

Second Swedish  
National Pension Fund  
Annual Report 2013



**Andra AP-fonden**  
Second Swedish National Pension Fund - AP2



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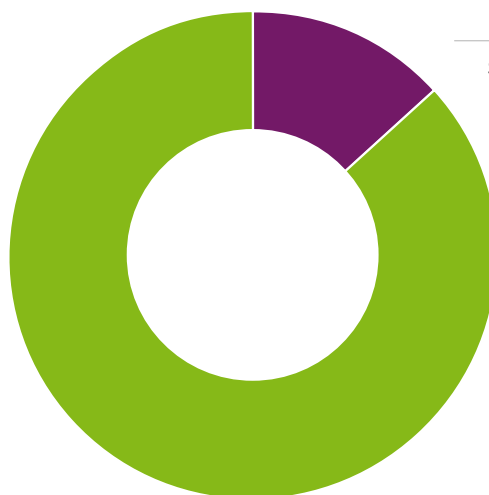
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With **SEK 264.7 billion** under management in virtually every asset class and all parts of the world, the Second AP Fund is one of **northern Europe's largest** pension funds. A **secure and stable** manager of assets, the Fund is tasked with an important assignment by the Swedish Government – minimizing the impact on future Swedish pensions that would derive from applying 'the brake'.

19 855

SEK million has been paid net to the national system 2009–2013.



129 365

SEK million total return generated since the Fund's 2001 inauguration.

\*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, where space requires, AP2.

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). Figures in parentheses refer to the preceding year.



# The Second AP Fund

The Second AP Fund is one of five buffer funds within the Swedish pension system, tasked with maximizing long-term return – and at low risk to pension disbursements. The Fund's consistent and responsible management has helped ensure that the return on portfolio assets exceeds its long-term commitments and compares well at the international level.

The buffer funds account for some 10 percent of the Swedish national pension system's total assets. In conjunction with the other buffer funds, the Fund is tasked with maintaining reasonably consistent pension levels, even during periods affected by peaks in the number of retirees, or by an economic downturn. The Second AP Fund shall therefore adopt a long-term approach, with a view to securing the managed buffer capital over the long-term.

## **Strategic management model**

The Fund's strategic management model is based on financial theory and incorporates long-term forecasts covering demographic, socio-economic and capital-market developments. The world has experienced several major stock market declines in recent years, but the Second AP Fund has performed well in comparison with similar funds, whether seen from a national or international viewpoint.

## **Efficient and sustainable portfolio management**

The Second AP Fund is an attractive employer with some 60 staff. It employs some of the foremost in their respective fields, as portfolio managers, analysts and other specialists. Together, this workforce has created an efficient portfolio management structure. One consequence has been that the Fund's management costs are lower than to those of similar funds at an international level.

The Fund adopts an active approach to ethical and environmental issues, with a view to promoting sustainable investment. Long-term investment requires companies capable of long-term sustainability, enabling them to generate a solid return that can provide a secure buffer for future pensions.



Our strategy is to achieve a solid return at balanced risk by creating a more diversified portfolio.

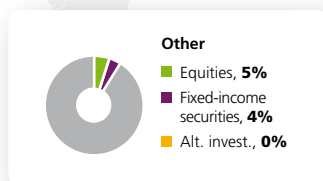
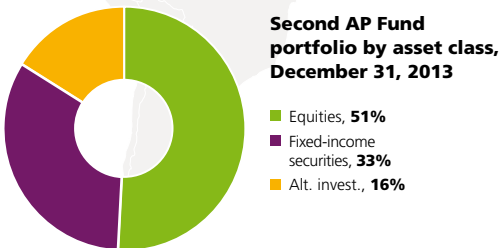
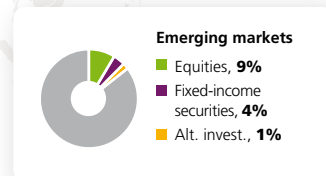
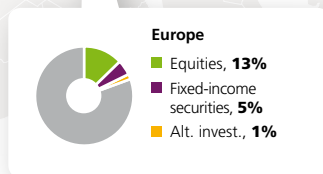
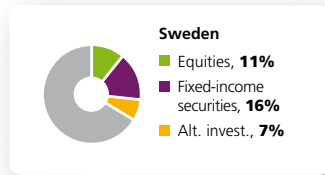
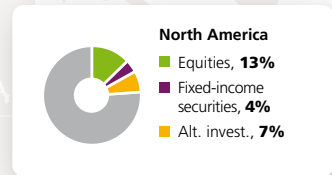
Eva Halvarsson, CEO, Second AP Fund.  
More in the Chief Executive's Review on page 2.

Accumulated return 2013

12.8%

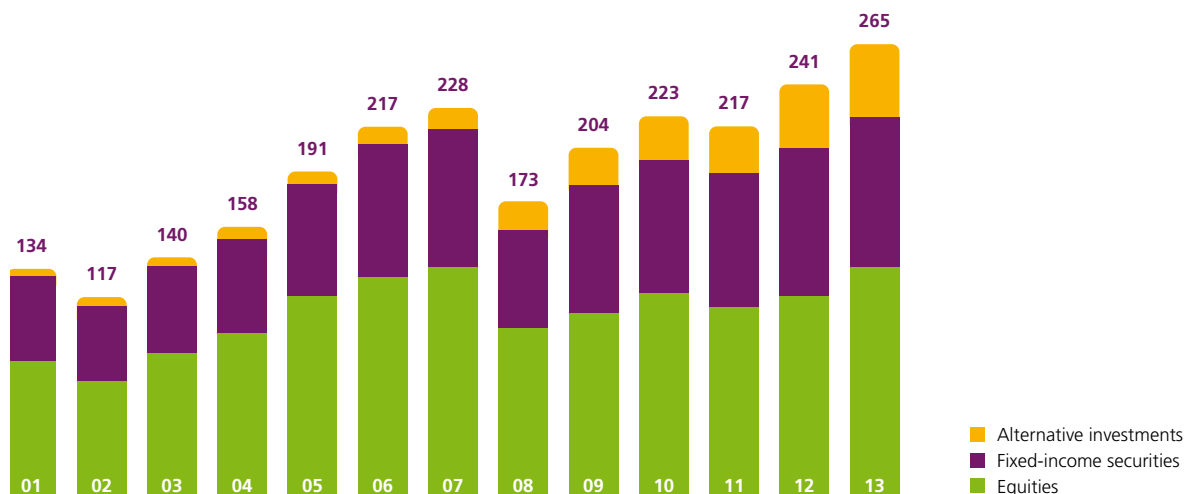


Efficient spread of global risk between asset classes.



Second AP Fund assets by geographic region, December 31, 2013.

Fund capital performance, 2001–2013, SEK billion





# 2013 in brief

Consequent to the Second AP Fund's strong performance over the year, return on investment exceeded the targeted average long-term annual real return of five percent. In the past five years, the Fund's average annual real return has totalled 9.8 percent and, over the past ten years, 5.8 percent. 2013 was a good year, especially with respect to the Fund's investments in non-listed and listed equities. For the fifth year in succession, net outflows to the pension system were negative and the Fund has now paid out a total of SEK 19.8 billion to cover the current shortfall in the pension system.

- The Fund's assets under management totalled SEK 264.7 (241.5) billion on December 31, 2013, against which net outflows to the national pension system were charged in an amount of SEK –6.9 (–3.8) billion.
- The Fund posted a net result for the year of SEK 30.1 (28.6) billion.
- The Fund's return on the total portfolio was 12.8 (13.5) percent, excluding commission costs and operating expenses. Including these costs, the portfolio generated a return of 12.7 (13.3) percent.
- Expense ratio for operating expenses remained low, totalling 0.07 (0.07) percent for the period.
- The relative return on the total portfolio, excluding alternative investments and costs, amounted to 0.4 (1.1) percent.
- Return on alternative investments was 13.4 (13.9) percent.

## Performance review since start

	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003	2002	2001
Fund capital, SEK m	<b>264 712</b>	241 454	216 622	222 507	204 290	173 338	227 512	216 775	190 593	158 120	140 350	117 090	133 493
Net result for the year, SEK m	<b>30 138</b>	28 620	–4 645	22 258	34 858	–55 058	8 718	24 506	29 568	16 119	20 693	–21 405	–5 005
Return on total portfolio, excl. commissions and operating expenses, %	<b>12.8</b>	13.5	–1.9	11.2	20.6	–24.0	4.2	13.0	18.7	11.6	17.8	–15.3	–3.7
Relative return on listed assets, excl. alternative investments, commission fees and operating expenses, %*	<b>0.4</b>	1.1	–0.3	0.8	0.7	–1.8	–0.4	0.2	0.2	–0.6	–0.5	–0.4	1.7
Active risk ex post, %	<b>0.3</b>	0.3	0.3	0.3	0.6	1.0	0.7	0.7	0.5	0.5	0.6	1.0	1.7
FX exposure, %	<b>23</b>	20	16	12	10	12	11	12	11	10	8	7	10
Share of external mandates, %	<b>25</b>	29	29	23	24	22	24	17	28	37	45	38	82

\* Relative return refers to the difference in return between a portfolio and its benchmark or reference index.



## CHIEF EXECUTIVE'S REVIEW

# World-class portfolio management

Our portfolio management generated a return of 12.8 percent in 2013. This means we have now exceeded our targeted long-term return over both the past five and ten years by a good margin. The implementation of our successful strategy, for achieving a solid return at balanced risk by creating a more diversified portfolio, continues.

Our result totalled SEK 30.1 billion. Consequently, the Fund's assets under management now amounts to SEK 264.7 billion, a result achieved in what has in some respects proved a challenging market environment. The requirement that at least 30 percent of Fund capital must be invested in fixed-income securities limited our potential for generating a return in the extremely low interest climate that affected most mature markets during the year. In contrast, however, the trend noted by other asset classes was much stronger. Our investments in equities generated 20.4 percent, while our portfolio of alternative investments noted continuing stable and favourable development, as did our investments in private equity funds, real estate and alternative risk premiums. In June, we were reminded of how we continue to be at the mercy of macroeconomic volatility, when the Fed announced plans to reduce its asset purchasing tempo. The nervous response of markets the world over offered further justification for our diversification strategy.

## We are gearing up on emerging markets

An important stage in this diversification process is to build up a portfolio that more accurately reflects the actual relationships that pertain in the global economy. Today, emerging markets account for four of the ten largest economies in the world. In the longer term, the emerging markets will acquire even greater significance, not only for the global economy but for international investors too. In light of the long-term horizons we adopt when making our investments, with a view to securing the needs of future generations, we need to increase our exposure in the major emerging economies. In 2013, we made our first direct investment in domestic Chinese equities. We have also built up an internally managed global portfolio of emerging market equities. Furthermore, we have established a special unit to manage investment in emerging markets, which has started to invest in government bonds. Total exposure on emerging markets has increased from 6 percent in 2010 to 13 percent by year-end 2013 – and it is likely to continue increasing. This is not only because the world is changing, but also because we wish to reduce the long-term risk of having the greater part of Fund capital invested in mature markets, such as the Swedish market. And we should keep in mind the fact that almost 90 percent of the pension system is already exposed to the Swedish economy though pension contributions paid into the system.

## We manage more Fund capital in-house

We continue to benefit from the structural capital we have built up at the Fund over the years. The knowledge we have accumulated in investment, processes and business support means that we are now able, in a cost-efficient manner, to manage an increasing amount of Fund capital in-house. During 2013, we took back some SEK 11 billion that was under the management of external emerging-market funds to be managed by our own quantitative portfolio management team. The ability to implement such a comprehensive change project not only demands a long horizon in terms of investment but in how we operate at the Fund too.

## We invest responsibly

We have worked for a long time at creating an effective model for responsible investment. At the Fund, we have built up extensive know-how and awareness, which makes me feel justified in claiming that our approach to responsible investment is more integral to our activities than at many other funds. During the year, for example, we have integrated environmental, ethical and corporate governance issues into our investment strategy for our Swedish equities portfolio, with good results. As for our quantitative portfolio management activities, we have initiated analyses of models in the field, with a view to creating excess return. When it comes to responsibility issues in our immediate environment, I am growing increasingly disappointed over the lack of will, or is it just ignorance, about the opportunities available for increasing diversity on corporate boards. As major investors, we must discuss more intensively what must be done to reverse this trend. We believe this would benefit the Swedish business community and, consequently, our return on investment.

## We cooperate across the globe

We are a global player and, over the years, have expanded our collaboration with numerous investors in every part of the world. In the case of non-listed assets, we prefer a partnership rather than investing in funds, mainly so that we can be an active participant and exert some influence. In partnership with the largest investor in South Korea, pension fund NPS, we have successfully invested in real estate in the USA. In close collaboration with US fund manager TIAA-CREF, we continue to invest in agricultural real estate. We share our experiences on various coordinating agencies and advisory committees, and participate in



conferences where we discuss the possibilities for achieving still better and more responsible portfolio management. Regardless of who we work with, we maintain our long-term perspective. One such example is our investment in Chinese domestic equities, where we are collaborating with two local fund managers, with the intention of gradually building up our investment competence in one of the world's largest economies. This will prove of great value when the Chinese equities market is eventually reformed and is opened up fully to international capital. We also collaborate with the other Swedish national pension funds. Since 2007, we have jointly operated our important Ethical Council as well as the Swedish and European real estate that we own jointly with the other AP funds. We also focus on special forms of collaboration to reduce our costs. In 2014, we shall conduct negotiations concerning the procurement of custodial banking services in partnership with the Third AP Fund.

#### **We help spread risk**

Although we may have produced a good result in 2013, what you see on the bottom line in any given year is not the most important thing. What is important is that we achieve a stable long-term return over time, for all generations. This is based on the long-term model we have developed to predict factors such as employment, income growth and the anticipated return on various asset classes. This information is then used in composing our portfolio. We have our model, and the other buffer (AP) funds have theirs. Consequently, the AP funds' portfolios are different, which may be difficult to understand when the return on these portfolios can sometimes be quite similar. In the longer term, however, this should help to spread risk in managing this combined buffer capital.

“An important stage in this diversification process is to build up a portfolio that more accurately reflects the actual relationships that pertain in the global economy.

#### **We are constantly developing**

Our long-term and successful route plan, with its emphasis on continual improvement, still applies. At the close of 2013, we updated our corporate governance policy, to further concretize how the Fund can contribute to good corporate governance and thereby add value as a key investor. In 2014, we shall evaluate our current risk analysis to make it even better. We are determined to maintain our leading posi-



tion in this field and to generate still more reliable data for investment and portfolio management. There are also a number of areas that need to be changed to facilitate our work: one such concerns our investment regulations. The opportunity to change investment regulations over time, to what is best for pensioners in the long term, is something that should have been built into the pension system right from the start. The fact that we are cost efficient already benefits the pension system. According to the latest report from analytical specialist CEM, the Second AP Fund's costs in 2012 were far less than those of our benchmark group of global fund managers. This is partly attributable to the efficiency of our in-house portfolio management. In 2014, there will be a temporary rise in costs, as we build up competence to increase our internal mandate, while still having external mandates. We are still moving in the right direction, with successful and cost-efficient asset management, which secures a higher return at lower risk and that continues to satisfy our long-term assumptions. Our ambition is to create asset management – in fact an entire organization – that is world class. It is this that will secure the best possible long-term prospects for Sweden's pensioners.

A handwritten signature in black ink, appearing to read 'Eva Halvarsson'.

Eva Halvarsson, CEO



# The Swedish pension system – stability over generations

When the current Swedish national pension system was introduced in 2001, it heralded an entirely new structure and new responsibilities for the AP funds. The funds' role as a buffer within the pension system was defined. A direct correlation was established between the return on fund assets and growth in the value of the income-based pension. Today, the buffer funds account for some ten percent of the pension system's capital assets.

In the Swedish national pension system, future pensions are determined by the level of each and everyone's individual income, based on income received over an entire working life. A key element of the pension system is the automatic balancing mechanism, or 'brake'. This ensures that pensions are adjusted upward more gradually at times when liabilities exceed assets.

## Robust system

From a financial perspective, the Swedish pension system is considered robust, since it reflects the development of the economy as a whole. If the economy goes well, with strong growth and a higher proportion of the population in work, pensions and salaries grow at the same rate. If the economy performs less well, with fewer in work, there is a risk pensions growths will decline.

The Swedish system is unique. So far, few countries have implemented the necessary reforms to their pension systems. The challenge is how such change can be implemented. Sweden launched its reformed pension system just over ten years ago. This makes Sweden an interesting example for many countries in Europe and other parts of the world.

Since 2001, the Second AP Fund has built up capital assets totalling SEK 264.7 billion, making it one of northern Europe's largest pension funds. In international terms, the Swedish AP Funds are among the largest national pension funds in the world. As a percentage of GDP, only Saudi Arabia, Norway and South Korea boast larger pension funds (OECD report: Annual Survey of Large Pension Funds and Public Reserve Funds, October 2013).

## The buffer funds' mission

The AP funds are tasked with maximizing long-term return on the pension assets under management, to ensure that the impact of automatic balancing on pensions will be as mild as possible.

In all, the buffer funds account for about 10 percent of total pension assets. The other 90 percent derives from the combined value of contribution assets. This mirrors the future value of inflows from pension contributions. The size of these contribution assets is determined primarily by levels of employment, salary and wage levels, and retirement age.

## Balancing the system

The size of pension is determined by length of time worked and level of income, up to a predefined level. Furthermore, an upward adjustment is made to account for the mean rise in income. However, for pensions to be optimally adjusted upwards, the system must be in balance, with pension assets equal to or in excess of pension liabilities. Contribution assets and the AP funds' combined capital assets shall at least equal accumulated pension liability.

Where liabilities are greater than assets, automatic balancing is applied. This slows the upward adjustment of pensions. This slower rate of adjustment is maintained until parity is re-established within the pension system.

## Big net outflows

During the past ten years, the strong performance of the AP funds' capital assets has obviated the need to activate the automatic balancing mechanism, or 'brake'. It was not until 2008 that the brake was activated for the first time. Once applied, this impacted on pensions in 2010. The reason the brake had to be activated was the sharp decline noted by global stock markets in 2008, as well as the significant upward adjustment of pensions and pension entitlements over the preceding years. The brake was applied yet again in 2009, in response to the sharp downturn in the economy and a rise in unemployment in the wake of the global financial crisis.

After the first net outflow in 2009 (the difference between national pension contributions, which are paid to the AP Funds, and pension disbursements, which are financed from the Funds' capital assets), the AP funds disbursed more in pension payments than they received in the form of contributions. As a consequence of an anticipated high level of new retirees over the next few years, this net out-flow is expected to continue for a considerable time. In practice, this means that the AP funds' assets are likely to decline.

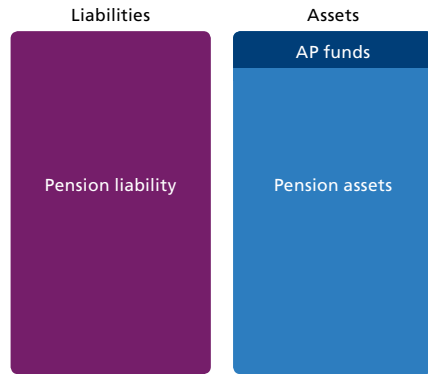
In 2013, net outflow amounted to SEK –6.9 billion, compared with SEK –3.8 billion in 2012.



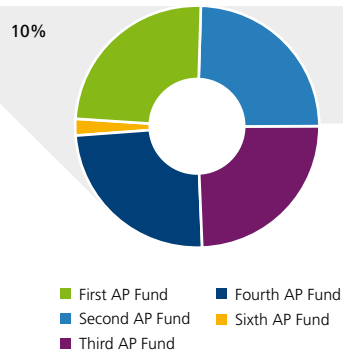
More about Sweden's national pension system at  
[www.ap2.se/en/about-ap2/Our-mission/A-unique-pension-system](http://www.ap2.se/en/about-ap2/Our-mission/A-unique-pension-system)



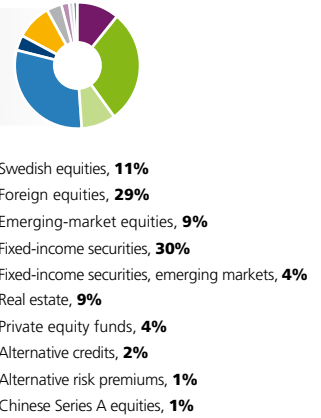
## Pension system balance sheet



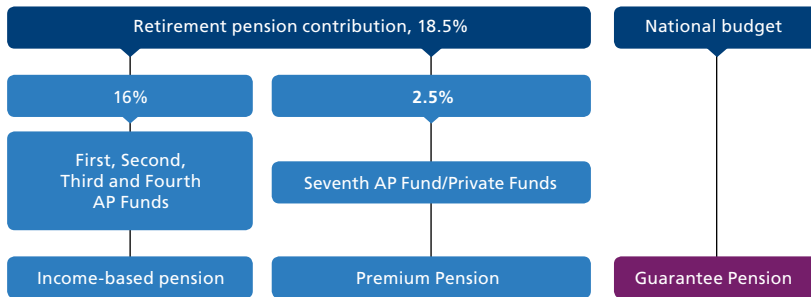
## Buffer fund shares



## Second AP Fund capital

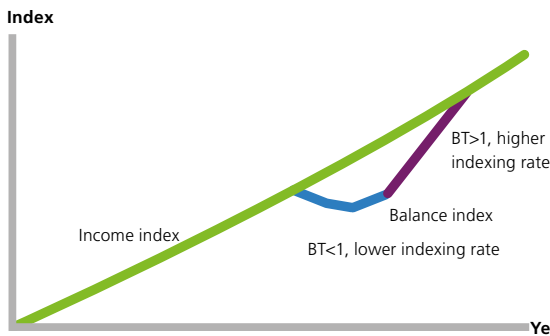


## The Swedish pension system



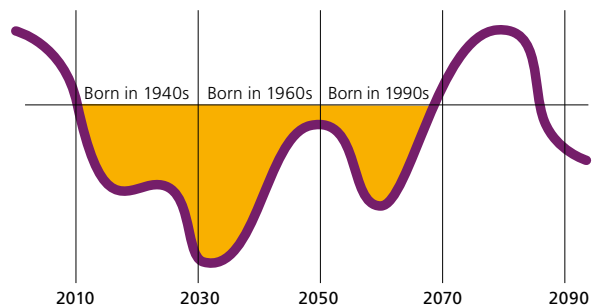
The national retirement pension comprises the following: an income-based pension, a premium pension and/or a guarantee pension. The pension is financed in the form of a levy of 18.5 percent on total income earned. Of this amount, 16 percent is used to finance annual disbursements (income-based pension) from the First, Second, Third and Fourth AP Funds, while 2.5 percent is invested, to generate interest in an individual premium pension account. There is also a guarantee pension, funded by the State.

## Automatic balancing mechanism



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. Once the balance ratio has regained a value in excess of 1, this triggers a more rapid upward adjustment in wage growth.

## Impact of retirement peaks on pension system



When baby-boomers retire, they create a demand for a buffer in the pension system. The system's disbursements have exceeded contributions since 2009, when the large post-war generation of baby-boomers started to retire.



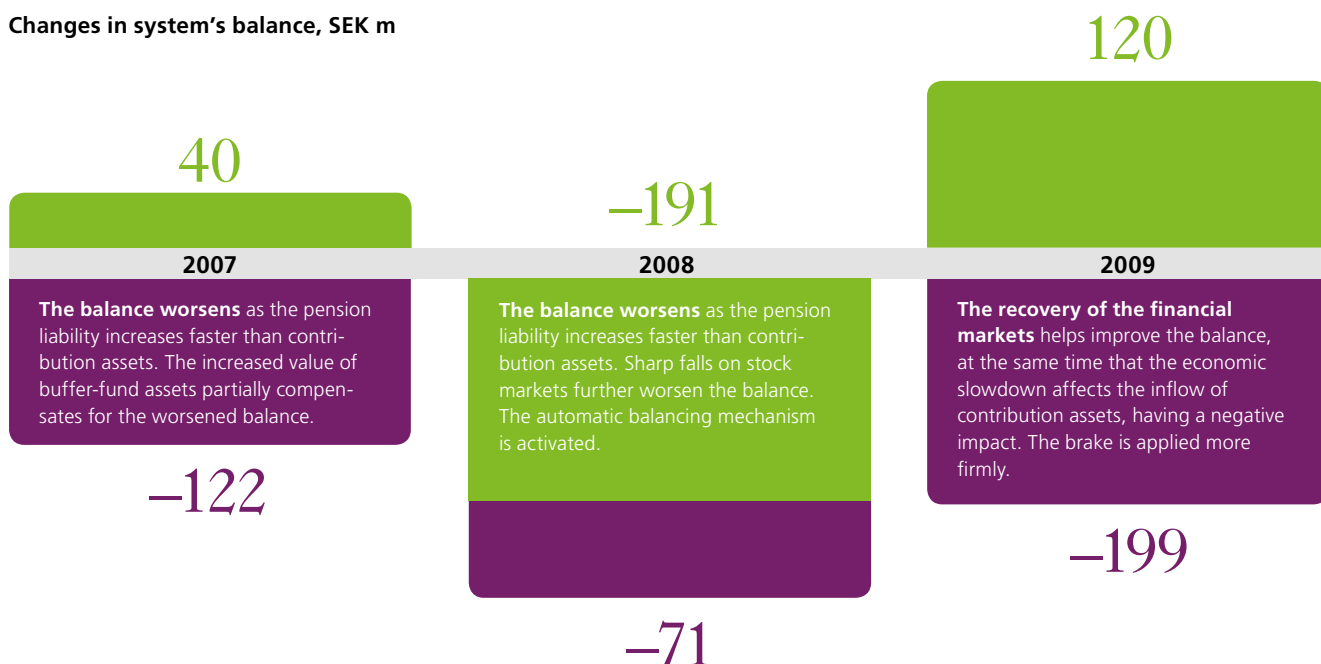
## ROBUST, GENERATION-NEUTRAL SYSTEM

# The buffer funds improve pensions

Since the launch of the new Swedish pension system in 2001, the return on assets generated by the buffer funds has on several occasions meant that the automatic balancing system, or 'brake', did not have to be applied, avoiding a temporary decline in the level of pension disbursements. The Second AP Fund's average annual return since its inauguration has been 5.2 percent, which is higher than average income growth over the same period.

“ Once the system is back in balance, pensions are adjusted upward at an accelerated pace until they regain parity with the rate of income growth.

Changes in system's balance, SEK m





# 19 855

SEK million has been paid out net by the Second AP Fund between 2009 and 2013 to the pension system.

## Why the brake is applied

Regardless of economic and demographic developments, the Swedish pension system is designed to ensure that national pension commitments are linked to the combined value of future contributions and buffer fund assets. The brake exists to guarantee this – to make sure the system's liabilities will not permanently exceed its assets. It brakes or reduces upward adjustment on the liability side of the system until it is once again in balance. There is a risk of having to apply the brake when:

- **Employment** declines (a change that can depend both on current age distribution and on the level of unemployment), causing a reduction in pension contributions.
- **The retirement age** falls, as greater numbers leave the labour market earlier than originally envisaged.
- **The average life expectancy** of pensioners rises, without a corresponding increase in pensionable age.
- **The value** of the AP funds' assets falls sharply, creating imbalance in the system.

Once the system is back in balance, pensions are adjusted upward at an accelerated pace until they regain parity with the rate of income growth. This means that the only people to suffer a lastingly negative effect when the brake is applied are those who are actually receiving a pension at the time.

## 358

**The economic recovery and firm application of the 'brake'** have a positive effect. The buffer funds' strong performance further contributes to a positive balance. In response, pensions are revalued upwards.

