The background is a blue-tinted photograph of a rocky cliff face. A white graphic consisting of six leaf-like shapes arranged in a circle is centered on the page. The text 'ANNUAL REVIEW 2014' is centered within this graphic.

ANNUAL REVIEW
2014

VER

VALTION ELÄKERAHASTO
STATENS PENSIONSFOND
THE STATE PENSION FUND



MISSION

The State Pension Fund (VER) is tasked to manage and invest the pension assets entrusted to it. Through the Fund, the state prepares to finance future pensions and equalise pension expenditure over time.

The State Pension Fund earns its income from pension insurance premiums and returns on investments. Premiums are paid by the employers and employees covered by the state pension system.

The pensions to be paid out by the state are included in the government budget to which VER transfers an amount equivalent to 40 per cent of the annual pension expenditure as provided in the State Pension Fund Act. Funds that are not transferred remain in the Fund.

Balancing state pension expenditure

VER is part of the state's partially prefunded pension system, and when established it was modelled on the private employment system (TyEL) and the Local Government Pension Institution Keva. As a so-called buffer fund, VER – unlike private (TyEL) pension companies – does not have any pension liabilities to cover individually. Therefore, VER is not subject to regulations governing solvency.

The guiding principle of pre-funding is to allocate the burden of cost to the right generation. In Finland, only a certain percentage of the cost of pensions is prefunded through funds. Since 2013, VER'S net premium income – or its pension premium income less the amount

transferred to the state – has remained negative. Consequently, VER contributes to the government budget more than it receives by way of premium income.

Over the next few years, the negative net premium income will increase to the extent that VER will be called upon to even out the state's pension expenditure with substantial amounts at or about the year 2030 when it peaks. The increase in pension expenditure will continue to grow even beyond 2030, albeit at a slower rate. It will not turn positive until 2045–2050.

Targeted 25 per cent funding ratio

The risk limits set by the operation guidelines by the Ministry of Finance are as follows: fixed-income investments must account for at least 35 per cent of the investment portfolio, equity investments may not exceed 55 per cent, and other investments may not exceed 12 per cent. VER's investments fall into four categories: fixed-income, equities, position management and diversified investments, and alternative investments.

According to the State Pension Fund Act, VER's target funding ratio is 25 per cent of the state's pension liabilities. The fund is grown until the level equivalent to this target is achieved. Whether this goal is achieved or not is determined by return on investments, pension contributions and transfers to the government budget.

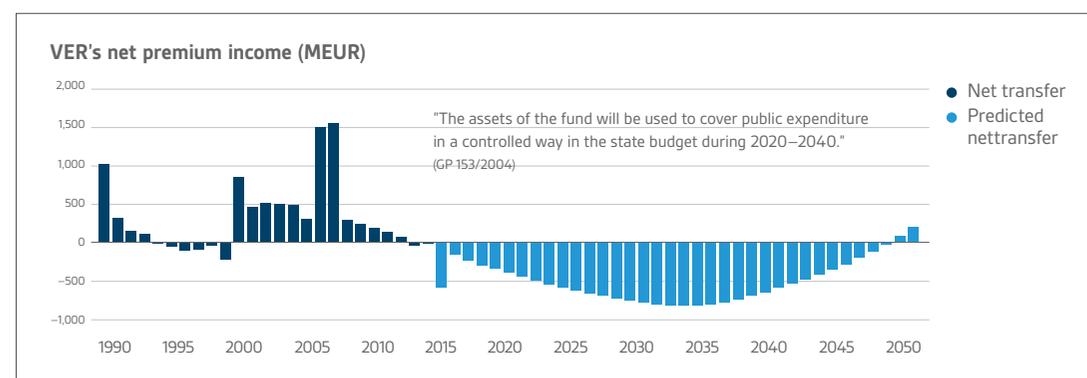
[READ MORE → VER.FI > MISSION](#)

Established in 1990, the State Pension Fund (VER) is an off-budget fund through which the state prepares to finance future pensions and equalise pension expenditure. VER is an investment organisation responsible for investing the state's pension assets professionally. VER operates as part of the prefunded Finnish pension system.

VISION



VER's vision is to be a valued and successful pension investor whose activities are characterised by a high standard of professional skill and ethical conduct.



