Earnings-related pension assets EUR 210 billion at the end of September 2020

In the third quarter, investment assets contributing to the financing of the earnings-related pension system continued to recover after the sudden crash earlier in the year. The investment assets increased by approximately EUR 6 billion during the quarter and reached a total of EUR 210 billion at the end of September. The recovery of equity investments had an impact on asset growth, although total return for the year has so far been negative. The strict lockdown measures adopted early in the year slowed the spread of the coronavirus considerably. This softened the impact on capital markets and the steep decline recorded at the beginning of the year levelled off.

Analyst **Kimmo Koivurinne** has drawn up an analysis of trends in earnings-related pension assets. It comprises the following sections:

- Annual return by the end of September nominally −1.5 per cent
- V-shaped stock market curve
- Basic facts about our investment statistics

Annual return by the end of September nominally −1.5 per cent

- Investment assets of the earnings-related pension system, in total: EUR 210 (*) billion
    - Investment assets in the private sector: EUR 132 billion
    - Investment assets in the public sector: about EUR 78 billion
- Growth in the third quarter: about EUR 6 billion
- Investments in equities and equity-like instruments: EUR 103 billion, share 49 per cent of all investment assets
- Fixed-income investments: EUR 70 billion, share 33 per cent
- Real estate investments: EUR 19 billion, share 9 per cent
- Alternative investments: EUR 17 billion, share 8 per cent
- Returns on investments for the first three quarters of the year: −1.5 per cent in nominal terms and −1.5 per cent in real terms

(*) The amount of assets invested by all of TELA's members and presented here differs from the figure in the interim reports by about one billion. The reason lies in different statistical processes. We will specify the amount of assets later.

The relative shares of the asset categories in the **investment distribution** remained virtually unchanged during the third quarter. The share of equities and equity-like instruments [1] (49%) increased by half a percentage point. The share of fixed-income investments (33%) remained mor or less the same. The shares of real estate investments (9%) and alternative [2] investments (8%) each fell by about half a percentage point.

The rise in the relative share of equities is largely explained by the recovery of the valuation levels of equities. The relative share of fixed-income investments in the investment distribution has shrunk by about ten percentage points during the past ten years, as fixed-income investments with weaker return expectations have been replaced by better performing equities, private equity and other alternative asset categories. Underlying this trend is the prolonged low interest rate level, which originated in the revival measures taken to offset the financial crisis. This has led pension providers, within the limits of the solvency regulations, to allocate investments from fixed-income investments to asset categories that are less liquid but have a higher yield. 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. equity funds) and other investments in equities, which include, for instance, private equity and investments in unquoted shares.

[2] In the main, alternative investments refer to hedge funds.

The regional distributions of investments changed only slightly during the past quarter. The relative share of investments in the euro area remained steady, but the share of investments outside the euro area decreased by one percentage point. Conversely, the share of investments in Finland rose by one percentage point. At the end of the third quarter, more than a quarter of investment assets (26%) was invested in Finland, less than one fifth (17%) elsewhere in the euro area, and more than half (57%) in countries outside the euro area.

Geographical diversification has evolved over the years. At the beginning of the 2000s, just over a third of investments were domestic, but as the volume of investment assets has increased, more and more investments have been made abroad. Apart from changes in the value of investments, 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 2020, the returns of the six largest operators **for each investment category** were as follows:

- Average returns on equity investments: −2.6 per cent in nominal terms and −2.6 per cent in real terms;
- Average returns on fixed-income investments: −0.6 per cent in nominal terms and −0.7 per cent in real terms;
- Average returns on real estate investments: 1.2 per cent in nominal terms and 1.1 per cent in real terms.
- Average returns on alternative investments: −0.0 per cent in nominal terms and −0.1 per cent in real terms

The trend of returns on pension investments must be examined over the longer term; changes occurring during one quarter — or even during a 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 the returns realized. Over the long term, in the end, pension assets placed into funds increase in step with economic growth and inflation. It should be noted that the selection of the examination period is also important.

Despite the weak investment returns of the current pandemic year, **realized returns** appear to be stable over the longer term:

- 2015–Q3/2020 (5.75 years): 4.6 per cent in nominal terms and 3.9 per cent in real terms;
- 2010–Q3/2020 (10.75 years): 5.5 per cent in nominal terms and 4.2 per cent in real terms;
- 1997–Q3/2020 (23.75 years): 5.6 per cent in nominal terms and 4.1 per cent in real terms.

