INVESTMENT

Francesca Fabrizi **explores how Nordic pension funds, often regarded as leading lights in the European pensions space, are handling the current crisis**

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Nordic pension funds – business as (un)usual

Nordic pension funds are some of the most sophisticated in the world, setting the bar high when it comes to pension fund management and investment expertise. But the Covid-19 pandemic has had a far-reaching impact across the globe, and even the most proficient and forward-looking of institutional investors are unlikely to come out of these difficult months unscathed.

So how have these most revered pension fund markets coped with the coronavirus outbreak, and what is the general feeling in the Nordic pensions space?

"Most Nordic funds seem to just weather the storm, making little changes," says BNP Paribas Asset Management client relationship manager, Johan Skoglund.

"Appetite for new investments seems quite low and most are focused on monitoring existing investments and managers."

There have been occasions of funds taking advantage of the sell-off, he continues, but this is more of an exception. "Given the fairly good solvency situation for most pension funds, they haven´t been forced to sell for most parts," he says.

This positive sentiment is echoed by PensionsEurope secretary general/CEO, Matti Leppälä. He believes that Nordic pension funds are in a much better place than most to deal with this crisis.

"Their solvency and funding levels have been high; they had excellent returns in 2019; their investment teams are sophisticated; and their governance models support long-term views that enable dealing with difficult situations, as does their role in the Nordic welfare societies," he argues.

But, while the overall sentiment may be positive, that's not to say Nordic pension funds haven't been impacted. In Finland, for example, the total amount of pension fund assets at the end of 2019 was €215 billion and half of them were in equities. The crisis had wiped out about €20 billion by April.

But due to the set-up of the Finnish pension system, the main focus for pension funds now is business continuity and securing funding in the long term, explains Leppälä."The Finnish pension system is a mix of pay-as-you-go (PAYG) and funded, and the PAYG part is and remains much bigger." Thus, he adds, the role of contributions is more important than the investment returns, and it is crucial that the real economy recovers and supports a high level of employment as quickly as possible.

The role of investments is important too, he qualifies. "In 2019, about one-fifth of the annual pension expenditure was covered from them and it is planned that this portion will grow into one quarter in the future," he says.

At the time of writing, the Q1 results for Finland were coming in and they were showing losses of between -7.5 per cent and -10.4 per cent. Leppälä comments: "Private-sector funds that have solvency requirements still have a healthy solvency situation due to the excellent investment returns in 2019. Pension funds have been able to manage the liquidity they need."

So, all in all, while the Finnish pension funds have concerns, they are confident that they and the Finnish pension system will remain resilient, and weather this crisis well.

As for other countries in the Nordic space, they are similarly working hard to keep things on track. Every pension fund in Europe has been rocked and, as Willis Towers Watson Denmark leader of the investment practice, Morten Linde, accurately puts it, "it's business as usual – although nothing is as usual".

In Denmark, for example, while strategies haven't necessarily changed, tactical asset allocation has been adapted to the situation and rebalancing is taking place. "There are more clients changing their risk profiles, but it's difficult to say whether it's towards higher or lower risk profiles – since some of them see the situation as a threat and want to de-risk and others see it as a possibility to add risk. Our advice is to stick with the long-term investment strategy and not to time markets, which is what the majority do," says Linde.

Battling low interest rates

One of the biggest challenges facing pension funds in the Nordic region and further afield, before the coronavirus took hold, was the search for returns in the low interest rate environment. This, says Skoglund, made funds abandon government bonds for more high-yielding bonds, invest more in alternatives and real estate, and also uphold a substantial equity allocation, even at quite high valuations. That battle against low interest rates continues, but how the crisis will affect things in terms of asset allocation going forward, he argues, remains to be seen.

"So far, Nordic pension funds have not, in general, made any major changes and the underlying challenge of finding returns prevails. Interest rates are as low as ever, but equity risk premia and credit spreads have widened. Whether this will prompt any long-lasting changes to their investment strategies is too early to say," he adds.

The effect of the crisis on illiquid investments, which is a part of the portfolios that has increased over recent years, is also yet to be seen.

Max Matthiesen (part of Willis Towers Watson in Sweden) head of investments, Jon Arnell, agrees that one of the biggest challenges facing pension funds pre-crisis was the low interest rates, "and one way to deal with that has been to diversify into more alternatives like private debt and direct investing".

Going forward, he says, they will not change their investment approach, but more adapt to the markets. "You should stick to your long-term focus and continue to work with the portfolio in terms of diversifying between and within different asset classes," he advises.

In Denmark specifically, Linde concurs that the low interest rates pre-crisis created significant challenges for pension funds, causing a general move from guaranteed to market-rate products.

"The continued dropping of interest rates has caused pension funds to look elsewhere and invest in alternative non-public traded actives. Real estate is one that has always been a part of the portfolio but is now a bigger part. Infrastructure, private equity and direct lending are now also a larger part of the portfolios," says Linde.

For some time, there has been discussion about the pricing of these alternatives and the problem with the delay of pricing due to them not being publicly traded. "The coronavirus crisis and its larger volatility has heightened this discussion," he adds.

Even in Finland where, although 2019 was a record investment return year, there have been debates about how to enable the pension system to increase returns going forward given the low interest rate dilemma.

Finnish Centre for Pensions former managing director, Jukka Rantala, produced a study in January that pointed out the conflict between the prevalent low interest rate environment and the expected returns, and the legal framework that restricts pension fund investments in assets with higher expected returns than in fixed income.

The report presented three possible options: increasing solvency capitals; introducing more flexibility in funding requirements; and easing solvency requirements. The ongoing crisis will undoubtedly have an impact on how and when this type of reform progresses.

ESG

Another pre-crisis trend prevalent in the Nordic pension space was the spotlight on sustainability and ESG-focused investing which, says Arnell, will continue to take market share in Sweden and become an even more integrated part of investment strategies: "It was a strong trend before the market turmoil, and it will continue to be one going forward."

Similarly, in Denmark, there was a focus on the development of climate and green lifecycle products. "Two pension funds introduced products before the coronavirus crisis and three are coming with products this summer. The coronavirus crisis hasn't changed this, but whether the demand has changed is yet to show," says Linde.

Learning lessons

Looking ahead, it remains to be seen how significantly the crisis will impact the Nordic space, but even if these pensions funds are fit to weather the storm, Arnell believes lessons can still be learned from these uncertain times.

"One challenge has been the long bull market, which has led to too many investors taking on too much risk. Or in other words, taking on risks they didn't see or believed to be risks. A downturn is healthy that way as it shakes out the weak cards," he argues.

Also, Arnell says, many investors have had too much equity-like exposure, given the low rate environment, which in hindsight was too risky. "Going forward, at least we will dig deeper into this topic."

In addition to forcing some investors to re-think their behaviour, Skoglund argues that there may be opportunities for Nordic pension funds going forward: "To quote Winston Churchill – 'never waste a good crisis'. Depending on the solvency situation, it may be wise to make use of the situation and look for undervalued long-term investments. This can be in terms of assets that have sold off too much but also asset classes with superior long-term growth prospects that are not fully priced." ■