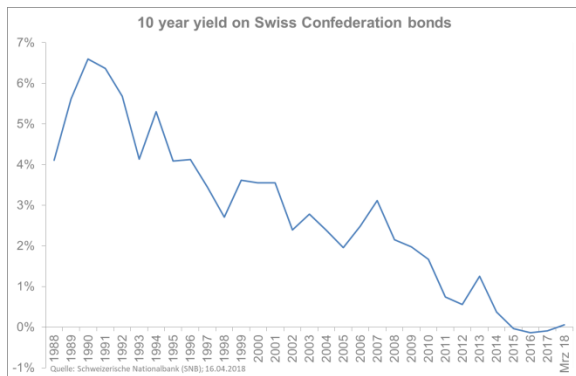


Considerations for Swiss pension funds investing in renewable energy

Swiss Pension funds are troubled with an investment dilemma. Generating an adequate return under the premise of low risk had traditionally been achieved by investing in bonds. Yet, nowadays even long-term government bonds yield a zero return. Higher returns however are not the only one reason why more and more pension funds are deploying capital in renewables.

Where to put the money?

Unprecedentedly low-interest rates are taking a toll on the attractiveness of conventional investment opportunities. 10-year Swiss federal bonds, for instance, currently offer a nominal return close to zero.



Not only bonds but also real estate and stocks became **more expensive**. According to the *UBS Swiss Real Estate Bubble Index*, the Swiss real estate market is at high risk. And looking at stocks, we see Shiller P/Es at record highs implying negative future returns.

As positive as this increase in prices may have been, the question arises, of how an adequate return under the premise of low risk can be achieved in the future. At the same time, the regulatory minimum rate of return for pension funds

is at 1.0%, which increases the pressure on the search for alternatives.

Arguably, investing in the energy transition might be a solution. Just like all other infrastructure investments, renewable energies require *long-term* capital.

Bank financing in this case is not the perfect fit as banks are more troubled by **term transformation** today, due to stricter and more sustainable regulation. This reduces their ability to lend money long-term that can be withdrawn at short notice. Pension funds on the other hand can better predict the short term cash outflows (retirement pay) and are in a better position for long-term investments.

Should pension funds invest in the energy transition?

Investing in the energy transition is **attractive**. The returns on equity in Swiss real estate are at roughly 4%. Wind farms with a fixed feed-in-tariff in contrast yield a return of approximately 5% in CHF. Considering the risk from real estate's terminal value after a 20 year investment period we estimate the risks of both asset classes to be roughly comparable. Furthermore, wind farms include chances of appreciation, as this asset class becomes more common and the illiquidity premium erodes.

Unfortunately, investments in the energy industry are very heterogeneous. Risks lurk in technology, regulation, market and financing. In addition the lack of pricing by a liquid market asks for due diligence. Some past infrastructure transactions proof the case. Obviously profound industry knowledge is the key to success.

Swiss Regulation allows pension funds to directly invest in capital companies in the infrastructure segment. Infrastructure assets are classified as alternative investments and per default they are limited to a percentage of the total portfolio. A deviation from this guideline however is possible.

Regarding diversification infrastructure investments are attractive to most portfolios. Globalization has decreased the effects of **geographical diversification**. The Asia financial crisis impacted Europe and European Banks were rescued due to the price collapse of American real estate. Therefore, diversification through investments in different sectors needs to be forced. Especially, because a crisis in the near term could not be fended off by lowering interest rates. Investments in the energy transition appeal with low correlation to the financial market, which stabilizes pension funds in addition to attractive returns.

Funds or direct investments?

Industry knowledge is crucial for the efficient utilization of the presented benefits. Small and medium-sized pension funds typically invest via funds to access this know-how. For this purpose and based on our experience we can recommend for example KGAL Group, with its 50 year track record in the industry.

Larger pension funds should think about **direct investments** to reduce the principal agent problem – maybe in cooperation with other pension funds. Investing in the necessary know-how is going to pay-off through higher returns.

Conclusion

For Swiss pension funds, investments in the energy transition are financially attractive. They do not only contribute to a stable and sustainable pension, but also to a sustainable environmental future. When considering investing in this field, the following aspects are crucial:

- 1) The standalone risk-return-profile of many clean energy investments is attractive in itself. From a portfolio management point of view, the attractiveness further increases, because of its diversifying nature. Additionally, the long-term investment horizon fits the investment horizon of pension funds.
- 2) The Swiss regulatory classification as “alternative asset” may appear daunting. However the regulatory framework allows also Pension funds to invest in this asset class.
- 3) Profound industry knowledge is the key to success. Investment funds are the best choice for small- and medium-sized pension funds. Large pension funds should think about investing on their own in order to diminish the principal-agent problem.

About the author



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