## 77

**The pension liability increases**, but more slowly than the inflow of contribution assets, which strengthens the balance. A negative return on the buffer funds' capital assets partially counteracts the improved balance.

## 85

**Sharp upward revaluation of pensions and the pension liability** leads to a new weakening in the balance. The continuing strong performance of the buffer funds helps counteract this weakening. Once again, the 'brake' is firmly applied.

2010

2011

2012

## 68

## -22

## -322

- Contributions from other factors
- Contributions from buffer funds



# Clear mission

As a buffer fund, the Second AP Fund's long-term mission is to maximize the return on pension assets under management, with a view to promoting strong growth in pension assets and thereby contributing to parity in the pension system, even when economic and demographic factors are in a state of flux. This is stated clearly in the Swedish National Pension Funds Act.

The AP funds' mandate includes maximization of return while maintaining a low level of risk. The investment strategy shall make provision for the impact of pension disbursements as well as the liquidity requirement associated with outflows from the funds.

## **Investment objective**

The mission and objective, as described in the Act and its preliminary drafts, define clear principles that the AP funds shall observe in managing their pension assets. The purpose of each fund's investment activities, as determined by its board of directors, is to minimize the negative effect on pensions that would derive from applying the 'brake'. Based on an analysis in which portfolio choice is integrated with an assessment of how the pension system as a whole is likely to develop over the long term, the strategic portfolio selected will be the portfolio judged best able to contribute to achieving the defined investment objective.

The mission requires equal treatment of all generations, in compliance with the principle of 'generation neutrality'. For this reason, long-term commitments regarding return and risk, whether in relation to individual assets or the portfolio as a whole, are absolutely crucial when composing the strategic portfolio. Once finalized, the selected portfolio may be defined in terms of anticipated return on investment and risk.

As instructed, the Second AP Fund has composed a portfolio that, including active return, is expected to generate an average long-term real annual return of five percent.

The Fund's purpose is linked to the pension system and the anticipated effect of investment on pensions. The targeted return, which is defined as a percentage, describes the properties exhibited by the long-term portfolio most likely to generate the greatest benefits in the form of pension disbursements.

In the past ten years, the Second AP Fund has generated a return of 99.4 percent, corresponding to an average annual return of 7.1 percent. Adjusted for inflation, this corresponds to an annual real return of 5.8 percent.

## **Value-generation strategy**

The Second AP Fund's strategy is based on a step-by-step approach to value generation: choice of strategic asset allocation, selection of index and active management.

This approach is based on a set of principles, or Investment Beliefs. These describe the Fund's view of how capital markets function and the opportunities and potential they present for generating a return on investment.

## **Strategic asset allocation**

The Second AP Fund's strategic portfolio is determined with the support of an in-house developed Asset Liability Model (ALM), which takes into account long-term developments in the pension system and on financial markets. This ensures that the mix of different asset classes that comprise the strategic portfolio represents those investments the Fund considers offer the best generation neutral long-term growth prospects for future pensions.

## **Benchmark index**

The Second AP Fund considers the choice of index to be part of the strategic investment process, where the index determines the investments selected for subsequent portfolio management, in-house and external. The Second AP Fund complements the broad and more traditional cap-weighted indices with more specialised indices.



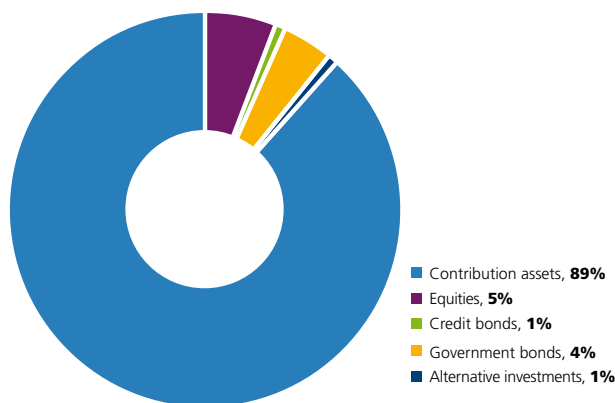
More about the Fund's management strategy at  
[www.ap2.se/en/](http://www.ap2.se/en/)

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## Asset allocation, Swedish national pension system

(Fund's share of pension system assets, %)



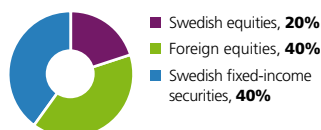
## Strategic portfolio 2013

(% of Fund capital)



## The Fund's first strategic portfolio 2001

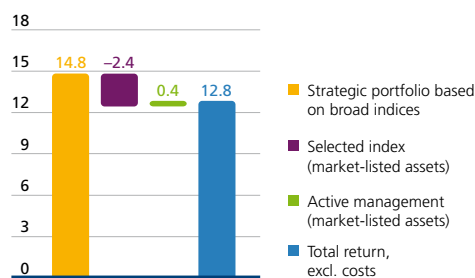
(% of Fund capital)



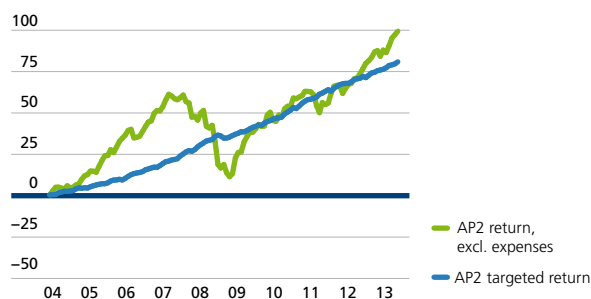
The upper pie chart at right shows the allocation of assets in the Second AP Fund's 2013 strategic portfolio, while the lower chart illustrates the first strategic portfolio, 2001. The above pie chart at left shows the same allocation of assets for the pension system as a whole, taking into account that the AP funds' answer for just over 10 percent of the Swedish national pension system's combined assets. In other words, about 90 percent of pension system assets are in no way exposed to the financial markets.

Source: The Swedish Pensions Agency and in-house calculations.

## Second AP Fund value creation, %



## Accumulated return, ten years, %



## Active management

The nature of the active management is determined by the Fund's choice of index. The purpose is that internal and external management shall outperform the indices selected by the Second AP Fund. Whether working with the strategic portfolio or active management,

both are equally dependent on efficient processes. The Fund's strategy combines cost efficiency with operational efficiency. These processes are in turn based on the Fund's pronounced result-oriented culture and ability to attract and develop its staff.



# Global economic recovery threatened by political pitfalls

Following several years of austerity and weak economic growth, the global economy's gears started slowly to mesh in 2013. However, the journey here has involved countless challenges, political as well as economic.

The economic recovery has started from a low level and is progressing rather slowly, although looks as if it may pick up speed in 2014.

## **A recovery led by the industrialized countries**

In 2013, for the first time in years, an economic recovery was driven mainly by the industrialized countries. For several years prior to 2013, global growth had been driven by the developing countries.

The USA has been the primary driver of this growth. A key factor is the rise in property prices. This has created a base for a positive upward spiral between the housing market, bank sector and consumers. Employment has risen sharply, which in turn has contributed to increased demand, both in terms of domestic consumption and in the form of imports. Since December 2012, America's central bank, the Federal Reserve (Fed), has been engaged in a Large-Scale Asset Purchase (LSAP) programme, purchasing mortgage-backed bonds to keep mortgage rates low. The Fed has also elected to peg its monetary policy to the level of unemployment (beside inflation). This



The USA has been the primary driver of this growth.

means the Fed will not raise the base lending rate until they forecast that unemployment will fall below 6.5 percent. At the close of 2013, the Fed decided to reduce its LSAP programme, while maintaining the low base lending rate.

In Europe, there was growing optimism after many lean years, with the return of positive growth from the second quarter of 2013. This was a crucial turning point, after such a profound recession.

However, in the wake of the national debt crisis experienced by many European countries, growth remains weak. This is mainly attributable

to the dramatic austerity packages implemented by several countries. These austerity measures are to be relaxed next year, promoting growth and hopefully contributing to an improved labour market.

In Sweden too, growth has remained relatively low. Riksbanken (Sweden's central bank) has maintained a low repo rate, reducing it by 0.25 percent to 0.75 percent, in December to help bolster the economy. Swedish companies are now hinting at a degree of optimism in their forecasts and many have started to notice somewhat better demand in Europe. Since a considerable percentage of Swedish exports are to northern Europe, mainly Norway and Germany, this is important. Swedish consumers have become steadily more positive and consumer confidence saw a notable rise during the autumn, which bodes well for a good start to 2014.

## **Reforms in Japan**

Perhaps one of the greatest surprises among the industrialized countries is Japan. Although one of the world's largest economies, Japan has posted weak growth of less than one percent, in average, over the past two decades. In autumn 2012, Shinzo Abe was elected as the new prime minister. When he took office in December 2012, his administration immediately launched an ambitious political reform project, referred to as Abenomics. The primary objective of this policy has been to raise Japan out of its almost two-decade-long stagnation, in conjunction with falling prices. The policy has involved implementation of relatively drastic changes in a range of areas. Through considerable injections of capital, the Japanese central bank has been able to push down the exchange rate, thus helping to boost exports. This has also contributed to the start of a rise in inflation. A number of structural reforms are necessary if the policy is to succeed. These include a relaxation of labour market regulations and increased opportunities for foreign ownership, as well as an increase in the percentage of working women. Abenomics represents the most ambitious effort to swing the country back onto the right course since the Japanese property crisis in the early 1990s.



### Weakness of emerging markets stabilized

In spring 2013, the developing countries entered a notably weaker phase of growth, for the first time since the global financial crisis. In China however, the single largest economy of the developing countries, macroeconomic growth remained relatively stable over the past year. At the party congress held in the late autumn, the new government, which took over in March 2013, announced a major reform programme, which will focus on rebalancing and liberalizing the economy over the next few years, up to 2020. It underlines the fact that the Chinese Government means business in launching this political initiative, with a view to orienting the country more towards domestic demand and away from its dependence on capital and exports.

In other large emerging economies such as Brazil and India, a marked slowdown has been noticed in the pace of growth. The fact that most developing countries have for several years enjoyed relatively easy access to credit at low rates of interest has enabled them to push domestic structural problems ahead of them. Bottlenecks in Brazil's infrastructure and the rigidity of its labour market must be addressed, for example, while growth in India is limited by bureaucratic obstacles and a budget deficit. In May, when the US central bank signalled its intention to rein back its purchase of mortgage-backed bonds and of subsequently raising interest rates, there was a marked decline in the risk-willingness of those developing countries with the highest indebtedness and weakest balance of payments situation. In many cases, this resulted in fairly sharp outflows from both

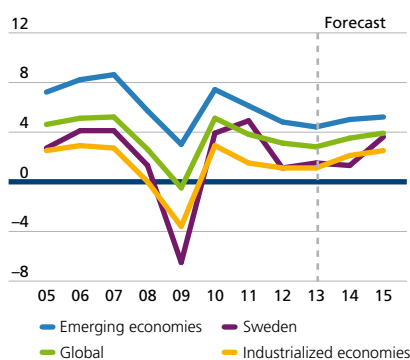
fixed-income and equities markets, with subsequent falls on stock markets, in conjunction with weakening exchange rates. However, largely due to the recovery staged by the industrialized countries, and especially by the USA, this trend was reversed during the autumn.

### Looking ahead

At the start of 2014, for the first time in many years, the Fund sees fewer obvious causes for political or economic anxiety on the horizon. Many of the industrialized countries have already come a good part of the way in their debt restructuring efforts. One key reason that growth started to gain momentum in 2013 was that the austerity measures implemented were less wide ranging than earlier. They are to be relaxed further in 2014, which suggests that the global economy will be stronger than for many years. Furthermore, we can expect to see an accelerating pace of investment. Both companies and consumers have held back on investment over a number of years now, when the main emphasis has been on reducing the burden of debt. Investment is needed to meet the anticipated demand. Stronger growth in the developed world benefits the economies of the developing countries and therefore poses no great threat.

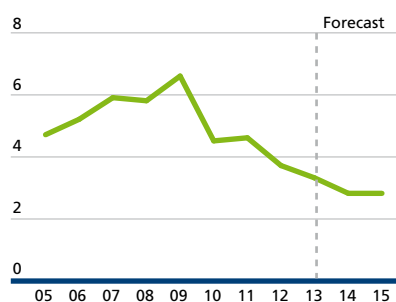
The utilization of resources remains at a relatively low level, while energy prices are also stable, suggesting that any potential increases in inflation are likely to continue to be limited. With low inflation, the central banks can continue to keep base lending rates low, providing support to the ongoing economic recovery.

### GDP growth (annual), %



### Difference in growth rates (annual), %

Emerging economies – Industrialized economies





# Fund capital continues to grow

The AP funds' portfolio management activities have made a positive contribution to the national pension system. Since its inauguration in 2001, the Second AP Fund has never had such considerable capital assets, which have increased by SEK 129.4 billion (net flows not included).

To contribute to maintaining or improving the balance in the pension system, the Fund's return must be higher than the income index which, since the buffer funds were established, has increased at an average annual rate of 3.3 percent.

Over time, the Second AP Fund believes that approximately 90 percent of the return on invested assets will derive from the composition of the strategic portfolio, the remaining 10 percent coming from active management.



**The Second AP Fund  
has never had such  
considerable capital assets.**

## **Internally developed ALM model**

To determine how the pension system is likely to develop in the long term, and how the Fund's selection of portfolio assets affects its balance, the Second AP Fund employs an Asset Liability Model (ALM). Developed in-house, this model includes assumptions about demographic and general economic development, as well as long-term prospects on the financial markets. The work with the ALM model is designed to result in the creation of a portfolio that will minimize the impact of the automatic balancing mechanism on future pensions.

One of the fundamental demands made on the ALM model is that it should embrace both the overall development of the pension system and address the factors affecting the return on the buffer funds' capital assets. The model's analytical horizon is 30–35 years.

The ALM model comprises three interlinked components:

- **Scenario simulation:** This component simulates the various growth trajectories for the asset classes in the Fund's portfolio, for Swedish inflation, for the capacity utilization rate and for salaries. Greatly

simplified, the model consists of one part that describes the average anticipated growth of these variables and another part that describes numerous possible deviations from this average. In 2013, the Fund developed a new model, to be able to simulate the scenarios that are basic to the ALM analysis. This change is intended to provide better decision data for analysing the links between the underlying pension system and the portfolio of assets chosen by the Fund.

- **Calculation of the pension system's balance sheets and income statements:** This component calculates the key ratios that are critical to pension system growth. Demographic scenarios are also factored into the equation.
- **Optimization component:** This component identifies the portfolio that best meets the overall objective. This is based on the other components of the ALM model.

The ALM model's most important key ratio is the balance ratio (the ratio between assets and pension liabilities). The balance ratio affects the degree to which pensions can be upwardly adjusted. If the balance ratio is less than one, i.e. if the system's assets are less than its liabilities, the brake is applied and pensions are upwardly adjusted at a lower rate than would otherwise have been the case.

## **Controlled risk**

An important factor governing the composition of the strategic portfolio is the fact that the AP funds jointly account for no more than 10 percent of the national pension system's combined assets. The largest part (90 percent) derives from the contribution assets, which can best be compared to index-linked bonds. This means that the AP funds can and should accept a higher degree of risk in their portfolios.

A degree of controlled risk is also necessary to be able to meet the targeted return. This is why the Second AP Fund has invested in equities and credit bonds, which offer potentially higher returns although incurring a higher risk compared to securities such as government bonds.



### Long-term diversification of investment strategy

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

### Changes in the strategic portfolio

In 2013, the Fund's board of directors reached several decisions concerning the strategic portfolio, reflecting greater focus on alternative asset classes and strategies. Towards the end of 2012, the Fund started to build up its own balanced portfolio of 'alternative risk premiums'. An initial allocation to a tailored portfolio featuring alternative risk premiums was made in 2012 and investments in this asset class continued in 2013, after the Fund had conducted an analysis and identified a number of systematic risk premiums on the financial markets. During the year, among other things, the Fund closed its externally managed portfolio of long convertibles and added convertible arbitrage as one of the strategies for this asset class. Alternative risk premiums should help increase diversification and generate a higher risk-adjusted return, given that the portfolio is constructed to be less dependent on traditional equity-market risk.

The strategies featured in the portfolio are linked to equity-market volatility, reinsurance premiums for insurance companies, premiums associated with the corporate acquisitions and convertibles market, as well as strategies focused on the FX market and market for future dividends on corporate profits. Possible additional risk premiums may be added in future.

During 2013, changes made to the benchmark index were instrumental in the Fund's reallocation of assets to global government and credit bonds. These changes resulted in a concentration on global government bonds and corporate credits.

### Alternative credits

A decision to allocate part of the Fund's global portfolio of government bonds to a portfolio of alternative credits was also taken in 2012. The first investments in this asset class were made in 2013. This type of investment has arisen from the fact that the banks are experiencing difficulty in maintaining their role as lenders, especially to small and medium-sized businesses. This process is the consequence of a lack of capital caused by substantial credit losses and the more stringent capital cover and liquidity requirements. Consequently, the anticipated returns reflect not only the credit risks but the lack of liquidity and lending capacity. In the Fund's opinion, this situation may not be simply the result of the short-term functional failures of credit markets, but could well prove to be a longer term phenomenon that reflects underlying structural changes.

### Benchmark index for the strategic portfolio, December 31, 2013

		Index
Equities	Sweden	SBX: Stockholm Stock Exchange Benchmark Index SEW: 'Equal weight Sweden Index' CSRX: 'Carnegie Small Cap Return Index'
	Foreign equities	MSCI World GDP Weighted <sup>1</sup> , MSCI World <sup>1</sup> , MSCI World Value Weighted <sup>1</sup>
	Emerging markets	MSCI Emerging Markets <sup>1</sup>
Fixed-income assets	Swedish nominal fixed-income	SHB Swedish All Bond <sup>4</sup>
	Global government bonds	Barclays Global Government <sup>2</sup>
	Global credit bonds	Barclays Global Credit <sup>5</sup>
	Government bonds in emerging markets	JP Morgan EMBIGD and JP Morgan GBI-EM Global Div <sup>3</sup>
Alternative investments	Swedish real estate	SFIX Svenskt Fastighetsindex
	Foreign real estate	7 percent
	Forest-and-agricultural real estate	8 percent
	Private equity	MSCI World Local currency + 3 percent
	Alternative credits	Barclays Global Government <sup>2</sup> + 4 percent
	Alternative risk premiums	MSCI World Local currency
	Chinese Series A equities	MSCI, China A

<sup>1</sup> Adjusted index: adjusted after excluded companies and tax levels.

<sup>2</sup> Adjusted index: excluding Japan and developing countries as per MSCI.

<sup>3</sup> Adjusted index: weighting of individual countries may not exceed 15% and they may not have a credit rating lower than BBB.

<sup>4</sup> Adjusted index: excluding bonds with a maturity of more than 20 years, and Kommuninvest.

<sup>5</sup> Adjusted index: excluding Japan and developing countries as per MSCI, as well as markets where issued volume is less than USD 500 million.



**Real estate**

Asset class Real estate has gained increasing significance in the past years. This applies as much to investments in forest-and-agricultural real estate as in traditional commercial real estate outside Sweden. In terms of portfolios, the Fund's forest-and-agricultural assets contribute most to the diversification process, while the geographic spread of risk is more pronounced in traditional real estate. The strategic allocation in forest-and-agricultural assets increased in 2013.

**First investments in Chinese Series A equities**

During the year, in line with the long-term strategy for creating a more stable return, the Fund continued the reallocation of its portfolio towards a greater share of investment in emerging markets. In 2012, as part of this strategy, the Fund received a licence for direct investment in the domestic Chinese equities market. At the close of the second quarter 2013, the Fund received confirmation from the Chinese State Administration of Foreign Exchange (SAFE) that it had been awarded a USD 200 million investment quota. At the end of the year, the Fund was able to make its first direct investments in Chinese equities. These equities are managed under an external mandate.

**Choice of index**

The index determines the investment choice within an asset class, thereby affecting the return the Second AP Fund is able to generate over the long term. The choice of benchmark index is therefore integral to the portfolio management process and the strategic portfolio.

In recent years, the Second AP Fund has chosen to use a variety of specialized indices that differ from the traditional cap-weighted indices. This is because a cap-weighted portfolio tends to feature a concentration of high-value individual stocks to award a higher weighting to those individual equities with the highest valuation, sometimes reflecting the fact that the share may be overvalued, and vice versa.

For this reason, the Second AP Fund therefore bases the composition of its portfolio partly on other methods. Examples of such methods include the equal weighting of Swedish companies in various size categories, GDP weighting of markets and weighting based on fundamental corporate factors (such as sales, dividend and profits) in the global equities portfolio. This is expected to lead to better diversification and a higher return in the long term.

**Active management**

Active management is based on the assumption that market inefficiencies exist and that there are a number of assets that temporarily are wrongly priced. By identifying these and utilizing the Fund's resilience, active portfolio managers can increase the return compared with portfolio management that is entirely index driven. For this reason, the Second AP Fund employs active elements in its portfolio management. This active management is employed both in-house and via external mandates. In 2013, actively managed portfolios generated 0.5 percent in excess return, equivalent to SEK 1.1 billion.

**In-house portfolio management**

The Second AP Fund has a number of asset classes under in-house management, concentrating resources on areas that it believes offer the greatest chance of success, based on the market, the available experience, the competence and the processes. Some 75 percent of the Fund's assets, in the following asset classes, are managed in-house:

- Swedish equities
- Foreign equities on developed markets
- Foreign equities on emerging markets
- Emerging-market bonds
- Swedish bonds
- Foreign government bonds on developed markets
- Tactical asset allocation
- Real estate (via directly-owned companies)
- Parts of the portfolio of alternative risk premiums.

The active management of Swedish equities during 2013 was conducted under two mandates. The larger mandate is aimed at a broad share index and the smaller at small caps. Swedish and foreign equities as well as Swedish fixed-income securities are also quantitatively managed, involving the use of mathematical models to locate market inefficiencies. This said, at the beginning of 2014, the Swedish equities that were earlier under quantitative management will be transferred to a new mandate for the active management of Swedish equities.

**External portfolio management**

The majority of the Second AP Fund's external mandates are active and are expected to generate an active return and contribute to the diversification of the portfolio. The Fund employs external asset managers for asset classes and markets that offer good yield potential, where the necessary in-house resources are lacking.

During 2013, the Second AP Fund employed external managers for the following areas:

- Global equities
- Government bond funds on emerging markets
- Global credit mandates
- Global TAA mandates
- Foreign equities on emerging markets
- Alternative investments (private equity funds, funds for forest- and agricultural real estate, Chinese Series A equities and parts of the portfolio of alternative risk premiums).

The procurement of external fund managers is based on criteria such as investment style, quality and analytical approach, organizational structure, staffing and historical performance.



A close-up photograph of a woman with dark hair and a young child with blonde hair. The woman is wearing a blue top and is looking down at a book. The child is wearing an orange top and is also looking down at the book. The background is blurred, showing a white surface with some blue and green patterns.

The Fund's long-term investment strategy and strategic portfolio has been subject to constant development from the start. A cornerstone of this process is to increase the spread of risk without compromising future return.



# Increased in-house portfolio management

The portion of the Second AP Fund's portfolio under in-house management is growing. At year-end 2013, it amounted to 75 percent, corresponding to SEK 199 billion, after termination of the external mandates for emerging market equity funds. The Second AP Fund has both the systems and competence to increase the volume of assets under in-house management – a strategy that has proved cost efficient as well as successful.

April 17, 2013 was a special day at the Second AP Fund. After an extended period of preparation, the Fund was able to invest close to SEK 3 billion in 511 companies on 21 emerging markets across the world – from the purchase of equities in Feng Hsin Iron & Steel on the Taipei stock exchange at 02:00:06 in the morning to the purchase of Arca Continental equities on the Bolsa Mexicana de Valores in Mexico, just over 16 hours later. With these purchases, the Fund's first in-house managed portfolio of assets in emerging market companies had become a fact. And everything went precisely to plan, supporting the viability of continued investment. By year-end, the portfolio comprised assets in 638 emerging market companies to a value of SEK 14 billion, capital recovered from the Fund's external mandates in the asset class.

## Extensive preparations

To be able to conduct the investment of such large sums in new markets with an in-house team requires extensive preparation. The Business Control unit at the Second AP Fund has worked intensively on building up the control and monitoring processes used for trading on the various markets.

"The work of establishing dialogues with counterparties, opening accounts and documenting local differences in matching, settlement, 'corporate actions', taxes and fees started as early as October 2012," states Anders Waller, Business Controller at the Fund. "Prior to making any actual investments, a number of test trades were made on each market to ensure that everything worked as planned."

"Markets that are experiencing rapid growth need to be closely monitored, to enable rapid identification of any changes and ensure that the Fund invests as efficiently as possible," says Mathias Eriksson, Senior Trader/Cash, equities and bonds. "One of the greatest challenges when trading in equities on emerging markets is to be able to manage the various currencies involved in an efficient manner, since they sometimes display volatility greater than the equities themselves. The Second AP Fund has built up its own FX system, which is designed to minimise the risks."

## Big differences

The considerable differences between various emerging markets were something that Second AP Fund personnel were to become rapidly aware of. In Chile, for example, it took time to convince the counterparty that a Swedish national pension fund was a serious investor. In Taiwan, cash must be available in a local account before a trade can be implemented, and the country can block an exchange transaction into its own currency when the inflow is considered too large. Furthermore, in Taiwan, South Korea and Thailand, limits are imposed that govern the amount foreign investors may own in certain companies that are considered of particular importance to the country. If the limit has been reached, investors such as the Second AP Fund cannot acquire equities in the company. A number of stock exchanges also impose stringent penalties in the case of serious transgressions which, in a worst-case scenario, can involve exclusion.

"This is not something we want to risk, given all the time and energy we've invested," says Mathias Eriksson. "The Fund must be fully aware of all the differences between the markets, while at the same time making sure that the investments it makes are as efficient and successful as possible."

## Increased globalization

The process of increasing the share of Fund capital managed in-house has been going on for some time. In 2012, for example, the Fund terminated all its external mandates in Swedish small caps and in 2013 started to wind-up the external mandates for emerging-market equities. By year-end 2013, 75 percent of Fund capital was managed in-house. This is a significant difference compared to ten years ago, when only 55 percent of Fund capital was under in-house management. As well as having established effective control systems to be able to manage increasing amounts of capital and ever greater numbers of asset classes, this progress derives partly from successful investment strategies and partly from the Fund's in-house developed model for 'quantitative management'. The in-house management



team can invest extremely large sums on liquid markets worldwide. Consequently, it has an important role to play in implementing the Fund's plan to take over the index-linked management of those external mandates in emerging market equities that were terminated in 2013.

### **Cost-efficient asset management**

The Second AP Fund's unique quantitative management of equities has been successfully built up over more than ten years and currently focuses on two main functions. The first is to effectively implement the component of the strategic portfolio of equities, fixed-income securities and FX that is managed in-house. Thanks to a high degree of automation, the level of costs is substantially lower than for the corresponding external management of index-linked securities. The other function of quantitative management is to generate active return. Employing mathematical models that are able to process large quantities of historical data makes it possible to test a range of different investment themes. If proved to work, they can then be applied to the market to generate additional return in the portfolios, thereby creating the potential to exceed benchmark index without increased risk. Some 20 different investment themes were tested during 2013. The top performer was the Fund's portfolio of value-weighted equities on developed markets.

