Andra AP-fonden

Second Swedish National Pension Fund - AP2

Second Swedish National Pension Fund 2006/2007

Content

Unless otherwise stated, the portfolio assets referred to in this report are "allocated exposures". In addition to booked fair values, these also refer to allocated (but not yet invested) liquidity for the specific class of asset, and the liquid funds held as collateral for positions already taken in derivative instruments. Classes of asset, derivative instruments and liquid funds are reported individually in the balance sheet at their fair values.

All monetary amounts are expressed in Swedish kronor and abbreviated as SEK k (thousand), SEK million or SEK m (million) and SEK billion or SEK bn (thousand million).

The 2006 Annual Report is available as a separate publication.

"AP2 must take the lead," says CEO Eva Halvarsson.

Page 6

Thomas Franzén is Chief Investment Strategist (CIS). In 2006, AP2 introduced fundamental indexing.

Page 14

Chief Investment Officer (CIO) Poul Winslöw presents the new portfolio management organisation.

Page 17

Lena Smeby-Udesen is Chief Financial Officer (CFO). "This is how we generate maximum value from every krona invested."

Page 21

Lena Sörensson, Head of Human Resources, and Eva Halvarsson, CEO, discuss team spirit within the Second AP Fund.

Page 28

This is the Second AP Fund

The capital assets invested in Sweden's publicly financed national pension system are managed by five "buffer funds", which invest these assets in the capital markets.

The joint investment regulations, which are identical for the First to Fourth Swedish National Pension Funds, permit investment in several different classes of asset and on different markets.

The Second Swedish National Pension Fund/AP2*, located in Gothenburg, started operations on January 1st, 2001. Since then, it has progressively developed and implemented its objectives, strategies and infrastructure, and is today a globally oriented portfolio management organisation.

The Board of the Second AP Fund is appointed by the Swedish Government. Each director is appointed to further the Fund's management goals, according to his/her individual competence.

The Second AP Fund is determined to be a leading pension manager with regard to return on investment, staff, inventiveness, efficiency and the respect of its peers.

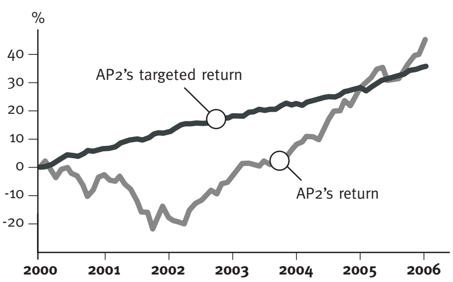
It will achieve this by means of efficient, professional and long-term portfolio management, featuring an effective utilisation of financial risk. This will ensure the maximum performance of Swedish pension assets under Fund management, to maximise future pension benefits.

*The Second AP Fund is officially translated as the Second Swedish National Pension Fund/AP2. In body text, for convenience, this is shortened to the Second AP Fund and, in some cases, AP2.

2006 in brief

- Since its inception, and including net profit for the twelve months ending December 31st 2006, the Second AP Fund has posted an annual average return on investment (ROI) of 6.3 percent. This exceeds the ROI average considered essential for the Fund to fulfil its long-term responsibilities within the Swedish pension system.

Accumulated return



- The Fund's capital assets totalled SEK 216.8 billion as per December 31st 2006, an increase of SEK 26.2 billion compared with the preceding year. During the year, the Fund reported a net inflow of SEK 1.7 billion. Net profit for the year totalled SEK 24.5 billion.

- The Fund posted a return of 13 percent on the total portfolio, before commission fees and operating expenses. If these expenses are included, the portfolio generated a return of 12.8 percent.

- The Fund posted a relative return of 0.2 percent for market-listed assets, before commission fees and operating expenses, for 2006. All asset classes noted a positive relative return. This return is primarily attributable to the successful in-house and external management of the Fund's portfolio of foreign equities.

- The solid growth in Fund capital may be attributed primarily to the maintenance of a high allocation of equities, in conjunction with limited foreign currency exposure, which was 11.7 percent as per December 31st 2006.

- The portion of the Fund's total portfolio managed in accordance with quantitative models has grown from 11 to 31 percent.

Three-year review	2004	2005	2006
Fund capital, SEK bn	158 120	190 593	216 775
Net inflows from RFV/National Social Insurance Board and liquidation/special funds, SEK bn	1 651	2 905	1 676
Net profit for the year, SEK bn	16 119	29 568	24 506
Annual return on total portfolio, before commission costs and operating expenses, %	11.6	18.7	13.0
Annual return on total portfolio, after commission costs and operating expenses, %	11.4	18.5	12.8
Relative annual return on market-listed assets, before commission costs and operating expenses, %	-0.6	0.2	0.2
Active risk, ex post, %	0.5	0.5	0.7
FX exposure, %	10	11	12
Under active (incl. enhanced) management, %	90	90	93
Under external management (incl. investments in private equity funds) , %	37	28	17
Share of management expenses, incl. commission costs, %	0.22	0.16	0.15
Share of management expenses, excl. commission costs, %	0.08	0.07	0.06

Adjustments due to changes in accounting principles relating to performance-based commissions are included in the figures shown in the income statement as of 2004.
* Relative return refers to the difference in return between portfolio and benchmark index.

Target, result and efficiency

Fund attains targeted return

Net profit for 2006 included, the Second AP Fund has attained the targeted long-term return established at the Fund's inception. The Fund's annualised return has averaged 6.3 percent against a targeted return of 5.7 percent.

The Second AP Fund's capital assets are managed with a view to generating a buffer for future pension disbursements as part of the reformed national pension system.

To generate the greatest possible benefit in this role, the Fund's primary focus is to maximise return on investment, so as to minimise the consequences of automatic balancing within the pension system over the longer term. The Second AP Fund's specific risk is a weak return on the assets under management, especially if the pension system underperforms. The target established for ROI in real terms for 2007 has been set at 5.0 percent, of which 4.5 percent from the strategic portfolio and 0.5 percent in relative return.

The Fund's activities are long term and are therefore judged over a long period. Rolling five-year periods are considered adequate for measuring the performance of actively managed assets, while that of the strategic portfolio may need to be assessed over a more extended period.

Solid absolute return in 2006

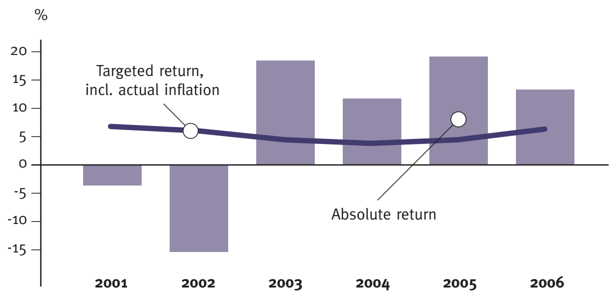
To ensure attainment of the pension system's long-term overall objective, the Second AP Fund deems the buffer funds must achieve a certain joint annual return on investment. If the Second AP Funds satisfy this long-term target, and if Sweden's demographic trend develops in line with the population forecasts published by SCB (Statistics Sweden), there is a good chance that the pension system, at least the national pension system, will function relatively smoothly.

The target for real return on investment in 2006 was 5 percent, including the target for relative return. The graph below presents absolute return in relation to the Fund's real target for return on investment since its inception.

The Second AP Fund posted a real return of 11.3-percent for 2006, achieving not only the target for the year, but for all six years since the Fund's inception. As shown in the bar chart, the Fund now shows an average return in excess of targeted long-term absolute return, following a troubled start in conjunction with the equity market downturns of 2001 and 2002. The Fund has met its targeted absolute return every year since 2003.

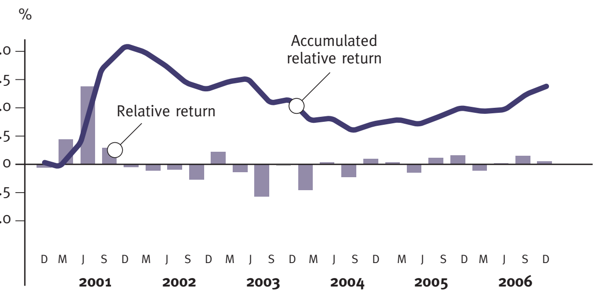
The key reasons for the solid return generated over the full

Six years' statistics for absolute return, 2001 - 2006



For the past four years, the Second AP Fund has exceeded its long-term target for return on investment.

Relative return on Fund's listed assets, 2001-2006



The graph shows the Fund's accumulated relative return since its inauguration in 2001. The bars show relative return by period.

period are the high percentage of equities in the portfolio, combined with low currency exposure. In 2006, these factors have again been crucial to the Fund's performance.

Favourable relative return

The Second AP Fund's targeted relative return on investment is 0.5 percent. This means that the Fund must outperform the selected strategic portfolio by 0.5 percentage units. This is a measure of the Fund's success in managing its assets to generate a value in excess of that generated by mere exposure to market trends. The Second AP Fund posted a relative return on investment of 0.2 percent in 2006. This is largely attributable to the favourable results generated by in-house and external management of foreign equities.

Risk utilisation within prescribed limits

Day-to-day management of the Fund's assets shall be conducted so that the anticipated active risk for the entire portfolio of listed assets shall not exceed 3 percent. In recent years, the financial markets have been characterised by low volatility, i.e. the markets have been unusually stable. Rated as a standard deviation from ROI, volatility for the portfolio of market-listed equities was 7.4 percent. As for risk utilisation by asset class, active risk for Swedish equities was 2.9 percent, foreign equities 1.0 percent and for fixed-income assets 0.3 percent. The Fund's degree of active risk has been concentrated to a limited number of mandates, including a portion of the Swedish equities portfolio as well as external global equity and asset allocation mandates.

