Andra AP-fonden
Second Swedish National Pension Fund - AP2

A View from Above: A Sovereign's Take on Risk & Reward

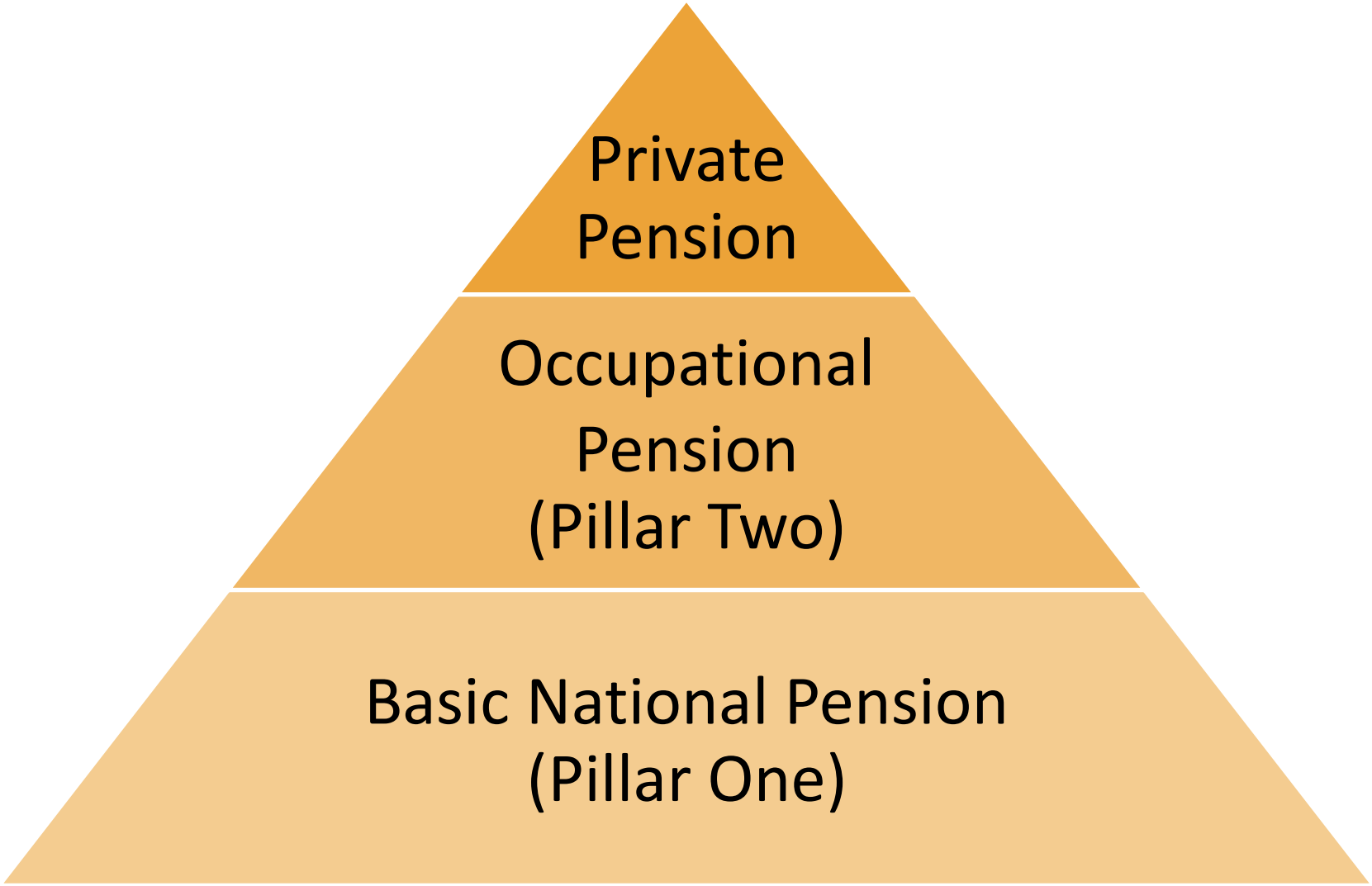
Italian Pension Fund Day, 2016

Naples, May 10, 2016

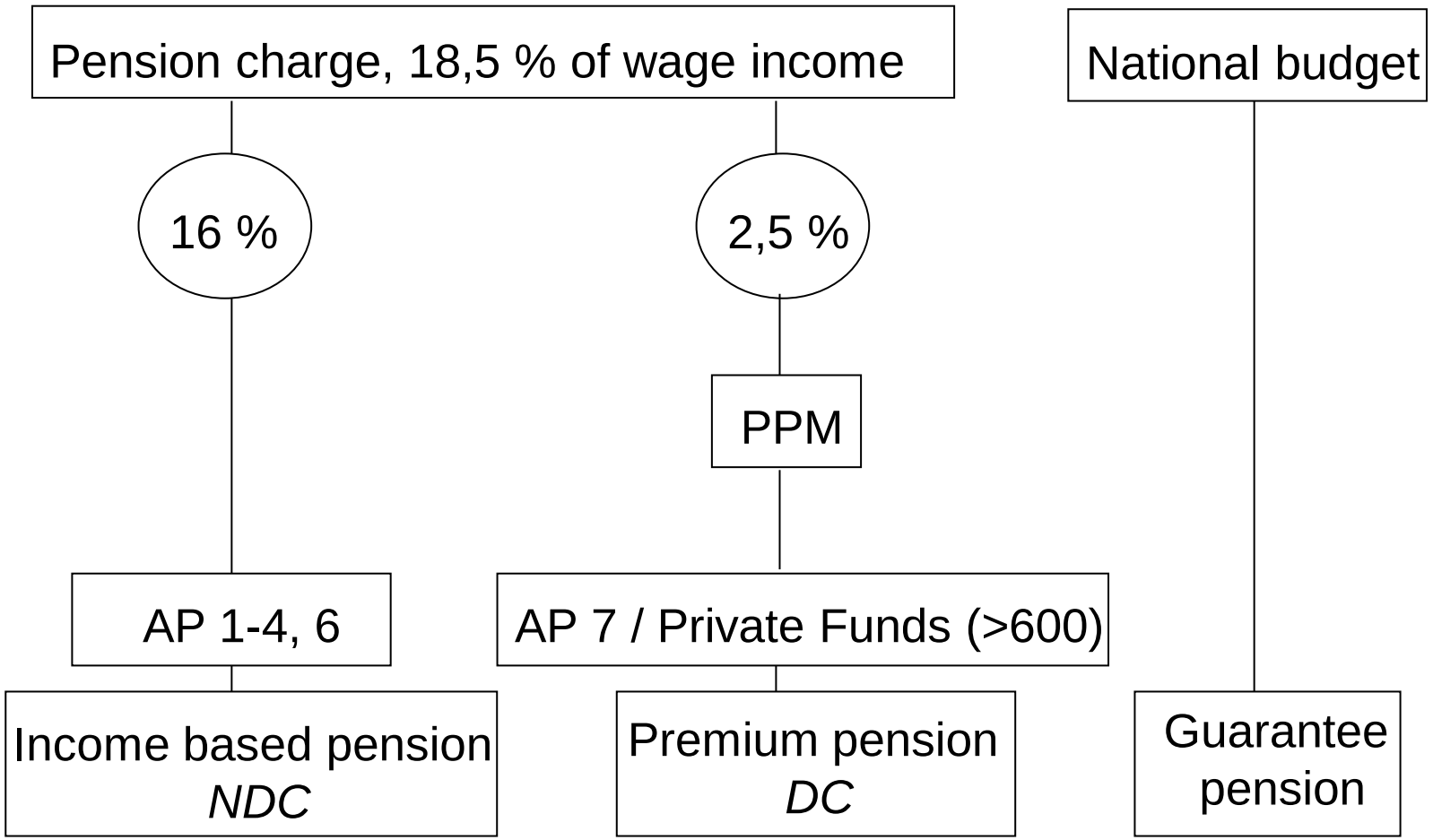
Backdrop to Reformed Pension System

- Reform driven by demographics.
- From DB system to NDC system in 2001.
- Autonomous Pension System.
- Fixed fee level (18,5 %).
- Longevity risk borne by beneficiaries.
- Interest-rate risk and inflation risk are subordinate risks.
- Reform aims at better incentive structure.
- Four new AP-funds with extended freedom to invest.
- A few quantitative restrictions that binds.

