AP2 – SECOND SWEDISH NATIONAL PENSION FUND

CORPORATE GOVERNANCE REPORT

Why Swedes vote so little in foreign companies

A new Generation steps forward

USD 15 000 billion comes to Gothenburg

Pure gold – but at what cost?

07/08

JULY 1 2007 – JUNE 30 2008

From Kyoto to Copenhagen

Welcome to the Second AP Fund's Corporate Governance Report

In recent years, I have noticed increased interest in the way large national pension funds think and act with respect to governance issues. This is a positive development.

This said, there are number of challenges we must address if we are to succeed in disseminating quality information to a broader public. It is difficult to present complex issues in the media, due to a tendency to focus on contention. Another obstacle is that many important questions are resolved behind closed doors, which sometimes creates an information vacuum that can generate misleading rumours or silence.

We are therefore keen to contribute to the creation of a forum dedicated to a broader discussion, partly through publication of the report that you now hold in your hand.

This edition addresses a number of important issues. Some of these affect the financial markets on which we operate. One such is the growth of large sovereign funds and trends relating to the exercise of voting rights in foreign holdings. Other issues are directly related to industries in which we invest, issues such as the environmental impact of mining.

At the same time, I should also like to draw attention to one of the most important global issues of 2008, namely the climate issue. The UN Climate Committee claims that the emissions of greenhouse gases must be halved by 2050 to prevent global warming.

How we are to achieve this is expected to be resolved next autumn in Copenhagen, when decision makers from all over the world will gather to discuss the next move in the process initiated by the signature of the Kyoto Protocol.

There is already talk of expanding the system for trading carbon emission rights as a way to reduce pollution. The result of the conference could prove decisive in determining the way companies and industries are rated, thereby affecting the composition of the Second AP Fund's portfolio. It is therefore important that one of the things we learn is how different carbon emission credit systems work and what their impact will be on our portfolio – a process in which we are currently engaged and which we hope to talk more about in future.

Eva Halvarsson
Chief Executive Officer

U$D 15 000 billion
COMES TO GOTHENBURG

In early March 2008, the Second AP Fund played host to the International Corporate Governance Network/ICGN's half-yearly conference. Representatives of the world's largest institutional investors came to Gothenburg to exchange thoughts on, among other things, SWFs (Sovereign Wealth Funds), and to discuss their impact on international capital markets.

In conjunction with the conference, the ICGN declared its response to the phenomenon: sovereign wealth funds play a significant role on international financial markets. They pursue the same long-term objectives as traditional long-term institutional investors such as pension funds and insurance companies, and should therefore be treated in the same manner, noted Peter Montagnon, chairman of the ICGN.

The imposition of strictures on a specific group of investors could have a damaging effect and the organization is negative to the idea, due in part to the fact that most countries already implement the restrictions needed to protect strategically important interests.

Increased awareness At the same time, ICGN and its members are keen to encourage a closer dialogue with SWFs, to create greater awareness with respect to the corporate governance issue.

"A WORST SCENARIO IS TO HAVE PEOPLE WHO INVEST REAL MONEY IN EQUITIES AND WHO THEN DECLARE THEY HAVE NO INTENTION OF EXERCISING THEIR RIGHTS AS OWNERS."

The idea is that SWFs, together with other established institutions such as the Second AP Fund, can help to ensure that capital markets function efficiently and that companies around the world are organized in a way to generate sustainable long-term returns.

The experience of ICGN's members is that institutions that practise responsible corporate governance, as by exercising their voting rights, gain access to a greater number of investment arenas. This eventually gives them greater influence and increases the opportunity of a good return.

Several SWFs are passive owners. The ICGN looks forward to a time when SWFs will also exercise their voting rights to positively influence corporate conduct.

"A worst scenario is to have people

ICGN GÖTEBORG 2008

Photographer: Erik Yngvesson

Per Lekevall, Swedish Corporate Governance Board, explained the benefits of Swedish corporate governance.

Anne Kvam (NBIM), Gao Xiging (from China's CIC) and Mahmoud Al-Kanderi (KIA) explain how it works.

Sir David Tweedie, chairman of the International Accounting Standards Board.

Anne Simpson, president of the International Corporate Governance Network, led the debate on Sovereign Wealth Funds.

who invest real money in equities and who then declare they have no intention of exercising their rights as owners," says Robert A.G. Monks, a pioneer among share-rights activists attending the conference, who now chairs the Governance for Owners Group LLP, in London.

Hoping for endorsement of ICGN statement Responsible governance also involves a high degree of transparency concerning investment policies and must demonstrate that investment decisions are based on the broad objective of creating an appropriate return within a predetermined period.

This is why the ICGN recommends that SWFs embrace the organization's Statement on Shareholder Responsibilities, which was approved at the 2007 AGM.

Representatives of the SWFs clarified their viewpoint Representatives of the SWFs who attended the conference stated that their investment decisions had no ulterior political motives and that they felt that SWFs created no imbalances in capital markets.

"What you have to ask yourself is whether the actions of SWFs have caused chaos on any financial markets? Are you sure that the question itself isn't politically motivated?" asked Mahmoud Al-Kanderi, director of the Kuwait Investment Authority, KIA, when questioned by reporters during the conference.

"Our investments have no political motive – they are based strictly on commercial priorities," he said.

Gao Xiging, president of the Chinese Investment Corporation, CIC, noted that China's decision to invest abroad was at least partially due to politicians in the USA and the EU.

"We were pressured by politicians in the USA and the EU to strengthen our currency, so we decided to employ some of our currency reserves and invest abroad. Their attitude was 'Yes – please do it!' Then, once we had carried out the business deals, the politicians came back and said ‘No, no, we’re afraid of you. We suspect your evil intentions’.”

He also noted that the lack of transparency derived from a desire to avoid unnecessary attention. No other motives exist. Like KIA, they tend to adopt a passive attitude to their holdings.

“We have absolutely no intention of exercising our voting rights or of acquiring seats on the boards of companies in which we invest, and our interests in these companies are very long-term. We have no wish to be anything but a responsible investor,” Gao Xiging stated.

Rescued the US economy once before

Chinese investors, and their money, were a major factor in helping American investment banks that needed new capital during the credit crunch. Christopher Ailman, president of CalSTRS, the second largest pension fund in the USA, claimed that this is not unique – and that the American economy has always survived thanks to foreign investment and capital. In his opinion, the disagreement among politicians stems from ignorance.

“What we see in Congress is a fear of the unknown. So this situation is likely to continue for a time. I just hope it will be brief.”

The world’s largest corporate governance network

The International Corporate Governance Network, ICGN, is the world’s largest corporate governance organization. ICGN, established in 1995, comprises some 500 members from 40 countries, representing total assets under management of USD 15 000 billion. The organization is dedicated to promoting favourable development in corporate governance, based on an international perspective.

What are Sovereign Wealth Funds?

Sovereign Wealth Funds is a generic term for state-owned investment funds in countries that normally enjoy a substantial surplus in their trade balances. Typically, such countries are major energy exporters, such as Russia and many parts of the Middle East.

In actual fact, about 62 percent of all SWF capital is oil or gas related. The remaining capital comes from nations such as China, where in many cases the trade surplus derives from cost benefits in the export industry.

It is thought that the state investment funds manage capital assets amounting to an approximate combined value of USD 3 000 billion. This corresponds to about 1.5 percent of the world’s total assets.

A forecast published by Morgan Stanley predicts that, in ten years, the largest SWFs will have a combined capital of USD 13 000 billion, corresponding to 5 percent of combined global capital.

For more background on SWFs, turn to page 24.

Photographer: Erik Yngvesson

Carl Rosén from the Second AP fund leads the debate on voting rights.

Carl Rosén joins the ICGN board

In conjunction with the ICGN conference in South Korea in June 2008, Carl Rosén, who heads Corporate Governance at the Second AP Fund, was voted onto the ICGN board. The eleven other members of the board represent pension funds and advisers from all over the world.



