



Andra AP-fonden
Second Swedish National Pension Fund - AP2

Year-end report 2004

Strong performance and solid return

The capital assets of the Second Swedish National Pension Fund/AP2 totalled SEK 158.1 billion as per December 31st 2004, an increase of SEK 17.8 billion compared with the preceding year. During the year, the Fund reported a net inflow of SEK 1.7 billion. The Fund posted a total return on invested assets of 11.6 percent for the full twelve months ending December 31st 2004. Net profit for the year totalled SEK 16.1 billion.

The solid return on invested assets may be attributed primarily to the portfolio's high exposure in Swedish equities and favourable exposure in foreign exchange.

During 2004, the focus and organisation of asset management activities has changed, moving towards a clearer distinction between the passive and active management of risk. A number of external mandates awarded for management of equities on the Swedish and European markets have been terminated and a substantial amount of these assets are now managed in-house. During the year, the Fund has established a quantitative analysis group. The proportion of active mandates awarded will increase in the field of tactical asset allocation and in the form of global mandates to manage equity, fixed-income and FX portfolios.

The Fund has also developed a completely new model for its strategic portfolio.

- The Swedish equities portfolio posted a return of 19.0 percent. The Fund's benchmark index rose by 20.2 percent. The value of the portfolio amounted to SEK 32.8 billion (28.4).
- The foreign equities portfolio noted a return of 11.5 percent while the Fund's currency-hedged benchmark index noted an increase of 11.8 percent. The value of the portfolio amounted to SEK 63.8 billion (56.7).
- The Fund's fixed-income portfolio generated a return of 7.3 percent, compared to the 7.6 percent increase posted for the benchmark index. The estimated worth of the portfolio, excluding liquidity, amounted to SEK 54.6 billion (50.4).
- Alternative investments, which comprise real estate, hedge funds and private equity funds, generated a 12.2 percent return on investment. Total worth was estimated at SEK 6.9 billion.
- FX exposure accounted for 10.2 percent of the Fund's combined assets at year-end, or 16.2 billion. The large proportion of hedged foreign assets proved beneficial, especially against the US dollar, which noted a sharp decline against the krona.
- The year has seen considerable activity in terms of corporate governance. The Fund exercised its voting rights in some 100 companies and participated in around ten nomination meetings, as well as in a large number of drafting committees, prior to numerous annual general meetings.
- Towards the end of 2004, the Second Swedish National Pension Fund/AP2 finalised its strategic portfolio for 2005. The general allocation of 59 percent equities, about 36 percent fixed-income instruments and five percent alternative investments remains valid. Currency exposure increased from eight to nine percent. The target for real ROI on in-house investment was raised from 3.5 to 4.5 percent.

Figures in parentheses apply to 2003-12-31.

Strong performance and solid return

2004 has been a good year for investment in most asset classes. The Second Swedish National Pension Fund/AP2 has stuck to its strategic allocation of assets, with a high proportion of equities. Low exposure in foreign currency and a relatively high exposure on the Stockholm Stock Exchange have further enhanced the strong performance of assets under management.

The absolute return on fixed-income instruments has contributed significantly to the Fund's overall return on invested capital.

The relative return on quoted assets, excluding operating expenses, is 0.6 percent lower than the Fund's strategic portfolio. This difference derives to a great extent from the type of securities selected on the Swedish market, and on positioning designed to benefit from an anticipated rise in long-term interest rates.

Since the start, the Fund has achieved an overall relative return of 0.7 percent.

New strategic portfolio

In December, the Board of Directors of the Second Swedish National Pension Fund/AP2 approved a somewhat altered strategic portfolio for 2005. The relative overall distribution of assets under management remains unchanged at 59 percent equities, 36 percent fixed-income instruments and five percent alternative investments. The difference, compared to the preceding year's strategic portfolio, is an increase in the degree of currency exposure (from eight to nine percent), and the adaptation of the Fund's hedging strategy to individual currencies. The Fund has raised its targeted real return on investment from 3.5 to 4.5 percent. The new model for Asset Liability Modelling (ALM), that the Fund has developed in association with Fraunhofer Chalmers Research Centre for Industrial Mathematics, will increase opportunities for developing and refining its strategic portfolio and asset allocation. The model can be used to illuminate possible alternative scenarios for Sweden's future national pension system.