The three pillars of a pension system



Basic National Pension System at a glance



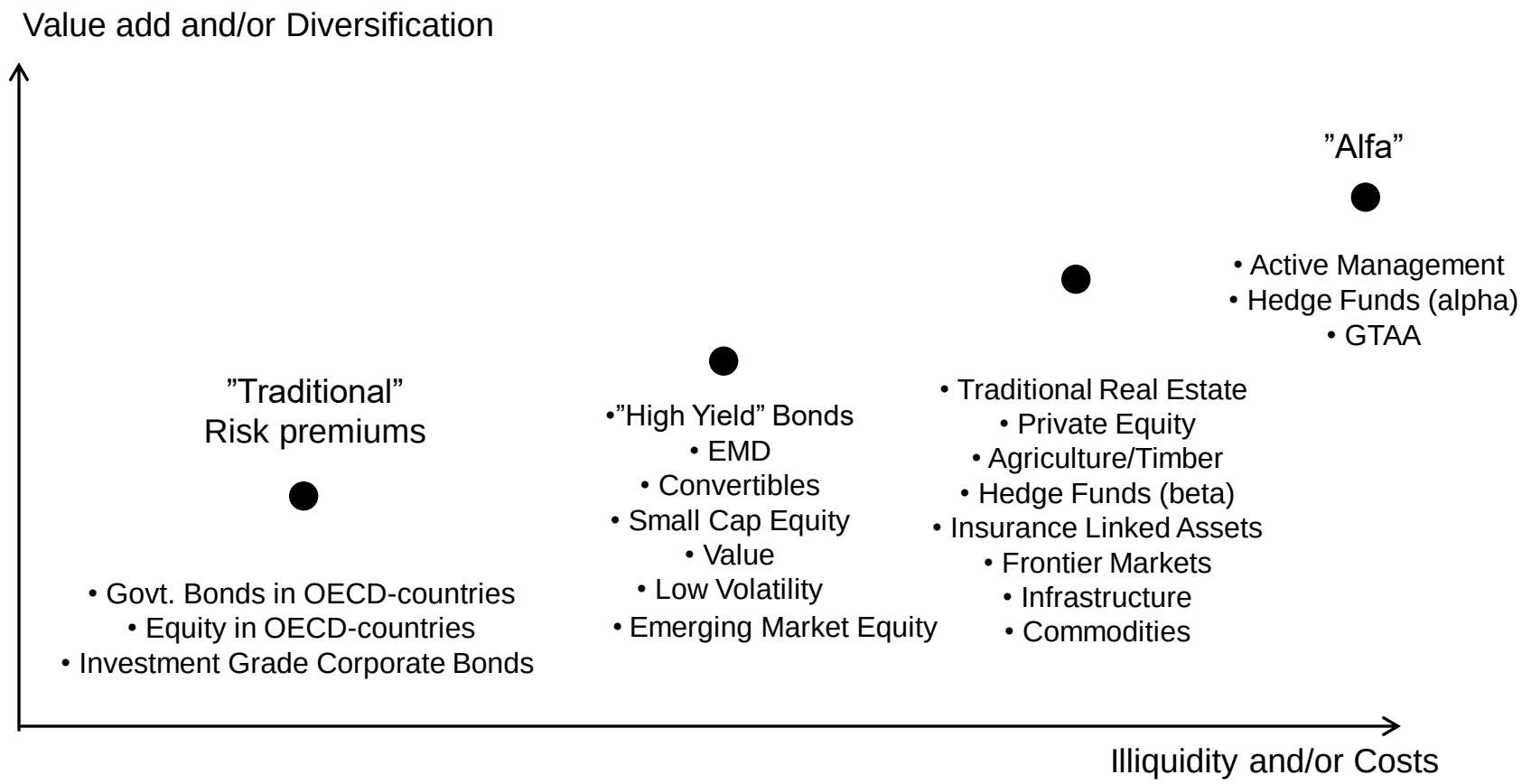
Investment objectives

- Parliament has assigned unambiguous *principles* for AP-funds investment objectives.
- AP-funds shall take financial risk *efficiently* with a clear focus on *future pensions*.
- AP-funds can effect future pensions only through its influence on the “break” mechanism.
- Minimize the consequences on future pensions from ”break” activation.
- Economic and Industrial Policy objectives explicitly banned.
- ESG-factors should be considered (Policy) but not to be traded off against returns.
- Long-term return objective is 4,5 % real, whereof 0,5 percentage point active return.

The Only Two Basic Sources of Portfolio return
("beta" and "alpha")

Exposure to economically motivated Risk Premiums ("beta")	Exploiting of inefficiencies ("alpha")
• Systematic Risk Premiums	• Sporadic inefficiencies
• Passive	• Active
• Low frequency ("Long term")	• High(er) frequency ("Short term")
• "Public" Good	• "Zero-sum" Game
• Low Cost	• High(er) Cost
• Low(er) diversification	• High Diversification
• Does not require inefficient markets	• Requires *inefficient* markets
• Investing *with* the market	• Investing *against* the market
• Makes up ~ 90 % of expected return	• Makes up ~ 10 % of expected return

