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Investment assets totalled EUR 194.7 billion at the end of March 2017

At the end of March, the total net amount of assets put into funds by earnings-related pension insurers came to EUR 194.7 billion. The amount increased by EUR 6.2 billion when compared against the situation at the end of year 2016. Our analyst **Peter Halonen** has drawn up the following analysis on the amount and allocation of investment assets at the end of March 2017.

Halonen’s analysis comprises the following sections:

- Overview - amendments to legislation
- The year started out on a positive note both in the real economy and on financial markets
- Investment returns itemized
- Changes in the calculation of pension insurers’ solvency
- Duration and Open currency position
- The investment portfolio rose again – net investment assets EUR 194.7 billion
- No major changes in the shares of various types of investment
  - A downturn for bonds and convertible bonds
  - The portfolio of quoted shares (incl. funds) rose together with other investments in equities
- The shares of investments in Finland and outside the euro area increased
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1. Overview - amendments to legislation

The investment year 2017 got off to a strong start in the first quarter, when net investment assets increased by EUR 6.2 billion. For pension insurers, the average rate of return on investments during the first three months was 2.7 per cent in nominal terms and slightly greater, or 2.8 per cent, in real terms.

The first quarter was characterized by optimism on markets, as expectations of economic growth kept rising globally. Apart from economic growth, positive figures regarding employment, inflation and corporate profits were obtained from the real economy of various continents. The indicators measuring confidence among various economic actors have also risen over a wide front. Above all, optimism was reflected as a favourable trend on the stock market.

On the other hand, the first months of the year were characterized by political risks on both sides of the Atlantic. Whether the major central banks will take measures to tighten monetary policy this year has also been a topic of discussion. Events on the financial market during the first quarter are described in more detail in section 2.

In total, pension assets rose to EUR 194.7 billion. Private-sector pension insurers accounted for EUR 121.9 billion of this sum, while the remaining EUR 72.8 billion was administered by public-sector pension insurers. The rise in pension assets was mainly attributable to an increase in investments in equities and equity-like instruments. Last year was the first time when the share of this investment category exceeded 50 per cent of all investment assets. At the end of March, the share was 51 per cent. The share of real estate investments rose slightly, while the share of fixed-income investments declined.

However, at the same time, pension assets were weighed down by the fact that the pensions paid out from the funds and their returns exceeded the pension contributions collected into the system. For instance, according to data for 2016, the entire pension sector collected EUR 2.4 billion of pension contributions into funds, while disbursements from the funds totalled EUR 3.6 billion. Thus, the net sum used for pensions from funds and their returns came to EUR 1.2 billion. In the coming years, the increased assets will be used ever more widely to meet the continually rising pension costs. On the other hand, good returns help reduce the pressure to raise pension contributions.

In other words, despite the record-high pension assets, there will be more and more uses for all assets. Finland’s economic growth and employment trend are also crucial for the sustainability of the pension system. They determine how much of the assets needed for financing pensions is obtained from pension contributions.

The trend of returns on pension asset investments should be examined over the long term; not too much weight should be given to changes during one quarter – or even during one year.

The medium-term and long-term returns realized for the whole sector are listed below:

- 2012–2016: nominal 7.2 and real return 6.1 per cent
- 2007–2016: nominal 4.5 and real return 2.8 per cent
- 1997–2016: nominal 5.9 and real return 4.3 per cent

A point worth noting in the analysis of returns is that past returns cannot be used to predict future returns. Secondly, as indicated by the figures, the returns differ from each other depending on which period is selected for the examination.

Pension insurers’ solvency has remained strong. Owing to these buffers meant for rainy days, pension insurers are able to withstand occasional worse times on the financial market – thanks to good historical returns. A solvency reform concerning private-sector operators that takes account of investment risks more widely than before entered into force at the start of the current year. This topic is discussed in more detail in section 4.