### **New in-house mandates**

As well as increasing the share of assets under in-house management, there is a longer-term ambition to increase the Fund's total exposure in large emerging economies such as Brazil, India and China. This ambition is based on fundamental investment approach that Fund capital, if it is to generate long-term return for pensioners, must more accurately reflect the actual global situation in terms of GDP. In addition to eventually increasing its allocation in emerging-market equities, the Fund has initiated in-house management of emerging-market bonds. During the year, a small portfolio has been built up of government bonds in emerging markets, issued in US dollars. This not only offers greater exposure on emerging markets but, as more capital is injected, should eventually also contribute to the increased flexibility of the Fund's in-house managed portfolio of fixed-income securities. Another small but fast-growing asset class within quantitative management is alternative risk premiums, a class that is less dependent of how equities markets perform.

By spreading risk between different types of active in-house asset management, the Fund achieves a mix that contributes to a higher risk-adjusted return. In managing parts of its Swedish portfolio of equities, as well of its fixed-income portfolio, it employs fundamental analysis.

## **Cost-efficient and effective in-house asset management**

The Second AP Fund has the competence and the effective systems necessary to manage an ever greater share of Fund capital in-house. This effectiveness is not just about costs, but about creating the control systems and key ratios needed to achieve still better portfolio management and better results. This is a field in which the Fund is at the cutting edge.

Since 2004, the Second AP Fund has participated with a company called Cost Effectiveness Measurement Inc. (CEM), to evaluate the Fund's effectiveness. In its analysis, CEM takes into account the volume of assets under management, the degree of assets under active management and the allocations for each class of asset. The Fund's costs are compared with those of a group of global pension funds of approximately the same size and with portfolios of a similar composition.

The result of the most recent analysis, pertaining to 2012, confirms that the Second AP Fund is deemed to conduct its portfolio management activities in a successful and cost-efficient manner. The difference in the level of costs between the Fund and the benchmark group is greater than at any previous time during the period of measurement, and is mainly attributable to a significantly lower level of external asset management at the Second AP Fund. Due to the fact that the Second AP Fund has a substantially higher share of equities under management than the benchmark group, which in itself would normally involve higher costs, this outcome clearly indicates the effectiveness of the Fund's in-house asset management. This is primarily a consequence of the Fund's quantitative management capacity, which enables it to invest considerable sums on liquid markets worldwide, at very low cost. For example: the cost of the in-house management of equities on emerging markets is substantially lower, compared to the management costs for the same portfolio of equities under external mandates. In the long term, the ability to secure a higher risk-adjusted return will significantly benefit Sweden's pensioners.

The level of costs reported for 2013 must also be considered competitive but, as will also apply in 2014, reflect the fact that the costs incurred in conjunction with the termination of external mandates coincide with the costs for the build-up of the in-house competence required to manage the capital recovered from these mandates.



## THE SECOND AP FUND'S NETWORK

# Value-generating collaboration

The Second AP Fund places great importance on collaboration with other investors, both in Sweden and abroad. One benefit of established collaboration is that it forms the basis for fruitful dialogues with companies and the exchange of know-how in asset management. The Fund is committed to the continual development and broadening of its network.

Through its membership of ICGN (International Corporate Governance Network) and ACGA (Asian Corporate Governance Association), the Fund broadens its network and increases its potential to promote corporate governance issues on markets in which it has holdings.

### Exchanging know-how with the Japanese and South Koreans

Membership of international organizations is not the only way the Second AP Fund can influence and broaden its networks: it also does this by meeting investors on other markets. During the year, to acquire a better understanding of the Japanese economic policy and to exchange insights about non-listed assets and alternative investments, the Fund visited the GPIF (Government Pension Investment Fund) and a number of other Japanese pension funds.

In this same year, the Second AP Fund received a visit from South Korea's NPS (National Pension Service) fund, one of the largest of its kind in the world. The purpose of their visit was to gain an insight into the way the Fund integrates sustainability concerns in its analytical and investment processes, and to acquire know-how about how the Fund develops its strategic portfolio. Since 2012, the Second AP Fund is a joint owner of US real estate company US Office Holdings, in partnership with NPS, Singapore's GIC and Tishman Speyer.

### Sparring group

In association with pension funds ABN AMRO (the Netherlands) and Publica Pension (Switzerland), the Second AP Fund has started a sparring group, to promote an exchange of insights on investment issues, in areas such as infrastructure and private equity. The group meets two to three times a year.

### Collaboration with the academic world

For the Second AP Fund, the need for active involvement in current research concerning the financial sector is self-evident. The Fund's employees conduct their own research in-house, as well as visiting conferences at which the latest research results are presented.

For some years now, Hans Fahlin, CIO (Chief Investment Officer) of the Second AP Fund, has been chairman of Inquire Europe. It is a cooperative, non-profit professional organization which was formed in Europe in 1990. The Group was established to bring together

leading academic researchers and investment professionals interested in understanding and developing quantitative solutions to financial and investment problems.

The Fund's CIS (Chief Investment Strategist), Tomas Franzén, chairs the international EDHEC (Ecole des Hautes Études Commerciales du Nord) Risk Institute, one of the world's leading centres of risk research in the field of financial management. In this context, the ability to share insights and experience with the financial industry is of critical importance in enabling relevant research.

To encourage students at Gothenburg University's School of Business, Economics and Law to write papers on finance and sustainability, the Second AP Fund has inaugurated a special award. The papers are to combine models/theories of business economy, asset management and corporate valuation. The Second AP Fund Finance and Sustainability Award, was presented for the first time in autumn 2013, for a paper illustrating ways in which investors can utilize environmental data to create a higher risk-adjusted return on investment.

### Membership and initiatives

Environmental and ethical issues are important elements of the Fund's investment process. The Second AP Fund is both a member of and provides support to various Swedish and international initiatives within this area. It was one of the first signatories to the UN's Principles for Responsible Investment (PRI). The Carbon Disclosure Project is another initiative supported by the Second AP Fund, a project in which some hundred major fund managers demand that the world's largest publicly-listed companies provide reports on their greenhouse emissions and how they are addressing the climate challenge.

### Exchange of experience and know-how

The Second AP Fund is engaged in a partnership-based joint venture in the field of agricultural investment with US fund manager TIAA-CREF. The Fund is also conducting dialogues with several external fund managers. During the year, the Fund has swapped insights and experience with Generation Investment Management and Investec about how best to integrate environmental, ethical and corporate governance concerns into the asset management equation.



# Gearing up for growth

The Second AP Fund has a long-term strategy for the continued diversification of the portfolio, designed to create a more stable return. One element of this strategy is to increase investment in emerging markets. In 2013, the Second AP Fund took a number of important steps in this direction.

Following a strong economic upswing in the past decade, emerging markets such as China, Brazil and India account for just over a third or half of global GDP, depending on how it's measured, but for a mere 12 percent of the market value of the global share index. Looking ahead, emerging markets will continue to derive benefit from political reforms, productivity gains and a dramatic increase in domestic consumption.

"Even if economic growth in these countries is unlikely to be quite as buoyant over the coming decade, an investor such as the Second AP Fund is justified in increasing its allocation to emerging markets, to achieve an appropriate level of diversification in the portfolio," explains Kristian Hartelius, who heads Emerging Markets at the Second AP Fund.

Forecasts suggest that the emerging markets' percentage of the global share index could rise from about 12 percent in 2013 to more than 30 percent by 2030. The growing importance emerging markets are acquiring will not only impact on the global economy: it will also affect the composition of many institutional investors' portfolios.

The Second AP Fund is taking a number of steps to secure the long-term build-up of a portfolio that more accurately reflects the economic relationships in the world. During the year, the Fund has utilized its licence for direct investment on the domestic Chinese equities market and filled its first investment quota. The successful and cost-efficient in-house management of a large global portfolio of equities in emerging market companies has been initiated. Furthermore, a special department for investment on emerging markets has been established, to which Kristian Hartelius, former head of macro-financial analysis of emerging markets at the IMF, has been recruited, tasked with its build-up.

"In addition to contributing over the long term to greater exposure on emerging markets, the idea is to increase the Fund's know-how of emerging-market economies and financial markets," Kristian Hartelius continues.

The Second AP Fund, as one of the first institutional investors in Sweden, has started to build up an in-house portfolio of government bonds issued by emerging market economies. An initial investment of USD 50 million has been placed in emerging-market bonds issued in USD by Indonesia and Russia, among others, with the JPM Emerging

Market Bond Index as the benchmark index. The Fund already has several external mandates in this asset class, equivalent to about one percent of Fund capital. Part of the reason for transferring these assets to in-house management is to reduce the fees the Fund pays to external asset managers.

"Investment in emerging-market bonds ensures greater macro exposure to the countries' economies, compared to investment in individual stocks. Interest levels are normally higher than in mature economies, but also have a higher volatility," adds Kristian Hartelius.

The combined market value of the world's emerging-market bonds is around USD 10 000 billion, which accounts for approximately a tenth of the global bond market. Most of these are nominal government bonds issued in local currency, the majority of which are of high credit quality. If the relatively large Chinese and Indian markets are excluded, which are difficult for international investors to invest in, the market is dominated by bonds issued by Latin American and East European states. At the same time, the proportion of emerging-market bonds issued by African states such as Ghana and Zambia is on the increase. As a consequence of this trend, the risk profile of the Second AP Fund's benchmark index is being retained, in spite of the fact that countries such as Mexico, Brazil and Poland are maturing rapidly, resulting in falling interest rates.

"With direct investment in Chinese equities, a global portfolio of equities in emerging-market companies and a new mandate for the in-house management of emerging-market bonds, we have taken a number of important steps towards finding the right global exposure for Fund capital and thereby contributing to meeting the long-term needs of pensioners," concludes Kristian.

For the time being, the Fund has decided against more extensive investment in Africa. This is because the majority of public African markets are still too undeveloped and illiquid. There are, however, not inconsiderable opportunities for investment in private assets, such as via private equity companies. This type of investment is nevertheless fairly risky in Africa. Because the Fund's investment regulations permit no more than five percent of capital to be invested in non-listed securities, it has decided to focus this very limited amount on private equity investment in other parts of the world, where the risk is lower.



## A MODEL FOR RESPONSIBLE INVESTMENT

# Focused investment process in Swedish equities

The Second AP Fund has integrated sustainability issues into its active in-house management of Swedish equities. This is based on the conviction that a long-term responsible approach to the environment, ethics and corporate governance increases the value of companies and, consequently, the return on the Fund's portfolio. In 2013, Swedish equities generated a return of 27.2 percent.

The Second AP Fund's actively managed portfolios of Swedish equities are managed in compliance with a structured model which, since the Fund's inauguration in 2001, has generated an attractive long-term return. Depending on how the companies are positioned in relation to various global trends, the portfolio is composed of companies that among other things fulfil the following investment criteria:

- Generate structural growth
- Attractively valued, both in absolute and relative terms
- High quality businesses, including sustainability programmes
- Potential for improving underlying profitability
- Of growing interest to other investors.

The Second AP Fund believes that, over time, share prices are determined by the above criteria and that higher returns can be achieved by consistent investment and overweighting (against benchmark index) in companies that fulfil these same criteria. By adopting a value-based approach and with active portfolio management, the Second AP Fund can also identify price inefficiencies and generate excess return (against benchmark index).

### Investment process

A robust investment philosophy is just the first step towards creating portfolios with excess return. This philosophy must also be imple-

mented effectively. The Second AP Fund has established a clearly-defined process to ensure this.

#### **Step 1 Selection process**

The Second AP Fund monitors a large number of companies on the Stockholm Stock Exchange on an ongoing basis, based on in-house analysis. The market is scrutinized in a disciplined manner to reveal companies that meet predetermined investment criteria and that are deemed to show a discrepancy between market and fair value. This limits the number of companies which are subsequently subjected to more profound fundamental analysis.

#### **Step 2 Fundamental company analysis**

A thorough analysis is conducted to determine contributing factors to the companies' success, their competitiveness, their sustainability programmes and which factors are likely to enhance the future value of the stock. To locate the best investment opportunities, this fundamental analysis also takes into account how companies are positioned with regard to global trends. This derives from the assumption that these companies operate on a global market – wherever they may be based – a consequence of an increasingly integrated world.


#### **Step 3 Portfolio composition**

The best ideas identified by the analysis form the basis for creating a portfolio that can exceed the benchmark index. The Second AP Fund's evaluation of the share, as per the above-cited investment criteria, combined with its volatility, liquidity and impact on the portfolio's overall risk, determines the size of the investment.

#### **Step 4 Monitoring and follow-up**

Managing the portfolio is an ongoing process, where the emphasis is on the active management of risk and return, while ensuring that the companies' 'investment cases' are intact. One way is by regular visits to the companies in question. In-house meetings are conducted to maintain a watching brief on the portfolio's overall composition.

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An attractive acquisition in the USA contributed to a substantial revaluation of the Opus Group.

Jonas Eixmann, Head of Equities

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#### What makes the Second AP Fund's Swedish portfolio management unique?

- A clear and active investment philosophy grounded in a disciplined and systematic framework for investment that makes it easier for the portfolio managers to concentrate on creating value.
- In-house fundamental company analysis. The Fund analyses 70–80 companies and regularly follows up these analyses through direct contact with the companies. Meeting the companies in their day-to-day operations adds a further dimension to the analysis.
- An evaluation of the companies' work with regard to ethics, the environment and corporate governance forms an integral part of the analysis and is intended both to increase return and reduce risk in the portfolio.
- A team of experienced and highly motivated staff that has participated in building up the investment model from the ground.
- An open corporate culture that helps attract and retain the very best.

“The trend towards a growing number of vehicle safety products was one reason for our overweighting in Autoliv.”

Johan Wadell, Equity Analyst

#### The portfolio management team

The team comprises a focused group of six persons, who base their work on a common structure to locate the best investment ideas. Well informed about global trends, they are able to analyse the impact on individual companies. Each member of the team is individually responsible for an industrial sector, conducts his or her own analyses and maintains ongoing contact with the companies. The team works in close collaboration with the Fund's sustainability analyst. Its members have an average of 11–12 years' experience in the industry.

#### Portfolio performance 2013

The Second AP Fund's portfolios of Swedish equities performed well in 2013, the active management of assets generating a solid return. For example, the Fund sold its entire holding in Swedish telecom operator Tele2, considering the company to be overvalued, following the divestment of its Russian operations. In the case of steel manufacturer SSAB, factors such as excess capacity, weak demand and fierce competition contributed to a negative view of the company and its underweighting in the portfolio. In contrast to these negative assessments, the Fund's portfolio managers chose to overweight holdings in the international vehicle test-equipment-and-inspection company Opus Group and in vehicle safety group Autoliv.

#### The return of Swedish equities 2013

27.2%

These decisions were based on factors such as attractive valuations, solid cash flows and the fact that these companies generate structural growth through increased focus on the environment and safety in the automotive industry. Investors' interest in both companies rose sharply in 2013. The value of the Opus Group share rose by no less than 469 percent.

#### Integrated sustainability analysis

The Second AP Fund is convinced that companies that adopt a long-term responsible approach to the environment, ethics and corporate governance increase their value. In its fundamental company analyses, the Second AP Fund focuses on how companies integrate these concerns to generate income and/or reduce costs, as well as to increase the confidence different stakeholders have in their businesses. These analyses are intended to illustrate how well such companies are equipped to grasp the opportunities and face the challenges they will encounter.

The Fund's sustainability analyst supply the portfolio management team with detailed analyses of companies and data on various areas of relevance. There is also collaboration on some specific dialogues with companies. The sustainability analyst and the team also work together on specific issues that require more in-depth analysis. Increased knowledge of sustainability is essential to its increased integration in fundamental analyses. To meet this need, the Second AP Fund arranges sustainability seminars for all employees, three or four times a year, inviting guest speakers to address the participants.

“SSAB seriously underperformed against the exchange index, so that our underweighting contributed to our active return.”

Marcus Neckmar, Equity Analyst





The Second AP Fund is convinced that companies that adopt a long-term responsible approach to the environment, ethics and corporate governance increase their value.



# Result and performance 2013

As of December 31, 2013, Fund capital totalled SEK 264.7 billion, the largest volume of Fund capital ever recorded. The Fund's investments both in listed and non-listed equities performed well in 2013, and the Fund reports a net result of SEK 30.1 billion.

Fund capital is affected by two factors, the net result for the year and net flows within the pension system. In 2013, Fund capital increased by a net of SEK 23 258 (24 832) million, deriving from the positive result of SEK 30 138 (28 620) million, against which net outflows from the pension system were charged in an amount of SEK –6 880 (–3 788) million. Capital flows consisted partly of contribution payments to the system and pension disbursements from it, amounting

to a net of SEK –6 650 (–3 568) million, and partly of the cost of administering the national pension system, which was charged against Fund capital in an amount of SEK –230 (–220) million. For the fifth successive year since the pension system was launched, the net of inflows and outflows to the pension system from the AP funds was negative.

## Fund capital performance 2013, SEK million

	2013	2012
Fund capital brought forward	241 454	216 622
Pension contributions received	56 839	55 441
Pension disbursements	–63 489	–59 009
Administration contribution	–230	–220
Net result for the year	30 138	28 620
<b>Fund capital carried forward</b>	<b>264 712</b>	<b>241 454</b>

## Composition of strategic portfolio, exposure and return as per December 31, 2013 and December 31, 2012

Asset class	Strategic portfolio, %		Exposure, %		Exposed value, billion		Absolute return, %		Relative return, %		Active risk ex post*, %	
	2013	2012	2013	2012	2013	2012	2013	2012	2013	2012	2013	2012
Swedish equities	11.0	11.0	11.4	11.2	30.3	27.0	27.2	16.3	1.2	0.4	0.5	0.4
Foreign equities	38.0	38.0	39.7	37.8	105.2	91.3	18.4	12.9	0.4	1.4	0.4	0.4
Fixed-income securities, incl. liquidity and accrued interest	34.0	36.0	32.9	35.9	86.9	86.7	–0.9	5.4	–0.1	1.0	0.3	0.4
<b>Total listed assets, excl. alternative investments, commission fees and operating expenses</b>							<b>12.7</b>	<b>13.4</b>	<b>0.4</b>	<b>1.1</b>	<b>0.3</b>	<b>0.3</b>
Alternative investments	17.0	15.0	16.0	15.1	42.3	36.5	13.4	13.9				
<b>Total Fund capital, excl. commission fees and operating expenses</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>264.7</b>	<b>241.5</b>	<b>12.8</b>	<b>13.5</b>				

\* Historical outcome, 12 months rolling.



# Net result for the year

The net result was SEK 30.1 billion and is primarily a reflection of the very strong performance of not only the Swedish stock market, but of many foreign stock markets too.

## Operating income

Operating income comprises direct return as well as net return per asset class, foreign exchange gains/losses and commission fees. Direct return, in the form of net interest income and dividends received, totalled SEK 6 745 (9 610) million for the year. The net result for listed equities comprises both unrealized and realized gains/losses, and totalled SEK 24 753 (15 557) million, including expenses for performance-based fees. This result derives from the high return generated on the Fund's portfolios of Swedish and foreign equities. The portfolio of Swedish equities generated a total return of 27.2 percent, while the Fund's portfolio of foreign equities noted a return of 18.4 percent.

The net result for non-listed equities totalled SEK 3 679 (2 657) million and is largely attributable to unrealized gains in the value of the Fund's non-listed portfolio of real estate and realized gains on its holdings in private equity funds.

The net result for fixed-income securities totalled SEK –1 913 (3 848) million, with positive contributions from the Swedish fixed-income portfolio and foreign government securities, while foreign credit bonds noted a slightly negative absolute return.

The Fund's trade in derivatives posted a negative net result of SEK –278 (1 241) million, investment in derivatives exposed to emerging markets having the greatest impact.

The Fund's net exposure in foreign exchange has generated a negative result, which has nevertheless been limited by the positive impact of its currency hedging process. The reported net of foreign exchange gains/losses totalled SEK –2 425 (–3 921) million.

Management costs in the form of performance-based fees, totalled SEK 74 (60) million for 2013, have been charged against the net result for externally managed assets. This cost arises when an external portfolio manager generates a return over and above the agreed target, which has a direct impact on the net result reported for each asset class, as per current accounting principles. Commission fees pertaining to fixed external management charges of SEK 230 (193) million, as well as custodial expenses of SEK 15 (10) million, were charged against operating income.

## Fund's total expenses

The Fund's total expenses include in-house expenses in the form of operating expenses, fixed external portfolio management and custodial charges. Variable expenses related to performance-based contracts and management fees reported as part of the acquisition value are charged against the net result for each asset class, as described in Note 4 on page 52. The Fund's operating expenses and commission fees, expressed as an expense ratio, amounted to 0.17 (0.16) percent for 2013. This increase derives from the Fund's investment strategy, where asset classes and markets that are believed to offer the prospect of solid returns and for which the Fund lacks the necessary in-house resources are managed during external mandates.

A global cost-efficiency comparison with other pension funds demonstrates that the Fund is highly cost efficient, which is commented on in greater detail on page 40.

## Operating expenses

Operating expenses totalled SEK 178 (169) million. Reported as a ratio of average Fund capital over the twelve months, this corresponds to a cost level (expense ratio excluding commission fees) of 0.07 (0.07) percent.

## External management costs

Management costs are to a large extent determined by the volume of Fund capital, the percentage of assets during external management and the degree of active risk adopted, as well as the asset class selected.

During 2013, an active focus was adopted for the capital assets during external management and, by year-end, SEK 65 (70) billion was being managed during external mandates, including non-listed assets. This corresponds to 25 (29) percent of the Fund's entire capital.

The cost for the external management of market-listed assets partly comprises a fixed element and, for certain assignments, a performance-based element. In 2013, the fixed cost amounted to SEK 226 (189) million and the variable performance-based element to SEK 74 (60) million. If the management fees for private equity funds are included, the combined fixed cost for external management of the Fund's assets was SEK 230 (193) million. The increase partly reflects the increased capital allocation to externally-managed alternative risk premiums, but also the rise in costs deriving from the fact that, since 2012, the AP funds have been liable to pay VAT on foreign acquisitions. Because the funds are not entitled to reclaim VAT payments, this VAT registration requirement has led to an increase in overall costs.



### Custodial expenses

The internalization process completed during the year has had an impact on the volume of custodial assets. Assets exposed to emerging markets are relatively expensive to place on deposit and involve high transaction costs. These types of assets, which have previously been managed via external funds, where custodial expenses have been included in fund fees, were gradually transferred to in-house management during the year. This transfer, combined with the rise in value of all assets, has led to higher custodial expenses during the year. These totalled SEK 15 (10) million for the 2013.

### Brokerage commission

A brokerage commission is paid on the purchase and sale of equities and participations. When buying and selling other asset classes, the

transaction cost is limited strictly to the difference between the buy and sell rate, known as the 'spread'. To establish comparability between different asset classes, commission is reported as a deductible item during Net result, listed equities and participations (see note 2 on page 52). Commission fees paid in 2013 totalled SEK 70 (57) million. Of these costs, 4 (2) percent derived from commission paid within the Fund's external management, the remainder to the Fund's in-house portfolio management organisation. Costs amounted to 0.05 (0.04) percent of the total trading volume. The following five counterparts (listed in alphabetical order) received commissions corresponding to approximately 71 percent of total commission payments: Credit Suisse, Deutsche Bank, Goldman Sachs, Instinet and JP Morgan.

### Contribution to absolute return, %

Asset class	2013	2012
Swedish equities	2.9	2.2
Foreign equities	7.0	4.7
Fixed-income securities, incl. liquidity and accrued interest	-0.3	2.0
GTAA	0.1	0.1
Overlay	-0.1	0.0
FX Hedge	1.1	2.6
Alternative investments	2.1	1.9
<b>Total assets, excl. commission fees and operating expenses</b>	<b>12.8</b>	<b>13.5</b>

### Contribution to relative return, %

Asset class	2013	2012
Swedish equities	0.1	0.1
Foreign equities	0.2	0.6
Fixed-income securities, incl. liquidity and accrued interest	0.0	0.4
GTAA	0.2	0.1
<b>Total market-listed assets excl. alternative investments and implementation effects</b>	<b>0.54</b>	<b>1.16</b>
Implementation effects*	-0.1	-0.1
<b>Total market-listed assets excl. alternative investments and incl. implementation effects</b>	<b>0.4</b>	<b>1.1</b>

\* Result effects to maintain exposure to the strategic portfolio.



# Portfolio return

The return on the total portfolio for 2013, excluding commission fees and operating expenses but including performance-based fees, was 12.8 percent.

Among asset classes, Swedish equities performed best for the second year in succession, generating a return of 27.2 percent. Foreign equities posted a return of 18.4 percent (in Swedish kronor and excluding FX hedging effects), despite the fact that the return on equities in emerging markets was negative. Alternative investments, i.e. real estate, private equity funds, alternative credits, alternative risk premiums and Chinese Series A equities generated a return of 13.4 percent. Fixed-income securities were affected by the rise in interest rates during the year and generated a return of -0.9 percent.

The contribution made by different asset classes to the total result depends both on the return generated and on the relative percentage of portfolio value they represent during the year. Constituting the largest share of the portfolio, foreign equities contributed 7.0 percent to the overall result. Swedish equities contributed 2.9 percent and fixed-income securities -0.3 percent. Alternative investments, which account for a smaller percentage of the total portfolio, contributed 2.1 percent.

The Fund's FX hedging policy is designed to mitigate portfolio risk. To achieve this, the Fund implements a systematic FX hedging programme, with a view to reducing variation in portfolio worth over the long term. This hedging programme contributed 1.1 percent.

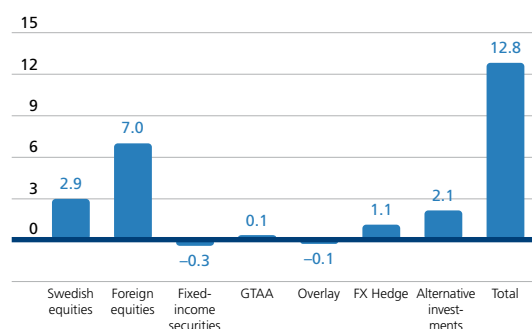
The Fund's real estate portfolio generated a return of 14.4 percent over the year. The return on private equity investments was 14.3 percent, while the portfolio of alternative risk premiums generated 2.5 percent.

The management of convertibles was terminated during the year and an arbitrage portfolio of convertibles was placed in alternative risk premiums instead. At time of termination, the convertibles had generated a return of 9.9 percent for 2013. During the year, the Fund built up a portfolio of alternative credits, mainly comprising listed corporate loans intended for short-term investment, but also including high-yield credit bonds. This portfolio generated a return of 5.8 percent.

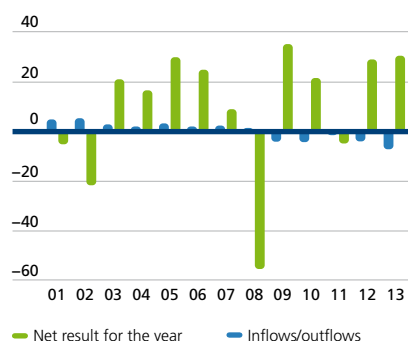
Over the past five and ten year periods, the Second AP Fund has generated an average return of 11.0 and 7.1 percent per year respectively. After adjustment for inflation, this corresponds to an annual real return of 9.8 percent over five years and 5.8 percent over ten years.

During the late autumn, the Fund initiated its management of equities in the domestic Chinese market. In view of the fact that opportunities for adding or withdrawing assets from this portfolio are subject to certain administrative constraints, it has been classified during alternative investments. The portfolio, which was built up at the end of 2013, generated a return of -2.7 percent.