The real return used by the Finnish Centre for Pensions for its long-term projections is 2.5 per cent until 2028. 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 big 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. The returns of the investment assets act as a buffer keeping the rise in pension contributions in check. Without investment funds, any increases in earnings-related pension expenditure would be paid directly through pension contributions collected from employers and employees. In addition, since 2014, the private sector's investment assets have been affected by the fact that the pensions paid out of the funds and pension fund returns have exceeded the sum of pension contributions placed into the funds. According to preliminary calculations, in 2019, the entire pension sector collected EUR 2.7 billion of pension contributions into funds, while the sum taken out for pensions paid totalled EUR 4.5 billion. This means that the net sum used for pensions from funds and pension fund returns totalled EUR 1.8 billion.

The increase in funded pension assets is also linked to total liabilities for pensions currently accruing and pensions already in payment, which at present amount to approximately EUR 700 billion. The bulk is to be financed by earnings-related pension contributions, since the Finnish earnings-related pension system is mainly a so-called pay-as-you-go system. However, the system also follows the principle of partial funding, which means that about a quarter of the pension liabilities are covered by assets in funds and the remaining pensions are paid from the pension contributions of people who are presently working.

Thanks to the good returns on investments in past years, the **solvency of pension insurers** is still at a secure level. Solvency ratios and solvency positions continued to recover during the past quarter. In the private sector, i.e. pension insurance companies, company pension funds, industry-wide pension funds, and the Seafarers' Pension Fund, the average solvency ratio, i.e. the ratio of pension assets to technical provisions, was 125 per cent at the end of September. At the same time, the solvency ratios of pension insurance companies ranged between 120.6 and 125.7 per cent. Solvency positions ranged between 1.4 and 1.8. Regarding the market instability caused by the coronavirus, the Financial Supervisory Authority has collected data from pension providers during the spring and summer in a compact manner. As things look now, compact data collection will continue at least until the end of the year.

V-shaped stock market curve

The immediate horror effect of the coronavirus had dissipated by the start of the third quarter last summer. Global stock markets recovered at a brisk pace led by the United States, even though it was seen that the onset of the second wave of the pandemic was only a matter of time. In fact, the stimulus packages adopted swiftly by central banks had already turned the markets to a strong upswing in the previous quarter. Thus, in addition to the left arm of the letter V, created by the market panic early in the year, the right arm had also got off to a good start.

With the rapid recovery, the gap between the stock market and the real economy had begun to preoccupy minds that had followed the market over the summer. The whopping rise in equities seemed kind of unrealistic, as the expectations of rising interest and inflation rates, i.e. economic growth, had been set to zero on a broad front. Despite this, the stock circus continued until September, when the number of COVID-19 cases in the world began to grow steadily again after a slight slump in August. At the end of the quarter, the market was also weighed down by uncertainty about the upcoming U.S. presidential election and the potential shift of power.

As mentioned, the rapid recovery of the stock markets during the quiet phase of the coronavirus crisis alleviated the catastrophic investment mood at the start of the year. However, returns on the main markets did not go hand in hand.

The New York Stock Exchange performed the best in the face of the crisis early in the year, and at the end of September the S&P 500 index already showed a positive return of about five per cent for this year. During the same period, the Helsinki Stock Exchange also recovered with vigour and reached a positive result. As to the Eurostoxx index, COVID-19 has left a gloomier mark. The STOXX Europe 600 index, which tracks the performance of the 600 largest listed companies in Europe, ended the third quarter with a negative return of about ten per cent (YTD). This was due to factors such as weaker-than-expected recovery in the European economy and the reintroduction of lockdown measures following the steady increase in COVID-19 cases. The FTSE 100 index, which describes the development of the 100 largest companies on the London Stock Exchange, has also lagged far behind during the past year. In the UK, the main concerns have been the smooth running of Brexit and the hundreds of thousands of cases of coronavirus detected in the country.

The mood in the fixed income market during the quarter was largely in favour of risk-taking. The US Federal Reserve changed its inflation target in August and will aim for an average inflation rate of two per cent in the future. The controversial EUR 750 billion COVID-19 recovery package previously announced in Europe inspired belief among euro area investors and strengthened the euro against other currencies. Aside from government bonds, other bonds also recovered on the buoyant market, which, however, took a downturn in September after the rise in COVID-19 cases.

Under such slightly confusing signs we set off for the last quarter of a horrendous investment year, with a wish list for Santa that is not long: an effective coronavirus vaccine and a harmonious change of administration in the United States.

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 following public-sector 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 collective supplementary pension funds managed by industry-wide pension funds and company pension funds, which was approximately EUR 4.3 billion at the end of 2019.