

# Tapiola Pension's Investment Review 2010

**TAPIOLA**

Tapiola Pension



# Successful Investment Year 2010

- Excellent year for investments: return on investments reached 10.8% and solvency strengthened further.
- Positive return compared to market was achieved through independent investment policy.
- Investment returns in five and ten year average were 5.1% and 5.9%. The investment return throughout 2000s achieved expected return targets.
- Equity investments remained at high level and the main focus was in the emerging markets as well as in the Nordic markets.
- In the fixed income investments focus was on the corporate bonds with stable underlying fundamentals.
- The total amount of investments in eurozone government bond decreased further and the allocation focus was sifted towards core European governments such as Germany, Finland, France and Holland.
- Tapiola Pension was chosen as Finland's best pension fund investor by IPE.

## Successful target-oriented investment strategy

The aim of Tapiola Pension's investment activities is to maximise returns in the long run. The risk levels are continuously monitored in the relation to the company's solvency and risk bearing capacity. Investments are expected to outperform markets in such way that returns remain at a good level over the economic cycle – regardless of market development. Good investment returns contribute high bonuses to our customers.

The basis of our investment activities is an independent and efficient allocation process. We analyse and implement the majority of individual investments ourselves. Our activities are supported by the efficient use of external and independent experts.

Transparent asset allocation enables us to achieve investment targets. We allocate assets between various investment instruments and asset classes and ensure sufficient diversification. We do not engage in trading or hasty profits.

Tapiola Pension is committed to the United Nations' Principles for Responsible Investment, and we have developed and continue to develop our investment policy in relation to responsibility.

Our systematic investment process has also received international recognition. Investment and Pensions Europe (IPE), an organisation evaluating the European pension fund investment market, chose Tapiola Pension as Finland's best pension fund investor. In the IPE European Pension Fund Awards, our company was the only Finnish company to be recognised. A year earlier, we were selected as the best in house investment organisation in Europe in the same competition.

## Successful long-term investing

In our opinion, the key to success in investing is rigorous risk management, efficient allocation process and in-house asset management capabilities. By analysing markets independently, our investment organisation forms a view of the long-term return potential of different asset classes and the related risks. Our own investment professionals follow and analyze all the main markets to gain extensive knowledge to support decision-making.

One of Tapiola Pension's main focus areas has always been on efficient allocation process. In total, Tapiola Pension utilizes three levels of asset allocation. The strategic allocation is based on long-term view and often changes the least, whereas tactical and dynamic allocation can be used to adjust investments more rapidly to market changes. Excessive trading in equities does not, however, guarantee good returns, and for this reason, our investments are often long-term.

The last decade as a whole was a successful period for Tapiola Pension's investments and a good example of the efficiency of systematic, independent investment activities that rely on efficient allocation process. Over the last ten years, Tapiola Pension's annual investment return has been among the highest in the industry, 5.9 per cent on average.

## Investments are carefully analysed

Across asset classes, all investments are analyzed thoroughly before making the final investment decision. Careful analysis and value appraisal of investments is one of the cornerstones that Tapiola Pension's investment activities rely on.

The global financial market demands that the investor has skill and ability to react. Weightings between various industries

over the different phases of the economic cycle, geographical allocation of investments, recognition of the world economy's growth prospects and identification of the development trends changing the world, as well as selection of individual investments, are key issues in daily investment work. Thus, it is of particular importance to take care of the skills and expertise of the company's own personnel.

## Responsible investing is not just risk management

Responsibility is also an essential part of Tapiola Pension's operations in investment activities, as well as a focus for continuous development. For several years, our own investment activities have been guided by jointly agreed principles that are applied to the various asset classes. An ongoing dialogue and meetings with companies' management teams, active ownership and in-depth knowledge of the investments reduce the chance of negative surprises and provide an understanding of the kinds of factors that make a good, responsibly operating company, and thus a good investment.

Observation of the extensive sub-areas that comprise responsible investing – such as environmental matters, good governance and social aspects – requires us to be methodical in our own operations. We focus on a specific area annually and develop our own investment processes on the basis of it.

We have assessed forward-looking responsibility by analysing the operations of companies from the angle of climate change. As a result of extensive analysis, we have identified those companies in our portfolio that have made efforts to slow down the progression of climate change, develop new operating models replacing the old, or reduce their environmental footprint. We believe that it is among these kinds of companies that future successes are to be found – as well as profitable investments.

