital placement in foreign real estate will indeed increase during the next three to five years. In 1989, exchange-control regulations in Sweden were relaxed, making it possible for Swedish investors to invest in foreign shares, bonds, and real estate.

Following this, the Swedish insurance company Skandia, one of the largest insurance companies in Europe and Sweden's biggest private owner of real estate, purchased an international property portfolio, with properties in the U.K., Spain, and Portugal valued at approximately $635 million. Roughly 23% of the overall group portfolio of SKr151 billion ($23 billion)[9] is invested in real estate, of which international real estate represents 12%, or roughly 2.75% of the overall portfolio. According to two of the company's investment managers, there are plans to divest a portion of the domestic portfolio and increase the international real estate allocation to meet the company's diversification objectives.

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9 To give some order of magnitude to amounts in Swedish kronor and Dutch guilders, the following exchange rates have been used throughout this thesis: one dollar converts to 6.5 Swedish kronor or 2 Dutch guilders. As these rates are more or less reflective of 1991 rates, krona and guilder amounts shown for previous years may not be accurate when converted to dollars.

Since 1989, the National Swedish Pension Fund (AP), with total capital of SKr400 billion ($61.5 billion), has been allowed to invest in real estate through a property company it acquired that same year. Through the acquisition of this company (Anders Nisses), AP added real estate valued at SKr4 billion ($615 million) to its portfolio of mostly domestic bonds. Although only a small percentage of this real estate portfolio was international (two office buildings in London) and no further international real estate has been acquired to date, AP has plans to invest 25% of its 5% allowable real estate allocation in the international property market, or SKr5 billion ($769 million).

The investment behavior of another recently de-regulated European institutional investor would further suggest that at least a portion of these Swedish funds will flow to foreign real estate. The General Public Service Pension Fund (ABP) of the Netherlands,[10] the world's second largest pension fund after the United States' TIAA-CREF with roughly $82 billion in assets, has only been allowed to make any overseas investments (stocks, bonds, or real estate) since 1987, and this limited to 5% of assets. Roughly half of this international allocation of $4 billion has been marked for real estate.[11]

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10 Algemeen Burgerlijk Pensioenfonds (ABP) represents over 1 million workers, including central and local government civil servants, employees of public utility companies, and employees in the educational and cultural sectors.

11 Price, Margaret and Curtis Vosti Pensions & Investments, 17 September 1990

Appeal of U.S. Real Estate

In the past, the U.S. could confidently expect a large percentage of deregulated foreign capital to flow to its shores. But why U.S. real estate?

There are a number of reasons why foreign investors have traditionally chosen to invest large sums in U.S. real estate. First, foreign investors have been attracted to the relatively higher rates of return available on U.S. real estate investments. These rate of return differentials were traditionally due to market differences such as larger size and greater depth relative to other real estate markets around the world. While yields on real estate typically range between 1% to 2% in Japan and 4% to 6% in Europe, yields of 8% to 10% have not been uncommon for existing income producing property in the U.S.[12]

Second, the lower cost of capital available to many foreign investors, particularly the Japanese, further enhanced these rates of return. As mentioned above, in 1988, the Japanese cost of capital was approximately 2.5%, compared to roughly 10% in the U.S.

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12 Foreign Investment in U.S. Real Estate: Status, Trends, and Outlook, 1988, joint project, National Association of Realtors and MIT's Center for Real Estate Development, p. 7

Third, the decline in the value of the dollar in recent years has made prices of dollar-denominated assets appear very low. This becomes an even stronger factor for real estate investments because U.S. real estate prices, even without favorable exchange rates, are often far lower than prices in the home markets of foreign investors.

Fourth, the sheer enormity of the U.S. market has ensured a high level of liquidity. Foreign institutional investors such as British and Dutch pension funds have for several years created a huge demand for high quality downtown office properties. The commercial real estate boom of the 1980's brought an ever greater supply of such properties to market. Furthermore, the depth of the U.S. market has enabled these properties to turn over on a more regular basis than properties in many overseas markets. Foreign investors have found they not only have more opportunities to make such investments, but also have been reassured knowing that a deep market exists should they need to liquidate their holdings.

Fifth, most foreign investors have viewed the U.S. real estate market as a safe haven for capital. Many of these investors have experienced tremendous losses of financial assets during time of war or domestic turmoil. The U.S. real estate market offers a haven for capital in the form of a physical asset that is likely to survive in spite of economic or military upheavals.

Sixth, some foreign investors have experienced high inflation in their domestic economies. Fixed-income assets, a traditional staple of many European pension funds, are generally a poor inflation-hedge compared to real estate investments. Inflation in the U.S. has hovered around 4% for most of the 1980's.

Seventh, by virtue of its size, the U.S. real estate market offers a tremendous opportunity for foreign investors to learn about new techniques for acquiring, financing, and managing commercial real estate.

Eighth, the U.S. tax code has offered some significant advantages to foreign investors in relation to the tax treatment they would receive at home on similar investments. For example, even though the recovery period for commercial real estate was extended from 19 years to 31.5 years in the Tax Reform Act of 1986, the depreciation deductions are still more beneficial to Japanese investors who face a 65 year recovery period back home.[13]

Finally, higher savings rates abroad, including pension fund surpluses, have often exceeded domestic investment needs and have encouraged institutions to seek opportunities for capital placement overseas.

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13 Foreign Investment in U.S. Real Estate: The New International Landlords, pp. 15-17

All told, Swedish institutional investors comprise approximately SKr1.34 trillion ($206 billion) in assets.[14] Assuming a 1% allocation to U.S. real estate and three to five year placement objectives, the U.S. could theoretically expect to see $2 billion of investment flow to its real estate markets during this period of time.[15] However, there are additional factors which will influence the ultimate placement of these funds.

This thesis looks at the historical and emerging investment patterns of Swedish institutional investors, as well as the socio-political trends in the European market, and questions whether the characteristics which have traditionally contributed to the appeal of the U.S. real estate market as discussed above are still strong enough to attract these deregulated funds. The thesis considers the future investment strategies of Swedish institutional investors and the effect they might have on the U.S. real estate market in the coming three to five years.

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14 SKr800 billion in pension funds and SKr540 billion in insurance companies and private pensions

15 Apparently, the AP Funds have tentatively established a maximum allocation to U.S. real estate over the next three years which is equivalent to .25% of total assets; Trygg-Hansa, 1.6% of group assets (including Trygg Life). The total portfolio of all Dutch pension funds and insurance companies is approximately Fl.500 billion ($250 billion), of which Fl.17 billion ($8.5 billion), or 3.4%, is in U.S. real estate. (VastGoedMarkt, Amsterdam) This information is only included to give perspective to the investment potential of Swedish institutional investors. It is not an estimate of what actually will be invested in U.S. real estate.

CHAPTER TWO - SWEDISH PENSION SYSTEM

Introduction

Swedish retirement benefits are composed entirely of government social security payments and compulsory employer plans. Of 19 countries analyzed in a study conducted by Business Insurance,[1] Sweden, a country with 8.5 million inhabitants, was found to replace 85% of factory workers' final earnings, the third highest percentage after Spain's 91% and Singapore's 87%. The United States, by comparison, replaces approximately 77% of factory workers' final earnings, 27% by Social Security, 50% by private pensions. Sweden had the second highest retirement benefits for middle managers and executives, replacing 79% and 75% of their final earnings respectively.

The socialist orientation of the Swedish political system has had a great deal of influence on the structure of the Swedish pension fund system as it stands today. As early as the 1940's, the Liberal Party had considered various proposals of joint ownership and profit sharing. In the mid-1950's, the Minister of Finance launched proposals for collective company savings for employees with the principal aim of improving the prospects of wage restraint, enabling workers to exert an influence in enterprise, and ensuring

1 Winston, Paul D. "Pension Income Worldwide", Business Insurance, 18 February 1991

economic progress. Finally, in 1959, the Swedish Parliament introduced a State system of statutory general supplementary pensions (the ATP scheme). The following year, the AP Fund was established to manage the fund created by these supplementary contributions.

The AP Fund is divided into three separate management boards (hereafter referred to as the first three AP funds). The first AP fund board manages the pension insurance premiums paid in by the state, local government, and related institutions and companies; the second fund board manages the premiums paid in by large business enterprises in the private sector; and the third board manages premiums paid in by small private sector employers and the self-employed. The members and deputy members of these boards are nominated by various employer and employee associations,[2] and are appointed by the government.

How the State Pension Scheme Works

Within the Swedish ATP scheme, the collection of premiums is delegated to a special insurance administration. Each year, this insurance administration transfers supplementary pension contributions[3] and profit taxes[4] to the

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2 Including the powerful blue-collar Swedish Trade Union Confederation (LO), Sweden's largest labor union.

3 Supplementary pension contributions are paid by various bodies, including the state, local authorities, private companies, cooperatives, and foundations. The portion of yields from the AP Funds not required to fund dibursements are maintained within the AP Funds. All yields from subsequent AP Funds (the 4th and 5th funds) and

AP Fund. As premiums paid into the ATP scheme are intended to cover current social security and supplementary pension disbursement requirements, the role of the AP Fund is merely to act as a buffer between premium income and pension liabilities.[5]

From their inception, the first three AP funds were allowed to invest almost exclusively in Swedish bonds. However, the categories of assets in which they are entitled to invest have been steadily expanded to include real estate (foreign as well as Swedish, but limited to 5% of total assets) and direct loans to business enterprises. With effect from 1990, they have also been entitled to invest in foreign interest-bearing securities, but with an upper limit on foreign purchases of 10% of their assets. Funds managed by the first three AP funds at the end of 1990 were valued at nearly SKr400 billion ($61.5 billion).

In 1974, a fourth fund board was instituted within the AP Fund, and in 1988, a fifth. The establishment of these funds made it possible to broaden the placement rights of the system to include equities and other securities on venture

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Wage-Earner Investment Funds are also transferred into the first, second, and third AP Funds.

4 Almost all Swedish enterprises were subject to these taxes, including foreign-owned Swedish companies, such as Svenska IBM and Svenska Shell.

5 In other words, the state pension system is unfunded or "pay-as-you-go". During the 1980's, roughly 20% of pension liabilities were financed out of interest income generated by the first three AP Funds.

capital markets, in addition to investments made by the first three AP funds in interest-bearing securities. Investment in real estate by the fourth and fifth funds is limited to indirect holdings through the Swedish stock market. Funds managed by the fourth and fifth AP funds total approximately SKr22 billion ($3.4 billion), less than 6% of the first three AP funds.

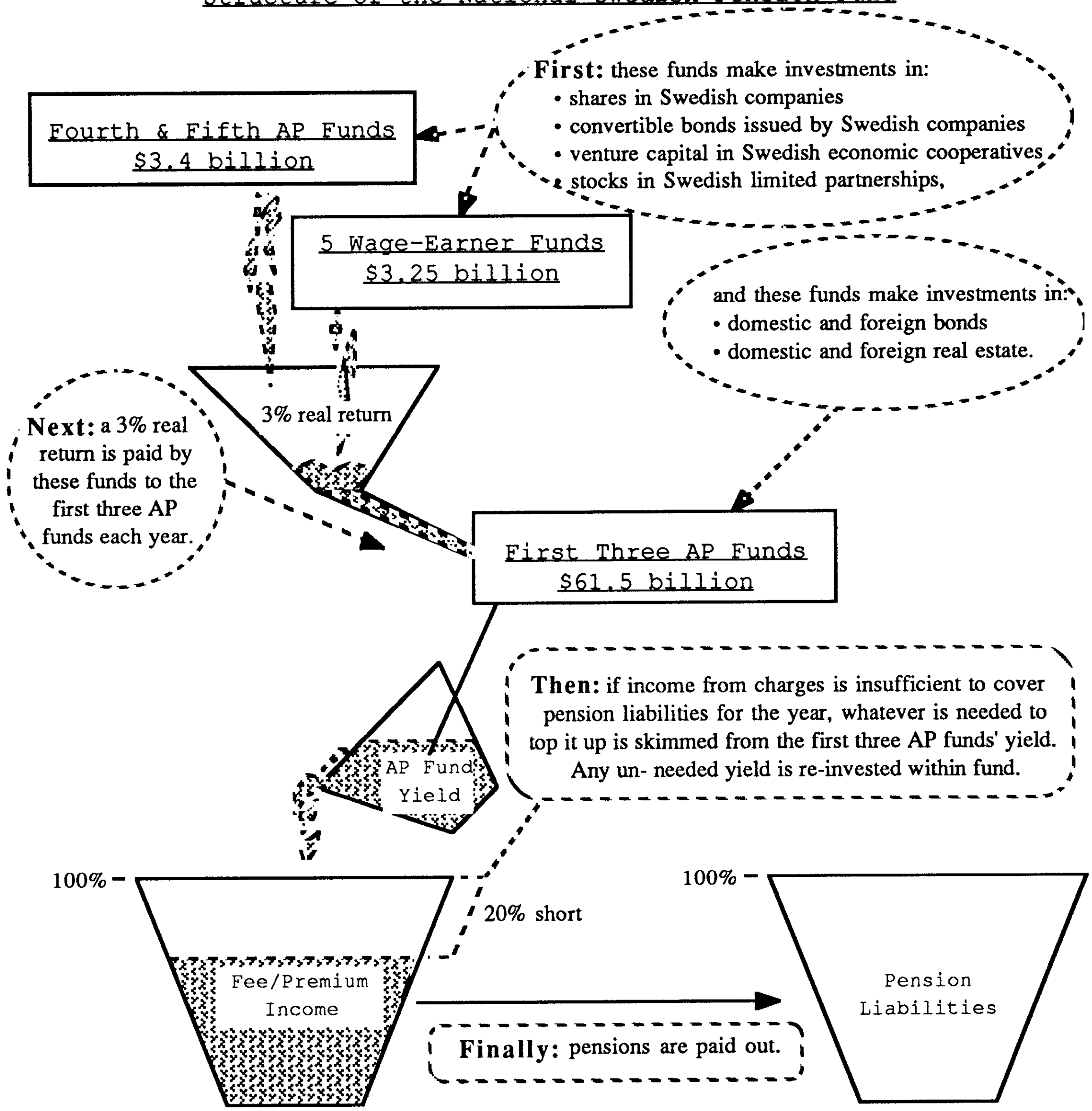
In 1983, Swedish parliament also approved the creation of five other funds within the ATP scheme, called wage-earner funds or employee investment funds. These funds were allotted SKr2 billion ($300 million) annually, up to and including 1990. The management boards of each of the wage-earner funds were required to invest in Swedish enterprises in the manufacturing and related sectors, with the fundamental aim of improving the supply of risk capital to these sectors. Funds managed by the five wage-earner fund boards is approximately SKr21 billion ($3.25 billion).

