# Sweden's SPK revises strategy and portfolio construction

**Stefan Ros**, chief investment officer of **SPK**, talks about why the pension fund's infrastructure plans have come to a halt, its recipe for success in 2020 and increasing investments in Asia.

By: **Caroline Liinanki**

At the end of last year, Sweden's SPK finalised its new investment strategy but part of the implementation has been stalled by unresolved matters in the Swedish pension regulation. Nevertheless, plenty of changes are already underway at the SEK 32 billion (EUR 3.2 billion) pension fund with real assets and investments in Asia as some of the key themes.

The last time SPK made any more large-scale changes to its investment strategy was in 2014, when the pension fund embarked on a significant overhaul. As a result, it moved away from a very domestically tilted equity and bond portfolio to a much more diversified portfolio strategy, which led to the introduction of several new asset classes. This time around, the steps taken are not quite as drastic but still meaningful.

As part of the revised strategy, SPK aims to double its real asset allocation to 20 per cent of assets at the expense of fixed income. More specifically, this means adding some more infrastructure and property funds as SPK uses external managers for all asset classes. However, SPK's chief investment officer Stefan Ros notes that uncertainty around the pensions regulation for infrastructure has caused the pension fund to put its investment plans on hold temporarily.

Sweden's implementation of the IORP II directive for the occupational pensions industry has been a long-standing saga. After a lengthy process, the country decided to go further than the EU-wide requirements and introduced capital requirement for pension funds. This replaced the former supervisory regime, called the traffic light system.

All aspects of the regulation are not yet settled. One of the current outstanding changes is about the capital requirements for green infrastructure. This spring, Finansinspektionen, the Swedish financial regulator, proposed that green infrastructure investments should have a 20 per cent capital requirement rather than the 45 per cent for infrastructure in general. The new infrastructure rules were supposed to come into force at the beginning of July but may be delayed as the supervisory authority is yet to announce its verdict about the new regulation.

SPK is now awaiting the decision before moving forward. "We need to know where the proposal will land and what the consequences will be, so we've had to take a step back. We had made some progress with infrastructure and looked at a few new managers, but we've had to take a temporary pause," says Stefan Ros.

In order for an investment to be eligible for the lower capital requirement, the regulator stipulates in its proposal that it can't be involved in the production of fossil fuel or linked to businesses connected with fossil fuel. Furthermore, it proposes that the investors need to assess whether the investment fulfils Sweden's or EU's legal environmental requirements. Stefan Ros notes, however, that this would be a difficult assessment for a pension fund to make. It also doesn't seem likely that infrastructure assets in other parts of the world would be in accordance with EU law and Stefan Ros points out that the proposal has a certain EU bias. Furthermore, he notes that it is unclear whether such an assessment should be made on the fund level or asset by asset.

If the rules are too unclear and complicated, Stefan Ros observes that it might lead pension funds to just ignore them in the allocation decisions or allocate a smaller portion, which would not have the stimulative effect the regulator presumably is striving for. "From an investment perspective, there's a significant difference between a capital requirement of 45 per cent and 20 per cent. You might need to prepare for the worst and make sure that you can handle a capital requirement of 45 per cent," he says, emphasising the importance of predictable long-term regulation, particularly for illiquid assets.

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While SPK's plans to increase its infrastructure allocation for the time being have come to a halt, it has already made some changes on the equity side. While its strategic allocation to listed equities remains at 30 per cent, the pension fund has deviated somewhat from how it usually invests. For investments outside of Sweden, SPK traditionally invests on a global basis but it has now added some country-specific exposures: a China A-shares and an India mandate. The country allocations have been made at the expense of its current global equity mandates. "We have a positive long-term view of Asia and want to tilt the portfolio strategically a bit more in that direction," says Stefan Ros.

He explains that the China and India mandates were awarded following a more selective search process, which eventually led to a double victory for Goldman Sachs Asset Management (GSAM). "It was important for us that we had confidence in the manager if we were to take the plunge and start investing in specific countries, so we looked at the managers in our inner circle. Five of them had something to offer, which meant that we were able to make a limited but still competitive search. It was pretty close between two of them when it comes to China but overall, we felt that awarding both of the mandates to GSAM was the best solution," he says.

GSAM was, on the other hand, not part of SPK's managers roster prior to the new mandates. However, Stefan Ros notes that the firm previously managed global fixed income for the pension fund and that relationships tend to withstand the test of time. "From time to time, we might not have any mandate to offer. But the relationship is still there because we know we will find each other again somewhere down the road and this is one such example," he says.

Similar to the changes within its equity portfolio, the pension fund also has its eyes on Asia when it comes to increasing its real estate exposure. "Today, we have a European real estate portfolio but we want to diversify globally. We're looking at adding some Asian real estate exposure, since we generally have a pretty positive long-term view on Asia," he says.