## Economic environment in 2010 and prospects for 2011

### Investment markets are still very volatile

In 2010, the recovery of the global economy continued at a relatively steady pace, although uncertainty regarding the sustainability of growth and concern about rapidly increasing government debt levels did at times cause strong market reactions. The theme dominating the year was the debt crises in Europe's peripheral states, which was a consequence of weak budget discipline that had been going on for years, as well as the unexpectedly deep recession in the real economy.

In addition to the debt problems in the eurozone, developed countries' confidence in the economy was strained by the temporary weakening of the economic outlook for the US around the middle of the year.

Fears of a so-called double-dip recession only started to dissipate in August after the US Federal Reserve indicated its willingness to launch a new, extensive government bond purchasing programme.

In Finland, the confidence of companies and consumers remained high. The unemployment rate began to decline in 2010, which was a particularly positive surprise. Due to the strong recovery of exports, Finland's economic growth is likely to reach three per cent.

In developed countries, the focus of stimulus measures moved increasingly from fiscal policy to monetary policy. The European Central Bank (ECB) and the US Federal Reserve kept their key interest rates at historically low levels throughout the year.

In the fixed income market, the debt crises in the peripheral states of the eurozone increased the demand for "core state" government bonds considered to be safe, which lowered the interest rates of bonds to countries such as Germany and Finland. In the peripheral states of the eurozone, however, interest rates rose very steeply and at the index level, the return on eurozone government bonds remained at about 1.2 per cent in 2010.

Despite share price fluctuations, equity market returns were excellent in 2010. The weakening of the euro against other major currencies significantly improved the return on investments made in equities outside the euro area.

### Uncertainty continues in the global economy

Tension between the short-term outlook for developed countries and the long-term structural problems is again increasing. During the first half of the year, cyclical recovery may even strengthen. In particular, confidence in the US economy's outlook in the near future has clearly increased. There are, however, still several factors creating uncertainty. In Europe, the biggest risks are political and connected with upholding the credibility of the monetary union. The further the year progresses, the more developed countries' structural problems will begin to weigh down growth opportunities.

Inflation pressures are still low in developed countries. As regards trends for nominal gross domestic product, there are still no bases for a significant rise in interest rate levels. The equity market outlook for the near future is boosted by the possible recovery of US economic growth and moderate valuation levels – particularly compared to the low interest rate. The structural problems of the global economy and Europe's political risks will, however, sustain uncertainty and increase the possibility of sharp corrective moves.

# Tapiola Pension's active portfolio management

Tapiola Pension's cornerstone of investment operations is a clear and efficient investment process which emphasises thorough investment analysis and a precise assessment of risks. Our goal is return that outperform the market and volatility that is lower than in the markets. The efficiency of the investment process has been enhanced and the organisation strengthened in the recent years. We ensure that the management of investment operations is as efficient as possible. We make most of the investments ourselves; only a fifth of investment assets are managed by external asset managers.

Tapiola Pension's investment performance in 2010 was excellent: return on investment was 10.8 per cent. This was the second best year in the company's history, after 2009. Direct equity investments generated the highest returns, rising as high as 23.1 per cent. Also, fixed income investments generated a good return of 6.4 per cent, which could be considered excellent in relation to the performance of the market as a whole. Return on equities and fixed income investments in the company's portfolios clearly exceeded the benchmark returns with volatilities remaining lower than the markets. The return on investments was also significantly increased by an active currency hedging strategy.

The most significant change in allocation concerned the amount of fixed income investments: their proportion of the investment portfolio was reduced during 2010 from about 60 per cent to 50 per cent. Fixed income investments were replaced with both equities and so-called alternative investments. The proportion of equity investments of the investment portfolio was increased from 28.5 per cent to 34.6 per cent.

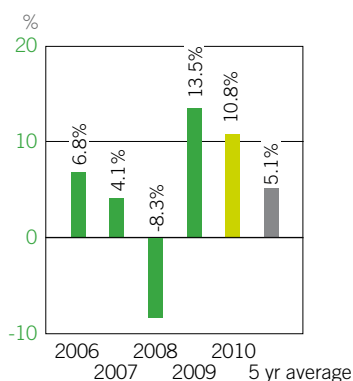
The alternative investment strategy has been carefully prepared at Tapiola Pension. This enables us to ensure that the strategy fulfils all the return and risk targets set for our investments. The first alternative investments were made during the autumn of 2010.