Economic trends: international and in Sweden

2004 saw a continuation in the recovery of the global economy. Generally speaking, the global economy grew more rapidly than anticipated at the beginning of the year, producing the highest rate of growth in the past 20 years. The rate of growth in the US was a highly welcome 4.4 percent. In the EMU zone, however, the rate of growth was lower, at 1.8 percent. The 3.9 percent growth noted by Japan, however, was the most surprising, especially in the light of the reduced risk of continuing deflation. Forecasts for the Swedish economy were below the 2.5 percent noted at the start of the year, although these forecasts are expected to be exceeded towards the end of the year by almost a whole percentage unit.

The favourable trend established on the Swedish equities market during 2003 was maintained during the first quarter of the new year. The global equity markets developed much more slowly, however, while key markets, such as the US stock market, noted a decline.

Positive surprises in the quarterly reports of some companies gave substance to the peaks attained by equities markets in April. Interest rates also rose during this period, a consequence of sustained strong growth, inflationary tendencies and expectations of imminent action by central banks to increase base rates.

During the late spring and summer, the financial markets were driven increasingly by rising oil prices, while equities markets declined. Market rates rose initially, only to fall back later. This decline was mainly due to the fact that rising oil prices were seen more as a threat to the global economy than as posing a risk in terms of accelerating inflation.

Following the US presidential election, interest in the equities market recovered. Falling oil prices and the sustained growth of the US economy added to the buoyant mood. This optimism was further fuelled by the positive signs generated by the Chinese economy and the fact that many corporations continued to favourably surprise the market, posting sharply increased profits for the third quarter.

The steady decline of the US dollar in the period 2001-2003 was finally halted and the trend reversed, with a modest recovery during the first quarter of 2004. Until the end of the summer, movements on

currency markets were relatively limited. During the autumn, however, the US dollar again fell sharply against other currencies, to its lowest level in eight years. Taken overall, the Swedish krona firmed against the basket of currencies that the Second Swedish National Pension Fund/AP2's global exposure in equities represented in 2004.

Earlier anxiety over possible deflation scenarios was replaced by growing concern over the risks of possible inflation. In the event, there was only a modest rise in inflation, in part the result of increased capacity, cautious wage increases and a credible monetary policy.

Ongoing development of asset management

The portfolio's overall composition, comprising 59 percent in equities, 36 percent in fixed-income instruments and five percent in alternative investments, remained the same throughout 2004.

Seen in international terms, the Swedish Stock Exchange accounts for a mere two percent of the global equities market. The Fund's investments in Swedish equities are clearly over-represented – they account for almost a third of the overall investment portfolio. In strict asset management terms, the resulting high degree of volatility can lead to numerous problems. Even so, rising rates noted by the Stockholm Stock Exchange during the year have significantly increased the Fund's market worth.

During the second half of 2004, the Fund progressively implemented a change in management style on the equities side. A key element of this new strategy is the clear definition of mandates, with respect to the relative degree of risk incurred.

Among other things, this has meant that a large part of the Fund's portfolio of Swedish and European equities is now managed in-house. A

significant proportion of risk utilisation will be transferred to global mandates.

By year-end 2004, the Fund had awarded 53 mandates for managing equities, compared with 72 at year-end 2003. In all, 37 (45) percent of the Fund's total assets are under external management. On the equities side, 59 (72) percent is placed under external management.

Fund utilisation of active risk, ex post, amounted to 0.5 percent as per December 31st 2004.

Key events of 2004

On the equities side, four Swedish and twelve European external mandates have been terminated, to align the portfolio with the Fund's new investment strategy.

In the field of Tactical Asset Allocation, negotiations were completed concerning the award of a number of global asset management mandates. These negotiations are part of the Fund's development and follow-up to determine the value of tactical asset allocation, as an active means of generating increased returns on invested assets.

During the year, the Fund completed negotiations concerning the award of external mandates to manage parts of its fixed-income portfolio. The Fund has sought fund managers for three separate mandates; one for an aggregated global mandate, one for US government and non-government bonds, and one to manage a portfolio of global non-government bonds. The tactical asset allocation and fixed-income mandates will be activated during 2005.

The Fund has also been working on a new corporate governance policy and, for the Fund, a new way of dealing with corporate governance issues. The aim is to secure a higher return on invested capital by implementing a consistent

Return as per index, 2004

The Second Swedish National Pension Fund/AP2		Benchmark index	
Total return on assets	11.6 %	Total index	12.0 %
Swedish equities – total	19.0 %	Swedish equities ¹⁾	20.2 %
Foreign equities, total	11.5 %	MSCI World, regionally adjusted ³⁾	11.8 %
Fixed-income securities	7.3 %	SHB Index Linked/Lehman Brothers	7.6 %
Real estate	15.1 %		
Hedge funds	5.1 %		
Private equity funds	2.1 %		
		SIXRX ²⁾	20.8 %
		MSCI World ²⁾	10.3 %

¹⁾ Composed of 65% SBX, 25% OSX and 10% CSX.

