The State Pension Fund

Summary of Annual Report 2003

Valtion Eläkerahasto
Statens Pensionsfond
The State Pension Fund

Contents

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2003 In brief

Established in 1990, the State Pension Fund is an off-budget fund by means of which the State prepares for financing pension's payable in the future and for evening out pension expenditure.

• The employers and employees covered by the State Pension Scheme make pension contributions to the State Pension Fund. Pensions are not paid out from the State Pension Fund, but instead all the pensions falling within the State Pension Scheme are paid from appropriations in the State Budget.

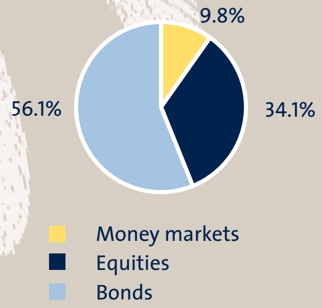
• The value of the investment portfolio was about EUR 5.8 billion at the end of 2003, against EUR 4.8 billion at the end of 2002.

• The investment portfolio is divided into fixed-income investments and equities. Fixed-income investments accounted for 66 per cent of the portfolio and equities for 34 per cent at the end of 2003. Fixed-income investments amounted to EUR 3.8 billion and equities to EUR 2.0 billion at the end of the year. A year earlier the corresponding figures were EUR 3.8 billion and about a billion euros.

• The investments yielded a return of 9.4 per cent in 2003, compared with a negative return of 0.4 per cent a year ago. The yield on fixed-income investments was 4 per cent (7.2 per cent) and the return on equity investments was 20.7 per cent (26.7 per cent negative).

• Operating expenses amounted to 0.05 per cent of total assets.

BREAKDOWN OF THE STATE PENSION FUND'S INVESTMENT PORTFOLIO, 31 DECEMBER 2003



AMOUNT OF ASSETS UNDER MANAGEMENT, EUR millions	2003	2002
State Pension Fund's investments, total	5 795	4 841
- Fixed-income investments	3 821	3 777
- Equity investments	1 974	1 064

INCOME FROM INVESTMENT OPERATIONS, %	2003	2002
Return on investments	9.4	-0.4
- Fixed-income investments	4.0	7.2
- Equity investments	20.7	-26.7

Income from investment activities has been calculated in accordance with the international GIPS standard. Expenses have been taken into account in the total yield on investments since 2003.

"Investing pension assets calls for a high sense of responsibility and a long-term approach," says Managing Director Timo Löyttyniemi.

Managing director's review

The State Pension Fund's task is to act as a buffer fund and asset manager. In carrying out this task, we assist the Finnish State in evening out ever-increasing pension expenditures. Providing for pension expenditures will be one of the paramount social themes in Europe over the next decades.

Finland has done fairly well in providing for the mounting pension expenditure. Major changes have also been made to the pension system we use. Some time ago, a new pension model that will go into use starting in 2005 was approved, and in the future it will also have implications for State employees.

The funding of investment assets is one way of preparing to meet future pension expenditures. The pension liabilities for State employees amount to about 55 billion euros, calculated in current money. Our funding ratio is thus about 11 per cent and plans are to increase it.

The 2003 investment year was tolerably good. The year took a turn for the better in March and equity prices swung upward. In the equity markets, prices strengthened substantially and bonds yields too were positive.

In its own investment activities, the State Pension Fund has done well in benefiting from the market rebound.

To diversify its asset management, the State Pension Fund began investing in the equity market in December 2000 and thereafter it has increased the weighting of equities gradually. At the end of 2003 their weighting was 34 per cent. The intension is to raise their proportion to 40 per cent by the end of 2004. It is now apparent that it has been wise to time such a major increase in the equity weighting over several years.

In autumn 2003 we commissioned several quantitative analyses of the State Pension Fund's optimal investment portfolio. On the basis of these calculations, we decided not to change our neutral weighting between fixed-income and equity investments. According to a number of experts, equities are expected to yield an additional annual return over bonds of about 3.5 per cent. At the present level of about 2 per cent for short interest rates and 4 per cent for long rates, this would mean that the expected return on the State Pension Fund's investment portfolio over the long term would be about 5 per cent.