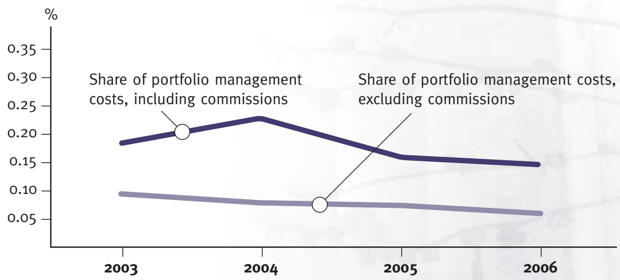
"Core/satellite" strategy promotes cost efficiency

The Second AP Fund has a target real return of 5 percent. With current real interest at 1.5 to 2 percent, it is essential that the Fund locate investment opportunities that can generate a higher return with a balanced risk.

Exposure in high-yield asset classes often incurs higher portfolio management costs. Private equity funds provide one example where, compared to other asset classes, the most successful fund managers have been able to generate high returns over a considerable period.

Conversion to a "core/satellite" strategy in 2004 has made the Fund's portfolio management more cost-efficient. In line with this strategy, the Fund has organised its asset management activities into "low risk" (assets with broad exposure to fixed-income and equities markets, managed in-house and at low cost) and "active risk" (assets involving greater active risk and broad exposure to less mature markets, requiring a higher level of specialist expertise and therefore often managed under external mandates).

Portfolio management costs as percentage of total assets, 2003-2006



Following the build-up phase, costs as a percentage of total assets have declined.

The Second AP Fund *must take the lead*

This marks my first "Review" as Chief Executive of the Second AP Fund. I took up my appointment in February. It has proved to be a busy year, for myself and for the organisation as a whole. Since it is my privilege to head such a competent organisation of skilled staff, one of the purposes of this annual statement is to present those who constitute the Second AP Fund.

Our task is unique: to manage the capital assets entrusted to us in a manner that will contribute to the economic security of current and future pensioners in their old age. This places considerable demands on those of us who work for the Second AP Fund, both in terms of our professional performance and the requirement that we also understand every aspect of our job.

Everything we do should derive from a common code of values. During the year, we have striven to identify a number of elements that are important to success in everyday life. Elements such as team spirit, committed leadership and an unassuming attitude.

Openness, clarity and a willingness to accept responsibility establish a basis for professionalism and creativity that also make it a pleasure to work at the Second AP Fund. A capacity for self-assessment, at the personal as well as organisational level, must naturally also form an important part of our common code.

This code of values is crucial to ensuring that we achieve our overall target of a maximum long-term return on assets under management. Furthermore, to achieve this target, we must succeed in our efforts to be more efficient and innovative and, naturally, to promote the development of our staff. If we achieve a strong position in all these areas we shall be one of the best investment managers. And this will enhance our credibility.

So how are we doing in our target areas?

In terms of return on invested assets, 2006 has been a good year. Return on assets amounted to 13.0 percent, the Fund's total capital assets increased by SEK 26.2 billion and net profit for the year was 24.5 billion. All asset classes noted a positive real return.

The 2006 net result means that the Fund, for the first time since its inception in 2001, has achieved the average return over time that was targeted from the start. Since the Fund's inception, the annualised return on invested assets (including 2006) has been 6.3 percent, against a targeted return of 5.7 percent.

When it comes to efficiency, the Second AP Fund is well to the fore. We have chosen to manage our entire business flow in-house, where we are committed to the ongoing improvement of our routines and processes. No less than 83 percent of the Fund's assets are under in-house management, where our own quantitative management activities are a key element. In cases where we feel in-house management would be unable to generate an excess return, we use specialised external portfolio managers.

We conduct regular studies to compare our performance with international fund managers engaged in similar assignments. These show that the Second AP Fund does well in terms of cost efficiency and net return.

A capacity for innovation is extremely important on a capital market that is becoming increasingly sophisticated and efficient. By practising an open attitude and by exposing ourselves to the latest feedback from every sector, to ensure that the Fund has a clear and up-to-date understanding of developments within the industry, we can be a frontrunner when it comes to benefiting from good examples and innovative thinking. We are dedicated to a constant search for new ideas that can add value and contribute to greater efficiency. Our introduction of fundamental indexing for our North American portfolio in 2006 provides a good example. We are here utilising a new way of looking at investment in the equities market in order to generate value. I see the sort of innovative thinking typified by this introduction of fundamental indexing in every part of the organisation.

My colleagues in the Fund are one of my key priorities. We have a solid platform in terms of advanced know-how, strong commitment and a thorough understanding of our mission. But we can be even better, through greater cross-fertilisation between different disciplines. Our recently implemented portfolio management organisation is one example. It represents a creative combination in three areas of expertise: fixed-income, FX and equities. It facilitates knowledge transfer, creating opportunities for generating higher returns.

If we can maintain our edge in these areas – return on investment, efficiency, a capacity for innovation and committed staff – we shall be one of the leading investment managers, which is of course precisely what we intend to be.

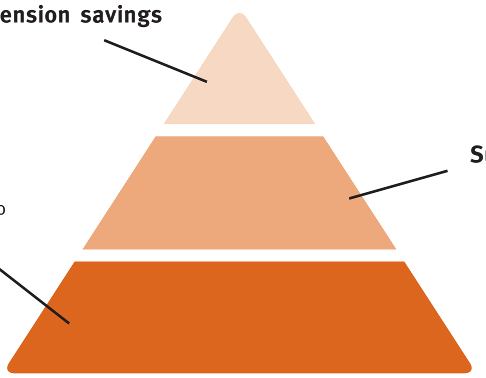
We are a strong team – and we can make a difference.

Eva Halvarsson
CEO

A tripartite pensions pyr

–with the AP Funds as buffers

The Swedish pension system may be compared to a pyramid comprising three levels. The national retirement pension forms the base of the pyramid and the primary source of income for the majority of future retirees. The next level consists of the supplementary pension, a benefit funded by employers, which covers almost all those who have been gainfully employed in Sweden. The top of the pyramid consists of voluntary, private pension savings.



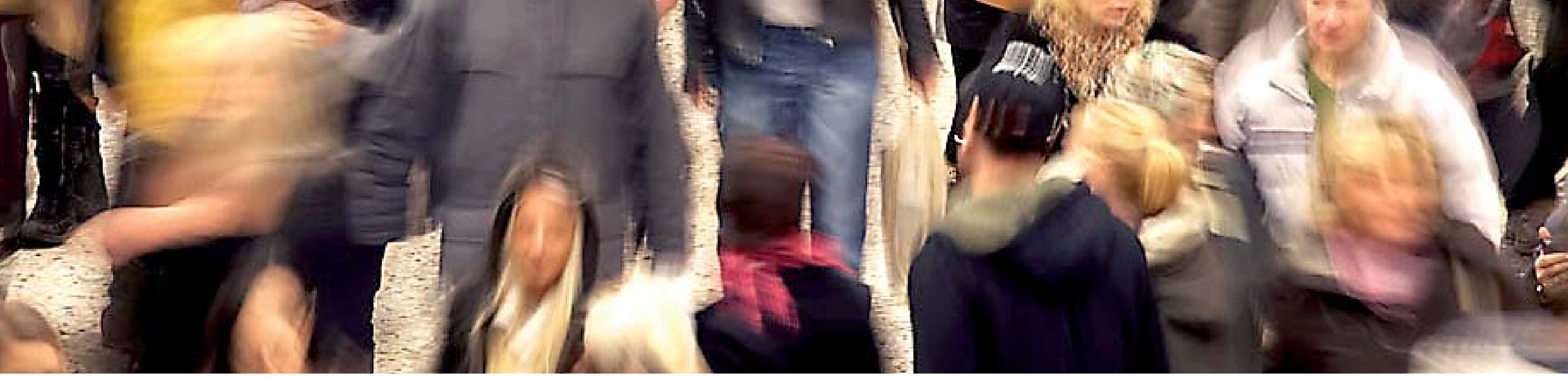
Since pension benefits derive from several sources, the recipient also receives several pension statements. These indicate the amount of pension entitlement accrued to date. In the case of the national retirement pension, future beneficiaries receive their pension statement in an orange envelope every year.

The base of the pyramid: the national retirement pension

The income-based pension system is autonomous, and does not rely on state finances. Basically, future pensions are determined by the size of individuals' wages/salaries, based on income generated over an entire working life.

The national retirement pension consists of an income-based pension, a premium pension and a guarantee pension. Every month, 18.5 percent of an employee's pensionable income is paid into the system. Of this, 16 percent contributes to the income-based pension and 2.5 percent to the premium pension.

The size of the income-based pension is, just as it sounds, dependent on the size of the pensionable income generated during an individual's working life.



amid

However, the money does not simply sit there waiting to be deposited in an account. It becomes part of a "distribution system", whereby pension disbursements are financed on a Pay-As-You-Go (PAYG) basis from the monthly payroll tax paid into the system by employers.

The size of the premium pension depends on the return on the mutual funds in which these capital assets are invested. Where the premium pension is concerned, each future pension beneficiary determines how the money, equivalent to 2.5 percent of pensionable income, shall be invested.

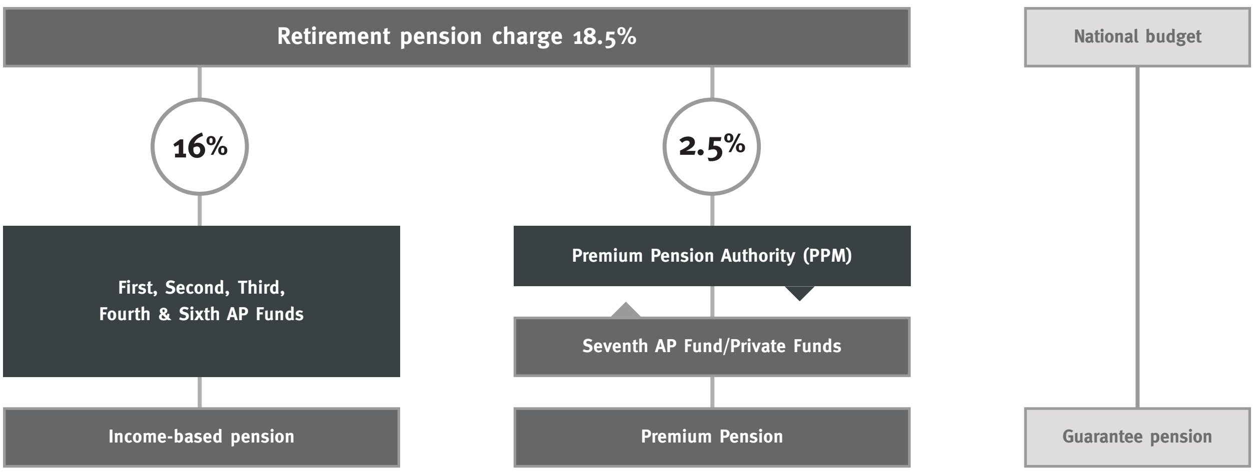
Those with low or no income are covered by a guarantee pension, funded from taxes.

