

Year-end report 2002

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AP-fonden**

Second Swedish National Pension Fund - APZ



Long-term fund management demands consistent approach

The capital assets of the Second Swedish National Pension Fund/AP2 totalled SEK 117.1 billion on December 31st 2002. At the start of 2002, the Fund had a total of SEK 133.5 billion under management. During the year, the Fund reported a net inflow of SEK 5 billion.

The return on the Fund's invested assets for the full twelve months ending December 31st 2002 amounted to -15.3 percent. This was a 0.4 percent improvement against the Fund's reference index (i.e. the Fund's "benchmark" index), corresponding to SEK 586 million. Excluding the Fund's operating expenses, this generated a relative* return on invested capital of 0.6 percent, corresponding to SEK 783 million. The decline in the market value of Fund assets may be attributed to the sharp drop in market rates on the world's leading stock markets during 2002. On average, the world's leading stock exchanges declined by 23 percent in 2002. The OM Stockholm Stock Exchange, in which the Second AP Fund has invested approximately 20 percent of its pension assets, declined by approximately -38,6 percent during the same year (SBX index).

During the second half of the year, the Fund's asset management activities have focused increasingly on active management and absolute yield requirements. To secure a stable return and more diversified risk, managers of equities and fixed income instruments have steadily diversified their portfolios, both in classes of asset and in terms of geographical markets.

The Fund operates according to an investment horizon of 10–15 years, which limits the impact of weak stock markets, even over periods of several years. A number of yield analyses show that, over the long term, investment in equities offers a higher return than fixed income instruments. Continual and active reallocation has maintained the proportion of equities in the Fund's portfolio at around 60 percent.

- The Swedish equities portfolio noted a return of -36.7 percent, compared to the -35.8 percent noted by the reference portfolio. The value of the portfolio amounted to SEK 22.8 billion (26.2).
- The foreign equities portfolio noted a return of -24.9 percent, compared to the -27.0 percent noted by the reference portfolio. The value of the foreign equities portfolio amounted to SEK 46.1 billion (53.9).
- The Fund's fixed-income portfolio generated a positive return of 8.9 percent, in parity with the reference index. The estimated worth of the portfolio, excluding liquidity, amounted to SEK 42.2 billion (46.3).
- As well as investments in equities and fixed-income instruments, the Second AP Fund also invests in two other classes of asset: Real Estate and Alternative Investments. The worth of these assets has remained generally stable during 2002.
- FX exposure accounts for approximately 7 percent, or SEK 8.0 billion, of the Fund's combined assets. A greater proportion of hedged foreign equities compared to the reference index favourably affected the return on overall investment when the Swedish krona strengthened during 2002.
- During the year, the Second AP Fund has modified its strategic reference portfolio to promote more active management and greater diversification of risk. In conjunction with this move, the Fund's various reference indexes have changed. Measured in terms of the Fund's total level of return and compared with the indexes used earlier, these changes in index have been neutral.

Unless otherwise stated, the portfolio assets referred to in this report are "allocated exposures". In addition to booked market values, these also refer to allocated (but not yet invested) liquidity for the specific class of asset, and other assets 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 market values.

* Corresponds to an active return on investment.

Weak result despite relative surplus ROI

2002 proved in many respects to be a year of extremes for global financial markets – one of the worst experienced by stock markets since the 1930s. Consequently, most fund managers have been forced to post sharply negative results. Even though the Fund's year-end result for 2002 is unsatisfactory, it has nevertheless been possible to limit this negative outcome, partly by diversifying risk among different classes of asset and geographical market, and partly due to a certain surplus in relative return on investment.

Unlike many other companies, such as the life insurance companies, the Second AP Fund has not found itself forced to sell any of its shares. This means that the negative result reported for the Fund's equity portfolios derives mainly from an unrealised decline in their market worth.

The Fund's absolute return on investment for 2002 amounted to -15.3 percent, corresponding to SEK -21.2 billion. The Fund's relative return on investment, including operating expenses, exceeded the Fund's reference index by 0.4 percent, or SEK 586 million. Less the Fund's operating expenses, this means a relative surplus return on investment of 0.6 percent, or SEK 783 million. This surplus return derives from a surplus allocation of hedged foreign equities and a good return on actively managed foreign equities. Conversely, the management of Swedish equities has been less successful. They have underperformed against index, making a negative contribution to the year-end result.

New strategic reference portfolio

During the autumn, the Fund changed and redefined the composition of its strategic reference portfolio within the general parameters specified: 60 percent equities and 40 percent fixed-income instruments. The new fixed-income portfolio features international diversification of the bond portfolio and an increase in corporate bonds.