## Tapiola Pension's investments in 2010

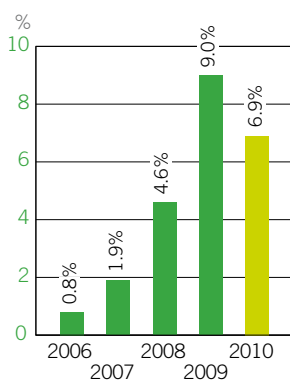
Tapiola Pension's return on investment at current value was 10.8 per cent (13.5 per cent in 2009). Investments at current value totalled EUR 9,378.3 million (EUR 8,473.4 million), and net investment income at current value came to EUR 922.3 million (EUR 1,013.0 million).

During the period 2001–2010, the average nominal return on investment was 5.9 per cent and real return 4.3 per cent.

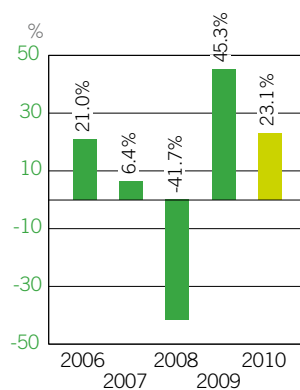
Overall return on the investment portfolio



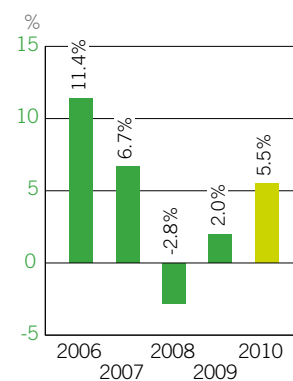
Return on fixed income investments



Return on listed shares



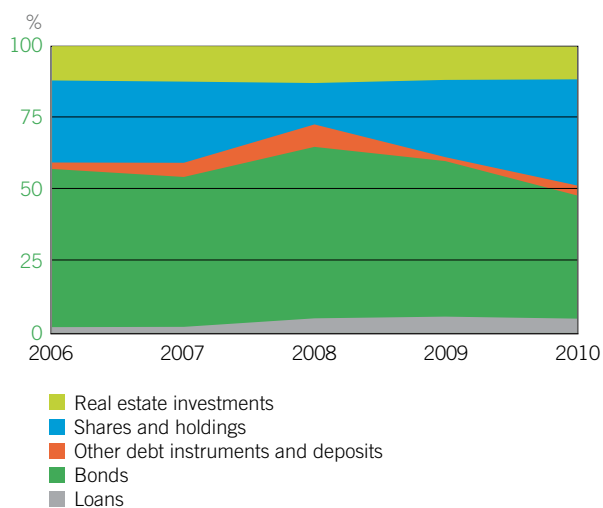
Return on real estate investments



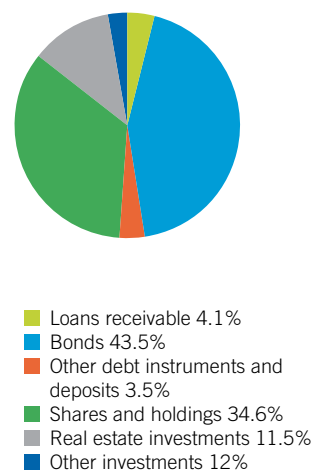
## Allocation as of 31 Dec 2010

	Market value, EUR m	Market value, %	Risk distribution, EUR m	Risk distribution, %	Return, %
Loan receivables	389.0	4.1	389.0	4.1	3.2
Public sector bonds	1,657.7	17.7	1,647.8	17.6	6.3
Other bonds	2,424.2	25.8	2,434.3	26.0	7.3
Other debt instruments and deposits	409.8	4.4	330.8	3.5	0.3
<b>Fixed income investments</b>	<b>4,880.6</b>	<b>52.0</b>	<b>4,801.8</b>	<b>51.2</b>	<b>6.4</b>
Listed shares	2,914.3	31.1	2,993.1	31.9	23.1
Private equity funds	188.4	2.0	188.4	2.0	13.0
Unlisted shares	61.9	0.7	61.9	0.7	9.2
<b>Equity investments</b>	<b>3,164.7</b>	<b>33.7</b>	<b>3,243.4</b>	<b>34.6</b>	<b>22.3</b>
Direct real estate investments	904.2	9.6	904.2	9.6	6.9
Real estate investment funds and collective investments in transferable securities	173.8	1.9	173.8	1.9	-1.3
<b>Real estate investments</b>	<b>1,078.0</b>	<b>11.5</b>	<b>1,078.0</b>	<b>11.5</b>	<b>5.5</b>
Hedge funds	80.6	0.9	80.6	0.9	-1.2
Commodity investments	0.0	0.0	0.0	0.0	-
Other investments	174.5	1.9	174.5	1.9	-6.0
<b>Other investments</b>	<b>255.1</b>	<b>2.7</b>	<b>255.1</b>	<b>2.7</b>	<b>-5.9</b>
<b>Total investments</b>	<b>9,378.3</b>	<b>100.0</b>	<b>9,378.3</b>	<b>100.0</b>	<b>10.8</b>

Structure of the investment allocation  
2006–2010



Breakdown of assets  
on 31 Dec 2010



## Fixed income investments

In the fixed income market, 2010 was characterised by a high level of uncertainty concerning eurozone banks and states. Public sector debt and budget deficits have grown rapidly in nearly all of the eurozone states. As a consequence, Greece and Ireland had to accept emergency aid offered by the other member states and the IMF, and the interest rates of bonds issued by the eurozone's peripheral states, in particular, rose steeply. During the latter part of the year, doubts about the sufficiency of support measures and increased political uncertainty also caused interest rate rises in the government bonds of stronger states.

