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Equity income strengthened pension assets

The investment assets of the earnings-related pension system reached a new all-time record during the third quarter of 2018. The assets increased by nearly EUR 3 billion and totalled EUR 204.7 billion at the end of September. The favourable trend of equities and real estate investments helped to offset the slim returns of the beginning of the year. By contrast, fixed-income investments remained slightly in the red. Overall, the market was characterized by an expectant atmosphere.

The role of pension funds will grow in the future as pension assets and the returns on their investment will be used to an increasing extent 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 **Kimmo Koivurinne's** analysis comprises the following sections:

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2. Growth in the third quarter
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1. Return on investment after the first three quarters 2.5 per cent in nominal terms

- Investment assets of the earnings-related pension system, in total: EUR 204.7 billion
- Investment assets in the private sector: EUR 128.7 billion
- Investment assets in the public sector: about EUR 76.0 billion
- Increase during the quarter: EUR 2.7 billion
- Investments in equities and equity-like instruments: EUR 110.7 billion, or 54.1 per cent of all investment assets
- Fixed-income investments: EUR 77.2 billion, share 37.7 per cent
- Real estate investments: EUR 16.8 billion, share 8.2 per cent
- Returns on investments for the first three quarters of the year: 2.5 per cent in nominal terms and 1.5 per cent in real terms

Changes in the relative shares of the various asset categories were small during the past quarter. The shares of equities and equity-like investments (54.1%), fixed-income investments (37.7%) and real estate investments (8.2%) remained almost unchanged. In the bigger picture, the proportion of equity investments has increased steadily since 2012, while the share of fixed-income investments has correspondingly declined. The underlying reason is the long period of low interest rates, which has made pension insurers seek more profitable investments, for instance, in unquoted shares, private equity funds and alternative investments. In the light of the returns, this strategy seems to have 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.

Nor did the regional distribution of investments change to any appreciable extent during the third quarter. The relative share of investments in the euro area declined by less than half a per cent, while investments outside the euro area and in Finland rose by slightly over one tenth of a per cent.

At the end of September, 25.3% of investment assets were invested in Finland, 19.9% elsewhere in the euro area and 54.8% in countries outside the euro area. Changes in the relative shares of investments are affected by net flows — that is, the difference between purchases, sales and maturities.

During the first three quarters of 2018, the returns of the six largest operators for each investment category were as follows:

- Average returns on equity investments: 4.5 per cent in nominal terms and 3.4 per cent in real terms;
- Corresponding average returns on fixed-income investments: -0.4 and -1.4 per cent, respectively;
- Average returns on real estate investments: 4.0 and 2.9 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 put into funds increase in step with economic growth and inflation. It should be noted that the selection of the examination period is also important.

The returns realized look good also in the longer term:

- 2014–2018Q3 (about 5 years): 5.9 per cent in nominal terms and 5.3 per cent in real terms
- 2009–2018Q3 (about 10 years): 7.1 per cent in nominal terms and 5.8 per cent in real terms
- 1997–2018Q3 (almost 22 years): 5.9 per cent in nominal terms and 4.3 per cent in real terms

The projected real return used by the Finnish Centre for Pensions for its long-term projections is 3 per cent until 2025. Thereafter, the projected real return is 3.5 per cent. The latter projection has been used to examine the pension system all the way until 2085. Then the whole picture depends the most on trends in employment, the birth rate and net immigration.

Pensions are financed not only by pension contributions but also by investment assets placed into funds and the subsequent returns. In addition, since 2014, investment assets have been affected 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, (Circulation of earnings-related pension contributions in the private and public-sectors), the entire pension sector collected EUR 2.5 billion of pension contributions into funds, while the sum taken out for pensions paid amounted to EUR 4.3 billion. This means that the net sum used for pensions from funds and their returns totalled EUR 1.8 billion.

Pension insurers' solvency has remained strong. At the end of September, the solvency ratios of the four largest pension insurance companies ranged between 123.6 and 132.8 per cent. Correspondingly, the solvency position ranged between 1.8 and 2.2. No major changes took place in the solvency ratio or solvency position during the past quarter. Thanks to the buffers meant for rainy days, pension insurers are also able to withstand worse periods on the financial market.

2. Growth in the third quarter

According to the economic forecast updated by the International Monetary Fund (IMF) in July, the global economy would grow at a rate of 3.9 per cent in both 2018 and 2019. More moderate estimates have also been presented, but in any case the growth rate would be over 3 per cent. The stock market continued its strong positive trend throughout the third quarter, but in the early autumn the market growth was mainly driven by the United States. This means that the American economy continued on a gently ascending curve, while the Asian and European markets were virtually standing still.

Unfortunately, not only the economy but also the budget deficit keeps increasing in the USA. This means that business support measures are financed — at least in part — by debt, which may become a problem in the future. However, the slim prospects of the world economy have not yet caused concern in the United States, as wages are being pushed upwards and skilled labour begins to be scarce in some areas. The interest rate hikes initiated by the U.S. Federal Reserve in 2018 did not have much time to affect the market by the end of the third quarter.

The pivotal themes in the world economy during the third quarter of 2018 included the economic crisis in Turkey and the consequent nosedive of the Turkish lira. The United States contributed to the acceleration of Turkey's crisis by doubling the import tariffs on Turkish steel and aluminium. In trade war matters, the United States had an increasingly defiant attitude towards China and Europe, but without immediate action, its impact remained slight. In Europe, eyes focused on the third largest economy of the euro area, Italy, and on its budget deficit and overall indebtedness. The increasingly sharp debate on Brexit in the UK has had a visible effect on the market for a long time, and by the end of September, the FTSE 100 index illustrating the trend on the London Stock Exchange had hardly developed in any direction over the past year. It can be said that, at present, the global economy has discords leading to uneven development. Amidst these discords, the United States is going strong while Asia, Europe, and especially the developing markets, are struggling to solve their economic and other problems.

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.

Analysis updated on 5 December 2018