

# Indices with sustainability focus

**In February 2018, when Andra AP-fonden implemented two new indices in quantitative management, it was an important step in the Fund's efforts to integrate sustainability into the portfolio management. It was also the result of long research efforts and a lot of work. With several positive effects from the indices, the work will continue in 2019.**

AP2's new indices was implemented in the asset class, global equities, in the quantitative administration, which amounts to approximately SEK 87 billion. In the two indices, one for developed markets and one for emerging markets, ESG factors (Environmental, Social and Governance) have been given great importance.

"We've worked intensively with ESG for many years and for a couple of years with integrating ESG into our indices. It's satisfying to see that the hard work has resulted in a more sustainable portfolio which is also expected to have a better return in relation to the risk," says Tomas Morsing, Head of quantitative strategies at AP2.

the data required. Although each part is not always very complicated, the totality has to exist," says Claes Ekman, Quantitative portfolio manager at AP2.

Another factor that simplified the work is that AP2, which is a relatively small organisation and gathered in one place, has short decision paths and great freedom to develop projects like this.

"Our skilled employees have been a crucial factor. We've also had good support internally with strong support from the board and management to push these issues forward," says Tomas Morsing.

## Experiences and employees decisive

The fact that AP2 has been conducting quantitative management since 2002 is an important explanation for the fact that the Fund has succeeded in this large and complex project.

"Through our long experience of quantitative management, we've gathered the knowledge, the methods and

## Several positive effects

Carbon dioxide footprint is the only standardised measure to evaluate the effect of an index on the sustainability area. After just one year, it's clear that the new indices have contributed to a significant reduction in AP2's carbon footprint.

"For us, ESG factors are interesting, and important to consider in our investments. We see clear indications that the world is not developing as it should, and this is our way of having an influence. We know that we've included factors that actually contribute to improvement," says Claes Ekman.

With just two indices instead of six, the internal administrative work has also decreased and been simplified, which

## Long-term investment for a more sustainable portfolio

The mission of the AP Funds states that sustainability has to be taken into consideration. Therefore, it was natural for AP2 to implement ESG factors also in the quantitative management. At the same time, it's a long-term investment that has required large resources.

## Several positive effects with the new indices

- Reduced carbon footprint compared to previous indices by about 40 per cent in the index for developed markets and about 30 per cent in the index for emerging markets.
- ESG and sustainability factors are taken into account even more in the investment process than previously.
- More well-diversified portfolio which contributes to a better risk spread.
- Better expected absolute and risk-adjusted returns.
- More cost-effective internal management.
- Lower transaction costs in the form of reduced trading in index rebalancing and lower cost against index supplier.

*“We see this as an iterative development work where we research, refine and improve as we come up with new and better ideas”*

has contributed to lower costs. After only one year with the new indices, it is too early to draw any conclusions about the return. But in AP2's tests of historical data, a better expected, absolute and risk-adjusted return is achieved than with the previous indices.

“For an evaluation of the return to be relevant, a period of at least five years is required, preferably longer. But we feel confident that our work, in addition to being good from a sustainability perspective, will also yield a good return,” says Tomas Morsing.

Since AP2 started with the underlying data in the development of the new indices, much greater consideration is given to the sustainability in the investments.

“When we constructed the indices, we had access to many ESG factors, where, in a concrete and simple way, it was possible to read how the companies have influence in different areas. In this way we were able to select the factors that were important for us to influence and contribute to a sustainable world,” says Claes Ekman.

#### **A lot of interest from the outside world**

The interest in the new indices has been great. The Fund's employees have also been invited to be lecturers and participants in various contexts.

“A lot of players from all major markets around the world want to learn more and cooperate with us. This shows that we are at the forefront in this area,” says Tomas Morsing.

#### ***Internally-developed indices***

The large interest from the outside world can also be explained by the fact that it is AP2's employees who have developed the new indices instead of an index provider.

“We wanted to construct the indices ourselves. But it requires functioning internal processes and a good partnership with the supplier of the data documentation, which many take for granted. We have worked hard on these parts and during the year it has been confirmed that it works the way we want,” says Claes Ekman.

#### ***Innovative working method***

The most common way of working with ESG management is through exclusion, that is, choosing not to invest in companies based on sustainability factors. In addition to exclusion, AP2 also works with the investment decisions by weighting companies based on ESG factors.

“Complementing exclusion with weighting, we think is a more nuanced and better way of working. We are ahead with this, which has meant that large investment banks, for example, want to cooperate with us,” says Tomas Morsing.

#### **Continuous development for better pensions**

AP2 is constantly reviewing the indices to identify possible improvements.

“We see this as an iterative development work where we research, refine and improve as we come up with new and better ideas. In addition, the circumstances change, not least in this industry. We are responsive and act on it,” says Tomas Morsing.

AP2's sustainability focus will be clear in the projects that the Fund will implement in the future. In the next step, AP2 will begin in 2019 to develop indices that takes into account ESG factors also in the quantitative management of bonds.

AP2 operates in an ever-changing world with major challenges, such as climate change. One of the Fund's projects is about identifying companies that can manage this change, but above all have solutions to future challenges. In another project, AP2 will use AI, artificial intelligence, to identify companies that distinguish themselves in different areas.

“For us as asset managers, these companies can be interesting investment objects. We want to identify such companies and then analyse different factors to determine if they contribute to our continued work on delivering sustainable and strong pensions,” says Claes Ekman.