

ESG factors in quantitative portfolio management

During 2016, the Second AP Fund introduced ESG (Environmental, Social and Governance) factors as an integral part of its quantitative management. A broader range of decision data enables better investment decisions, resulting in better conditions for higher return for Sweden's pensioners. Being among the first to incorporate these factors offers clear benefits.

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Accounting for some SEK 140 billion of the Second AP Fund's total portfolio of SEK 324.5 billion, quantitative management represent the largest part. Investment decisions for this portion of the Fund's total assets are based on in-house-developed quantitative models. In the asset class global equities, with some SEK 90 billion under management, the model comprises source data of different factors, covering some 2 500 companies.

The model is then used to process all this data, which is condensed into 10-15 aggregated factors. These factors are then used to extrapolate the possible future levels of return on equities under management. This in turn determines which equities the Fund decides to over/underweight, to outperform index.

"Our job is to try to look into the future and invest to achieve the highest return. In companies that are expected to perform well in future, we wish to adopt a position in which our equity holding exceeds the company's index share. To make these decisions, we need to have an idea as to which companies to seek over or underweighting in, and why we should," explains Claes Ekman, quantitative portfolio manager at AP2.

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Integration of ESG

The Second AP Fund regularly reviews the model employed for quantitative management, which means that occasionally certain factors are removed or added. During 2016, a number of ESG factors were added to the model for asset class global equities, the work being done internally by AP2's staff. The Fund initiated this process by analyzing source data from the quantitative management perspective, to predict excess return by identifying equities that offer better future performance than index. This data should be sourced over a considerable period of time, feature input from many companies and be supplied in a structured format.

"The Second AP Fund's model analyzes portfolio companies with reference to ESG factors in two equally important areas. The first concerns the classification of companies according to their status with regard to factors such as carbon emissions. The second refers to their capacity for change, i.e. companies' actual progress on the level of carbon emissions," says Tomas Morsing, head of Quantitative strategies at AP2.

Good for Sweden's pensioners

In AP2's case, the integration of ESG factors as part of the investment decisions can be explained broadly in two ways. For one thing, there is historical evidence that companies with, for instance, a clear environmental profile and strong corporate culture, generate better returns than other companies. For another, there is reason to believe that this trend may continue, encouraging additional players to invest in these companies. These factors favour, in that case, the Second AP Fund, which already considers these aspects in making investment decisions.

"We are one of few players in the industry to have taken this process to the next level, by analysing the source data instead of relying on pre-determined ESG factors. It is vital to get as close to the source data as possible, a recognition that is fully

in line with the Fund's overall approach to quantitative management," notes Tomas Morsing.

The Fund's ESG model includes environmental factors that feature concrete measurements, such as the level of carbon emissions released by companies, or the amount of energy they consume. The model also comprises measurements and indicators relating to social and corporate governance factors that can, simply put, give an idea of whether the company is sound.

"A fundamental portfolio manager responsible for a small number of companies can acquire this information by meeting the companies on an individual basis. For the Fund, which invests in some 2 500 companies, this is not easy. Now that we have succeeded in quantifying an indirect scale of measurement to determine a company's corporate culture, however, we can include this information anyway," explains Claes Ekman.

An interesting observation AP2 has made is that companies that feature a high ratio of women in leading positions also perform better, regardless of size or type. One possible explanation is that these companies are more focused on issues relating to values and corporate culture, reflected in the Fund's quantifiable indicators – such as the ratio of women in leading positions and the abundance of in-house training.

The process continues in 2017

The Second AP Fund gradually started to integrate ESG factors into the six different indices of its quantitative model in the autumn of 2016. This process is now complete, making ESG considerations, in combination with a number of other factors, integral to the investment decision.

The next stage of this process is a project started in 2016, designed to ensure that the Second AP Fund, in its management of global equities, will develop a more strategic working approach concerning these issues, by developing an ESG-weighted index. During 2017, the Fund plans to integrate ESG factors in the management of its portfolio of global corporate bonds, as has now been achieved in its quantitative management of equities.



Claes Ekman



Tomas Morsing