The fourth and fifth AP funds and the five wage-earner funds were funded through the supplementary contributions and profit taxes paid into the first three AP funds. They are required to transfer 3% of the value of the funds (recalculated in accordance with changes in the CPI) they administer back to the first three AP funds each accounting period. Therefore, a 3% real rate of return is their threshold required return.

Diagram 1, Structure of the National Swedish Pension Fund, illustrates in broad terms the roles of each of the funds.

Diagram 1

Structure of the National Swedish Pension Fund



The organization of the fourth, fifth, and wage-earner funds is indicative of the growing influence of labor in the private sector. The fourth and fifth management boards include roughly equal proportions of representatives from employer and employee associations. Almost 70% of wage-earner board members, on the other hand, must represent the interests of wage-earners.

Politics Behind the Wage-Earner Funds

Although the value of the funds managed by the five wage-earner funds is relatively small ($3.25 billion), the pressures behind their evolution are indicative of a greater political turmoil which appears to be reaching a head in 1991. Because both the AP Funds and the wage-earner funds stand to be significantly changed by any resolution, these pressures are worth looking at more closely.

A great deal of Sweden's production is located in the mining, steel, and shipbuilding sectors and is particularly dependent upon imported oil. Therefore, during the international economic crisis of the 1970's, Sweden was doubly hit by rising oil prices and slowing growth of the traditional heavy industries. At a point where industry should have expanded by 5% or 10% to cope with the rising oil prices, Sweden's production level fell by roughly the same amount. High corporate profits in the early 1970's led to very rapid wage increases, which, combined with the pegging of the Swedish krona to the rising Deutschmark, further impaired the competitiveness of Swedish industry.

In 1982, the Social Democrats redirected economic policy with a view to making industry and commerce more competitive and boosting investment, employment, and production. As industrial profitability increased, however, due partly to a 16% devaluation of the Swedish krona, they were determined to stabilize the relationship between, on one hand, rising profits and increasing self-finance in enterprise, and, on the other, the growth of prices and costs. Yet, the Social Democrats felt that Sweden should avoid using unemployment as a weapon against inflation, which they perceived other OECD[6] countries were doing. They believed that such strategies would undermine the spirit of "consensus" that had contributed to Sweden's prosperity for so long and would lead to lower levels of industrial output.

The Social Democrats saw it as their task to spread power and ownership so that more people would participate in the accumulation of wealth. This would make it possible to restrain rising costs and accelerate growth, and at the same time intensify pressures for equitable distribution of resources. This, they hoped, would go far in stabilizing the economy and was the driving force behind the wage-earner fund proposals.[7]

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6 Organization for Economic Cooperation and Development

7 Similarities can be drawn with the U.S. experience. As the population has grown and the economy has shifted from labor intensive to capital intensive, many Americans believe that the economy should be restructured so that all households will eventually produce an expanding proportion of their incomes through their privately owned capital and simultaneously generate enough purchasing power to consume the economy's output. As a result, there has been an increasing growth of "democratic financing methods",

In reversing the downturn in the Swedish economy, they believed that four requirements would have to be met to guarantee enduring industrial growth:

1) That production, investment, and employment must take priority over consumption, and that, in this context, the future development of costs would prove decisive.

2) That inflation would have to be reduced from 8% to 4% by the end of 1984.

3) That both the necessary burdens and the sought-after rewards of the production effort must be fairly distributed among different sectors of the community.

4) That enduring industrial growth presupposes a steady supply of risk capital and that this should be available on a long-term basis, should be of national origin, and should focus on the sections of Swedish industry which have potential for development.

The employee investment funds were seen to contribute to these ends as follows:

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such as Employee Stock Ownership Plans (ESOP). Like the Swedish wage-earner funds, the value of ESOPs is their natural tendency to finance capital ownership for economically underpowered individuals at the same time that they finance corporate growth. (Kelso)

- Employee investment funds could help reduce conflicts of a distributional nature and improve the ability of the employees' organizations to help maintain a high level of profitability.

- The funds could help, primarily through their profit sharing, break the pattern whereby high profits always tended to be accompanied by substantial wage increases, which in turn led to higher inflation and a deterioration of growth potential.

- The appearance of the funds as buyers in the stock market would increase the supply of capital. This would counteract the tendency of rising demand for risk capital to elevate yield requirements, which could inhibit the expansive capacity of enterprise.

- The funds would give workers direct responsibility for the investment of risk capital and, at the same time, would give them a share in future profits and greater influence within enterprise. This would hopefully resolve some of the powerful conflicts existing between capital and labor.[8]

Today, the Swedish government, together with the Swedish Trade Union Confederation (LO), wants to further strengthen

8 In fact, the introduction of the wage earner funds was partially in response to demands made by the LO for greater control over industry.

the role of the state pension funds in the private sector by allowing the first three AP Funds, set up in 1960, to invest directly in the stock market. As mentioned above, the fourth and fifth funds were set up primarily as conduits for pension fund investment into the Swedish stock market.

Swedish industry, however, remains firmly committed to the private sector. Many company executives argue that an increased presence of the AP Funds in the stock market will prove an unacceptable extension of public power into company ownership structures.[9] The Federation of Swedish Industries believes that pension funds should first be privatised before their investment role expands.

At the end of 1989, the total surplus of the first three funds equalled roughly 43% of the total valuation of the Stockholm bourse.[10] The fourth and fifth funds, together with the wage-earner funds, own around 8% of the capital and voting shares in Sweden's top 50 stock market listed companies. Moreover, the wage-earner funds are required to transfer 50% of the voting rights conferred by their shareholding in a company to the local trade union organizations in that company if they so request.

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9 Taylor, Robert "A Share of the Corporate Action" Financial Times, p. 30, 12 October 1990

10 In the U.S., total outstanding equities owned by all U.S. institutional investors was 39.4% for the first quarter, 1991. (45.9% including foreign institutional investors) (Tobin, NYSE)

In the run-up to the elections in September, 1991, polls show that the Social Democrats' popularity has fallen to approximately 30% (nearly a 15% drop since last year) in favor of various parties further to the right.

Although no one is certain how the Swedish pension fund system will be affected by the outcome of these elections, a few thoughts have been put forward during the course of my interviews. If the conservatives take control, they may look for ways to dissolve the five wage-earner funds and loosen the tightening grip of labor in the private sector. However, they wouldn't be able to liquidate the funds, as the stock market is not large enough to absorb their positions. Furthermore, although it is clear that the funds belong to "the people", it is not clear how proceeds of these funds would be divvied up in the event of liquidation. If the Social Democrats win, some people feel that the wage-earner funds would be combined with the AP Funds.

Situation Today

Unlike the situation during most of the 1980's, Sweden's premium income in 1990 was able to cover almost all of the year's pension liabilities. However, this was due to a 2% drop in liabilities and an increase in the premium rates during that year. During the past ten years, the government has had to draw nearly 20% of annual liabilities, which totalled SKr77.4 billion in 1990 ($11.9 billion), from the AP fund's annual yield.

According to AP fund executives, due to the increasing number of pensioners and the sluggish growth of the Swedish economy, the premium rate today (13%) will not be sufficient to cover future pensions. Therefore, they project that the fund yields will once again be appropriated to a large extent to finance pension disbursements.

Against this background, AP fund executives feel it is to their advantage that their investment possibilities have been expanded to include real estate and foreign bonds. This is especially important because Sweden's pension liabilities are linked to real wages up until the time of retirement. Investment in real estate will enable the fund to more closely tie yields to real values.

CHAPTER THREE

SWEDISH INVESTMENT STRATEGIES

In Sweden and some other European countries, investment assets are split into two categories: "real", which are assumed to be inflation-linked, and "nominal", which are assumed not to be. The classification of some assets as real has created substantial controversy in Sweden and many institutions are pushing for change. To facilitate reading the text which follows, I have included broad definitions of real and nominal assets for reference:

Real Assets

- Equities
  - quoted (stocks and convertible bonds)
  - unquoted (partnerships)
- Real Estate
  - including sale-leasebacks[1]

Nominal Assets

- bonds and all other fixed-interest bearing instruments, including overnight lending

Furthermore, it is useful to know the tax status of Swedish institutional investors:

State pension	tax-exempt
Life-insurance companies	15% - 17% on realized net income[2]
Non-life companies	30% on profit

1 Sale-leaseback payments in Sweden are typically based on a real interest rate of 3.5% plus the inflation rate for the year.

2 Difference between the book value of an asset and the value of its sale.

Property Taxes:

Valuations	every 5 years
Assessment Ratio	75% of market value[3]
Ad Valorem Tax Rate	3.5% (expected to fall to 2.5% by 1992)

A look at the recent investment patterns of Swedish institutional investors will help explain how they might invest in the U.S. market in the future.

Swedish Institutional Investors

To understand the general investment strategies of some Swedish institutional investors, I have looked at the aggregate asset allocations of the National Swedish Pension Fund (AP), as well as SPP-Trygg-Hansa (Trygg), the second largest private insurance company in Sweden, and Trygg Life, its affiliated life insurance company.

These investors are of particular interest since they have recently formed a partnership for investment in North American real estate, including Trygg (45%), AP (45%), Grosvenor, Vancouver (5%), and Lundbergs (a Swedish-owned development company) (5%). AP and Trygg have chosen to link up with Lundbergs and Grosvernor, both well-established in the U.S. market, because they feel it is the best way for them to break into and learn the U.S. market. Trygg and AP

3 The assessed valuation of property has typically been expressed as some fraction of this 75%. In 1989, it was 55% of 75%; in 1990, 65% of 75%; and in 1991, increased to 100% of 75%.

each plan to invest between SKr0.5 - 1 billion ($77 - $154 million) over the next three years in this partnership. All initial investments will be direct investments, as both investors believe that indirect investments would not allow them to learn the market. They feel that they have sufficiently minimized their risk through the ownership structure. Due to the particular strengths of the local partners, the partnership will focus on retail properties.

For a more specific look at real estate investment patterns, I have looked at a 1989 survey conducted by the Royal Institute of Technology in Stockholm which analyzes the invesment patterns of Swedish investors in domestic commercial real estate and draws some comparisons with American studies.[4] The real estate portfolio of Skandia, the largest private insurer in Sweden, will provide further insight into property investment by Swedish institutional investors. Skandia has indicated that, if they were to enter the U.S. real estate market, they would do so with another large U.S. institutional investor.

National Swedish Pension Fund (AP)

The first three AP funds (hereafter referred to as the AP Fund) employ 27 employees to manage their SKr400 billion ($61.5 billion) portfolio of assets. With restrictions on

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4 Brzeski, J., A. Jaffe, and S. Lundström Commercial Real Estate Investment Survey in Sweden,, The Royal Institute of Technology, Stockholm, 1989, Report 5:29

investment in equities, real estate, and foreign assets, investments of the AP Fund have historically been concentrated in bonds. However, since relaxing these regulations, the AP Fund has begun adjusting its allocations away from bonds towards other asset categories, including real estate. Table 1, AP Fund's Investments by Type, shows the heavy concentration of the fund's investments in fixed-income instruments.

Table 1: AP Fund's Investments by Type

	1989	1990
Bonds	84%	82%
Promissory Notes	12%	10%
Money Market Investments	2%	3%
Debenture Loans	1%	3%
Properties	1%	2%
Total	100%	100%

Activity in the money and bond markets constitutes an integral part of the fund's overall investment strategy for interest-bearing instruments. The fund's objective is to ensure that the portfolio holds an optimal combination of interest risk, credit risk, and liquidity. To even out swings in AP Fund's liquidity and to take advantage of temporary pricing errors, the forward market is used in the management of the portfolio.

In 1990, investments in housing bonds accounted for the largest part of the fund's net investments. Table 2, AP Fund's Investments by Category of Borrower, shows that, at the end of the year, the housing sector's share of interest bearing investments was roughly 57%.[5] .

Table 2: AP Fund's Investments by Category of Borrower

	1989	1990
Housing	59%	57%
State	22%	21%
Corporate	13%	14%
Local Authorities	3%	3%
Money Market Investments	2%	3%
Properties	1%	2%
Total	100%	100%

Such a large allocation to mortgage-backed securities (MBS) contrasts sharply with the typical allocation of a U.S. institutional investor. Table 3, Mortgage-Backed Securities as % of Total Portfolio, compares the approximate MBS holdings of the AP Fund and Trygg-Hansa Holding,[6] a large private insurer in Sweden, with those of U.S. institutional investors[7].

5 Housing finance has increasingly become integrated within general credit markets in Sweden. High real interest rates have attracted corporate retained earnings to mortgage finance, inducing an increased use of mortgage-backed securities, interest rate swaps, options and futures. (Lundström)

6 Data from: The National Swedish Pension Fund 1990 Annual Report and Trygg-Hansa Holding 1989 Annual Report, Stockholm

7 Hollie, Leonard J. "Mortgage Securities Lure Insurers, Banks" Pensions & Investments, p. 50, 25 June 1990

Table 3: Mortgage-Backed Securities as % of Total Portfolio

	1989
AP Fund	54.9%
Trygg-Hansa Holding	25.5%
U.S. Insurance Companies	10.0%
U.S. Commercial Banks[8]	3.5%
Calpers[9]	12.5%

Groups traditionally targeted for direct lending by AP Fund include local authorities and municipal companies. However, during the last few years, new financing alternatives in the form of municipal papers and borrowing in foreign currencies have caused margins to shrink in this market.