Robust structure prevents collapse

Seen in the broader context of the national budget, the Swedish pension system is a robust structure. It can tolerate significant economic swings, as well as demographic change. Special control mechanisms are built into it to ensure financial autonomy.

The total pension liability is adjusted on an ongoing basis, to reflect changes in the income index, i.e. to keep pace with changes in average income in Sweden. This is designed to counteract an actual decline in purchasing power caused by possible inflation. There is, however, an exception, when this basic principle is ignored.

This exception is known as "automatic balancing". Should Sweden enter a prolonged period of weak economic conditions and slow job growth, with an ageing population and an unacceptably low number of childbirths, it would have to deviate from its income-indexed principle. Adjusting the income-based pension at a pace commensurate with growth in average income, without jeopardising the system's long-term stability, would be impossible – and make increased pension contributions inevitable.

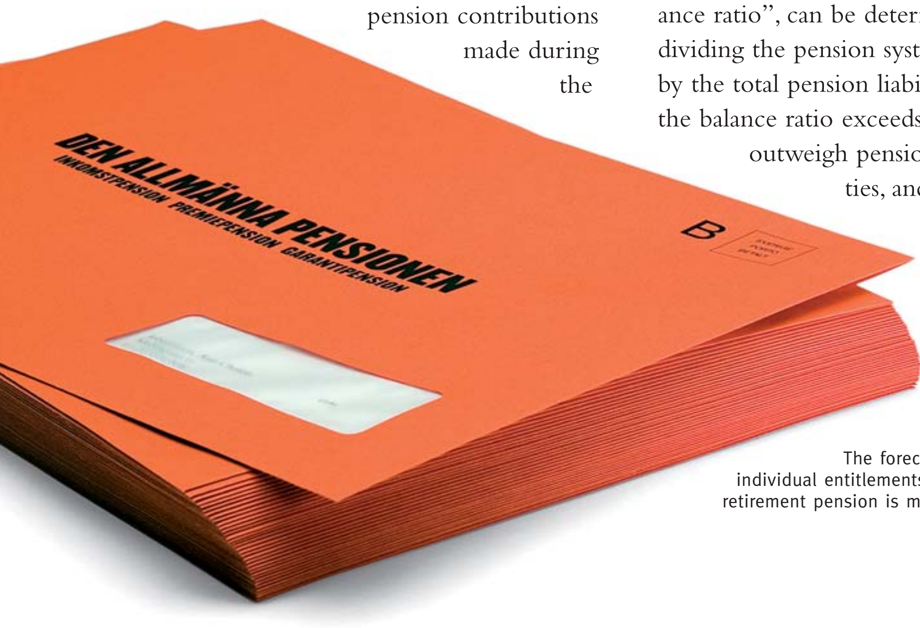


Contributions are calculated on the basis of pensionable salary. Of this, 16 percent contributes to the income-based pension and 2.5 percent to the premium pension.

Ongoing balancing act – that looks after itself

The assets of the national pension system comprise two elements. The combined assets of the "buffer funds" and what are referred to as "contribution assets" which account for close to 90 percent of total pension assets. Expressed simply, these funded assets are the sum of all pension contributions made during the year multiplied by the assumed average period each krona is expected to remain within the system, from initial contribution to final disbursement. Liabilities consist of pension entitlements due on each occasion.

To ensure that the system is robust, its assets must exceed its combined pension liability. This relationship, reflected in the "balance ratio", can be determined by dividing the pension system's assets by the total pension liability. Where the balance ratio exceeds 1, assets outweigh pension liabilities, and pensions continue to be adjusted upwards in line with the income index. However, where the balance ratio is less than 1, pension liabilities outweigh assets. When this happens, the automatic balancing function is applied. At this point, the accrued pension liability and the ongoing pension disbursements are indexed according to the change in balance index rather than income index. This continues until the system is in balance again. In brief, this means that pensions are adjusted upwards more slowly than would appear to be motivated by the income index.



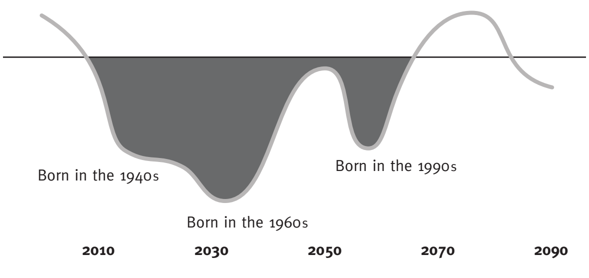
The forecast concerning individual entitlements to a national retirement pension is mailed annually.

The pyramid features an important buffer zone

The role of the national pension funds, known as the AP Funds, is to even out discrepancies that may arise from fluctuations in the level of pension contributions received and pension disbursements made,

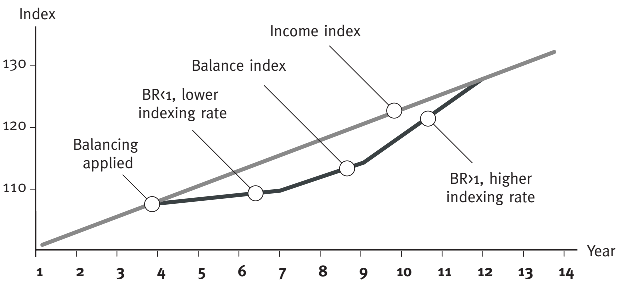
Impact of retirement peaks on pension system

(Source: Swedish Social Insurance Administration)



When baby-boomers retire, they create a demand for a buffer in the pension system. The system's disbursements are likely to exceed contributions within the next two years, when the large post-war generation of baby-boomers retire.

The way balancing works (Source: Swedish Social Insurance Administration)



The balance ratio (BR) represents the system's assets divided by combined pension liability. If the balance ratio is less than 1, balancing is applied. This means that pension liability and pensions are adjusted upwards only by wage growth multiplied by the balance ratio. This process continues until parity is re-established.

The AP Funds

– a small part of the pension system

The Second AP Fund's overall task is to manage the pension assets with which it is entrusted as a buffer within the pension system. As far as is possible, it shall strive to minimise any negative impact on future pensions that might derive from the negative development of the unfunded portion of the pension system.

In this context, the AP Funds constitute a relatively modest part of the total pension system. A slight weakening of the pension system, as a result of an unfavourable demographic trend or a weak labour market, could probably be compensated by a higher return on the buffer funds' invested assets.

However, this ability to compensate for underlying weaknesses in the pension system is limited. In the first place, the size of the assets managed by the AP Funds limits the size of the potential return. Secondly, the possibility of adopting a higher level of risk, and thereby increasing possible returns, is limited. The number of major sources offering high returns is just not that great.

The employment situation will therefore have a much greater impact on future pensions than the result of the AP Funds' investment activities. The employment situation is in its turn dependent on the size of the labour force, as well as other factors, such as age of entry to the labour market and the age at which individuals choose to retire.

especially in the long term. The AP Funds manage the assets that comprise the income-based pension system.

When baby-boomers retire, they create a demand for a buffer in the pension system. The system's disbursements are likely to exceed contributions within the next two years, when the large post-war generation of baby-boomers retire.

The AP Funds are dimensioned to compensate for such imbalances without having a negative impact on pensions.

The First, Second, Third and Fourth AP Funds manage the majority of the buffer capital that comprises a small amount of the income-based pension system's assets. The Sixth AP Fund also manages buffer capital, if on a smaller scale, but this is subject to different investment regulations.

Income-based pension contributions, paid on a monthly basis by all employers, are transferred to the First to Fourth AP Funds. Each Fund receives a quarter of the pension contributions received and funds a quarter of pension disbursements made. Monthly disbursement of the national retirement pension is therefore handled via the buffer funds.

In principle, contributions received during a given month are the same as the sums disbursed in the form of payments to pensions for the same period. This means that the income-based pension system generates almost no savings at the national level. For those covered by the system, however, the pension contribution may be seen as a form of saving.

Status of Swedish pension system as per December 31st 2005, SEK bn
(Source: Swedish Social Insurance Administration)

ASSETS	SEK bn
Contribution assets	5 721
Buffer funds	769
	6 490

LIABILITIES	SEK bn
Pension disbursements due	6 462
Surplus	28
	6 490

Small surplus in pension system

The global PENSION CHALLENGE

Sudhir Rajkumar, head of Pension Investment Partnerships at the World Bank Treasury, a programme that assists pension funds in strengthening their investment capacity, answers eight key questions on challenges facing the global pension system and their impact on future investment strategies.

What are the three greatest challenges currently facing the global pension system?
First and foremost, the need to ensure that state finances will be able to maintain current pension commitments in the long term. This ability is being strained by the demands of an ageing population in many parts of the world, creating an imbalance in the system. The second challenge is to improve governance of both state and private pension systems, something that has a direct impact on their financial stability. If this can be achieved, it will generate greater public confidence, which is important. The third challenge is to extend coverage of obligatory and voluntary pension systems so that they meet the needs of the elderly, among the vulnerable and poor, in a satisfactory manner.

Some describe the pension system as a "time bomb" just waiting to go off – what do they mean?
The "time bomb" that many refer to comes from the impact a rapidly ageing population will have on many countries – in combination with a lack of financing for pension systems. The main source of revenue for pension disbursements to those of pensionable age derives from taxes paid by those in gainful employment. It works fine when those in gainful employment significantly exceed those living on pensions, but not so well if they do not.

