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Pension assets EUR 198.9 billion at the end of September 2017

During the third quarter, returns from all asset types were positive. Returns were positive especially for equities and equity-like investments, which accounted for over 50 per cent of all investment assets. Among the various regions, Finland and the rest of the euro area increased their share of the total assets invested. The recent rise in investment assets has been fuelled by the acceleration of global economic growth and its positive impact on financial markets, but also by the easy monetary policy pursued by central banks, such as the European Central Bank (ECB). The role of pension funds will grow in the future as pension assets and their returns will be used increasingly often to finance pensions.

Analyst Peter Halonen's analysis comprises the following sections:

- Pension assets increased by EUR 2.3 billion during the quarter
- Economic situation and the financial market
- The positive impact of monetary policy on pension insurers through various channels of influence
- The direction of monetary policy is changing; is there cause for concern?

1. Pension assets increased by EUR 2.3 billion during the quarter

- Pension assets in total: EUR 198.9 billion.
  - Pension assets in the private sector: EUR 124.2 billion.
  - Pension assets in the public sector: roughly EUR 74.7 billion.
- Growth during the quarter: EUR +2.3 billion.
- Investments in equities and equity-like instruments accounted for EUR 101.0 billion, or about 50.7 per cent of all investment assets.
- Bonds and convertible bonds: EUR 81.7 billion, share 41.1 per cent.
- Real estate investments: EUR 16.2 billion, share 8.2 per cent.
- Returns on investments from the beginning of the year: nominally 5.6 per cent and in real terms 5.3 per cent.

The third quarter of 2017 followed the same trend as both the first and the second quarter: net investment assets continued to grow, with an increase of EUR 2.3 billion for the quarter. The increase in assets was the result of positive returns for all investment types: fixed-income investments, equities, real estate and other investments. Stock markets, for instance, showed a positive trend, mainly because of higher expectations concerning global economic growth. The share of equities and equity-like investments rose to over 50 per cent of all investment assets. The shares of other investment categories declined.

The most positive net flows were seen for equities (EUR +5.6 billion). The clearest negative net flows were recorded for fixed-income investments (EUR -1.7 billion). A positive net flow refers to a situation where purchases exceed sales and maturities. Correspondingly, when the net flow is negative, sales and maturities are greater than purchases.

As in the second quarter, the relative shares of Finland and the rest of the euro area increased in pension insurers' investment portfolios while the relative share of investments outside the euro area declined. The net flow of investments in Finland increased by just under two billion euros. The net flow for the rest of the euro area was about half a billion euros, while the volume of investments outside the euro area remained virtually unchanged. In total, investments in Finland accounted for EUR 55.3 billion, and were EUR 35.7 billion in the rest of the euro area and EUR 107.9 billion outside the euro area.

For the seven largest earnings-related pension providers, the returns on the various types of investments during the first three quarters were:

- average returns on equity investments 10.0 per cent in nominal terms and 9.7 per cent in real terms;
- average returns on fixed-income investments 1.8 and 1.5 per cent, respectively;
- average returns on real estate investments 3.1 and 2.8 per cent, respectively.

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

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

- 2012–2017 Q3: 7.3 per cent in nominal terms and 6.2 per cent in real terms
- 2007–2017 Q3: 4.7 per cent in nominal terms and 3.1 per cent in real terms
- 1997–2017 Q3: 6.0 per cent in nominal terms and 4.4 per cent in real terms

Apart from investment returns, the difference between pension contribution income and expenses affects the financing of pensions. In the coming years, pension funds – and their returns – will be used increasingly often in a controlled manner to finance pensions, in order 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.

The rule of thumb is that a change of half a percentage point in the long-term average returns has an effect of one percentage point on pension contribution income. If the returns decrease (increase) by half a percentage point, there will be pressure to raise (reduce) the pension contribution by one percentage point. This, in turn, affects the pension contributions of companies and wage-earners and, in the end, their income in hand.

Pension insurers' solvency has remained strong. At the end of September, the solvency ratios of the five largest pension insurance companies ranged between 116.3 and 133.6 per cent. Correspondingly, the solvency position ranged between 1.5 and 2.3. Both the solvency ratio and the solvency position strengthened slightly when compared against the previous quarter. Thanks to these buffers meant for rainy days, pension insurers are able to withstand occasional worse times on the financial market.

2. Economic situation and the financial market

Underlying the pension insurers' good returns was market actors' optimistic view of the future. This optimism was visible, for instance, as rising values of equities. One reason for the positive atmosphere has been the fact that the major central banks – headed by the Fed of the United States and the European Central Bank ECB – so far have proceeded cautiously when taking measures to tighten their monetary policy.