Contributions to the total portfolio, absolute return 2013, %



Fund performance and flows, 2001–2013, SEK billion



Since the Fund was established, the market has experienced two profound crises. First came the 'IT bubble', coinciding with the launch of the Fund, followed by the financial crisis, which peaked in 2008. During 2011, the financial markets were sharply affected by debt crises in different parts of the world, although in 2012 and 2013, the world's stock markets once again produced strong growth. These crises are mirrored by the fluctuations in the Fund's net result and capital over its first thirteen years.



# Relative growth for portfolio of listed assets

The Fund's portfolio of market-listed securities comprises Swedish and foreign equities, Swedish and foreign fixed-income securities, tactical allocation and FX management. In 2013, the listed portfolio posted a positive return of 12.7 percent. Total relative return, i.e. active return minus implementation effects (costs arising in connection with rebalancing and transactions that are not attributable to active management) was 0.41 percent. Of these costs, –0.13 percent are attributed to implementation effects.

Over the past five years, the Fund's active return has averaged 0.72 percent per year. For four of these five years, the active return has been positive. Over the same period, implementation effects have averaged –0.18 percent. Thereby, the average relative return has been 0.54 percent. This is better than the Fund's targeted positive relative return of 0.5 percent per year.

## Swedish equities

The portfolio of Swedish equities outperformed benchmark index by 1.2 percent. The portfolio of fundamental-focused large caps outperformed index by 0.8 percent, while the management of small caps proved exceptionally successful, generating an excess return of 8.5 percent. The quantitative management of Swedish equities developed in line with index. As an efficiency measure, it was decided towards the end of the year that the quantitative portfolio of Swedish equities will be transferred to fundamental management. The Fund manages all Swedish equities in-house.

## Foreign equities

Management of the portfolio of foreign equities produced a positive active result of 0.4 percent. Both the quantitative in-house management and the external mandates in industrialized countries as well as the external management in emerging markets generated a positive

active return. The in-house management of emerging-market equities that started at the beginning of the year generated an active return of –0.2 percent.

## Swedish and foreign fixed-income securities

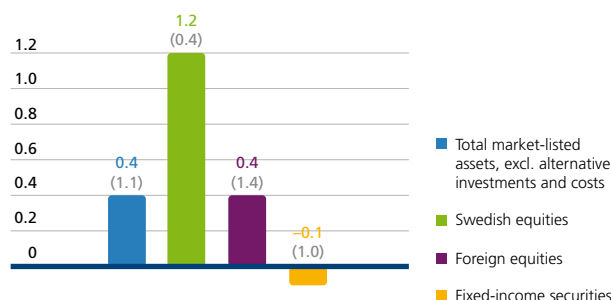
Management of fixed-income securities produced a combined active return of –0.1 percent. The in-house management of Swedish fixed-income securities, employing a fundamental focus, outperformed index by 0.2 percent. The Fund's active return on its quantitative management was also positive, amounting to 0.1 percent. This quantitative in-house management of fixed-income securities, featuring low risk, has generated a positive active return every year since it was started in 2007. The portfolio of foreign government securities, also managed in-house, outperformed index by 0.9 percent.

Apart from a single exception, the externally managed portfolios of credits also posted a positive active return during the year. In 2012, the return on emerging-market bonds was high, between 10 and 15 percent, and external managers generated an overall positive active return. In 2013, the trend was reversed. Most mandates showed a negative return of around 10 percent and, with a single exception, failed to outperform their benchmark indices. The in-house management of emerging-market bonds, issued in US dollars, has so far been handled passively.

## Tactical allocation and FX

The Fund's in-house tactical allocation activities delivered a positive result of SEK 110 million. The Fund's in-house FX trading during the year delivered a result that was just below break-even. The externally managed GTAA mandates continued to make a positive contribution to the active return.

Relative return per asset class 2013 (2012), %





<b>Swedish equities</b>	<b>2013</b>	2012	2011	2010	2009
Exposed value, SEK billion	30.3	27.0	30.8	44.9	37.4
Absolute return, %	27.2	16.3	-13.3	27.8	52.8
Relative return, %	1.2	0.4	-0.5	0.8	1.4
SIXRX, %	28.0	16.5	-13.5	26.7	52.5
Share of external management, %	0	0	9	5	7
Active risk ex post, %	0.5	0.4	0.7	0.5	1.1

<b>Foreign equities</b>	<b>2013</b>	2012	2011	2010	2009
Exposed value, SEK billion	105.2	91.3	81.2	75.0	71.1
Absolute return, %	18.4	12.9	-8.2	5.2	25.0
Relative return, %	0.4	1.4	-0.1	0.4	-0.2
MSCI AC World, %	21.9	10.8	-5.0	6.6	22.3
Share of external management, %	14	26	26	26	26
Active risk ex post, %	0.4	0.4	0.5	0.5	1.1

<b>Fixed-income securities</b>	<b>2013</b>	2012	2011	2010	2009
Exposed value incl. liquidity, SEK billion	86.9	86.7	77.7	77.2	74.5
Absolute return, %	-0.9	5.4	6.8	0.5	2.5
Relative return, %	-0.1	1.0	-0.6	0.5	0.7
Share of external management, %	32	30	31	22	24
Active risk ex post, %	0.3	0.4	0.4	0.3	0.6

<b>Five-year review</b>	<b>2013</b>	2012	2011	2010	2009
<b>Fund capital, flows and result, SEK million</b>					
Fund capital	264 712	241 454	216 622	222 507	204 290
Net inflows from the Swedish Pensions Agency	-6 880	-3 788	-1 240	-4 041	-3 906
Net result for the year, SEK million	30 138	28 620	-4 645	22 258	34 858
<b>Annual return, %</b>					
Annual return on total portfolio before commission fees and operating expenses, %	12.8	13.5	-1.9	11.2	20.6
Annual return on total portfolio after commission fees and operating expenses, %	12.7	13.3	-2.1	11.0	20.3
Annualized return after commission fees and operating expenses, 5 years, %	10.8	2.4	0.6	3.5	4.9
Annualized return after commission fees and operating expenses, 10 years, %	7.0	7.4	4.3	4.2	-
<b>Risk, %</b>					
Standard deviation ex-post, total portfolio, %*	9.3	-	-	-	-
Standard deviation ex-post, daily market-listed portfolio, %	5.7	6.4	10.0	8.4	12.0
Sharpe ratio ex-post, daily market-listed portfolio	2.1	1.9	neg	1.1	1.9
Sharpe ratio ex-post, total portfolio	2.4	2.0	-	-	-
<b>Expense ratio as % of assets under management</b>					
Expense ratio, incl. commission fees, %	0.17	0.16	0.17	0.17	0.18
Expense ratio, excl. commission fees, %	0.07	0.07	0.07	0.08	0.08

\* Calculated over ten-years' quarterly returns.



# Alternative Investments 2013

The Second AP Fund has gathered its investments in non-listed real-estate equities (including forest-and-agricultural real estate), private equity funds, alternative credits, alternative risk premiums and the domestic Chinese equities market, as well as convertibles with targeted absolute returns (convertible investments were terminated in 2013), under asset class Alternative Investments.

Alternative investments jointly account for 16 percent of total Fund assets under management. Real estate represents the largest share (including forest-and-agricultural real estate), accounting for 8.7 percent of total Fund assets. This share is followed by private equity funds (4.0 percent), alternative credits (1.6 percent), alternative risk premiums (1.0 percent) and Chinese equities (0.5 percent).

The overall return on alternative investments was 13.4 percent during the year.

## Commercial real estate

The Fund's non-listed real-estate holdings consist of a 25-percent interest in Vasakronan Holding AB, a 50-percent interest in NS Holding AB (Norrporten) and Cityhold Property AB, as well as a 41-percent interest in US Office Holdings LP. All these investments focus on high-quality commercial real estate, centrally located in real-estate markets with good liquidity. The portfolio has been expanded by additional investment in a real-estate fund which targets the faster

economic growth noted in Asia, mainly China. By investing in real estate, the Fund generates a solid long-term direct return on investment and contributes to a satisfactory spread of risk in the total portfolio.

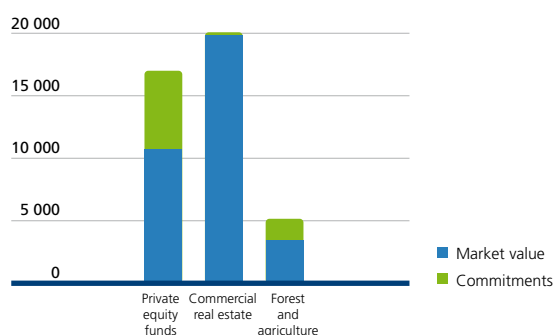
Vasakronan, which is owned jointly by the First, Second, Third and Fourth AP funds, is Sweden's largest real-estate company, with a concentrated and attractively located portfolio of real-estate holdings in the Stockholm, Gothenburg, Öresund and Uppsala areas. The company owns and manages more than 192 properties, totalling some 2.6 million square metres of floor space, with a total market worth of SEK 87 billion.

Norrporten is owned jointly (50/50) by the Second AP Fund and the Sixth AP Fund. The company's portfolio of real estate consists mainly of commercial properties (offices) in mid-sized Swedish cities that enjoy solid growth (Luleå, Umeå, Sundsvall, Örebro, Jönköping and others). Norrporten also has real estate in Stockholm, Copenhagen and Hamburg. It owns and manages some 130 properties, totalling some 1.1 million square metres of floor space, with a total market value of SEK 25 billion.

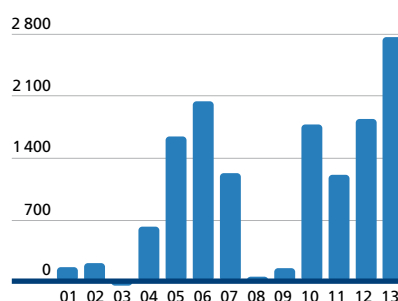
This value growth in the Fund's Swedish real-estate portfolio means that it has increased its share of the Fund's total worth to approximately 5.9 percent.

In the past three years, the Fund has been investing in real estate outside Sweden. In 2011, in association with the First AP Fund, the Second AP Fund established Cityhold Property AB, a real-estate investment company, focused primarily on real estate in major European cities. To date, the company has acquired three centrally located office properties in London, comprising a total of approximately 50 000 square metres of floor space, with a market value in

**Non-listed investments classified according to investments completed and commitments remaining, SEK million**



**Annual result from the Fund's holdings in commercial real-estate companies since start, SEK million**





excess of SEK 5 billion. During 2013, Cityhold Property signed an agreement to acquire a property in Munich, marking the company's first investment outside London.

During 2012, the Fund acquired a 41-percent interest in US Office Holdings, an American real-estate company, owned jointly by the state-owned South Korean pension fund NPS and the real-estate company Tishman Speyer. In addition to three direct-owned properties, US Office Holdings, in partnership with the Government of Singapore Investment Corporation (GIC), also owns the real-estate company PPI (Prime Plus Investments Inc). The real-estate portfolio comprises 15 centrally located office properties, with floor space totalling 830 000 square metres. US Office Holdings' total market value exceeds SEK 12 billion. Of this, 70 percent consists of real estate on both the east and west coasts of the USA, in New York, San Francisco, Seattle and Beverly Hills. Another 20 percent of the portfolio's value derives from real estate located in Chicago.

In June 2013, the Second AP Fund invested in Gateway Real Estate Fund IV (Gaw), which invests in real estate in East Asia, mainly in China. Gaw is a fully-integrated real-estate fund manager, handling both acquisitions and portfolio management in-house. Investment in this fund offers the Second AP Fund good diversification through investment in a range of different properties in a broader geographical area.

### Forest-and-agricultural real estate

In 2010, the Second AP Fund made its first investments in forest-and-agricultural real estate by investing in an agricultural fund in the USA and in two forest funds – one in the USA and one in Australia/New Zealand. In 2011, a joint venture was established with TIAA-CREF for investment in agricultural real estate in Australia, Brazil and the USA. These investments mainly involve commercial-scale grain production on high quality agricultural real estate in countries with clearly defined legal structures, where agricultural production is efficient and independent of state subsidies and other forms of support. The Second AP Fund feels it is essential that the fund managers it selects subscribe to the same values concerning a long-term view and the importance of responsible and sustainable investment. In 2013, no new investments were made in agricultural real estate.

The Second AP Fund made its first two investments in forest real estate in 2010. During 2013, the Second AP Fund increased its investments in forest real estate by investing additional capital in follow-ups to these funds. In the same year, to complement these

investments in the USA and Australia/New Zealand, which focus on conventional forestry, the Second AP Fund invested in a fund for forest real estate, where some of the production is focused on bioenergy.

All funds in which the Second AP Fund has invested are clearly focused on sustainable, responsible ownership and management of forest real estate, as well as certification (SFI, FSC and AFS) of their operations.

Investments in forest-and-agricultural real estate form part of the Second AP Fund's strategy for diversifying the overall portfolio. Forest-and-agricultural real estate are both considered to generate a stable return, in light of the fact that the underlying trend towards increased urbanization and improved welfare, in combination with a growing global population, is increasing demand for forest and agricultural products. Both asset classes are also deemed to be relatively insensitive to cyclical fluctuations, added to the fact that covariance with other asset classes – such as equities – is considered to be low.

The total return on the Fund's non-listed real estate holdings amounted to 14.4 percent in 2013, corresponding to approximately nine percent of Fund assets.

### Private equity funds

As in 2012, 2013 has been notable for the relatively stable flow of corporate deals. Activity in the North American market has been more buoyant than in Europe and Asia. Although the total number of transactions was somewhat lower than in 2012, total transaction volumes were higher. Among other factors, the market was affected by a few really big transactions, the Silver Lake buy-out of Dell from the US stock market being one of the largest, as was the Berkshire Hathaway acquisition of Heinz.

As for the private equity funds' divestment of corporate assets, these have been made both to strategic buyers and via a relatively large number of IPOs (initial public offerings). Once again, the highest frequency of IPOs was noted by the North American market.

New funds have found it easier to attract capital in recent years, but even so the Fund has seen several fund managers reduce the size of their newly established funds. That more funds were established in 2013 may also be explained by the fact that many of the funds started in 2007 and 2008 are now fully invested, leading to the establishment of new follow-up funds. One part of the market attracting increasing attention is infrastructure funds.



Every part of the Second AP Fund portfolio saw considerable activity. As well as many investments, the funds completed a large number of divestments and IPOs. Profit growth in the funds' portfolio companies has been good.

The Second AP Fund made seven new investments in 2013, involving commitments of totally SEK 1.9 billion. These new investments, which provide a good complement to the Fund's current portfolio, were made in funds managed by Abris, MBK, H.I.G. (two funds), CVC, New Mountain and The Jordan Company.

A number of attractive investment opportunities in funds with both the experience and characteristics sought by the Second AP Fund had to be rejected, in light of the statutory five-percent limit imposed concerning the Fund's total capital exposure to private equity funds. As of December 31, 2013, the Fund's total investment commitment was SEK 18.9 billion. Since the start 2001, SEK 14.5 billion (including management fees) has been invested, of which SEK 2.0 billion in 2013. Although the portfolio is still at a relatively early stage of its development, a growing number of its private equity investments may be considered mature. So far, the portfolio has repaid SEK 7.8 billion since its start. The return on investment in private equity funds was 14.3 percent at year-end 2013, the market worth of the portfolio amounting to SEK 10.6 billion, excluding FX hedge. Fees paid for the management of non-listed assets, where reimbursement is permitted prior to profit sharing and is deemed likely, are reported as part of the acquisition value of such assets. See also the Fund's accounting and valuation principles (page 50).

#### **Alternative credits**

For some years now, the global economy and financial markets have been undergoing a debt restructuring process that has adverse effects on general economic growth and on the financial institutions' ability to maintain their normal function as lenders and intermediaries in the financial markets.

For this reason, the Second AP Fund has allocated two percent of its strategic portfolio to investments in credit opportunities that, for example, can arise in connection with the imposition of increased capital coverage requirements on banks (which reduce their lending ability). These investment possibilities derive as the result of several knock-on effects from changes in regulations and increased capital coverage requirements. One example is that bank lending shifts from small and medium-sized companies to the largest corporations.

The Second AP Fund's investment mission is long-term, providing the stability needed to benefit from prevailing market conditions. The full worth of the value created can only be realized when the securities and credits mature, requiring the investments to be retained for their full term.

The average term for the credits that dominate the investments selected in the credit market segment (loans to companies) is shorter than for the more common bonds that institutional investors these days have large exposure towards. Shorter terms and, not uncommonly, FRNs (floating rate notes), mean that sensitivity to potential hikes in interest rates from the currently extremely low levels is less.

A number of the investment strategies mentioned above target the types of assets defined as non-listed, a type of asset in which the Second AP Fund has only limited freedom to invest, due to the current legislation affecting non-listed investments. Even though the restriction to market listed structures somewhat limits the investment choice, both the breadth and depth in the choice of these listed investments is adequate to enable the Fund to generate the investment opportunities it seeks.

The anticipated return is in line with the Fund's long-term assumptions concerning the return on equities (seven-eight percent). With an anticipated return at this level, the investment contributes to an increased, absolute and risk-adjusted, return in the long term.

During 2013, the Second AP Fund has conducted ongoing investment in corporate credits by utilizing external fund managers that apply broad and in-depth credit analyses. The portfolio is estimated to be fully invested during the first half of 2014.

The total return for 2013 was 5.8 percent.

#### **Alternative risk premiums**

Alternative risk premiums shall contribute to increased diversification and generate higher risk-adjusted return, since the portfolio is constructed to be less dependent on traditional stock market risk.

The strategies adopted by the portfolio are linked to stock market volatility, premiums for reinsuring insurance companies, premiums associated with the market for corporate acquisition and convertibles and strategies focused on the FX market and the market for future dividends on corporate profits. Other possible risk premiums may be added later. The total return for 2013 was 2.5 percent.



**Chinese Series A equities**

In 2012, as part of its drive to achieve greater exposure on emerging market economies, the Second AP Fund was awarded a QFII (Qualified Foreign Institutional Investor) licence by the Chinese authorities, enabling it to invest in equities listed on China's domestic stock markets.

During the summer of 2013, the Second AP Fund was granted a permit to invest an amount equivalent to USD 200 million and, following negotiations, two fund managers were appointed to manage the Chinese equities.

**Convertibles**

Since 2009, the Second AP Fund has allocated some two to three percent of its assets to a global portfolio of convertibles. This exposure to convertibles has contributed to the diversification in the Fund's overall portfolio and has been an investment that has generated an absolute return.

The Fund's holdings, which has featured a generally low-risk profile, were managed actively under four external mandates, operating with different management styles.

The portfolio of convertibles, which was terminated during 2013, generated a return of 9.9 percent. Since it was established in 2009 and through to its termination in 2013, the portfolio generated a total return of 44.6 percent (an average of 9.4 percent per year). This means that the portfolio outperformed its targeted annual return of seven percent by 2.4 percent per year.



# Risk in focus

Sweden's Parliament has formulated clear guiding principles as to how the AP funds shall interpret their task as fund managers. The AP funds shall adopt financial risk in an effective manner with a clear focus on future pensions. Apart from a few constraints, the funds have been awarded considerable freedom in selecting appropriate risk and investment strategies, independent of one another. The selected strategy shall be neutral with regard to the generations involved and shall ensure the maintenance of pension disbursements.

The starting point for the Second AP Fund's investment strategy and financial risk is that the AP funds are only able to influence future pensions to the extent that their portfolio management activities impact on the pension system's automatic balancing mechanism ('brake'). The board of directors has therefore concretized the Fund's goal for its asset management activities as minimizing the consequences to future pensions of activating the automatic balancing mechanism. It is this primary risk that determines the way in which investment strategy is formulated, rather than the selected portfolio's risk profile. By far the greatest portion of financial risk adopted by the Second AP Fund in its portfolio management operations derives from its long-term exposure to financially motivated risk premiums, as expressed by the strategic portfolio.

The financial risk is thus directly linked to the Fund's assessment of the development of the total pension system over the coming decades. This is subject largely to factors outside the Fund's control, such as demography, immigration, employment levels, economic growth and so on. The financial risk is also governed by the Fund's assessment of the financial markets' long-term prospects for generating a return. A key point when determining the choice of strategy is that the AP funds, compared to the Swedish national pension system as a whole, are of relatively limited size. Their limited size means that the funds are forced to adopt a significant level of financial risk. However, this also means that the financial risk adopted will have less of an effect on the pension system.

The long-term allocation of assets and spread of risk that the Second AP Fund deems will minimize negative effects on future pensions features a relatively high proportion of higher-risk assets. This means that the value of the portfolio, from one time to another, is expected to show a higher variation than if the allocation had been more defensive. A guiding principle governing the development of the Second AP Fund's long-term investment strategy is to diversify risk in the portfolios where possible, without compromising on the requirement for a high return. In this way, the Fund hopes to mini-

mize the risk of a negative trend in pensions over the long term, while at the same time limiting the portfolio's short-term risk as far as possible.

The long-term orientation the Fund chooses for its portfolio may be characterized in a several ways. One way is to describe it as an allocation of assets between different assets and strategies. Another way is to describe it in terms of anticipated future returns. A third way is in terms of the portfolio's expected risk profile, which plays a key factor in achieving the overall objective – to minimize the risk of lowering the level of future pensions – which is the mission the AP funds have been tasked with.

## Controlling risk

The selected level of risk is determined by three parameters. The risk policy, which is determined by the board of directors, prescribes the parameters governing the Fund's exposure to risk. The CEO's document 'Guidelines for Investment' contains still more detailed instructions for the management and monitoring of financial risks. For individual mandates, parameters defining acceptable levels of exposure to risk are specified in the form of an 'Investment Guideline'.

The starting point for the Second AP Fund's risk process is the annual ALM study, based on a number of assumptions concerning market growth and risk levels for different asset classes, and which is a key tool in formulating the strategic portfolio.

## Compliance

Compliance is responsible for ensuring that the legal and ethical aspects are managed correctly, in compliance with current rules and regulations. The unit is independent both from the asset management function as well as the Fund's other support functions. The main task of the compliance-function is to spread awareness throughout the organization of the regulations that, in the broadest sense, are important to the Fund. This can be done in a number of



different ways, not least by ensuring that in-house rules, policies and guidelines are established and firmly rooted in the organization. External regulations include legislation and regulations that apply specifically to the AP funds, as well as other regulations affecting the capital market, such as those applied to flagging. In-house codes of conduct address areas such as employees' private securities transactions and ensuring that external fund managers observe the terms of their contracts.

### **Two collaborative risk functions**

The Fund's ongoing risk management is conducted by two independent but collaborative functions.

#### ***Risk budgeting***

The Fund's board of directors has established the target of a 0.5 per cent excess return, over and above the return determined for the strategic portfolio. In generating this return, the board has specified that the active risk (tracking error) in managing the portfolio shall not exceed three percent.

The purpose of the risk budget is to allocate excess return targets and limits for active risk between the Fund's portfolio management teams, to achieve the most effective risk utilization: in other words, to maximize the Fund's information ratio. The idea of a risk budget is to delegate targets and resources among departments. Within the framework of the respective active-risk mandates, therefore, heads of department are responsible for allocating the return targets and risk among the departments mandates. The target and active risk is defined in the Investment Guidelines for each mandate. The risk budget is drafted annually. Senior portfolio managers draft a proposal which is presented to the Fund's executive management for approval.

#### ***Risk Management***

Risk Management is responsible for the monitoring and analysis of the Fund's financial and operative risks. This function is operationally separate from the asset management organization, ensuring independence. It is also responsible for developing guidelines and risk models, as well as providing advice and support to the Fund's executive management and portfolio management teams.

### **The Fund's risks**

The most significant risks to which the Fund may be subjected can be divided into financial and operative risks. The financial risks primarily comprise market risk, credit risk and liquidity risk.

#### ***Market risk***

Market risk refers to the risk that fair value or future cash flows from a financial instrument will vary due to changes in market rates. Market risk in the day-to-day asset management process is measured in absolute terms and relative to the benchmark portfolio. The market risks most relevant to the Second AP Fund are share price risk, interest risk and exchange rate risk. The Second AP Fund analyses and monitors market risk at total fund level, by asset class and per mandate. In this process, the Fund relies on a number of different tools and methods: risk attribution, stress tests and scenario analyses. It also conducts ongoing ad hoc analyses to illuminate the level of risk borne by different parts of the portfolio. Furthermore, the Fund conducts back testing of risk models, as well as the assessment and review of the limit structure.

#### ***Credit risk***

Credit risk refers to the risk of loss arising from a creditor's failure to fulfil a credit commitment. In its turn, this credit risk comprises:

- Counterparty risk – the risk that a counterpart in an OTC transaction may become insolvent and unable to fulfil its commitments.
- Issuer risk – the risk that an issuer may become insolvent and unable to fulfil its commitments.
- Liquidation risk – the risk that the counterpart may be unable to fulfil the contract when payment is due.
- Concentration risk – the risk posed when large, important or substantial volumes and/or commitments are concentrated among a limited number of issuers or to a specific sector or geographical area.

Ways in which the Second AP Fund limits credit risk in the fixed-income portfolio include statutory credit checks and exposure limits. The starting point is an agreed interest-rate index for the strategic portfolio. This index is then used to define the parameters determining permitted deviations in terms of credit risk limits as per credit rating. To determine the credit risk, the Fund employs median ratings which are available from rating agencies Standard & Poor's, Moody and Fitch. When a rating is available from two institutes only, the lowest rating is selected. If a rating is available from just one institute, the judgement is based on this alone. It may be noted that the Fund also has credit risks in fixed-income funds and alternative credit funds.

The Fund's counterparty risk is monitored and analysed on a daily basis. Each new counterparty is subject to a credit check, followed by the continual evaluation of all current relationships. The purpose and



nature of the specific business relationship is always the starting point for this process. As well as the counterparty risk associated with deposits and non-cleared derivatives (OTC derivatives), there is a risk concerning cleared transactions against clearing institutes, although this is minimal.

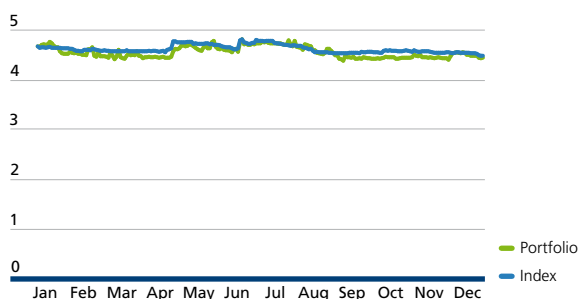
Issuer risk is not limited to the risk that the issuer may become insolvent. Losses may often arise long before a declaration of bankruptcy. The Second AP Fund limits issuer risk by establishing credit-risk limits, for individual issuers as well as groups of issuers.

This is achieved, for example, by limiting the total credit risk posed by different groups of issuers based on credit ratings per security.

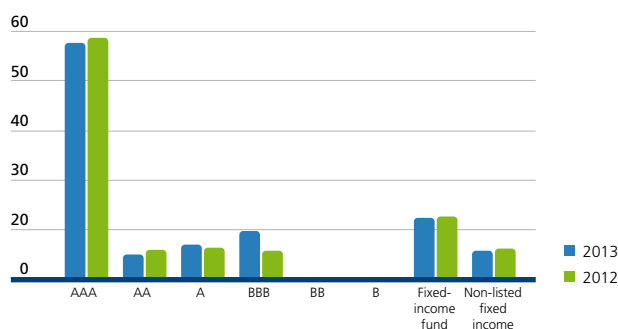
The liquidation risk is minimized by automatically checking the purchase and sale of equities and bonds with reference to the broker/counterparty. Special attention is paid to possible deviations, which can quickly be corrected. Payment and execution of the transaction is executed simultaneously.