While Sweden hasn't had any official lockdown, many have still spent most of the pandemic working from home. Stefan Ros says that he has only been in the office a few times since last spring, adding that the plan is for a gradual return to the office after the summer. While people often emphasise how great everything has been going throughout the pandemic, it has, of course, also had its challenges and downsides. "One thing I've missed is the quick and spontaneous exchange of ideas with colleagues. It has also been a bit boring from a social perspective. Then there are questions of what becomes of the corporate culture if

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you never meet and interact with each other. But returning to the office might lead to a bit of a rediscovery of one's colleagues," Stefan Ros comments.

The office return should also involve getting to know some new faces. SPK is currently recruiting a new analyst to its four-member strong investment team to replace Maria Letmark, who will be taking on a new role at the pension fund as head of sustainability this autumn. Asked whether it is necessary with someone in charge of sustainability considering the general focus on ESG integration, Stefan Ros points to the rapid development within the field. "There's so much happening around ESG and so many new initiatives that are being launched that we need someone to take the overall responsibility. The strategy we've chosen is also to try and influence our managers rather than focusing on exclusions. Then it's important to have a common approach within the investment team, so it doesn't depend on who deals with the manager," he says. He adds that Maria Letmark will be working closely with the investment team but also focusing on ESG-matters relating to SPK's internal sustainability work.

SPK has also made some changes to its portfolio construction. Most notably, it has split its fixed income allocation into two parts: government bonds and credit as well as combined real estate and infrastructure under the new umbrella of real assets. Furthermore, the pension fund has established an additional portfolio structure that runs parallel to its asset class portfolio, which Stefan Ros notes isn't advertised publicly and only used internally. The new portfolio structure focuses on the different roles that asset classes play in the portfolio and splits the asset classes into the categories of long-term return-seeking, long-term liability matching, risk diversifying and absolute returns. "We've done this to clarify to ourselves and to our stakeholders why we invest the way we do and what the purpose of the different investments are, given our obligations and our liabilities," Stefan Ros says. He adds that the pension fund has set up normal allocations and limits for this portfolio structure as well.

As part of its revised strategy in 2014, SPK decided to move into the alternative risk premia space. It did so with a great deal of enthusiasm but the venture ended up in disappointment. The pension fund pulled its last money from alternative risk premia strategies in the autumn of 2019 due to the poor performance. "It was a difficult decision since I really believed in alternative risk premia," says Stefan Ros. "I thought there was a stable and sound rational behind the strategies and they ticked a lot of boxes but it just didn't work out. The returns were appalling. We had a long process with our managers for several months when we tried to find out the reasons why the strategies hadn't worked but unfortunately, the managers couldn't provide any good answers. So we decided to exit. It was too much of a black box and the strategies just didn't live up to our expectations." Instead, SPK has turned to hedge funds, which currently make up 20 per cent of its assets.

SPK started this year on a high note as 2020 turned out to be a year when everything went its way. The pension fund posted its best returns since 1998, reaching 12 per cent. Stefan Ros points to three reasons behind the good returns. Most importantly, the pension fund's strategy of only using active managers really paid off. Many of its managers had their best year ever in 2020. "The inflows into passive strategies and ETFs have increased dramatically over the past years and our belief is that in this environment, active management has an edge. That's also what the experiences from 2020 show, even if that perhaps was a year when all the stars aligned. The excess performance of our managers was in many cases way beyond expectations," he says, adding that he also expects the beneficial environment for active managers to work in favour of hedge funds.

Furthermore, the pension fund succeeded in making some good tactical moves. It entered the year with a slight underweight in equities of around 24 per cent of the portfolio. When financial markets came crashing down last March, the pension fund made the decision to increase risk, despite plummeting assets and rising liabilities. "We still made that call, which I'm incredibly proud of. Historically, our reaction would have been to reduce risk and sell equities and buy fixed income in order to be more comfortable from a regulatory point of view. But we did the opposite. Even if no one knew how things would pan out, we thought the strength and the speed of the market reaction felt like an overreaction. We had, of course, no idea that markets would bounce back so quickly. We didn't dare to go all in but we still reallocated about SEK 1 billion," he says.

The pension fund was also thinking about which sectors that might emerge as the potential winners when markets bounced back. When the board gave the all clear to make the reallocation, SPK put money into Swedish small-caps. "We took a disproportionate part and added that into small caps. Swedish small-cap managers also beat their indices significantly, so that reallocation turned out to be a double blessing," Stefan Ros says.

Lastly, he points to the decision to exit the alternative risk premia space prior to 2020, which largely turned out to be a pretty disastrous year for the strategies. "I almost don't dare to think about what would have happened otherwise," he says.