Investment Policy Roadmap



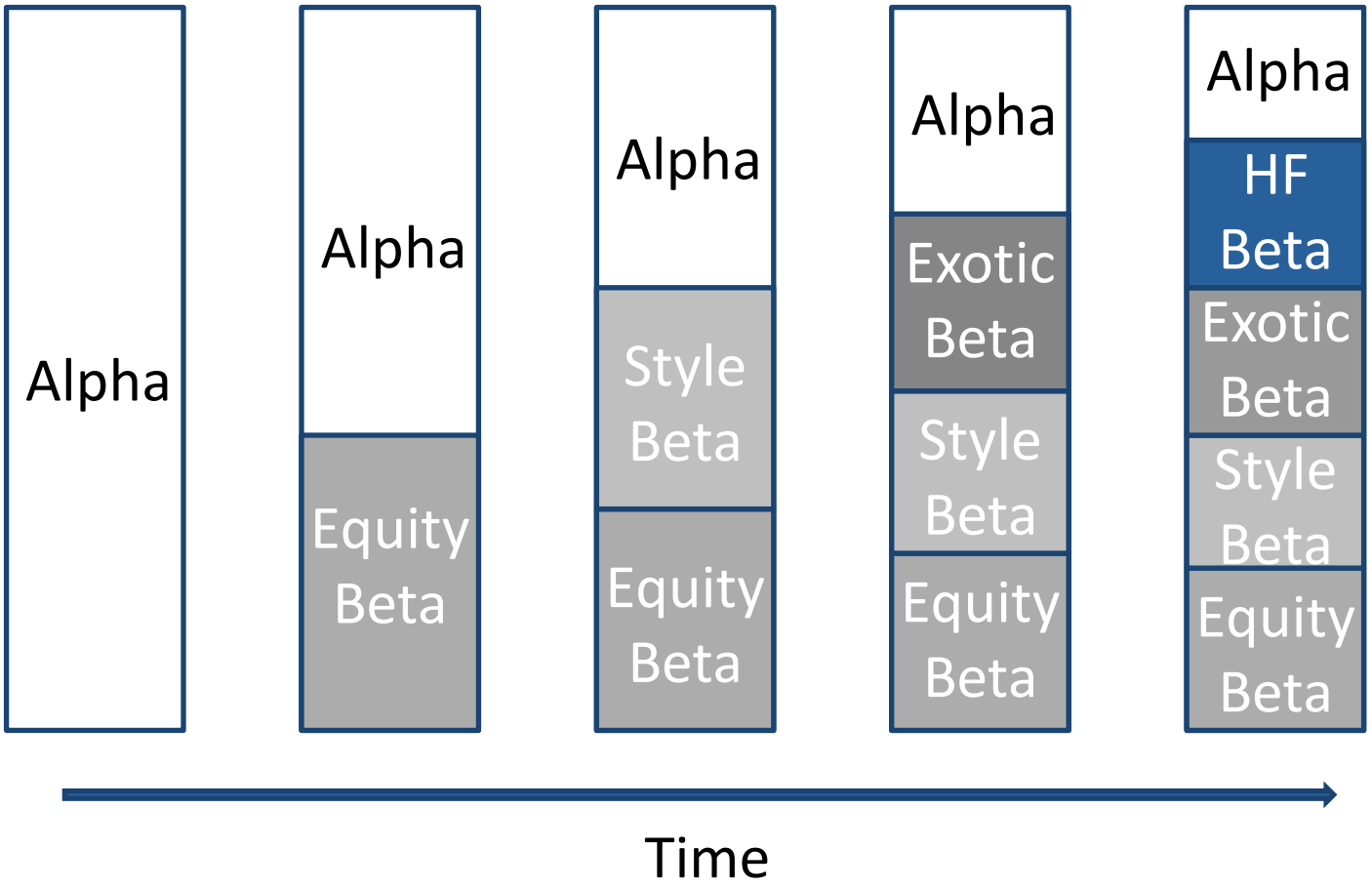
Factor-based equity investing

- ”Smart beta” a misnomer
  - Flaws in market-cap weighting – “Lazy beta”
  - Overweighting overvalued stocks and underweighting undervalued stocks
- Priced risk-factors or behavioral biases – does it matter?
  - Eugene Fama or Robert Shiller – the Nobel committee undecided in 2013?
  - Extended CAPM can comprise risk-factors but not anomalies.
- Investment motives remain
  - Large-cap growth likely to generate a “return-drag” also in future
  - Better diversification and less concentrated portfolios
  - More defensive exposure to equity risk
- Implementation and Governance
  - Long-only portfolios managed by in-house Quant Team
  - Time-varying risk-premiums
  - Part of policy portfolio rather than active portfolio

Alternative Risk Premiums

- Exposure to systematic risk premiums (β) and the exploiting of market inefficiencies (α) are key (only) portfolio return drivers.
- Traditional CAPM and MV not sufficient to capture ARP.
- Hedge Fund returns produce lower or even negative alpha when proper considerations to risk factors and distributions are taken.
- There is no denial that HF can generate (pure) alpha – but it is less capacity than one might be mislead to believe.
- Exposure to ARP is not the same as HF replication.
- Financial engineering skills is not the same as investment insights.