How should these challenges be met, generally speaking?
No single formula can hope to address all these problems. Each country must consider a number of alternative approaches to reform, based on its individual requirements, limitations and possibilities. In each case, the objective will be to secure a satisfactory pension level based on a robust and sustainable system.

Are there regions where the challenges are particularly demanding?
The pension systems of different countries and regions vary considerably. In some cases, the challenge is how to avoid extensive poverty among a majority of the elderly. In other cases, where the majority is not subject to the threat of poverty, the main challenge is to ensure that the system is within the financing capacity of society at large, and is sustainable. The pension systems of many countries lack the ability to withstand major economic and demographic shocks and political turbulence.

Are some countries or regions better prepared than others?
Latin America is considered by many to be a forerunner in pension reform; the former planned-economies of Europe and Central Asia are also reforming rapidly. Sweden's pension system is often cited as offering a

number of advantages compared with those of many other countries. This said, however, I lack sufficient in-depth knowledge of the Swedish pension system to express a detailed opinion.

From a strict investment perspective, what problems do you anticipate for future pension systems?

There are several. Improving the governance of pension investments to increase transparency and create a clearer division of responsibilities is a key challenge for pension systems globally, and has a direct impact on their investment returns. There is also a need for an ongoing effort to educate policy makers in the benefits of spreading investments across a broad spectrum of asset classes. A reduction in the amount of legal and political restrictions imposed on international investment would also be a step in the right direction. Looking ahead, the general view is that the return generated by financial markets will be lower than has traditionally been the case. However, the impact of an ageing population on overall return from financial markets can sometimes be exaggerated. The effects of global growth and globalization of markets are likely to be more important than an ageing population in specific countries. An ageing population could, of course, make certain sectors (such as health care) more financially rewarding than others.

What strategies should be adopted to deal with these challenges?

Strategies that will help address these challenges include: improvements in investment expertise and control functions among pension funds; expanded opportunities for investment in a broader range of asset classes, and ensuring that investments in an individual financial market are compatible with its size and liquidity. It is also important that innovative new investment products are developed for pension funds, whose investments are long-term by nature. Exploring international investment opportunities and innovative ways of dealing with the consequent foreign exchange risks would also help.

Would you say the scope for improvement in the way pension funds invest their assets is considerable or merely limited?

There is considerable scope for improvement. For example, it is important that strategic allocation of the funds' assets takes their liabilities into consideration too. In other words, the underlying causes of the size and growth of combined pension liabilities should be evaluated on an ongoing basis – and should be taken into account in deciding the funds' investment strategy. In this respect, the expected investment horizon (i.e. the time up until the assets are sold and the money disbursed in the form of pensions) is very important in determining investment decisions and the overall level of risk. When striving to achieve a better balance between risk and return on investment, it is therefore a good idea to clearly define and quantify the level of risk the fund is prepared to tolerate. Using a risk budget can contribute to increased efficiency in this respect.

The views expressed in this interview are the personal opinions of Sudhir Rajkumar, and may in no way be interpreted as representing the official opinion of the World Bank, even though the interviewee has access to the World Bank's broad institutional competence in this area – a competence developed over many years as an advisor to member countries on issues concerning pension system design and investment of pension assets.

Brief facts on the World Bank

The World Bank, with its 185 member countries, is a non-aligned supranational organisation, operating within the framework of the United Nations Economic and Social Commission. The Bank was established in 1944, at the Bretton Woods Conference in the USA. Since then, the Bank has grown into the World Bank Group, which carries out a broad range of duties involving loans and advice to countries in need of economic development.

Sudhir Rajkumar, Head of Pension Investment Partnerships at the World Bank Treasury.

With sights set on fundamental balance

"Fundamental indexing": not the most riveting words with which to kick off a lunchtime discussion. But if you add the fact that a portfolio based on fundamental indexing over the past 40 years would have generated a final market value twice that of a conventionally managed portfolio…? Well, you're likely to grab the attention of your audience.

Tomas Franzén is Chief Investment Strategist (CIS) at the Second AP Fund, where he has worked since 2001.

Put simply, he is responsible for the Fund's long-term strategic asset allocation. And he must allocate the assets in a manner that will secure the required level of pension disbursements 30 to 40 years ahead.

To help him and his colleagues, Tomas Franzén employs a model, developed in-house, which describes the impact of different portfolio strategies on future pensions. This in-house analytical approach involves an advanced mathematical-statistical instrument known as Asset Liability Modelling (ALM). It is an important instrument in enabling the Second AP Fund to develop a fundamental strategy and thereby contributes to achieving stable exposure to economically motivated risk premiums.

Employment levels have a major impact on future pensions

The Fund's strategic analysis and ALM projections form the basis for all investment activity at the Second AP Fund.

"The ALM analysis studies a large number of scenarios, aiming to determine an allocation of portfolio assets that will ensure that future pensioners receive as high a pension as possible", says Tomas Franzén.

Not surprisingly, a considerable quantity of fact-based assumptions is fed into the Second AP Fund's model. The most crucial element of this strategic analysis addresses the long-term development of financial markets. Other key elements include future demographic change, salary/wage levels, and the rate of inflation and employment levels.

"The labour market trend is especially important. The number of people in employment has a decisive impact on future pensions", notes Tomas Franzén.

Another critical factor is the point at which we decide to retire. For instance, many Swedes are currently in the age range 60-65. The precise point at which they choose to retire will have a real impact on the stability of the pension system.

"A low retirement age affects the pension system in two ways: pension disbursements have to made over a greater number of years, and retirees will have worked fewer years. The inevitable result is less money per pensioner and month."

High percentage of equities to achieve goal

To achieve the goal of providing the highest possible future pensions, the Second AP Fund's portfolio features a high allocation of equities (60 percent).

"The high percentage of equities is not just because we believe the equities markets will yield a high return. It is vital, if the Fund is to generate the return necessary to meet its commitments within the pension system."

In actual fact, the Second AP Fund deems that the future risk premium for equities has fallen sharply. It currently stands at about 3 percent above the risk-free rate. Calculated over the past 100 years, on average, the premium has been around 5 to 6 percent.

Fundamental indexing – a new way to enhance performance

Some types of equity are priced to generate a higher long-term return. The Second AP Fund exploits this fact by utilising fundamental indexing, a new investment style that the Fund introduced in the summer of 2006. The first portfolio based on this model features North American equities, involving a total investment of SEK 5 billion. During the second half of 2006, the portfolio exceeded a traditional cap-weighted index by 2.1 percentage points (it generated a return of 7.5 percent compared to the 5.4 percent noted for MSCI North America).

In early 2007, the Fund invested a further SEK 10 billion, although this time in Swedish equities.

One of the first

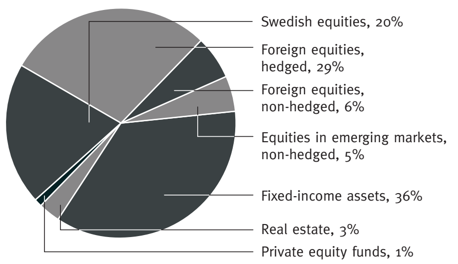
"We are among the first to introduce this investment strategy," says Tomas Franzén.

This has attracted the attention of others in the pensions world. The magazines *Global Pensions and Investment* and *Pension Europe* are among those that have written about the Second AP Fund's new investment strategy.

Studies indicate that fundamental indexing would on average have generated 2-2.5 percent more than conventional indexing during the past 40 years in the USA.

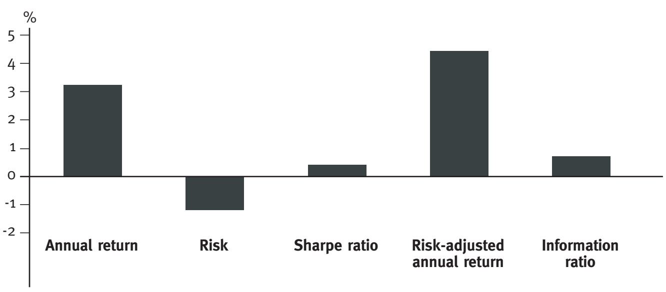
"In Sweden, we have conducted an historical analysis to determine what

Strategic portfolio 2007



The strategic portfolio is developed using an in-house ALM model, which considers expected developments affecting assets and liabilities more than 30 years ahead.

Fundamental indexing, January 1984- – June 2006



The diagram shows the differential in return and risk between RAFI North America and equivalent cap-weighted indices. (Source: Research Affiliates)

Two fundamental engines of growth:

1

Exposure to economically motivated risk premiums

- Systematic risk premiums
- Long-term
- Available to all
- Low cost
- Limited degree of diversification

2

Skilled utilisation of temporary inefficiencies*

- Sporadic market inefficiencies
- Short-term
- Zero-sum games
- Cost reflect short supply
- High degree of diversification

* Refers to "pure alpha" with no exposure to risk premium.

the impact of this type of investment strategy would have been over the past 25 years. The results indicate a return close to 3 percent above a traditional cap-weighted index. These studies also show that this approach functions particularly well during market downturns. Of course, we have no means of knowing whether these figures will be repeated over the coming years. But we do believe that fund managers' tendencies to place an excessive proportion of their portfolios in equities, which are already highly rated and will therefore yield lower returns, are likely to continue for some time," says Tomas Franzén.

Fundamental indexing – how it works

In all relevant respects, global asset management is based on cap-weighted indices. In this type of index, the equities are weighted according to their market value.

This is not the case with fundamental indexing. This approach takes no account of market value. The focus is on a number of other predetermined fundamentals. These variables (cash flows, dividends, sales and book value) reflect the company's size in the real economy. The basic idea, in the long term, is to generate higher returns at lower risk, by avoiding the overweighting of "overvalued" equities and the underweighting of "undervalued" equities that can occur with cap-weighted portfolios.