The amendments to legislation also changed how the weight of the equity-linked proportion is calculated in the return requirement. The weight is raised gradually first at the start of the current year (15 per cent) and thereafter again at the start of 2018 (20 per cent). The increase in the weight shifts the risk associated with equities more from private actors to the level of the whole system. In consequence, pension insurers can raise the risk level of the portfolio by increasing the proportion of equity investments. In practice, this means that pension insurers have the option of increasing the share of equity-type investments up to 65 per cent of the total amount of their investments, provided that the pension insurer's own solvency allows this. Further information on the equity-linked buffer is available on our page Calculation of technical provisions.

The investment analysis has been revised slightly since the previous time. We have added a new section that describes a few figures illustrating the risks involved in investment portfolios. In addition, the first three analyses of the year will be slightly more concise in certain parts than the final analysis of the year. Our intention in implementing these changes is to make the analysis more reader-friendly.

2. The year started out on a positive note both in the real economy and on financial markets

The first quarter of the year continued the favourable trend of the previous year's last quarter, as returns were received on a wide front from different types of assets. The most successful investment category was quoted shares.

Markets have been fairly optimistic lately. The optimism is boosted, above all, by the positive changes in the real economy, as economic figures reported from the various continents have been highly encouraging for instance in terms of economic growth, employment and inflation. Alongside higher inflation, the interest rates of fixed-income investments have also risen from the low ebb of last year. Other factors creating optimism include the increase in corporate profits, consumers' broad belief in the future, and the fact that the major central banks have – at least so far – pursued an easy monetary policy.

Various research institutes have raised their forecasts for future economic growth. For example, the International Monetary Fund IMF predicted in its World Economic Outlook Update in January that the world economy would grow by 3.4 per cent in 2017. Owing to the improved expectations, the report published in April raised the forecast by 0.1 percentage points, to 3.5 per cent. Last year, global economic growth reached 3.1 per cent.

According to the IMF, most economic growth will come from emerging and developing economies, such as China and India. Nevertheless, developed countries, such as the United States, will also contribute to global economic growth. The faster-than-expected growth of the economy has already been evident, and will probably also continue to be evident, in corporate profits. In part, this was reflected in the first quarter as higher stock prices.

It is also essential for the Finnish pension system that positive signals have been obtained from the real economy in Finland, for instance as concerns employment figures. Moreover, confidence indicators measuring various economic actors' belief in the future have risen.

Future risks exist, too. Concerns during the first quarter focused on politics and political actors – especially the French presidential election. Political uncertainty will continue in Europe as new elections will take place, for instance in Italy. In addition, the Brexit negotiations are just getting into full swing. The indebtedness of the world economy, the weak financial standing of some European banks and the future direction of the central banks' monetary policy give cause for concern on the market.

On the other hand, it may also be asked whether markets have been too optimistic with regard to President Donald Trump: Will he be able, with the support of the Republican Party, to implement the stimulating fiscal policy that he has talked about? Will it work in the desired way? And how will Trump's protectionist ideas be realized? So far, however, it seems that the market expectations with regard to the impact of Trump's economic policy on economic growth in the United States will remain positive despite the above-mentioned uncertainty factors pertaining to his actions.

What is certain is that pension insurers will have to keep relying on the most important guideline in investments: productivity and security. However, pension insurers have very good solvency, which is why they can withstand occasional market fluctuations. The long-time span of investment and the diversification of assets invested, i.e. good risk management, play a key role now and in the future.

3. Investment returns itemized

Each quarter, our seven largest members – the five largest pension insurance companies and the two largest pension insurers in the public sector – report on the breakdown of their investments and on their returns voluntarily and in keeping with the same principles. When combined, their assets account for about 94 per cent of all earnings-related pension assets. The reporting takes place in so-called return-risk tables. Using consistent principles independent of the return-risk tables, all our members report their returns semi-annually, at the end of June and December.

Mathematically, the nominal mean return on investments for the seven largest authorized pension providers came to approximately 2.7 per cent. The real return on capital employed was 2.8 per cent. The real return was slightly better than the nominal return because the index value of the consumer price index collected by Statistics Finland was smaller in March 2017 than in December 2016.