In acting as an asset manager, we strive to make optimal use of our own and external resources. Part of the investments are made as direct bond, money market and equity investments, whereas part are handled through funds run by external asset managers. In using our own and external resources, our objective is professional and cost-effective asset management.

At the end of 2003, the expenses of the State Pension Fund's investment asset management were 0.05 per cent of aggregate investment assets. Estimated on an annual basis, the cost of external asset management was 0.5 per cent. The cost level is affected by the use of efficient asset management on an indexed basis compared with asset management that actively seeks higher returns. Moving optimally between these approaches is a continuous process which will be a particular focus of attention for us.

As a portfolio investor, we seek to diversify our investments. This enables us to improve the risk-return ratio of the investment portfolio. The State Pension Fund's portfolio comprises more than 200 direct investments and about 40 different holdings of shares in the mutual funds. Taking into account the target companies of the mutual funds, we have spread our investments over a few thousand companies in different parts of the world. The portfolio is nevertheless overweight in Europe, where euro-denominated investments can be made without incurring foreign exchange risk.

Investing pension assets is a responsible and long-term activity. We want to carry out our mission professionally. In managing investment assets, continuous market fluctuation must nevertheless be taken into account. This will also hold in coming years as well. We nevertheless hope that by means of professional asset management we will be able to assist the State in providing for pension expenses in coming decades.

I wish to thank our staff for their very successful investment performance in 2003. At the same time, a special vote of thanks goes to Jukka Wuolijoki, the former managing director, for his long years of work for the State Pension Fund. Developing the State Pension Fund's operations and asset management has been a multi-year project which can now be fruitfully continued. My best wishes to all our partners in co-operation for a successful year.

Timo Löyttyniemi

The State Pension Fund

The Finnish State has provided for its employees' pensions for a very long time. Back in the 19th century, the view was that civil servants deserve a salary and a pension in return for the work they do for the State. Today, the State Treasury, which operates under the Ministry of Finance, functions as the State's employment pension institution.

At the beginning of 2003 the State Pension Act covered about 180,000 people, of whom 130,000 were State employees. Benefits were being paid to nearly 290,000 people. Pensions paid out amounted to EUR 2.8 billion. State pensions are paid from appropriations in the State Budget. The State's pension liability in 2003 was about 55 billion euros.

The State Treasury, which has operational responsibility for the State's pension security, each year determines pension contribution percentages for State offices and institutions and collects pension contributions for the Pension Fund. The size of the pension contributions is determined in accordance with the employer's number of staff, the breakdown by age and sex, the risk of employment disability and lower pensionable ages.

The State Pension Scheme was overhauled in the course of the 1990s by giving new State employees entitlement to the same level of pension security as in the private sector. In line with the pension reform that is planned to come into force from the beginning of 2005, the differences compared with the private pension system will disappear once and for all.

A common theme running through the employment pension reform is to keep Finns in working life for 2–3 years longer than at present and thereby to ensure pensions for future generations. In State workplaces, work intended to support job well-being and stamina has been carried out for a long time. The guiding principle is to enhance working ability and the entire workplace so that fewer and fewer people will have to retire from employment in the State sector before they are eligible for an old age pension.

Established in 1990, the State Pension Fund is an off-budget fund by means of which the State prepares for financing pension's payable in the future and for evening out pension expenditures in different years, especially those that will soon be paid out to baby boomers.

The State Pension Fund's funding objective is proportioned to both the State's payroll and the pension liability. In 2010 the State Pension Fund must have funded assets of one and a half times the payroll amount, but at least 20 per cent of the full amount of the State's pension liability.

Investment activities are controlled by a Board of Directors appointed by the Ministry of Finance. The Board's members represent both the employer and employee side. To support the Board of Directors' decision-making process, a Consultative Committee for Investments has been appointed, whose duty it is to issue a statement on the investment plan. The State Pension Fund's accounts and operations are supervised by auditors appointed by the Ministry of Finance as well as by the Insurance Supervision Authority and State Audit Office.