The Transformation of Alpha into Beta



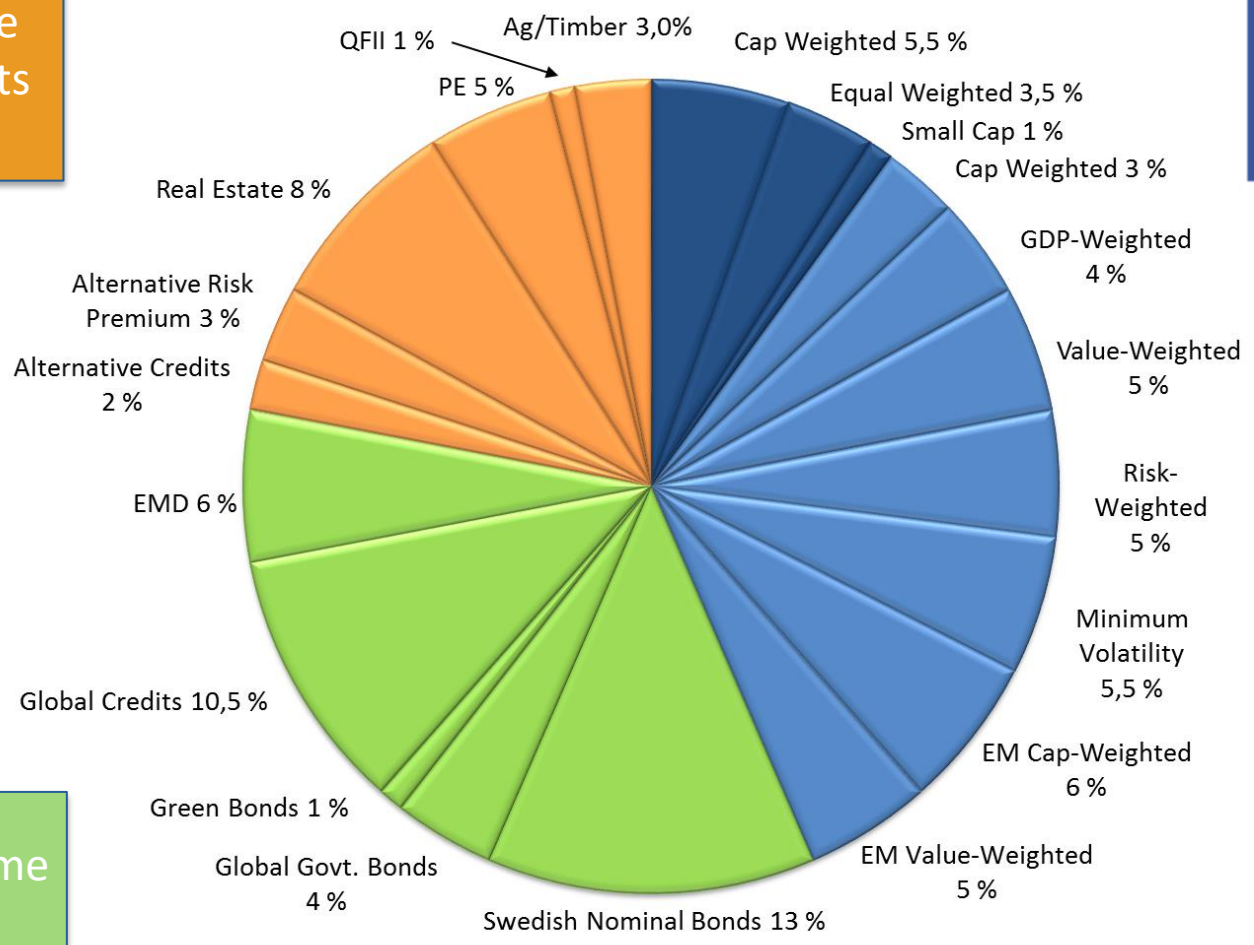
A selection of Alternative Risk Premiums

- Currency Carry
  - Compensation for unexpected and sharp currency depreciation – "Peso problem".
- Merger Arbitrage
  - Compensation for the risk of deal failure.
- Convertible Arbitrage
  - Compensation for illiquidity associated with the embedded optionality of the convertible bond itself.
- Short Volatility
  - Compensation for supplying other equity investors with tail risk protection.
- Insurance Linked Securities
  - Compensation for supplying the Insurance industry with tail risk protection.
- Dividend Futures
  - Compensation for off-loading dividend risk from Investment Banks.

Present Strategic Portfolio

Alternative Investments 22 %

Swedish Equity 10 %



Fixed Income 34 %

Global Equity 34 %

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