Fondbolagens förening
SWEDISH INVESTMENT FUND ASSOCIATION

Facts and myths about the premium pension

January 2013
(translated into English in March 2013)

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Summary

Critics of the premium pension system have often claimed, during the public debate about the Swedish pension system, that it is expensive and that its returns are substandard. It is blamed for the income pension system's balancing mechanism having been activated. The system's critics also claim that not only do few people care about their premium pension, but that those who actually do are jeopardising their entire future pension.
It is these allegations that this Memorandum is intended to counter.

Summary of conclusions:

- The premium pensions system has, several financial crises notwithstanding, outperformed the income pension in terms of value growth since its launch in 2000, growing by an average of 3.5 per cent each year as opposed to 2.2 per cent.
- 99 per cent of pension savers had, at the year-end, seen a positive value performance by their premium pension accounts since entering the system. Very few savers were to be found at either end of the curve with either a very low or a very high return.
- Differences in pensions will, in future, be primarily due to factors other than the returns generated by the premium pension.
- Savers are interested. Over half of all savers (58%) had made their own choice and account for 74 per cent of the assets under management.
- 71 per cent of people aged between 18 and 42 appreciate being able to make their own premium pension choices, even if they have not personally taken advantage of this opportunity.
- There is a competitive default alternative for people who want the state to handle their entire pension for them.
- The average discount on fund charges corresponds to over half the actual charge. 9 out of every 10 people, however, are unaware of these discounts. Saving in funds via the premium pension system may actually offer the best value for money.
- The original objectives of the premium pension system – the possibility of a better return, risk diversification and the ability to make decisions based on personal preferences – have been met.

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What is the premium pension?

Pension savings as a whole can be divided into three parts – the national public pension, the occupational pension, and private pension savings. The premium pension comprises only a small part of the national public pension. Pension credits comprising 2.5 per cent of an individual's pension base are allocated to the premium pension every year, in comparison with the 16 per cent credited to the income pension every year. Pension credit allocations are based on salaries and other pensionable income up to 7.5 times the income-related base amount, corresponding to SEK 424,500 for 2013.

The premium pension is the part of the national public pension that the individual saver can personally influence by choosing their own investment funds. Savers can choose up to five funds from the 800 or so funds registered with the Swedish Pensions Agency. If a saver decides not to choose their own funds, the capital is invested in the state management alternative, AP7 Såfa.

The premium pension capital is deposited in an individual account held by the Swedish Pensions Agency and is, unlike the other component of the national public pension (the income pension), credited directly to the individual premium pension saver.

Three overall objectives were formulated when the premium pension system was set up:

- **Improve the return**. Offering access to capital market investments generates the potential for returns that exceed economic performance (the growth in production value per capita).
- **Offer savers an increased risk diversification**. The ability to invest in economies other than the Swedish one enables the premium pension to be disengaged from demographic and economic trends in Sweden.
- **Enable investment decisions based on individual preferences**. Allowing savers to take their own investment decisions with regard to their premium pension means that the decisions can be made in line with the saver's personal preferences, e.g. with regard to risk level.