The Second AP Fund manages concentration risk by analysing distribution, in terms both of geographical region and industry, as well

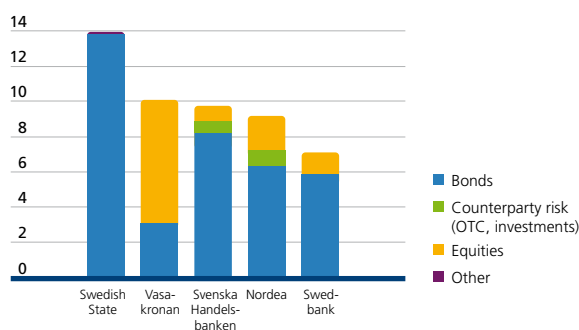
#### Duration 2013



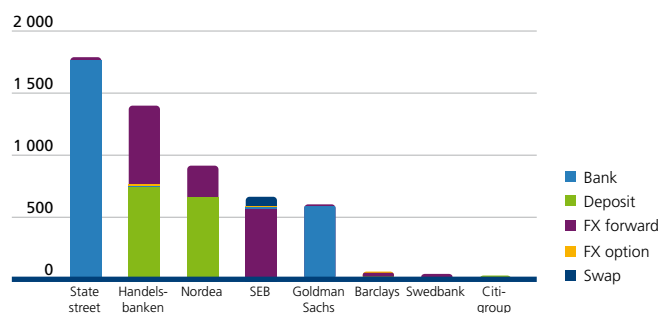
#### Credit risk, SEK billion



#### Exposure to issuer, SEK billion



#### Counterparty risk, SEK million





as the distribution between issuers/issuer groups. The most influential factor in managing concentration risk is the choice of benchmark index.

### **Liquidity risk**

Liquidity risk refers to the risk that securities cannot be converted into cash at the appointed time without incurring a substantial loss or considerable cost. The AP funds must also be prepared to transfer funds to the Swedish Pensions Agency.

The Fund's liquidity risk is limited by legislation that requires that no less than 30 percent of the Fund's assets shall be placed in rights to claim at low credit and liquidity risk, and that a maximum of five percent of the Fund's total assets may be invested in private equity funds. The liquidity risk on the liability side, which is very small, consists of derivative debts.

### **Operative risk**

Operative risk refers to the risk of losses arising from inappropriate or unsuccessful in-house processes, human error, incorrect systems or external events. The Second AP Fund identifies operative risks using a variety of analytical methods and tools – including self-assessment, incident log, process analysis, risk indicators and workshops.

The assessment of identified operative risks is then based on determining the likelihood of their happening and the potential consequences. Based on this analysis, the risks are allocated priorities and an action plan is drafted.

In the spring of 2013, to increase awareness and understanding, workshops were held for all members of staff, to address ethical and moral issues and a number of other dilemmas. The idea was to forestall incidents that could lead to undesirable economic loss or declining confidence in the Second AP Fund as a state agency and fund manager.

In the autumn, in association with external consultants, the Fund developed an overall process map for its main processes and implemented a preliminary study prior to charting processes within asset management. The purpose of the project was to gather, compile and present relevant information to decision makers as to how the Fund could best move forward in its efforts to chart its asset management processes.

### **Portfolio risk 2013**

The Second AP Fund reports a continuing low level of active risk for the total portfolio in 2013. Portfolios where the Fund has chosen a higher-risk profile have in most cases generated a solid return.

The level of active risk on the Fund's total listed portfolio, measured over twelve months, declined somewhat during 2013. At year-end 2013, it was at 0.25 (0.3) percent. The level of active risk noted for asset class Swedish equities rose from 0.4 percent to 0.5 percent, while the level for asset class foreign equities remained virtually unchanged, at 0.4 percent. The level of active risk for fixed-income securities declined during the year, amounting to 0.3 (0.4) percent at year-end. Covariance between the relative returns on asset classes in the listed portfolio remained low over the year, indicating a good risk spread in the Fund's portfolio. The volatility of the listed portfolio declined during the year, from 6.4 to 5.7 percent, mainly a consequence of reduced market volatility. During the year, market volatility measured as per a volatility index (VIX – implicit volatility for S&P 500 index options) declined from 18 percent to 12 percent at year-end. A normal level for VIX estimated over time is around 20 percent.

The information ratio for the total listed portfolio declined in 2013 to 1.6 (4.2). This was mainly attributable to a decline in the relative return. The Sharpe ratio for the Fund's listed portfolio rose during the year, due to an improved absolute return, rising to 2.1 (1.9) by year-end.

The duration calculated for the portfolio of fixed-income investments was 4.4 (4.7) years as per December 31, which corresponds to an approximate decrease of 0.3 years compared with the preceding year. This decrease derives from asset class foreign government bonds. The duration of global credits has increased by 0.1 year during 2013. The remaining asset classes note smaller changes compared to the total fixed-income portfolio. The share of duration that derives from maturity segment 0–10 years has increased from 75 to 82 percent in the past year. During the year, the Fund has changed its index for foreign government bonds and global credits.

The credit quality of the fixed-income portfolio has changed somewhat during the year. The Fund has a triple-A (AAA) share of 54 (57) percent and a triple-B (BBB) share of 11 (7) percent. The reduction in the triple-A share and increase in the triple-B share is a consequence



of the adjustment to a new Corporate Index. Credit risk, expressed in SEK billion, is illustrated by the graph on page 35.

The concentration risk between the Second AP Fund's portfolio of listed equities and private equity funds varies somewhat. Private equity funds feature the greatest exposure to North America (48 percent) while the portfolio of listed equities' greatest exposure is to Europe (47 percent). They also differ with respect to sector diversification, finance being the largest industry represented in the portfolio of listed equities (24 percent), while the largest sector for private equity funds is consumer discretionary (19 percent).

Fund exposure to Portugal, Ireland, Italy, Greece and Spain in equities and bonds remains limited. Exposure as per December 31 amounted to 2.9 (3.0) percent of the Fund's total capital.

A sensitivity analysis of the Fund's Value-at-Risk (VaR) forecast for the total portfolio highlights equities as having the greatest VaR, at SEK 1.7 (2.0) billion. The analysis shows good diversification in the portfolio.

MSCI's risk system RiskManager is used to calculate VaR. VaR is calculated for the Fund's total portfolio, including alternative investments, for a confidence interval of 95 percent over a day, based on historic simulation. The historic period employed is one year, with daily data.

Based on the VaR calculation, there is a 95-percent likelihood that the Second AP Fund will lose no more than SEK 1.6 billion in absolute terms over a day, per year-end.

For asset classes that are classified as alternative investments and that lack daily quoted rates, the Fund employs proxies. The proxies for these asset classes are as follows. For asset class Private Equity: S&P Listed Private Equity Index, Bloomberg: SPLPEQTR. For asset class Real Estate: Carnegie Real Estate Index, Bloomberg: CRERX. For Convertibles: 50 percent MSCI World/50 percent JP Morgan Global Bond Index.

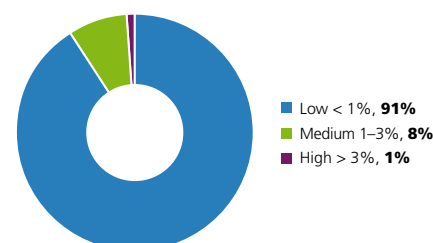
#### Risk calculated as Value at Risk (VaR) for the Second AP Fund's total portfolio

SEK million	2013 VaR (95%,1 day)	2012 VaR (95%,1 day)
Share risk	1 715	2 029
Exchange rate risk	690	519
Interest risk	148	188
Diversification	-909	-1 033
<b>Total, Second AP Fund</b>	<b>1 644</b>	<b>1 703</b>

#### Volatility in listed portfolio past five years, %

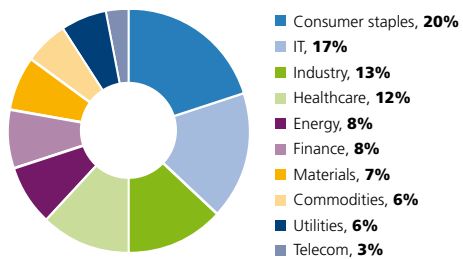


#### Allocation of active risk, %

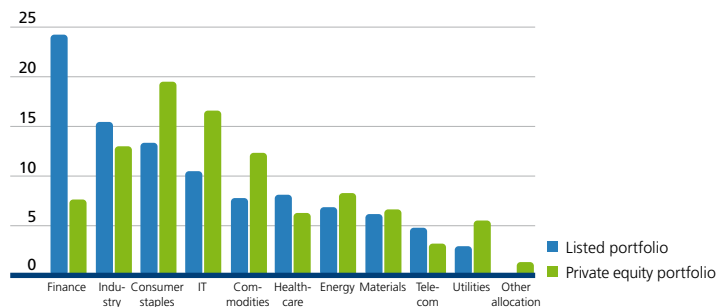




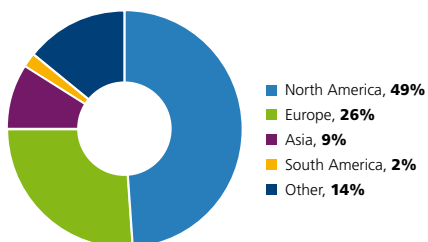
### Investments in private equity funds by sector, %



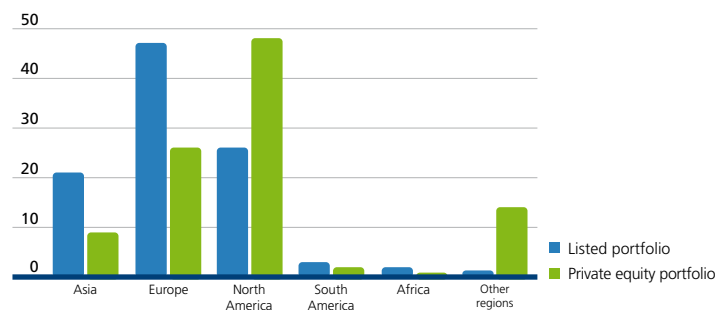
### Sector diversification: listed portfolio compared with private equity portfolio 2013, %



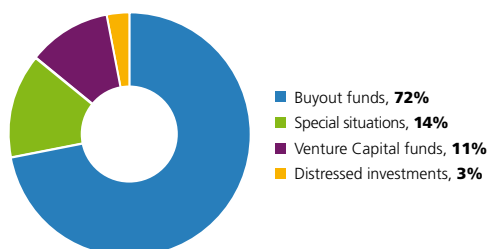
### Investments in private equity funds by region, %



### Regional diversification: listed portfolio compared with private equity portfolio 2013, %



### Original investment commitments in private equity funds, %





# FX exposure

The degree of exposure in foreign exchange (FX) is a risk factor that can have an impact on the worth of all asset classes traded in currencies other than the Swedish krona. By the end of the year, 23 (20) percent of the Fund's portfolio was exposed in foreign currency. The largest part was the Fund's exposure in USD and euros. The Fund's hedging policy aims to reduce portfolio risk, and a systematic FX hedging programme has been actively implemented. The portfolio's

total FX exposure in 2013 has had a net negative impact on the result, although this has been limited by the FX hedging programme's positive impact on the result. The Fund reported an overall negative result on FX transactions for its total portfolio (including interest gains/losses on FX contracts), amounting to a foreign-exchange loss of SEK –1.3 (–0.6) billion.

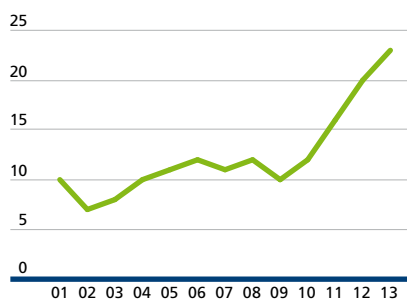
## FX exposure 2013 and 2012, equivalents in SEK million

December 31, 2013	USD	EUR	JPY	HKD	KRW	Other	Total
Equities and participations	53 559	21 333	9 929	3 516	2 346	24 237	114 920
Bonds and other fixed-income securities	31 376	10 041	–	–	–	3 531	44 948
Other assets and liabilities, net	1 248	1 892	152	67	–	492	3 851
Derivative instruments excl. FX derivatives	7 032	1 092	42	–	–	–7	8 159
FX derivatives	–64 667	–22 161	–6 720	–641	7	–16 784	–110 966
<b>FX exposure, net</b>	<b>28 548</b>	<b>12 197</b>	<b>3 403</b>	<b>2 942</b>	<b>2 353</b>	<b>11 469</b>	<b>60 912</b>

December 31, 2012	USD	EUR	CHF	NOK	JPY	Övr	Total
Equities and participations	52 918	20 906	1 821	651	8 506	11 880	96 682
Bonds and other fixed-income securities	31 702	10 599	–	128	–	4 154	46 583
Other assets and liabilities, net	3 810	948	14	20	–1 348	202	3 646
Derivative instruments excl. FX derivatives	9 028	219	–4	–	–1 346	1	7 898
FX derivatives	–58 913	–23 748	–540	239	–6 939	–16 911	–106 812
<b>FX exposure, net</b>	<b>38 545</b>	<b>8 924</b>	<b>1 291</b>	<b>1 038</b>	<b>–1 127</b>	<b>–674</b>	<b>47 997</b>

FX exposure is reported as per the Fund's true management of FX risk. This means it is based on local currency at the trading location, not on the currency pertaining at the company's registered office.

## FX exposure, growth since start, %



Statutory limit for FX exposure is 40 percent.



# Broad, integrated competence ensures effective in-house management

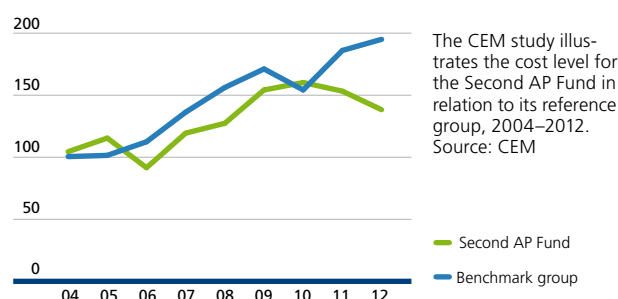
Several large and labour-intensive projects – especially in administrative terms – were launched in 2013. One such was the Fund's initiation of its management of Chinese Series A equities during the latter part of the autumn, under two external mandates. The Fund's in-house management of equities and bonds on emerging markets was implemented gradually during the year. The fact that several resource-intensive projects have been completed during one and the same year has been a challenge. That they could be so successfully implemented is a tribute to the qualities of the Fund's staffs, in terms of collaboration, competence, perseverance and willingness to embrace new methods and ideas. New markets have made – and continue to make – new demands on multiple competencies across the entire administrative spectrum in which a global portfolio manager operates. This applies to IT support, the updating of settlement rules, taxes and country-specific regulations, many of which are unique in their application. Conscious and lengthy development of the necessary competencies in all these areas, combined with the experience gained during 2013, has ensured that the Fund is well prepared to face the new challenges of 2014.

The Second AP Fund's current organization is the result of a more than ten-year build-up of and focus on competence and innovation. Thanks to in-house recruitment and the potential for career development within the Fund, a great many members of staff have chosen to remain with the Fund over the years. Part of this competence devel-

opment process involves allocating personnel resources to areas where demand is greatest. For example, in response to the considerable expansion of the Second AP Fund's real-estate portfolio in recent years, the focus of an existing position within the Fund has been redefined to initially act more as a control function for the real-estate segment. Furthermore, during 2013, the benefits of being able to access in-house competence in systems development became manifestly obvious. The fact that this competence has been available in-house for just over a year has enabled the Fund to maintain momentum in its systems development programme, in parallel with its other IT-dependent projects.

“New markets have made – and continue to make – new demands on multiple competencies...”

**Cost efficiency of Second AP Fund, compared with international pension funds, 2004–2012, indexing**



## Cost-efficient management

For a fund manager in general, and a global pension fund in particular, determining an appropriate cost level is a complex process. Calculating costs in isolation gives an all too simplistic picture. The costs level should form part of the broad canvas instead of being seen as the primary criterion of valuation. This means adopting a holistic view, involving an assessment of revenue and risks as well as costs. It is cost-efficiency that needs to be in the spotlight.

An established method for measuring and comparing the cost efficiency of pension funds from an international perspective has been developed by CEM (Cost Effectiveness Measurement Inc.). The method enables a comparison that takes into account several factors that have a decisive impact on the overall cost of managing a fund: the volume of assets under management, the degree of assets under active management and external mandate, and the allocations for each class of asset. In the study, a pension fund's costs are compared with those of an international group of fund managers of approximately the same size and with a portfolio of similar composition. The



Second AP Fund has participated in CEM's annual benchmark study since 2004 and results confirm that the Second AP Fund has conducted its portfolio management activities in a consistently successful and cost-efficient manner.

During the year, the Fund extended its collaboration with CEM, resulting in comparisons based on parameters other than costs. The first analysis revealed that the Fund is managed effectively not only in terms of costs but, when compared with a relevant benchmark group, even in terms of the number of personnel employed in its various functions. An added benefit of this extended collaboration with CEM is the opportunity it offers for building an interesting network of contacts with the other global fund managers involved in the study, for future benchmarking.

#### **Implementation effects and rebalancing**

The fact that the credit market is occasionally subject to a high degree of volatility places special demands on flexibility, to enable adjustments in mandate and investment focus. Fund assets shall be exposed to the markets in an efficient manner, as per the strategic portfolio, and shall be rebalanced during major fluctuations in the market. The constant interaction between asset classes requires competence and a well-developed approach.

The costs and revenues attributable to the exposure and rebalancing of the strategic portfolio are referred to as 'implementation effects'. These effects can derive from forward positions, the management of foreign exchange and weight deviations between indices.

In 2013, these implementation effects have been charged against relative return in an amount of -0.13 percent.

#### **VAT**

As of 2012, the AP funds became VAT registered. Consequently, VAT is now liable on services charged from outside Sweden. Since the funds are not entitled to claim refunds on VAT paid, this VAT registration has led to a direct increase in the Fund's costs for such services.

#### **Cooperation with the other AP funds**

The decision to create four separate buffer funds was partly a way to spread risk by enabling all four funds to manage their capital assets independently, and partly a way to stimulate healthy competition between them. However, these objectives do not prevent the funds



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**The constant interaction between asset classes requires competence and a well-developed approach.**

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from cooperating in areas that offer economies of scale and a more efficient utilization of resources. During the year, to increase competence concerning the private equity market, and in addition to ongoing collaboration between several established specialist groups, the Second AP Fund arranged a joint one-day training seminar in which all the affected AP funds participated. The seminar focused on the IPEVs (International Private Equity and Venture Capital Guidelines) that are applied in the appraisal of – and reporting by – private equity funds. Furthermore, in 2013, the Fund and the Third AP Fund initiated a collaborative venture concerning the joint procurement of custodial services. The main benefits of this collaboration are the advantages that derive from a joint capital base when negotiating with potential custodial banks, as well as the effective in-house utilization of resources and a reduction on total procurement costs.



## ATTRACTIVE EMPLOYER

# Steadily growing competence

The Second AP Fund's ability to recruit new staff, retain them and contribute to their development is essential in achieving the Fund's long-term objective. A key element of this long-term strategy is to use the Fund's own resources to build up still more professional and cost-efficient portfolio management.

Since its inauguration in 2001, the Second AP Fund has enjoyed rapid development and of all the AP funds, throughout its existence, has had the largest or second largest volume of capital assets under management. Today, the Second AP Fund is an archetypal knowledge-based organization, where the specialist competencies, creativity and commitment of its staff are critical to a successful result.

## More in-house management

Seventy-five percent of the Fund's capital assets are managed in-house, involving a growing number of asset classes and strategies, placing considerable demands on its competence in different investment sectors, as well as on its business services and risk and return analysis. Among other things, the Fund started to manage equities on emerging markets in-house during the year, confident that it has both the necessary resources and competence within the organization. This is a key element of the Fund's long-term strategy to steadily build up still more professional and cost-efficient portfolio management, based on its own resources. All members of staff are offered ongoing skills development within their individual fields of competence. During the year, all members of staff have also undergone in-house training in sustainability issues, with a view to increasing everyone's competence in this area. The asset management also attended a special day-long seminar, focused on sustainability. Colleagues from Generation Investment Management, Investec and IFC, as well as from the Fund's business network, were also invited to attend the seminar and present how they are integrating sustainability into their investment processes.

## Common ethical compass

During 2013, each department has continued to work towards realizing the objectives established concerning areas for improvement, based on the employee survey conducted in 2012. The Second AP Fund's corporate culture is characterized by personal responsibility and individuality, within the broader framework of a strong team spirit. Ethical behaviour is an important element of this corporate culture, forming a self-evident feature of the new values that the Fund continued to work with during the year. As part of these efforts, the Fund held a number of workshops for all employees, in which groups discussed a range of ethical dilemmas. The aim

was to develop the common ethical compass. This is created mainly by maintaining an ongoing dialogue about such issues.

As a manager of pension assets, the Fund is entrusted with a vital task. This places considerable demands, requiring that we demonstrate sound judgement in our daily activities and that we are transparent in how we operate. Such issues are often the subject of internal discussion at the Second AP Fund. We share a common code of values and have established clearly-defined in-house policies as to how we should act. In 2012, the Fund conducted a review of all personnel-related policies. Following the review, the Fund introduced a limited number of changes, to further clarify and strengthen the policies. Over the past year, the Fund has been engaged in following up and evaluating these policies.

## Leadership training

Strong leadership is a key competitive tool in promoting the development and motivation of members of staff. The Second AP Fund's strategy defines the skills, attitudes and responsibilities that managers within the organization are expected to possess. This leadership strategy is regularly assessed, providing the basis for the drafting of an individual development plan for each manager.

## The importance of diversity

Exercise and good health are a crucial aspect of the Fund's corporate culture, and all employees are therefore offered a fitness-activity subsidy and regular medical check-ups. The Fund considers it important that its workforce should reflect diversity in terms of background, experience, age and gender. It enables men and women to combine work with family responsibilities by offering flexible working hours and working under one's own responsibility. In 2013, one man and one woman took parental leave at different times during the year.

## Remuneration

To be able to recruit and retain the right staff, the Second AP Fund strives to remunerate its employees at a level consistent with the industry at large.

## The Board's area of responsibility

The Board of Directors of the Second AP Fund determines the guidelines for remuneration to senior executives. These guidelines



are reviewed annually by the Board and shall be compatible with Swedish Government guidelines pertaining to terms of employment as applied at the AP funds. These guidelines address the actual decision-making process as well as the construction and appraisal of appropriate and reasonable remuneration within the Fund. The Board ensures that the remuneration paid to the Chief Executive and other senior executives is consistent with the Board's guidelines.

#### **Guidelines for remuneration**

The total remuneration paid to leading executives should be reasonable and well balanced. It should also be competitive and appropriate, featuring clearly defined upper limits and contributing to solid business ethics and a healthy organizational culture. These levels of remuneration are not salary-inflationary in relation to comparable institutions, but are moderate in character. The remuneration shall comprise a fixed basic salary, performance-based variable remuneration (not applicable to the Fund's executive management), pension and benefits.

#### **The Board's follow-up**

For more than a decade, the Second AP Fund has participated in the annual salary and benefits survey conducted by Towers Watson, a firm of independent analysts. This annual survey generates comparative statistics for individual positions held at relevant and comparable organizations in the financial industry. The purpose of this survey is to report on the market rate for salaries and benefits paid to different staff categories, based on data supplied by the participating companies. The Second AP Fund has used this statistical data to compare remuneration levels for all its employees. In 2013, the levels of remuneration provided by the Fund were compared with some 15 other players in the financial sector, including Swedish pension fund AMF, other AP funds, Riksbanken (Swedish Central Bank), Kammarkollegiet (Swedish Legal, Financial and Administrative Services Agency) and Riksgälden (Swedish National Debt Office).

The Fund's remuneration policy is based on the idea that the level of remuneration should be close to the median for the reference group employed in the Towers Watson salary and benefits survey. Having said this, there are certain positions that will command pay levels that exceed the median, positions that demand specialist competence deemed of particular value to the activities of the organization. The Board considers that the levels of remuneration paid to senior executives, as well as to other members of the Fund's staff, are reasonable, well balanced, competitive and appropriate, featuring clearly defined upper limits and contributing to solid business ethics and a healthy organizational culture. These levels of remuneration are not salary-inflationary in relation to comparable institutions, but are moderate in character and fall well within the parameters prescribed by the Board concerning staff remuneration. The Board is satisfied that the Fund is in compliance with Swedish Government guidelines on remuneration, apart from the period of notice. Nevertheless, the combined costs incurred in connection with a dismissal are well within the limits defined in the Swedish Government guidelines. More information on page 54–55.

#### **Performance-based variable remuneration**

The Board of Directors approves a programme for variable remuneration in line with the Swedish Government's guidelines. The Second AP Fund's incentive programme comprises all staff apart from the CEO and other members of the Executive Management Group. This incentive programme means that all other members of staff are entitled to a maximum of two months' salary in variable remuneration. The programme is linked to long-term goals calculated over three and five years. This variable remuneration may only be paid out when the Fund reports a positive total return. In 2013, a variable remuneration was paid to all employees entitled to a bonus. More about the programme at [www.ap2.se](http://www.ap2.se).

#### **Focus on internal mobility**

As a global fund manager operating across a broad range of asset classes, the Second AP Fund fosters many specialist roles and creates many career opportunities. The Second AP Fund strives first and foremost to recruit from within the organization and to encourage internal mobility. In this way, specialist skills and expertise can better be utilized. For a number of years, the Fund has cooperated with the School of Business, Economics and Law at the University of Gothenburg, and Chalmers Institute of Technology, enabling them to offer students opportunities of temporary employment on specific projects, trainee positions and temporary employment during summer vacations. This has created a recruitment base for future employees. Eight of the Fund's current members of staff have come direct from studies at the School of Business or Chalmers.

At year-end 2013, the Fund numbered 59 full-time employees, 37 percent of whom were women. Women also accounted for 29 percent of the Fund's executive management. The average age of employees was 43, as was the median age. Personnel turnover remained low during the year, with five leaving and four new staff being recruited.

#### **In-house environmental programme**

The Fund works in a number of ways to highlight and minimize the environmental impact of its own activities. The introduction of an in-house environmental management system therefore seemed entirely logical. Based on the Gothenburg City environmental certification programme, the Fund gained certification in January 2009 and has been recertified yearly since then. The system applies the same fundamental concepts as implemented by the major ISO 14001 and EMAS standards systems, but is better suited to smaller organizations. The in-house environmental audit shows that the greatest environmental impact caused by the Second AP Fund's own business activities derives from the consumption of electrical energy and from carbon dioxide emissions in conjunction with travel. In-house goals have been established based on the Fund's updated environmental policy. The Fund's in-house environmental programme is managed by a specially appointed environmental group, and environmental training is ongoing for all members of staff.





Integrating analyses of environmental issues, ethics and corporate governance as part of the portfolio management process generates better decision data for investment decisions.



# Governance issues in focus

A large part of the Second AP Fund's capital assets is placed in equities in Swedish and foreign companies, making the Fund a significant investor. The engagement and involvement of shareholders is crucial to the long-term development of companies, contributing to better value growth. For this reason, the Fund is an active investor, with a view to promoting good corporate governance, robust ethics and a sustainable environmental approach.

The Second AP Fund is responsible both for the management and governance of the assets with which it has been entrusted and works proactively with environmental, ethical and corporate governance issues in both these areas. Integrating analyses of environmental issues, ethics and corporate governance as part of the portfolio management process generates better decision data for investment decisions. As a manager of Sweden's national pension assets, the Second AP Fund has a responsibility to create value for all who have ever worked in Sweden. The Second AP Fund will act in a manner most appropriate to this task.