Ron Nickel / IBL Bildbyrå

Second AP Fund's governance

VOTING AT SWEDISH AGMs

During the period July 1 2007 to June 30 2008, the Second AP Fund has exercised its voting rights at the annual general meetings (AGMs) of 51 Swedish publicly quoted companies. In two instances, the Fund voted against board proposals presented at the AGM. The Fund voted against discharging the outgoing board of Carnegie from responsibility for their administration. This was primarily intended as a means to 'keep the doors open' for possible future action for damages against members of the old board. The new board has now studied the feasibility of conducting a successful claim for damages against the old board and concluded that such a claim would not succeed. It is good that the new board has put the issue to the test. It is also good that, by withdrawing its appeal against the Swedish Financial Supervisory Authority (FI), the board has accepted the supervisory authority's decision.

The Second AP Fund voted against the incentive system operated by Lundin Petroleum, since it lacked any performance-related requirement, and was not treated as a separate item in the notice convening the general meeting.

VOTING AT FOREIGN AGMs

The Second AP Fund has exercised its voting rights at the AGMs of 64 foreign quoted companies during the period. The selection was made on the basis of the size of the holding, in connection with the work of the Ethical Council of the Swedish National Pension Funds, or in collaboration with international investors. At most of these meetings, the Fund either voted against the boards' proposals or for proposals submitted by shareholders. This is a consequence of the fact that the selection focused on companies in which a number of shortcomings had been detected.

Where the Fund voted against a proposal, the issue was shareholder rights. Concerning the right to elect the board according to the majority principle, the Fund has collaborated with the American pension fund CalPERS. On the issue of expanded information and the opportunity to vote on remuneration matters, the Fund has cooperated with America's TIAA-CREF. With respect to the introduction of more detailed coverage of environmental issues, the Fund has worked with the American investor network CERES. Where a board has proposed a CEO who also chairs the company, the Fund has voted against, in line with the view of shareholders' rights subscribed to by the Swedish market.

Jiri Rezac / Gamma / IBL Bildbyrå

activities 2007/2008

FUND'S PARTICIPATION IN NOMINATING COMMITTEES 2007-2008

The Fund has been represented on the nominating committees of five companies: Biotage (chairman), Haldex, Fabege, Meda and Oriflame.

FUND POSITIVE TO EXPANDED USE OF CODE FOR CORPORATE GOVERNANCE

The new Swedish Code for Corporate Governance formally came into effect on July 1 2005, although the first results were not apparent until publication of the annual and corporate governance reports of Swedish companies at the beginning of 2006. The Swedish Corporate Governance Board monitors observation of the Code on an ongoing basis, and in most cases, respect for the Code has been good. Criticism from companies about excessive bureaucracy has declined, and several companies have elected to explain why they do not observe the Code, in line with its observe-or-explain principles.

For the Second AP Fund and other major investors, one great advantage of the Code has been the finalization of routines governing the makeup of nomination committees, the way board performance is evaluated and reporting routines relating to the work of nominating committees. This simplifies matters and reduces unnecessary discussion of the legal formalities, as well as enhancing the quality of the work performed by nominating committees.

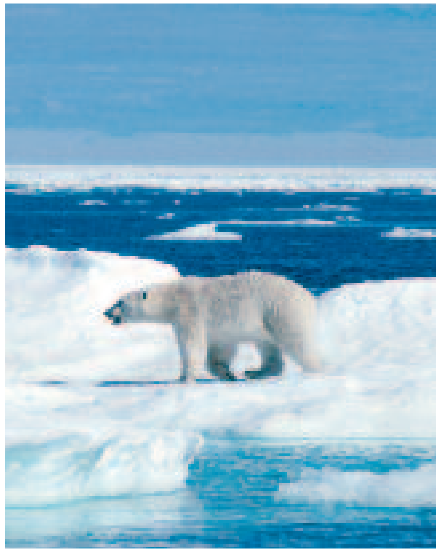
Given the result, it was only natural that the Swedish Corporate Governance Board should propose that the Code should embrace all publicly quoted companies by 2009. This has received a positive response from most market players, even though it may place new demands on many institutional investors, requiring them to provide representatives willing to serve on nominating committees. The reply submitted by the Second AP Fund endorsed the Swedish Corporate Governance Board's proposal.

BOARD COMPOSITION: WOMEN

For the first time in ten years, the trend of a growing number of women on corporate boards has been broken. According to the Second AP Fund's index, the proportion of women on corporate boards declined from 19.3 to 18.6 percent. The proportion of women in executive management positions remained unchanged at just under 13 percent.

During the autumn, the Fund plans to initiate a dialogue with companies (nominating committees and managements) in various industries that feature the lowest proportion of women in their executive managements and on their boards.

Bassignac Gilles / Gamma / IBL Bildbyrå



Dan Guravich / PhotoResearchers / IBL Bildbyrå

PROTECTION OF SHAREHOLDERS' RIGHTS:

1. Review of takeover regulations in Sweden

The Swedish Industry and Commerce Stock Exchange Committee (NBK), which administers and develops the takeover rules covered by Swedish self-regulation, has initiated a review of the rules in 2008. The Second AP Fund participates in a reference group that is cooperating with NBK on this issue.

2. Possibility to nominate board members in the USA

Traditionally, shareholders' rights in the USA have been weak compared to many other countries. Among other things, shareholders have in practice lacked any possibility of nominating their own board members. Many believe that this is part of the explanation for the high levels of remuneration in American companies, something that has even spread to non-American companies. In autumn 2006, the Norwegian Government Pension Fund, Britain's Hermes, Holland's APG and PGGM, all of which are among Europe's largest pension funds, decided to write a joint letter to America's SEC (Securities and Exchange Commission) to ask that these regulations be reformed, to grant shareholders the right to nominate their own board members. Sweden's Second and Third National Pension Funds have sent similar letters.

In November 2007, the Second AP Fund participated in a conference in New York that highlighted this issue. After the conference, the SEC proposals for new regulations were withdrawn, and the issue is now unlikely to be addressed prior to the election of a new US president.

3. Shareholder rights on the Asian markets

The focus of economic activity is shifting towards Asia. Consequently, an ever greater share of the global index is going to comprise Asian shares. It is therefore also likely that the Second AP Fund will have a higher share of its portfolios invested in these markets.

Traditionally, protection for minority shareholders has been fairly minimal on many of the Asian markets. It is therefore important that investors from other parts of the world seek to protect their investments by encouraging improvements in the sphere of shareholder rights.

The Fund was invited to speak about corporate governance issues by the Chinese National Pension Fund, and in concert with other major institutional investors has also pushed to improve the possibility of voting at AGMs in Singapore.

At the ICGN annual conference in June 2008 in Seoul, South Korea, one of the conclusions was that the reintroduction of "poison pills" by a number of companies, with a view to preventing hostile takeovers, has worsened rather than improved the situation on the Japanese market.

INITIATIVE

- The Ethical Council of the Swedish National Pension Funds was established on January 1 2007 and published its first annual report in the spring of 2008. The Ethical Council is engaged in monitoring and analysing the portfolios of the First to Fourth AP Funds, to

Gamma / IBL Bildbyrå

Morgan David de Lossy / IBL Bildbyrå

ensure that the companies in which they invest are not involved in infringements of international conventions to which Sweden is a signatory. The Committee has established routines for monitoring all holdings, selecting 10-15 companies for placement on a 'dialogue list', in cases where the Funds believe it will be possible to exert influence on the companies, encouraging them to institute new routines that can prevent future incidents or infringements of conventions.

The companies on the list are public and the report may be downloaded from the Second AP Fund's website at www.ap2.se. During November 2007, the Ethical Council carried out a comprehensive study visit in China, with the emphasis on environmental and labour rights issues. During 2008, the Second AP Fund chairs the Ethical Council.

- In 2006, the Second AP Fund, together with some 30 other major fund managers, were founding signatories of the United Nation's Principles for Responsible Investment (PRI). The extent to which these Principles have since been observed was monitored during 2008 and published on the PRI website.

  The Ethical Council of the AP Funds also used the PRI information forum.