For the five largest private-sector actors, the mean rate of return on investments was 2.5 per cent in nominal terms and 2.6 per cent in real terms.

Correspondingly, the mean rates of return for the two largest public-sector actors were nominally about 3.0 and in real terms 3.1 per cent.

When making comparisons, it is good to remember that requirements for solvency have only been laid down for private-sector pension providers. In the public sector, decision-making bodies guide investment activities by setting allocation limits for each investment category. Changes in currency exchange rates also have an impact on returns and on differences between them.

For all seven authorized pension providers that reported their return data, investments in equities yielded the best returns during the first quarter. The returns by investment type were as follows:

- The returns on equity investments ranged between 4.3 and 5.8 per cent. Among equity investments, quoted shares, in particular, benefited from the rising stock market prices.
- Fixed-income investments and real estate investments yielded fairly steady rates of return for the various pension providers. For fixed-income investments, the range of returns was between 0.8 and 1.5 per cent.
- For real estate investments, the returns ranged from -0.2 to 2.1 per cent.

The long-term and medium-term rates of return were presented above in section 1.

4. Changes in the calculation of pension insurers' solvency

Some changes were made to the calculation of pension insurers' solvency as of the start of 2017. The changes in the calculation had an effect on the solvency ratio and solvency position, which are calculated using the solvency limit. The new calculation model considers a wider range of risks associated with investments. The presentation of the solvency ratio also changed: from now on, the solvency capital is calculated by dividing pension assets by technical provisions.

Earnings-related pension providers in the private sector must meet statutory solvency requirements. The solvency of pension providers was strong at the end of March. This reflects good preparation for potential uncertainties on the financial market. The solvency ratio describes a company's risk-bearing capacity. The solvency ratio is obtained by dividing the pension assets by technical reserves.

The solvency ratios of the five largest pension insurance companies, calculated according to the new formula, ranged between 116.4 and 130.8 per cent at the end of March. At the end of 2016, the corresponding range was wider, or between 15.4 and 30.9 per cent, when calculated using the old formula. However, on average, the solvency ratios increased slightly during the first quarter of 2017. In the same way as in the previous quarters, this is because of the good returns on equities. The express purpose of solvency capital is to serve as a buffer for the varying returns on investments.

At the end of March, the solvency position of the five largest pension insurance companies, calculated according to the revised formula, ranged between 1.4 and 2.3. The corresponding figures obtained using the old calculation method at the end of December last year were between 1.4 and 2.6. The solvency positions decreased slightly when compared against the situation at the end of 2016, owing in part to the new calculation formula.

The solvency position is the solvency capital in relation to the solvency limit. Factors affecting the solvency limit include the risks involved in investments and their mutual correlation. In practice, the solvency position describes a company's risk-bearing capacity in relation to the risks taken. More information about the calculation of solvency is available on our page Calculation of solvency.

5. Duration and Open currency position

Last year, in connection with the return-risk table, we began to publish duration information associated with bonds. Correspondingly, this is the first year when we publish information on the open currency position on the same page. The figures have been collected from the interim reports of authorized pension providers. The aim has been to increase openness, and it has therefore become easier, in some ways, to compare the returns of the various actors with each other.

5.1 Duration

For the interest rate risk, duration means a modified duration that describes the sensitivity of bond investments to changes in the interest level. However, as the duration does not measure, for instance, the credit risk, it does not reveal everything about the risks associated with fixed-income investments. For example, if the duration is 4, it means that the price of a fixed-income investment changes by about 4 per cent of the interest received, i.e. the investor's required rate of return, changes by one percentage point. In practice, the greater the duration, the greater is also the interest-rate risk.

In certain situations it is also possible, for instance by means of derivatives, to have a negative duration. A negative duration can be used to prepare against rising interest rates. When interest rates rise (fall), the prices of fixed-income investments fall (rise).

The average weighted duration of the seven largest pension insurers was 3.3 at the end of March. At the end of 2016, the corresponding figure was slightly higher, or 3.5. Among the various actors, durations ranged between -0.1 and 6.0.