## **The Second AP Fund's role as investor**

The Second AP Fund's corporate governance work primarily targets companies and areas where it deems it has the greatest chance of having an impact and of doing the greatest good. In Sweden, the Second AP Fund focuses first and foremost on governance issues in companies where it is one of the largest shareholders and in companies where it has most capital invested. When matters of principle are involved, it is sometimes important for the Second AP Fund to adopt an active stance, even when this concerns a minor holding.

In its activities with regard to corporate governance in companies outside Sweden, concerning ethical and environmental issues, the Fund operates mainly through the joint Ethical Council of the AP Funds. The Fund shoulders its corporate governance responsibilities in foreign companies by exercising its voting rights in a selected number of its holdings and by engaging in follow-up dialogues with some of them. In such dialogues, the Fund presents its view of committed governance and, in some cases, explains why it cannot support a particular board proposal.

## **Revision of corporate governance policy**

The Second AP Fund revised its corporate governance policy in 2013. The intention has been to clarify the Fund's plans for contributing to robust corporate growth and consequently adding value as an investor. This revised policy also aims to increase an appreciation of

what the Second AP Fund expects of companies in areas such as the environment, ethics and corporate governance.

The Second AP Fund's governance policy now has two parts. The first specifies what the Fund expects of publicly-listed companies, and what these companies may expect of the Fund. The second part details how the Fund exercises its governance rights in non-listed holdings and private equity companies.

## **Organization and responsibilities**

The Second AP Fund's board of directors determines guidelines and policies pertaining to governance issues, entrusting day-to-day management of these issues to the Fund's CEO. The CEO is backed by an investor group featuring members of the Fund's executive management, the head of Swedish equities and the Fund's sustainability analyst. This group is responsible for the strategic and operational aspects of these activities.

The investor group targets and drafts action plans and monitors progress on an ongoing basis. At every meeting, a report on the Fund's activities within the areas of corporate governance, ethics and the environment is submitted to the board of directors.

## **Remuneration issues**

The Second AP Fund continued to maintain its focus on remuneration issues in 2013, conducting a number of dialogues with the boards of portfolio companies concerning the formulation of incentive programmes, with a view to achieving improvements. The Fund is legally required to formulate an independent corporate governance policy that shall serve to promote its objectives in the most effective way. In December 2013, the Board of Directors decided to introduce an updated version of this policy. This updated version features a section on management and executive remuneration, providing a basis for the Fund's work on remuneration issues within its portfolio companies. The Fund considers variable remuneration may form an integral part of a remuneration model if, in combination with the other elements, it promotes the company's long-term sustainable



development. In most respects, the Fund notes that its new corporate governance policy complies with Swedish Government guidelines on remuneration. The guidelines governing remuneration at the Fund's non-listed real-estate companies comply with the Swedish Government guidelines.

### **Diversity**

For several years now, the Second AP Fund has stressed the importance of increasing the number of women on the boards of publicly-listed companies, and duly observes this principle when participating in the nomination process. The Fund also feels that nomination committees should draft a concrete plan to attain the most appropriate board composition, with respect to gender, age, background, experience and competence. More about the Fund's annual Female Representation Index at [www.ap2.se](http://www.ap2.se)

### **Voting at AGMs**

The AGM is the primary forum in which shareholders are able to exercise their influence. Being able to exercise your voting right as a shareholder at the AGM is one of the most important opportunities available for influencing a company. This is why the Second AP Fund is active at both Swedish and foreign AGMs.

The Fund has holdings in some 250 Swedish companies. It has decided that it is impractical to attempt to attend and vote at the AGMs of all the companies represented in its portfolio of Swedish equities. The Second AP Fund exercised its voting rights at a total of 50 AGMs of Swedish publicly-listed companies during 2013. The Second AP Fund and other institutional investors have for many years enjoyed a positive and constructive dialogue with Swedish publicly-listed companies, which have included discussions about many of the issues raised at AGMs.

During the year, the Fund exercised its voting rights by proxy at 506 foreign AGMs held by 492 different companies. The Fund voted against proposals concerning remuneration issues in 63 percent of these foreign companies. Further details of how the Second AP Fund voted on specific issues may be found at [www.ap2.se](http://www.ap2.se)

### **Nomination committees**

The Second AP Fund favours having a representative on the nomination committees of portfolio companies, as this provides a valuable opportunity to exercise investor influence. The Fund practices a policy of accepting all invitations to participate in the nomination process. Prior to the start of the 2013 AGM season, the Second AP Fund was represented on the Opus Group nomination committee, as chair, as well as on the nomination committee of Melker Schörling AB. In

the run-up to the 2014 AGM season, the Fund will be represented on the nomination committees of Opus Group and Ratos, as chair, and on the nomination committees of Kungsleden and Semcon.

### **Ethical Council**

The Ethical Council is a joint council that was formed by the First, Second, Third and Fourth AP Funds in 2007. It monitors and analyses the AP Funds' portfolios of foreign equities, to prevent companies from contravening international conventions to which Sweden is a signatory. The work of the Ethical Council is based on the principles of engagement, active ownership and change, with the aim of making a difference. The Ethical Council identifies companies that can be linked to the violation of a convention and act concretely to persuade companies to deal with documented breaches of conventions and to implement systems and measures to prevent future violations. The Ethical Council also works proactively to prevent violations by initiating a dialogue with individual companies, as well as by a range of initiatives focused on different industries or specific issues.

Dialogues are one of the Ethical Council's essential instruments in influencing companies. The Council believes that active ownership is the best way to achieve change. Even if the funds sell their holdings, this fails to eliminate the problem, and the violations continue. As an absolutely final resort, the Ethical Council can recommend that the fund in question exclude a company from its investment universe, when the prospects of making a difference seem hopeless. In 2012, the Second AP Fund chaired the Ethical Council. More at [www.ethicalcouncil.com](http://www.ethicalcouncil.com)

### **Collaboration with other investors**

In addition to cooperating with the other AP funds through the Ethical Council, the Second AP Fund is both a member of and actively supports various Swedish and international initiatives focused on the environment, ethics and corporate governance.

The Fund also collaborates with other investors on influencing new legislation, mainly within the field of corporate governance. These forms of collaboration are becoming increasingly important as a means to influence and effect change and thereby improve share value over the long term. Further details of the Second AP Fund's memberships and initiatives at [www.ap2.se](http://www.ap2.se)

### **Integration of ESG<sup>1</sup> in portfolio management**

The Fund is convinced that a positive long-term approach to the environment, ethics and corporate governance enhances a company's value. For these reasons, the Second AP Fund integrates corporate governance, ethics and environmental concerns into its asset

<sup>1</sup>ESG (Environment, Social and Governance).



management strategy, in the knowledge that this provides a sounder basis for analysis and investment decisions. By adopting a proactive stance on ethical and environmental issues, the Second AP Fund can help its portfolio companies identify the opportunities and risks that affect return.

The Second AP Fund is a signatory to the UN's Principles for Responsible Investment (PRI) initiative. Implementing these Principles is an ongoing job, requiring the Second AP Fund's active commitment to sustainability issues both as pension fund manager and investor.

Although the Fund's corporate governance work focuses primarily on its portfolio of listed equities, it also works on integrating aspects of sustainability within other asset classes, such as in its investments in forest-and-agricultural real estate. For example, in partnership with a group of other international investors, the Fund has developed a set of principles for responsible investment in agriculture. Sustainability issues are central to the Second AP Fund's investments in agriculture and form part of the actual investment decision. The Fund integrates sustainability into the management of its fixed-income portfolio too, by investing in 'green bonds'.

For some years now, the Second AP Fund has addressed the question of how private equity companies can be better at integrating sustainability issues into their day-to-day operations by initiating direct dialogues with them. In the past year, in collaboration with the private equity industry in eleven countries, the Fund has developed a framework that investors can utilize in their dealings with private equity companies, when they state their reporting requirements with regard to ethical, environmental and corporate governance issues.

The Second AP Fund has included these issues in its appraisal of private equity funds. During the year, the Fund has also developed a structured process for analysis, appraisal and follow-up, which as

well as sustainability includes fund economy, as well as risk and return analysis. This process can also be applied to the Fund's real-estate investments, including those in forest and agricultural assets.

A survey was conducted in 2013 to determine how the private equity companies in the Fund's current portfolio deal with sustainability issues, both within their own organizations and with regard to their portfolio companies. The survey revealed that all the companies in the survey included sustainability to some extent when valuing portfolio companies, but that there were considerable differences in how portfolio managers addressed the issue. However, all these issues are highlighted in some form when acquiring new portfolio companies.

To create greater understanding and awareness of sustainability issues among employees, the Second AP Fund arranged a number of seminars and training sessions during the year. These events included a special day-long seminar for portfolio managers on sustainability issues and how they might be better integrated into investment processes. This type of activity is important in facilitating the integration of sustainability concerns into the day-to-day business of the Fund.

#### **Annual Corporate Governance Report**

More detailed information on the Fund's corporate governance activities and its actions at AGMs will be presented in conjunction with the release of the Fund's annual Corporate Governance Report. More at [www.ap2.se](http://www.ap2.se)



More on our corporate governance activities at  
[www.ap2.se](http://www.ap2.se)

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# Income statement

Amounts in SEK million	Note	January–December 2013	January–December 2012
<b>Operating income</b>			
Net interest income	1	3 428	6 647
Dividends received		3 317	2 963
Net result, listed equities and participations	2	24 753	15 557
Net result, non-listed equities and participations	3	3 679	2 657
Net result, fixed-income assets		–1 913	3 848
Net result, derivative instruments		–278	1 241
Net result, exchange gain/loss		–2 425	–3 921
Commission expenses, net	4	–245	–203
<b>Total operating income</b>		<b>30 316</b>	<b>28 789</b>
<b>Operating expenses</b>			
Personnel expenses	5	–112	–101
Other administration expenses	6	–66	–68
<b>Total operating expenses</b>		<b>–178</b>	<b>–169</b>
<b>NET RESULT FOR THE YEAR</b>		<b>30 138</b>	<b>28 620</b>



# Balance sheet

Amounts in SEK million	Note	December 31, 2013	December 31, 2012
<b>ASSETS</b>			
Equities and participations			
Listed	7	129 335	109 747
Non-listed	8	30 508	25 412
Bonds and other fixed-income assets	9	91 279	92 224
Derivative instruments	10	9 582	10 260
Cash and bank balances		2 383	2 987
Other assets	11	951	184
Prepaid costs and accrued income	12	1 656	1 740
<b>TOTAL ASSETS</b>		<b>265 694</b>	<b>242 554</b>
<b>FUND CAPITAL AND LIABILITIES</b>			
<b>Liabilities</b>			
Derivative instruments	10	897	873
Other liabilities	13	20	119
Deferred income and accrued expenses	14	65	108
<b>Total liabilities</b>		<b>982</b>	<b>1 100</b>
<b>Fund capital</b>			
	15		
Fund capital at beginning of year		241 454	216 622
Net payments to the national pension system		–6 880	–3 788
Net result for the year		30 138	28 620
<b>Total fund capital</b>		<b>264 712</b>	<b>241 454</b>
<b>TOTAL FUND CAPITAL AND LIABILITIES</b>		<b>265 694</b>	<b>242 554</b>
<b>Pledged assets, contingent liabilities and commitments</b>			
	16		
Other assets pledged and comparable collateral		1 067	1 879
Commitments		8 650	8 650



# Accounting and valuation principles

The Second Swedish National Pension Fund, corporate identity number 857209-0606, is one of the 'buffer' funds of the Swedish National Pension System, based in Gothenburg, Sweden. The annual report for fiscal 2013 was approved by the Board of Directors on February 5, 2014. The income statement and balance sheet shall be adopted by the Swedish Government.

The annual report shall be prepared in accordance with the "Act concerning National Pension Funds (2000:192)" and implemented in line with generally accepted accounting principles, on the understanding that the assets in which the Fund's capital is invested shall be booked at market value. On this basis, the First to Fourth AP funds have drafted and implemented joint accounting and valuation principles, as applied and summarized below. The accounting and valuation principles are unchanged from the preceding year. For a review of the fair value adopted for non-listed real-estate equities, see Non-listed equities and participations below.

The AP funds' accounting and valuation principles are being gradually adjusted to comply with the international IFRS accounting standard. Since the IFRS standard is currently undergoing extensive revision, this adjustment process has focused on the IFRS 7 and IFRS 13 information requirement during the year. Full compliance with the IFRS standard would not essentially affect the reported net result and capital assets. Compared with the current IFRS standard, the only significant difference is that no consolidated financial statements or cash flow analyses have been drawn up.

## Transaction-date accounting

Transactions in securities and derivative instruments on the money and bond market, equities market and currency market are reported in the balance sheet on the transaction date, which is to say the date on which the significant rights and thereby risks are transferred between parties. The claim on or debt to the other party, between transaction date and settlement day, is reported under Other assets or Other liabilities. Other transactions, especially transactions involving non-listed equities, are reported in the balance sheet as per settlement day, in line with generally accepted market practice.

## Net accounting

Net accounting is applied to the Fund's liquid assets, buy-backs and derivative instruments, where there is a real right of set-off for assets and liabilities, and where the intention is simultaneous liquidation.

## FX conversion

Transactions in foreign exchange are converted into Swedish kronor at the rate applied on the transaction date. On the accounting date, assets and liabilities in foreign currency are converted into Swedish kronor at closing day rates.

Changes in the value of assets and liabilities in foreign currency are separated into that part attributable to the change in value of the asset or liability, and that part attributable to the change in the exchange rate. The exchange rate differential arising due to the change in the exchange rate is reported in the income statement under Net result, exchange gain/loss.

## Equities in subsidiaries/associated companies

In compliance with the Swedish National Pension Funds Act, equities in subsidiaries/associated companies are recorded at their fair value. Fair value is determined by the same methods applied to non-listed equities and participations. There is no requirement to draw up consolidated financial statements.

## Valuation of financial instruments

All Fund investments are calculated at their fair value, whereby realized and unrealized changes in value are reported in the income statement. Consequently, realized and unrealized gains/losses per asset class are included under Net result. In cases where reference below is made to the selected index supplier, refer to page 13 of the annual report for information about current indices. For a description of how fair value is determined for the Fund's numerous investments, see below.

## Listed equities and participations

In the case of equities and participations traded on a regulated market or trading platform, fair value is based on the official market rate applied at the balance-sheet date, according to the Fund's selected index supplier, often the average market rate. Holdings not included in the index are valued at the listed rates observable in an active market. Commissions paid are taken up as income under Net result, listed equities.

## Non-listed equities and participations

As regards equities and participations not traded on a regulated market or trading platform, fair value is based on the valuation made by the counterparty or other external party. This valuation is updated once the new valuation has been received and adjusted for eventual cash flows up to the end of the accounting period. In cases where the Fund has good reason to believe that the value assigned by the Fund administrator is incorrect, the received value is adjusted.

The valuation of non-listed participations shall follow IPEV (International Private Equity and Venture Capital Valuation) Guidelines or simi-



lar valuation principles, first and foremost being based on transactions with third parties, although other valuation techniques may also be employed.

The valuation of non-listed real-estate equities is based on the material value method, in as far as the equity has not been the subject of transactions on a resale market. A method for appraising the value of holdings in non-listed real-estate companies has been developed, with a view to securing an estimate of their fair value. Consequently, as of 2013, deferred tax liabilities are reported at the value recorded at the time of the real-estate transaction, which differs from the valuation as reported in the accounts of the real-estate companies. This adjusted method for calculating fair value has affected the net result for the year: see Note 3 Net result, non-listed equities and participations.

#### ***Bonds and other fixed-income securities***

For bonds and other fixed-income assets, fair value is based on the official market rate (usually the bid rate) applied on the balance-sheet date, according to the Fund's selected index supplier. Holdings not included in the index are valued at the listed rates observable in an active market. In cases where such instruments are not traded on an active market, and where no reliable listed market rates are available, the instrument shall be valued with the support of generally accepted theoretical models, whereby cash flows are discounted according to an appropriate valuation scale.

Interest calculated according to the effective interest method, based on accrued acquisition value, is reported as interest income. The accrued acquisition value is the net present value of future payments, where the discount rate is the compound interest at the time of acquisition. This means that acquired premiums or discounts are accrual accounted over the security's remaining term or until the next adjustment in the interest rate – and are reported as interest income.

#### ***Derivative instruments***

Where derivative instruments are concerned, fair value is based on their listed rates at year-end. In cases where such instruments are not traded on an active market, and where no reliable listed market rates are available, the instrument shall be valued with the support of generally accepted theoretical models, where input data consists exclusively of observable market data.

Derivative contracts with a positive market value on the balance sheet date are reported as investment assets, while transactions with a negative market value are reported as liabilities. The difference arising between the forward rate and the spot rate on exchange forwards is straight-line accounted over the term of the forward contract, and is reported as interest.

#### ***Buy-backs***

In a true buy-back transaction, also known as a repurchase agreement, the asset sold is still reported in the balance sheet and the payment received is reported as a liability. The sold security is reported

as a pledged asset among memorandum items in the balance sheet. The difference between spot payment and forward rate is accrual accounted over the term and reported as interest.

#### ***Securities lending***

Securities on loan are reported in the balance sheet at their fair value, while premiums received are reported as interest income in the income statement. Collateral received for securities lent consists of securities and cash. In cases where the Second AP Fund has rights of disposal over the cash received as collateral, this is reported in the balance sheet as an asset and a corresponding liability. In other instances, collateral received is reported not in the balance sheet, but separately, under Memorandum items. The net worth of securities on loan and their collateral is also reported under this heading.

#### ***Items entered directly against Fund capital***

Contributions to and disbursements from the pension system are entered directly against Fund capital.

#### ***Commission expenses***

Commission expenses are reported in the income statement as a deduction under operating income. These comprise direct transaction costs such as custodial fees and fixed fees to external portfolio managers, as well as fixed fees for market-listed funds. The performance-based fee, which is paid out if the portfolio manager attains a return on investment in excess of the agreed level, where profit-sharing is applied, is reported as a deductible item under net result per asset class in the income statement.

Commissions and fees paid for the external management of non-listed assets, where reimbursement is permitted prior to profit sharing and is deemed likely, are reported as acquisition expenses and are therefore included in the unrealized result. In other cases, they are reported as commission costs.

#### ***Operating expenses***

All expenses incurred, excluding brokerage commissions, performance-based fees to external portfolio managers and commission costs, are reported under operating expenses.

Investments in equipment and in-house developed and externally purchased software are booked on current account.

#### ***Tax***

The AP Funds are exempt from all income tax on investments in Sweden. The tax some countries levy on dividends, as well as withholding tax, is net accounted in the income statement under respective income classes. As of 2012, the Second AP Fund became VAT registered. Consequently, VAT is now liable on services charged outside Sweden. It is therefore not entitled to recover invoiced VAT. VAT paid and for which provision has been made in the accounts is reported together with the respective cost item.



# Notes to the income statement and balance sheet

## 1 Net interest income/expense

Amounts in SEK million	Jan.–Dec. 2013	Jan.–Dec. 2012
<b>Interest income</b>		
Bonds and other fixed-income assets	2 248	3 337
Derivative instruments	4 458	4 471
Other interest income	89	60
<b>Total interest income</b>	<b>6 795</b>	<b>7 868</b>
<b>Interest expenses</b>		
Derivative instruments	–3 318	–1 186
Other interest expenses	–49	–35
<b>Total interest expenses</b>	<b>–3 367</b>	<b>–1 221</b>
<b>Net interest income/expense</b>	<b>3 428</b>	<b>6 647</b>

## 2 Net result, listed equities and participations

Amounts in SEK million	Jan.–Dec. 2013	Jan.–Dec. 2012
Net result, listed equities and participations	24 823	15 614
less brokerage commission	–70	–57
<b>Net result, listed equities and participations</b>	<b>24 753</b>	<b>15 557</b>

## 3 Net result, non-listed equities and participations

Amounts in SEK million	Jan.–Dec. 2013	Jan.–Dec. 2012
Capital gains, net	565	748
Unrealized changes in value*	3 114	1 909
<b>Net result, non-listed equities and participations</b>	<b>3 679</b>	<b>2 657</b>

\* Unrealized changes in value include management fees of SEK 138 (172) million, refunded in 2013.

A method for appraising the value of holdings in non-listed real-estate companies has been developed, with a view to securing an estimate of their fair value. Consequently, as of 2013, deferred tax liabilities are reported at the value recorded at the time of the real-estate transaction, which differs from the valuation as reported in the accounts of the real-estate companies. This adjusted method for calculating fair value has affected the net result for the year in an amount of SEK 969 million, of which SEK 766 million is deemed attributable to previous years. The impact on the result derives primarily from the Fund's interest in Vasakronan.

## 4 Commission expenses, net

Amounts in SEK million	Jan.–Dec. 2013	Jan.–Dec. 2012
External portfolio management fees, listed assets	226	189
External portfolio management fees, non-listed assets	4	4
Other commission expenses including custodial expenses	15	10
<b>Total commission expenses</b>	<b>245</b>	<b>203</b>

Commission expenses do not include performance-based expenses. During the year, performance-based expenses amounted to SEK 74 (60) million and reduce the net gain for respective asset classes. External portfolio management fees for non-listed assets are reported under commission expenses in so far as the contracts do not permit repayment prior to profit sharing in conjunction with future profitable exits.

During 2013, a total of SEK 161 (149) million has been paid in management fees for non-listed assets. Of these, SEK 157 (145) million pertains to agreements concerning repayment of management fees paid prior to profit-sharing on sale of assets. These are reported as part of the asset's acquisition value.



# Cont. Note 4

## Distribution of Fund capital between external mandates and in-house portfolio management as per December 31, 2013, SEK million

Mandate	Benchmark index	Average capital under management 2013	Dec. 31, 2013* Market value	% of Fund capital	External management expense
<b>External discretionary mandates</b>					
Equity mandates					
Active management					
MFS	Global equities	MSCI World	7 632	8 473	
APS	Chinese equities	MSCI China Series A	646	646	
Cephei	Chinese equities	MSCI China Series A	647	647	
<b>Total</b>		<b>8 925</b>	<b>9 766</b>	<b>4</b>	<b>30</b>
Fixed-income mandates					
Active management					
Rogge	Global credit mandate	Barclays Global Credit	4 718	4 694	
Pimco	Global credit mandate	Barclays Global Credit	4 757	5 279	
Standish	Global credit mandate	Barclays Global Credit	4 843	5 246	
<b>Total</b>		<b>14 318</b>	<b>15 219</b>	<b>6</b>	<b>31</b>
GTAA mandates					
Active management					
First Quadrant					3
<b>Total external discretionary mandates</b>		<b>23 243</b>	<b>24 985</b>	<b>10</b>	<b>64</b>
<b>Investments in listed external funds</b>					
Equity funds	as per respective fund	17 336	6 986		
Fixed-income funds	as per respective fund	22 514	18 236		
GTAA funds	as per respective fund	2 094	1 261		
<b>Total investments in listed external funds</b>		<b>41 944</b>	<b>26 483</b>	<b>10</b>	<b>162</b>
<b>Investments in non-listed private equity funds, forest-and-agricultural real estate</b>		<b>13 016</b>	<b>14 039</b>	<b>5</b>	<b>4</b>
<b>TOTAL CAPITAL ASSETS UNDER EXTERNAL MANAGEMENT AND MANAGEMENT EXPENSES</b>		<b>78 203</b>	<b>65 507</b>	<b>25</b>	<b>230</b>
<b>In-house management mandates</b>					
Listed equities and participations	SBX, SEW, CSRX, MSCI		117 975		
Fixed-income mandates including convertibles in alternative investments	SHB, Barclays, JP Morgan		59 419		
Cash and bank balances			-103		
Non-listed equities in associated companies, including subordinated debentures			21 914		
<b>TOTAL CAPITAL ASSETS UNDER IN-HOUSE MANAGEMENT</b>			<b>199 205</b>	<b>75</b>	
<b>Other assets and liabilities</b>			<b>0</b>		
<b>TOTAL FUND CAPITAL</b>			<b>264 712</b>	<b>100</b>	

\* Market value including allocated liquidity, derivative instruments and accrued interest.



## 5 Personnel

Number of employees	2013			2012		
	Total	Men	Women	Total	Men	Women
Average number of employees	60	38	22	59	37	22
Number of employees, December 31*	59	37	22	60	37	23
Number of persons in Executive Management Group, December 31	7	5	2	7	5	2

\* At year-end 2013, the Fund had 59 full-time employees.

Personnel costs in SEK k, 2013	Salaries and remuneration	Variable remuneration	Pension costs	Social costs incl. special employer's contribution	Total
Chair of the Board	104	–	–	34	138
CEO	3 083	–	1 233	1 288	5 604
Board of Directors, excluding Chair	609	–	–	191	800
<b>Executive Management Group, excl. CEO</b>					
Chief Investment Officer (CIO)	2 769	–	781	1 080	4 630
Head of IT, Business Control and Accounts	1 422	–	643	616	2 681
Chief Investment Strategist (CIS)	2 156	–	792	888	3 836
General Counsel	2 039	–	612	807	3 458
Head of Communication & HR	1 572	–	694	697	2 963
Head of Performance and Risk Management	1 516	–	480	593	2 589
Other employees	43 298	4 466	16 007	18 624	82 395
<b>Total</b>	<b>58 568</b>	<b>4 466</b>	<b>21 242</b>	<b>24 818</b>	<b>109 094</b>
Other personnel costs					3 283
<b>Total personnel costs</b>					<b>112 377</b>

Personnel costs in SEK k, 2012	Salaries and remuneration	Variable remuneration	Pension costs	Social costs incl. special employer's contribution	Total
Chair of the Board	100	–	–	32	132
CEO	2 834	–	1 078	1 170	5 082
Board of Directors, excluding Chair	305	–	–	95	400
<b>Executive Management Group excl. CEO</b>					
Chief Investment Officer (CIO)	2 601	–	781	1 027	4 409
Head of IT, Business Control and Accounts	1 261	–	565	549	2 375
Chief Investment Strategist (CIS)	2 262	–	716	903	3 881
General Counsel	1 965	–	611	784	3 360
Head of Communication & HR	1 506	–	646	663	2 815
Head of Performance and Risk Management	1 234	–	680	554	2 468
Other employees	40 734	1 734	14 647	16 732	73 847
<b>Total</b>	<b>54 802</b>	<b>1 734</b>	<b>19 724</b>	<b>22 509</b>	<b>98 769</b>
Other personnel costs					2 482
<b>Total personnel costs</b>					<b>101 251</b>

### Board of Directors

Fees and other remuneration paid to the Board are determined by the Swedish Government. This remuneration is paid yearly in the following amounts: to the Chair, SEK 100 000; to the Vice Chair, SEK 75 000 and to each of the other directors, SEK 50 000. The Swedish Government has determined that remuneration totalling SEK 100 000 may be paid for committee work carried out by board members. No remuneration has been paid to board members for their work on the Remuneration Committee. Work on the Risk Committee is remunerated as follows: SEK 30 000 to the Chair and SEK 25 000 to the other directors. Work on the Audit Committee is remunerated as follows: SEK 20 000 to the Chair and SEK 15 000 to the other directors.

### Other directorships held by Members of the Board

See page 70.

### CEO

In the CEO's contract of employment, the Fund undertakes to pay pension benefits and health insurance up to a pensionable age of 65 years, in the form of an annual premium corresponding to 30 percent of the gross salary. Where the contract of employment is terminated by the Fund, the CEO is entitled to a severance payment equivalent to eighteen months' salary, in addition to salary paid during the six-month period of notice, less income from an eventual new appointment. The severance payment is calculated according to the cash



monthly salary received at the end of the notice period. Benefits received by the CEO amount to SEK 66 (59) k.

