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Pension assets EUR 196.6 billion at the end of June 2017

Especially returns on equities boosted Finns' pension assets during the second quarter. Investments shifted from outside the euro area to Finland and other euro area countries. The role of pension funds will grow in the future as pension assets and the returns on their investment will be used increasingly often to finance pensions.

Our analyst **Peter Halonen**'s analysis comprises the following sections:

- Pension assets increased by EUR 1.8 billion
- The positive economic trend is reflected in the results
- Low interest rates still have an impact
- Funds to account for a larger share of the financing of pensions

1. Pension assets increased by EUR 1.8 billion

- Pension assets in total EUR 196.6 billion.
  - Pension assets in the private sector EUR 123.1 billion.
  - Pension assets in the public sector EUR 73.5 billion.
- Growth during the quarter EUR +1.8 billion.
- Investments in equities and equity-like instruments accounted for EUR 97.1 billion, or 49.4 per cent of all investment assets.
- Bonds and convertible bonds EUR 83.4 billion, share 42.4 per cent.
- Real estate investments EUR 16.1 billion, share 8.2 per cent.
- Returns on investments for the first six months of the year nominally 4.0 per cent and in real terms 3.8 per cent.

The second quarter of 2017 followed the same trend as the first quarter: net investment assets continued to grow, with an increase of EUR 1.8 billion for the quarter. A factor contributing to this increase was the rise in investments in equities and equity-like instruments, especially the returns on quoted shares. Stock markets showed a positive trend, mainly because of higher expectations about global economic growth and business performance.

After a long break, Finland and the rest of the euro area increased their relative share and volume in pension insurers' investment portfolios, while investments outside the euro area declined both in terms of volume and relative share. The net flow was as much as EUR 2.5 billion to Finland and EUR 0.9 billion to the rest of the euro area. For outside the euro area, the net flow was EUR -1.0 billion.

For the first two quarters in the whole sector, the returns on the various types of investments were:

- Returns on equity investments nominally on average 6.7 per cent.
- Returns on fixed-income investments nominally on average 1.3 per cent.
- Returns on real estate investments nominally on average 2.4 per cent.

However, the trend of returns on pension investments should be examined over the long term; changes during one quarter – or even during one year – are not important to the sustainability of the pension system. On the other hand, future returns cannot be predicted on the basis of past returns. In the end, pension assets increase over the long term in step with economic growth and inflation.

The selection of the examination period also affects how the returns realized appear in the medium and long term:

- 2012–2017 Q2: 7.3 per cent in nominal terms and 6.3 per cent in real terms
- 2007–2017 Q2: 4.7 per cent in nominal terms and 3.0 per cent in real terms
- 1997–2017 Q2: 6.0 per cent in nominal terms and 4.3 per cent in real terms

Pension insurers' solvency has remained strong. The solvency ratios of the five largest pension insurance companies ranged between 116.2 and 133.3 per cent at the end of June. Correspondingly, the solvency position ranged between 1.4 and 2.2. Owing to these buffers meant for rainy days, pension insurers are able to withstand occasional worse times on the financial market.

2. The positive economic trend is reflected in the results

The world economy is growing at a decent pace, and unemployment rates in key markets, such as the euro area and the United States, have developed positively. A particularly positive feature in companies' earnings trends is that, increasingly often, profits have risen because of greater turnover, not because of cost cutting.

For many companies, financial performance has exceeded analysts' forecasts in terms of turnover and profit growth. At least the reports on the first quarters indicate that the positive economic trend is also being realized in companies' financial performance. This is also good news for the stock market.

In the main, the central banks have continued their stimulating monetary policy, which has, for its own part, improved the figures on economic growth. However, there have already been indications of a gradually stricter monetary policy.

On the other hand, the second quarter of the year was characterized by political risks on both sides of the Atlantic. Examples of this included the French presidential election, preparation for the exit of the UK from the European Union, and the political situation in the United States. Market actors' belief in the strength of President Trump's administration to follow through with important political reforms was still solid in the second quarter but as the year has advanced, this belief has shrunk because of the dissension prevailing in the Republican Party. Market actors are therefore contemplating what will happen to the tax reliefs and deregulation promised by Trump.

Geopolitical risks were also a hot topic in the Korean Peninsula in spring. A particularly clear indication of pension insurers' preparation for risks was the growth of short-term receivables, such as money-market investments, which were considered to have small risks (EUR +5.0 billion).

Other risks have included uncertainty about China's continued economic growth and, as a partly related topic, the indebtedness of the world economy. So far, China's economic growth has been better than what was feared previously. For example, the IMF expects that China's economic growth will be 6.7 per cent this year when compared against the previous year. In the longer term, a source of uncertainty for the market is China's demographic development, as the relative share of the working-age population keeps shrinking and that of pensioners increases. This will reduce the growth potential of the Chinese economy. China accounts for a very large share of the global economic growth; for instance last year it was over one third.