The figures from the real economy have also been positive. The broad revival of economic growth, positive employment statistics and the solid performance of businesses globally are good examples of this. In the euro area, economic growth has strengthened further over the past two years or so.

For example, in its most recent forecast, the IMF has predicted the following growth figures for various regions:

- For this and next year, economic growth in the euro area will reach 2.1 and 1.9 per cent in real terms. The last time when growth was equally strong was before the euro crisis in early 2011.
- Correspondingly, the IMF predicts that the world economy will grow by 3.6 and 3.7 per cent.
- The figures for Finland are 2.8 and 2.3 percent.

In contrast, in its own growth forecasts, the World Bank is slightly more pessimistic than the IMF. For the most part, global economic growth comes from Asia, especially China and India. Finland is a small open economy driven by exports. The country's employment trends, and hence the income from pension contributions, are largely dependent on input from larger economies.

In line with positive growth figures, the unemployment rate in the euro area has also developed favourably. Unemployment has been falling for about four years, and reached 8.9 per cent at the end of September this year. In contrast, inflation has slightly lagged behind the European Central Bank's medium-term inflation target of about two per cent. Annual inflation at the end of October was 1.4 per cent. At the same time, however, the core inflation, which excludes items such as changes in food and energy prices, was under one per cent.

In the euro area and Finland, both consumers and companies have gained considerably more confidence in the economy within the past few years. The last time when confidence in the economic situation was this high in the euro area was before the financial crisis in 2007. Likewise, the ifo Business Climate Index measuring investors' confidence in the economy has risen high. The positive economic trend is also reflected in companies' financial performance and thereby on the stock market. All of this has had an impact on pension insurers' investment returns, especially for equities.

Admittedly, there was also occasional market turbulence in the third quarter. This was caused, in particular, by geopolitical risks on the Korean Peninsula. Another factor swaying the financial market was market actors' fears that central banks would tighten their monetary policy faster than anticipated. However, this fear diminished as the quarter progressed. The fairly rapid weakening of the dollar against the euro also caused concern among investors during the third quarter.

Political risks still include uncertainty about the progress of the Brexit negotiations and the possibilities of President Trump and his administration to push through important legislative amendments, such as the tax reform. In addition, the political situation and next year's parliamentary elections in Italy cause some pondering in Europe. The high indebtedness of the world economy is still seen as a long-term risk. Pension insurers keep a close eye on the above risks.

3. The positive impact of monetary policy on pension insurers through various channels of influence

Early in 2015, the European Central Bank announced an extensive programme for purchasing securities. It was agreed that the monthly purchases would amount to EUR 60 billion. Later, the volume of purchases has gone up and down and, according to the latest information, it will fall to

EUR 30 billion as of the beginning of 2018. Thus, the ECB is gradually starting to tighten its monetary policy.

Despite this, the very stimulating monetary policy will continue. Through this purchase programme, debt securities worth over EUR 2,000 billion have been purchased into the balance sheets of central banks in the euro area. Most of these securities are government bonds. Other monetary policy tools have also been in use for a long time. These include the target interest rate and the deposit rate, the targeted longer-term refinancing operations (TLTROs) and the central bank's forward guidance. All of these measures have been designed to help the ECB to reach its inflation target, but also to revive the euro area economy.

After the financial and euro crisis, economic indicators in the euro area have slowly recovered to their current values. The economy of the euro area is just picking up speed, unlike in the United States, where the economy and employment have developed very positively for a longer time. The ECB's official target is to reach an inflation rate that in the long run would be about two per cent or slightly less. Effort is made to support inflation by means of monetary policy. When the economy and employment are improving at the same time as wages rise, consumer demand will increase, which should also be visible as rising prices, i.e. inflation.

The purchase programme has had a decreasing effect on the interest rates of government bonds and, in certain cases, corporate bonds. In consequence, states and companies have been able to obtain loans from the bond market at a lower cost. In contrast, the fall in the central bank's key interest rate has had a decreasing effect on money market rates, such as the Euribor rates generally used for housing loans. This means that households have also been able to get loans at lower rates. With the general downturn in interest rates, it has been increasingly profitable for various financial actors to take loans, for example, for business investments. This has contributed to economic revival. The easy monetary policy has also reduced the value of the euro against other currencies. This, in turn, has boosted exports from the euro area to other countries.

Exports have clearly picked up in Finland, too. This has had positive impacts on the economy in general and on employment. The development of Finland's economy and employment plays a crucial role in determining how much pension contributions flow into the pension system. This, in turn, has a direct impact on the sustainability of the pension system. Finland's unemployment rate was 8.7 per cent at the end of September. The figure has fallen by one percentage point during the past two years or so.