#### Executive Management Group

In addition to salaries, other remuneration and pension contributions, the Executive Management Group has received benefits as per the following disclosure: Chief Investment Officer (CIO), SEK 66 (32) k; Head of IT, Business Control & Accounts, SEK 44 (49) k; Chief Investment Strategist (CIS), SEK 58 (60) k; General Counsel, SEK 58 (58) k; Head of Communication & HR, SEK 61 (59) k and Head of Performance & Risk Management, SEK 1 (3) k. Members of the Fund's executive management are not covered by the terms of the programme for performance-based variable remuneration. Senior executives come under the terms of the retirement benefit agreement between BAO (The Employers' Organization of the Swedish Banking Institutions) and JU SEK/CR/CF (SACO), The Swedish Confederation of Professional Associations. Swedish Government guidelines specify six months' notice and eighteen months' severance pay for senior executives. Senior executives of the Second AP Fund, who were appointed before these Government guidelines came into force, are entitled to twelve months' notice without severance pay. These terms have not been renegotiated, as this would incur higher costs for the Fund.

#### Salary swap

All employees are offered the opportunity to swap part of their salary for an additional pension benefit.

#### Variable remuneration

The Board of Directors has approved a programme for variable remuneration in line with the Swedish Government's guidelines. In 2013, the Second AP Fund's incentive programme comprised all staff apart from the CEO and other members of the Executive Management Group. This incentive programme meant that all other members of staff were entitled to a maximum of two months' salary in variable remuneration. The programme is linked to long term goals. This variable remuneration may only be paid out when the Fund reports a positive return. The extent of the programme is presented on the Fund's website at [www.ap2.se](http://www.ap2.se).

#### Drafting and decision process

The remuneration paid to the Board of Directors is determined by the Swedish Government. The Board determines the CEO's salary and the guidelines applied in remunerating the Fund's senior executives.

#### Government guidelines

For a number of years now, the Second AP Fund has participated in the Towers Watson salary and benefits survey. The purpose of this survey is to report on the market rate for salaries and benefits paid to different staff categories, based on data supplied by the participating companies. The Second AP Fund has used this statistical data to compare remuneration levels for all its employees. In 2013, the levels of remuneration provided by the Fund were compared with some 15 other players in the financial sector, including Swedish pension fund AMF, the other AP funds, Riksbanken (Swedish Central Bank), Kammarkollegiet (Swedish Legal, Financial and Administrative Services Agency) and Riksgälden (Swedish National Debt Office). The Fund's remuneration policy is based on the idea that the level of remuneration should be close to the median for the reference group employed in the Towers Watson salary and benefits survey.

The Board considers that the levels of remuneration paid to senior executives, as well as to other members of the Fund's staff, are reasonable, well balanced, competitive and appropriate, featuring clearly defined upper limits and contributing to solid business ethics and a healthy organizational culture. These levels of remuneration are not salary-inflationary in relation to comparable institutions, but are moderate in character and fall well within the parameters prescribed by the Board concerning staff remuneration. The Board is satisfied that the Fund is in compliance with Swedish Government guidelines on remuneration, apart from the above mentioned exceptions regarding the period of notice. Nevertheless, the combined costs incurred in connection with a dismissal are well within the limits defined in the Swedish Government guidelines. More information at [www.ap2.se](http://www.ap2.se)

## 6 Other administrative expenses

Amounts in SEK million	Jan.–Dec. 2013	Jan.–Dec. 2012
Rental expenses	5	5
Information and IT expenses	38	40
Purchased services	10	10
Other expenses	13	13
<b>Total other administrative expenses</b>	<b>66</b>	<b>68</b>
<b>Fees to auditors</b>		
Audit assignments		
EY	0.72	0.76
Accounting activities in addition to audit assignments		
EY	0.09	0.09
<b>Total remuneration to EY</b>	<b>0.81</b>	<b>0.85</b>

## 7 Equities and participations, listed

Amounts in SEK million	December 31 2013	December 31 2012
Swedish equities	31 236	27 080
Foreign equities	89 852	63 395
Participations in foreign funds*	8 247	19 272
<b>Total listed equities and participations</b>	<b>129 335</b>	<b>109 747</b>
* of which participations in mixed funds	1 259	2 056

Like others engaged in long-term asset management, the Second AP Fund is also active in securities lending. This lending concerns foreign equities and is to counterparties that have high credit ratings and that provide guarantees corresponding to about 105 percent of the market value of the pledged securities. Both the administration and management of the guarantees secured for the loans has been transferred from the Fund's custodial bank to an external party during 2013, as part of a strategy to transform the Fund's securities lending activities into a more active business area. Discussions are in progress with an additional party that the Fund believes may be expected to contribute in the form of a good risk spread and an increased return on pledged securities. In 2013, total income from pledged securities amounted to SEK 35 million. This income made a positive contribution to the Fund's relative return and is reported as interest income in the income statement. The guarantees secured for securities pledged are reported in Note 16.

The 20 largest Swedish and foreign shareholdings, by value, are listed on pages 63–65.

A complete list of Swedish and foreign holdings may be found on the Fund's website at [www.ap2.se](http://www.ap2.se)

## 8 Equities and participations, non-listed

Amounts in SEK million	December 31 2013	December 31 2012
Equities in Swedish associated companies	13 682	11 391
Equities in foreign associated companies	4 872	3 664
Equities in other non-listed Swedish companies	10	23
Equities in other non-listed foreign companies	11 944	10 334
<b>Total non-listed equities and participations</b>	<b>30 508</b>	<b>25 412</b>



## Cont. Note 8

Amounts in SEK million	Corp. Reg.	Registered office	No. of equities	Participation right capital/votes, %	Dec. 31, 2013 Fair value	Dec. 31, 2012 Fair value	Equity	Result
<b>Swedish equities and participations, associated and subsidiary companies</b>								
Cityhold Property AB	556845-8631	Stockholm	2 820 342	50	1 406	1 116	2 232*	-31*
NS Holding AB	556594-3999	Sundsvall	1 819 884	50	5 266	5 143	6 996*	16*
Vasakronan Holding AB	556650-4196	Stockholm	1 000 000	25	7 010	5 131	24 357**	3 844**
<b>Foreign equities and participations, associated and subsidiary companies</b>								
U.S Office Holding LP		New York, USA		41	2 785	2 583		
TIAA - CREF Global Agriculture LLC		New York, USA		23	2 087	1 081		

Amounts in SEK million	Registered office	Capital participation, %	Dec. 31, 2013 Acquisition value	Dec. 31, 2012 Acquisition value
<b>Other non-listed Swedish equities and participations</b>				
EQT Northern Europe KB	Stockholm	1	63	64
Swedstart Life Science KB	Stockholm	5	10	10
Swedstart Tech KB	Stockholm	3	8	9
<b>Five largest holdings in other non-listed foreign equities and participations</b>				
Pathway Private Equity Fund IXB	USA	99	1 158	1 142
Pathway Private Equity Fund IXC	USA	99	755	646
Pathway Private Equity Fund IX	USA	99	634	666
Nordic Capital VI	Jersey	3	390	424
Nordic Capital VII	Jersey	1	376	366

\* Refers to figures published as per December 31, 2012. \*\* Refers to figures published as per December 31, 2013.

See Note 3 re. changed method for calculating fair value for non-listed real-estate companies.

A complete list of Swedish and foreign non-listed shareholdings is available on the Fund's website at [www.ap2.se](http://www.ap2.se)

## 9

## Bonds and other fixed-income securities

Amounts in SEK million	December 31, 2013 Fair value	December 31, 2012 Fair value
Swedish State	10 208	10 862
Swedish municipalities	40	1 150
Swedish mortgage institutions	19 251	17 034
Other Swedish issuers		
Financial companies	11 618	9 948
Non-financial companies	3 012	3 838
Foreign states	5 059	8 130
Other foreign issuers	40 673	39 582
Deposits	1 418	1 680
<b>Total</b>	<b>91 279</b>	<b>92 224</b>
Other bonds	68 620	65 919
Certificates	—	1 939
Non-listed loans	3 000	3 781
Participations in foreign fixed-income funds	18 241	18 905
Deposits	1 418	1 680
<b>Total</b>	<b>91 279</b>	<b>92 224</b>



## 10 Derivative instruments

Amounts in SEK million	December 31, 2013			December 31, 2012		
	Nominal amount*	Fair value, positive	Fair value, negative	Nominal amount*	Fair value, positive	Fair value, negative
<b>Equities-linked instruments</b>						
Options, held	3	3	–	0	17	–
Options, pledged	3	–	13	0	–	0
Forward contracts	6	109	0	7	37	0
Equity linked note	6 423	7 027	–	6 505	7 123	–
<b>Total</b>	<b>6 435</b>	<b>7 139</b>	<b>13</b>	<b>6 512</b>	<b>7 177</b>	<b>0</b>
of which cleared	12			8		
<b>Index-linked instruments</b>						
Options, held	106	29	11	–	–	–
Options, pledged	213	16	27	180	24	23
FRA/futures	122 023	44	18	129 529	26	13
Swaps	1 000	76	–	1 000	12	–
<b>Total</b>	<b>123 342</b>	<b>165</b>	<b>56</b>	<b>130 709</b>	<b>62</b>	<b>36</b>
of which cleared	122 333			129 700		
<b>Currency-linked instruments</b>						
Options, held	6 590	9	–	400	3	–
Options, pledged	6 239	–	5	1 247	–	1
Futures	176 766	2 269	823	207 093	3 018	836
<b>Total</b>	<b>189 595</b>	<b>2 278</b>	<b>828</b>	<b>208 740</b>	<b>3 021</b>	<b>837</b>
of which cleared	–			–		
<b>Total derivative instruments</b>	<b>319 372</b>	<b>9 582</b>	<b>897</b>	<b>345 961</b>	<b>10 260</b>	<b>873</b>

\* Nominal amount refers to the number of contracts multiplied by the contract amount for the derivative instruments' absolute amount. The amount thereby includes both forward contracts purchased and sold, gross.

All derivatives with negative fair values have a maturity of less than twelve months. Pledged put options are part of the Fund's strategy for reducing total risk. The net position of put options features a limit on maximum loss. In the case of currency options sold, the Fund is always required to meet the commitments specified in the options contract, i.e. once the Fund has sold a currency option, the buyer is entitled to utilize the option, whether favourable or not in comparison to the current rate. Where other put options are concerned, the Fund is not subject to any special delivery requirement.

### Use of derivative instruments

Derivative instruments are the primary means of hedging the Fund's portfolios. They also contribute to more efficient asset management, create added value and reduce risk. The employment of derivative instruments is governed according to the Fund's business plan. Restrictions include the injunction that call options and forward contracts may only be issued if adequate collateral is available in the form of holdings in underlying assets. During 2013, derivative instruments have principally been utilized in the following areas:

- Foreign exchange derivatives – forward contracts and options – for managing the Fund's FX exposure.
- Equity derivatives – mainly standardized equity-index forward contracts – for efficient rebalancing of the portfolio and when adopting positions in tactical asset allocation.

- Interest derivatives – mostly standardized interest forwards and interest-rate swaps – for rebalancing, tactical asset allocation and managing the Fund's interest risk. Limited utilization of interest options to position the Fund in respect of interest risk.
- Structured derivatives – not strictly exposed to a single asset class – such as dividend forwards. These derivatives are utilized to generate relative return.
- The adopting of positions within the framework of the Fund's GTAA mandates is handled with the help of derivatives. These mandates are able to act freely with the help of short and long positions in the permitted asset classes. This said, these mandates are not permitted to adopt a net long position.

Exposure in derivative instruments is subject to ongoing monitoring and analysis. Equity and interest derivatives are traded mainly on standardized markets in cleared products, which is why counterparty risks only are limited to the clearing institute. Trading in currency and credit market derivative instruments is not standardized. Consequently, both counterparty and delivery risks exist with respect to the Fund's counterparties.

The CEO approves and determines limits for those counterparties the Fund utilizes for non-standardized products and the exposure is subject to ongoing monitoring. For OTC trading, the Fund requires standardized contracts, such as ISDA contracts.



## 11 Other assets

Amounts in SEK million	Dec. 31, 2013	Dec. 31, 2012
Incoming payments, unsettled transactions	947	180
Other receivables	4	4
<b>Total</b>	<b>951</b>	<b>184</b>

## 12 Prepaid expenses and accrued income

Amounts in SEK million	Dec. 31, 2013	Dec. 31, 2012
Interest income accrued	1 496	1 621
Dividends accrued	77	57
Restitutions	56	36
Other prepaid expenses and accrued income	27	26
<b>Total</b>	<b>1 656</b>	<b>1 740</b>

## 13 Other liabilities

Amounts in SEK million	Dec. 31, 2013	Dec. 31, 2012
Outgoing payments, unsettled transactions	5	104
Accounts payable	7	8
Other liabilities	8	7
<b>Total</b>	<b>20</b>	<b>119</b>

## 14 Deferred income and accrued expenses

Amounts in SEK million	Dec. 31, 2013	Dec. 31, 2012
Accrued external management fees	19	37
Accrued interest expenses on currency forwards	20	50
Other accrued expenses	26	21
<b>Total</b>	<b>65</b>	<b>108</b>

## 15 Fund capital

Amounts in SEK million	Dec. 31, 2013	Dec. 31, 2012
<b>Opening Fund capital</b>	<b>241 454</b>	<b>216 622</b>
<b>Net inflows to the national pension system</b>		
Pension contributions received	56 839	55 441
Pension disbursements to the Swedish Pensions Agency	-63 490	-59 005
Transfer of pension entitlements to EC	-2	-5
Adjustment of pension entitlements regarding previous years	3	1
Administration contribution to the Swedish Pensions Agency	-230	-220
<b>Total payments to the national pension system, net</b>	<b>-6 880</b>	<b>-3 788</b>
<b>Net result for the year</b>	<b>30 138</b>	<b>28 620</b>
<b>Closing Fund capital</b>	<b>264 712</b>	<b>241 454</b>

## 16 Pledged assets, contingent liabilities and commitments

Amounts in SEK million	Dec. 31, 2013	Dec. 31, 2012
<b>Other pledged assets and comparable collateral</b>		
Securities on loan for which guarantees have been secured in the form of securities and cash*	739	1 434
Securities pledged in connection with exchange-cleared derivatives	328	445
<b>Commitments</b>		
Commitments regarding future payments, non-listed holdings	8 650	8 650

\* Guarantees secured for pledged securities: SEK 788 (1 490) million.



### Valuation of Fund capital – Market-listed assets

The great majority of the Fund's assets are market-listed, which means that they are traded on an active market at rates that reflect actual and regular market transactions. The Fund's market-listed assets are valued on a daily basis at listed market rates and comprise equities, bonds, derivatives and foreign exchange (FX).

In the case of so-called OTC derivatives, the appraisal is based either on theoretical modelling or on a valuation by an outside party. Where the Fund's holdings in exchange forwards and interest swaps are concerned, the appraisal is based on theoretical modelling, where at present the only subjective elements are the interest curves selected and the methods adopted in calculating and forecasting future values (interpolation and extrapolation). The same methods are applied for deposits, short-dated certificates and similar instruments.

When it comes to other OTC derivatives, the appraisal is handled exclusively by external parties, without subjective input from the Fund. At yearend 2013, the Fund's portfolios contained only a few outstanding structured OTC derivatives.

At times when the market lacks the liquidity necessary for market-listed papers, a higher degree of subjectivity is required in the valuation process. At such times, the market exhibits sharp differences in bid and offer rates, leading even to marked differences between one market player and another. At times like these, the Second AP Fund adopts a conservative approach to appraisal. Should an asset be deregistered, the market rates listed by alternative trading centres shall be taken into consideration. In such instances, each individual security is appraised separately.

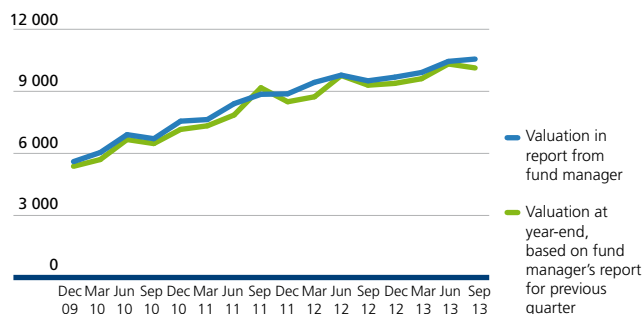
### Valuation of Fund capital – Alternative investments

For assets not valued on an active market, various appraisal techniques are applied in the calculation of fair value at the valuation date.

Fair value is deemed to be the market rate at which a transaction between informed and mutually independent parties can be completed. In the case of the Second AP Fund, these non-market-listed assets consist of non-listed real estate assets (about nine percent of the total portfolio), private equity funds (four percent of the total portfolio) and OTC derivatives.

Private equity funds are appraised in accordance with the IPEV (International Private Equity and Venture Capital Valuation) Guidelines or equivalent valuation principles and shall first and foremost be based on transactions with third parties, although other valuation methods may be used. In calculating fair market values, private equity funds rely mainly on discounted cash flows,

### Validation of valuations in private equity, SEK million



An analysis of the impact on the result arising from the time-lag reveals that the Second AP Fund's valuations in its official annual accounts are in all essential respects lower than the values cited in the final report submitted by managers of private equity funds.

the material value method and multiple valuation. Valuation of holdings is based on the most recent interim reports published by individual private equity funds. Interim reports are normally available within 90 days of the last quarterly financial statement. This means that Fund holdings valued at year-end 2013 were based mainly on an appraisal of private equity funds made on September 30, 2013, adjusted for in- and outflows during the fourth quarter. This method of appraisal has been applied consistently by the Second AP Fund, right from the start.

An analysis of the relative impact of this time-lag since December 2009 reveals that the Fund's valuation, as shown in the official year-end accounts, has in all essential respects been lower than the value declared in the final report submitted by the private equity fund managers. A third-party assessment of market growth during the fourth quarter of 2013 confirms that private equity funds in the Fund's key geographic markets enjoyed continuing positive growth during the final quarter.

### Fair value

Fair value is defined as the amount for which an asset could be sold or a debt settled by means of an orderly transaction between market players on the valuation date. For this reason, the Fund's holdings are sorted at three different levels and classified according to the in-data used for the appraisal. The Second AP Fund classifies its assets at fair value as per the hierarchy shown below.

### Fair value hierarchy, SEK million

	December 31, 2013			Total fair value
	Level 1	Level 2	Level 3	
Equities and participations, listed	123 747	5 534	54	129 335
Equities and participations, non-listed	–	–	30 508	30 508
Bonds and other fixed-income assets	80 941	7 333	3 005	91 279
Derivative assets	202	9 381	–	9 583
Derivative liabilities	–59	–838	–	–897
<b>Sum total of assets, valued at fair value</b>	<b>204 831</b>	<b>21 410</b>	<b>33 567</b>	<b>259 808*</b>

	December 31, 2012			Total fair value
	Level 1	Level 2	Level 3	
Equities and participations, listed	104 243	5 458	46	109 747
Equities and participations, non-listed	–	–	25 412	25 412
Bonds and other fixed-income assets	82 140	6 303	3 781	92 224
Derivative assets	104	10 156	–	10 260
Derivative liabilities	–33	–840	–	–873
<b>Sum total of assets, valued at fair value</b>	<b>186 454</b>	<b>21 077</b>	<b>29 239</b>	<b>236 770*</b>

\* The difference compared to reported Fund capital refers to items unrelated to financial investments, such as interim items and other assets/liabilities.



**Cont. Note 17**

**Level 1:** Listed rates (unadjusted) on active markets for identical assets or liabilities.

**Level 2:** In-data other than the listed rates cited in Level 1, which are observable for the asset or liability either directly (excluding rates) or indirectly (derived from rates).

**Level 3:** In-data for the asset or liability which is not based on observable market data (non-observable in-data).

Level 3 primarily features the Fund's holdings in private equity funds and non-listed real estate, where the appraisal is not based on observable market data.

**Change during 2013 in Level 3, SEK million**

	Equities and participations, listed	Equities and participations, non-listed	Bonds and other fixed-income assets	Total
Value brought forward, January 2013	46	25 412	3 781	29 239
Purchases	10	2 119	5	2 134
Divestments	-4	-2	-781	-787
Changes in value	2	2 979	-	2 981
Reclassifications	-	-	-	-
<b>Total</b>	<b>54</b>	<b>30 508</b>	<b>3 005</b>	<b>33 567</b>

100 percent of the changes in value are unrealized as per year-end.

**Change during 2012 in Level 3, SEK million**

	Equities and participations, listed	Equities and participations, non-listed	Bonds and other fixed-income assets	Total
Value brought forward, January 2012	49	15 487	5 641	21 177
Purchases	19	8 635	784	9 438
Divestments	-	-	-2 641	-2 641
Changes in value	-22	1 290	-3	1 265
Reclassifications	-	-	-	-
<b>Total</b>	<b>46</b>	<b>25 412</b>	<b>3 781</b>	<b>29 239</b>

100 percent of the changes in value are unrealized as per year-end.

**Sensitivity analysis, non-listed assets****Forest-and-agricultural real estate**

Growth in the value of forest-and-agricultural real estate is largely determined by the demand for forest-and-agricultural raw materials. The value of forest and agricultural land can nevertheless vary considerably within the same region, as can the correlation with raw material prices. The operational focus of the agricultural asset, the quality of the land, the size of the property's forest assets, the long-term felling plan, the infrastructure, topography and various macroeconomic factors are all parameters that have a significant impact on the value of the property.

In the long run, the value of forest and agricultural land is mainly determined by the anticipated income it can generate, combined with the effect of interest levels. The value of forest and agricultural land tends to rise when interest rates are low and raw material prices are high. Conversely, the value of land tends to fall as interest rates rise, a consequence of the discounting of anticipated future income from cultivation of the land. Higher interest rates lead to a decline in the price of forest and agricultural products, which means reduced revenues for operators and, eventually, a reduction in the value of the land. This said, however, the grain price needs to fall fairly dramatically over an extended period to have any really significant effect on land values.

**Private equity funds**

The valuations of the individual companies in the portfolio of a private equity fund are determined largely by the following factors:

- profit growth in the company, improved sales and EBITDA
- multiple expansion, improved margins
- reduced debt
- increased market shares, development of products and services (geographic expansion, technical advances, unique/new range of products/services).

The guidelines pertaining to the valuation of fair value for this type of investment feature valuation models which in many cases are linked to listed companies in relevant benchmark groups. Consequently, the valuation of these portfolio companies is affected by the publicly-traded market, but not to the same extent, and always with a three-month shift in time. In the Second AP Fund's experience, most fund managers generally adopt a conservative approach in their valuations, something that is especially apparent in markets that feature rapid and sharp rises in share prices.

**Commercial real estate**

Although many different factors can affect the performance and financial status of real-estate companies, the growth in the value of the companies' real estate portfolios constitutes the greatest risk and has the greatest impact on their net result. The market value of real estate is affected by changes in rental and vacancy levels, as well as operating costs and dividend yield requirements. The assumptions made when making these valuations are based on the economic health of the markets where these properties are located. Economic growth is assumed to generate increased demand for commercial premises, thereby causing a decline in vacant leases and creating opportunities to increase market rents. The single most important factor is the dividend yield requirement. Concerning the Second AP Fund's holdings in commercial real-estate companies, the combined effect on the Fund's share in profits of a planned change in the direct yield requirement of +/-0.25% on companies' reported pre-tax results is estimated at SEK -1.3 billion and SEK +1.4 billion respectively.

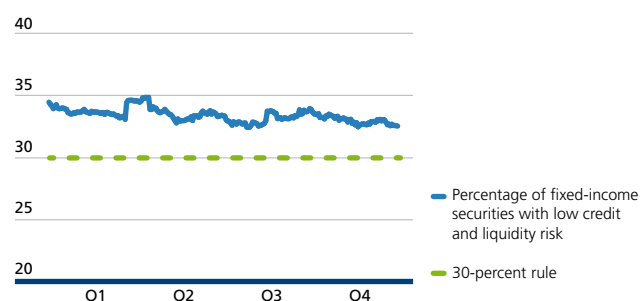


## 18 Financial risk

The liquidity risk is limited, among other things, by the 30-percent rule (external investment regulations for AP1-AP4, which specify that a minimum 30 per cent of the funds' total capital shall be invested in securities with a low credit and liquidity risk) and that no more than five percent of the Fund's total assets may be invested in private equity funds. During 2013, the Fund's share was around 33–34 percent. The liquidity risk on the liability side is very limited, consisting of derivative liabilities.

For further risk data, see "Risk in focus", page 33.

**Liquidity risk, %**



**The administration report, income statement, balance sheet and notes for 2013 have been approved by the Board of Directors.**

Gothenburg, February 5, 2014

Marie S. Arwidson  
*Chair*

Sven Björkman  
*Vice Chair*

Ole Settergren

Helén Källholm

Jeanette Hauff

Ola Alfredsson

Lenita Granlund

Ulrika Boëthius

Our audit report was submitted on February 5, 2014

Jan Birgeron  
*Authorized Public Accountant*  
*Appointed by the Swedish Government*

Peter Strandh  
*Authorized Public Accountant*  
*Appointed by the Swedish Government*



# Auditors' report

Corporate identity number: 857209-0606

## Report on the annual accounts

We have audited the annual accounts of the Second Swedish National Pension Fund for the year 2013. The annual accounts of the fund are included in the printed version of this document on pages 23–61.

### *Responsibilities of the Board of Directors and the Managing Director for the annual accounts*

The Board of Directors and the Managing Director are responsible for the preparation and fair presentation of these annual accounts in accordance with the Swedish National Pension Funds Act, and for such internal control as the Board of Directors and the Managing Director determine is necessary to enable the preparation of annual accounts that are free from material misstatement, whether due to fraud or error.

### *Auditor's responsibility*

Our responsibility is to express an opinion on these annual accounts based on our audit. We conducted our audit in accordance with International Standards on Auditing and generally accepted auditing standards in Sweden. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the annual accounts are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the annual accounts. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the annual accounts, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the fund's preparation and fair presentation of the annual accounts in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Board of Directors and the Managing Director, as well as evaluating the overall presentation of the annual accounts.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### *Opinions*

In our opinion, the annual accounts have been prepared in accordance with the Swedish National Pension Funds Act and present fairly, in all

material respects, the financial position of the Second Swedish National Pension Fund as of 31 December 2013 and of its financial performance for the year then ended in accordance with the Swedish National Pension Funds Act. The statutory administration report is consistent with the other parts of the annual accounts.

We therefore recommend the income statement and balance sheet to be adopted.

## Report on other legal and regulatory requirements

In addition to our audit of the annual accounts, we have also audited the inventory of the assets managed by the Second Swedish National Pension Fund. We have also audited if there are any remarks against the Board of Directors and the Managing Directors administration under the Second Swedish National Pension Fund for the year 2013.

### *Responsibilities of the Board of Directors and the Managing Director*

The Board of Directors and the Managing Director are responsible for the annual accounts, and for administration of the fund's assets according to the Swedish National Pension Funds Act.

### *Auditor's responsibility*

Our responsibility is to express an opinion with reasonable assurance from the result of our audit and inventory of the assets managed by the fund and the administration in general. We conducted the audit in accordance with generally accepted auditing standards in Sweden.

As a basis for our opinion on the inventory of the assets we have audited the fund's statement of assets and a sample of supporting documents.

As a basis for our opinion concerning discharge from liability, in addition to our audit of the annual accounts, we examined significant decisions, actions taken and circumstances of the fund in order to determine whether any member of the Board of Directors or the Managing Director is liable to the fund. We also examined whether any member of the Board of Directors or the Managing Director has, in any other way, acted in contravention of the Swedish National Pension Funds Act.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinions.