- The Second AP Fund has also participated in the Carbon Disclosure Project, an initiative adopted by some 100 major fund managers, who demand that the world's largest publicly quoted companies take a stand on a number of issues pertaining to the greenhouse effect. The contents of the reports from the Carbon Disclosure Project form part of an internal project that during 2008 analysed the financial effects on the Fund's portfolio of the various possible consequences arising from continued negotiations in connection with the Kyoto Protocol.

- The Second AP Fund is one of the first investors in the world to insist that the private equity funds in which it invests shall subscribe to the United Nations' Global Compact principles. These are ten principles that, among other things, address areas such as human rights, labour standards, the environment and anti-corruption measures.

- The Second AP Fund is a member of the European Corporate Governance Institute in Brussels and the Swedish SNS Corporate Governance Network.

- In autumn 2007, the Göteborg Award for Sustainable Development, of which the Second AP Fund is a sponsor, was presented to Al Gore.

EXCLUDED COMPANIES

Wal-Mart and Singapore Technologies are two companies that have already been excluded from the Second AP Fund's investment universe.

In September 2008, the Fund excluded nine companies that market cluster bombs, in contravention of the convention banning cluster bombs, which Sweden supports. These nine companies are Alliant Techsystems, Gencorp, General Dynamics, Hanwha, L-3 Communications, Lockheed Martin, Poongsan, Raytheon and Textron.

Why Swedes vote so little in foreign

Few Swedish investors exercise their voting rights in foreign holdings. This behaviour costs more than might appear. The fact is that many large foreign companies lack clearly defined owners. This allows power to be shifted to their executive managements – raising the risk of short-term policies devoted to enriching company executives, rather than long-term policies geared to improving their owners' profits.

In Sweden, we are used to having well defined owners, many of whom exercise an active responsibility in publicly quoted companies. At the start of 2006, 265 of 295 of the principal owners of quoted companies in Sweden controlled more than 10 percent of the voting rights and capital. The remaining 30 companies were classified as 'ownerless'. This is not the situation on many foreign stock markets. In the USA, just a few percentage units (or even less) of the voting rights and total capital may be enough to qualify as a major investor in many listed companies.

'Ownerless' companies spawn more options programmes A clear problem with 'ownerless' companies is that they risk creating a disproportionate power shift from owner to management. According to the agent theory, this power shift can lead to decisions that favour executive management, but which may not be in line with the long-term owner's desires. There is good reason to give this agent theory credence. At least if one studies the link between ownership concentration and the incidence of options programmes for top management. A thesis presented at Lund University in 2004, based on a study of the 31 companies possessing the lowest ownership concentration on the Stockholm Stock Exchange, demonstrates that the incidence of generous options programmes for top management in 'ownerless' companies is significantly higher than for companies with a clearly defined principal owner.

Obvious impact in the US If you also take a look at remuneration decisions in American quoted companies in connection with the market's hysteria over the Internet, around the turn of the millennium, the impact is even more obvious. At the time, the top managements and other employees of the 1200 largest quoted companies in the USA held options valued at more than 10 percent of total capital. It is hardly likely that this transfer of power and money would have been possible if the US stock market had featured a larger number of principal owners. Or not on the same scale, anyway.

They used to vote with their feet Seen from a historical perspective, major institutional owners have chosen to 'vote with their feet', i.e. sell their holdings, when dissatisfied with the management of a foreign company. This approach was justified by the argument that it was far too costly to involve personnel in the type of corporate governance that required the active employment of voting rights.

Trend towards increased voting by institutions In recent years, however, increasing numbers of investors have had second thoughts. The greatest changes have been seen abroad. According to RiskMetrics, almost 45 percent of the world's total combined capital comes from the USA, Great Britain and the Benelux countries, where the exercise of voting rights in foreign companies has become relatively common. Sweden still has some way to go in this respect, even though

The Second AP Fund does it this way

The Second AP Fund chooses to utilize its owner status to vote. During 2007-2008, the Fund exercised its voting rights in 64 foreign holdings, via proxy.

"For us, it is self-evident that we should try to influence our holdings in a manner that we believe will generate better long-term returns," states Carl Rosén, who heads Corporate Governance at the Second AP Fund. With holdings in more than 2 200 foreign companies, the Fund exercised its voting rights at 64 AGMs. In this context, the Second AP Fund concentrates on companies with problems. It cooperates with foreign investors and exercises its voting rights electronically, by proxy. See the report on page 8.

there are exceptions such as the Second AP Fund, which exercises its voting rights in a limited number of foreign holdings (see box on page 12).

Some of the largest institutional investors in the world, such as America's CalPERS and Norway's NBIM (Norway's Bank

n companies

Investment Management) have chosen to go considerably further than the Second AP Fund, and exercise their voting rights in the majority of their investments. There are even types of savings where the exercise of voting rights in all holdings is statutory, domestic and foreign. One such example in the USA is the corporate funds established as 'employee benefit plans', where the exercise of voting rights in all foreign investments is statutory.

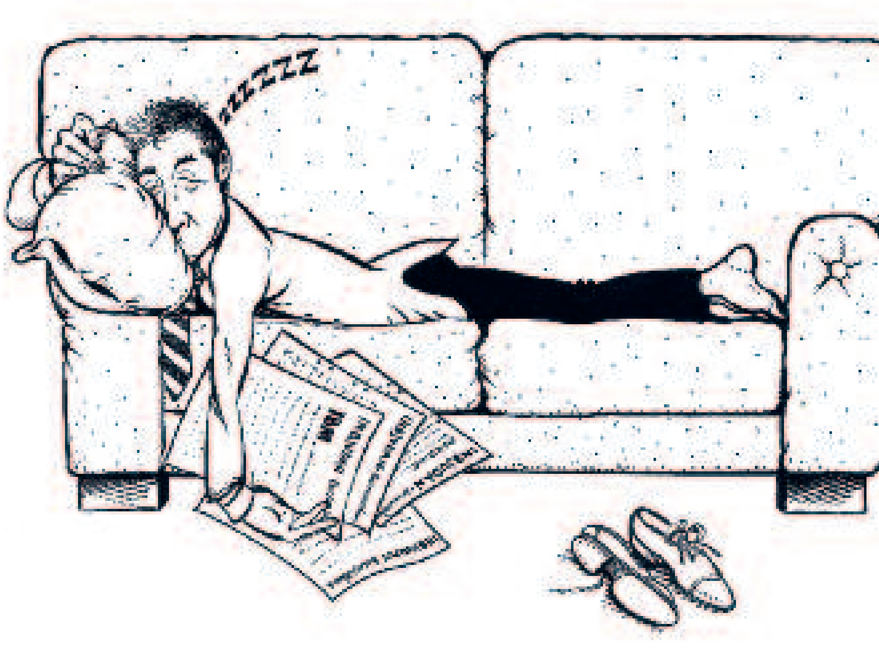
Foreign investors more accustomed
There may be several reasons why foreign investors have reacted earlier than their Swedish counterparts when it comes to exercising voting rights in international holdings. One reason may be that foreign investors are used to the lack of clearly defined principals on their domestic markets, making them more alert to the problems that can arise and giving them more experience of how to deal with them.

Media interest has an impact This development is the result of multiple influences, of course. Media interest is one such factor, another is the rankings published by market analysts. The reason is simple: few funds wish to be highlighted as bottom of the class in terms of their willingness to vote. To this is added political pressure. Both national and international authorities and organisations are striving towards making the funds' voting policies public. There are even strictly technical reasons for investors to adopt more active voting policies. Many institutions follow investment directives that require a long-term approach, a broad spread and which place limits on the amount of stock owned in individual companies – to achieve a good risk-adjusted return on the portfolio. In practice, these directives may result in a major institutional investor holding joint interests in all the companies forming a specific index. A sweeping decision to dispose of all holdings when dissatisfied with management's actions can narrow the portfolio's spread and increase risk. In such a situation, it may be better to retain the holdings and try to exert pressure on the company to adopt a more favourable long-term policy by, among other things, exercising the available voting rights.

And since the funds are normally so large that it becomes difficult to sell even a 'small' holding without depressing the share price, there is a limit as to many how times one can 'vote with one's feet' in companies, before the costs of selling such holdings outweigh those of staying in and trying to influence the company in a more favourable direction – by exercising one's voting rights.