²⁾ For the sake of comparability, the SIXRX (Swedish equities) and MSCI World (foreign equities) indexes are also shown, 80% local currency, 20% SEK.

³⁾ The Second AP Fund's regionally-weighted MSCI world index: 42% North America, 37% Europe, 9% Japan and 12% other regions.

approach to corporate governance issues throughout the investment process.

Financial review

The Fund posted a return on invested assets, excluding operating expenses, of 11.6 percent for 2004, or SEK 16.4 billion. The Fund's relative return on market-listed assets, excluding expenses, amounted to -0.6 percent.

The inflow of liquid assets during the year amounted to SEK 1 651 million, SEK 1 397 million of which consisted of net payments from the National Social Insurance Board (RFV). The remaining inflows are dividends from the liquidation and special funds, administered by the First and Fourth Swedish National Pension Funds.

The Fund's foreign currency exposure at year-end 2004 was 10.2 percent. In all essential respects, this exposure derived from the Fund's foreign fixed-income and equity portfolios, consisting mainly of positions taken in USD, EUR and GBP.

Development of different aspects of asset management

Tactical asset allocation

The absence of long-term trends during the year has limited the benefits offered by tactical positions. The overall contribution to the portfolio was negative and may be attributed to a certain under-exposure against the US dollar during the first quarter.

Swedish equities

The market value of the portfolio of Swedish equities, as per December 31st 2004, was SEK 32.8 billion. These holdings were distributed in accordance with the strategic portfolio.

The return generated on the portfolio of Swedish equities was 19.0 percent for the year, compared with 20.2 percent for the benchmark index. The deviation from benchmark is attributable to the type of securities selected, mostly Ericsson. The broad Swedish SIXRX index posted a return of 20.8 percent for the same period.

The entire portfolio was under active management during the year. This was handled

partially in-house, rising to about 73 percent by year-end, and partially in the form of several external mandates. The results achieved by different external fund managers have varied significantly.

The Fund's five single largest Swedish holdings in terms of the total portfolio of equities were Ericsson (4.1 percent), SHB (2.9 percent), Volvo (2.1 percent), H&M (2.0 percent) and Nordea (1.9 percent).

Foreign equities

The Fund's portfolio of foreign equities generated an 11.5 percent return on investment. The benchmark index, one of the Second Swedish National Pension Fund/AP2's regionally-adjusted MSCI World indexes, posted a return of 11.8 percent for the same period. The relative return was -0.3 percent, as compared to the benchmark index. The deviation from benchmark is primarily attributable to the type of securities selected. The broader MSCI World index rose by 10.3 percent during the same period.

The market value of the Fund's portfolio of foreign equities was SEK 63.8 billion at year-end 2004. The portfolio's composition was geographically diverse, comprising 41 percent in North American equities, 36 percent in European equities, ten percent in Japanese equities, eight percent in emerging markets and five percent in other markets.

The portfolio of foreign equities has mainly been under active management. By year-end 2004, 80 percent of the portfolio was actively managed, while 20 percent was passively managed against index. The greater part of these management activities, 77 percent, were conducted at the end of the year by external fund managers. At year-end 2004, the Fund's five single largest foreign holdings in terms of the total portfolio of equities were BP (0.7 percent), Citigroup (0.6 percent), General Electric (0.6 percent), Vodafone Group (0.6 percent) and Johnson & Johnson (0.5 percent).

Fixed-income assets

The market value of the Fund's fixed-income instruments as per December 31st 2004, including liquidity, was SEK 54.6 billion, compared to SEK 50.4 billion at the start of the year. The return on the fixed-income portfolio was 7.3 percent. The benchmark index rose by 7.6 percent. This deviation may largely be attributed to the taking of positions

with a view to benefiting from an anticipated rise in interest rates towards the end of the year.

The portfolio of fixed-income assets comprises Swedish and global bonds, with government and corporate bonds, as well as other instruments that involve a credit risk. The portfolio has primarily been handled in-house, under active management.

Alternative investments

Real estate

The Fund's real-estate exposure consists partly of listed equities in a number of real estate companies, partly of substantial interests in two unlisted real-estate companies. The Fund's unlisted real-estate holdings consist of a 25-percent participation in AP Fastigheter Holding AB and a 33.3-percent participation in NS-Holding AB (Fastighetsbolaget Norrporten AB).