In 1990, AP Fund's holding of debenture loans increased by approximately 7%. The majority of the growth in this area occured within the banking sector as a result of revised capital ratio regulations, which will scale up to 8% by 1993. At the end of 1990, the requirement was 7.25%.

The AP Fund was first allowed to invest in real estate in 1989, with stipulations that it could only hold real estate or shares in real estate companies. It can not own

8 Represents holdings at end of 1st quarter, 1989; this figure rose to 5.3% a year later.

9 California Public Employees' Retirement System, second largest U.S. pension fund at end of 1990 with roughly $54 billion in assets.

shares in construction companies.[10] During this year, it acquired the listed real estate company Anders Nisses AB for SKr4 billion ($615 million) and also bought into a newly formed real estate company, Pleiad Real Estate AB. As described earlier, Anders Nisses' portfolio included two office buildings in London, the only foreign properties held by the AP Fund to date. One of the London properties is Four Millbank, a completely renovated 19th century classical revival office building located near the Houses of Parliament.

In 1990, three large property deals were concluded by the AP Fund in Sweden, including two office properties purchased for SKr560 million ($86 million) and the purchase of the domestic property holdings of Esselte, the Swedish office products and media group. Although analysts had judged Esselte's property, which included prime sites in Stockholm and Gothenburg, to be worth around SKr2.5 billion, the AP Fund paid SKr3.4 billion ($523 million).[11]

Total real estate investments in 1989 and 1990 were SKr9.7 billion ($1.5 billion). However, the market value of the AP Fund property holdings had fallen to approximately SKr8.2 billion ($1.25 billion) at the end of 1990, with

10 The property development function in Sweden has traditionally been integrated within construction companies.

11 Burton, John "Esselte Sells its Property Holdings in Restructure" Financial Times, p. 27, 13 June 1990

rental income for 1991 estimated at SKr455 million ($70 million) in Sweden and SKr50 million ($7.7 million) in England. Distribution of the AP Fund's real estate by method of investment is shown in Table 4.

Table 4: AP Fund's Real Estate by Method of Investment

	1989	1990
Direct Investment	90%	64%
Shares in Real Estate Cos.	5%	4%
Partnerships	5%	32%
Total	100%	100%

In 1990, the AP Fund's overall portfolio had a total yield of 14%, including a current yield of 12.4% and capital appreciation of 1.6%. A weakening property market in 1990 resulted in a 10.9% drop in the value of the real estate portfolio. According to the management board, real estate's current yield of 3.6% was unusually low because a substantial amount of the portfolio was in the earlier phases of development.[12] Charts 2, 3, and 4 show the AP Fund's current yields and changes in value[13] by investment type since 1987.

12 The National Swedish Pension Fund (First, Second, and Third Fund Boards), Annual Review 1990

13 According to recommendations by the Swedish insurance industry, this value and all other change of values indicated in subsequent tables consist of the market value at the beginning of the year plus half the net investment minus half the yield.

Chart 2: AP Fund's Returns - Current Yields

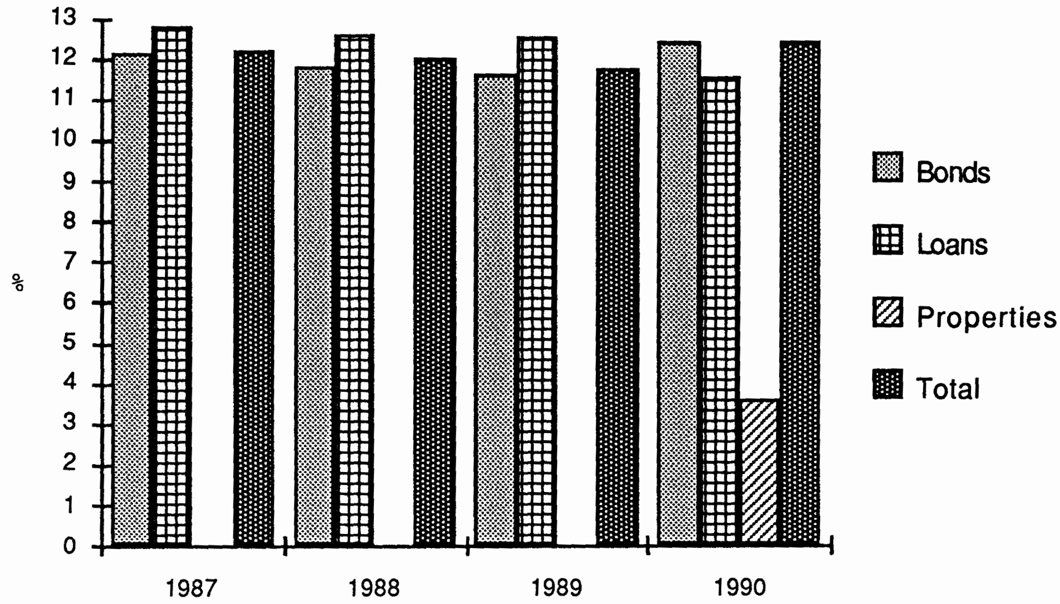


Chart 3: AP Fund's Returns - Change in Value

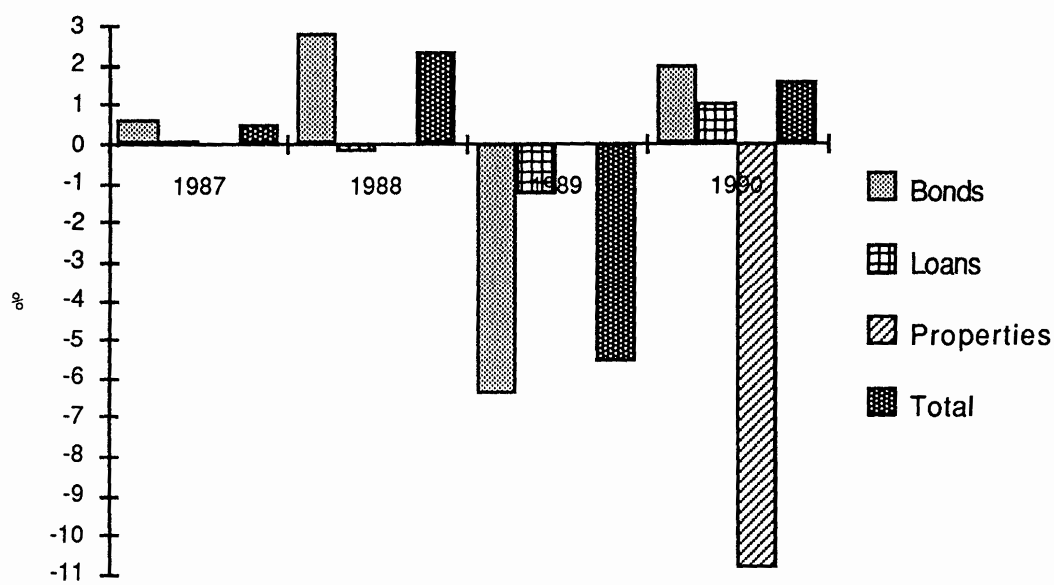
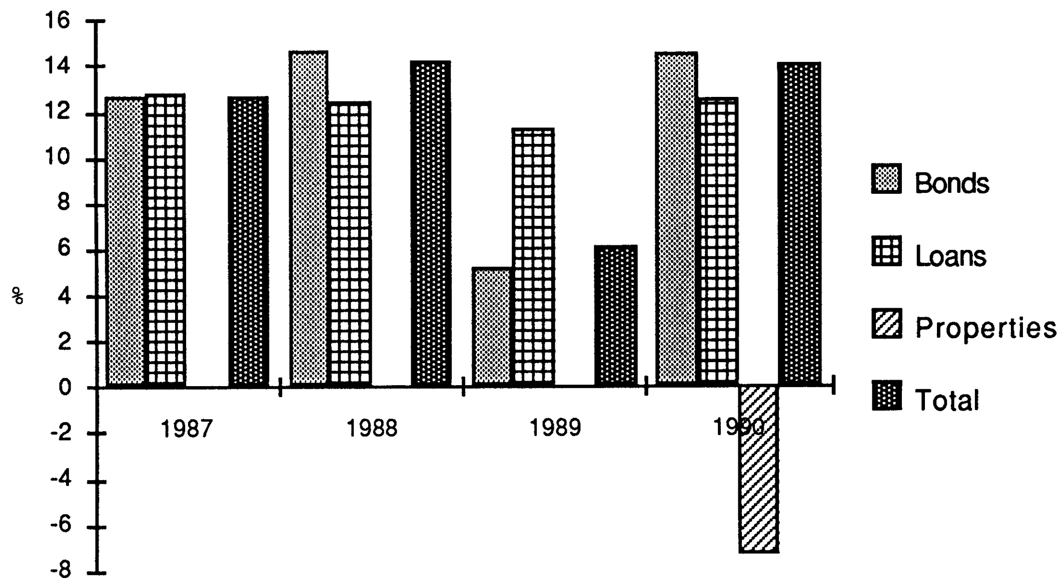


Chart 4: AP Fund's Total Return



Trygg-Hansa Holding

Trygg-Hansa Holding's investments are distributed among real estate, shares, bonds, short-term investments and various types of deposits. Their combined value at the end of 1989 was approximately SKr20 billion ($3 billion), excluding Trygg Life.

Traditionally, Trygg-Hansa has grouped its assets into real and nominal assets, in order to achieve an optimal risk-return profile for the portfolio. As mentioned at the beginning of the chapter, real assets are assumed to be inflation-linked, and nominal assets aren't.

In order to minimize capital losses from high inflation, Trygg-Hansa adopted a strategy in the 1980's which raised the proportion of real assets in their portfolio.[14] Between 1985 and 1989, the market value of all investments increased by an average of 18%, while the corresponding increase for shares and real estate alone was more than 30%. Between 1980 and 1989, the combined value of shares and real estate rose from 12% of total investment assets to 55%.

Unlike the National Swedish Pension Fund (AP), Swedish insurance companies had been allowed to invest in real estate before 1989 and had always been allowed to invest in shares provided their holdings of any one company did not exceed 5%. However, like AP, they have only been permitted to make foreign investments since 1989. Therefore, tofurther diversify the portfolio and link movements in the value of their investments more closely with those of the international economy, Trygg-Hansa increased the proportion of foreign assets in its portfolio from 0 % to 16% by the end of 1989. This trend towards foreign investment has been carried out primarily in the real estate and shares categories.

As of 1991, Trygg-Hansa's broad investment policy is 50% real assets, 50% nominal assets, with a real estate

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14 Office building rents from the Stockholm market rose by 54% during the period 1982-85, roughly twice the rate of inflation during the same period.

allocation of 15%. Within the real asset categories, more and more of the investments will be foreign. Trygg-Hansa's investments in Swedish stocks, for example, will continue to decrease in coming years in favor of foreign shares.[15] Although the 15% allocation to real estate probably will not change, a portion of the domestic real estate portfolio will be sold to accommodate planned expansion in foreign property holdings. The standing policy regarding foreign real estate investment is to purchase commercial property only and to hold long term.

Part of Trygg-Hansa's decision to increase its foreign real estate holdings stems from its broad diversification strategy. However, the poor general outlook for Sweden's economy in the 1990's and increasing real estate tax burdens provide further incentive to look for higher returns abroad. In early 1989, a rapidly heating real estate market in Stockholm prompted officials to levy an investment charge of 10% of building costs on certain new construction. More recently, as mentioned above, the effective tax rate on property has increased from 1.44% of market value in 1989 to 2.63% in 1991.

These tax increases must have been painful for Trygg-Hansa. At the end of 1989, 95% of their nearly SKr3 billion

15 Trygg-Hansa (including SPP) owns between 6% and 7% of shares traded on the Swedish stock exchange.

property portfolio was located in Sweden, as shown in Table 5, Trygg-Hansa's Property Portfolio by Location.[16]

Table 5: Trygg-Hansa's Property Portfolio by Location

Central Stockholm	53%
Rest of Stockholm	26%
Rest of Sweden	16%
London	5%

In 1990, Trygg-Hansa realized a 6% real rate of return on their overall portfolio.[17] Table 6, Trygg-Hansa Investments by Asset Class, shows an increasing proportion of stocks within the portfolio.