To reduce dependence on the share performance of a few large companies in the Swedish equities portfolio, the class of assets termed "Swedish equities" has been divided up to increase the relative proportion of small and midsize companies included. Furthermore, new classes of asset such as "Equities in emerging markets" have been added, and "Real estate" has been more clearly defined than before.

Build-up of the Second Swedish National Pension Fund/AP2

In 1999, the Swedish Parliament decided to introduce a reformed national pension system and that the new Second Swedish National Pension Fund/AP2 should be located in Gothenburg, where it was to be built from the ground up. This build-up, initiated in the autumn of 2000, was completed during 2002, and the Fund now conducts a full range of investment management activities in-house.

Economic development in Sweden and abroad

Uncertainty about long-term global economic growth continued during 2002. The international security situation, especially with respect to events in Iraq, and several accounting scandals within a number of large American corporations, further fuelled this uncertainty. With this in mind, and a general feeling that many equities were overvalued, stock markets in many parts of the world were exceptionally volatile, with extended and dramatic drops in market rates interspersed with short sharp recoveries. The forced sale of equities by a number of institutional investors was a major contributory factor to these falling share prices.

Even so, economic performance between individual countries and regions varied greatly, as did the monetary and financial policies introduced to maintain momentum. The USA implemented a sharply expansive monetary policy, featuring low

Class of asset	Reference-portfolio	Interval	Dec. 31 st 2001 market value ²⁾	Dec. 31 st 2002 market value ²⁾	Dec. 31 st 2002 exposure ²⁾³⁾
Swedish equities	20%	15–25%	27.7	22.4	22.8
Foreign equities ¹⁾	40%	25–50%	50.0	34.5	46.1
Fixed-income assets, incl. liquidity and accrued interest	37%	>30%	51.3	54.9	43.4
Real estate	3%	0–15%	4.1	4.0	4.6
Alternative investments	-	0–5%	0.1	0.2	0.2
Total	100.0%		133.2	116.0	117.1

¹⁾ Not more than 20 percent of the Fund's assets may be exposed in foreign currency (2002).

²⁾ Amounts in SEK billion.

³⁾ The difference between total market value and exposure consists mainly of derivative instruments.

interest rates and a range of economic incentives that included additional tax breaks. This helped to maintain consumption at a relatively high level, which fuelled fairly strong growth, but also added substantially to the federal deficit. Within the EMU (Economic & Monetary Union) area, the “Stability and Growth Pact” was placed under a certain amount of strain when economic growth in a number of EU countries proved too weak to combat the downward economic spiral without external help. In Germany in particular, Europe’s largest economy, the economic problems became only too apparent, with low growth and substantial unemployment. In contrast, the performance of the Swedish economy, with its low rate of inflation and relatively good growth, seems fairly satisfactory.

The outlook for 2003 is coloured by continuing and genuine uncertainty about the direction in which the global economy is headed and about the current geopolitical situation, in particular the risk of conflict in Iraq, but also the risk of new terrorist outrages. Even so, in the first few weeks of 2003, several analysts have expressed cautious optimism and predict that we shall see a turnaround of the global economy during the latter part of the year. When it comes to the performance of the financial markets, it seems as if analysts incline towards a rise in market rates rather than the reverse. Support for this view may be found in the fact that many commentators are convinced that the market valuation of most equities now seems reasonable, compared with other investment opportunities. After three years of plummeting share prices on global stock markets, many consider it highly unlikely that 2003 will go the same way, especially when placed in a historical perspective.

The Fund is also cautiously optimistic that the improvement in the global economy during the latter part of the year will be significant enough to have an impact on the regularly published forecasts and growth ratios. However, given the current

climate of terrorist threats and political destabilisation, this optimism must be qualified by a realisation that an upswing in the economy could nevertheless be delayed.

Asset management

At the start of 2002, the Fund had combined pension assets of SEK 133.5 billion under management, most of which were invested in equities and fixed-income assets. The share portfolio was in its turn divided into Swedish and foreign equities, the greater part of the foreign equities portfolio being hedged.

In the middle of 2002, based on an analysis of the Fund’s long-term undertakings, the Fund’s reference portfolio was modified somewhat, involving a limited change in the composition of the Fund’s assets. The overall composition of these assets, however, with approximately 60 percent in equities and 40 percent in fixed-income instruments, remains unchanged. This has led to an ongoing re-weighting process during the year, involving the net purchase of equities to a value in excess of SEK 14 billion. Portfolio performance is matched on an ongoing basis against the reference index, with a more thorough evaluation every three years. The long-term target, based on a 10 to 15 year horizon, is to generate an annual surplus return on invested assets of 0.5 percent compared with the reference portfolio. Since the Fund was established in January 2001, the surplus return as against index has amounted to 1.8 percent. When seen in the context of the Swedish Stock Exchange’s relative size in international terms, accounting for not more than about two percent of the market, Fund investments in the Swedish stock market are clearly over-represented – almost a third of the share portfolio consists of Swedish equities. Seen in terms of the Fund’s role in Swedish society, this is both natural and reasonable, given the fact that the Swedish National Pension Funds are an integral