Reduced costs of voting Moreover, the fact is that these days, the costs of monitoring one's interests and voting can be kept down by employing information technology, through inter-fund collaboration and by using proxies. "Voting is a low-premium insurance, especially given the fact that the Swedish National Pension Funds own foreign equities worth hundreds of billions of kronor," notes Carl Rosén, who heads Corporate Governance at the Second AP Fund.

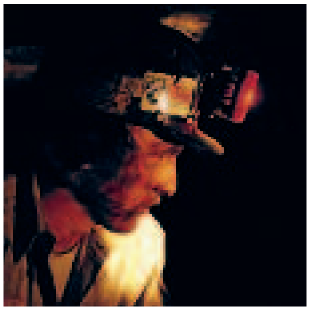
"VOTING IS A LOW-PREMIUM INSURANCE, ESPECIALLY GIVEN THE FACT THAT THE SWEDISH NATIONAL PENSION FUNDS OWN FOREIGN EQUITIES WORTH HUNDREDS OF BILLIONS OF KRONOR"

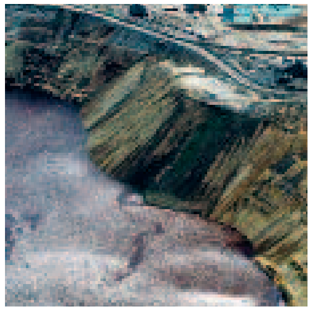


"TO BE ABLE TO ENGAGE IN MEANINGFUL DIALOGUE AND MAKE DEMANDS THAT REALLY LEAD TO SUSTAINABLE DEVELOPMENT FOR EMPLOYEES, THE ENVIRONMENT AND THE SHARE PRICE, YOU'RE GOING TO NEED A LOT OF KNOW-HOW."

PURE GOLD
– but at what cost?

Göran Pensjö / IBL Bildbyrå





Calvin Larsen / Photo Researchers, Inc. / IBL Bildbyrå

Many mining companies have attracted highly critical headlines in recent years. These media reports have led responsible shareholders to demand improvements. However, to demand the right conditions you need to have the right knowledge, which means some serious digging.

Kersti Karltop, a doctoral student in environmental systems analysis, at Chalmers Institute of Technology in Gothenburg, is well aware of this. She has recently completed a report for the Ethical Council, commissioned by the Second AP Fund, addressing the mining industry's impact on the environment.

The mining industry features more or less all you could possibly wish for to fill every single chapter of a blockbusting bestseller, such as hardworking entrepreneurs who stake everything and grit their teeth when faced by overwhelming odds. Some succeed, find the mother lode and are whisked away to a life of indescribable wealth. For others, the end of the story is dramatically reversed. This is the grim destiny embraced by all those miners involved in serious accidents, and local inhabitants living near mines that can damage their environment for generations to come.

Because of the inherent drama of the story, the media is constantly on the lookout for news of winners, losers – and sinners who can be paraded before an insatiable public.

There have been plenty of eye-catching headlines in recent years. Most often, they highlight serious mining accidents, dangerous working conditions and environmental issues. In addition to the physical harm caused to those working in or living close to mines, such negative factors can

Ethical Council pinpoints environmental risks

"IT WAS A REAL EYE-OPENER TO SEE HOW MANY DIFFERENT PROCESSES ARE INVOLVED AND THE HUGE VARIETY OF ENVIRONMENTAL PROBLEMS THEY CAN CAUSE – AND THAT THEY CAN HAVE SUCH SERIOUS LONG-TERM CONSEQUENCES."

also erode share value in the longer term.

Shareholders' tone sharpens Both aspects are stiffening the resolve of responsible shareholders to push for change. One such group is the Ethical Council of Sweden's First, Second, Third and Fourth AP Funds.

However, to be able to engage in meaningful dialogue and make demands that really lead to sustainable development for employees, the environment and the share price, you're going to need a lot of know-how.

"This is a highly complex industry. Just for starters, there is a bewildering variety of processes for mining and dressing the product, as well as different ways of storing the environmentally dangerous waste generated. The environmental problems can become extremely comprehensive if there are weaknesses in the company's routines for managing different processes or if an accident occurs," states Kersti Karltorp.

Charting the environmental dangers This is why, on behalf of the Ethical Council, she has conducted an exhaustive survey covering virtually every process, from prospecting to dressing and the treatment of harmful waste generated. This has involved a considerable amount of work, which is probably the main reason no institutional investor has done anything like it before.

"It was a real eye-opener to see how many different processes are involved and the huge variety of environmental problems they can cause – and that they can have such serious long-term consequences."

"The most obvious example is the waste product generated from dressing sulphide ore, commonly referred to as dressing sand. This sludge-like waste product poses the greatest environmental problem in mining operations. If the sludge is allowed to interact with air and water, this initiates a chain chemical reaction which is difficult to stop, releasing large quantities of sulphuric acid and heavy metals – one consequence being the elimination of marine organisms for a long time ahead."

Could prove very costly "The risks mean that the demands placed on waste management are increasingly stringent. Research has already demonstrated that certain types of waste must be stored securely for thousands of years, to avoid environmental damage."

The problem is that few business plans and interim reports address a timescale of this sort. Naturally, the risk of such short-sighted thinking is that it can lead to huge costs in the long run. And even short-term too. This is something that Swedish mining company Boliden has become all too well aware of, since the accident in Los Frailes, Spain, in 1998. The walls of a settling pond collapsed and some seven million cubic meters of sand and water ran out into a river delta.

This type of environmental disaster is what the Second AP Fund and fellow members of the Ethical Council wish to prevent, by participating in and actively contributing to sustainable development.

The Report in brief

"Environmental impact of the mining industry" surveys the ways in which common processes for mining, dressing, waste management and subsequent site sanitation impact on the environment.

The report has been prepared by the Second AP Fund on behalf of the Ethical Council of the Swedish National Pension Funds. Its primary purpose is to establish a broad knowledge base prior to continuation of the Committee's dialogue with selected mining companies.

The report can be downloaded from www.ap2.se

Impact of heavy metals on health

Element	Health risk
Antimony	Heart disease, skin afflictions
Arsenic	Cancer
Lead	Brain damage, convulsions, behaviour disorders, death
Cadmium	Heart and vascular disease, high blood pressure, brittleness of the bones, kidney disease, fibrosis of the lung, probably cancer
Copper	Liver damage
Quicksilver	Nerve damage, death
Magnesium	Nerve damage
Nickel	Allergies, lung cancer

ETHICAL COUNCIL promotes a more effective dialogue

The Ethical Council represents a coalition between the First, Second, Third and Fourth AP Funds, established to address environmental and ethical issues, in the context of the funds' corporate governance directives.

Up until the end of 2006, the First to Fourth AP Funds had dealt independently with ethical and environmental issues. The common denominator linking the four funds was not simply that this work was based on international conventions, but the joint appreciation of dialogue as a vital instrument in achieving change and enhanced awareness of ethical and environmental issues.

The Ethical Council comprises a permanent representative from each fund, with the right to co-opt an additional deputy. The chair, which rotates between the funds, was held by the First AP Fund in 2007, passing to the Second AP Fund in 2008.

Collaboration within the Ethical Council ensures that the funds' work in this sphere is conducted more efficiently, sometimes expressed through an increased number of corporate dialogues.

A united committee also makes an attractive partner for other international investors who subscribe to a similar agenda with respect to ethics and the environment, further improving the likelihood of being able to persuade companies to introduce positive changes.

Read more about the Ethical Council and the companies it engages in dialogue in the 2007 Annual Report. It can be found at www.ap2.se

Source: Norges Bank / Photographer: Nancy Bundt

Committed to a better climate. For investment too.

The Norwegian Government Pension Fund or 'The Oil Fund', as it is often called, is often referred to as top of the class when it comes to transparency and corporate governance. Among other things, it has attracted attention for its commitment to climate issues, involving an active dialogue with the representatives for major holdings in selected industries. "The aim is to steer development in a sustainable direction – to the benefit of the Fund's long-term return on investment," says Anne Kvam, head of Corporate Governance at NBIM.

