COUNTRY SPOTLIGHT NORDICS

Leading the way

David Adams considers why Nordic pension funds are so often ahead of their European counterparts with their investment strategies, and not just with their consideration of ESG

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For many years there has been a trend for pension fund managers across Europe to regard the way some pension funds in the four continental Nordic countries (Denmark, Finland, Norway and Sweden) approach investment strategy as unusually innovative. One reason why this argument looks strong today is that many of these pension funds have already successfully integrated environmental, social and governance (ESG) considerations into investment strategies, but there are other reasons one could use to make this argument.

In Denmark, PKA deputy director of investments Michael Flycht believes there have been some innovations in investment strategy in the Nordic countries, particularly in Denmark, from which other pension funds could learn. “It seems that all of us are a little bit ahead of most of the rest of Europe, although Dutch pension funds are also very sophisticated,” he says.

The widespread adoption of ESG policies may reflect the relatively high profile and advanced development of green finance within these countries.

“In the past couple of years there has been a huge momentum in sustainability and responsible investing,” says Nordea Life and Pensions acting group chief investment officer Erik Callert. “Many green funds and pension funds have started to reduce carbon emissions. Many funds are also making more impact investments, investing in green energy, in infrastructure or new technologies.”

Danish discipline

Of course, it is important to try to avoid generalising about pension fund strategies in four quite different countries. Strategies followed by pension funds within each of them are influenced by different factors within each country.

Many pension funds in Denmark are in a strong financial position in part because of disciplines imposed upon them by the country's financial regulators during the first two years of the current century, when the country entered a low interest rate environment ahead of most other European countries. This meant the funds needed to use hedging mechanisms, valuing assets and liabilities in the light of interest rate risks.

"That started pension funds having to improve their understanding of derivatives, because what people used was overlays, using derivatives – options and swaps – to get that interest rate sensitivity they needed," says Flycht. "Danish pension funds got used to using derivatives with credit and equities."

This has translated into strong performance: Denmark's pension funds delivered real net investment returns of 7.8 per cent in 2016, according to OECD figures; the second highest returns in any OECD country. The national compulsory occupational pension scheme, ATP, delivered investment returns of 29.5 per cent in 2017.

Innovation, within flexible, evolving investment strategies, has helped to deliver these results. Flycht says one important component of PKA's own investment strategy is to take a pragmatic approach regarding the benchmark. "If you do that then you invest much more freely," he explains. "We invest based on the true risk contrary to tracking error *[the risk of underperforming the benchmark]*. That leads us to a lot of investments that other people would never make."

Another important element of PKA's strategy has been the use of insurance-linked securities. "If there's a big hurricane then we risk losing quite a bit of money, but if things turn out the way we expect we make a lot of money," says Flycht.