Table 6: Trygg-Hansa Investments by Asset Class

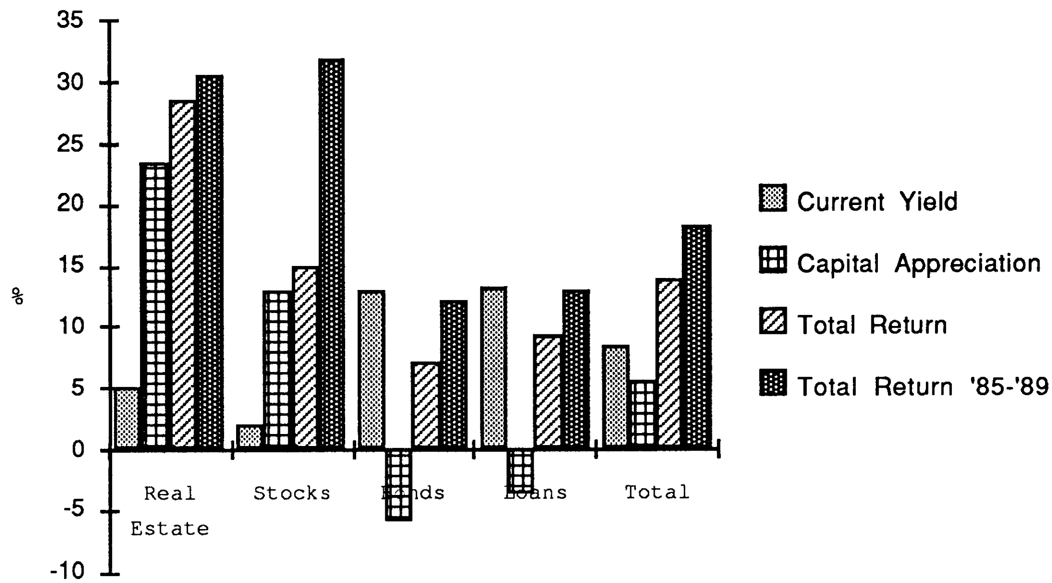
(in millions)	1988		1989	
	SKr	%	SKr	%
Real Estate	2,260	14.4	2,958	15.0
Stocks	4,771	30.3	7,878	40.0
Bonds	5,119	32.5	6,066	30.8
Loans	1,692	10.7	2,025	10.3
Cash	1,913	12.1	765	3.9
Total	15,755	100.0	60,472	100.0

Chart 5, Trygg-Hansa 1989 Returns, shows almost equal total returns in 1989 for Trygg-Hansa's real estate and stocks.

16 One property in London (Lexicon House, 24,000 sf of commercial space built in 1985, at 82 Charing Cross Road) represents 5% of the market value of the entire real estate portfolio. This would put the value of the building at roughly $23 million.

17 Sweden's 12-month consumer price inflation was 10.9% in June, 1991.

Chart 5: Trygg-Hansa 1989 Returns



In 1990, Trygg-Hansa only realized a total return of 7.7% on it real estate portfolio, of which 4.7% was current yield and 3% was capital appreciation.

Trygg Life

Trygg Life is a mutual company, which means among other things that it is owned by its policy holders. It owns 27% of the capital and 63% of the voting rights in Trygg-Hansa Holding AB and is thus its largest individual shareholder.

Much of Trygg Life's investment strategy resembles that of Trygg-Hansa. However, where Trygg-Hansa's investment assets totalled roughly SKr20 billion at the end of 1989, Trygg Life's were over SKr60 billion ($9.2 billion).

Furthermore, where SPP-Trygg-Hansa held 16% of its portfolio in foreign assets at the end of 1989, Trygg Life only held 5.5% in foreign assets. Additionally, while Trygg Life's ratio between real and nominal assets is the same (55% and 45% respectively), its allocation between individual asset categories is different. For example, as a life company, Trygg Life does not have the liquidity requirements of its non-life affiliate[18] and therefore can afford to make a higher allocation to real estate, nearly 20% compared to Trygg-Hansa's 15%.[19] Table 7, Trygg Life Investments by Asset Class, reflects growing proportions of stocks and real estate within Trygg Life's overall portfolio.

Table 7: Trygg Life Investments by Asset Class

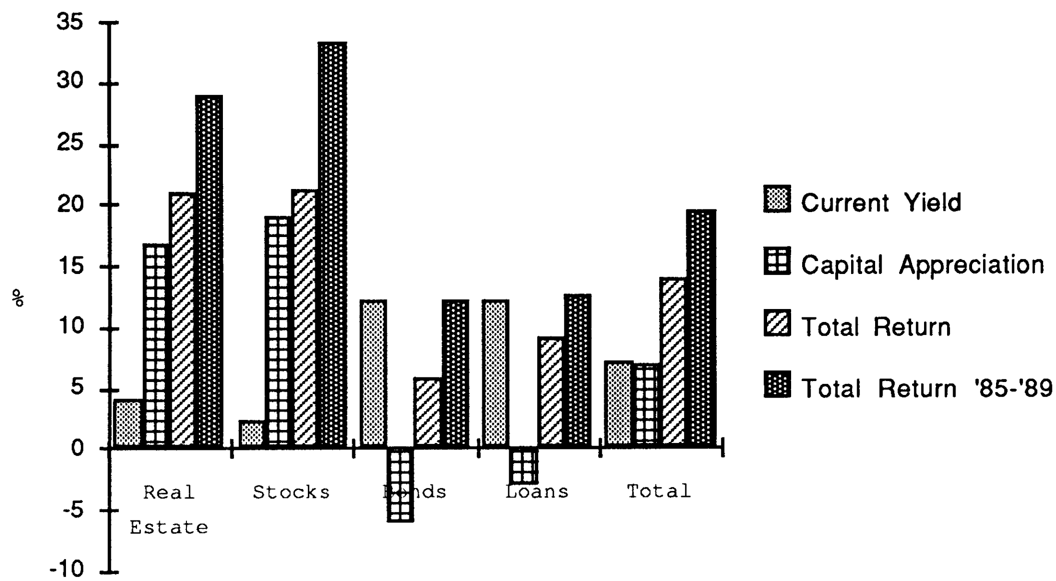
(in millions)	1988		1989	
	SKr	%	SKr	%
Real Estate	9,640	18.5	11,955	19.8
Stocks	16,237	31.2	22,100	36.5
Bonds	20,608	39.6	20,298	33.6
Loans	2,751	5.3	2,664	4.4
Cash	2,778	5.3	3,455	5.7
Total	52,014	100.0	60,472	100.0

18 Although there are no legal liquidity requirements for insurance companies in Sweden, casualty and reinsurance activities generally require higher liquidity and stronger cash flows than life activities. In Italy, on the other hand, insurance companies are legally required to hold at least 16 different types of assets. In Germany, at least 10 types, with no more than 50% in bonds. (Lundkvist)

19 However, at the end of 1989, only one property was owned outside Sweden; a 63,000 sf office building built in 1987 at 77 Shaftesbury Avenue in London.

Chart 6, Trygg-Life 1989 Returns, reflects 1989 returns almost identical to Trygg-Hansa

Chart 6: Trygg-Life 1989 Returns



Survey of Swedish Investors

A study published in 1989 by the Department of Real Estate Economics at The Royal Institute of Technology in Stockholm (the study will be referred to as the JAS study) looks at the investment patterns of Swedish investors in income-producing real estate.[20] The survey instrument consisted of a questionnaire sent to 350 companies, and generated information concerning the structure of real estate portfolios, the use of analytical techniques, various investment concerns, and operational methods used in the acquisition, monitoring, and disposition of real estate

20 Brzeski, Jaffe, & Lundström Commercial Real Estate Investment in Sweden

investments. Of the 228 respondents, 14 (7%) were pension funds or insurance companies. The following findings pertain only to these investor categories.

Not surprisingly, all pension and insurance respondents held high concentrations of commercial properties in their portfolios.[21] While over 90% also held apartments, they did so in considerably smaller proportions. Industrial space, shopping centers, and hotels were also held by more than 25% of the respondents.

The major business objective sought by 71% of the respondents for their real estate investments was capital placement. Nonetheless, 43% also cited property management as a business objective or profit center, and 14% value-enhancing renovating or remodeling.

Long-term real return on equity was ranked as the number one investment goal of the pension and insurance companies who responded. Risk diversification and capital appreciation were second and third. The relative unimportance of current return on equity may reflect greater emphasis on the capital appreciation potential of real estate. Tax benefits were not

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21 Between 1981 and 1987, prices for the best investment-grade properties increased at the rate of 100% every three years and reached $770 per square foot at central Stockholm locations in 1987. (Lundström)

important as most pension funds and life insurance companies are tax exempt and are all-equity investors by law.

By comparison, a study conducted by Louargand & Taylor in the United States in 1990[22] reveals that the 118 U.S. pension plan sponsors and advisors who responded ranked total expected return as the number one real estate portfolio performance goal. However, unlike the JAS study, most respondents placed much more importance on the current yield portion of total return. Where 42 respondents ranked cash flow from operations as their first or second most important performance goal (on a scale of 7), only 14 ranked potential for high appreciation as heavily. However, because of the timing of this study, these results are probably a reflection of current market conditions, where real estate investors are experiencing negative capital appreciation.

Interestingly, the recent acquisition trends of the respondents to the JAS study revealed that industrial space was the second most desired property type after office properties, with most of the reported acquisitions transacted through sale-leasebacks in the industrial category.[23]

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22 Louargand, Marc & Timothy Taylor Institutional Real Estate Portfolio Risk Management Practices, MIT's Center for Real Estate Development, Working Paper #30, 1991

23 There has been considerable interest in sale-leaseback deals in recent years. The 50-year sale-leaseback of Gothenburg harbor, for example, was structured by Trygg with the municipality of Gothenburg. Although it is of interest to note that the buyback option is legally unenforceable in Sweden (it constitutes an encumbrance on the title

Apartments were the third most active category of property recently invested in, despite a long history of country-wide rent controls. The authors of the JAS study suggest that rent controls lead to a lower level of construction and, subsequently, lower vacancy rates and risk. Another possible explanation is that many respondents are able to build apartments with favorable government subsidies and retain the properties for management and operating profits.

Risk diversification strategies were utilized by only 57% of the Swedish pension and insurance respondents. The authors of the study attribute part of this to the fact that the respondents tend to invest in investment-grade prime-location real estate which implicitly carries the lowest systematic risk, even though specific risk is still likely to exist. Of the different strategies favored by those who did have diversification strategies, property type and geographic location were used by 63%, portfolio mix by 50%, financial structure (debt/equity mix) by 25%, and other methods including ownership structure by 13%.

The Louargand & Taylor study found that 93% of U.S. respondents made a systematic attempt to diversify risk. Of these, 83% used property type, and 47% property size as explicit criteria for diversification. Location was broken

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and, as such, is not recognized by the Swedish Land Act), in most cases, such as this, it is a non-issue.

down into five categories, with 23% of respondents using both state and metro area sub-market as criteria, and nearly 38% using each of the following: region, metropolitan area, and economic location. Unlike the JAS study, financial and ownership structures were not specifically offered as diversification criteria, although these may have been included in the category other, which was ticked off by 13% of the respondents.

Eighty-six percent of the JAS study respondents explicitly adjusted for risk differences across property type and location prior to an investment decision. Of the preferred risk adjustment techniques, adjusting expected benefits downward was the method most preferred by pension and insurance companies. While all other investor types responding to the survey[24] preferred increasing the required return as a risk adjustment technique, the authors of the survey attribute pension and insurance company preference for the expected benefit method to policy guidelines stipulating fixed required rates of return for their real estate investments.

Table 8, Comparison of U.S. & Swedish Risk Adjustment Strategies, compares the risk adustment findings of this study (JAS) with those of a study of 176 U.S. insurance

24 Including publicly traded real estate corporations, construction/development companies, property holding companies, and foundations.

companies conducted by James R. Webb in 1984[25] and Louargand & Taylor's 1990 study.

Table 8: Comparison of U.S. & Swedish Risk Adjustment Strategies

	Webb '84	Louargand/ Taylor '90	JAS '89
Required Return	54/16	42/14	29/21
Expected Benefits	21/17	16/15	29/36
Sensitivity Analysis	21	47/10	29/15
Probability Judgement	18	4/15	15/29
Mean Variance Analysis	n/a	7/3	n/a
Beta Coefficients	n/a	3/2	n/a
None	21	22	14

Figures are given in percent of respondents. Where two figures are provided, the first indicates the primary reported technique and the second the secondary technique. For Louargand's study, the first indicates the percentage of respondents who often used that method, the second, those who sometimes did.

According to comparisons drawn between the JAS study and Webb's '84 study, the authors of the JAS study contend that explicit risk analysis is far more sophisticated and formalized in Sweden than in the United States. However, when compared to the findings in Louargand & Taylor's 1990 study, this argument is not as strong. Since 1984, there has been a marked increase in the use of sensitivity analyses in the United States. More notable, however, is the increasing use of the mean variance and beta coefficient techniques, reflecting a growing acceptance on the part of real estate professionals to apply Modern Portfolio Theory (MPT) in the systematic analysis of their real estate portfolios.

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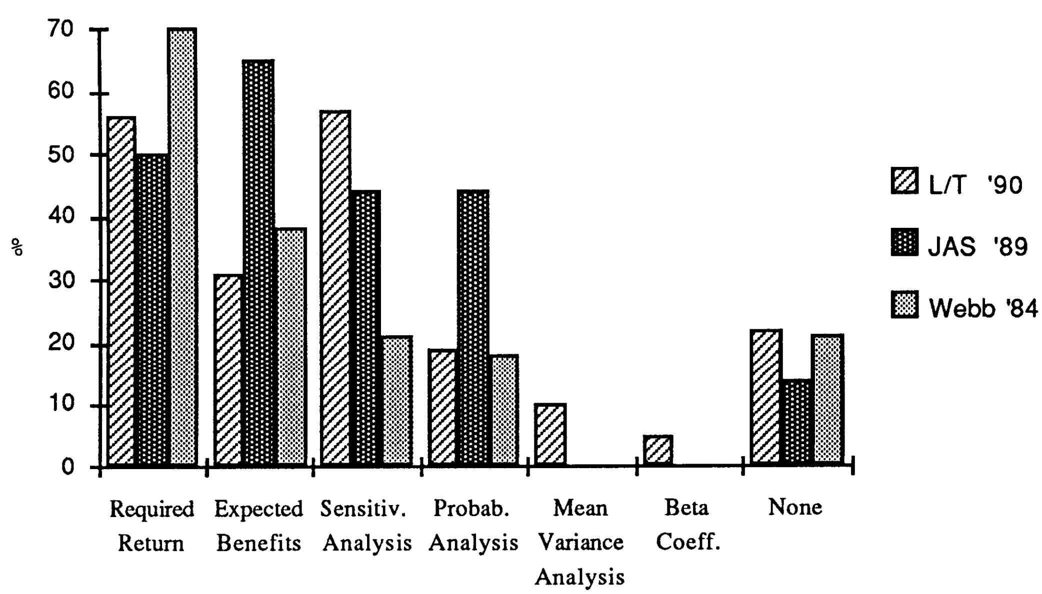
25 Webb, James R. "Real Estate Investment Acquisition Rules for Life Insurance Companies and Pension Funds: A Survey", American Real Estate and Urban Economics Association Journal, 12 (1984), pp. 495 - 520

This increased sophistication can be attributed, at least in part, to diversification requirements as laid out in ERISA, which set out new standards of fiduciary care for private pension plans.[26] Although a growing acceptance of MPT indicates that those respondents who use explicit diversification criteria are becoming more sophisticated in their approach, the percentage of respondents who use no risk-adjustment techniques has surprisingly stayed the same. Chart 7, Comparison of Risk Adjustment Techniques, shows the total percentage of respondents to each survey using each of the various risk adjustment methods always or sometimes.