Passive process

These fundamentals, applied mechanically to rank the companies, determine the portfolio's passive weightings. These passive weightings are updated on a yearly basis and, in most cases, tend to be fairly sluggish. This strategy requires no continual analysis or the adoption of positions, as with a traditional active management approach.
It means that the weights allocated for different equities may vary sharply compared to a normal cap-weighted index.

The facts speak for themselves

Historical analyses point consistently to higher long-term returns. Over a period of 40 years, up until 2004, the fundamental index yielded an annual risk-adjusted return that, on average, was 2.4 percentage points higher than a cap-weighted index. This study focused on equities in the USA. Including "interest-on-interest", this means that a portfolio based on fundamental indexing would have more than doubled its market value compared to a traditional cap-weighted portfolio over the same period.

Higher performance at lower risk

Fundamentally weighted portfolios have also proved to produce a more stable performance. This produces a remarkable conclusion: fundamental indexing not only generates a higher return, it helps reduce risk as well. This characteristic is especially manifest during market downturns.

The hunt for ALPHA

Forget centralised control and many restrictions. Think outside the frame: think individual skill, multiple investment opportunities and a generous share of individual responsibility. And think uncorrelated – just like Poul Winslöw, Chief Investment Officer at the Second AP Fund, and the brain behind the new organisation.

"At the Second AP Fund, each portfolio manager should have his/her own idea of what currently offers the best investment opportunity. And here they will be given the chance to implement their ideas faster than in many other organisations, just as long as they can demonstrate that the idea will generate added value", says Poul Winslöw.

Individual skill, multiple investment opportunities and rapid implementation of ideas are three points he often reverts to when talking about portfolio management.

"It creates a stable foundation for innovation – to dare to invest differently and in a smarter way, but responsibly."

Integrity is important when seeking higher performance

Personal integrity is essential if you are going to invest differently from everyone else. Some believe the Fund's Gothenburg location gives it an advantage. If you have the rest of the investment industry within lunching distance, as in Stockholm, there is the clear risk of developing a "herd" mentality, without necessarily being aware of its influence.

"We avoid this risk, because we are located on the opposite side of the country. The fact that the environment here is more international than in many other Swedish financial organisations is an added bonus. We are closer to other parts of the world, mentally as well as geographically", says Poul Winslöw, whose previous positions include posts as Chief Portfolio Manager at Unibank in New York and Head of Asset Allocation at Nordea, in Stockholm.

Alpha is found where nobody's been looking

One of the problems faced by the financial markets is that they are subject to increasingly exhaustive analysis. Talented analysts cluster like bees round a honey pot when it comes to mature markets.

For this very reason, the Second AP Fund also looks for enhanced performance where others don't, while simultaneously ensuring that its investments in "exhaustively analysed" markets are managed using a cost-efficient, quantitative approach.

One alpha concept is to search for price variations arising between equities and corporate bonds in the same company. Locating this type of deviation before anyone else can be highly profitable.

A mix of skills – an unusual approach

To ensure that this form of cross assets class analysis is conducted as efficiently as possible, the Fund's asset management activities have been reorganised.

"We no longer have an equities department, a fixed-income department or tactical allocation department. Instead, we now have a Global Department and a Sweden Department, staffed by experts in each asset class category. This automatically creates a new dynamic."

The Second AP Fund's new organisational structure is actually quite unusual.

Chief Investment Officer

External portfolio management

Share of total portfolio, January 1st 2007*	**21%**
Allocation by asset class, equities	**62%**
Allocation by asset class, fixed-income	**15%**
Allocation by asset class, alternative investments	**22%**
No. of employees	**3**

Global portfolio management

Share of total portfolio, January 1st 2007*	**17%**
Allocation by asset class, equities	**56%**
Allocation by asset class, fixed-income	**44%**
No. of employees	**8**

Swedish portfolio management

Share of total portfolio, January 1st 2007*	**26%**
Allocation by asset class, equities	**36%**
Allocation by asset class, fixed-income	**64%**
No. of employees	**7**

Quantitative portfolio management

Share of total portfolio, January 1st 2007*	**31%**
Allocation by asset class, equities	**91%**
Allocation by asset class, fixed-income	**9%**
No. of employees	**6**

* Excluding currency hedge and liquid funds

Investment approach:

1.

Better results through individual skill, multiple investment opportunities in several asset classes and fewer constraints on the individual portfolio manager.

2.

Portfolio managers shall take personal responsibility for their investment decisions.

3.

Clearer distinction between alpha and beta management. Focused adoption of risk with a limited number of holdings to generate alpha value and cost-efficient quantitative management to generate beta value.

4.

The ability to shift investments rapidly between in-house/external management, between different asset categories and between specific securities.

"Yes, we are among the first institutional investors to do this", says Poul Winslöw, noting that current research supports many of the conclusions he has himself reached during years of practical experience. One such example is a book entitled "The Fundamental Law of Active Management".

Written by researchers Grinold and Kahn, it emphasises the importance of uncorrelated investments in generating returns that outperform the average.

Money is a better incentive than percentages

Poul Winslöw's focus on separating alpha and beta, is based on a conviction that has developed gradually over the years. But it places severe demands on the organisation.

"Which is why I want individually skillful portfolio managers and as few investment restrictions as possible. This applies equally to in-house and external managers."

Another change is that the Fund is to focus more on absolute returns, actual money, rather than percentages – which is common in the management of institutional portfolios.

"Yes, it means we ask ourselves every day how much money we've actually earned. SEK 200 million sounds more than 0.1 percent. It adds an extra incentive to generate exceptional returns", notes Poul Winslöw.

What you should know about alpha and beta values

The Second AP Fund's investment approach is based, in principle, on the understanding that financial markets offer two forms of return on invested capital.

BETA

In the long term, a systematic and passive exposure to risk premiums that are economically motivated is the main source of return on investment. The financial term is "beta".

Examples of this type of risk premium include the maturity premium on long bonds, the credit risk premium on corporate bonds and government bonds in developing countries, the equity risk premium on well developed and mature equity markets, equivalent to the equity risk premium in developing countries.

Exposure to this type of risk premium is inexpensive and available to all. Some of these risk premiums feature relatively high correlation and therefore offer limited diversification.

ALPHA

Skillful management of more or less temporary inefficiencies in the financial markets generates an active return that constitutes the second source of value creation in portfolio management. The financial term is "alpha". Pure alpha features no exposure to risk premiums.

Different financial markets exhibit varying degrees of inefficiency, making them consequently more or less suitable as alpha generators. Alpha assumes active management, involving short-term positions.

Since there is a lack of pure alpha, by definition, it will cost more. At the same time, pure alpha features greater diversification. Consequently, pure alpha can simultaneously enhance return while reducing portfolio risk.

"My job: to find the 20 percent...

...that generates that extra return."

She has her eye on them every day, those external portfolio managers responsible for SEK 34 billion of the Second AP Fund's assets. And those who hope to be chosen, too. She knows that only one in five are good enough. The problem is she can't be certain which they are.

"The difficulty is to locate skill that only reveals itself over the long term. Only a few external managers are able to provide the sort of return we are interested in", says Mimmi Kheddache-Jendeby, portfolio manager of external mandates at the Second AP Fund.

She maintains close and regular contact with those managing the Fund's external mandates and other managers as well – at least ten calls a day. And at least as many e-mails. Many would like to manage the Second AP Fund's capital assets. Every week, the Fund receives three or four visits from portfolio managers keen to promote their services.

"I think it's healthy. It ensures we keep up-to-date on what's going on."

"External managers are used in two instances...

...such as when we lack the capacity to manage index portfolios internally. This may be due to administrative limitations, as can be the case with emerging markets. The second case is when we hire external managers to diversify our own internal alpha capabilities."

Always ready to respond

The procurement process normally takes 6-8 months. The Fund usually negotiates agreements with more portfolio managers than it actually uses, to enable a rapid changeover if required.

The Second AP Fund's total portfolio currently includes 22 externally managed mandates and funds.

In December 2004, 37 percent of Fund assets were managed by external managers. At year-end 2006, the figure was 17 percent.

This reduction meant that the Second AP Fund was featured on the front cover of the February issue of the industry magazine IPE (Investment and Pension Europe), under the heading "AP2 – The Terminator".

"Well yes, we have reduced the number of external managers.

The reason is simple: we want better results. We achieve this by putting together portfolios of active mandates that are managed by skilful portfolio managers, with low correlation," says Mimmi Kheddache-Jendeby.

Consistent conduct important

The investment process and the organisation itself are very important factors. It is important to understand these external managers and their investment style, to be able to judge their performance in relation to the appropriate index. Some investment styles underperform during certain periods. If a growth-oriented manager seriously underperforms when growth-oriented equities are performing, it could be time to think about a switch. If, on the other hand, the external manager has outperformed its index through active investment decisions, year after year, things obviously look promising. This said, excessive success can create a different risk. The fund manager or, more correctly, the assets under management, can get too big. If liquidity issues force a manager to modify its investment process and style, there's a problem.

"Many portfolio managers say that we are very demanding. In my opinion, it's only natural, for the sake of future pensioners."

ABOUT ENDING UP

in the right quadrant

It takes muscle and flexibility to move a portfolio that weighs in at SEK 217 000 000 000 to the highest level when it comes to return on investment.

It also requires perseverance, taking those small steps every day that eventually add up to major advances.

"It's more about a lot of small steps than about taking one big one."

"Our job is to ask ourselves how we can generate the highest value for every krona invested – every day, not once or twice a year. It's often those small day-to-day steps that make the difference between those who are really successful and those who don't do so well", says Lena Smeby-Udesen, CFO and head of Business Services at the Second AP Fund.

Business Services comprises six departments, responsible for the Fund's external and in-house financial reporting and control functions, follow-up and analysis of results, and administrative efficiency. Responsibilities also include IT and HR.

The Fund was inaugurated at the start of 2001 and business support functions were the first to be built up, to create stability for the Fund's asset management activities.

