New indices for better and more sustainable pensions

During 2017 AP2's employees designed new indices for the global equities asset class. This means that the Fund at the start of 2018 will have ESG exposure on all internal capital in the foreign equity asset class, totalling SEK 99 billion. This is an important part of the Fund's continued work with implementing ESG factors (Environmental, Social and Governance) in investment decisions. The new indices are fully in line with AP2's mission, as they are expected to give a greater return at a lower risk and at the same time take into account aspects of sustainability.

A basic question for investors has always been how to distribute capital between different assets in the best possible way. For AP2, this is a strategic decision, where the Board decides on the distribution of fund capital of SEK 345.9 billion between different asset classes and which index the asset class will have.

Within the global equities asset class in AP2's quantitative management, which amounts to approx. SEK 99 billion, six different indices have been used so far. Four of these include approximately 1 600 companies in developed countries and two include approximately 800 companies in emerging countries. These indices are so called single factor indices, which means that the weighting of the equities in each index is determined by one equity specific or company specific property. Examples of these properties are the equities' volatility or a company's valuation.

"Selection of index has always been an important part of AP2's investment strategy. An equity index consists of several different equities which are weighted based on a rule. This will give investors an opportunity to distribute their capital wisely," says Tomas Morsing, Head of Quantitative Strategies at AP2.

Two new indices with four properties

At the end of 2016, a project was initiated with the aim of replacing the current six indices with two new ones; one for developed countries and one for emerging countries. These two indices would reflect all the properties that AP2 is seeking exposure to, so-called multi-factor indices. After implementing ESG in the active management of global equities, another goal of the project was also to include exposure to ESG in the index design.

"We didn't think that it was an effective solution to use several different single-factor indices, which research also shows. At the same time, we wanted to add other properties and examine their significance for an index's return and risk," says Claes Ekman, Quantitative Portfolio Manager at AP2.

The project resulted in AP2 deciding to replace the current index structure, which includes several single-factor indices, with two multi-factor indices.

"We analysed which properties that were interesting to have in our new indices and concluded that we wanted to have exposure to four properties, but just two indices. This means that we have designed the indices for the benefit of equities in companies that have a low value and a good ESG profile, and equities whose returns are low volatile and independent of the returns of other equities," says Tomas Morsing.

ESG takes priority

Including exposure to companies with a good ESG profile in the indices has been especially important for AP2. That is why the Fund's new indices consider many different aspects of climate and environment, social factors and corporate governance factors during index construction. For example, equities in companies with low carbon dioxide emissions or that have many women employees are favoured, while equities in companies that are often involved in a variety of controversies or that attempt to devote themselves to manipulative accounting will receive a lower index weighting.

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"Our new indices include many properties in ESG. To determine what we should focus on, we have turned to our sustainability strategy, our previous ESG work and to research within the area," says Tomas Morsing.

Previously, AP2 purchased finished indices from an external party, but the indices will now be designed internally. For this purpose, the Fund has developed a methodology that makes it possible to compare and study how the different properties affect an index return and risk profile.

"When we tested the indices on historical data, we saw that we could evaluate the ESG higher than the other three properties without sacrificing the return or increasing the risk. This is completely in line with our assignment at AP2," states Claes Ekman.

Many benefits of new indices

The tests showed that the new indices have a better expected absolute and risk-adjusted return than the current indices. This is because they are more widely diversified and provide a significantly better exposure to the four selected properties. Going from six different indices to two also makes the internal management more cost effective and reduces the transaction costs.

"The benefits of our new indices for today's and tomorrow's pensioners are many. They have a better expected absolute and risk-adjusted return, reduced costs and take account of ESG in the investment process to an even higher degree," says Claes Ekman.

With the new indices, all of AP2's internal management of foreign equities take into account ESG aspects. As a result of this, the Fund's carbon footprint will decrease.

"We measure the proportion of the carbon dioxide emissions that can be said to be our responsibility by calculating the Fund's ownership in every company. With the new indices, we will have a significantly smaller carbon footprint than with today's indices," said Tomas Morsing.

Far ahead but continued focus forwards

The range of complete ESG indices and multi-factor indices are growing and are becoming more common on the market. However, to date, they have not been able to provide a sufficiently good return. At the same time there is currently a desire among investors to take control of their own indices by designing them in-house.

"Now that we have designed multi-factor indices involving ESG factors, we can say that we are one of the first and have come a long way in this area. This is also confirmed by the great interest in our work from both colleagues in the industry as well as other index suppliers," says Tomas Morsing.

The next step in AP2's work with even more sustainable investments is to develop a method that can identify companies with solutions to the challenges of the future, for example, climate change, and which are therefore good investments. Because these companies today are often too small, they are not included in the thousands of companies that the Fund's quantitative management invests in.

"It will be important for us to identify opportunities that include companies that are future proof. By finding tomorrow's winner within different green areas, these investments will contribute to pensions with both a better return and sustainability," says Claes Ekman.