Chart 7: Comparison of Risk Adjustment Techniques



26 Mean variance and beta coefficients were not included as categories in either the Webb or JAS study. I base my belief on their growing use on the assumption that their growing use is what warranted their inclusion in the Louargand study.

Approximately 65% of the Swedish pension and insurance respondents use between eleven and twenty years as the holding period for calculating investment returns. This is consistent with their investment objectives of long-term real returns on equity capital.

When looking at performance measures, 86% of the Swedish respondents utilized before-tax criteria. Only 14% (or two respondents) used after-tax information, reflecting the favorable tax postion of most pension and insurance companies in Sweden. Table 9, Performance Measures Preferred by Swedish Institutional Investors, shows preferences for the various measures as a percentage of respondents using before-tax criteria.

Table 9: Performance Measures Preferred by Swedish Institutional Investors

NOI/Initial Equity	67%
PV of Total Capital	67%
IRR on Total Capital	58%
IRR on Equity	50%
NOI/Price	50%
PV of Equity	42%
Equity Payback	33%
Price/Gross Rents	33%
BTCF/Initial Equity	25%

Compared to a study conducted by Webb in the early 1980's, Louargand & Taylor's study found that respondents using cash-on-cash and net present value as performance measures had dropped from 63% and 48%, to 44% and 11% respectively. Like Webb's study, Louargand's results showed a preference (60%) for internal rate of return (IRR). Just as beta coefficients and mean variances had been introduced as new categories in risk adjustment methods, more sophisticated performance measures were included, as well: partitioned IRR (2%), financial management rate of return (FMRR) (1%), risk-adjusted performance measure (4%), and annual holding period return (HPR) (10%).

The primary motive for Swedish pension and insurance companies investing in smaller cities was higher risk-adjusted regular returns, presumably to compensate for low current yields they obtain in metropolitan areas. Higher potential capital appreciation, diversification, and lack of metropolitan investment opportunities were less important reasons.

Respondents to the JAS study were asked how they searched for information supporting investment decisions in non-metropolitan areas. Of the 64% who said they were recent investors in smaller cities, 78% used their own market knowledge or that of local contacts. Appraisal reports with cash flow projections were used by 33% of the respondents, as were local development studies including information on property prices, economic structure, and population and incomes. Only 22% relied on consultant reports and none on intuition or feel of the market, unlike 20% of the property-holding and construction companies.

In evaluating their real estate holdings, JAS respondents relied most heavily on market valuations, both internally and externally generated. Table 10, Real Estate Portfolio Valuation Techniques, lists several valuation methods in descending order of preference.

Table 10: Real Estate Portfolio Valuation Techniques

Internal Market Valuation	71%
External Market Valuation	64%
Budget Feed-Back at Property Level	57%
Return Ratios	36%
Portfolio Review*	29%
Physical Inspections	21%

* Including identification of properties to be sold, readapted, renovated, etc.

When asked to describe their companies' property management and financial control systems, a surprising 79% of the Swedish respondents had complete internal property management, covering all technical and financial aspects, while only 14% hired external property managers. Table 11, Property Management Organization in Sweden, reflects some of the more common organization and control systems used by Swedish institutional investors in real estate.

Table 11: Property Management Organization in Sweden

Complete Internal Property Management		79%
Performance Feedback on Property		71%
Formal Plans for Each Property		50%
with time horizon of:	1 year	29%
	2 - 5 years	29%
	6+ years	7%
Manager Responsible for Each Property		36%
Management Partially Contracted Out		29%
Externally Hired Property Manager		14%

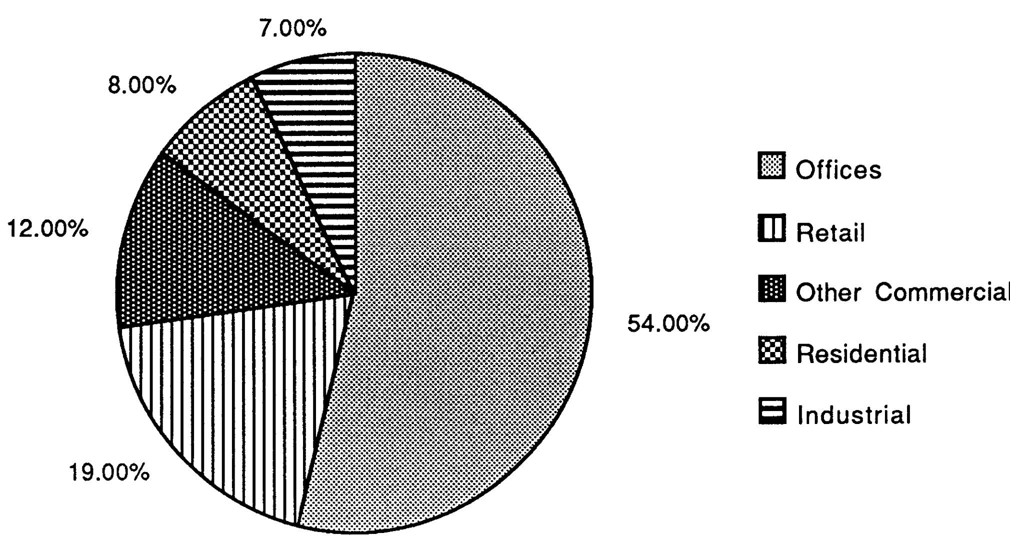
Following a formal comparison of American and Swedish surveys, the authors of the JAS study suggest that Sweden is far ahead of the United States in the area of property management. Although they attribute part of this to lower turnover rates in Sweden, they propose that property management in Sweden is a more fundamental part of real estate decision-making than in the United States. Although some of their findings might explain this conclusion, such as high expectations from capital appreciation as a contributor to total return, greater involvement in property management on the part of Swedish institutional investors might also be a function of differences in organization structures and the relatively small size of the country. Few and proximate markets, for example, actually encourage the adoption of in-house property management.

Skandia

The largest private insurer and owner of real estate in Sweden, Skandia's assets amounted to roughly SKr151 billion ($23 billion) at the end of 1990, with asset allocation objectives of 50% nominal and 50% real. Of the 50% real, their objective is to hold half in shares and half in real estate. As of 1990, SKr35 billion ($5.4 billion) or 23% of the portfolio was in real estate.

Also the largest developer in Sweden, Skandia undertakes nearly SKr1 billion ($154 million) in projects each year.[27] Chart 8, Skandia's Portfolio of Real Estate by Property Type, reflects a predominance of commercial and retail properties.

Chart 8: Skandia's Portfolio of Real Estate by Property Type



27 "Swedes Have a Way With Real Estate", Skandia informational brochure

The company's approach to real estate investment supports the theory that property management is a fundamental part of real estate decision-making in Sweden. Property is not a speculative investment and is valued by Skandia for three of its primary investment characteristics: 1) it serves as a hedge against inflation, 2) it is an asset that can be actively managed, and 3) it provides diversification for the overall portfolio. They invest in property to place their capital and generally have no interest in borrowing.

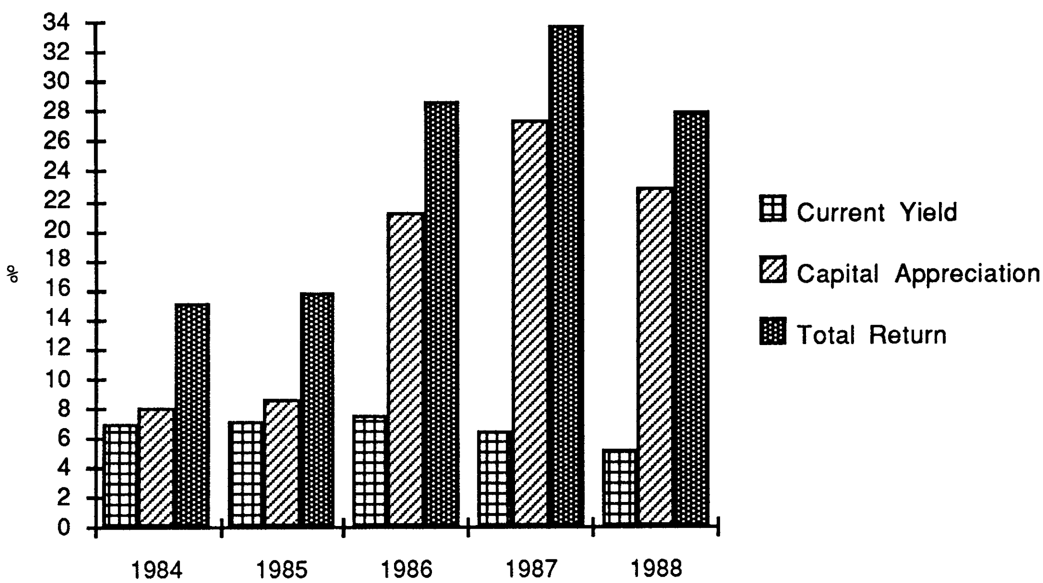
Skandia's strategy is to act as property owners, project developers and real estate managers, and to establish close working relationships with those they work with. They have in-house management for all domestic and international properties and are particularly interested in projects which offer potential for added value through renovation, expansion, or new construction. They prefer to invest direct so they can manage their own investment and learn the market.

Of their SKr35 billion combined real estate portfolio (of which 25% is held by the non-life company, and 75% by the life company) roughly SKr4.2 billion ($645 million) or 12% is in foreign real estate. These properties, located in London, Madrid, and Lisbon, were all purchased in 1989 and are mostly office and retail properties. Their policy for all future foreign real estate investment is to purchase well-located, top-quality, commercial property only. In the future, the company plans to reduce their holdings in Swedish real estate and will be working towards penetrating three main foreign markets: the U.K., France, and Germany. Within these countries, they have narrowed their focus to fifteen cities/regions which they chose because they were large, liquid, and self-contained markets.

Executives at Skandia have chosen to focus on the European market before venturing into the U.S. One reason is that they feel tougher European planning and zoning restrictions are more likely to protect their investments than the laxer U.S. restrictions. Furthermore, as part of the EC, they view Europe as their "home market" and feel that physical proximity and cultural similarities will make it easier for them to find their way in foreign property investment. They have chosen deep markets to justify the investment they intend to make in learning those markets and plan on setting up regional management offices.

Part of Skandia's general investment policy is to invest in currencies in which they have reserves and to match those reserves with investment assets. For their overall portfolio, they expect a total return of approximately 14%. Chart 9, Skandia's Real Estate Returns, reflects total real estate returns of nearly 30% before the acquisition of foreign real estate.[28]

<u>Chart 9: Skandia's Real Estate Returns</u>



However, by 1990, the total returns for the non-life and life companies' real estate portfolios had fallen to 3.85% and 5% respectively, of which current yield represented 1% in both portfolios. This dramatic plunge was attributed primarily to write-downs on property acquired in London the previous year and large development projects in Spain not yet generating returns.

28 In determining the capital appreciation portion of returns, Skandia uses the weighted average of three appraisal methods: market value, replacement cost, and capitalized cash flow. The last method is weighted most heavily.

How Are Institutional Investors in Other Countries Investing?

Although investor behavior in foreign real estate markets has been found to reflect their behavior at home,[29] some investment managers believe that the general investment patterns of European institutional investors are increasingly resembling U.S. and U.K. institutional investors as sophisticated portfolio management techniques reach the Continent. In The Netherlands, for example, a growing acceptance of equities and a greater receptiveness to asset allocation theory is attributed to a more thorough understanding of U.K. and U.S. research.[30]

If this is true, a comparison of the foregoing profile of Swedish investment patterns to the investment patterns of institutional investors in the United States and the U.K. would be insightful. An example of a Dutch instititutional investor, Shell Pension Fund Foundation, has been included for further perspective, primarily because they are widely recognized as one of the most sophisticated and innovative fund managers in Continental Europe. As European markets merge, the theory of market efficiency might indicate that other European fund managers will not lag far behind in adopting similar portfolio management techniques. Moreover,

29 Bacow, Lawrence S. The Internationalization of the U.S. Real Estate Industry, MIT's Center for Real Estate Development, WP #16, Section II, November 1988

30 Price, Margaret and Curtis Vosti "Dutch Funds Conquering Fear of Equities" Pensions & Investments, 17 September 1990

Shell's investment strategy will offer interesting contrast; their outlook for real estate investment in the U.S. differs markedly from that of the U.K.

Pension funds in the U.S. are adopting a very conservative attitude toward international real estate investment, even greater than they showed toward domestic real estate and international stock and bond investing in the early 1980s. One of the major reasons for their skepticism stems from their disappointment with the performance of domestic real estate in their portfolios. Relatively new players in the area of real estate investment,[31] pension funds had expected long-term returns substantially over the rate of inflation, yet in 1990, for example, only achieved a total return of 1.3% on domestic core real estate, according to the Russell-NCREIF index.

With this backdrop, real estate investment managers are not selling the virtues of international real estate to U.S. funds easily. As of May, 1991, only two of eight real estate money managers offering commingled international realty funds have signed any U.S. institutional clients. According to consultants Greenwich Associates, only 2% of 1,016 corporate pension funds and 3% of 310 public funds have any international real estate investments. And only another 2%

31 Investment in real estate by U.S. pension funds only took off in the early 1980's, partly in response to diversification requirements as laid out in ERISA.

of corporate funds and 4% of public funds have plans to start investing in international real estate.