5.2 Open currency position

The open currency position describes potential risks affecting the investment portfolios of authorized pension providers, especially in terms of the currency risk. The figure is given as the percentage of the market value of investments.

If the open currency position in foreign currencies (other than the euro) is, say, 10 per cent of the market value of the entire investment portfolio, this means that 10 per cent of all investments is not hedged by derivatives and is therefore exposed to possible changes in exchange rates.

The greater the open currency position is, the greater are the investment risks when the value of the currency falls. On the other hand, when the value of the foreign currency in relation to the euro rises, the value of the investment also rises correspondingly with respect to the currency component. Thus, an open exchange rate may be either a positive or a negative factor.

The average weighted open currency position of the seven largest pension insurers was 21.9 per cent at the end of March. The range of variation was fairly wide, i.e. between 13.0 and 29.5 per cent.

6. The investment portfolio rose again – net investment assets EUR 194.7 billion

At the end of March, the total net amount of assets put into funds by earnings-related pension insurers, i.e. the net investment portfolio, came to EUR 194.7 billion. Compared against the end of 2016, the value of the investment portfolio increased by EUR 6.2 billion.

When examined using the more important indicator, i.e. the longer term, between 2006 and 2016 the investment portfolio increased on average by EUR 7.4 billion per year. For the sake of prudence, however, it should be noted that the amount of assets has fluctuated over a rather wide range from year to year. For instance, during the financial crisis in 2008, assets fell by as much as EUR 17.3 billion, whereas in 2009 assets increased by EUR 19.8 billion on the previous year. For its own part, the rise in pension expenditure will curb the rise in assets ever more in the future.

Both investment returns and the difference between pension contributions and pension expenses have an impact on investment portfolio trends. Most of the pension contributions are used to finance current pensions. The remaining pension contributions are placed into funds and invested so that pension contributions can permanently be kept lower than in the alternative where no investments of this type are made. In fact, assets are put into funds and invested so that some of the financing needed for pensions can be obtained from these sources.

In 2016, for example, the increase in assets in the entire earnings-related pension system was solely attributable to returns, since part of the pension expenditure was financed from investments in both the private and the public sector. This trend will continue in the coming years – though with increasing intensity.

7. No major changes in the shares of various types of investment

At the end of March, the investment portfolio for the entire sector was broken down as follows:

- investments in equities and equity-like instruments [1] roughly 51 per cent (EUR 99.4 billion);
- fixed-income investments [2] 40.7 per cent (EUR 79.2 billion);
- real estate investments 8.3 per cent (EUR 16.2 billion).

Euro-denominated and relative changes by investment category, for the entire investment portfolio, when compared against the previous quarter:

- investments in equities and equity-like instruments: growth about four billion euros; relative share up by about half a percentage point
- fixed-income investments: increase by slightly over a billion euros; relative share diminished by about half a percentage point

- real estate investments: no major changes.

The change in investments in equities and equity-like instruments during the quarter is explained by two factors. The first reason is the positive value trend of over four billion euros when quoted shares, in particular, gained extra impetus with rising stock markets in the same way as late in 2016. On the other hand, the growth in the value of shares was dampened by their net flows, which were slightly negative all round.

Among investments in equities, the single investment type that was sold the most in net terms was hedge funds, which were sold for about half a billion euros. Quoted shares were also sold a little in net terms. With respect to the above investments, pension insurers have thus been more sellers than buyers. Late last year, pension insurers did the opposite: the purchases of equity investments exceeded their sales. Despite the slight negative net flow during the first quarter, the total amount of shares has remained great thanks to good returns. In part, the diminished risk level is also reflected as rising money market investments.

The net flow of fixed-income investments was positive, which means that purchases were greater than sales and maturities.

The changes in real estate investments were very moderate, although their purchases exceeded their sales during the last quarter of the year.

