

# AP2 designs pioneering ESG benchmarks for global equities

Sweden's quant-savvy **AP2** takes the next step in its sustainability integration by setting up new global equity indices with an ESG tilt, created according to the pension fund's own recipe. Nordic Fund Selection Journal finds out more.

By: **Caroline Liinanki**

Sweden's AP2 has taken an important step in its ESG-integration journey by replacing its global equity benchmarks with two new internally designed indices with a sustainability tilt. This spring, the Swedish national pension fund has been shifting its large global equity portfolio, which makes up almost a third of its assets, to be invested along the new indices.

Hans Fahlin, AP2's chief investment officer, says that the new benchmarks are the fruit of quite extensive work at the pension fund and a continuation of its work previously done around ESG integration. "We've used ESG signals in the active management for some time but integrating this in our indices will have a much bigger impact," he says. "We feel like we're breaking new ground. We've heard of others that are looking to make similar attempts but not of anyone that has come as far as we've come."

Tilting the benchmark to include ESG factors is also expected to pay off in terms of higher returns. "With the ESG factors that we've included, it's not a trade-off between ESG and returns but the inclusion of ESG signals actually improves returns," notes Hans Fahlin.

AP2's global equity portfolio was previously managed against five separate single-factor indices, while ESG factors were added as a layer in the active management against those benchmarks. The newly designed indices for developed market and emerging markets equities integrate not just ESG but also a range of risk factors, for example low volatility and value, under the same umbrella.

"We did it against the backdrop that we've included ESG signals in the active management for some time, so we wanted to investigate whether we could integrate them into the benchmarks. For many years, we've had a large degree of smart beta or alternative indices in our foreign equity portfolio. The choice of benchmarks determines what we invest in. Our ability to deviate from the benchmarks is limited, so by adding the ESG factors to the benchmark, the impact becomes greater," says Hans Fahlin.

He further notes that the academic literature suggests that integrating risk factors into the same benchmark



HANS FAHLIN, AP2

leads to a more efficient total portfolio instead of managing the portfolio against several single-factor benchmarks.

The new indices have been invented internally at AP2. "We wanted a very specific implementation of the ESG exposures and no one else was offering that. We had also designed our former smart beta indices ourselves, so given that we

have this competency internally, doing it ourselves was a more attractive route. That gives us full control over our exposures and we can design the portfolio exactly the way we want to," he says. He adds, however, that doing so would have been difficult without having a large internal quant team.

Designing one's own indices also comes with the upside of lower costs than buying one off-the-shelf from an index provider. "We design and create the recipe and then use an external party for calculating daily returns and dealing with corporate actions," says Hans Fahlin, a set-up that he calls a cost-efficient form of outsourcing.

However, identifying the ESG factors that actually contribute positively to returns hasn't been an easy task. "It's been major work," says Hans Fahlin. "One problem is that the data series are fairly short and the public data [around ESG factors] at companies hasn't been accessible for that many years. That creates greater uncertainty. But the quality of data is improving and will become even better, so there's a clear positive development."

Some of the ESG signals that according to the tests showed evidence of improving returns and hence were selected to become part of the new benchmarks includes CO2 emissions adjusted across sectors and the number of women employed at a company.

"It's been a challenging task for the team to select the

ESG factors without becoming involved in data mining," says Hans Fahlin. "We did a blind study and anonymised the factors so we wouldn't have any biases. It was only after we had the results that we looked at what the factors were. A lot of them didn't add anything in terms of improving returns."

He is, however, very positive about the result of from this rather extensive work. "We're very enthusiastic," he says. "We think that this has been very exciting and innovative. It's a big step for our portfolio, so we're looking forward to see how things are progressing." ●

## THE PROS AND PITFALLS OF BESPOKE INDICES



TOMAS FRANZÉN, FOXBERRY

Not all asset owners have the internal capabilities of AP2 of being able to create their own indices but there is a growing industry of providers looking to help investors in setting up bespoke solutions.

Tomas Franzén, senior advisor at the London-based index provider Foxberry and previously chief strategist at AP2, talks about how investors can use tailor-made indices, what is driving this trend and what to consider when setting up bespoke indices.

### WHY SHOULD AN ASSET OWNER CONSIDER USING TAILOR-MADE INDICES?

"Tailor-made indices enables asset owners to take into account their specific circumstances and objectives as well as proprietary insights and investment views. For instance, in ESG investing, it tends to differ how asset owners perceive ESG factors."

### IS DOING SO A TREND?

"It's definitely a strong trend. As the index investment segment keeps growing, there's a need for asset owners to differentiate themselves and express their own investment beliefs. Index investing is cost efficient but it doesn't mean the investment process needs to be wholly passive. Choosing an index is an active decision, while replicating it in portfolios is a passive process."

### ARE THERE NOT ENOUGH INDICES OUT THERE ALREADY? WHY WOULD YOU NEED YOUR OWN?

"You're right that there are many indices available but some of them are similar to each other and the market is dominated by a few broad-based indices. There's also a difference in transparency and executability between indices and index providers."

### WHAT ARE THE OTHER MAIN USES APART FROM ADDING AN ESG TILT?

"ESG factors are a strong driver of tailor-made indices at the moment but tailor-made indexing can be used to achieve other factor tilts that specific asset owners believe characterise asset pricing and returns. Bespoke

indexing can meet specific investment guidelines, regulatory requirements, risk profiles, risk management features or portfolio allocations."

### WHAT ARE SOME OF THE KEY CONSIDERATIONS?

"Transparency is a critical aspect. How can you be sure that you get the exposure you want if the index construction methodology, even in the smallest detail, is not clearly defined? An asset owner must make sure that an index provider understands the trading process of the index and how you're planning to use it. It should be beneficial to use a provider that can actually help you tender the exposure to the index itself. In that way, you can get a full A-Z service, with help all the way from the conception of the idea to an implemented exposure. Another important consideration is how you as an asset owner are planning to take the exposure to the index. Will you replicate it in-house or get the exposure from a third-party, like an investment bank or an asset manager? Even if the index will initially only be used as a reference or benchmark index, it's beneficial to think about these questions early on."

### WHAT ARE THE POTENTIAL RISKS AND DOWNSIDES?

"You should ensure that the index provider can guide you in making sure that the final index is investable in the format you're planning to use it and that it fits under the EU benchmark regulation. For instance, under this regulation it's important to give up the ultimate control of the index, as the control itself triggers regulatory consequences. If you think you need help with, for instance, tendering the index or formal advice, you should make sure you work with an index provider that's regulated to provide these services. Another key point is to ensure that you're able to tender the exposure to the index, so that you get a fair price on the actual exposure, and that you're not locked into a specific counter-party."

### IS IT A COSTLY PROCESS?

"No. Firstly, compared to using an active manager, the cost is obviously much lower. And secondly, often you can get a tailor-made index done for the same price as a standard off-the-shelf index but on the back of the tailor-made indices, you get other benefits such as better transparency, potentially improved returns and reduced operational costs, which completely dwarf the cost of running the index itself."