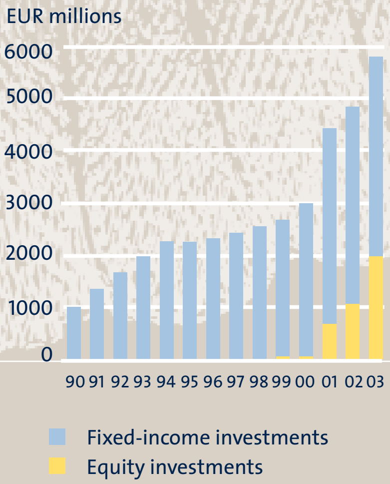
Mission

The State Pension Fund's mission is to manage the assets entrusted to it over the long term and to ensure that the investments are secure, deliver a good return and can be converted into cash, whilst also seeing to it that they are properly diversified.

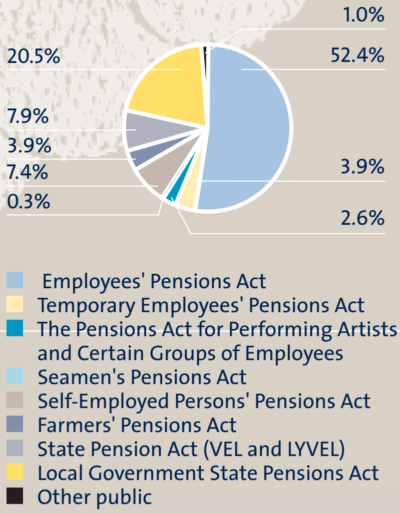
Vision

We want to be a well-regarded and successful pension investor that stresses high professional skill and ethics across all its operations.

TREND IN THE STATE PENSION FUND'S INVESTMENTS 1990-2003



RECIPIENTS OF PENSION SECURITY UNDER THE EMPLOYEES' PENSIONS ACTS, 31 DECEMBER 2003



A person can be covered by more than one employment pension acts at the same time. The figures are estimates.

Source: Central Pension Security Institute

Investment activities

Portfolio Managers Esa Artimo and Jan Lundberg analyse changes in the foreign exchange markets.

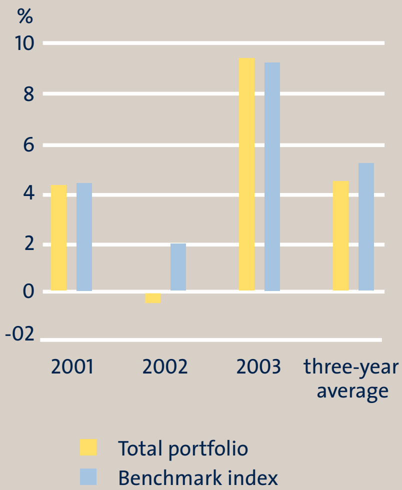
The uncertainty over economic growth at the start of the year gave way to strengthening economic fundamentals towards year-end and to an optimistic outlook for the next year.

Economic environment

There were no clear signs of an upswing in the economy in the early part of 2003. The economic data that came in right at the beginning of the year were still positive but as the year wore on, the figures and market sentiment grew more and more dismal. Redundancies and unemployment increased both in the United States and in Europe. In the early months of the year, economic growth has not yet recovered as expected.

The outbreak of war in Iraq was seen as the main reason for the uncertainty over which way the economy was headed. On the other hand, several growth-retarding factors were in effect even prior to this. For example, industrial capacity utilisation rates have been at a historically low level for some time now. In addition, a new factor of uncertainty that impacted the markets was the threat posed by the SARS epidemic, the extent and significance of which were difficult to assess. Against this backdrop, economic actors refrained from making large and long-term purchases during the spring.

TOTAL PORTFOLIO RETURN COMPARED WITH THE BENCHMARK INDEX



The conclusion of hostilities and the easing of the SARS hysteria boosted faith in the future, especially amongst consumers. This showed up in the confidence indicators that were published in the early summer, particularly in the United States. In the second half of the year, private consumption picked up sharply in the United States. This was attributable largely to lower loan servicing expenses due to the refinancing of home mortgages and to tax cuts, both of which bolstered consumers' finances. This was reflected particularly in the 8.2 percentage point growth in the United States' third quarter gross domestic product. Another manifestation of the strong growth was the drop in the unemployment rate, which declined from a year high of 6.3 per cent to a level of 5.7 per cent. In the eurozone and Japan too, economic growth was faster in the second half of the year than in the early months.