" We were able to build a solid platform right from the start. We made a number of strategic decisions, including the need to establish a high degree of transparency and flexibility – to enable us to implement rapid change in asset management activities if and when required."

The capacity to adapt rapidly to changes in strategy

In this context, the TradeseC communication system plays a significant role. The system enables the Second AP Fund to see all trades executed by its external managers, in real time. The system is easy for new external portfolio managers to use, and logs all activities between external parties and the Fund. It offers excellent opportunities for switching between external managers, or to retrieve capital assets for in-house management.

"The Second AP Fund is the only buffer fund to have chosen this type of infrastructure. We consider it vital that we have full insight into the trades conducted by our external managers and thereby day-to-day knowledge of the capital's market exposure."

Broad experience and knowledge

Other strategic decisions made at the Fund's inception were to secure a high degree of control and a thorough analysis of the business processes involved, to eliminate unnecessary effort and reduce operative risks.

"These processes should flow through the organisation with as little interference as possible. This frees up time and energy for more important issues, the sort of tasks that everyone at the Fund is interested in – such as generating value by means of better analysis and portfolio management."

The Fund possesses considerable portfolio management expertise. But its employees also bring wide-ranging and advanced expertise from other parts of the financial services sector and other industries.

"Much of our staff has come from investment banking, treasury departments and corporate finance departments. This means we benefit from a broad range of insights and ideas, creating opportunities to develop solutions that are even more efficient."

Some members of staff also bring experience from industry. Know-how from mature industries is highly valuable, in our field of expertise too.

"There are likely to be plenty of opportunities for enhancing the efficiency of the industry as a whole. Thanks to our broad competence, we have every chance of defining and utilising these opportunities."

The Second AP Fund's cost-efficiency is an established fact

The financial services sector has undergone major changes. Fifteen years ago, today's ALM models did not exist, no attribution was made of the return and many of the financial instruments featured in current portfolios had yet to be launched on the market. These are changes that have made considerable demands on competence and the will to pursue endless development.

Assessing pension funds in the manner adopted by Canada's Cost Effectiveness Measurement Inc. (CEM) is also fairly new. CEM's analyses pro-

Business Services

Departmental responsibilities

Risk Management	Performance analysis	Business control	Financial control	IT	Human Resources
• Risk analysis • Attribution • Risk control • Stress tests • Risk models	• Market valuation • Performance analysis • Index follow-up • Attribution analysis • Systems responsibility SCD	• Global business administration • Control and follow-up • Flow analysis • Corporate actions • Systems infrastructure	• External/internal accounts • Financial reporting • Internal budget • Cost efficiency CEM	• Operations • Support • Technical development • Systems management • Continuity projects	• HR strategy • Recruitment • Competence development • HR administration • Labour legislation

vide the Second AP Fund with relevant benchmarking for its operations and result. The latest survey, conducted in 2005, compared 18 pension funds in the USA and Europe, with average assets under management of SEK 183 billion.

The result of the survey confirmed the cost-efficiency of the Second AP Fund. Taken over a five-year period, the Second AP Fund has posted a higher average active return than the benchmark group. In 2005, however, the Fund noted slightly higher costs than the rest of the group, attributable to the excellent performance of some of the external mandates, resulting in a consequent increase in costs for performance-based commissions.

"Our global tactical allocation mandates performed well, and this had an impact our cost level", says Lena Smeby-Udesen.

Heading diagonally towards the upper left corner

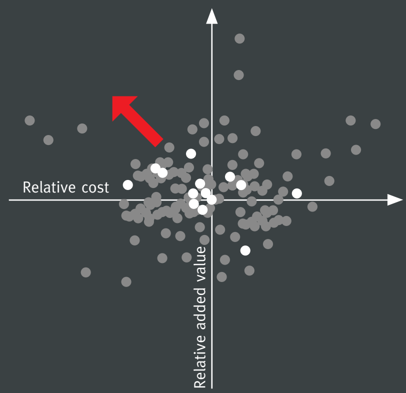
Everybody wants to be in the upper left sector of CEM's four-field model, which distinguishes successful portfolio managers from the rest. To get there, return on investment must be better, in relation to more than cost alone. This analytical method also takes into account the volume of assets under management, allocation per asset class, geographical spread and degree of active management – all factors that have a major impact on the result.

"We are prepared to pay for a result – if it generates a higher risk-adjusted return in the end", says Lena Smeby-Udesen.

But the costs have been cut. Reduction in the share of total assets under external management is a contributory factor. In 2004, 37 percent of the Fund's capital was under external management. In 2006, this figure had been reduced to 17 percent.

"What we are able to manage effectively in-house must be managed in-house. And not just for short-term economic gains. It is also a matter of having challenging assignments for our own organisation."

Improved cost-efficiency



The diagram shows value creation and costs in relation to the benchmark group.

Execution compared to market standard

The Second AP Fund places increasingly stringent demands on its external suppliers. One such area concerns commissions, the actual transaction costs charged when buying or selling an asset. There has been considerable discussion over the years concerning the need to separate analytical costs from commission, and there is clearly room for improvement here. Another interesting cost is "market impact cost", whose size is proportional to the brokering house's ability to execute the trade at a favourable rate within the available spread.

The Second AP Fund can save millions of kronor a year by optimising execution efficiency. For this reason, the Fund has commissioned an external analysis, in which a holistic approach has been adopted in analysing trades. This analysis compares the Fund's combined trading costs with an international benchmark that includes custodial costs, brokerage and market impact. Interestingly, these external analyses conclude that the Second AP Fund's in-house traders are more skilful at achieving good trading results than some other players on the market. The Fund's patience regarding high market impact is limited.

"The Fund is an extremely demanding buyer of services. We are determined to collaborate only with the most efficient and professional asset managers. We work for Sweden's pensioners, and they are unlikely to tolerate costs that derive from an inability to perform to the highest market standards."

Challenges in 2007

Determined to be one of the foremost fund managers, the Second AP Fund continues to benchmark itself against funds noted for their high efficiency and expertise. Although the challenges faced by different funds are not identical, there are always areas of common interest that offer opportunities for a mutual exchange. The Fund's staff maintains an ongoing dialogue with other market professionals. The plans for 2007 include the hope that it will be possible to agree on a clear definition of "efficiency". In this particular context, it is important to stress that efficiency does not refer exclusively to costs. The next step is to establish key ratios with a view to achieving even better long-term asset management and performance. Our sights are set on moving the Fund to the "CEM quadrant" for high returns and cost-efficient management (see diagram).

“When you get the green

How to exert corporate governance to increase long-term value

light, things are fine”

“The governance agenda has a purpose – to generate a higher value. And it does. There’s absolutely no doubt about it”, says Fredrik Carlsson, Head of Equities & Fixed Income, Sweden.

There are two ways corporate governance can be used to create added value. The first is to institute a long-term improvement programme. This is something that is implemented on a day-to-day basis, and that seldom grabs the headlines. The other is to make a major effort on individual occasions. This can involve events such as take-overs, where a clear understanding of the company’s true worth is essential – and of how it can be realised with the help of the tools available in the corporate governance portfolio.

Institutional owners advance their positions

Using corporate governance as a means to add value is relatively new in the institutional sphere. It was barely on the agenda 10-15 years ago. Of course, there were exceptions. One such was the Fourth AP Fund, which played a central role in the Volvo-Renault deal, in 1993.

Slowly but surely, institutional investors continued to advance their positions. Two foreign precedents are Britain’s Hermes and the USA’s CalPers.

“They acted as pioneers and were able to act relatively free from interference in the ‘governance vacuum’ that arose. They gained a lot by being early starters”, says Carl Rosén, head of Corporate Governance and Communications.

Capio and Meda are two successful examples

The Second AP Fund created value in 2006, which included Capio and Meda, thanks to a clearly defined governance agenda and a focused piece of precision work with the corporate governance toolbox.

The system is simple to use. The Fund’s Corporate Governance Policy contains a predetermined list of criteria, by which companies are rated. And each criterion is furnished with instruments to determine the value. Areas analysed include capital structure, investments, corporate acquisitions and disposals, ethics and environmental issues, as well as the governance structure. Analysis of corporate structure is also included. It is not unusual for large companies to conduct operations in different industries. In such cases, the board of directors ought to be able to explain how the company’s best interests are being served by conducting such diverse activities, and why spinning them off and focusing on its core business might not be preferable.

When you get the yellow light, it’s time to act

Once the analysis is completed, the company is rated. There are three levels: green, yellow and red. Green means things are fine. No need to take out the toolbox and start getting involved in governance issues.

“If many of the lights are yellow, this means there is plenty of potential for us to add value by implementing our agenda. If red, we should avoid investment”, says Carl Rosén.

Two analyses are better than one

The equity analysts do their bit too, of course.

“In the day-to-day work of the Fund, our investment analyses adopt different perspectives. The corporate governance team uses its tools. Our approach, however, focuses mainly on valuation. If we find a company where our views coincide – that there is potential for improvement in corporate governance and that it is attractively valued – we get to work. The fact that we can adopt a really long-term view also creates opportunities. There are fewer funds in the long-term horizon playing field” notes Fredrik Carlsson.

Several opportunities are presented every year. But the number fluctuates in conjunction with boom and recession. “The problems are more apparent when the economy is in decline. Just a few years ago, perhaps as many as 15-20 such companies could be found every year. Now the number is more like 10-15”, says Fredrik Carlsson.

A pension fund like the Second AP Fund is able to operate on a much longer horizon than other investors, such as open funds, where shareholders can withdraw their money at short notice.

"In this sense, the Second AP Fund has greater freedom of action than others concerning corporate governance issues. Our ability to act long-term creates opportunities for participating and financing business deals, which is what we were able to do at Meda during the year. Of course, the price we pay is that we can become insiders for an extended period of time", says Carl Rosén.

Stable alliances are the key

Capio is another company where the Fund has acted in accordance with a clearly defined governance policy. In this instance, the Fund initiated the formation of an alliance between the major stakeholders soon after Apax and Nordic Capital made their first bid for the company, in September 2006.