The market value of the Fund's total holdings in unlisted real estate, including debenture loans, amounts to SEK 4.7 billion.

Norrporten continued the strategic expansion of its real-estate portfolio during the year and, among other locations, has invested in Helsingborg and Uppsala. The company reports vigorous earnings growth. The market value of the Second Swedish National Pension Fund/AP2's real-estate holdings amounted to SEK 1.6 billion, including debenture loans.

AP Fastigheter's real-estate portfolio is concentrated primarily to the Stockholm, Uppsala and Gothenburg regions. The properties are attractive and well located. Although the market for rental accommodation in Stockholm has been weak in the past few years, the situation stabilised during 2004 and the first signs of change could be discerned. By year-end 2004, the market value of the Second Swedish National Pension Fund/AP2's real-estate holdings, including debenture loans, amounted to SEK 3.1 billion. The company enjoys strong profit growth.

Private equity funds

The strategy adopted by the Second Swedish National Pension Fund/AP2 is to create a geographically well-diversified portfolio of private equity funds. The first step in this direction was taken in 2004, when the Fund embarked on its first major undertaking outside the Nordic region. This took the form of a USD 150 million investment

commitment in a "fund-of-fund", managed by Pathway Capital.

In conjunction with the undertakings made to seven funds in the preceding year, this brought the Fund's total investment commitment to SEK 2.8 billion. Actual investments to date total SEK 649 million, of which SEK 373 million in 2004.

Hedge funds

During the year, a total of SEK 501 million was invested in hedge funds, and three new fund managers were engaged. Consequently, the Fund now operates ten hedge fund mandates. These activities generated a 5.1 percent return on invested assets during the year, slightly better than the benchmark index.

Operating expenses

The Fund's operating expenses amounted to SEK 330 million in 2004, of which SEK 64 million in personnel expenses and SEK 198 million in external management fees.

Management expenses, defined as total operating expenses in relation to the Fund's total average assets in 2004, amounted to 0.22 percent.

The cost of external asset management services amounted to 0.13 percent of the average market value of the Fund's total capital assets over the full twelve month period.

The bill for external management fees rose from SEK 110 million in 2003 to SEK 198 million in 2004. This increase is attributable to the additional costs incurred in connection with the change in management focus, involving a greater degree of active management and an absolute return on invested assets.

Personnel

As per December 31st 2004, the Fund numbered 44 permanent employees, as well as five project-employed staff.

Gothenburg, February 10th 2005

The Second Swedish National Pension Fund/AP2

Board of Directors

Income statement

Amounts in SEK million

Jan-Dec 2004 Jan-Dec 2003

	Jan-Dec 2004	Jan-Dec 2003
Operating income		
Dividends received	1 902	1 639
Net interest income	2 632	2 915
Net capital gain/loss	3 119	-1 666
Exchange loss, net	-1 370	-2 621
Unrealised changes in value, net	10 166	20 660
Total operating income	16 449	20 927
Operating expenses		
External asset management expenses	-198	-110
Personnel expenses	-64	-62
Other asset management expenses	-68	-62
Total operating expenses	-330	-234
Net profit for the year	16 119	20 693

Balance sheet

Amounts in SEK million

Dec. 31st 2004 Dec. 31st 2003

	Dec. 31 st 2004	Dec. 31 st 2003
ASSETS		
Shares and participations		
Listed	88 844	77 263
Unlisted	2 267	4 016
Bonds and other fixed-income securities	63 223	54 718
Derivative instruments	2 278	2 717
Cash and bank balances	1 193	1 562
Other assets	103	16
Prepaid expenses and accrued income	1 289	1 257
Total assets	159 197	141 549
FUND CAPITAL AND LIABILITIES		
Liabilities		
Derivative instruments	741	1 018
Other liabilities	214	86
Prepaid income and accrued expenses	122	95
Total current liabilities	1 077	1 199
Fund capital		
Fund capital at start of year	140 350	117 090
Net payments to the pension system	1 397	2 143
Transferred from special and liquidation funds	254	424
Net profit for the year	16 119	20 693
Total fund capital	158 120	140 350
TOTAL FUND CAPITAL AND LIABILITIES	159 197	141 549

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 the liquid funds held as collateral for positions already taken in derivative instruments. Classes of asset, derivative instruments and liquid funds are reported individually in the balance sheet at market values.

Next report

The Second Swedish National Pension Fund/AP2 publishes its financial results in the form of a six-month interim (half-year) report and a year-end report of unaudited annual earnings. The full

Annual Report for the financial year 2004 will be published in March 2005. The financial results for the period ending June 30th 2005 will be published on August 17th.