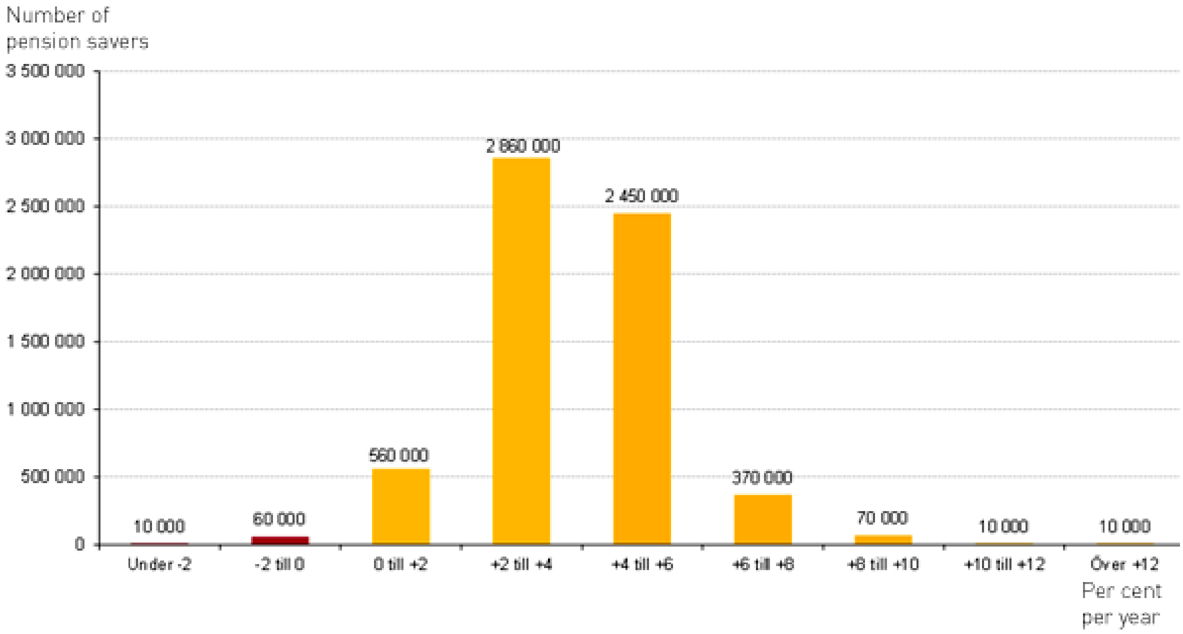
Premium pension system returns

The period since the introduction of the premium pension system has been an extremely turbulent one for the financial markets, but the system has still managed to deliver relatively good returns on investments.

Since 2000, when the premium pension was launched, we have seen a gigantic IT bubble burst, and then a global financial crisis, followed by a deep euro crisis. The average per annum return on the premium pension during this period has been 3.5%, successive crises notwithstanding, in contrast to the 2.2% per annum return that would have been generated if the capital had tracked the index, as the income pension does. [1]

Viewed from the perspective of the individual savers' returns, 99 per cent of all premium pension savers had seen a positive return on their premium pension account investments by the end of 2012.

Annual average investment return as a percentage (Internal rate of return, IR), individual accounts, 31 Dec. 2012



Source: The Swedish Pensions Agency: Monthly statistics – Funds and fund-based saving, 31 Dec. 2012

[1] Capital-weighted return from start (incl. temporary management by the Swedish National Debt Office, 1995–2000) up to and including the end of 2012. Source: the Swedish Pensions Agency: Monthly statistics – Funds and fund-based saving, 31 Dec. 2012.

Premium pension system costs

The following section addresses the commonly held beliefs that the premium pension system is costly (at the taxpayers' expense) and that a fund-based system (with "high charges" on the funds) risks undermining the value of future pensions.

The administration of the premium pension system is not financed through taxation but through the administrative charges that the premium pension savers pay. The average figure for these charges in 2011 was 0.11 per cent, or a maximum of SEK 110 per saver.

The elective funds' charges are, furthermore, heavily discounted in the premium pension system. The discounts are possible because the fund management companies have only a single customer within the system, namely the Swedish Pensions Agency, which handles all contacts with savers and administration. The size of the discount is based on the amount of premium pension capital that is invested in a fund management company's funds. 9 out of every 10 savers are, unfortunately, unaware of these discounts[2], even though these discounts account for the equivalent of over half the charge, and both the industry and the Swedish Pensions Agency need to improve their information provision in this respect.

The average fund charge within the premium pension system is a mere 0.3 per cent per annum after the deduction of discounts equivalent to 0.5 per cent. It should also be borne in mind that the individual saver is completely free to choose their own funds from an extremely wide range that offers funds with different orientations and charge levels, including at present, for example, funds that levy no charge at all within the premium pension system. If the saver makes no choices, the capital is automatically invested in a competitive fund with a charge that totals no more than 0.14 per cent per annum.

It may be wise, within the premium pension system and in the light of the substantial discounts available within that system, to take a slightly different approach to fund charges than that normally adopted, in that the construction of the premium pension discount means that funds with high charges outside the system are generally those that provide the biggest discounts, even in percentage terms, within the premium pension system. As a result, some types of funds can be bought at a "huge discount", specifically thanks to the premium pension system.

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[2] 2012 fund saver survey conducted by TNS Sifo Prospera

If one assumes, for example, that a person not only saves in funds through their premium pension but also has private fund-based savings, and that this person wishes, to some extent, to invest in emerging market funds (a type of fund characterised by relatively high charges), there are good rational reasons for that person to primarily use their premium pension savings for this type of investment in order to take advantage of the very large discounts offered. An emerging market fund may, for example, have a fee of 0.7 per cent within the premium pension system, but one of 2.5 per cent outside the system.

It is sometimes suggested that the state will be obliged to compensate people whose premium pension investments have not performed particularly well. The guaranteed pension is, however, not affected by the return within the premium pension system; rather, it is calculated as if the entire national public pension had been the income pension.