The Second AP Fund's analysts did their sums and came up with an estimate of the true value of the company, and what would be required to enhance it still further. When contacting the other major stakeholders, Carl Rosén used this information to establish an alliance. This was to ensure that the final bid would reflect the true value of the company.

"It's largely to do with establishing sustainable alliances. This applies to sellers as well as to buyers. The ones that win are those with the best arguments and the most perseverance", says Carl Rosén.

Clarity increasingly vital in the hunt for value

The relaxed collaboration between the corporate governance and equity team is one of the key reasons for the Fund's success. This teamwork ensures that the Fund's governance arguments are both more sophisticated and more convincing.

"We must have an inkling of what can be improved and how to achieve it. This increases our chances of getting more out of our investment. And it also makes us more attractive as a speaking partner. This is an area we can develop still more in the future", says Fredrik Carlsson.

"Many seem to have got the message that we are different. Consequently, we are receiving increasing numbers of business proposals that are quite new for us. This alone clearly demonstrates the value of our corporate governance efforts", says Carl Rosén.

Activities in the ethics and environmental fields 2006:

1

The Fund has been engaged in a dialogue with the companies that constitute its 20 largest shareholdings about addressing ethical and environmental issues as a form of value creation. This involves a two-dimensional analysis. The first dimension embraces measures to be implemented, both in the short and long term. The second indicates whether these measures are to be implemented in-house or externally.

2

The Second AP Fund has participated in the Carbon Disclosure Project, an initiative in which some 100 major fund managers are exerting pressure on the world's 500 largest listed companies, requiring them to state their position on a number of issues related to the greenhouse effect (global warming).

3

The Second AP Fund, in association with some 30 other major international fund managers, has signed the United Nation's Principles for Responsible Investment (PRI).

4

A Joint Ethical Committee has been established in collaboration with the First, Third and Fourth AP Funds. It has been established for joint 'screening' of the three funds' foreign holdings, to determine which companies the Committee should conduct a dialogue with in order to secure improvements.

“Company visits yield a deeper understanding”

– 2007 is going to be “Company Visit Year”

A multidimensional understanding of a company normally yields better investment decisions. It isn’t enough just to scan the same reports that the rest of the market is reading. To gain a deeper understanding of the company, you have to make an on-site visit. So claims Claes-Göran Lyrhem, Portfolio Manager Swedish Equities.

The Second AP Fund’s portfolio of Swedish equities is managed by a team of seven people. The team manages three portfolios of Swedish equities – a large-cap portfolio, a small-cap portfolio and a third more compact portfolio, featuring companies where the Second AP Fund is adding value through active governance.

“We monitor the progress of some 60 companies on a regular basis. We allocate the analytical work by sector”, says Claes-Göran Lyrhem.

Much time is invested in gathering information

“We discuss our portfolios and holdings on an ongoing basis throughout the week. Every working day features news that needs to be analysed.”

The remaining time is used to gather the latest information, which is then analysed. In future, the team plans to establish an even closer relationship with its portfolio companies, to gain a deeper understanding. Which is why 2007 is going to be “Company Visit Year”.

Claes-Göran Lyrhem notes that company visits are an important complement to the information disseminated via traditional corporate communication channels and secondary sources such as the media and firms of brokers.

The interviews yield a more profound understanding, provided directly by the companies themselves, ensuring higher quality analytical data.

“We use this data to generate a higher return on our portfolio.”

A tour of the company can reveal still more...

Given the fact that time is in short supply, company visits are carefully planned, and each company visit always has a clearly defined goal.

“We only visit a company when we have a highly specific idea that we want to check out. And the questions we ask are carefully designed to really put the company’s general claims to the test.”

Even so, the interview sometimes fails to provide the analysts with exhaustive answers to all their questions. At such times, a tour of the company can prove a valuable complement.

“A one-hour tour of the factory can sometimes be worth more than an hours’ interview.”

A model for every company

The absolute valuation, which provides a solidly based assessment of a company’s true long-term value, is an important part of the valuation process. Claes-Göran Lyrhem and his colleagues build their own valuation models. There is no universal solution that fits every company. Each model must be built and adapted for its “own” company.

“If we are monitoring the performance of 60 companies, it means we are in principle using 60 different valuation models.”

In addition to absolute valuation, the Swedish Equities team analyses how comparable companies are valued in relation to each other. Sales growth, earnings growth, executive management and capital structure are factors that typically affect true value. The extent to which these different factors affect the analysis varies over time.

“In 2006, for example, Swedish equities benefited from the considerable importance attached to capital structure issues during the year. The companies’ strong balance sheets fuelled expectations of extraordinary dividends and buy-backs”, says Claes-Göran Lyrhem.

Common values:

the key to successful cooperation

If you've played a sport, you know the score. As when you flick a pass with the back of your heel, and know another member of the team will be right there behind you, ready to shoot for goal. You're part of a team that can't be stopped.

It takes time to build a team like this, in both sport and industry. Success demands equally generous portions of courage, self-awareness, willpower and perseverance. This is something of which Eva Halvarsson, CEO of the Second AP Fund, and Lena Sörensson, head of Human Resources, are well aware.

"I want it to feel right when people join the Fund. We want a Fund where the sky's the limit and people have a twinkle in their eye, while remaining uncompromisingly professional. Like any top performing team that wins in the long run", states Eva Halvarsson.

Working with values in the comprehensive manner embraced by the Second AP Fund is hardly the norm in the finance sector. The ultimate motive in establishing these common values is simple, however: to achieve higher performance. The whole idea is founded on the conviction that what distinguishes good portfolio management from poor is the team's combined expertise – and that this in turn depends on the extent to which the members of the team cooperate and utilise each others' competence.

Close similarities to sport

Building a winning team spirit is crucial to success. Anyone who has been involved in a team sport knows that the right spirit can boost the mood and enjoyment of a team, and also what it can do for the end result.

Of course, there are plenty of obstacles along the way that can threaten this team spirit. A potentially serious one is a lack of understanding of each other's roles.

"The Fund features a high level of specialist expertise. Some say that our organisation has as many experts as employees. But an understanding of and interest in each other's skills and professional roles can be developed. In this context, it is important that we don't stand on ceremony", says Lena Sörensson.

Parallel with organisational change

The process of establishing a platform of common values was initiated in the spring of 2006. Parallel to this, another important change process was also underway at the Second AP Fund. Described simply, this involved

The Second AP Fund's common values

- Self-awareness
- Openness
- Team spirit
- Committed leadership
- Flexibility
- Clarity
- Enjoyment
- Responsibility
- Professionalism
- Creativity

Examples of improvement measures

- Establishment of code of conduct
- Personal development reviews with set targets
- Utilisation of common values in the recruitment process
- New meeting technique
- Regular evaluation and follow-up

merging management of the equities and fixed-income portfolios, and realignment of these activities by geographical market rather than asset category. The idea was to establish an asset management process where different experts could benefit from each other's specialist competence. Once again, the Second AP Fund was ahead of the pack.

"This is an industry where cooperation has not always been highlighted as a means to success. In this respect, we differ somewhat from others. We are convinced that smooth interdisciplinary cooperation helps us achieve better results on the geographic markets we analyse", says Eva Halvarsson.

Even better when it comes to recruitment

A winning corporate culture that features a clearly defined code of values and effective norms that govern the conduct of employees offers several benefits. In many cases, more time is spent at work than at home with the family. This enhances the importance of smoothly functioning relations, based on common values and clearly defined norms to govern staff relationships. Leadership is an important element.

"Good leadership is an attitude that clearly demonstrates a true commitment to employees and shows that they valued as individuals. Probably the most important thing is to practise what you preach, at every level", says Eva Halvarsson.

The code of common values applies to every Fund employee. Even those who are waiting to come in and are potential applicants can reckon on learning about the Fund's values, since their consideration forms part of the recruitment process.

"It's easier to recruit the right person if both parties are fully conversant with what working for the Second AP Fund entails. It gives new employees a much better chance of getting off to a good start – of adjusting to the job more quickly and of feeling more at home – while increasing the likelihood that they will contribute to an improved result," notes Lena Sörensson.

Identifying the right "theme" is the key

to global portfolio management

We hear all the time that it is getting more and more difficult to beat the market. Yet the number of smart investors determined to outperform index continues to grow, and everyone is chasing the same 'hot' investments.

"But we have found a model that works well in spite of the competition – a model that provides excellent opportunities for enhanced performance."

Cristian Stoian is head of Global Balanced Product, which includes both equities and fixed-income securities. The portfolio had combined assets of SEK 40 billion at the end of 2006.

Cristian's approach is to identify global structural changes ("themes") and invest accordingly. One example is the restructuring of the steel industry, which was set in motion in 2006.

"Our most important investment last year was in Mittal Steel."

Cristian and his colleagues believed the steel industry's consolidation would begin sooner than the rest of the market anticipated – an assessment that proved right, as Mittal Steel acquired Arcelor and formed the world's largest steel company. This had a positive effect on the industry as a whole, and on share prices.

More than 1000 companies to invest in...

The team can choose from more than 1000 companies for its global portfolio, in addition to fixed-income securities and currencies. Such a range of opportunities creates considerable potential for outperforming the market. On the other hand, this demands substantial resources. The Fund relies on external support in this respect, mainly from London's investment banks. The input is provided in the form of basic research which enables the Fund's own portfolio managers to conduct further in-depth analysis.

Cristian, who is British Romanian, heads a team that also comprises a Swede and two Canadians. Between them they have accumulated substantial experience, working in London with the best banks and brokers. "It is very important that our investments are based on the best quality research: we want fast on-demand research, and we are stringent in our requirements," says Cristian.

...but the focus is on about 20

The global team "bets" on up to 20 themes at a time. A "bet" is a long or a short investment position relative to index.

"We make a small number of large 'bets' on themes we believe to be undervalued/overvalued and which we expect to correct in the foreseeable future. Our "bets" are relatively large in comparison with other portfolios of a similar nature", says Cristian Stoian.

The ingredients of a successful investment

The first step is to identify investments that clearly have more upside than downside.