During 2003 the United States dollar weakened by more than 20 per cent against the euro and by just over 10 per cent against the Japanese yen. The strengthening in the euro was not attributable to the relative strength of the eurozone economy but mainly to the weakness of the dollar. The appreciation of the yen in turn reflected an improvement in the country's economy. The dollar was weakened by investors' concern over the United States' mounting current account deficit and the means of financing it. Not even strong economic growth was enough to curb the dollar's slide.

Strengthening economic fundamentals were also reflected in the strong rise in the prices of the main raw materials, such as metals, during 2003.

Monetary policy was very stimulatory throughout the world during 2003. Maintaining a relaxed monetary policy was made possible by the prevailing low inflation. Central bank interest rates were dropped well into the first half of the year, but the first central bank rate hikes were seen in the latter part of the year as the Reserve Bank of Australia and the Bank of England tightened their rates. Fiscal policy was very loose, and this was reflected in the strong increase in public sector deficits in the main industrial countries.

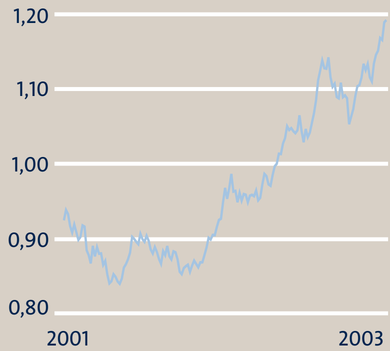
The State Pension Fund's investment portfolio and its development

The State Pension Fund's investment portfolio grew significantly during 2003. The size of the portfolio at the end of the year was EUR 5,795 million (EUR 4,841 million at the end of 2002). The portfolio's time and capital-weighted yield calculated according to the GIPS standard was 9.4 per cent. The yield figure includes all the expenses of investment activities since the beginning of 2003. The portfolio's benchmark index yielded a 9.3 per cent return during the same period. In 2002 the yield on the investment portfolio was 0.4 per cent negative.

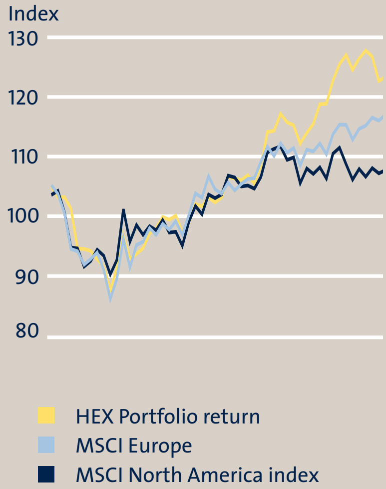
The market value of fixed-income investments at the close of the year was EUR 3,821 million. The Fund was slightly overweight in fixed income investments (66 per cent of the total allocation at the end of the year). The market value of fixed-income investments at the close of the year was EUR 3,821 million. A neutral weighting at the turn of the year would have been 65 per cent. The fixed-income portfolio yielded a return of 4.0 per cent (the reference index was 4.0 per cent).

The return on equity investments last year was 20.7 per cent (benchmark index: 19.2 per cent). The market value of equity investments at the end of 2004 was EUR 1,974 million.

TREND IN THE EURO/DOLLAR EXCHANGE RATE 2001-2003



TRENDS IN THE EQUITY MARKETS



Source: Reuters

Fixed-income investments

Fixed income investments were still profitable in 2003.

Fixed income investors faced a challenging environment in 2003.

High volatility in the fixed-income market

At the start of the year, there was a slight rise in long interest rates – over five years – but the rise went into reverse as weak economic figures and geopolitical uncertainties piled up. Interest rates headed upward again in mid March when the hostilities began in Iraq. The perspective of a quick conclusion to the war sent the interest rates on both short and long-term bonds upward again at the beginning of April as market demand shifted away from the safe harbour of sovereign bonds.

With economic indicators again pointing to slowing growth and against the backdrop of a strengthening euro, low inflation and fears of deflation – particularly in the United States – interest rates dropped to the lowest levels of the year in June. Thereafter, improved economic prospects lifted interest rates very strongly up until August. In the latter part of the year, the movements have been falling and rising by turns, but the amplitude of the movements was more moderate than previously.

