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Pension assets top the 200-billion-euro mark for the first time

Net investment assets rose slightly in the second quarter of 2018. However, owing to political crises, the financial market experienced occasional turbulence. Thanks to diversification, equity and real estate investments helped investment assets to achieve a positive return, while fixed-income investments dragged below zero. Over a longer period, investment assets have increased fairly steadily for many years in succession, thanks to wide diversification, the central banks' relaxed monetary policy, the acceleration of global economic growth, improved employment and also good corporate earnings.

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. At the level of the entire pension system, contributions have been insufficient in recent years to cover pension expenditure. The difference is financed by investment assets and their returns.

Analyst **Peter Halonen's** analysis comprises the following sections:

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1. Return on investment after the first half of the year nominally 1.0 per cent

- Pension assets in total: EUR 202.0 billion.
    - Pension assets in the private sector: EUR 127.0 billion.
    - Pension assets in the public sector: about EUR 75.0 billion.
- Increase during the quarter: EUR 2.4 billion.
- Investments in equities and equity-like instruments accounted for EUR 107.8 billion, or 53.4 per cent of all investment assets.
- Fixed-income investments: EUR 77.6 billion, share 38.4 per cent.
- Real estate investments: EUR 16.6 billion, share 8.2 per cent.
- Returns on investments for the first six months of the year: 1.0 per cent nominally and 0.2 per cent in real terms.

Pension assets rose by slightly over EUR 2 billion during the second quarter of 2018. In the first quarter, the returns were below zero. Thanks to second-quarter earnings, however, the entire first half was positive. Occasional market turbulence is characteristic of the financial markets. It is eventually manifested as fluctuations in the value of investments. This time, the positive mood stemmed from positive returns on the equity and real estate markets. In contrast, returns on fixed-income investments pointed downwards. On the whole, the quarter was rather polarized; pessimism among market actors was fuelled by increasing fears of the negative impact of a trade war on the world economy and by uncertainty associated with the actions of Italy's new government. Eventually, however, the market atmosphere was raised by companies' earnings during the period, as well as the continuing positive trend of other real economy indicators. Inflation, too, has been kept in check on many continents. These topics are discussed in more detail in the next chapter.

The changes in relative shares were slight. During the quarter, the shares of equities and equity-like investments[1], fixed-income investments and real estate investments remained almost unchanged, i.e. at 53.4, 38.4 and 8.2 per cent, respectively. There was virtually no change in the share of real estate investments. In the bigger picture, the proportion of equity investments has increased steadily from 2012 onwards, while the share of fixed-income investments has declined. The underlying reason is the long period of low interest rates, which has made pension insurers seek more profitable investments, for instance, in quoted shares, private equity funds and hedge funds. In the light of returns, this strategy has worked well.

[1] When the analysis refers to investments in equities and equity-like instruments, this means the following categories of investment figures: quoted shares (incl. funds); hedge funds; and other investments in equities, which include, for instance, equity investments and investments in unquoted shares.

During the quarter, the shares of investments in the various regions changed slightly. The relative shares of investments in the euro area increased, while investments outside the euro area declined and investments in Finland remained virtually unchanged. At the end of June, the relative shares of assets were broken down as follows: Finland 25.2 per cent; the rest of the euro area 20.1 per cent; and countries outside the euro area 54.7 per cent. Changes in the relative shares of investments are affected by net flows – that is, the difference between purchases, sales and maturities. Value changes also have an impact. More information about investments in Finland is available in my blog ‘ Eläkevarat ovat hyödyttäneet Suomen taloutta kautta aikojen‘. [in Finnish]

In the first half of 2018, the returns of the six largest operators for each investment category were as follows:

- Average returns on equity investments: 2.0 per cent in nominal terms and 1.2 per cent in real terms;
- Corresponding average returns on fixed-income investments: -0.6 and -1.4 per cent, respectively;
- Average returns on real estate investments: 3.0 and 2.2 per cent, respectively.

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 financial 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:

- 2013–2018Q2 (about 5 years): 6.3 per cent in nominal terms and 5.5 per cent in real terms
- 2008–2018Q2 (about 10 years): 4.6 per cent in nominal terms and 3.1 per cent in real terms
- 1997–2018Q2 (about 21 years): 5.9 per cent in nominal terms and 4.3 per cent in real terms

Pensions are financed not only by pension contributions but also by investment assets placed into funds and the subsequent returns. Already since 2014, 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 2017, according to our preliminary data (Yksityisten ja julkisten alojen työeläkerahan kiertokulku), the entire pension sector collected EUR 2.2 billion of pension contributions into funds, while the sum taken out for pensions paid amounted to EUR 4.0 billion. This means that the net sum used for pensions from funds and their returns totalled EUR 1.8 billion.

In the coming years, pension funds will be used in a controlled manner increasingly often to finance pensions, in order to meet the continually rising pension costs as the population ages. Then the pension funds and their 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 by half a percentage point, there will be pressure to raise the pension contribution by one percentage point, and vice versa. This, in turn, affects the pension contributions of companies and wage-earners and, in the end, their income in hand. Ultimately, fiscal sustainability is ensured by the development of employment, the sum of wages and salaries, and fund returns, as well as by the birth rate.