Return, 2002¹⁾

AP2		Reference index	
Second AP Fund, total return	-15.3%	Total index	-15.7%
Swedish equities, total	-36.7%	Swedish equities ²⁾	-35.8%
Foreign equities, total	-24.9%	MSCI World, adjusted by region	-27.0%
Fixed-income assets	+8.9%	SHB Interest Index/Lehman Brothers	+8.9%
Alternative investments	-8.1%		
Real estate	+5.5%		

¹⁾ Since the autumn, the composition of the strategic reference portfolio and the Fund’s reference index has changed. The composition of the sub-portfolios of the Swedish share portfolio, as well as the share portfolio for emerging markets, was determined during the final months of the year.

²⁾ Consists of 70% SBX, 20% OSX and 10% CSX.

part of the Swedish economy as a whole. In strict asset management terms, however, this can cause a number of problems. It has therefore been important to reduce dependence on the favourable performance of shares in a few large and index-heavy corporate equities in the Swedish share portfolio.

In a move to secure a higher share of “absolute return”, and to diversify risk, the Fund has established a more refined and differentiated share portfolio.

In practice, this means that the composition of the strategic reference portfolio for Swedish equities will be distributed as follows: 70 percent market-value weighted equities, 20 percent equally-weighted equities (where the 50 largest companies are accorded the same weighting, regardless of actual market worth) and 10 percent equities in small Swedish companies. All in all, this somewhat reduces the portfolio’s earlier dependence on the performance of few large Swedish companies, while increasing its dependence on small and midsize companies.

Highlights of the second half

A reallocation of portfolio assets was implemented during the second half of the year, in line with the modified strategic reference portfolio determined by the Board of Directors.

At the close of the year, the Second AP Fund signed a contract making the State Street Bank & Trust Co. its global custodian. This signing was the culmination of an exhaustive evaluation and procurement process.

Within the portfolio management area, the Fund completed negotiations concerning the award of external mandates to international investment managers. This procurement process is part of the development and implementation of the Fund’s strategy for managing a significant proportion of its assets by co-opting the expertise of external investment managers. The plan is to become a highly competent “manager of managers”.

During the year, the Fund reacquired responsibility for the entire fixed-income portfolio, which had been delegated to external managers as passive investments during the Fund’s build-up phase. On completion of the diversification of the fixed-income portfolio, certain parts will revert to external management in 2003, although this time the mandate will be active management.

The Fund’s role as an institutional investor has attracted growing attention in the broader context of public concerns about excessive incentive programmes, accounting scandals in the USA and other matters relating to ethics and values. During 2002, the Fund has revised and tightened up its governance policy, as well as intensifying its efforts in this area.

Financial review

The Fund posted a return of –15.3 percent on invested assets for 2002, including operating expenses. This meant that the Fund had exceeded its reference index, which noted a return of –15.7 percent. Relative surplus return, less operating expenses, amounted to 0.6 percent. The net inflow of liquid funds for the year amounted to SEK 5.0 billion, of which SEK 2.0 billion in the form of disbursements from the National Social Insurance Board (RFV). The remainder of this net inflow, amounting to SEK 3.0 billion, was transferred from the liquidation fund, which is managed by the First Swedish National Pension Fund (Första AP Fonden).

At year-end 2002, foreign currency exposure corresponded to approximately 7 percent of total assets. This exposure, deriving mainly from the foreign equities portfolio, consisted mainly of positions taken in US dollars, euros and sterling.

Growth trends for different classes of asset Swedish equities

The market value of the Fund’s portfolio of Swedish equities totalled SEK 22.8 billion as of December 31st 2002. Holdings were distributed in accordance with the new reference portfolio and were well diversified among the large exchange-listed Swedish companies. During the latter part of the year, to compensate for the uncertainty and volatility of the market, the Fund maintained a certain excess weighting in defensive equities, mainly in the form of bank shares.

During the year, some 80 percent of the portfolio has been under active management, while the remaining holdings have been managed passively against index. Some of the Fund’s investments were handled by in-house portfolio managers (approximately 50 percent), some by external managers under the terms of specific mandates. The results achieved by different external managers have varied considerably.

The return on the portfolio of Swedish equities amounted to –36.7 percent for the year, as against the –35.8 percent noted by the reference index.