VALUES



PROFESSIONALISM



ETHICS



TRANSPARENCY

KEY FIGURES

EUR 17.6 billion

At the end of 2014, the market value of VER's investment portfolio stood at EUR 17.6 billion.

KEY FIGURES

7.8%

In 2014, the rate of return on VER's investments was 7.8 per cent.

KEY FIGURES

Key figures	2010	2011	2012	2013	2014
Total investments, MEUR	13,937	13,736	15,359	16,335	17,600
Fixed-income investments, MEUR	7,574	7,781	8,380	8,431	8,874
Fixed-income investments %	54	57	55	52	50
Listed equity investments, MEUR	5,632	5,006	5,899	6,511	6,951
Listed equity investments %	40	36	38	40	39
Alternative investments, MEUR	731	948	1,080	1,392	1,774
Alternative investments %	5	7	7	9	10
Return on investments %	11.7	-2.3	11.3	6.4	7.8
Fixed-income investments %	3.9	4.1	8.8	-1.6	4.9
Listed equity investments %	23.6	-12.3	16.8	18.2	11.7
Alternative investments %	8.6	6.1	3.5	5.7	7.8
Cost of investment operations % (of average capital)	0.05	0.05	0.05	0.04	0.04
Number of personnel	19	20	21	22	23
Income from pension contributions, MEUR	1,622	1,614	1,639	1,634	1,712
Net premiums, MEUR	154	104	35	-45	-16
Transfer to state budget, MEUR	1,473	1,509	1,604	1,678	1,728
Balance sheet total, MEUR	12,763	13,087	13,676	14,321	14,715
Pension liability, MEUR	90,600	89,700**	92,600**	94,000**	95,400**
Funding ratio %*	15	15	17	17	18

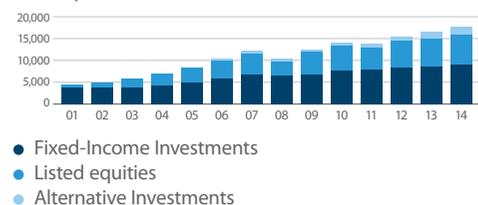
* Investments / pension liability

** A life expectancy coefficient was first taken into account in the pension liability calculations on 31 December 2012. The calculation is made using forecasts for the development of life expectancy from the Finnish Centre for Pensions. The like-for-like liability figure for 31 December 2011 has been recalculated to account for the life expectancy coefficient.

VER's portfolio allocation, 31 Dec 2014



Development of VER's Investments 2001–2014 (MEUR)



INVESTMENT STRATEGY

The State Pension Fund invests its funds responsibly and securely to generate profit. The Fund also aims to clarify and promote its corporate image as an independent portfolio investor.

In its operations, VER is called upon to ensure the security, return and convertibility of its investments as well as their due diversity and distribution. Investments have been spread and diversified as customary in the employment pension system.

VER is a long-term investor whose returns may fluctuate sharply over short time spans. All investment decisions are based on target return and the yield potential offered by prospective investments with due regard to the risk involved. Risks are spread by investing in different asset classes, markets, industries, instruments, companies, government bonds and maturities.

Objectives of the investment activities

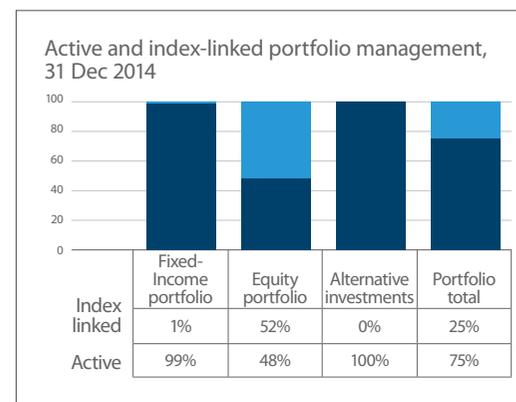
According to the target return established for VER by the Ministry of Finance, the investments are to generate a higher rate of return than an alternative investment considered risk-free from the state's point of view. 'Risk-free alternative' refers to the cost of the state's net debt, including the cost of derivative contracts made as part of debt management. Here, 'net debt' refers to the difference between the state's budgeted debt and cash reserves. The return on VER's investment activities, when adjusted for risk, must exceed the return of the benchmark specified in the fund's investment plan.