Political risks loosened their grip for a while when, for instance, the pro-EU candidate Emmanuel Macron won the final round of the French presidential election. This alleviated market actors' fears about intensified disintegration in Europe after the exit of the UK from the European Union. Following Macron's victory, the interest on a 10-year French government bond fell sharply, more than 10 basis points.

The euro also strengthened against the dollar, and a steep rise was visible on the stock market. However, the weakening of the dollar also has negative impacts, for example, on the dollar-denominated investments of pension insurers. On the other hand, pension insurers have in part hedged their investments against foreign exchange risks by using currency derivatives.

In some respects, the election result has also been visible in the breakdown of the investments of institutional investors, such as pension insurers, by country: more money flowed into than out from the euro area (excluding Finland) during the spring (EUR +0.9 billion). The second factor contributing to the positive net flow is the financial performance of companies in the euro area during the first quarter. Moreover, in the light of various indicators, some euro area shares have been valued at lower rates than U.S. shares, which for its part favours investment in euro area equities.

According to leading indicators in the euro area, economic growth is expected to continue in the future as well. In consequence, expectations of European companies' financial performance will remain good in the near future.

3. Low interest rates still have an impact

Good diversification of pension asset investments and, in general, risk management, as well as pension insurers' solid solvency make it easier to cope even in an unsteady environment and to withstand occasional market fluctuations.

Global economic growth also plays an important role for Finland's economic growth and thereby for the sustainability of the Finnish pension system. The adequate financing of pensions for present and future generations has been a topic of active debate in Finland lately.

The basic logic behind the sustainability of the pension system is that, in the long run, the income collected as pension contributions and the returns on investments together should be more than the pensions paid out. Then the financing of pensions will remain in balance. Funds are therefore needed for obtaining returns in the future as well.

Investment returns vary over time, sometimes even considerably. In particular, low interest rates in recent years have posed their own challenges for the activities of pension insurers, and for all other investors as well. The problem is that, with falling interest rates, it will be increasingly challenging to receive the same kinds of returns on fixed-income investments that were customary before. If the aim is to continue receiving reasonable returns on fixed-income investments, this means that investment capital must in part be channelled to fixed-income investment with higher risks and/or to investment categories of different types.

In recent years, interest rates have fallen to a very low level, particularly in the case of government and corporate bonds of good credit rating on developed markets. On the other hand, the generally low interest rates have increased the popularity of alternative investment categories, such as real estate investments and private equity funds. An indication of the challenging situation is that, in connection with the updating of its long-term calculations, the Finnish Centre for Pensions reduced the long-term assumption for real return from 3.5 per cent to 3.0 percent for the next ten years.

However, interest rates have recently been rising from their rock-bottom values since the major central banks, such as the Federal Reserve of the U.S. (Fed), the European Central Bank (ECB) and the People's Bank of China (PBoC), have indicated that they would gradually tighten their monetary policy. The Fed has already raised its interest rate a couple of times, the People's Bank of China has, among other things, introduced stricter conditions for lending by banks, and some market actors expect that the ECB will cut the size of its bond-buying programme in the near future.

Expectations of measures to tighten the ECB monetary policy emerged following the speech of Mario Draghi, President of the ECB, in late June. In his speech, he stated that deflationary pressures had diminished while economic development in the euro area was positive.

It has already been possible to start gradual and slow measures tightening monetary policy in certain market areas, since the economic indicators, such as inflation and economic growth, have warranted such measures. However, some market actors hope that caution would be exercised when tightening monetary policy, so that the measures would have as few negative impacts as possible for short-term economic growth.

4. Funds to account for a larger share of the financing of pensions

Alongside investment returns, the difference between pension contribution income and expenses affects the financing of pensions. Already for the past few years, pension assets have been reduced by the fact that the pensions paid out of the funds and their returns have exceeded the sum of pension contributions placed into the funds. For instance in 2016, the entire pension sector collected EUR 2.4 billion of pension contributions into funds, while the sum taken out for pensions paid 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, pension funds will be used increasingly often in a controlled manner for financing pensions, to meet the continually rising pension costs as the population ages. Then the returns on investments will help to reduce the pressure to raise pension contributions. So far, the pressure to raise pension contributions has been kept low, thanks to good investment returns.

It is impossible to predict the future development of investment assets, but the goal is still to cover part of the financing for pensions by means of these assets. A lot depends on factors such as the future economic trend, the capacity of companies to make a profit, the stimulus measures of central banks and their effects, and the confidence of consumers and businesses. The indebtedness of the global economy, potential political crises and geopolitics continue to be uncertainty factors.

In international comparison, Finland has prepared well for population ageing and rising pension expenditure. Pension expenditure will rise markedly over the next 15 to 20 years. For us to be able to continue to finance the current percentage of expenditure with investment assets, the average growth of the assets in the long run must be in step with pension expenditure and the total payroll.

The financing of the pension system depends not only on investment returns but also on pension contributions. The contributions collected depend especially on the development of Finland's economy and employment. In the long run, birth rates also play an important role in securing sustainability. If the birth rate is too low, there will be pressure to increase pension contributions. Thus, despite the record-high pension assets, there will be more and more uses for all assets.