Trends in the corporate bond markets were guided by the concerns caused by the eurozone peripheral states last year. Because of this, the volatility of bonds issued by the banking sector and companies in the peripheral states of the eurozone remained high throughout the year. Otherwise, growth was positive as a whole. Banks and companies with high credit ratings issued substantially fewer bonds than in the previous year. In contrast, there was a record increase in the proportion of high yield corporate bonds on the European corporate bond market.

Tapiola Pension's 6.4 per cent return from fixed interest investments in 2010 clearly outperforms the return of 2.1 per cent of the iBoxx index, which describes the European bond markets. The return on fixed income investments was higher than the benchmark index due to successful allocation decisions and management of the interest rate risk. Overweight in government bonds and significant underweight in the bonds of the peripheral states had the biggest impact on the

difference between the returns. Investments in corporate bonds accounted for about one third of fixed income investments.

At the start of 2010, we increased investments in developing markets, which, as a single asset class within fixed income investments, generated the best return. As a result of the financing crisis in the European peripheral states, we significantly decreased our investments in the financial sector. Toward the end of the year, we increased the proportion of money market investments in the fixed income allocation. Half of the fixed income investments had a credit rating of AAA.

At the end of the year, the company's fixed income investments totalled EUR 4,801.8 million. The modified duration of the portfolio, which indicates its interest rate risk, was 4.8 years, slightly lower than the benchmark.

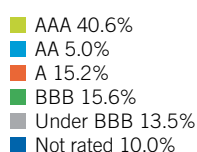
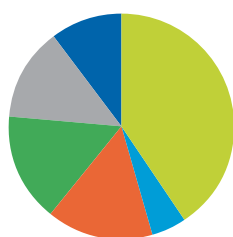
## Loans

The demand for premium loans was steady during 2010, albeit somewhat slower than the previous year's level. The demand was mainly focused on working capital financing and reorganisation of financing and ownership. Companies are also increasingly keen to diversify their sources of finance.

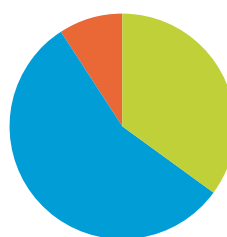
The positive market sentiment during the year did not, however, translate into significant new investments or company acquisitions.

Overall, the proportion of loan receivables of Tapiola Pension's total investments declined slightly and was 4.1 per cent at the end of the year. Return on loans was 3.2 per cent.