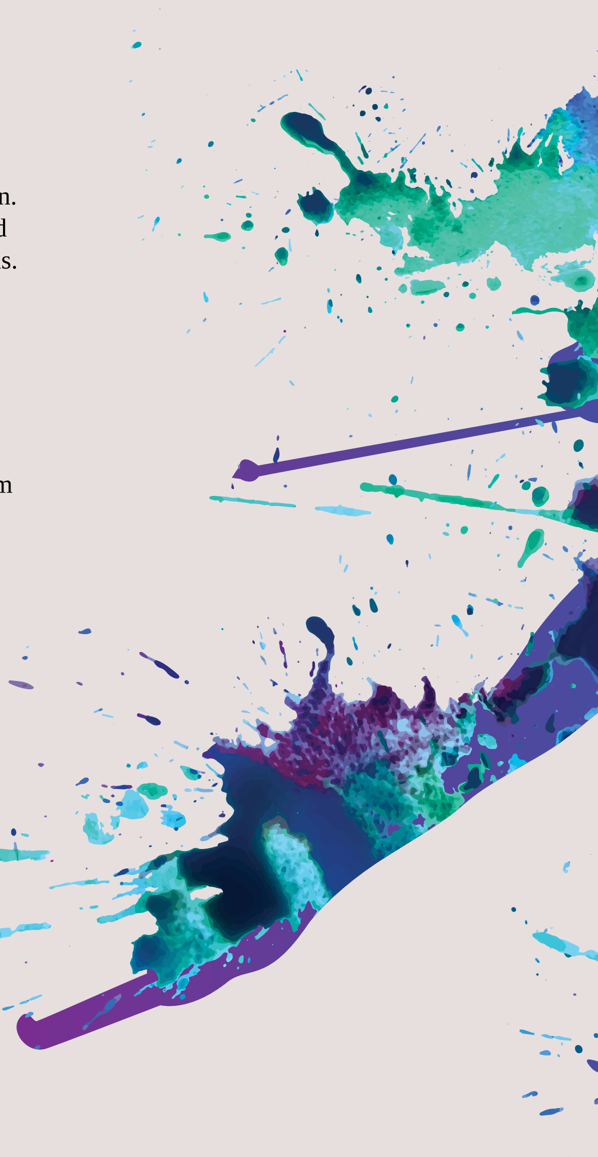
Use of these instruments forms part of a broader theme within the strategy: a search for diversification. "We're not only trying to find good returns versus risk," Flycht explains. "Every time we make a new investment we look at the risk on a standalone basis and on a portfolio basis."

Alternative approaches

In Finland, a stable pensions system may have helped to encourage the successful development of deep investment management expertise within pension funds. Mutual pensions insurance provider Varma has developed extensive in-house expertise in the creation and execution of investment strategies, says Varma director and head of cross assets and allocation, Kari Vatanen. "We are not using asset managers: we can create derivatives trading strategies, such as alternative risk premia strategies, because we have experience and expertise in direct investment in-house," he explains.

Vatanen has recently been presenting a new research paper on the subject of alternative risk premia investing to interested audiences across the globe. The paper proposes a new framework for this type of investing, to enable the construction of balanced investment portfolio, comprising fundamental, behavioural and structural risk premia, with each of these categories including defensive and offensive elements.

"Funds in the Nordics have been frontrunners in the use of alternative risk premia," says Vatanen. "All the



FUNDS IN THE NORDICS HAVE BEEN FRONTRUNNERS IN THE USE OF ALTERNATIVE RISK PREMIA

biggest pension funds in Finland are now involved in alternatives and have implemented some kind of factor-based investing programme."

Varma has also incorporated ESG considerations into its strategy. "We have integrated ESG into our investment management process when managing bonds or equities directly," says Vatanen. "ESG is a continuous development process for us. We have already achieved our short-term targets for carbon reduction, but there will be more to do in the longer run."

Scale and sophistication

The broader context of pension provision in Sweden has also had a strong influence on the development of pension fund investment strategies there. The country's state pension system is unique: based in part on the use of individual investment accounts, overseen by fund management companies. In addition, many employers auto-enrol workers in occupational schemes, or offer them on a voluntary basis. A stable, carefully structured system has helped pension funds to deliver reasonably healthy returns: pension funds in Sweden achieved real net investment returns of 4.9 per cent in 2016, according to the OECD.

KPA head of asset management Michael Kjeller believes Sweden has an equities culture. "You find larger allocations to equities than elsewhere in Europe," he claims.

But Kjeller is not sure Sweden's pension funds really deserve a reputation as innovators. "It's not a view we have of ourselves," he says. "If you were to ask which pension funds we believe are ahead of us, I think you would look at some funds in the Netherlands. We might also look at some funds in Denmark.

"But Swedish pension funds are in a good financial position in general. One thing I think we have been strong in is investing in derivatives." He also suspects Sweden is well ahead of many other countries in its attitude to ESG.

The ESG question also has a high profile in Norway, in part because of the influence on the two funds that form the Government Pension Fund of Norway. The Pension Fund Global, also known as the Oil Fund, is one of the largest sovereign wealth funds in the world and holds investments across the globe. The Pension Fund Norway invests only in Norway and some other parts of the Nordic region. Both use an investment mix of roughly 60 per cent equities and 40 per cent fixed income assets, with asset selection and management based on ethical investment principles.