The Norwegian Government Pension Fund is managed by NBIM (Norway's Bank Investment Management). The investment horizon is very long. This means that the Fund must consider more than short-term financial data in its management of assets, given the fact that what may seem wise in the short term may not necessarily be so wise when viewed in a 10-20 year perspective. With this in mind, the board has included other factors that could have a significant financial impact in the long term, but which are not that noticeable in the short term. Commonly referred to as 'extra-financial factors', these include corporate governance issues.

Six priority areas The NBIM corporate governance strategy during the period 2007-2010 comprises six priority areas. Four are classic in nature: the right to vote, the right to nominate and select board members, the right to trade shares freely and the right to transparent information. The other two areas are somewhat different. These comprise issues related to social and environmental sustainability.

Climate change an important long-term factor According to NBIM, there is no question that far-reaching climate change is an 'extra-financial factor' that could have a severely negative impact on the Fund's global portfolio. A number of studies support the Bank in its conclusion. These include reports from the IPCC (Intergovernmental Panel on Climate Change) and the Stern Review, which demands that action be taken to develop functional control systems for reducing emissions and thereby long-term costs – which is of crucial importance to a broad-based and long-term fund manager such as NBIM.

"ONCE YOU'VE BECOME AWARE OF THE CHANGES NEEDED TO ADDRESS THE CLIMATE PROBLEM, IT'S DIFFICULT TO REVERT TO OLD WAYS."

"The Stern Review is brutally clear in evaluating the long-term losses in terms of global GNP, if the impact of climate change cannot be controlled," notes Anne Kvam, who heads Corporate Governance at NBIM.

Apply pressure via one's holdings In NBIM's opinion, investors who try to go it alone in seeking regulatory change with a view to introducing better control systems and long-term environmental improvements have chosen the wrong route. On the other hand, the Fund believes pressure can be effectively exerted via one's holdings in a company. Many large corporations are actively engaged in lobbying in their home countries, in attempts to influence regulatory development. Engaging in a dialogue with these companies, to persuade them to contribute to more favourable development, or at least not to obstruct it, is becoming an increasingly important tool in promoting positive long-term development in terms of the climate and thereby many of the Fund's holdings.

At the same time, the Fund encourages companies to establish long-term strategies to address the various environmental threats and, simultaneously, to prepare themselves for future environmentally-related political change.

NBIM has been implementing this approach for just over a year. The initial idea was to gain an understanding of the companies' situation and to clarify the needs of long-term investors. During this period, the climate issue has climbed ever higher on the agenda, and a number of different legislative proposals have been tabled for discussion, regionally and globally.

"These proposals establish a natural basis for discussion and we notice that the companies' detailed knowledge and strategic awareness of the issue has grown, which is only natural," notes Anne Kvam.

"We shall never know exactly what the companies are lobbying for, but they are certainly more aware these days that they will be taking a greater risk than previously, if they lobby against the long-term interests of their shareholders."

Dialogue with major corporations In all, NBIM has analysed some 100 of the largest companies in its portfolio, in terms of sustainability. Of this total, some 20 companies were selected, in view of the fact that they are expected to be affected by future legislation. During 2007, the Fund conducted an exhaustive dialogue with

More than NOK 580 000 for every Norwegian

The Norwegian Government Pension Fund, which is managed by Norway's Bank Investment Management, NBIM, is the second largest national investment fund in the world. The Fund is expected to top NOK 2 700 billion in assets under management during the year, which is 13 times more than ten years ago. This translates into more than NOK 580 000 for every Norwegian.

Given today's high oil prices, the Norwegian State could in principle fund all its current costs from oil revenues and reduce tax to 0 percent.

The idea must be tempting. But the fact is that it would probably cost more than it was worth, by causing soaring inflation and hiking the exchange rate for the Norwegian krona. We are talking about changes that would probably wipe out Norwegian industry outside the oil sector. The Norwegian Government Pension Fund, where a large proportion of the country's oil revenues are transformed into financial investments abroad, functions as a stabilizing instrument, reducing the risk posed by this type of problem.

these companies, addressing this type of issue – a process which continued in 2008.

“We are really less interested in the number of companies than in the degree of influence individual companies might have on the regulatory process,” says Anne Kvam.

This process, in conjunction with the general debate concerning the environment, encouraged several of the Fund’s portfolio companies to review their stance on climate issues. Many of them changed the way they conducted their lobbying activities. Moreover, a number of strategic measures were adopted with a view to better satisfying future environmental requirements, including technological improvements.

Many have changed their attitude The Fund’s attempts to exert influence are focused mainly on holdings in the USA, since regulatory development in the US is considered to have a major impact on legislation in other countries. Special attention is paid to companies in the energy sector and industries featuring companies that are major energy consumers.

Corporate managements have demonstrated a growing interest in discussing these types of issue in recent years.

“Once you’ve become aware of the changes needed to address the climate problem, it’s difficult to revert to old ways,” says Anne Kvam.

“For example, at one point we visited the chairman of a major energy producer. One of the topics discussed was developments in climate-related legislation. The chairman, who was also president of the company and in constant contact with legislators, subsequently came to Oslo on his own initiative to continue the discussion with NBIM. This dialogue is still in progress.”

These discussions have generally moved on from the scientific issues to solutions to the problem and how it might best be tackled.

“The corporate managements we meet all participate in this discussion. At the same time, we must always remember that their primary objective is to secure the best possible result for their particular company. Consequently, the genuine degree of interest may vary.”

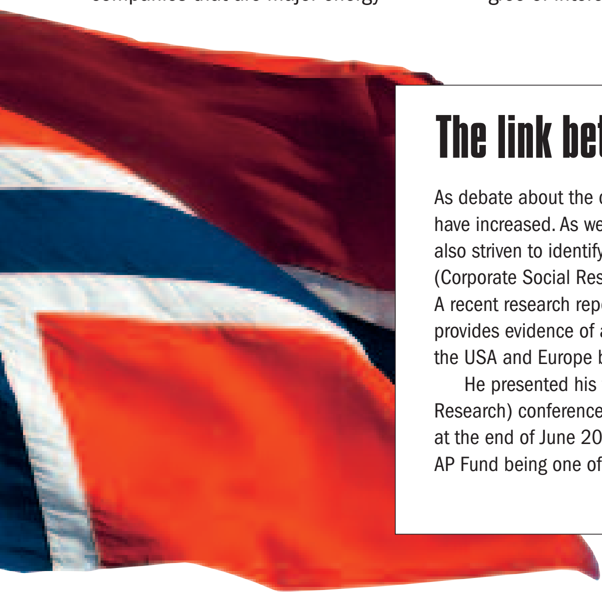
Although the level of interest may vary, NBIM normally receives a friendly welcome. This may well be due to a joint interest: long-term and sustainable growth in asset value.

“Our mandate is to secure the long-term value of the entire portfolio, and we strive consistently to implement this mandate. It heightens the relevance of what we are saying to the companies we talk to,” states Anne Kvam.

Collaboration with other funds The Norwegian Government Pension Fund also collaborates with other institutional investors on the climate change issue – the greater the number working together, the greater the negotiating power. This is something that is expected to continue.

“We cooperate in one way or another with several funds, in connection with our climate strategy. We shall have to wait and see how this develops, of course, but so far our experience has been positive.”

“The climate issue will be a vital issue on the agenda for a long time to come, and there are likely to be plenty of opportunities for many forms of cooperation to develop practical solutions to the problem,” concludes Anne Kvam.



The link between CSR and return

As debate about the climate issue has intensified in recent years, financial studies of the subject have increased. As well as studies to determine the possible costs of climate change, many have also striven to identify the link between responsible corporate behaviour, often referred to as CSR (Corporate Social Responsibility) and return on investment. There is much to suggest such a link. A recent research report published by Dr Andreas Ziegler at the University of Zurich, for example, provides evidence of a positive link between CSR and share price. The study covers companies in the USA and Europe between 2003 and 2006.