Activity levels within the premium pension system

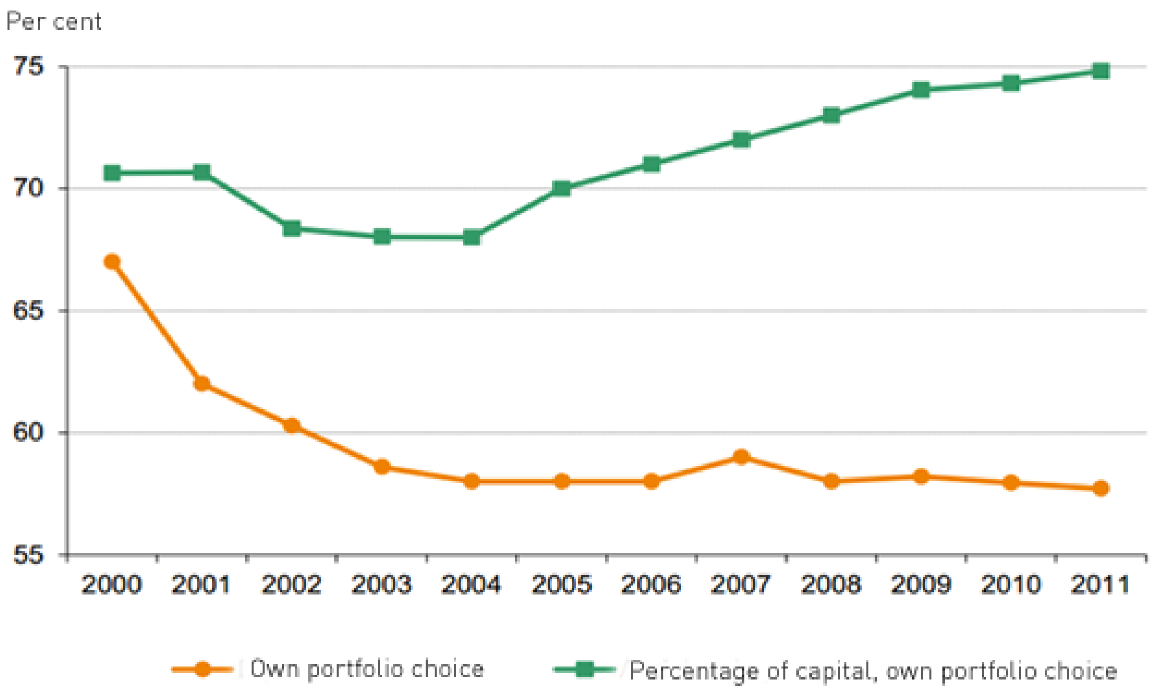
One of the arguments sometimes made against the premium pension system is that fewer than 2 per cent of all new savers in recent years have actually chosen a fund.

It is undeniably true that a very small percentage of new savers in their 20s choose their own funds for the premium pension system during the first few weeks after they receive their first annual statement. But it is also true that a larger percentage of premium pension savers who have been “in the system” for some time move their capital from the default alternative, AP7 Såfa, to their own, personally structured fund portfolio.

In 2011, for example, the default alternative gained approximately 130,000 new savers as a direct result of the fact that over 98 per cent of the new savers did not make an active choice. In the same year, however, approximately 100,000 savers took the opposite route, i.e. they chose to leave AP7 Såfa, opting instead to choose their own funds from the private range of funds available to them.

If all premium pension savers are taken into account, 58 per cent have chosen their own funds (2011) and this share has remained more or less constant for many years. These premium pension savers' capital accounts, furthermore, for a massive 74 per cent of the total assets under management[3], which is the highest share measured to date and means that only approximately one quarter of the total premium pension capital is invested in the no-choice default alternative.

Percentage of premium pension savers who have chosen their own fund portfolio, and their share of the capital



Source: The Swedish Pensions Agency report: "The premium pension – Pension savers and pensioners, 2011"

[3] The fact that the percentage of total capital is higher than the percentage of savers is due to the fact that savers with larger amounts of capital in their premium pension accounts are more likely to make their own fund choices. (Savers with AP7 Såfa have an average total capital of SEK 41,200, while those who make their own portfolio choices have an average total capital of SEK 89,800.)

A survey[4] conducted by TNS Sifo Prospera and commissioned by the Swedish Investment Fund Association has also shown that Swedes appreciate having the ability to choose their own funds within the premium pension system. The survey shows that two out of every three Swedes (63%) like the fact that you can make your own choice of funds within the premium pension system. It is worth noting that the youngest age group (aged 18–42) share this belief (71%) to an even greater extent.

Percentage who appreciate being able to make one's own choice or who would prefer the state to handle it, %

Age:	All	18–42	43–62	63–74
Personal choice is good	63	71	60	55
It's better that the state handles it all	30	23	35	32
Don't know/No answer	7	6	5	13

It should also be noted in this context that there is a completely suitable alternative for those who would prefer not to make their own choice. If no active choice is made, the premium pension capital is, as noted above, invested in a state-managed, competitive and well-diversified fund with a low charge.