7.1 A downturn for bonds and convertible bonds

Fixed-income investments (EUR 79.2 billion) rose on the figure at the end of last year by more than one billion euros. Owing to the changes, fixed-income investments can be broken down as follows:

- Bonds and convertible bonds 30.8 per cent of total investment assets (EUR 60.0 billion);
- Money market investments 6.8 per cent (EUR 13.3 billion);
- Investment loans 2.5 per cent (EUR 4.9 billion);
- TyEL premium lending 0.5 per cent (EUR 1.0 billion).

Changes in fixed-income investments, in euros and relative to the entire investment portfolio, when compared against the previous quarter:

- Bonds and convertible bonds: a decrease of slightly under one billion euros; at the same time, their share declined by slightly over one percentage point
- Money market investments: an increase of about two billion euros; at the same time, their share rose by slightly less than one percentage point
- Investment loans and TyEL premium lending: no major changes.

The primary reason for the decrease in bonds and convertible bonds is their negative net flow, which was exactly one billion euros. Not only the difference between purchases and sales, but also the maturing of bonds affects the net flow of fixed-income investments. The fall in the value of bonds and convertible bonds was softened by a positive price trend.

In contrast, money market investments increased clearly by about two billion euros. Most of this sum was positive net flow.

This investment category has risen in a nearly trend-like manner for the past two years. However, the last quarter of 2016 was an exception: the value of money market investments declined by about EUR 1.6 billion. An increase in money market investments usually reflects preparation for the realisation of potential uncertainty factors on the investment market, when investors want to reduce risk levels.

Alternatively, the assets may be kept on the money market for a while before they are invested in longer-term instruments and/or instruments that, in part, involve higher risks. However, the volume of money market investments has still remained fairly high, when it is compared to figures from, say, 2013 and 2014.

No major changes occurred in the amounts or relative shares of investment loans and TyEL premium lending. In addition, their net flows were fairly small.

New investment loans and TyEL premium lending granted by pension insurance companies totalled about EUR 0.3 billion during the first quarter of 2017. The figures are far from the amounts recorded during the financial crisis; for instance, in 2009 the value of new loans granted in the first quarter was as high as EUR 1.3 billion.

The figures give an indication of the availability of financing for Finnish companies from sources other than earnings-related pension providers. The higher the sums for these two types of loans are, the more challenging it is for companies to obtain financing, for instance, from banks. On the other hand, the increase in lending for investment loans and TyEL premium lending may reflect the confidence that pension insurers' customers, i.e. enterprises, have in the economy, indicating that they have the courage to take out a loan, for instance for new investments.

7.2 The portfolio of quoted shares (incl. funds) rose together with other investments in equities

As in the previous quarter, quoted shares, in particular, were behind the substantial increase of about four billion euros in investments in equities and equity-like instruments. Other equity investments also rose, whereas the volume of hedge funds declined. Owing to the changes, investments in equities and equity-like instruments can be broken down as follows:

- Quoted shares (incl. funds) 35.9 per cent (EUR 69.9 billion);
- Hedge-funds 7.6 per cent (EUR 14.9 billion);
- Other equity investments 7.5 per cent (EUR 14.6 billion).

Changes in investments in equities and equity-like instruments, in euros and relative to the entire investment portfolio, when compared against the previous quarter:

- Quoted shares (incl. funds): an increase of exactly four billion euros; the share strengthened by about one percentage point

- Hedge funds: a decrease of about half a billion euros; the share declined by about half a percentage point
- Other equity investments: an increase of about one billion euros while the share rose slightly.

The main factors underlying the fairly rapid increase in the amount of quoted shares (incl. funds) are the positive value changes: EUR +4.2 billion. At the same time, this investment category was subject to a small negative net flow. Hedge fund units were also subject to a negative net flow – to the tune of half a billion euros. Equity investments, in turn, had a positive net flow of almost the same volume.

Purchase and sales data show how pension insurers' combined net flows in equity investments were fairly modest.

In summary, the first quarter of 2017 continued from where the fourth quarter of 2016 had left off, while stock markets continued to rise.