Sovereign bond issuance in the EMU area remained large, amounting to a total of EUR 576 billion in 2003. The factors behind this were fiscal policy stimulation and the fact that the improved economic situation did not yet have time to boost the growth in tax revenue. Major changes did not take place in the spreads on the bonds of different states. Even the abandonment of the Growth and Stability Pact by France and Germany did not lead to wider spreads.

Demand for corporate debt remained strong last year as investors sought higher yields in a low interest rate environment. This meant that the spreads on corporate debt against government bonds narrowed markedly. Expectations of an improving economic situation, companies' stronger balance sheets and the scarcity of corporate bond issuance compared with demand had a positive effect on the yield on corporate bonds.

The State Pension Fund's fixed-income market investments in 2003

The State Pension Fund's fixed-income portfolio yielded 4.0 per cent, or roughly the same as the benchmark index. The State Pension Fund was again overweight in fixed-income investments in the first half of the year. The overweighting was at its greatest in March. The reason for being overweight in fixed-income investments was the fall in the equity market and the rise in the fixed-income portfolio. In the latter part of the year, the weightings of fixed-income instruments and equities were fairly close to neutral.

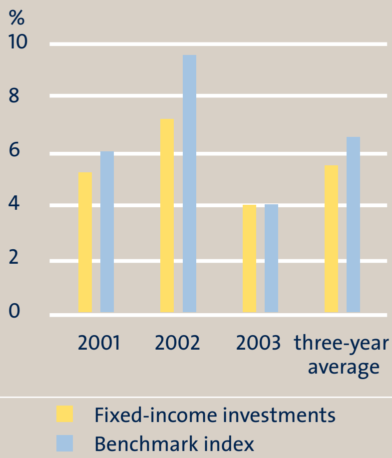
The diversification of fixed-income investments continued during the period. The State Pension Fund began its own direct investments in corporate bonds in 2002 and continued to build up the portfolio. Within sovereign bonds too, the composition of the portfolio was made more diversified.

Calculated in market value terms, the fixed-income portfolio grew from EUR 3,776 million at the start of the year to EUR 3,821 million. The State Pension Fund purchased EUR 3,120 million of bonds and notes during the year and sales of them amounted to EUR 2,762 million. Money market investments over the same period totalled EUR 1,898 million. Of the sub-portfolios, the corporate bond portfolio outperformed the benchmark index clearly. The success was attributable to the good return on High Yield investments and the properly timed weighting of the corporate bond allocation. The EMU portfolio also exceeded the reference index by making use of the Fund's reading of the interest rate curve and good judgement in country weightings.

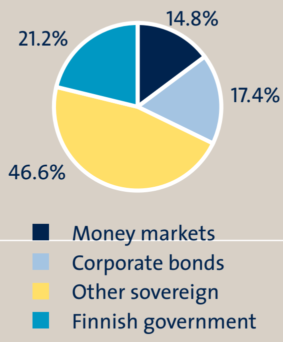
As a rule, the State Pension Fund makes its own direct fixed-income investments in sovereign bonds, Investment Grade corporate bonds and money market instruments. Other investments are made through mutual funds. Direct investments accounted for 90 per cent of the aggregate fixed-income portfolio.

The entire fixed-income portfolio was kept below the average duration for nearly the whole year, but in the last month of the year it was brought up to the index duration. Corporate bonds were overweighted in the allocation in the first part of the year, but the overweight position was reduced as the summer approached. At the end of the year, the corporate bond allocation was overweight again. The proportion of money-market instruments varied between over- and underweighting during the year, ending up at an underweight position at the end of the year.

YIELDS ON FIXED-INCOME INVESTMENTS COMPARED WITH THE BENCHMARK INDEX



FIXED-INCOME INSTRUMENTS BY SECTOR AT 31 DECEMBER 2003



Source: Reuters

Equity investments

In the equity markets, 2003 was the first year of positive returns in the new millennium.

The equity market rebounds

With a quick resolution to the Iraq war, stock prices began to rise in the first part of the year in the aftermath of the stock market crash. In the summer, economic growth began to pick up, first in United States and later on in Asia too after the SARS fever receded. During the autumn, earnings were at least at the expected level. Comments issued by companies when reporting results were for the most part cautiously positive, and corporate earnings forecasts for 2004 were raised during the latter part of the year.