For investors, the fall in the interest level has been visible as an increase in the value of fixed-income investments. This has meant better investment returns. When the interest rate of a fixed-income investment – i.e. the investor's return requirement – decreases, the value of the fixed-income instrument rises. This has been seen as pension insurers' fairly good returns on fixed-income investments. On the other hand, low interest rates have meant challenges for the investment activities of pension insurers. The problem is that as interest rates fall, it will be increasingly challenging to receive the same kinds of returns on fixed-income investments as 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 different types of investment categories.

This phenomenon is known as the search for yield. This has made some market players reflect on rational valuation levels for various asset categories, such as equities, in relation to the financial performance of companies. Nevertheless, it is good to compare the current levels with risk-free government bond yields, positive economic development and low inflation. However, it seems that investors' risk-return ratio has become weaker than in previous years. The low interest level has been visible in pension insurers' investment activities so that alternative investment categories – such as hedge funds, private equity funds and real estate investments – have become more popular.

In part, this view found support in the third quarter, when hedge funds showed a positive net flow of almost two billion euros. These types of investment, also known as absolute return funds, were purchased clearly more than they were sold. The net flow of quoted shares was also positive – about three billion euros. In contrast, the net flow of bonds, convertible bonds and money market investments was negative. Thus, on average, pension insurers increased the weight of asset categories considered to be more risky in their investment portfolios, but on the other hand, reduced their interest rate risk in fixed-income investments. During the current year, this has also been seen as a fall in the average duration, or the interest rate risk.

With the stricter monetary policy, there are pressures to raise the interest level. This, of course, will also require an increase in inflation. The greater the inflation, the greater the nominal return, i.e. interest, that investors want on their fixed-income investment so that the real return after inflation would be positive. When interest rates rise and yield good returns again, some money will flow from equities to fixed-income investments. However, interest rates should rise enough so that the returns on the government bonds of developed countries, in particular, would be sufficiently attractive in relation to equities.

On the whole, monetary policy has had a favourable impact on pension insurers in multiple ways, thanks to the positive development of both the financial market and the real economy. In its own calculations, about a year ago the Bank of Finland demonstrated how monetary policy has helped to avoid a clearly weaker economic trend both in the euro area and in Finland.

In addition to monetary policy, major economic recovery measures include structural reforms, for example on the labour market, and investments to increase productivity.

4. The direction of monetary policy is changing; is there cause for concern?

More widely, other major central banks, such as the Federal Reserve of the United States (Fed), the People's Bank of China (PBoC) and the Bank of England (BoE), have also indicated that they would gradually tighten their monetary policy.

The Fed has already raised its key interest rate a couple of times and has disclosed its plans to reduce its own balance sheet total. For its part, the People's Bank of China has, among other things, introduced stricter lending terms for banks at the same time as the ECB announced that it will reduce monthly volumes under the programme to purchase debt securities. According to the ECB management, for instance, stimulation can be reduced because deflation fears have been alleviated at the same time as economic development has been largely positive – on more than one continent. Despite the stepwise tightening monetary policy, the ECB still supports the prerequisites for economic activity using exceptionally strong measures.

However, the big question is how to exit from this type of exceptionally stimulating monetary policy in a controlled manner. The economic stimuli cannot be cut too suddenly because that might have unexpected negative impacts on the real economy and also on the investment market. The easy monetary policy has contributed to the rise of various asset prices. It can therefore be asked what happens to asset prices, such as fixed-income investments and equities, if the stimulus measures are shut down too rapidly. However, it is likely that stricter monetary policy will be introduced cautiously. Then it would have as few negative effects as possible on economic growth, the employment trend and the financial market, and thereby also on pension insurers' investment yields and on the development of pension contributions.

However, monetary policy can already be tightened by degrees, despite the above listed fear scenarios. In addition to the good economic indicators, there is another perspective supporting the gradual tightening of monetary policy. When the next financial crisis comes, it is important that stimulus capacity is available. If monetary policy has been turned to the maximum and all available tools are already in use, coping with a new crisis would be even more difficult without stimulus capacity.

In the United States, the Fed has taken action to restrict stimulus measures more than the ECB has done. Therefore, the Fed is in a better position to face a new crisis than the ECB. To a great extent, the American economy has already reached the peak of the economic cycle. Since this is not the case in Europe, there are differences in the way monetary policy is applied on different sides of the Atlantic.

The ECB anchors its monetary policy stance largely to inflation, but in part certainly also to economic growth. The best scenario for both the real economy and the financial market would be if inflation could be kept within the ECB's target at the same time as there is positive economic growth.

Various bumps will certainly occur on the road towards a normalized monetary policy. However, pension insurers have very good solvency, which is why they can easily withstand occasional market fluctuations. Assets are also spread widely across various types of investment and various continents. In this situation, too, the phrase 'profitably and securely' is an excellent guiding principle for pension insurers' investments.