This general disappointment with the performance of real estate has prompted some U.S. funds to reduce their allocations to this asset class. Eaton Corporation's $1.7 billion pension plan has reduced its real estate allocation from 15% - 20% to 2% - 3%. Southwestern Bell's $8.3 billion fund reduced its allocation to 8% - 9% from 10% in 1990.

Throughout the 1980's, U.S pension funds' real estate portfolios also changed considerably by property-type mix, reflecting, perhaps, a growing awareness of risk tolerance levels in the area of real estate. Table 12, U.S. Pension Fund Portfolios by Property Type, shows decreasing proportions of offices and hotels, in favor of retail property, multifamily and land.[32]

Table 12: U.S. Pension Fund Portfolios by Property Type

	1983	1989
Offices	50%	38%
Retail	20%	27%
Industrial	19%	19%
Hotels	6%	2%
Multifamily	3%	9%
Land	2%	5%

32 Roulac & Dimick, The Real Estate Finance Journal, p. 10, Winter 1991

Yet there are other reasons behind U.S. pension funds' reluctance to enter the international real estate market. According to a study conducted by the Roulac Consulting Group for the $62 billion California Public Employees' Retirement System unfamiliarity with investment environment, lack of knowledge of important investment networks and relationships, and concern about potential economic and political instability are three of the major deterrents shared by U.S. pension funds towards international real estate investment.

However, according to this study, due to the continuing globalization of the world's economy, diversification strategies will demand that portfolios more closely reflect the relative distribution of global wealth. Today, the California Public Employees Retirement System is actively pursuing the concept of international real estate investment. Although many pension plans will undoubtedly follow suit in the future, the poor experience they have had so far in the domestic market may encourage foreign real estate initiates to buy into funds.

British Coal

U.K. pension funds have had some of the best investment performance in the world, with an average real rate of return of 4.4% per annum over the past 15 years. In contrast with U.S. pension funds, they have had a long tradition of international real estate investment. However, like their

U.S. counterparts, some are currently following a strategy of disinvestment in the U.S. market. The pension fund for the British Coal Corp., with 13% of its $12 billion in assets allocated to real estate, is one example.

During the past two years, British Coal has been liquidating its $1 billion U.S. property portfolio that was invested through two New York-based real estate investment trusts. British Coal decided to sell its U.S. portfolio because it wanted more liquidity and because returns were disappointing. Although the U.S. investments did, in fact, have good overall returns, they were due to favorable currency movements, not intrinsic property performance.

According to CIN Properties, the real estate subsidiary for British Coal's pension fund, the only real estate investments they make in the future will be in the U.K., in spite of the opportunities in other European countries. Unlike some of the Swedish investors, their feeling is that the size and diversity of the European market will always work to the favor of local investors and that they can conduct much more business in the U.K. simply because they know their own market so well.[33]

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33 Williams, Terry "Realty Gets Mixed Reviews" Pensions & Investments, 30 April 1990

Their policy of disinvestment of U.S. property does not extend to other U.S. equity investments, such as stocks. This is consistent with the current U.S. preference for international equity investments to international real estate, equities being a tried and true investment at home.

Shell Pension Fund Foundation

Dutch institutional investors also share an interest in equity investments. But this phenomenon is relatively recent. Traditionally, Dutch pension funds held as much as 90% in fixed interest instruments. However, this has been changing since the 1980's when yields on government bonds dropped from 12% in 1981 to 6.5% in 1987. A 1990 survey conducted by Bank Mees & Hope N.V. in Amsterdam shows that, on average, Dutch funds target 20.3% equity allocations, up from an average 8.35% at the end of 1988.

The Shell Pension Fund Foundation, with assets of nearly $9 billion, is no newcomer to the equities scene. While other Dutch funds held less than 10% of their portfolios in shares in 1988, Shell held 28% in stocks and intends to significantly increase this in the future. Table 13, Shell Pension Fund's Investments by Asset Class, shows recent aggregate allocations compared to long-term targets.

Table 13: Shell Pension Fund's Investments by Asset Class

	1988	1989	Long-Term Target
Fixed-Income	58%	47%	20%
Stocks	28%	37%	50%
Real Estate	14%	15%	30%

Table 13 shows a remarkable 30% maximum allocation to real estate and a dramatic move away from bonds.[34] Where several Swedish institutional investors are looking to achieve a 50/50 mix of real and nominal assets in the next few years, Shell appears to be moving away from this profile towards an 80/20 mix. As illustrated in Table 14, U.K. Pension Fund Aggregate Asset Allcoations, this is more along the lines of U.K. pension funds, which held roughly 80% of their portfolios in real assets at the end of 1988 (as per the definitions at the beginning of the chapter).

Table 14: U.K. Pension Fund Aggregate Asset Allocations

	U.K. Pensions 1988
Fixed Income	14%
Stocks	69%
Real Estate	11%
Cash	6%

The Shell pension fund has a reputation for being amongst the most sophisticated and independent-minded

34 However, a 30% allocation to real estate is not an unusual strategy for Shell, having been as high as 40% in 1985. These allocation ceilings have never been reached.

institutional investors in Holland, standing somewhat apart from the other Dutch funds. According to Mr. J. A. de Kreij, General Manager of the fund, the fund's active liabilities are increasing at least as fast as increases in GNP. Therefore, his primary objectives are to narrow the gap between the development of liabilities and the development ofinvestments and to reduce the cost of incremental liabilities to plan sponsors.

This strategy is reflective of the kinds of efforts being made by European investment management firms and performance measurers to get pension funds to focus on performance as well as security as investment objectives. A simple calculation used by Frank Russell Consultants in London drives this point home. For every pound paid out by a British pension fund, approximately 21p comes from contributions and 79p from investment return. If the investment return were only 75p, the cost of contributions would increase from 21p to 25p. A portfolio limited to bonds might only yield 60p in investment return, requiring 40p in contributions. In this scenario, an employee might have to make double the contributions to receive the same benefits upon retirement.

For the fund's real estate investments, Mr. de Kreij expects a long-term real rate of return similar to stocks and significantly higher than that of bonds. In his view, real estate is attractive to the fund for three primary reasons. It is appreciated first for the stabilizing effect its low correlation with stocks has on the overall portfolio. Furthermore, real estate is viewed as a long-term investment and, mixed with stocks, helps the fund achieve a more efficient fit between its liabilities and investments. And lastly, Dutch schemes are required by law to achieve a minimum performance of 4% growth per annum. This, and the downside of not being able to meet disbursements, clearly makes a heavier weighting in equities too risky.[35]

A sister company in the U.S., Argus Realty Services, Inc., is Shell's real estate management and acquisition arm. All acquisitions are handled directly by Argus, who sometimes relies on outside advisors for specific services, such as marketing reports.

Traditionally, Shell has focused on a core real estate portfolio which met certain criteria. Within any one city, they want the best locations. Shell has had to develop over 70% of its properties in order to get the locations it has wanted. According to de Kreij, the size of their portfolio allows them to undertake this development risk. Furthermore, Shell wants to invest primarily in the property they know

35 Although it would appear that the effects of a real estate cycle could be equally devastating, presumably the low correlation between stocks and real estate will help assure return objectives.

best (office buildings) and intends to build on that strength worldwide.

One of the first Dutch pension funds to enter the U.S. real estate market in the 1970's, Shell currently has over half a million square feet of space under development in each of the following cities: Boston, New York, Atlanta, and Cincinnati. They believe there is no country in the world which better enables them to place the volume of funds they need to invest in high quality properties. Nonetheless, Shell holds no property in California for two reasons: earthquake risk and the unitary tax.[36] However, there was minimal damage to the newer, better-engineered buildings following the recent earthquake in San Francisco, and problems arising from the unitary tax have been resolved. As a consequence, Argus has recently been contemplating entering that market.[37]

Closing Remarks

In this chapter, I have tried to provide a general explanation of the investment patterns of some Swedish institutional investors. I have contrasted them with investment patterns of the Dutch, who are viewed as some of the most sophisticated and progressive investors in Europe, with the purpose of illustrating a possible direction Swedish

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36 The unitary tax taxed the worldwide operations of a company doing business in California.

37 Interview, Melba Eakin, Vice President & Commercial Manager, Argus Realty Services, Inc., New York, 11 July 1991

investment behavior may take in the future. U.S. and U.K. institutional investment profiles have been included because it is their research and investment practices which are, to a large extent, having the most influence on the patterns of European investment.

The next chapter will look at social and political trends and pressures which are likely to further shape the patterns of European investment.

CHAPTER FOUR - ECONOMIC & SOCIO-POLITICAL TRENDS

The uniting of the European markets in 1992, the "marketization" of Eastern Europe, and the growing momentum of Asian economies are creating an abundance of investment opportunities. These will undoubtedly be in direct competition with U.S. real estate in attracting foreign investors. Or will they be?

According to feedback I have received in various interviews, the Eastern European markets are still too thin to be attractive to institutional investors. One person believed that even the largest cities in Eastern Europe will have the equivalent depth of, say, a small city in America's mid-west for the foreseeable future.

Similarly, like their U.S. counterparts, most European institutional investors are not yet prepared to make a big splash in Asian real estate. Some markets, Tokyo, for example, have very high barriers to entry. Most, however, are avoided simply for the inherent risk stemming from a lack of information, political instability and shallowness of market. In Asia, the uncertainty and unfamiliarity confronting foreign investors spans several countries, requiring perhaps a greater educational and administrative process than is warranted by other better established markets, such as Europe and the U.S. Some institutional investors have found that investing in cities linked to Pacific Rim activity, such as Vancouver and Seattle, is an attractive alternative to Asian investment.[1]

Although unification of the European economies is unlikely to create an explosion of real estate opportunities, there are undeniably pressures which, combined with the effects of unification, will impact the investment patterns of European institutional investors and ultimately affect European placement of capital in U.S. real estate.

Two issues which are likely to shake the dust from conservative fund management policies are the aging of the European population and the deregulation of financial markets across Europe. Both phenomena will accelerate the transition to a more performance-oriented environment and thereby create a much more competitive climate in the area of fund management.

Aging Populations

As illustrated in Chart 10, % of Population Aged 65 or Older, future demographic developments in most Western countries will reflect a progressive aging of the population.[2]

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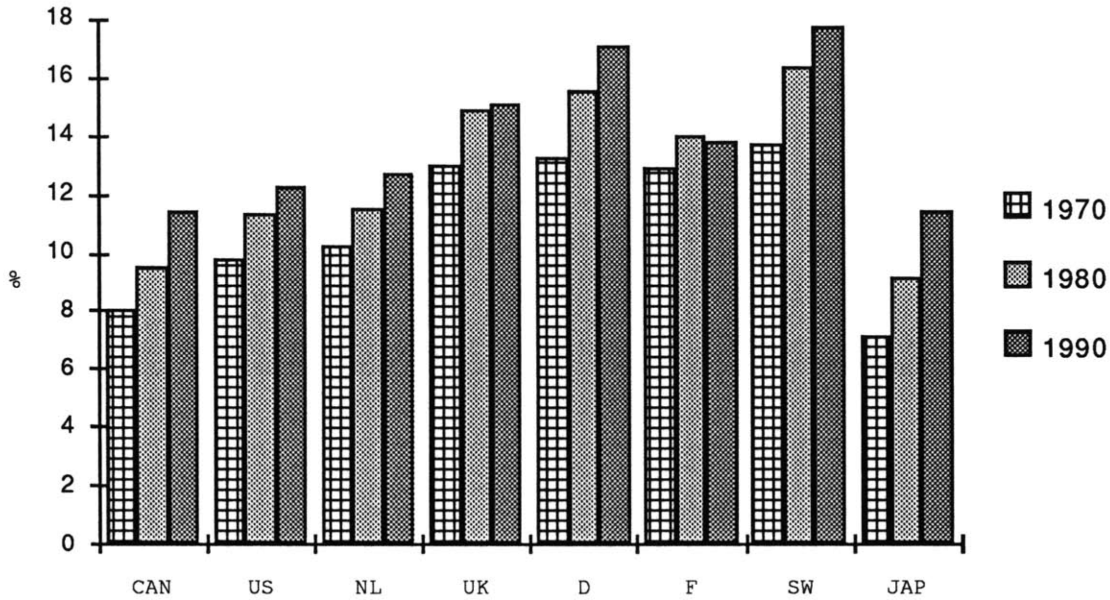
1 Williams, Terry "Dutch Fund Roars into World's Realty Markets" Pensions & Investments, p. 3, 25 June 1990

2 1990 percentages are forecasted.

Chart 10: % of Population Aged 65 or Older



Source: Organization for Economic Cooperation and Development, Ageing Populations, Paris, 1988

It can therefore be expected that the wealth of pension funds will increase and, at the same time, that their role in the capital market will strengthen.

A study was conducted in 1989 to show the influences of an ageing population on the capital market supply of pension funds over the long term. The analysis covered the period 1990 - 2025 and made use of an extended version of an economic and demographic computational model published in Huijser and Van Loo (1986).[3] The model served to project

3 The findings of this analysis, which are included in this paper, were summarized in the following citation: Huijser, A.P. "Capital Market Effects of the Ageing Population" European Economic Review 34 (1990) 987-1009 (North-Holland)

movements in benefits, premiums, and reserves for both State and supplementary pensions in the Netherlands, on the basis of alternative assumptions about economic growth, inflation, and interest rates. This study is of particular interest for the purposes of this paper because, like Sweden, the Netherlands is a small, open economy with an unfunded State pension system.