Pension insurers' solvency has remained strong. The solvency ratios of the four largest pension insurance companies ranged between 123.8 and 132.4 per cent at the end of June. Correspondingly, the solvency position ranged between 1.6 and 2.1. No major changes took place in the solvency ratio or solvency position during the quarter. Thanks to these buffers meant for rainy days, pension insurers are able to withstand occasional worse times on the financial market.

2. Politics again figured prominently during the second quarter

The world's political climate had a strong impact on the returns of different asset types. The stock markets were rolling with the punches when especially China and the United States had a go at each other in trade policy. The rise of protectionism has its own negative impact on both the financial market and the real economy. A trade war can have severe adverse effects on the world economy and on the confidence that economic actors, such as companies and consumers, have in the future. In its World Economic Outlook for July, the International Monetary Fund (IMF) expressed its concern over the negative effects of protectionism on the world economy. A rise in uncertainty is always poison to economic growth. In addition, it means that the relative competitive advantage developed by various countries cannot be utilized fully and freely, owing to trade restrictions. More information about protectionism is available in my blog 'Mitä vaikutuksia protektionismilla voi olla työeläkejärjestelmälle?'. [in Finnish]

Other negative factors for both equity and fixed-income markets were the formation of a new government in Italy, the third largest economy in the euro area, and especially the new government's plans for a very relaxed fiscal policy. The idea has been to increase public spending at the same time as making tax cuts. Regarding the Italian situation, market actors were also concerned about the sceptical attitude held by the political parties Five Star Movement and Northern League to the euro area and the deeper integration of the euro area. All of this was reflected, above all, as rising interest rates on Italy's sovereign debt, as investors began to consider Italy's insolvency more probable than before. The purpose of a relaxed fiscal policy is to increase employment and economic growth, but according to some assessments, the problems of the Italian economy are mostly structural and cannot be remedied merely by adjusting public finances.

Despite the uncertainty factors of the second quarter, the atmosphere on the stock market as a whole remained positive. This was also seen as positive returns on equity investments made by pension insurers. Optimism for the future was fuelled, among others, by the good performance of U.S. companies and the consistently strong economic indicators, such as rapid economic growth and low unemployment across the globe. Inflation figures have also remained moderate. The higher the rate of inflation is, the more seriously the central banks must consider the tightening of monetary policy. In consequence, the stimulating effect of monetary policy on the economy decreases. Stock markets usually respond negatively to shrinking stimulation – especially in a situation where monetary policy is tightened faster than expected.

It is important to monitor short-term risks, but this should not attract too much attention. It is important to monitor short-term risks, but it is even more important to pay attention to longer-term risk factors. One risk factor relates to the normalization of monetary policy. Central banks have been able to normalize the pace of their monetary policy with a light hand because inflation figures have not begun to rise too sharply. The higher the rate of inflation is, the more seriously the central banks must consider the tightening of monetary policy. In consequence, the stimulating effect of monetary policy on the economy decreases. The pace of the central banks' monetary policy has a very important impact on future economic growth and corporate profitability. It is therefore imperative that – whenever allowed by the economic figures – the central banks keep a cool head in raising interest rates to ensure that economic growth does not suffer too much. Other long-term risks that should be mentioned include the indebtedness of the world economy and the number of problem loans in Italian banks. These are factors that may be forgotten from time to time if too much attention is focused on a single topical risk factor.

Owing to uncertainties, it is very important that the investment portfolio is diversified broadly among different asset types and different continents. Pension assets must be invested profitably and securely. This is exactly what pension insurers have done. Nor can it be overly emphasized that in investment activities – especially in the case of the pension system, where responsibilities extend over decades – the most relevant factor is long-term returns. Noteworthy for the sustainability of the entire pension system, alongside returns, is Finland's economic and employment trend. The drive of the Finnish economy depends largely on what is happening elsewhere in the world. Also for this reason – and not only from the perspective of returns on investments – it is imperative to analyse what is happening at the global level in monetary policy, geopolitics, trade policy and generally in politics. All of these aspects have their own impact on the financial markets and the real economy, both outside Finland and here in this country rich in forests and lakes. For a small and open economy, such as Finland, it would be very harmful if the growth of the world economy slowed down. This would be reflected directly in the export earnings and profitability of Finnish companies. It would have a negative impact on both investment assets and Finland's employment figures, and thereby on premium income.

3. 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, as well as the public-sector earnings-related pension providers: Keva, the State Pension Fund (VER), the pension liability fund for employees of the Social Insurance Institution (Kela), the Church Pension Fund (KER) and the Bank of Finland's Pension Fund (SPERA). Also included is the group of specialized pension providers, which comprises the Farmers' Social Insurance Institution (Mela) and the Seafarers' 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 industry-wide pension funds and company pension funds. These totalled about EUR 4.3 billion at the end of 2017.