INTERVIEW

A return on responsible investment

With the fund recently introducing new global equities indices focusing on ESG exposure, Natalie Tuck **speaks to Sweden's AP2 head of communications and HR** Ulrika Danielson **about the fund's commitment to investing responsibly whilst securing positive returns**

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Tell us about the fund and its responsibilities?

AP2 is one of Northern Europe's largest pension funds and manages SEK 345.9 billion, invested in virtually all asset classes and all around the world. The fund is a long-term and responsible fund manager that has an important mission – to give those who have worked in Sweden the best possible future pension by reducing the risk of the so-called 'brake' being released.

The mission as a buffer fund means that AP2, with its return, will contribute in the long term to balancing the pension system, and thus a good pension trend, even in times of economic and demographic changes. This is stated clearly in the Swedish National Pension Funds Act. The act and its preliminary work set clear principles for the AP funds' assignment. The capital must be managed so that it provides the greatest benefit for the pension system. The AP funds should also have the liquidity levels that the outflows from the funds require.

The AP funds' management mission means that the effects on the pensions of the automatic balancing should be limited, because it is only through this that the AP funds' return is linked to outgoing pensions. The AP funds will generate a high return

while at the same time the risk will be low, with the basis of the trend in disbursements. In the preparatory work in the AP Funds Act, it is stated that the AP funds must consider ethics and environment without sacrificing the goal of providing a high return.

The fund returned 9.1 per cent in 2017, what is the fund's investment strategy? What percentage is active, and passive? How have such successful returns been achieved?

AP2's strategy is based on a step-by-step approach to value generation: choice of strategic asset allocation, selection of index and active management. AP2's strategic portfolio is produced with the support of an in-house developed Asset Liability Model (ALM), which simulates the development in the pension system and in the financial markets. The model makes it possible for the fund to calculate how different asset compositions can be expected to influence future pensions. This also enables the model for the fund to select the strategic portfolio that can be expected to provide the best target fulfilment for the 30-year time frame that the und is based on, i.e. to minimise the negative effects of the so called brake.

AP2's long-term investment strategy and strategic portfolio have been subject to constant development from the start. A cornerstone of this process is to increase the spread of risk without compromising the potential future return. In 2007, the fund intensified its efforts to achieve the long-term diversification of its investment strategy and primarily reduce its concentration on mature equity markets. This took place by introducing asset classes and strategies that fall outside traditional investment sectors. This change of course in investment strategy is long term and has taken several years to develop.

During 2017, AP2's board of directors decided on a couple of changes in the strategic portfolio. We increased allocation to Chinese A-shares, from 1 to 2 per cent, at the same time as the allocation to equities in developed countries was reduced in the corresponding extent. We also made an initial strategic allocation to domestic Chinese government bonds of 1 per cent of the strategic portfolio. We developed internally multi-factor indices for foreign equities. Previously, the fund has applied a number of different single factor indices in the management of foreign shares. During the year, the fund has further developed the effort by instead developing multifactor indices which integrate exposure to several different risk factors within the same index. A central part of these new indices is that they integrate factors related to the ESG directly in the index composition, such as factors related to carbon dioxide emissions, equality and pollution. For example, these new indices are expected to reduce the carbon footprint without weakening the expected risk-adjusted return.

Active management is based on the assumption that market inefficiencies exist and that there are a number of assets that are wrongly priced. By identifying these and utilising the fund's sustainability, active management can increase the return compared with portfolio management that is entirely index driven. For this reason, AP2 employs active elements in its portfolio management. This active management is employed both in-house and via external managers. In the past five years, the average active management has generated 0.4 per cent, which is equivalent to SEK 3.9 billion.

During 2017, the fund announced it had developed new indices for the global equities asset class, which means the fund has ESG exposure on all internal capital in the foreign equity asset class. What has been the impact of this on the fund?

As we have only just put the new indices in place, at the beginning of 2018, it's a bit early to talk about what the impact has been. But with the new indices we now have ESG exposure on all internal capital in the foreign equity asset class, totalling SEK 99 billion. For example, equities in companies with low carbon dioxide emissions or that have many women employees are favoured. As a result of this, our carbon footprint will decrease.

AP2 appears to take its work on sustainability very seriously. Can you give examples of some of the fund's investments that reflect this value?

Yes, we take this work very seriously, both because it is in our mandate, but also because all our employees really drive this work and think it's really important. We invest around SEK 17 billion in assets/ managers with a business strategy that is primarily based on sustainability. In addition, the fund has investments in Vasakronan, Cityhold Office Partnership, Castellum, Kungsleden, Fabege and Wihlborgs Fastigheter, all of which received a Green Star from the Global Real Estate Benchmark (GRESB) to a total value of SEK 19 billion. In total, this represents approximately 10 per cent of the fund's total portfolio.

The most important example, which we did last year, was the development of the new ESG indices. Other examples is the investment we did in The Rise Fund, which is managed by TPG Growth. The Rise Fund amounts to USD$ 2.1 billion in commitments primarily from global institutions, making it the largest so called impact fund that has ever been established. It aims to achieve measurable, positive social and environmental results and a marketable financial return. All investments should have a positive impact on at least one of the UN's global sustainable development goals. The Rise Fund measures the specific size of the impact a potential investment is expected to have during its investment lifecycle, with a focus on the impact of the result as defined by the UN's global sustainability goals.

Another example is our investments in green and social bonds. We invested SEK 85 million in a social bond issued by NWB Bank. NWB Bank primarily lends to the public sector in the Netherlands and the purpose of the bonds is to finance the project planning of housing for people who have difficulty gaining access to accommodation. AP2 had holdings in green and social bonds corresponding to approximately SEK 5.7 billion as at 31 December 2017.

In what way does AP2's culture and values and vision of 'world class management' help to achieve positive returns?

We have a very strong culture and have for long been involved with issues relating to culture, values and our attitudes towards each other. Respect and openness are important prerequisites for creating a good working environment, just as this is important for us to succeed with the assignment that we have and that we feel very proud of.

What are the fund's goals for 2018?

The fund is committed to minimising the consequences that derive from activation of the automatic balancing mechanism, by generating a solid return on invested capital. To meet this requirement, AP2 has composed a portfolio that is expected to generate an average annual real return of 4.5 per cent over the long term. Except for this, we have a new business plan for the next coming years. We also have many sustainability goals that we communicate and follow up in our annual report. ■