He presented his findings at the MISTRA (Swedish Foundation for Strategic Environmental Research) conference on sustainable investment, held at the Gothenburg School of Economics at the end of June 2008. The actual presentation was held at the Centre for Finance, the Second AP Fund being one of its associate companies.

A new Generation steps forward

In autumn 2007, the Second AP Fund invested in the global equity fund Generation. This is an actively managed fund with a long investment horizon. Investments are based on a fundamental analysis in which sustainability issues are awarded considerable significance. The Second AP Fund has talked to David Blood, earlier president of Goldman Sachs' global capital management.

The Second AP Fund selected Generation because of its exceptionally competent and experienced investment team. The fund's strategy is clear, demonstrating a good balance between return and risk.

Generation's ability as a 'stock picker' (selecting the right company to invest in, based on a broad index) has contributed to a good historically risk-adjusted return. The fund's integration of sustainability issues as an important parameter in its share analysis distinguishes it from most other equity funds. In concrete terms, this means that the fund compares and analyses how long-term economic and environmental factors, as well as social and geopolitical considerations, are likely to affect the share value.

What's the main difference between your fund and most other ethical funds?
"First and foremost, we consider ourselves to be a 'normal' investor. We don't usually compare ourselves to other ethical funds. We aim to be one of the leading global equity funds on the market."

"Our greatest strength is the integration of a sustainability analysis with the fundamental equity analysis. Many other organizations divide their fundamental equity and sustainability analyses between two different teams. We don't. Here, each member of the investment team is responsible for both the fundamental equity and sustainability analyses in their sectors and among the companies they cover."

How does this make your analysis better? "It provides us with additional data that others either fail to gather or simply lack the processes and people necessary that enable such data to be integrated in an effective manner. Our broader information spectrum probably gives us a different and more balanced perspective on the executive managements, business operations and market worth of corporations."

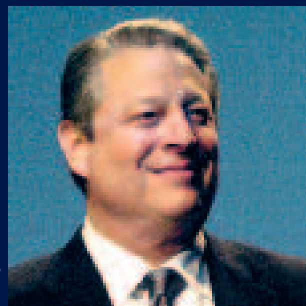
How long had you planned to start this type of fund, where sustainability is integrated into the analysis? "I spent much of my childhood in Brazil. This has contributed to my deep commitment to issues affecting social development and a reduction in poverty. When I left Goldman Sachs in 2003, I wanted to establish something that united my interest in capital markets and investments with sustainability and social development."

"The same applies to Al Gore, another of the fund's founders, who has invested decades of his life in highlighting the problems that the climate crisis could generate. We had both pondered sustainability issues for several years before we started Generation 2004. We understood, as did the other founders, that these issues have a huge impact on corporations. We sought a way to apply our way of thinking to capital markets."

What persuaded you to actually start the fund? "I think the timing was fairly fortunate. When I met Al Gore in 2003, we were both in a position to act on our convictions that sustainable investment is the best way to manage money. This catalyzed the creation of Generation in early 2004. But it was another 18 months before we actually started managing assets for our clients. We wanted time to gather our team and develop our processes, since we really started with a blank sheet."

In what sense is corporate governance an important instrument in your management of assets? "Corporate governance is a key factor we take into account when analysing the quality of the management team, in a company we might invest in. It is therefore an important part of our investment theory. We really try to get to know the company well before we invest. Our investment process involves a detailed analysis of factors such as corporate culture, respect for shareholders, ethics and management. Companies that fail to meet our quality requirements don't get into the portfolio."

Environmental award to Gore



Photographer: Rolf Hallin

The Göteborg Award for Sustainable Development, of which the Second AP Fund is a sponsor, was presented to the environmental debater Al Gore in 2007. "Nobody has alerted the world to the climate issue as he has," stated the jury, in its award dedication.

Al Gore was presented with the prize of SEK 1 million by HRH Crown Princess Victoria of Sweden, at a major gala reception held at Gothenburg's Scandinavium Arena on January 22nd 2008.

The Göteborg Award for Sustainable Development is an international award presented for notable achievements in sustainable development. The Award was first presented in 2000, at that time entitled the Gothenburg International Environmental Award.

Every year, an independent jury selects an award winner who has contributed to sustainable development, within one of the Award's chosen criteria. Award winners have ranged from environmental certification agencies and cooperatives to politicians and company presidents.

Previous winners have included Toyota, for its hybrid technology, as well as Sweden's Hans Eek and Germany's Wolfgang Feist, for developing ways to construct low-energy 'passive' houses.

The Award, amounting to SEK 1 million, is presented in association with the City of Gothenburg and twelve other sponsors, including the Second AP Fund, Handelsbanken, Nordea and SKF.

State + CAPITAL

Over the past few years, the media, politicians and the financial establishment have identified a new global investor group: Sovereign Wealth Funds (SWFs) – state-owned investment funds.

Voices have been raised in favour of limiting the influence of such funds through legislation. Others feel that this is not the way to go, as it would merely cripple global capital markets, with costly after-effects in the form of imbalances and reduced efficiency.

Chinese, Russian and Arabic Sovereign Wealth Funds In just a few years, SWFs have progressed from being a concept that raised barely an eyebrow to one that is forcing both politicians and the financial community to do some serious thinking about how to respond.

Started as early as the ’50s Although the term SWF may be only a few years old, the phenomenon itself is really not that new. For example, Kuwait’s state-owned investment fund has been managing its wealth since 1953. The fund proved invaluable in helping rebuild the country after Iraq’s invasion in the early 1990s.

A fortune in bird droppings The tiny Pacific island of Kiribatis also has a fund, based on revenues generated from the sale of guano which, since 1956, has created huge economic benefits for its population of just over 100 000 citizens. The fund’s worth is currently rated at about USD 400 million.

’80s wave of investment soon beached Even so, the first big wave of state-investment fund activity did not arrive until the 1980s. The greatest difference between then and now is the way such funds invest.

In th ’80s, these funds invested mainly in their domestic industries. The results were discouraging. The funds generated poor returns and fuelled inflation – as demonstrated by Norway, among other countries. The fact that this phenomenon has been named ‘Dutch Disease’ is quite another story (see box on page 27).

The new wave is much stronger Now the second wave of state investment funds has arrived. Just since 2005, twelve large new SWFs have appeared. The greatest difference compared with the previous generation is that they invest globally. And they are much bigger. According to the latest figures from the Sovereign Wealth Fund Institute, these funds represent a combined capital of USD 3 850 billion. Although these are big numbers, it means that the SWFs still have a good way to go before reaching the same level as the pension funds’ combined assets, which are in excess of USD 20 000 billion. Nevertheless, the rate of growth is dramatic: 18 percent in 2007 alone, according to Britain’s IFSL (International Financial Services London). This increase is to a great extent fuelled by the sharp rise in the price of commodities.

A forecast published by Morgan Stanley notes that, within ten years, the largest funds will have more than USD 13 000 billion in assets and will control 5 percent of the world’s combined capital.

Power shift creates anxiety This could mean a shift of power – which is why many politicians are demanding that constraints be imposed. These include how much funds will be allowed to own in individual companies and how far they will be allowed to exploit their governance rights. In the EU, for example, there has been talk about the possibility of instituting a ‘golden share’, similar to our Swedish ‘A’-class shares, which can be used to retain power in the company. This is something that has been suggested by Angela Merkel, Germany’s Federal Chancellor, among others.

Critics of SWFs are mainly concerned about protecting national interests – they say they are averse to selling off national treasures to funds whose aims are unclear and which in many cases are governed and controlled by undemocratic governments. Theoretically, this could occur in conjunction with the privatisation of a state-owned company if it was floa-

The bar diagram at right shows the world’s largest Sovereign Wealth Funds. Bar height corresponds to the size of the fund, while the figure in parentheses indicates the degree of transparency.