One of the requirements for good overall returns is a comprehensive network of partners. This means that VER actively networks with the management of companies in which it invests, as well as with public authorities, Finnish and foreign providers of investor and brokerage services, and other European pension investors.

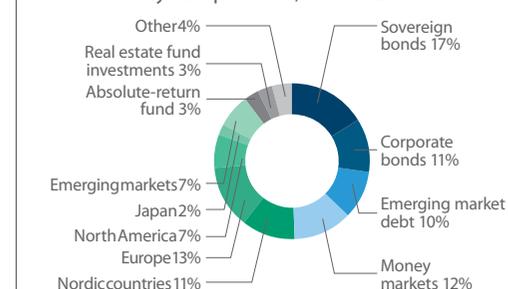
Investment plan

Every year, VER draws up an annual investment plan. It defines the strategic allocation of the portfolio, meaning how the investments are divided between the various asset classes. The goal is to create an optimum investment portfolio that generates a maximum return at the selected risk level. The investment plan and policy are subject to confirmation by VER's Board of Directors.

Anticipated rates of return and risk levels are determined for the various asset classes and the entire portfolio using a scenario analysis with due regard to market rates and changes in risk premiums as well as correlations over time in each asset class. The strategic allocation is continuously monitored and can be adjusted in accordance with market changes by Board decision, within the given risk limits. Changes to the strategic allocation require adjustments to the fund's investment strategy.



Allocation by sub-portfolio, 31 Dec 2014



READ MORE → VER.FI > INVESTMENT STRATEGY

VER'S ROLE IN EQUALISING PENSIONS GROWING

VER is an important actor in society. In terms of pension expenditure, the government is under greater pressures than other sectors: in the private sector, pension expenditure and premiums are more or less at an equilibrium, whereas the state's pension expenditure has increased rapidly while at the same time the premiums have declined substantially. In fact, state pension expenditure is expected to nearly double by 2030 when the costs peak. As a result, there will be a gap of almost EUR 3 billion between expenditure and income, most of which will be covered by taxes. VER equalises the state's pension expenditure by contributing to the national budget an amount equivalent to 40 per cent of all its pension costs. Over the next few years, VER's role in equalising pensions will only grow.

Since 2013, VER'S net premium income – or its pension premium income less the amount transferred

to the state – has remained negative. Previously, the accrued net premium income increased VER's investments assets.

The increase in pension expenditure will continue to grow beyond 2030, albeit at a slower rate. It is forecast that finances will not be back in positive until 2045–2050.

Consequently, the return on investments is the key to VER's success. By 2015, VER had generated EUR 3.5 billion added value for the State of Finland through its investments. Over the same period, the value of VER's investment portfolio more than quadrupled.

Boost to employment and economic growth in Finland

Through its investments, VER supports employment and economic growth in Finland. A sizeable percentage of investments in real estate, infrastructure and private equity are made in Finnish companies,



either directly or through funds. Some 10 per cent of VER's bond investments are directed in Finland.

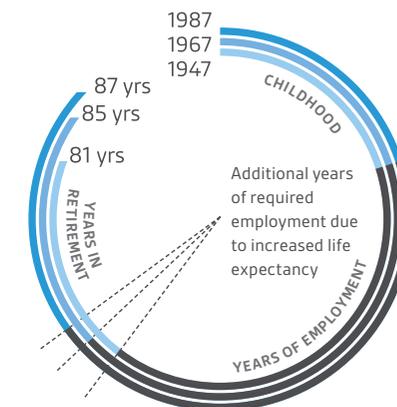
In 2008 and 2009 when share prices plummeted and companies had problems with financing, VER participated in several share and corporate bond issues. All in all, VER invested a total of EUR 1.5 billion in equities and corporate bonds in 2008 and 2009. At the same time, VER was a major investor in commercial papers in the Finnish market.

Over the past two years, VER has focused on new opportunities in the private credit market and invested in several European funds, some of which also invest in Finland.