"The steel industry is such an example. Our analysis showed a substantial valuation upside. Such opportunities are relatively rare, not more than a few times a year", says Cristian Stoian.

The next step is to make a correct allocation of the risk in the overall portfolio of investments. This is to avoid unwanted bias towards specific industries, currencies, commodities etc.

The third step is to implement clear risk limits and upside thresholds. Action should automatically follow when either is reached, be it increasing or reducing the size of the investment or further analysis.

"Our investment process is based on successful teamwork. However, there is always someone ultimately responsible for each stage of the process", says Cristian Stoian.

THE PROUD AP2 TEAM:

We are the Second AP Fund…

Executive management and staff

Executive management

Eva Halvarsson
CEO
20 years' professional experience
AP2 since 2006
Previous career: Näringsdepartementet, Kommunikationsdepartementet, Skatteförvaltningen

Lena Smeby-Udesen
CFO
23 years' professional experience
AP2 since 2001
Previous career:
Swedbank, Ericsson, Volvo

Poul Winslöw
CIO
17 years' professional experience
AP2 since 2003
Previous career: Danske Securities, Danske Invest, Unibank Investment Management, Nordea Investment Management

Executive management (cont.)

Tomas Franzén
Chief Investment Strategist
26 years' professional experience
AP2 since 2001
Previous career: Swedbank, Handelsbanken, SAF

Martin Jonasson
General Counsel
17 years' professional experience
AP2 since 2001
Previous career:
Volvo, Mannheimer Swartling

Carl Rosén
Head of Corporate Governance and Communications
24 years' professional experience
AP2 since 2004
Previous career: Nordic Investor Services, Enskilda, Affärsvärlden, Alfred Berg

Margaretha Veres
Personal Assistant to the CEO
40 years' professional experience
AP2 since 2000
Previous career: Ericsson

AnCi Johannisson
Information & Projects
35 years' professional experience
AP2 since 2000
Previous career: Intra International, Almedahls, Wicanders

Cathrin Olsson
Reception & Office Administration
15 years' professional experience
AP2 since 2001
Previous career: Poolia, Hotell Opera, Hotell Kung Oscar, Håfreströms AB

Maria Andersson
Reception & Office Administration
15 years' professional experience
AP2 since 2004
Previous career: Proffice, Samuelsons Inredningar, Åhléns

Portfolio management

Quantitative Strategies

Poul Winslöw
CIO
See "Executive Management & Staff"

Tomas Morsing
Head of Quantitative Strategies
16 years' professional experience
AP2 since 2002
Previous career: AstraZeneca R&D

Mia Larsson
Quantitative Portfolio Manager, Equity & Fixed Income
8 years' professional experience
AP2 since 2004
Previous career: Citigroup Asset Management, Hagströmer & Qviberg, Dunross & Co

Walter Levy
Quantitative Portfolio Manager, Equity
5 years' professional experience
AP2 since 2002
Previous career: Gothenburg University

Quantitative Strategies (cont.)

Thomas Ekström
Quantitative Analyst, ALM & Tactical Allocation
3 years' professional experience
AP2 since 2004
Previous career: Gothenburg University

Peter Enarsson
Quantitative Portfolio Manager, Fixed Income
2 years' professional experience
AP2 since 2005
Previous career: Chalmers Institute of Technology, Gotenburg School of Economics

Reine Säljö
Quantitative Analyst, Equity
8 years' professional experience
AP2 since 2006
Previous career: Own software company

Swedish Alpha Strategies

Fredrik Carlsson
Head of Equities & Fixed Income, Sweden
11 years' professional experience
AP2 since 2002
Previous career: Bank of America, HSBC Investment Bank and Fidelity

Swedish Alpha Strategies (cont.)

Claes-Göran Lyrhem
Portfolio Manager, Swedish Equity
26 years' professional experience
AP2 since 2003
Previous career: PricewaterhouseCoopers, Bilspedition, KPMG

Jonas Eixmann
Portfolio Manager, Small Cap
11 years' professional experience
AP2 since 2005
Previous career: Handelsbanken Capital Markets

Mattias Saläng
Equity Analyst
2 years' professional experience
AP2 since 2005
Previous career: Linköping University

Dennis Ågren
Portfolio Manager, Fixed Income
15 years' professional experience
AP2 since 2001
Previous career: Robur, Aragon, Hagströmer & Qviberg, United Securities

Swedish Alpha Strategies (cont.)

Anders Lekholm
Portfolio Manager, Equities
10 years' professional experience
AP2 since 2001
Previous career: Bear Stearns (USA), Matteus Fondkommission

Daniel Schmidt
Equity Analyst
9 years' professional experience
AP2 since 2006
Previous career: SEB Enskilda, S&P, Nordea Markets

Global Alpha Strategies

Ole Petter Langeland
Head of Equities & Fixed Income, Global
19 years' professional experience
AP2 since 2001
Previous career: SEB, E.Öhman jr Fondkommission, Volvo Group Finance Sweden AB

Cristian Stoian
Head of Global Balanced Product
20 years' professional experience
AP2 since 2001
Previous career: Daiwa SBCM, Marketpower Ltd.

Global Alpha Strategies (cont.)

Francis Dallaire
Portfolio Manager, Equity

12 years' professional experience
AP2 since 2001
Previous career: SEB

Anna Lannér
Equity Analyst

7 years' professional experience
AP2 Since 2002
Previous career: Gotenburg School of Economics

Robin Belec
Portfolio Manager, Foreign Fixed Income

15 years' professional experience
AP2 since 2001
Previous career: Lehman Brothers, Schlumberger

Anders Sköldberg
Portfolio Manager Cash-management & F/X

19 years' professional experience
AP2 since 2002
Previous career: SKF, Nordbanken, PKbanken, Posten

Global Alpha Strategies (cont.)

Michael Störup
Portfolio Manager, Foreign Exchange

19 years' professional experience
AP2 since 2001
Previous career: Inter IKEA Treasury SA, SKF Treasury, Hafnia Insurance, Jyske Bank

Richard Nilsson
Tactical Allocation

17 years' professional experience
AP2 since 2004
Previous career: Handelsbanken Capital Markets, Handelsbanken Asset Management, ABB Treasury

Portfolio Management, External Mandates

Anders Strömblad
Head of Alternative Investments

27 years' professional experience
AP2 since 2000
Tidare; SCA, Swedish Meats (Scan), National Tax Board

Britta Ersman
Portfolio Manager, External Mandates & Private Equities

6 years' professional experience
AP2 since 2001
Previous career: Sjätte AP-fonden, Gotenburg School of Economics

Portfolio Management, External Mandates (cont.)

Mimmi Kheddache Jendeby
Portfolio Manager, External Mandates

4 years' professional experience
AP2 since 2003
Previous career: Gotenburg School of Economics

Business services

Lena Smeby-Udesen
CFO

See "Executive Management & Staff"

Human Resources

Lena Sörensson
HR Manager

30 years' professional experience
AP2 since 2001
Previous career: Delphi Automotive Systems AB, Ericsson, Bostads AB Poseidon, Gothenburg Municipality

Financial Control & Accounting

Marianne Stenberg
Head of Financial Accounting & Control

17 years' professional experience
AP2 since 2002
Previous career: KPMG

Financial Control & Accounting (cont.)

Yvonne Janslätt
Financial Accounting

20 years' professional experience
AP2 since 2001
Previous career: Ernst & Young, SEB

Anders Eriksson
Financial Accounting & Control

13 years' professional experience
AP2 since 2003
Previous career: Proffice, GNLD

Business Control

Lars Lindblom
Head of Business Control

8 years' professional experience
AP2 since 2001
Previous career: SEB

Anders Waller
Business Controller

20 years' professional experience
AP2 since 2003
Previous career: SEB och SKF

Business Control (cont.)

Mathias Eriksson
Business Controller

5 years' professional experience
AP2 since 2005
Previous career: Svenska Garantiprodukter

Susanne Sohlberg
Business Controller

25 years' professional experience
AP2 since 2002
Previous career: Volvo

Performance Analysis

Ola Eriksson
Head of Performance Measurement

17 years' professional experience
AP2 since 2001
Previous career: Volvo, Nordiska Finanssystem, Celsius

Håkan Wilke
Performance Measurement

8 years' professional experience
AP2 since 2001
Previous career: Svensk Fondstatistik

Performance Analysis (cont.)

Olle Eriksson
Performance Measurement

5 years' professional experience
AP2 since 2002
Previous career: Gothenburg University

Portfolio Management Systems

Jessika Ingvarsson
Systems Manager

9 years' professional experience
AP2 since 2001
Previous career: Sveriges Ångfar-tygs Assurans Förening – The Swedish Club

IT

Gunilla Engelbrektsson
Head of IT

14 years' professional experience
AP2 since 2001
Previous career: Volvo IT, Volvo Treasury

Björn Iveland
IT Support & Operations

9 years' professional experience
AP2 since 2006
Previous career: Nobel Biocare, Telia

IT (cont.)

Christian Salomonsson
IT Support & Operations

8 years' professional experience
AP2 since 2002
Previous career: Volvo IT, Merkantildata

Risk Management

Mia Tegbrant
Head of Risk Management

16 years' professional experience
AP2 since 2001
Previous career: PWC, SEB Enskilda Banken, Trygg Hansa Livförsäkring

Camilla Jenedahl
Senior Risk Analyst

11 years' professional experience
AP2 since 2001
Previous career: Volvo Treasury AB

Håkan Tobiasson
Senior Risk Analyst

10 years' professional experience
AP2 since 2005
Previous career: Riksbanken

Rhino&Co Reklambyrå Photography: Nils Olof Sjödén English translation: Jeremy Lamb

Andra AP-fonden

Second Swedish National Pension Fund - AP2

Andra AP-fonden · P.O. Box 111 55 · SE-404 24 Gothenburg · Sweden · Visitors: Östra Hamngatan 26–28
Phone +46 31 704 29 00 · Fax +46 31 704 29 99 · www.ap2.se