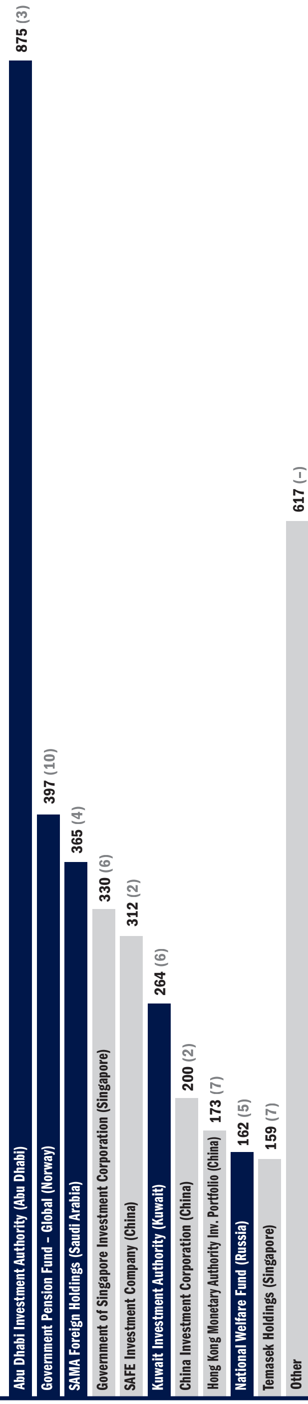
= origin of fund capital: oil

= origin of fund capital: other

000 = capital under management, USD billion

(0) **= degree of transparency,** 10 is the highest. The Linaburg-Maduell Transparency Index ranks SWFs according to ten criteria, all of which are related to transparency. The Norwegian Government Pension Fund, which is a model of transparency and clarity, provided the starting point when developing the index’s structure.

Source: Sovereign Wealth Fund Institute



ted on the stock exchange and an SWF subsequently acquired a controlling interest. There is worry that the funds might function as political instruments in the service of their owner countries – such as acquiring control of companies in strategically important sectors such as commodities and technology. We are here talking about investments based on political motives, which do not necessarily lead to optimal financial returns.

SWFs might become too skilful At the same time, some critics fear what might happen if the opposite proves true – that the funds become too skilful as investors, when seen strictly in terms of the hunt for high returns. They paint a picture of a new George Soros syndrome, but with a lot more money. Gigantic funds playing the percentage game can wipe out a national currency in just a few days, by identifying temporary inefficiencies in the financial system and exploiting them to the full.

Lack of transparency The most vociferous critics of these funds base their argument on the extremely limited nature (which is putting it mildly!) of the information such funds provide. They have a long way to go before they will be able to satisfy the EU's proposals for guidelines governing long-term investment strategies, corporate governance and financial transparency.

In most instances, criticism of the funds has been dealt with in a polite and almost subtle manner, in the true tradition of diplomacy. In some cases, however, things have gone a step further. Political representatives for Germany and France have unequivocally declared their dislike of SWFs.

Even in the US, some politicians have openly expressed their anxiety over the oil funds' increased influence in the current election campaign – which has been dominated by the economy and a distrust of globalization.

Even Sweden's own Minister for Local Government and Financial Markets, Mats Odell, has noted that such funds offer scope for improvement. In an interview for Swedish business daily Dagens Industri, on March 6 2008, he noted: "There are some definite challenges that need to be met, of course, in terms of transparency."

Proposed constraints As a direct consequence of this anxiety, the IMF (International Monetary Fund) has been tasked with drafting a code of conduct for SWFs. As well as placing constraints on the amount of stock a fund can own in individual companies, additional demands for further changes include the establishment of 'mutual investor rights': if a Chinese SWF wishes to invest in Sweden, Swedish investors must be able to invest in a Chinese company. Another demand that has been under discussion is that these types of fund should not be allowed to undermine the viability of an entire currency through speculation, as George Soros did in conjunction with the turbulence on currency markets in 1992. Many also point to the need for greater transparency and that SWFs must be more open about how they are operated, whether they report direct to the governments of their countries or have entirely independent boards of directors, and numerous other matters.

Wall Street welcomed the cash The list

of constraints and demands could be extensive – as could a list of the ways such demands have been presented.

The tone adopted by the most vociferous supporters of imposed constraints tends to mellow, for instance, when the state-owned investment funds are the only ones prepared to 'put up' some capital.

Since the credit crunch sank its claws into the USA, and until the spring of 2008, China, Singapore and the Arab oil states had invested hundreds of billions of USD in the country. The greater part of this sum found its way to precisely that area of commerce where the crisis started: the country's most eminent investment banks.

It is notable that the SWFs have themselves made an effort to cosy up to the West, both by expressing themselves in a relaxed manner to the media and by linking themselves with some key names. As recently as July 8th 2008, Temasek Holdings – ranked tenth largest SWF in the world –declared that it had recruited Marcus Wallenberg to its board of directors.

“CRITICS OF SWFS ARE MAINLY CONCERNED ABOUT PROTECTING NATIONAL INTERESTS – THEY SAY THEY ARE AVERSE TO SELLING OFF NATIONAL TREASURES TO FUNDS WHOSE AIMS ARE UNCLEAR AND WHICH IN MANY CASES ARE GOVERNED AND CONTROLLED BY UNDEMOCRATIC GOVERNMENTS.”

Market liberals averse to constraints The proposals for constraints have generated criticism from a predictable quarter. Most market liberals claim that the cost of imposing protectionist constraints on the capital markets could be high. Market liberals believe that an increased element of cross-border ownership contributes to greater balance in the global economy, thanks to more integrated ownership, where money, know-how and technology are disseminated throughout every part of the economic sphere. If this flow of capital vanishes, there is risk of a global decline in growth.

This is also the OECD's conclusion. In 2007, the G7 countries tasked the organization with looking at the SWF problem, from the host countries' view-point. As a result of the study, the G7 member countries adopted the OECD's declaration on SWFs and policies for host countries at a meeting of ministers in early June 2008. Briefly, the declaration states that host countries shall avoid the erection of protectionist barriers and discriminatory practices that hinder SWFs. At the same time, the declaration expresses a wish for greater transparency and more clearly defined governance of the funds in their countries of origin. This thinking is based on the unanimous conclusion that SWFs and a free capital market are good for the host countries and for global growth.

“MARKET LIBERALS BELIEVE THAT AN INCREASED ELEMENT OF CROSS-BORDER OWNERSHIP CONTRIBUTES TO GREATER BALANCE IN THE GLOBAL ECONOMY, THANKS TO MORE INTEGRATED OWNERSHIP, WHERE MONEY, KNOW-HOW AND TECHNOLOGY ARE DISSEMINATED THROUGHOUT EVERY PART OF THE ECONOMIC SPHERE.”

Constraints already in place It should also be noted that constraints already exist, but they are not directed specifically at SWFs. Most countries, for example, already impose constraints relating to the ownership of banks and defence contractors. Nevertheless, the regulations applied to ownership and corporate governance vary from one country to another in a number of important aspects – for instance with regard to seats on the board.

In some countries, the position is far from clear, as in the USA. There, there is a committee for monitoring foreign investments, either classed as active or that exceed 10 percent in an American company.

Dutch Disease – something all wish to avoid

One of the reasons the majority of SWFs elect to invest abroad is their determination to avoid the affliction known as 'Dutch Disease'. This was named after a phenomenon that affected Holland in the 1950s, but which can affect any country that has amassed a large trade and budget surplus, as can be generated by oil exports. During the 1950s, major finds of natural gas were made in Holland. Their exploitation generated huge revenues for the country. Even so, these export successes also had a downside, which included a soaring exchange rate and inflation. This had a negative impact on the rest of the country's export industries – leading ultimately to a decline in growth.

"Special rules for SWFs – a step in the wrong direction"

Knut N. Kjaer
Knut N. Kjaer, earlier head of the world's second largest SWF, the Norwegian Government Pension Fund.

Introducing special regulations to limit the freedom of action of sovereign wealth funds (SWFs) would be a step in the wrong direction. It would risk creating an inefficient capital market. Instead, we should focus every effort on helping SWFs become more professional. So claims Knut N. Kjaer, former head of the world's second largest SWF, the Norwegian Government Pension Fund, considered a model of transparency and responsible governance.

What's the difference between a pension fund, like the Second AP Fund, and an SWF?