Fixed income investments  
by credit rating  
on 31 Dec 2010



Allocation of fixed  
income investments  
on 31 Dec 2010



## Shares and holdings

### Listed shares

As a whole, the market for equities developed positively in 2010. The sharp rise in prices that started in March 2009 was reversed in the early part of the year when uncertainty regarding the sustainability of economic growth increased. The bottom of the market was reached in May 2010, when the equity markets in the US plummeted by nearly 10 per cent in one day. After a summer of fluctuation, share prices began to rise sharply in the beginning of September. The price rise can be considered to have resulted from improved economic development and the good results of companies. Furthermore, the Federal Reserve's decision to start new support purchases of US government bonds amounting to USD 600 billion improved the sentiment in the equity markets, particularly during the second half of the year. Developing markets assumed their place as the growth engine of the global economy.

The Nordic equity market performed better than the rest of Europe, and developing markets were strong. Cyclical industries, such as mechanical engineering, mining and the auto industry, were the strongest sectors. In contrast, development was more modest in sectors that have generally been considered stable and safe, such as healthcare and utilities. Currency movements were unusually big, so the implemented currency hedging policy has had a major impact on the equity returns for euro-based investor.

Tapiola Pension further increased the proportion of equity investments in its total investment portfolio. Equity allocation was increased throughout the year, even though the majority of purchases were made in the early part of the year. Tapiola

Pension focused its purchases particularly on shares of well-established global companies. The proportion of emerging markets in the investments was also increased.

Thanks to successful company, industry and country selections, as well as good timing, the company's investments in listed shares returned 23.1 per cent. Tapiola Pension's investments in listed shares totalled EUR 2,993.1 million. Equity allocation increased by about 6 percentage points during 2010. The company's investments in Finnish shares returned 33.4 per cent and in Nordic shares, 37.5 per cent. The return on our investments was also significantly increased by an active currency hedging strategy. During the same period, the Stoxx600 index describing the European equity markets returned 11.6 per cent and the MSCI World index describing the global equity markets returned 20.6 per cent.

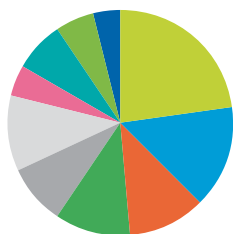
Finnish shares accounted for about 20 per cent of listed equity investments, which was slightly less than in the previous year, but slightly over 30 per cent of direct equity investments. At the turn of the year, Tapiola Pension owned shares in 82 companies, 31 of which were in Finland. The company had fund investments in 28 funds.

### Investments in non-listed companies

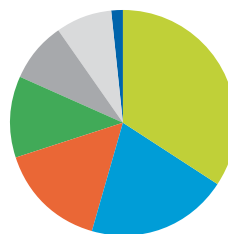
In 2010, Tapiola Pension continued to be active in the markets, making some further investments, but also some exits.

After 2009, a year of historically few company acquisitions, activity in mergers and acquisitions showed a moderate recovery during 2010. Activity is expected to recover further in 2011.

Equity investments  
by industry  
on 31 Dec 2010



Equity investments  
by region  
on 31 Dec 2010



The positive performance of portfolio companies and the general rise in valuation levels had a positive effect on the returns on unlisted investments. The annual return on unlisted direct investments was 9.2 per cent.

### Private equity investments

Private equity investments are investments in private equity and venture capital funds, in which the main focus is on international funds. The activity of private equity investors increased globally compared to 2009 and, boosted by improved valuation levels and return on investment targets, return on investment turned positive. We are expecting the activity to increase further during 2011 and also fund-raising to be more active than in the previous year.

At the end of 2010, the current values of investments in private equity funds totalled EUR 188.4 million and the annual return was 13 per cent.

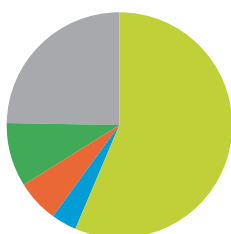
## Real estate investments

There was a slight recovery in international real estate markets, and investment transaction volumes have already grown in many European countries. The Finnish real estate market remained fairly subdued, although the market atmosphere improved markedly compared to the uncertain situation of the previous year. Increasing numbers of real estate investments were made during the latter part of the year. The challenges of the real economy continued to have an impact on the office rental market.