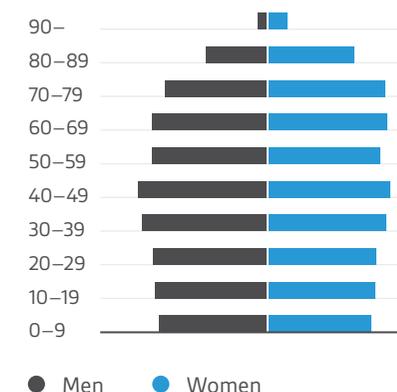
As the state's pension expenditure will not peak until later, VER's contribution to sustaining the Finnish economy will grow.

READ MORE → VER.FI > FUTURE OUTLOOK REPORT

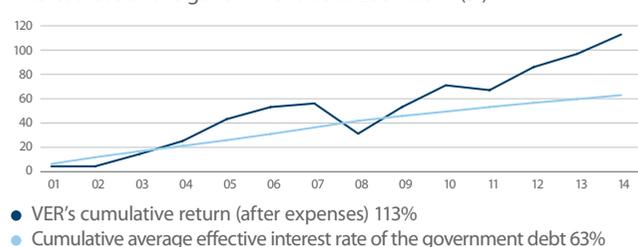
Life expectancy according to year of birth and additional years of required employment



Demographic structure according to age and gender in 2030 (forecast)



VER returns on investment vs. average effective interest rate of the government debt 2001–2014 (%)



18%
funding ratio

KEY FIGURES

EUR 95.4 billion
pension liability

KEY FIGURES

INVESTMENTS BY VER

Fixed-income investments

Investments in fixed-income instruments are designed to offset the risks associated with equities. Under normal market conditions, the defensive element in the portfolio consisting of government bonds and money market instruments has a negative or very weak correlation to equities. Government bonds are used primarily for generating income through the management of interest rate risks by modifying the portfolio duration and interest curve position.

The money markets serve as a sort of liquidity buffer when values in other asset classes fluctuate. At the same time, the most risk-laden investments exhibit a stronger correlation with equities. In these asset classes, the objective is to earn by taking credit risks in addition to managing the interest rate risks. The fixed-income portfolio is further divided into four sub-portfolios: government bonds, corporate bonds, emerging market debt and money markets.

In 2014, the overall return on the fixed-income portfolio was sound, reaching 4.9 per cent. Interest rates declined sharply while inflation was record low, mainly as a result of a substantial fall in the price of oil and weak economic growth.

Direct investments accounted for 73 per cent of the entire fixed-income



FIXED-INCOME INVESTMENTS

In 2014, the return on fixed-income instruments reached 4.9 per cent.



EQUITIES

In 2014, the return on equities reached 11.7 per cent.



POSITION MANAGEMENT AND DIVERSIFIED INVESTMENTS

Towards the end of 2014, a new portfolio called Position Management and Diversified Investments was established at VER. The new portfolio and the limits applied to its operations took effect on 1 January 2015.

portfolio, and fund investments for 27 per cent. At the end of the year, VER held direct fixed-income investments in 199 debt instruments as well as investments in 34 funds.

Equities

VER's equity investments are spread globally and divided into five sub-portfolios: Europe, Nordic countries, Emerging Markets, North America and Japan. Investments are made directly in listed companies or through funds. Most of the direct investments are made in listed Nordic companies while other geographical areas are mainly addressed through fund investments. They include both passive index investments and active funds of various forms. The strategies pursued by the individual funds may vary greatly depending on the investment policies employed. VER also makes use of exchange-traded funds (ETFs) in its investment operations.

In 2014, equity investments yielded a healthy return of 11.7 per cent. By the end of the year, the size of the equity portfolio reached EUR 7.0 billion. At the end of the period, direct equity investments accounted for 31.2 per cent of the total with 68.8 per cent invested through funds. Direct investments were held in 156 companies and fund units in 60 funds.



Position Management and Diversified Investments

Position Management focuses on limiting the market risks affecting the entire portfolio by using derivatives. Market risks consist of interest rate, credit, equity and currency risks.

Diversified investments consist of absolute return and blended funds that include risk premium and parity funds as well as so-called total return funds. Aside from funds, investments are made through total return swaps.

In 2014, VER's absolute return funds yielded a return of 5.96 per cent. The highest returns were generated by macro funds that benefited from the strong trends in the US dollar, crude oil and fixed-income instruments.