AP7 Såfa is a fully acceptable alternative to a personally structured fund portfolio. The perception that this fund is the very best option is, however, incorrect. The return of the no-choice default alternative has been more or less the same as the average return for the privately chosen funds. Several hundred of the elective funds have, in other words, shown a better return on investments. It is also important to know that the default alternative is not a low-risk fund but an equity fund with leverage, which means larger rises and falls in line with stock market fluctuations, but that this also offers the potential for a greater long-term return.

Inequities and risks

The premium pension system is sometimes described as a casino in which you risk "gambling away" your future pension. It is also often stated that the premium pension system entails significant inequities due to the fact that different premium pension savers achieve different balances in the premium pension accounts.

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[4] fondbolagen.se/Documents/Fondbolagen/Studier%20-%20dokument/Fondspararunders%c3%b6kning%202012%20Fondbolagens%20f%c3%b6rening.pdf

In English: fondbolagen.se/en/Studies/General-facts-about-fund-saving-in-Sweden/

The premium pension accounts for only a small part of the national public pension – and an even smaller part of the total pension received. Taking a certain amount of risk in conjunction with premium pension saving does not, in other words, mean risking one's entire future pension. The majority of the national public pension (the income pension) tracks growth, i.e. equates to a fixed income investment. It could, therefore, be argued from a risk diversification perspective that the premium pension component should be exposed to the equity market, or at least that this opportunity should exist.

The opportunity for the individual to determine their investments' orientation and risk level on the basis of their personal preferences and financial position is at the heart of the premium pension system's structure. The premium pension system includes a very wide range of funds offering both low and high risk and those who do not wish to take the risk that exposure to the equities market entails already have the option of choosing a relatively secure fixed income investment instead.

Equities are a means of financing companies. Equity funds offer the opportunity to own shares in companies all over the world and to share in the growth created. Their value can fluctuate substantially in the short term, but in the long term, equities have always generated higher average returns than the risk-free fixed income option.

One common perception is that the number of funds available is far too large and that as a result, many pe0ple refrain from making personal choices. A wide-open range offers the potential for savers to fulfil different desires and, at the same time, the competition helps not only to increase pricing pressure, but also to enhance quality (increased value). A free product range has no predetermined optimal number of products, nor is the intention that everyone should be informed about every fund, but rather that the funds that different savers with different desires want should be available. It is important, however, that the choice is facilitated by means of a well-structured product range and the provision of high quality information and advice, and this is one area where there is scope for improvement.

The benefit that results from individual savers being able to influence their own risk level and return potential in line with their own preferences, also means is that the returns on investments will differ from one saver to another. This does not, necessarily, have to be a negative thing, however. The fact that a person who has chosen to take a slightly higher risk in their premium pension savings reaps the benefits of so doing in the form of a slightly higher return than a person who preferred to save in a more secure investment with a more consistent return is not, necessarily, inequitable.

Differences in pensions will continue in future to be due, in the main, to factors other than the return on the premium pension investment; acquisition frequency, salary levels, age of entry/withdrawal from the labour market will play a greater role. For pensioners with low pensions, higher marginal effects, i.e. the fact that increased earned income makes no tangible difference to the contents of the pension envelope, are a bigger problem.

Reduced premium pension component – who benefits?

A wish to see funds transferred from the premium pension system to the income pension, not least in order to stabilise pension disbursements to existing pensioners, has been expressed in a variety of contexts. The appropriateness of such a transfer, particularly given that it would, to some extent, entail a transfer from tomorrow's pensioners to today's, must be questioned in the light not only of the above arguments but also of the demographic trend we currently face. The percentage of people who are gainfully employed will decline while the percentage of pensioners will increase, and at the same time, the increase in people's lifespans will necessitate pension disbursements over an extended period of time.

Summary comments

The launch of the premium pension system at the start of the new millennium coincided with very high expectations of future stock market performance after a period of dramatically rising stock market prices. These high expectations have not been realised, largely due to a series of financial crises, but the returns generated within the premium pension system have, nonetheless, been better than those that would have been generated if the capital had tracked the income pension performance instead.

Pension saving is, for the vast majority of people, a very long-term savings project and a project of this sort of duration should include the option of a certain exposure to the stock market and hence, to the possibility of reaping the benefits of the risk premium that this entails – for those who want it.

Having the ability to influence part of one's own pension savings investment generates the potential not only for adjusting these savings in line with the individual's personal situation and preferences when it comes to risk and return opportunities, it also clearly helps give rise to a situation in which the individual is aware of and involved in their pension savings in particular and their savings in general.

In conclusion, it is clear that all three of the premium pension objectives formulated when the system was launched have been met: returns have, on average, been slightly better than economic performance, and savers have been offered a greater risk diversification while, at the same time, being offered the opportunity to make their own investment decisions based on their own, personal preferences.