Unlike in previous buoyant years, the rise in share prices in Finland last year was not Nokia-led. Suffering from growth pains, the company's share price fell by ten per cent, whereas the HEX Portfolio Index was up 22.7 per cent over the same period. Amongst the strongest gainers in the latter months of the year were cash-rich companies, which were judged to be about to pay out big dividends on the eve of the reformed dividend taxation.

Asia's strong economic growth was also reflected in returns on equities. China's strength fed through to the other countries in South East Asia. The MSCI index, which the State Pension Fund uses as a reference index for the Asian equity market outside Japan, rose by nearly 40 per cent in local currency terms, but the appreciation of the euro trimmed the index yield to twenty per cent.

The State Pension Fund's equity investments in 2003

The State Pension Fund's equity portfolio returned about 20.7 per cent last year, against a return of 19.2 per cent for the benchmark index. Outperforming the benchmark index was due mainly to successful investments in small company funds as well as to the correct choice of companies for direct equity investments. Good timing also played a part. The annual returns on the equity portfolio have varied greatly, because in 2002 the equity portfolio returned a negative yield of 26.7 per cent.

> **The State Pension Fund's equity portfolio yielded about 20.7 per cent**

The acquisition cost of the equity portfolio was a good 16 million euros above the market price at the close of 2003. Over the past three years, the State Pension Fund's equity portfolio has earned slightly less than 44 million euros in dividends.

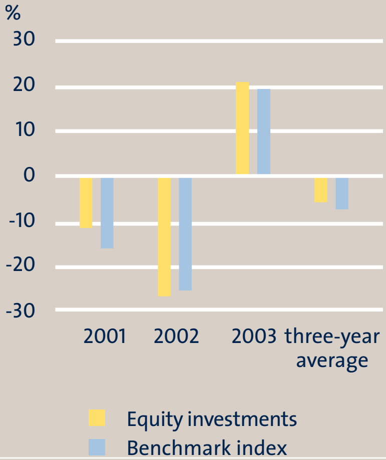
The neutral equity weighting increased from 25 per cent to 35 per cent during last year. The equity portfolio was underweight throughout the year, most of all in March. The upswing in the equity market and net purchases kept the equity weighting relatively close to a neutral weighting during the latter part of the year.

Measured in terms of market values, the equity portfolio grew from EUR 1.1 billion at the beginning of 2003 to nearly two billion euros. The State Pension Fund purchased EUR 656 million of shares and mutual fund units and sales of them totalled EUR 57 million. The largest amount of euro-denominated purchases of shares and mutual fund units - EUR 84 million worth - was purchased in June.

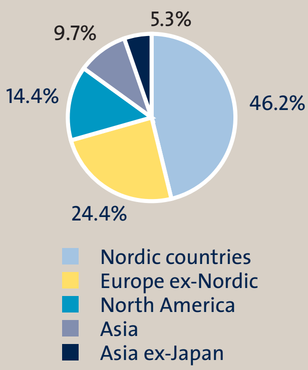
The State Pension Fund makes direct equity investments in the Nordic countries and Europe. Of the entire equity portfolio, 48 per cent consisted of direct equity investments at the turn of the year and, similarly, 52 per cent was invested via mutual funds, primarily index funds.

The equity portfolio is divided into five geographical areas. Last year the Nordic equity portfolio yielded 27.8 per cent. The portfolio is made up of Finnish companies along with Swedish, Norwegian and Danish companies. Most of the investments in the rest of Europe were in index products at the close of the year. Last year these investments returned an 18 per cent return. The State Pension Fund invested in North America solely via mutual funds, primarily index funds and enhanced index funds. This portfolio had a return of 9.2 per cent. Investments in Japan (a return of 17.5 per cent) and the rest of Asia (a return of 18.6 per cent) have been handled via mutual funds.

RETURN ON EQUITY INVESTMENTS COMPARED WITH THE BENCHMARK INDEX



BREAKDOWN OF THE EQUITY PORTFOLIO BY COUNTRY AT 31 DECEMBER 2003



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