The 8.5 trillion Norwegian kronor assets held in the Global Fund are managed by Norges Bank. In January 2018 it recommended to the Norwegian government that the fund should able to invest in private equity. At the time of writing no decision had been made, but the suggestion had led to heated debate.

Either way, the emphasis on ethical investment will remain – and the sheer size of these two funds and their commitment to ethical investment effectively helps to set the tone for investment strategies for all institutional investors in Norway; and, through the Global Fund, in many other countries. (There is an irony here, of course, in that so much of Norway's wealth comes from oil.)

While these are pension funds unlike any others, their influence can also be seen as another example of the way that those who devise investment strategy for pension funds in the Nordic countries sometimes set trends that are followed elsewhere.

While each of these countries may be very different from each other and from countries elsewhere, the strategies they are following around ESG and also, perhaps around alternative investments, are teaching other investors useful lessons from which they and the people whose money they manage may well benefit in future. ■

Nordic pension systems

Denmark

In 2012 Denmark's pension system became the first in the world to be awarded an A-grade by Mercer, in recognition of the funding, asset and contribution levels present in the country's state pension system and its highly developed and effective regulation of private pensions. The system incorporates the state pension, two statutory occupational schemes and voluntary private pensions. The state pension (folkepension) is partly means-tested and funded through general taxation on a pay-as-you-go basis. State retirement age will rise in line with life expectancy after 2025.

The compulsory occupational pension scheme is ATP, into which anyone who does more than nine hours of paid work per week must contribute, but employers pay two-thirds of the full contribution. Benefits are paid either as a lump sum if the amount saved is small or as a taxable annuity. ATP delivered investment returns of 29.5 per cent in 2017.

Many workers also join what are effectively compulsory industry-wide schemes set up under agreements made between employers and trade unions. Overall, Denmark's pension funds delivered real net investment returns of 7.8 per cent in 2016, according to OECD figures; the second highest returns in any OECD country.

Norway

The foundation of the pensions system in Norway is the state pension, which consists of a flat rate pension, supplemented by an earnings-related supplement to which all employees and self-employed individuals contribute. Employee contributions are 7.8 per cent of income, while employers pay 14.1 per cent. Additional supplements are provided for those who have had only low earnings during their working lives, or who support spouses with no income or children under the age of 18.

Pension provision is compulsory for employers and usually funded either through a group insurance arrangement or a pension fund. Many large employers offer DB schemes, although use of DC schemes is becoming more widespread. Insurance schemes dominate this sector.

Finland

Finland's national pension provides a flat rate benefit of up to 20 per cent of average wages. A minimum guaranteed income is set in accordance with the amount of earnings-related state pension for which an individual is eligible. The earnings-related element is funded on a pay-as-you-go basis, but administered by pension providers including insurers, company pension funds and industry-wide pension funds. Workers aged between 18 and 52 pay 4.1 per cent contributions, while those aged 53 and over pay 5.2 per cent. Employer contributions are larger and determined by the employer's total wage bill.

A 2017 European Commission report hailed Finland's linking of retirement age to life expectancy as an "exemplary" reform from which other countries in Europe could learn.

Voluntary occupational schemes are used by only 15 per cent of workers, usually on higher salaries. Not all of these pensions include employer contributions.

Sweden

The Swedish state pension system uses individual investment accounts, overseen by fund management companies. Pension benefits are based on three elements: an income-based element, funded on a pay-as-you-go basis, the earnings-related premium pension, which is funded and based on the individual investment accounts; and a guaranteed old age pension.

Many employers also automatically enrol workers in various funded occupational schemes, while others offer voluntary membership. Smaller schemes are usually insurance-backed.

Pension funds in Sweden delivered real net investment returns of 4.9 per cent in 2016, according to OECD figures; the fourth highest figure in the OECD.