For a better understanding of the study, a brief comparison of the Dutch and Swedish pension systems precedes a discussion of the study's findings.[4]

Similar to Sweden, there are three basic categories of pension arrangements in The Netherlands[5]: the social security or State pension scheme, supplementary pensions, and individual arrangements. Unlike Sweden however, where State and supplementary pensions are both unfunded, only the State pension scheme is unfunded in The Netherlands, the supplementary system being funded.

As of 1987, State pension liabilities totalled Fl.24 billion ($12 billion),[6] or 6.3% of net national income. As illustrated in Table 15, Dutch State Pension Income &

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4 Unless otherwise noted, the information contained in this section was obtained from the following source: Huijser, A.P. "Capital Market Effects of the Ageing Population" European Economic Review, 34 (1990) 987-1009. (North Holland)

5 The population of The Netherlands is approximately 14 million, compared to Sweden's 8.5 million.

6 The symbol "Fl." is used to signify Dutch guilders.

Liabilities, between 1970 and 1987, premiums paid by all income earners have been more than sufficient to cover pension liabilities in most years. As mentioned in Chapter 2, this has not been the case in most recent years in Sweden.

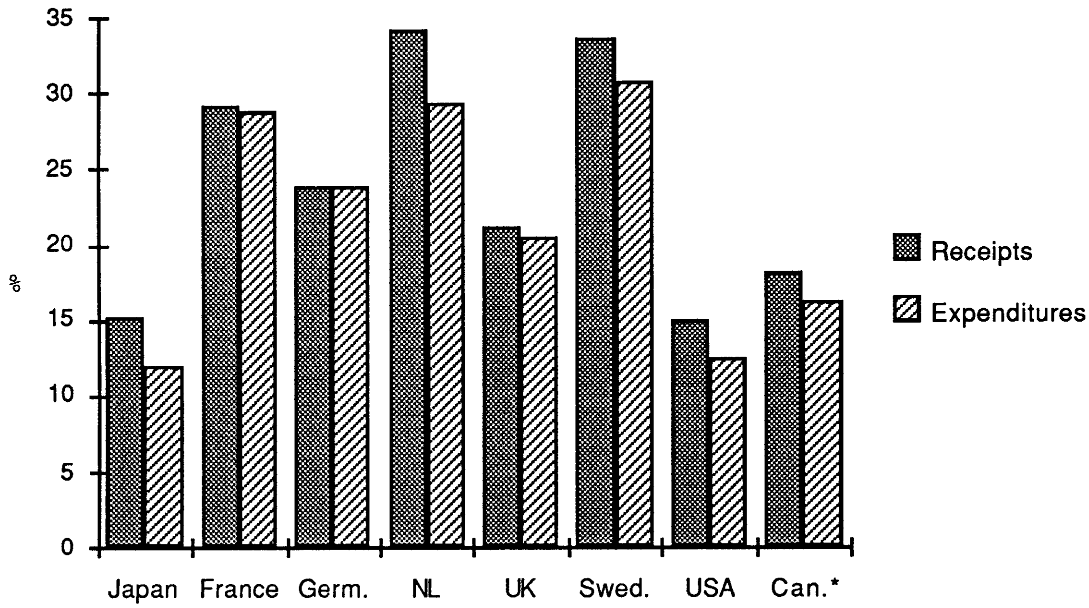
Table 15: Dutch State Pension Income & Liabilities
(in % of net national income)

	1970	1975	1980	1985	1987
Pensions Paid Out	4.7	5.8	6.3	6.1	6.3
Premiums Received	4.7	5.6	5.6	6.3	6.6
Public Grants	0.1	0.4	0.7	0	0
Interest Received	0	0	0.1	0	0
Surplus	0.1	0.2	0	0.2	0.3

For perspective, Chart 11, Receipts & Expenditures of Social Security Schemes as % of GDP, 1984 - 1986, shows that average expenditures on OASDI,[7] public assistance, government schemes and family allowances in Sweden and The Netherlands exceeded those of six other developed countries between 1984 and 1986.

7 old-age, survivors, and disability insurance

Chart 11: Average Receipts/Exenditures of Social Security as % GDP, 1984 - 1986



* Average for 1984 and 1985 only.
Source: International Labor Office, Geneva

In The Netherlands, an estimated 90% of employees participate in supplementary pension schemes. Most of these are compulsory and are regarded as supplementary income to the State pensions. In 1987, supplementary pension liabilities totalled roughly Fl.19 billion ($9.5 billion), or 5% of net national income.[8]

Two interesting points brought out in Table 16, Dutch Supplementary Pension Income & Liabilities, are that, between 1970 and 1987, an increase in investment income resulted in a proportionate decrease in required premiums, and that in 1987

8 Including State liabilities, total payout in 1987 was roughly $21.5 billion. This compares to Swedish State pension liabilities of SKr69 billion ($10.6 billion) in 1989, which then increased to SKr77 billion ($11.9 billion) in 1990, a 10.6% increase.

the financial surplus of supplementary pensions equalled almost half the domestic supply of capital.

Table 16: Dutch Supplementary Pension Income & Liabilities
(in % of net national income)

	1970	1975	1980	1985	1987
Suppl. Pensions Paid	2.2	2.8	2.9	3.5	3.9
Life Insur. Premiums	0.8	0.9	0.9	1.0	1.1
Premiums Received	5.5	6.6	6.2	4.9	4.7
Investment Income	1.9	2.8	4.1	6.1	6.5
Surplus	4.4	5.9	6.4	6.4	6.1
As % of domestic capital market	43	41	46	45	43

One of the first conclusions drawn from the study concerns the financing of the State old age pension. Under the basic scenario, the premium percentages required to meet liabilities in this unfunded system were found to increase from 11.9% in 1990 to almost 20% in 2025. Under different scenarios in which partial funding was applied and a real rate of return of 1.5% was assumed, it was possible to slow, but not eliminate, this increase in premium percentages. This illustrates that even a partially-funded system would be inadequate to keep pace with the increase in liabilities. Furthermore, this model does not consider the impact of an increased role of pension funds on the domestic capital market supply, of which pension fund surpluses already exceeded 43% in volume in 1987.[9]

The most significant finding of the study was that, as a result of the ageing of the population, the relative wealth of the pension funds would grow by 60% - 80%.[10] This increase, in tandem with the at least partial inflexibility of pension premiums, suggests that the capital market supply of pension funds may become more sensitive to the variability of interest rates and nominal economic growth. As a consequence, it is inevitable that the investment strategies of fund managers in a small economy like The Netherlands will take on a more international orientation. This is true because, even though the ageing population is a worldwide phenomenon,[11] differences in timing and magnitude will provide a greater diversity in supply and demand conditions than are available within a small domestic market.

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9 In 1969, Dutch employers and employees organizations adopted the principle that all employees with 40 years' service should receive 70% of their last salary from the old-age pension (basic plus supplementary). However, current discussions to reduce the cost of financing supplementary pension plans may change this norm. (Lutjens, Erik "The Legal Aspects of Dutch Supplementary Pension Plans" Benefits & Compensation International, p. 5, March 1990)

10 Huijser notes that this result depends on the relative level of pensions and on the choice of the actuarial interest rate. Nonetheless, according to the model, this 60-80% growth is not affected by assumptions about economic growth, inflation, or interest rates.

11 At least, it is safe to assert this for most developed countries.

Through a comparison of results of the basic and stationary scenarios,[12] Huijser found that, given the demographic development, the assumed nominal income growth was a dominant variable in determining the capital market supply of the pension funds over a long term perspective. From his simulations, he concluded that the long term role of pension funds would become more sensitive to short term economic conditions, while their structural supply of funds would depend primarily on the unpredictable development of nominal income growth.

Assuming Huijser's findings are accurate, they suggest that pension fund managers in countries affected by the ageing phenomenon will increasingly adopt performance-oriented investment policies. Despite many fund managers' disenchantment with equity investment following the crash of 1987, a performance-oriented strategy would further suggest an increasing role of equities within the aggregate asset allocation. If this is so, in order to take advantage of the stabilizing effects of real estate on a portfolio of shares, allocations to that asset class should increase as well.

12 In stationary scenarios, the influence of productivity, growth, and inflation is eliminated. Economic growth is wholly determined by population growth, labor participation, and unemployment.

Deregulatory Environment in Europe

Political expectations geared to 1992 are pressing deregulation forward both at the EC level and in the individual member countries, with a free flow of services between member countries as one of the primary objectives.

Banks and Insurance Companies

One effect deregulation will have within the financial industry is worth looking at more closely: an increasing number of mergers between banks and insurance companies. Mergers between banks and insurance companies are a natural outcome of deregulation as these institutions attempt to position themselves for survival as rules governing their operations are adapted to legislation in the EC area and the industries become more competitive.

In the area of insurance, for example, EC law makes a distinction between large risks and mass risks. Large risk refers to property and casualty insurance written for large industrial corporations. Mass risk refers to consumer insurance, like auto, home, and boat insurance. Since 1990, an insurance company that has been set up in one EC country has been permitted to insure large risks in another member country, without having to be licensed in that country. If adopted, current EC legislation will also remove most legal barriers in the field of non-life insurance.

Similar changes are underway in the banking sector. For example, a credit institution in the EC which is licensed to do business in its home country, will, in principle, be able to conduct all the banking activities for which it has permission at home throughout the EC. This means that all citizens and companies within the EC will have access to the same range of financial services.

As a result of these kinds of changes, both industries are undergoing restructuring within the EC. Alliances are being formed between companies in the various countries, and groups with both banking and insurance operations are being formed in an increasing number of countries.[13] Concepts for covering the insurance requirements of large industrial companies throughout the EC are being worked out.

During the past year in Sweden, a round of mergers has been set off by a proposal that would remove ownership barriers between banks and insurance companies. Increased financial resources would enable Swedish banks and insurance firms to protect their markets from outsiders as Sweden removes restrictions on financial operations by foreigners. As the proposals also remove ownership restrictions, enabling foreigners to take 20% voting control and 40% equity in Sweden's financial institutions, some banks and insurance

13 Skandia, for example, has formed alliances with Vesta in Norway and Storebrand in Denmark. (Kruse)

companies are banding together to reduce the possibility of foreign takeovers.[14]

For example, SPP, the white-collar worker's pension insurance fund, made a SKr4.6 billion bid for 44% of the voting control of Gota, the parent of Sweden's fourth largest commercial bank. In another transaction, SPP and Trygg-Hansa Life have co-ordinated their businesses under Trygg-Hansa Holding, in which SPP is an owner and has equal voting power as Trygg-Hansa Life. Sweden's largest bank, SE Banken, lured by the possibility of capturing a slice of the growing European market for pension and life insurance policies, made a SKr4.7 billion bid for 28% of the voting control in Skandia.[15]

These trends would suggest that an insurance company's expansion of business activity in foreign markets would be accompanied by a similar amplification of foreign liabilities. If it is true that most institutional investors try to balance the amount of investments they hold in a particular currency to the liabilities they carry in that

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14 Burton, John "Insurance Against Hard Times Ahead" Financial Times, p. 26, 2 November 1990

15 Nonetheless, scepticism persists that the mergers will not deliver the promised benefits. SPP could find, for instance, that minority shareholders in Gota, including SE Banken and other insurers, will block its use of the bank as an entrée into the private insurance market. Skandia officials feel that Skandia and SE Banken should concentrate on overseas expansion, since not enough money could be saved in Sweden to justify the cost of the acquisition. (Burton)

currency, this would also suggest that allocations to foreign real estate by institutional investors will increase.

Pension Funds

Other ambitious EC objectives include freedom of cross-border participation in supplementary pension schemes and free competition for fund managers. In The Netherlands, for example, pension funds are not required to have a license to provide services. According to an EC condition of equal treatment of pension funds domiciled in The Netherlands and pension funds domiciled in other EC countries,[16] it follows that the licensing requirement may not be imposed on pension funds domiciled elsewhere in the EC either. The pension funds domiciled in other EC countries are therefore free to provide services in The Netherlands regardless of whether they have an office there.

All told, there are over fifty different EC measures influencing pensions and employee benefits in the community, including directives governing financial services, free movement, company law, and taxation.[17] A community-wide

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16 According to a European Court of Justice decision taken on 4 December 1986, it is permissible to make the provision of insurance services dependent on the granting of a licence by the member state in which the services are to be performed, provided that the licensing requirement· applies equally to national insurance companies and insurance companies located in another EC member state. (European Court Reports, 1986, p. 3791)

17 In the area of fund management, there has been speculation that the European Court will rule on asset allocation policies in the future. This could benefit some institutions, such as the Dutch fund ABP, which is currently restricted by law to an asset allocation ratio of 85% nominal, 15% real. (Rompelman)

scheme has even been discussed. However, the problems relating to transferability in all cross-border proposals are so complex, they dwarf any differences in national pension structures and investment policies.[18]

The personal pension plan, already popular in the U.K., would solve many of the questions of transferability, as it is not tied to a company. As yet, this idea has not taken hold on the Continent. Furthermore, although personal plans are appealing to financial institutions and many employees, those with vested interests in existing systems are likely to resist change.[19]

As confidence in State pension systems in Europe wane, for reasons including those discussed earlier, another emerging trend is increasing demand for private pension schemes. The U.K. private pension industry, more mature than those in other European countries, is perhaps a bell-wether for the future direction of the Continental private pension industry. In the past twenty years, the U.K. has witnessed a proliferation of private schemes and a tremendous growth in pension fund assets. This has been accompanied by similar growth in investment management companies, benefit

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18 Euromoney, July 1990

19 ibid.

consultants, performance measurers, and asset allocation advisers.[20]

Conclusions

Following are several conclusions which can be drawn from the body of this chapter:

1) As populations age in most Western countries, the coffers of State pensions will accumulate significantly larger amounts of funds which will need to be invested.

2) As State pension systems are strained, beneficiaries will look for alternative ways to protect their retirement pay and larger amounts of money will flow to privately insured pensions.