A pension fund has a clearly defined objective: to secure the viability of future pensions. It also normally features a high degree of transparency.

The expressed objectives of Sovereign Wealth Funds vary greatly. Russia and Iran refer to their funds as stabilization funds, whose primary function is to manage sharp fluctuations in energy prices.

The funds operated by China and South Korea focus on achieving a solid return and access to new markets, ideas and technology. Some SWFs declare none of their objectives. The Norwegian Government Pension Fund is an exception, with clearly defined objectives.

Husmofoto / IBL Bildbyrå

Proposals to limit the SWFs' freedom of action have arisen as a knee-jerk reaction to the growth of these funds. This is something that worries Knut N. Kjaer. For instance, Knut N. Kjaer doesn't have much time for the proposal that the funds be restricted to the role of passive owners, because it could well result in management-governed companies, inadequate control and low value generation. Another point is that many SWFs are already managed according to passive investment strategies: they exhibit no interest in exercising their voting rights and demand no seats on the board.

"TRANSPARENCY IS CRUCIAL TO THE CREATION OF A UNIFORM AND RESULTS-BASED ORGANIZATION, WHERE EVERY MEMBER OF STAFF FULLY UNDERSTANDS THE OVERALL OBJECTIVE OF ITS BUSINESS ACTIVITIES."

"What we really need is more active owners, including those who manage public assets at arm's length from the state," notes Knut N. Kjaer.

Demands should apply to all Some even claim that minimum demands should be made concerning transparency in SWFs.

"This type of demand should apply to the entire capital market, not directed specifically at a single group of investors. Transparency is crucial to the creation of a uniform and results-based organization, where every member of staff fully understands the overall objective of its business activities."

"Instead of talking about special rules and constraints, we should be discussing how we can contribute to making the funds more professional in the way they operate. I believe that state-owned funds, whether SWFs or pension funds, can be run just as professionally as the best privately owned funds."

Some useful principles There are a few basic principles that managers of SWFs should adopt to generate higher returns. The first is to ensure that there is financial know-how at the highest level – and this is not something that should be purchased via external managers.

"Moreover, the funds should be absolutely clear about their financial objectives, and ensure that portfolio managers have the instruments and mandates necessary to achieve the returns expected of them. There should also be a clear allocation of responsibility for each investment made and each objective achieved – all the way from portfolio manager to board level."

Such a system leads to reliable risk control while at the same time building staff confidence, something that helps counteract the follow-my-leader mentality that is so often associated with mediocre results and, occasionally, radically erroneous decisions.

"WHAT WE REALLY NEED IS MORE ACTIVE OWNERS, INCLUDING THOSE WHO MANAGE PUBLIC ASSETS AT ARM'S LENGTH FROM THE STATE"

The Fund's governance activities in brief

The Second AP Fund shall through its actions actively promote sound practice in the areas of ethics, the environment and asset management, with the ultimate aim of enhancing the long-term value of the Fund's capital assets. The Fund adopts a number of different approaches in addressing governance issues, based on an in-house analysis of portfolio companies from an investor perspective. A description of the instruments employed in corporate governance is given below. A more comprehensive description may be found in the Second AP Fund's Corporate Governance Policy, which may be downloaded from www.ap2.se

The Fund's actions are guided by ten key indicators, each of which is subjected to thorough analysis. These are:

1. Capital structure
2. Corporate structure
3. Shareholder structure
4. Board of directors and nomination process
5. Executive management and executive remuneration
6. The role of auditors and audits
7. Information and corporate communication
8. Investments, acquisitions and divestments
9. Corporate culture
10. Ethics, the environment and gender equality.

The Second AP Fund: gets in touch with companies directly if necessary In companies where the Fund identifies a need for change concerning one or more of the ten principles, it attempts to establish contact at an early stage. This may even involve collaboration with other investors. The Second AP Fund believes that an ongoing dialogue with companies is invaluable in contributing to change that creates increased shareholder value, without thereby placing the Fund in an insider position.

The Second AP Fund: focuses on companies in which it can exert a major governance role In Sweden, the Second AP Fund mainly becomes engaged in governance issues in companies in which it is one of the largest stakeholders or in which it has invested most. In cases where matters of principle are concerned, even where other portfolio companies are involved, the Fund may consider it important to make a stand.

The Second AP Fund believes that a clear majority interest is inappropriate due, for one thing, to the danger that a high degree of active involvement in portfolio companies on the part of Fund personnel can have a limiting effect that risks undermining efficient portfolio management. The Second AP Fund shall not hold shares in an individual quoted company, Swedish or foreign, that corresponds to more than ten percent of the voting rights. Outside Sweden, the Fund exercises its voting right at the AGMs of some 60 of its largest holdings.

Concerning its holdings through mutual funds, private equity funds and share-index forwards, the Fund has neither the intention nor the possibility of adopting an active role as a shareholder. In cases where the Fund is informed of governance-related problems in such companies, any action taken will be determined by the nature of the case in question.

The Second AP Fund: excludes the portfolio company where the dialogue fails to produce the desired result Should a suspicion arise that one of the companies in which the Second AP Fund has invested has been in breach of sound ethics, ignored important environmental considerations or has deviated in some serious respect from the desired governance principles, the actual state of affairs must be ascertained immediately. Should this suspicion be confirmed, the company shall be asked to provide immediate clarification and submit a plan of action to remedy the situation. In evaluating the situation, the Fund shall consider the nature of the event and any corrective measures that may have been taken, or are to be taken, to ensure that the problem does not recur. If the response is unsatisfactory, if corrective action is not implemented and if the nature of the event is sufficiently serious, the Second AP Fund shall divest itself of the holding as quickly as possible.

The Second AP Fund: participates in nominating committees and votes at AGMs The Second AP Fund makes it a principle to participate in nominating committees in companies where it is one of the largest shareholders. When not represented on the nominating committee, the Fund submits its views via the chairman of the nominating committee. To avoid complicating the Fund's role as an active portfolio manager, Fund employees shall in principle not serve on the boards of quoted companies.

The Annual General Meeting of a company is its highest executive organ, and the Fund assumes that important decisions are well prepared prior to the AGM. The Second AP Fund shall participate in, exercise its voting rights at and, in some cases, also act at the AGMs of companies in which it has a significant interest.

The Second AP Fund: places the same high demands on holdings owned via external managers When an external mandate is awarded for the active management of Fund assets, the Second AP Fund shall inform the selected manager about its current Corporate Governance Policy. If necessary, an ongoing dialogue shall be conducted with the portfolio manager concerning governance issues. The Second AP Fund always retains responsibility for governance matters, whether the corporate holdings form part of an in-house or an externally managed portfolio.

Sources of additional information

- The Second AP Fund's Corporate Governance Policy, www.ap2.se
- The Second AP Fund's 2007 Annual Report, parts 1 and 2, www.ap2.se
- The Second AP Fund's Female Representation Index 2008, full presentation, www.ap2.se
- The Ethical Council Annual Report 2007, www.ap2.se
- Orange Report, Swedish Pension System's Annual Report 2007, www.forsakringskassan.se/filer/publikationer/pdf/par06.pdf
- UN report "Responsible Investment in Focus: How leading public pension funds are meeting the challenge", in which the work of the Second AP Fund is presented, www.unepfi.org/fileadmin/documents/infocus.pdf
- Presentation of the Principles for Responsible Investment, www.unpri.org/files/pri.pdf
- Presentation of the Global Compact, www.globalcompact.org/docs/about_the_gc/gc_brochure_final.pdf

The Second Swedish National Pension Fund/AP2

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

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

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

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

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

It will achieve this by means of efficient, professional and long-term portfolio management, featuring an effective utilisation of financial risk.

Since it was established in 2001, the Second AP Fund has maintained a strategic portfolio that features a high percentage of equities, to attain a high long-term return. Fund capital amounted to SEK 207.2 billion on June 30 2008. Equities account for 60 percent of the portfolio, fixed-income securities 36 percent and real estate and private-equity funds 4 percent.

Andra AP-fonden

Second Swedish National Pension Fund - AP2

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