The Fund's five single largest Swedish holdings by worth were AstraZeneca (2.7 percent), H&M (2.0 percent), SHB (1.9 percent), Ericsson (1.8 percent) and Nordea (1.7 percent).

Foreign equities

The return on the Fund's portfolio of foreign equities amounted to –24.9 percent. The reference index, a regionally adjusted MSCI World Index, has noted a return of –27.0 percent during the same period.

At the close of 2002, the Fund's foreign equities portfolio had a market worth of SEK 46.1 billion. The Second AP Fund's total exposure in share-related securities was distributed as follows: Sweden (30 percent); North America (28 percent); Europe, not including Sweden (30 percent); Japan (7 percent), Asia/Pacific region (3 percent) and emerging markets (2 percent).

The greater part of the foreign equities portfolio has been managed passively against index. Most of the holdings have been handled by external managers.

At year-end 2002, the five single largest foreign holdings were Nokia (1.0 percent), General Electric (0.8 percent), Microsoft (0.8 percent), ExxonMobil (0.8 percent) and Pfizer Inc. (10.7 percent).

Fixed-income assets

The market worth of the Fund's fixed-income instruments, excluding liquidity, amounted to SEK 42.2 billion on December 31st 2002, compared to SEK 46.3 billion at the start of the year. The difference corresponds to reallocations involving the sale of fixed-income instruments and the purchase of equities. Consequent to this diversification, the fixed income portfolio now consists of Swedish and international bonds, government securities and corporate bonds, as well as other instruments involving a credit risk. The fixed income portfolio generated a return of +8.9 percent, which was in line with the reference index.

During the year, the greatest deviation from the reference portfolio derived from an excess

allocation in real-interest bonds up to the start of October, and the cautious level of credit risk noted in corporate bonds. In addition to its fixed income assets, the Fund reported liquid funds amounting to SEK 1.2 billion at year-end 2002.

Alternative investments

During 2002, the Fund signed undertakings with two new funds. In combination with undertakings signed during the preceding year with three additional funds, this brought the total worth of new undertakings to SEK 740 million. Of this sum, SEK 169 million has already been invested, of which SEK 113 million in 2002.

Real estate

The Fund's real-estate exposure consists partly of listed real-estate equities and partly of substantial holdings in two unlisted real-estate companies. The Second AP Fund's unlisted real-estate holdings consist of a 25-percent participation in AP Fastigheter AB and a 33.3-percent participation in NS-Holding AB (Fastighetsbolaget Norrporten AB). The Fund's participations in both companies, including subordinated debentures, amount to SEK 4.6 billion. Both companies have performed fairly well during the year, even though AP Fastigheter AB was affected by the harsher property market conditions that prevailed during the latter part of the year, especially in and around Stockholm.

Next report

The Second AP Fund publishes its financial results twice yearly, in the form of a half-year and year-end report. The full Annual Report for 2002 will be published in March 2003. The financial results for the first six months ending June 30th 2003 are scheduled for publication on Friday August 29th, 2003.

Gothenburg, February 6th 2003

The Second Swedish National Pension Fund/AP2

The Board of Directors

Income statement

Amounts in SEK million	Jan-Dec 2002	Jan-Dec 2001
Operating income		
Dividends received	1.578	823
Net interest income	3.193	3.570
Net capital loss	-12.602	-3.918
Exchange profit/loss, net	-835	899
Unrealised changes in value	-12.542	-6.192
Total operating income	-21,208	-4,818
Operating expenses		
External asset management costs	-46	-39
Personnel costs	-61	-23
Other asset management costs	-90	-125
Total operating expenses	-197	-187
NET PROFIT/LOSS FOR THE YEAR	-21.405	-5.005

Balance sheet

Amounts in SEK million	2002-12-31	2001-12-31
ASSETS		
Investment assets		
Shares and participations		
Listed	56.906	77.743
Unlisted	4.131	4.139
Bonds and other interest-bearing securities	51.361	48.172
Derivative instruments	1.750	585
Total investment assets	114.148	130.639
Receivables and other assets		
Cash and bank balances	2.253	1.916
Other assets	240	43
Prepaid expenses and accrued income	1.534	1.193
Total receivables and other assets	4.027	3.152
TOTAL ASSETS	118.175	133.791
FUND CAPITAL AND LIABILITIES		
Fund capital		
Fund capital at start of year	133.493	133.975
Net payments to the pension system	1.985	3.062
Transferred from the special fund and the liquidation fund	3.017	1.461
Net profit/loss for the year	-21.405	-5.005
Total fund capital	117.090	133.493
Liabilities		
Derivative instruments	928	217
Other liabilities	28	48
Prepaid income and accrued expenses	129	33
Total current liabilities	1.085	298
TOTAL FUND CAPITAL AND LIABILITIES	118.175	133.791