The euro-denominated index values for returns on quoted shares in various industrialised countries (including the world index) indicate how stock markets developed at a different pace in different parts of the world. The index values for returns showed a rather wide range of variation as during the period from the start of January to the end of March, the nominal returns ranged from +4.4 to +6.1 per cent:

- MSCI Europe Index +6.1%.
- MSCI World Index +5.1%
- OMXH Portfolio Index +4.4%

8. The shares of investments in Finland and outside the euro area increased

The sums and relative shares of investments in Finland increased in the same way as investments outside the euro area. By contrast, the share and sum of investments in the euro area decreased. Both net flows and rates of return affect the increase in investment portfolios in various areas.

The list below shows the sums and relative shares of investments in the various areas, as well as the changes on the first quarter:

- Investments outside the euro area: 55.5 per cent (EUR 108.1 billion). Changes: an increase of over four billion euros in the sum and half a percentage point in the share.
- Finland: 26.1 per cent (EUR 50.8 billion). Changes: the sum rose by about two billion euros while the share increased by just under half a percentage point.
- Other countries in the euro area (pois luettuna Suomi): 18.4 per cent (EUR 35.9 billion). Changes: a decrease of less than half a billion euros; the share simultaneously shrank by just under one percentage point.

The following figure shows the distribution of various investment categories among the geographical regions:

The investment category of equities and equity-like instruments (EUR 99.4 billion) was broken down geographically as follows:

- domestic investments 17.4 per cent (EUR 17.3 billion);
- the rest of the euro area about 13.9 per cent (EUR 13.8 billion);
- investments in equities outside the euro area 68.7 per cent (EUR 68.3 billion).

Fixed-income investments (EUR 79.2 billion) were distributed as follows:

- domestic investments 26.4 per cent (EUR 20.9 billion);
- the rest of the euro area 25.0 per cent (EUR 19.8 billion);
- investments outside the euro area 48.6 per cent (EUR 38.5 billion).

Real estate investments (EUR 16.2 billion) were distributed as follows:

- domestic investments 76.5 per cent (EUR 12.4 billion);
- the rest of the euro area 14.2 per cent (EUR 2.3 billion);
- investments outside the euro area 9.3 per cent (EUR 1.5 billion).

8.1 Investments in Finland

The three largest investment categories among domestic investments were, in descending order:

- quoted shares (incl. funds) 28.6 per cent (EUR 14.5 billion);
- real estate investments 24.5 per cent (EUR 12.4 billion);
- money market investments 19.2 per cent (EUR 9.7 billion).

No major changes took place in the shares of domestic investments during one quarter. It’s worth noting that the sums of nearly all investment categories rose, with the exception of TyEL premium lending and other equity investments. In the long term, the changes are greater, for instance in the case of money market investments and quoted shares.

9. Basic facts about our investment statistics

Our member organizations are responsible for investing the statutory earnings-related pension assets. The statistics cover the pension insurance companies, the TyEL funds of industry-wide pension funds and company pension funds, and the public-sector earnings-related pension providers: Keva, the State Pension Fund (VER), the pension liability fund for the employees of the Social Insurance Institution (Kela), the Church Pension Fund and the Pension Institution of the Bank of Finland

(SPERA). Also included is the group of specialized pension providers, which encompasses the Farmers' Social Insurance Institution (Mela) and the Seafarer's Pension Fund (MEK).

The statistics only cover the statutory earnings-related pension assets put into funds. They do not include the value of the funds for collective supplementary pension provision, managed by company pension funds and industry-wide pension funds, which totalled about EUR 4.7 billion at the end of 2016.

The statistical data are collected using the Statistics Finland model for reporting earnings-related pension assets [3], which we have used since 2016. Thanks to this model, certain sections in the reporting have become more precise when compared against the previous data collection model. For instance, cash collateral given and received in connection with derivatives, and purchase price claims and liabilities associated with investments, are considered at their net value in the new reports.

The statistical summaries include the adjusted figures in investment loans. The way in which the net value of derivative contracts is reported and handled has also been specified.

More detailed information on the impact of investment statistics for each investment category is available, for instance on pages 7–9 of Investment Analysis Q4/2016.