3) As funded and partially funded State pension systems (and even unfunded systems protected by a buffer fund, such as Sweden's AP) increase their premium rates to keep pace with pension liabilities, they will be pressured to maximize investment income.

4) As demand increases for private schemes and market barriers are torn down, the marketing efforts of insurers will have to focus on the performance of their funds.

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20 Beavan, Benefits & Compensation International, May 1990

5) As European fund managers place more emphasis on performance as an investment objective, they will become more sophisticated in their investment practices. MPT will have a growing influence on aggregate asset allocation, causing the disparity between European fund management behavior and U.K. and U.S. behavior to narrow.

6) An increasingly open market would suggest greater market efficiency, a force which would further level any dissimilarities in investment behavior.

7) There will be increased interest in foreign investment as European institutions:

a. seek to place a growing amount of capital as domestic opportunities become scarcer
b. adopt more sophisticated portfolio management techniques and seek wider diversification of risk
c. endeavor to match their investments to growing foreign liabilities

CHAPTER FIVE - THE OUTLOOK

Although the consequences of such issues as an aging population, a weakening State pension system, and a growing sophistication in portfolio management strongly suggest that Swedish institutional investors will significantly increase their investments in foreign real estate, it is not a foregone conclusion that they will have any great presence in the United States during the next three to five years.

This is so for a number of reasons. First of all, the effects of the aging phenomenon as described by Huijser and the impact that a perceived weakening of the State pension system will have on the demand of private schemes probably will not be felt with any real significance for many years. Therefore, there will not be an immediate and inordinate swelling of State and private pension funds in Sweden, nor the concurrent surge of new capital into foreign markets that might be expected.

Growing investor sophistication, on the other hand, probably will have a significant impact on the aggregate asset allocation of Swedish institutional investors in the next five years. As they have been deregulated, these investors have increasingly shifted into international equities and real estate for the diversification attributes they bring to a portfolio of investments.

However, most Swedish institutional investors view the next several years as teething years in foreign real estate investment. Furthermore, as EC deregulatory measures are exercised, Swedish insurance companies will be largely preoccupied with strengthening and expanding their presence in Europe. With their focus so oriented, it is possible that Europe, the "home market", will be the major recipient of Sweden's allocations to foreign real estate during the next five years.

Yet, it is not enough to consider what is happening in Sweden's "home market" in contemplating to what extent they may invest in U.S. real estate in the coming few years. For a more complete picture, it is worthwhile considering if some of the reasons foreigners have traditionally invested in U.S. real estate, as summarized in the first chapter, carry the same weight today with Swedish institutional investors.

There is evidence, for example, that high property returns in the U.S. are being seriously challenged by returns on European properties. Although total returns on U.S. office space, a staple of foreign institutional investors, averaged 15% between 1981 and 1986, that average dropped to 1% between 1987 and 1990. As mentioned earlier, British Coal found that, in recent years, the high returns on U.S. real estate investments had more to do with favorable exchange rates than the intrinsic performance of U.S. property.

The results from a recent study of seven major European property markets would suggest that European markets are much healthier than U.S. markets. Table 17, U.S. Total Property Returns -vs- European Real Property Returns, contrasts the findings of that study with performance data provided by the Russell-NCREIF Property Index.[1]

Table 17: U.S. Total Property Returns -vs- European Real Property Returns

	Total Return U.S. Office	Total Return U.S. Retail	Real Return Europe
Last 5 Years	1.6%	10.5%	16.2%
Last 10 Years	7.2%	11.4%	12.5%

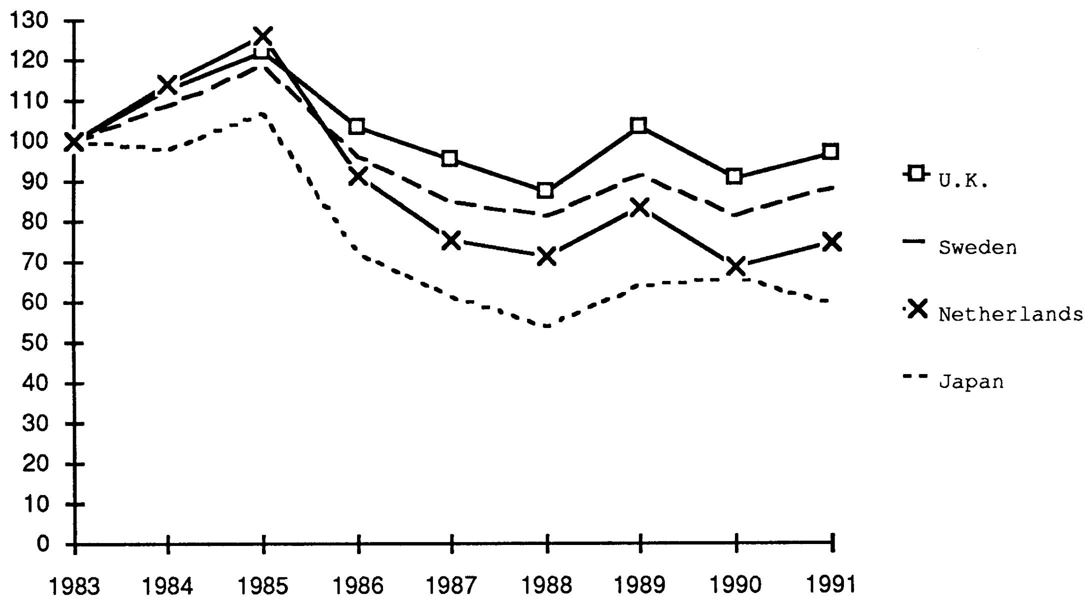
Although the decline in the value of the dollar against most currencies in the 1980's made the value of dollar-denominated assets appear low, the value of the dollar has more or less stabilized since 1988. Therefore, although U.S. real estate may still be comparatively inexpensive, it may have as much to do with over-supply factors as exchange rates. In fact, according to at least one pension advisor, the recent strengthening of the dollar has caused some prospective foreign investors to consider transacting only when rates are more favorable.

Chart 12, Devaluation of the Dollar Against Other Currencies, indexes each of the graphed currencies to a

1 Gelbtuch, Howard C. "The London Office Market" The Appraisal Journal, p. 29, Vol. LIX, Number 1, January 1991

benchmark of 100 in 1983 and plots subsequent changes in value of the dollar against those currencies.[2] By 1991, the index value of the British pound is 97 and that of the Swedish krona 88, reflecting significantly less gain on the dollar than the Japanese yen or Dutch guilder over this time period.

Chart 12: Devaluation of the Dollar Against Other Currencies



Another consideration when investing in foreign currencies is exchange risk. Japanese who invested in U.S. property in the early 1980's, for example, have seen the value of any capital gains they may wish to repatriate in 1991 fall by nearly 40% against their own currency. Since May, 1991, the Swedish krona has been linked to the European Currency Unit (ecu). The future replacement of all existing

2 The Economist, various issues

EC currencies by the ecu would suggest less exchange risk for Swedish investments within the EC.

The size and depth of the U.S. market has ensured liquidity for foreign investors in the past. However, compared to the mid 1980's, this phenomenon is less evident today. As a result of a variety of factors, including changing financial markets, an increased presence of institutional investors in U.S. real estate, and favorable tax codes, most U.S. markets are oversupplied. While office space under construction in the U.S. at the beginning of 1990 equalled approximately 4.5% of existing inventory, the same figure for Europe was only 2%. Furthermore, unlike the United States, prime space is not readily available in most European markets, causing an upward pressure on rents. Table 18, Summary of U.S. & European Office Markets, December 1989, reflects higher average rents and lower vacancies in European markets.[3]

Table 18: Summary of U.S. & European Office Markets, December 1989

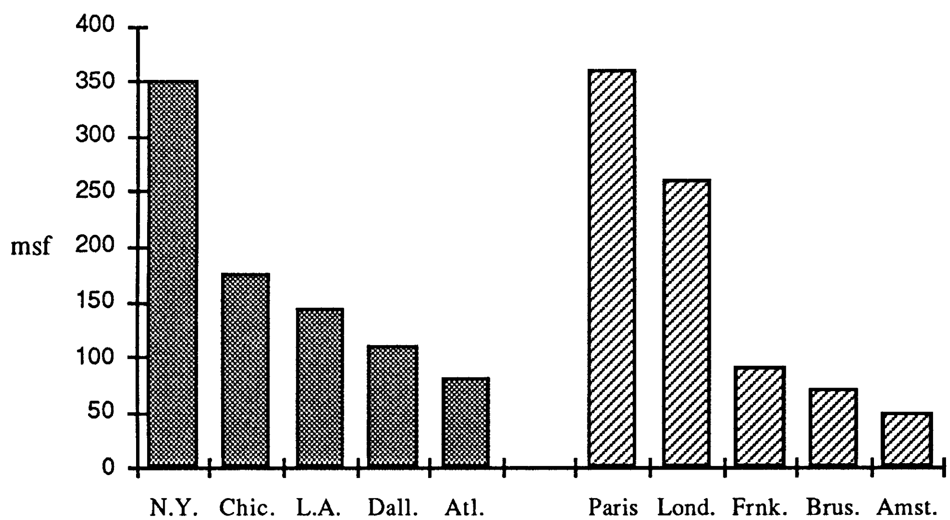
	Market Size (msf)	Constr. (msf)	Vacancy	Absorption 1989	Change from 1988	Avg. Rent p.s.f. (US$)
Europe	1,492	29.2	2.5%	18.3%	+3.4%	$36.63
United States	2,549	111.0	19.5%	70.0%	+0.4%	$21.70

Although commercial properties tend not to transact as frequently in Europe as they do in the U.S., which creates a

3 Gelbtuch The Appraisal Journal, 1991

less liquid market, the sizes of many of the individual markets are comparable to those in the U.S.. Chart 13, U.S. & European Office Markets, reflects similarities in the approximate sizes of eight U.S. and European office markets, in millions of square feet.[4]

Chart 13: U.S. & European Office Markets



Inflation in the U.S. has averaged 4.8% over the past three years, almost half Sweden's 8.9%. Assuming equal performance of property in Sweden and the U.S., this suggests the opportunity for higher real returns in the U.S. (At the same time, however, for Swedish institutional investors with a predominance of fixed-income investments, it could be argued that investing in inflation-linked assets in an economy with almost half the rate of inflation to which the

4 European and New York data from Pensions & Investments, 29 April 1991. Other U.S. data from Roulac Group. These numbers are intended to roughly convey the relative sizes of some European and U.S. office markets. It is not known to what extent fringe markets have been included in tabulating square footages in each of these markets.

institution's liabilities are tied might yield only half the hedging benefit for the overall portfolio.) Such would be the case for the AP Fund, for example, which is only entitled to allocate 5% of the entire portfolio to real estate and none to stocks. This point would be moot, however, for some of the large Swedish insurance companies seeking to match investments with their U.S. liabilities.

According to the current U.S. tax laws, foreign tax-exempt investors are exempt from taxes in the U.S. on interest income earned on bank deposits. To be exempt from taxes on any other interest earned, the interest must either be treated as portfolio interest or be sheltered through a tax treaty between the home country of the investor and the United States. Non-sheltered income from equity investments (rental income, dividends, capital gains, etc.) is taxable at the prevailing U.S. corporate rates.

If a loan is made to an organization in which the foreign tax-exempt lender holds more than 10% of the equity, interest earned is not classified as portfolio interest and the lender is subject to a maximum 30% withholding tax on this income. A U.S. treaty with Japan has reduced this tax to a maximum of 10%. U.S. treaties with the U.K., The Netherlands, and Sweden, however, have eliminated the withholding tax completely.

Not surprisingly, many foreign investors have found ways to further reduce their U.S. tax liabilities, through thin capitalization and equity-kickers, for example. Yet, the U.S. tax code is a wild card in U.S. real estate investment. Although there are no pending bills in Congress to change these regulations, history shows a tendency to revise the tax code every few years.

Alhough a snapshot of the U.S. real estate market today is grim, Swedish institutions are interested in the long-term benefits of real estate investment and may share the attitude of many Dutch institutional investors, which is "no market is a good market forever". The investment strategy of many foreign institutional investors generally cuts across cycles and, if anything, regards cyclical troughs as providers of opportunity. If this is true of Swedish institutional investors, we should expect to see their growing influence in U.S. real estate investment during the next five years.

Working With Swedish Institutional Investors

So far, Swedish institutional investors have really only made inroads into international real estate investment in Europe and, like in Sweden, have shown a propensity for controlling as much of the development/ownership process as possible. Less than a year after exchange-control restrictions were relaxed in 1989, Trygg-Hansa's Investment Division established an office in London specifically to monitor developments in that market and oversee its growing portfolio of investments. Reflecting a similar desire for control, Skandia prefers direct investment in Europe and intends to establish in-house property management expertise for its European holdings through a network of regional management offices.

However, neither company believes it understands the U.S. market well enough to follow similar strategies here. Both Trygg-Hansa and Skandia have indicated that any ventures into U.S. real estate would be pursued with a well-established local partner and that, at least initially, property management services would be purchased locally.

I would conclude that, disregarding tax implications and speaking from a Swedish perspective only, a general partnership would provide the appropriate framework for a working relationship between Swedish institutional investors and interested U.S. parties. From the Swedish standpoint, this would allow them to add value through a higher degree of participation and, at the same time, to learn the U.S. market firsthand.

If the main reason that European real estate markets will be more attractive to Swedish institutions in the next five years is because the Swedes are more familiar with those markets, prospective U.S. partners could facilitate and even encourage investment in U.S. real estate by making both the investment process and U.S. market behavior as familiar and unambiguous as possible. Bearing the profile of this investor group in mind, interested U.S. parties could, for example, organize a series of educational seminars through the help of real estate professionals at the Royal Institute of Technology in Stockholm. An initial approach such as this would be effective in establishing the foundations for the kind of good-faith relationship sought by developers and investors in real estate on both sides of the Atlantic.

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