### *Opinions*

The audit has not given rise to any remarks regarding the inventory of the assets or otherwise regarding the administration.

Stockholm, February 5, 2014

Jan Birgersson  
Authorized Public Accountant  
Appointed by the Swedish Government

Peter Strandh  
Authorized Public Accountant  
Appointed by the Swedish Government



# Equities, participations and fixed-income securities

## The Second AP Fund's 20 largest Swedish shareholdings\*

Company name	Share of equity, %	No. of equities	Market value (SEK m)	Share of voting rights, %	Sector
Assa Abloy B	0.68	2 536 297	862	0.47	Industrials
Atlas Copco A	0.37	4 552 161	812	0.52	Industrials
Atlas Copco B	0.25	3 024 020	494	0.03	Industrials
Autoliv Inc SDB	0.81	890 721	527	0.81	Consumer discretionary
Electrolux B	1.05	3 250 765	548	0.85	Consumer discretionary
Ericsson (LM) B	0.59	19 612 122	1 540	0.35	IT
Hennes & Mauritz B	0.45	7 392 520	2 190	0.22	Consumer discretionary
Hexagon B	0.80	2 835 918	577	0.57	IT
Investor A	0.01	52 935	11	0.01	Financials
Investor B	0.65	5 000 102	1 107	0.14	Financials
Kinnevik Investment B	0.93	2 591 701	772	0.39	Financials
NCC B	2.13	2 309 317	485	0.65	Industrials
Nordea Bank	0.55	22 175 184	1 921	0.55	Financials
Sandvik	0.78	9 769 152	886	0.78	Industrials
SCA SV Cellulosa A	0.04	300 676	60	0.20	Consumer discretionary
SCA SV Cellulosa B	0.52	3 690 631	731	0.25	Consumer discretionary
SEB A	0.84	18 516 442	1 570	0.85	Financials
SKF B	0.81	3 678 982	621	0.46	Industrials
Swedbank A	0.61	6 885 506	1 246	0.61	Financials
Swedish Match	1.25	2 522 149	521	1.25	Consumer discretionary
Svenska Handelsbanken A	0.42	2 664 654	842	0.43	Financials
TeliaSonera	0.49	21 300 100	1 141	0.49	Telecoms
Volvo A	0.06	1 314 455	111	0.19	Industrials
Volvo B	0.60	12 720 330	1 074	0.19	Industrials

\* The above table lists the Second AP Fund's 20 largest holdings in Swedish equities, by worth.

A complete list of the Second AP Fund's holdings may be found on the Fund's website at [www.ap2.se](http://www.ap2.se)



**Second AP Fund's holdings in unit trusts**

Name	No. of equities, participations	Fair value, SEK m
Ashmore Sicav Emerg Mark Investm Grade Local Curr	4 330 829	2 453
Investec Emerging Markets Investment Grade Debt	17 989 538	2 155
Genesis Emerging Markets Class A	5 475 561	1 971
BNY Mellon Emerg Mark Local Curr Invest Grade Debt	297 887 689	1 794
Babson Capital	2 533 332	1 700
Ares Strategic Investment Partners IV	250 000 000	1 669
Generation Im Global Equity Fund Class I 20071201	1 007 553	1 579
Vanguard US Invest Grade Cr Ind Ins USD Shs	1 537 334	1 542
Stone Harbor Emerging Market Debt	1 562 517	1 504
Generation Im Global Equity Fund Class A 20090401	893 838	1 383
Bridgewater GTAA Fond	75 115	1 213
Stone Harb Invest Grade Emerg Mark Local Curr Debt	2 011 059	1 201
CVC Credit Partners	1 000 000	898
Wellington Opportunistic Emerging Markets Debt	8 406 337	793
Vanguard Euro Investment Grd Bd Ins EUR Shs	459 369	773
AQR Emerging Equities Fund, L.P.	1 070 000	743
GAM FCM Cat Bond Inst Initial Series	859 176	722
AQR Merger Arbitrage Fund	730 434	492
Generation Im Global Equity Fund Class I 20090401	289 774	459
Generation Im Asia Fund	492 402	359
AQR Opportunis Convertible Arbitrage Offshore Fund	520 000	332
GAM FCM Cat Bond Inc. Institutional 2013 Series 5	350 000	236
Vanguard UK Invest Grade Bd Index Fund Ins Gbp Shs	223 581	174
Gam FCM Cat Bond Inc. Institutional 2013 Series 4	200 263	136
Gam FCM Cat Bond Inc. Institutional 2013 Series 3	110 000	75
Gam FCM Cat Bond Inc. Institutional 2013 Series 6	110 000	74
Bridgewater GTAA Fond Major Market 1100-031	5 655	48
State Steet Short Liquidity Fund	701 843	5
<i>GAM FCM Cat Bond Inc. Institutional 2013 Series 10</i>	<i>685</i>	<i>0</i>
<i>GAM FCM Cat Bond Inc. Institutional 2013 Series 7</i>	<i>452</i>	<i>0</i>
<i>GAM FCM Cat Bond Inc. Institutional 2013 Series 1</i>	<i>116</i>	<i>0</i>



### The Second AP Fund's 20 largest foreign shareholdings\*

Company name	No. of equities	Market value (SEK m)	Sector
ABB Ltd	5 392 091	917	Industrials
AstraZeneca	1 615 682	619	Healthcare
Bayer	672 438	607	Healthcare
Apple Inc	162 600	586	IT
Samsung Electronics Co Ltd	66 255	553	IT
ENI	3 440 258	535	Energy
Exxon Mobil Corp	821 200	534	Energy
Toyota Motor Corp	1 025 900	402	Consumer discretionary
Disney (Walt) Common	797 768	391	Consumer discretionary
Johnson & Johnson	660 633	389	Healthcare
Nestlé	737 784	352	Consumer discretionary
Honeywell International	587 400	345	Industrials
Visa Inc	237 156	339	IT
BASF	489 400	336	Commodities
Microsoft Corp	1 379 100	332	IT
Chevron Corp	412 500	331	Energy
Google Class A	45 700	329	IT
Banco Santander S.A.	5 671 032	328	Financials
Oracle Corp	1 322 062	325	IT
Siemens	365 411	321	Industrials

\* The above table lists the Second AP Fund's 20 largest holdings in foreign equities, by worth The Fund's capital shares and voting rights in the foreign companies listed in the above table in no instance exceed 0.24 percent, and are therefore not reported.

A complete list of the Second AP Fund's holdings may be found on the Fund's website at [www.ap2.se](http://www.ap2.se)

### Second AP Fund holdings in bonds and other fixed-income securities

#### Swedish nominal bonds, five largest holdings

Bond	Fair value, SEK m
Swedish Government 1047	3 081
Nordea Hypotek AB	3 050
Stadshypotek AB 6	2 418
NB Hypotek 5520	2 150
Swedish Government 1052	2 125

#### Global government bonds, five largest holdings

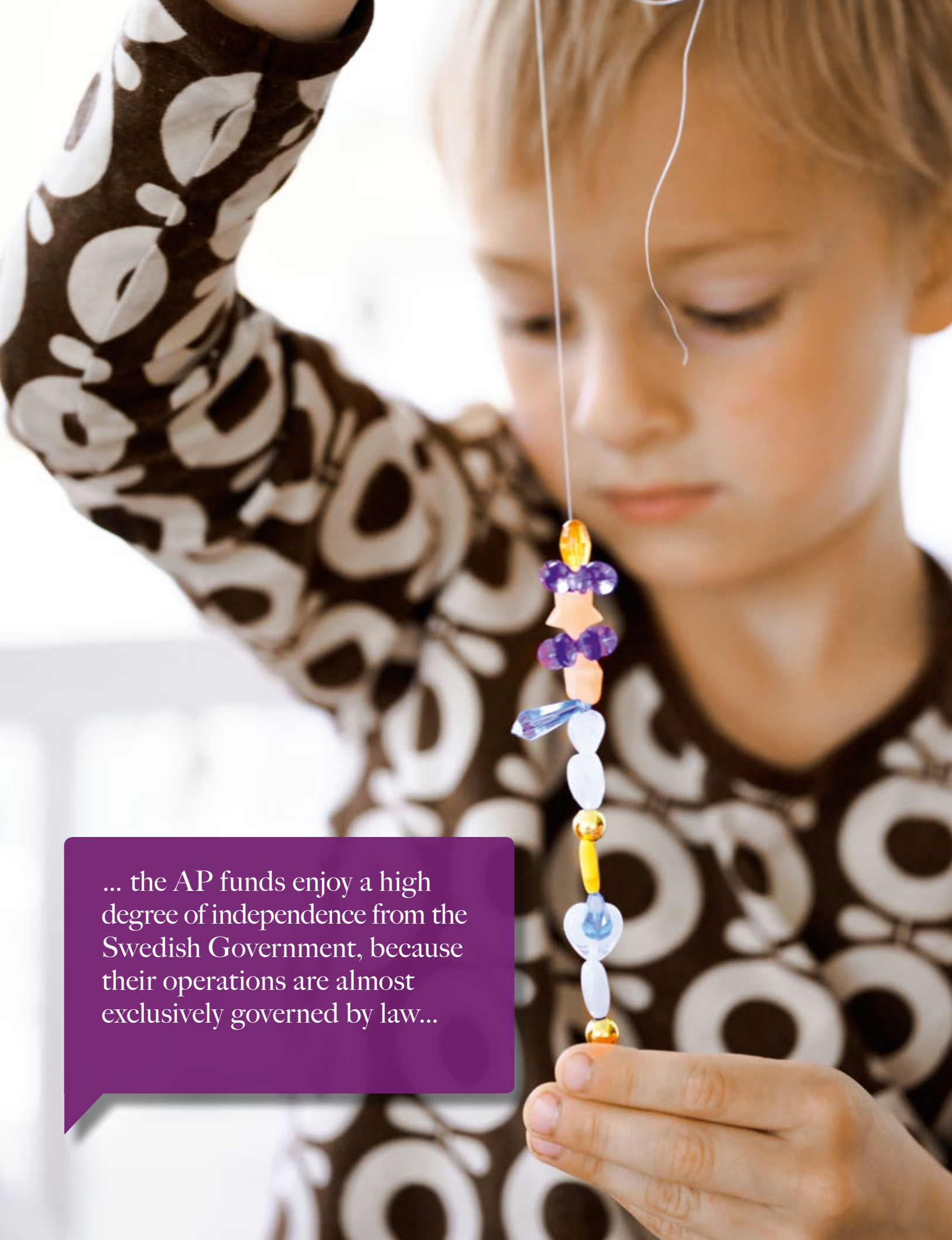
Bond	Fair value, SEK m
BTPS 5	246
Instit Crdt Ofcl Ico 4	245
European Invt Bk Eib 1	220
Land Hessen Hessen	220
European Invt Bk Eib 1	207

#### Global credits, five largest holdings

Bond	Fair value, SEK m
Bank of America Corp	135
Royal Bk of Scotland PLC	118
BNP Paribas	114
Nordea Bank AB	93
Commonwealth Bank Australia	92

Detailed information about Second AP Fund holdings in fixed-income securities is available on the Fund's website at [www.ap2.se](http://www.ap2.se)





... the AP funds enjoy a high degree of independence from the Swedish Government, because their operations are almost exclusively governed by law...



# Second AP Fund governance report

To comply with the Annual Accounts Act and the Swedish Code of Corporate Governance, Swedish quoted companies are required to submit a corporate governance report.

The Code is considered to set the tone for what shall be considered good practice for corporate players on the Swedish stock market. This Fund governance report has derived inspiration from the Code of Corporate Governance, while also taking into account the special characteristics that apply to the Second AP Fund.

Like the other AP funds, Second AP Fund is a state agency. Even so, the difference between the AP funds and other state agencies is considerable. The greatest difference is that the AP funds enjoy a high degree of independence from the Swedish Government, because their operations are almost exclusively governed by law and the Government thereby has no provision in law to exercise control over them.

## The Board

The Board of Directors of the Second AP Fund, which is appointed by the Swedish Government, comprises nine Members. Two are appointed in accordance with proposals submitted by organizations that represent employees' interests, two in accordance with proposals submitted by organizations that represent employers' interests. The Chair and Vice Chair are appointed by the Government, selected from the Members of the Board not put forward by employer or employee organizations. Each director shall be appointed on the basis of his/her individual ability to enhance the management of the Fund.

In May 2013, the Swedish Government decided on a new Board, involving the following changes: Anders Jansson left the Board of

Directors and Ole Settergren was appointed a new Member. To date, the Government has chosen to implement twelve month mandate periods for Board Members, whereby current appointments remain in effect until the Fund's balance sheet and income statement for 2013 have been adopted. Niklas Johansson left the Board in June 2013, when appointed to the position of Commissioner at the Ministry of Finance by the Swedish Government. The Board has subsequently consisted of eight Members.

The Board has full and undivided responsibility for the operations of the Fund, within the parameters established by the Swedish Parliament concerning the organization of the Fund and management of its assets. In instances where the work of the Board falls outside the terms of the Swedish National Pension Funds Act, it is governed by the rules of procedure annually adopted by the Board.

Fees and other remuneration paid to Board Members are determined by the Swedish Government. The remuneration paid per annum amounts to SEK 100 000 for the Chair, SEK 75 000 for the Vice Chair and SEK 50 000 for the other Members of the Board. The Swedish Government has determined that payments amounting to SEK 100 000 in total may be made for committee work. No fees have been paid for work conducted by Board Members on the Remuneration Committee. For work on the Risk Committee, remuneration has been paid to the Chairman in an amount of SEK 30 000 and to individual Members in amounts of SEK 25 000. For work on the Audit Committee, remuneration has been paid in an amount of SEK 20 000 to the Chair and in amounts of SEK 15 000 to individual Members.

Board Member	Remuneration Committee	Risk Committee	Audit Committee	Attendance/ total meetings	Comments
Marie S. Arwidson	X		X	6/6	
Sven Björkman	X	X		6/6	
Jeanette Hauff		X		6/6	
Ola Alfredsson				6/6	
Helén Källholm			X	4/6	
Lenita Granlund				3/6	
Ulrika Boëthius				6/6	
Ole Settergren				4/4	From May
Anders Jansson				2/2	Until May
Niklas Johansson				3/3	Until June



### **The work of the Board**

The most important tasks assigned to the Board of the Second AP Fund involve the establishment of operational targets, the recruitment and evaluation of the CEO and the taking of decisions concerning broad strategic issues, such as the composition of the Fund's strategic portfolio. To ensure that the Board's decisions are implemented, that intrinsic risks are managed and that the Fund's operations are in all other respects conducted in an appropriate manner, effective control and follow-up are essential.

During the year, the Board held six ordinary meetings, one being of greater duration, at which broad strategic issues were addressed, with special emphasis on investment strategy, the Fund's long-term business plan and its quantitative management. As well as Board Members, Board meetings are attended by the Fund's CEO and the Secretary to the Board. Other Fund employees may also participate, in an advisory role as experts or to submit a report on a given issue. The CEO's performance is evaluated once a year. The CEO does not attend this meeting.

### **Fund targets**

The Fund is committed to minimising the consequences that derive from activation of the automatic balancing mechanism, by generating a solid return on invested capital. To meet this requirement, the Second AP Fund has composed a portfolio that is expected to generate an average annual real return of five percent over the long term.

### **Strategic portfolio**

A new strategic portfolio has been approved for 2014.

### **Discussion about performance, governance issues and costs**

The Fund's management performance is reviewed at every Board meeting. The Board regularly discusses fundamental governance issues, the strategic allocation of assets and investments in private equity funds and real estate.

Cost trends are considered on a quarterly basis, and the Board regularly reverts to the issue of the Fund's cost efficiency. Its annual responsibilities also include decisions concerning the adoption of the year-end accounts, the budget, business plan and strategic portfolio.

### **Board Committee**

The Board has established a Remuneration Committee. The Remuneration Committee consists of the Fund's Chair and Vice Chair. The CEO is normally co-opted to meetings of the Remuneration Committee. The CEO is not present when the Committee determines his/her remuneration.

The Remuneration Committee is a drafting committee for the Board, tasked with considering the level of remuneration for the CEO, establishing guidelines for the remuneration of the Fund's executive management and determining issues related to incentive programmes for Fund employees. Decisions reached by the Remuneration Committee are submitted for consideration by the Board at its next meeting.

The Board has established a Risk Committee. The Risk Committee, whose members are appointed by the Board, shall advise, monitor and provide support to the Board concerning the Fund's risk control and risk management activities. The Risk Committee comprises two Members of the Board. The items placed before the Committee for consideration are presented by the Fund's CEO and the Head of Performance and Risk Management.

The Risk Committee is not authorized to make decisions on behalf of the Board or Fund, except in those cases where such authority has been delegated by the Board. The responsibility of the Board and its individual directors is on no way limited by the establishment of the Risk Committee or its duties. The operations of the Committee, which meets six times a year, are conducted according to an agenda determined by the Board on an annual basis. During 2013, among other activities, the Risk Committee has reviewed developments concerning the Fund's financial and operative risks, as well as the investment and follow-up process for alternative investments. The Fund's latest risk status was also presented and discussed at each of these meetings.

The Board decided to establish an Audit Committee in 2013. The Audit Committee, whose members are appointed by the Board, has been established as an advisory, supervisory and preparatory body for the Board in the areas of financial reporting, auditing, internal control and external auditing. The Audit Committee comprises two Members of the Board. The items placed before the Committee for consideration are presented by the Fund's CEO, the Head of IT, Business Control and Accounts, and the Chief Financial Officer (CFO), as well as the Fund's auditors.



The Audit Committee is not authorized to make decisions on behalf of the Board or Fund, except in those cases where such authority has been delegated by the Board. The responsibility of the Board and its individual directors is on no way limited by the establishment of the Audit Committee or its duties.

### **Audit**

The Second AP Fund's auditors are appointed by the Government. Current responsibility for the audit is shared by Jan Birgersson and Peter Strandh, from EY, who were appointed on May 30, 2013. EY is also tasked with conducting the audits of the other AP funds, and Jan Birgersson has furthermore been appointed to coordinate the audits of all AP funds. This mandate applies until adoption of the Fund's income statement and balance sheet for 2013.

The auditors submit an audit report, as well as making an oral report direct to the Board at least once a year. They also submit written reports concerning their audit of the annual accounts administration and a report to the Ministry of Finance once a year.

The auditors' assignment includes inspection of current business operations, the administration, the annual accounts and the annual report. The auditors express their opinion of the annual accounts and administration, based on their audit. This assignment also includes an assessment to determine that the accounts of the Second AP Fund have been prepared in compliance with generally accepted accounting and valuation principles jointly determined by the AP funds, and that they provide a true and fair picture of the Fund's financial position.

The audit has also involved an examination of the Fund's guidelines on remuneration in compliance with the Swedish Government guidelines on remuneration to key executives and employees, and compliance with these. A separate statement has been submitted; see the Second AP Fund website at [www.ap2.se](http://www.ap2.se)

### **Internal control**

The Board has ultimate responsibility for the Fund's internal control. In the Fund's risk policy, the Board has established frameworks and guidelines for the overall allocation of responsibilities, risks, risk limits and routines to monitor and control that such guidelines are observed.

The Risk Management Department ensures that these risk parameters are respected. Implementing this risk control process ensures that the organization, as a whole and in its individual elements, keeps within the specified limits and observes the restrictions and instructions that apply.

Ongoing internal control of the Fund's financial and operational risks is handled by the Risk Management Department. The Department is organizationally independent of functions that are engaged in active trading decisions. This risk control process is based on the generation of effective and transparent risk reports and analyses. Reporting to the Fund's executive management is conducted on a daily basis, while regular updates are submitted to the Board at its meetings.



## Board of Directors



### Marie S. Arwidson

Chairman since 2010. M.Sc. (Econ). Formerly Managing Director of the Swedish Forest Industries Federation. Directorship on the board of the Royal Swedish Academy of Engineering Sciences. Born 1951.

### Jeanette Hauff

Member of the Board since 2010. L.Econ. Active at Gothenburg University's School of Business, Economics and Law. Savings Advisor at Skandia. Directorship on the board of Svenska Försäkringsföreningen. Born 1965.

### Lenita Granlund

Member of the Board since 2012. Negotiations Secretary for Svenska Kommunalarbetarförbundet (Swedish Municipal Workers' Union). Vice Chair KOM-KL Omställningsfonden and LO-TCO Rättskydd AB. Directorships on the boards of Sunt Arbetsliv, Riksborgen Bospar, AFA's KL-delegation, KPA Pensionsförsäkring, Fastighetsbolaget Polstjärnan and a deputy member of the board of Prevent. Born 1962.

### Sven Björkman

Vice Chairman since 2009. Former head of SEB Region Väst. Born 1949.

### Ole Settergren

Member of the Board since 2013. Head of Pensionsmyndighetens utvecklingsavdelning (The Swedish Pensions Agency Development Unit). Born 1964.

### Ulrika Boëthius

Member of the Board since 2012. Chair of Finansförbundet (The Financial Sector Union of Sweden). Directorships on the boards of TCO (Confederation of Professional Employees), NFU (Nordic Financial Unions), Cefin (Centre for Banking and Finance at KTH). Born 1961.

### Ola Alfredsson

Member of the Board since 2010. CEO of Kockums AB. Born 1964.

### Helén Källholm

Member of the Board since 2011. Managing Director of Svenska kyrkans arbetsgivarorganisation (Church of Sweden Employers' Federation). Directorship on the board of Svenska Kyrkans Trygghetsråd. Born 1957.



# Executive management



“ ... the specialist competencies, creativity and commitment of the Fund’s staff are critical to a successful result.

## Eva Halvarsson

CEO. Employed since 2006. Other directorships: Vasakronan AB, Norrporten AB, FinansKompetens-Centrum and the Swedish Corporate Governance Board. Vice Chancellor of Gothenburg University. Born 1962.

## Martin Jonasson

General Counsel. Employed since 2001. Other directorships: ETC Battery and FuelCells Sweden AB. Born 1964.

## Hans Fahlin

Chief Investment Officer (CIO). Employed since 2010. Chairman of the Institute of Quantitative Research Europe (INQUIRE). Other directorships: AFS Interkulturell Utbildning Sverige; Centre for Finance (CFF) at the School of Business, Economics and Law, Gothenburg University; Polar Music Prize Administrative Board, the Finance Committee and Riksbankens Jubileumsfond (Swedish Foundation for Humanities & Social Science). Born 1957.

## Ola Eriksson

Head of IT, Business Control and Accounts. Employed since 2001. Born 1965.

## Henrik Westergård

Head of Performance and Risk Management. Employed since 2012. Born 1973.

## Ulrika Danielson

Head of Communication & HR. Employed since 2009. Born 1965.

## Tomas Franzén

Chief Investment Strategist (CIS). Employed since 2001. Chairman of International Advisory Board, EDHEC Risk Institute. Other directorships: Chalmers University of Technology Trust, Finance Committee. Born 1957.

## Auditors

**Jan Birgersson,**  
Authorized Public Accountant, EY.

**Peter Strandh,**  
Authorized Public Accountant, EY.



# Definitions

## Absolute return on investment

The return generated on a portfolio or portfolios of assets, measured in kronor or percent, of the original invested amount.

## Active/passive management

*Active management:* Portfolio management actively deviates from the benchmark index, to generate an active return.

*Passive management:* Portfolio management strives for a return equal to benchmark index.

## ALM study

Asset Liability Modelling. An analytical model used to determine the Fund's strategic portfolio. The study, which is revised on a continual basis, is designed to determine the optimal composition for the different classes of asset under Fund management, to ensure that it satisfies the Fund's long-term commitment to the collective requirements of the Swedish national pension system. The judgements based on this analysis shall take into account demographic change as well general economic trends.

## Benchmark index

Index based on the Second AP Fund's strategic portfolio, against which the Fund's management performance is measured.

## Credit risk and counterparty risk

*Credit risk:* Refers to the risk that an issuer may become insolvent or be awarded a lower credit rating.

*Counterparty risk:* Refers to the risk that the other party may be unable to meet its business obligations.

## Credit spread

The yield difference arising from the difference in creditworthiness between two otherwise comparable bonds.

## Discretionary mandate

A mandate that is limited and specific to a single investor. The alternative to discretionary management is traditional fund management.

## Duration

A measure of interest risk that yields an asset-relative change in value with an interest adjustment of one percentage unit.

## Fair value

Fair value is defined as the amount for which an asset may be transferred or a debt settled, between parties who are mutually independent and who have a vested interest in completing the transaction. Normally speaking, this means that listed assets are valued at the buying-rate (market value) and that the fair value of non-listed assets is estimated with the help of generally accepted valuation models.

## FX forward contract

A derivative instrument involving a contract to purchase foreign currency at some future date at a predetermined rate of exchange.

## GTAA

Global Tactical Asset Allocation mandate. A mandate that applies a TAA strategy on a global basis.

## Implementation effects

Contributions to the overall return that derive from implementation of the strategic portfolio and index switches.

## Implicit volatility

The forecast volatility of an asset class.

## Information ratio

A gauge of risk-adjusted relative return. Measured as relative return, divided by tracking error/active risk.

## Interest swap

A contract between two counterparties, in which one interest flow is exchanged for another. Normally, the undertaking given by one party to pay a fixed rate of interest is exchanged for the other party's undertaking to pay a floating rate of interest.

## IPEV

International Private Equity and Venture Capital Valuation Guidelines.

## ISDA contract

International Swaps and Derivatives Association. An ISDA contract is a standard contract for the regulation of trading in derivatives between two counterparties.

## Liquidity risk

Refers to the risk that securities cannot be converted into cash, because of reduced access to or demand from the market, which either precludes the purchase or sale of such securities, or would require their sale at a loss.

## Market risk

The market risks most relevant to the Second AP Fund are share-price risk, interest-rate risk and currency risk.

## MSCI index

International equity indices managed by Morgan Stanley Capital International.

## Operative risk

Refers to the risk that an error or stoppage in operations could lead to economic loss or reduced credibility.

## Quantitative management

Portfolio management that focuses on exposing incorrect market pricing with the help of a mathematical model.

## Relative return

Portfolio return compared to return on Fund's strategic portfolio. The return is cleared of commission and operating expenses.

## Sharpe ratio

A gauge of risk-adjusted return. Measured as the portfolio's absolute return less risk-free interest (SSVX 12 months), divided by the standard deviation on absolute return.

## S&P 500

Standard & Poor's 500 composite index. A cap-weighted share index of 500 US companies. Selection is based on size, liquidity and industrial sector, among other factors.

## SIX RX

Six Return Index: a cap-weighted share index, reflecting average growth on the Stockholm Stock Exchange, including dividends.

## Strategic portfolio

The Second AP Fund's strategic portfolio is determined annually by the Board of Directors and confirms the Fund's decision on strategic asset allocation.

## TAA

Tactical Asset Allocation. A portfolio management strategy focused on overperformance in diverse asset classes.

## Tracking error/Active risk

The variation in relative return. Often measured as standard deviation on the relative return. Active risk is calculated using daily data to determine relative return.

## Value at Risk, VaR

A measure of risk that indicates the maximum loss, based on a given confidence level, that a portfolio may incur over a given period. VaR is normally calculated at a confidence level of 95 percent, and for a ten-day time interval.

## Volatility

Volatility refers to the amount the price of a financial asset varies over time. This is normally expressed as a percentage, in terms of the standard deviation.









The knowledge we have accumulated in investment, processes and business support means that we are now able, in a cost-efficient manner, to manage an increasing amount of Fund capital in-house.

Eva Halvarsson, CEO, Second Swedish National Pension Fund/AP2



**Andra AP-fonden**  
*Second Swedish National Pension Fund - AP2*