At the end of 2010, the current values of Tapiola Pension's direct real estate investments totalled EUR 904.2 million, and the rate of return was 6.9 per cent. The main additions to the real estate portfolio included investments made by our private equity real estate funds and direct investments in Helsinki, Espoo, Kokkola and Oulu.

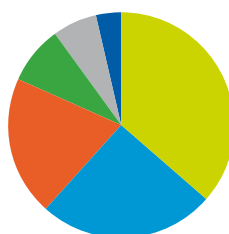
Indirect real estate investments consist of investments in private equity real estate funds and investments in mutual real estate funds. The listed real estate market developed favourably, following the rise in equity markets. This had a positive effect on the value and return of mutual real estate fund investments. The year was challenging for private equity real estate funds, but returns are expected to be positive during 2011.

Private equity investments by type on 31 Dec 2010



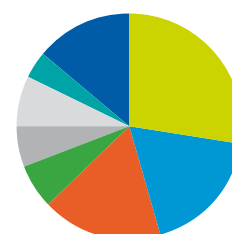
- Buyout 56.4%
- Mezzanine 3.6%
- Secondary 6.3%
- Venture 9.0%
- Unlisted shares 24.7%

Real estate investments by type on 31 Dec 2010



- Office 36.5%
- Commercial 25.5%
- Residential 20.0%
- Hotel 8.1%
- Logistics 6.6%
- Other 3.4%

Real estate investments by region on 31 Dec 2010



- Helsinki 27.6%
- Vantaa 18.1%
- Espoo 17.4%
- Turku 6.2%
- Tampere 5.9%
- Oulu 7.2%
- Jyväskylä 3.9%
- Other 13.8%

# Investment risks

Management of risks associated with investment activities is one of the core processes of investment operations and an important part of the investment policy. Limits and diversification targets in line with the company's investment policy are set for risks in such a way that the company's solvency is not endangered under any circumstances. Investment allocation and other return and risk targets and limitations are specified in the investment plan confirmed annually by the Board of Directors.

In decision-making concerning investment class allocation, Tapiola Pension utilises its own analysis model, which includes returns, spreads and interdependence of investment classes. The general solvency of the earnings-related pension insurance sector is also taken into account in the calculation. The so-called strategic allocation thus calculated describes the investment class allocation that is likely to generate the best result at the desired risk level. The asset class weightings are reviewed several times a year.

Key investment risks include market risks, counterparty risks, liquidity risks and operational risks. Market risk refers to the possibility of losses from investments as a result of changes in market prices or volatility. Market risks include equity risk, interest risk, currency risk, commodity risk and the risk caused by changes in real estate values. Equity risk refers to changes in share prices in the markets. The unsystematic equity risk, i.e., a risk relating to a company or an industry, can be reduced by diversifying investments across several investment objects and also geographically across several different regions. Systematic equity risk is created as a result of changes in the economic situation and sudden market disturbances. Interest risk refers to the impact of the general interest rate level and

credit risk margins on fixed income investments. Currency risk is created when investments other than euro-denominated investments are made and the currency risk is not hedged.

Counterparty risk refers to the inability of the other contracting party to fulfil its obligation; for example, as regards the payment of interest, capital or rent. When defining risk limits, the aim is to take into account the likelihood of the counterparty's insolvency and to avoid the creation of excessively large risk concentrations.

Liquidity risk refers to the weakening of the company's own liquidity due to a lack of liquid funds. In order to ensure liquidity, Tapiola Pension keeps a sufficient proportion of its investments in liquid assets and takes into account the repayment schedules of investments. To ensure sufficient liquidity, some of the investments are kept in short investment instruments.

Investment risks are managed, monitored and reported on in accordance with the financial industry practices. Risk monitoring is implemented both as an internal function within the investment organisation and as risk management control independent of the organisation making investment decisions. Return on investment is also regularly compared with market returns and competitors' returns. The key targets and limits of the investment plan are monitored daily. Standard-form reports are provided to the Board of Directors monthly.

As regards operative risks, the company complies with its own general operational risk management procedures in investment activities. Deviations (close calls and actual risk events) are registered and the events are reviewed regularly in various meetings and in the Management Group. The operating model is a good tool for the development of operations and risk management.