ALTERNATIVE INVESTMENTS

In 2014, the return on alternative investments was 8.2 per cent. The rate of return does not include absolute return funds transferred to the new portfolio as of the beginning of 2015.

Alternative Investments

Alternative investments refer to investments in real estate, private equity, infrastructure and private credit funds. Aside from funds, investments are made in unlisted Nordic companies, of which there are currently four in the portfolio. Most of the fund investments are in Europe while all the direct investments have been made in Finland. Over the next few years, the objective is to diversify private equity investments in the emerging markets and the United States, and private credit investments in the United States.

The construction of the alternative investments portfolio was begun in 2006; by the end of 2014, the market value of the investments had reached EUR 1,275 million accounting for 7.25 per cent of VER's entire investment portfolio. In 2014, the all-year return on the portfolio was 8.2 per cent. The best performance was put in by private equity funds at 12 per cent followed by real estate funds at a healthy 9.9 per cent. Private credit investments returned 5.1 per cent and the infrastructure portfolio 3.7 per cent.

Fixed-Income Investments, 31 Dec 2014



Equity Investments, 31 Dec 2014



Alternative Investments, 31 Dec 2014



READ MORE → VER.FI > PORTFOLIO

RISK MANAGEMENT

As part of the Internal Audit function, risk management refers to the identification, assessment, limitation and control of principal risks arising out of VER's own operations or external circumstances. Internal Audit seeks to minimise unforeseen risks and ensure efficient, reliable and financially sound operations.

VER's risk management policies are controlled jointly by the Financial Supervisory Authority (FSA), the Ministry of Finance, VER's Board of Directors, Investment Consultative Committee and auditors.

Risk management in practice

A risk analysis is carried out on an annual basis as part of the risk management plan and in consultation with Internal Audit. The analysis aims at defining the key operational risks, their effects and probabilities including

any needs to develop the risk management capabilities. In addition, it aims at charting the external operating environment with regard to investments, the probabilities and effects of the risks present in the operating environment and the potential of VER's risk management function to regulate such risks. Risk management also seeks to identify ways of controlling and limiting risks.

At VER, risks are divided into investment risks and operational risks. Risk management comprises both a qualitative risk management plan and a quantitative risk analysis undertaken in the form of portfolio stress testing. At its core, risk management amounts to the identification of acceptable and non-acceptable investment-related risks and the tools available to control them.

[READ MORE → VER.FI > RISK MANAGEMENT](#)



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RESPONSIBLE INVESTING

For VER, responsible investment implies effective and consistent observance of the investor's responsibility. It encompasses monitoring the responsibility and sustainable development of target companies, as well as conducting responsibility-related dialogue with these companies and with external asset managers.

VER pursues a policy of responsible investment in respect of all investment categories. However, actual policy implementation may vary according to asset class because the latitude available for the application of the underlying principles varies.

VER has signed the United Nations Principles for Responsible Investment (PRI) and complies with the Responsible Investment Guidelines issued by the Finnish Pension Alliance TELA. VER is also a member of Finland's Sustainable Investment Forum (FINSIF). This is the Finnish contact organisation for the PRI, and it promotes awareness of responsibility within financial management and investment-related decision-making.

Ethical and sustainable investing

In its responsible investment operations, VER observes the following principles of ethical and sustainable development:

- Ethical investment refers to avoiding certain industries (companies with significant portions of revenue coming from arms, alcohol, tobacco, gambling or adult entertainment).
- Sustainable investment refers to considering ESG (environmental, social and governance) factors in the investment process.

The ethical principles are applied in all direct investments. The sustainable development principles are applied by using ESG criteria in evaluating investment targets. Ethical and ESG factors are included in the investment decisions. VER is aware of the fact that these principles may be difficult to abide by in the case of certain complex investment instruments.

[READ MORE → VER.FI > RESPONSIBLE INVESTING](#)

FIXED-INCOME INVESTMENTS	EQUITY INVESTMENTS	POSITION MANAGEMENT AND DIVERSIFIED INVESTMENTS	ALTERNATIVE INVESTMENTS	RISK MANAGEMENT AND ANALYSIS	FINANCE AND SECURITIES OPERATIONS
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