



Annual Report 2008
THIRD SWEDISH NATIONAL PENSION FUND



2001-2008

Fund capital hit hard by the financial crisis

The financial crisis had a major impact on fund capital

Falling asset prices and losses due to the financial crisis in 2008 precipitated a sharp fall in the cumulative value generated by AP3 since inception, and Fund capital is now back at its 2005 level. Fund capital is now back at its 2005 level, though portfolio diversification has cushioned the impact of the crisis. The Fund started out in 2001 with capital of SEK 134 billion. As of 31 December 2008 this had risen to SEK 181 billion, representing a total return of SEK 25.8 billion. Including net inflows, fund capital rose by SEK 47.0 billion in this period.

Positive contributions from strategic positions

The Fund's strategy of using forward-looking assessments when making strategic portfolio¹ selections has proved beneficial over time. Between 2001 and 2008 our strategic positions generated active returns of SEK 5.0 billion, despite a negative return in 2008.

Restructuring of active management

AP3's active management¹ deploys a wide variety of strategies to generate active returns with limited risk. Active management did not contribute to Fund returns in 2001-2008, but we believe that the separation of alpha and beta mandates will improve the scope for active returns in the future.

Alternative assets add value

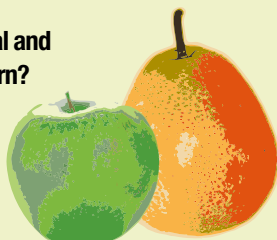
AP3 was an early mover when it came to seeing the potential of alternative investments and we have built up a diversified portfolio that generated a return of SEK 7.2 billion in 2001-2008.

Nominal returns beat inflation but fell short of the real return target

The average annual real return on these investments was 3.8% in 2001-2007, but losses in 2008 cut the figure for 2001-2008 to just 0.4%, which is well below our average annual target of 4%.

¹ See Glossary

What is real and active return?



Real return includes unrealised and unrealised changes in the value of the AP3 total portfolio and is measured by deducting inflation (increases in the consumer price index) from nominal returns. Active return is the difference between returns on the listed portfolio and the reference index.

2008

Financial crisis had negative impact on AP3's result

Turbulence on the financial market had a strong adverse impact on results

Fund capital stood at SEK 181.0 billion at year-end, a decrease of SEK 43.9 billion from the start of the year. The turbulence that swept through world bond and stock markets during the year had an adverse impact on AP3's equity and fixed income portfolios, as well as on our other assets. As a result, AP3 recorded a loss of SEK 44.8 billion in 2008. Total return was -19.7% before expenses and -19.8% after expenses.

Diversification of the normal portfolio tempered losses

The normal portfolio¹, which comprises listed equities, fixed income assets and alternative investments, contributed -16.3 percentage points to total return. The portfolio is diversified, which helped to temper losses. At global level, equity markets plunged by around 40% in 2008. AP3's equity portfolio posted a return of -24.8 percentage points, while the fixed income portfolio made a positive contribution of 2.2 percentage points. Alternative investments in real estate, private equity and new strategies contributed -0.1 percentage points. Currency exposure after hedging made a positive contribution of 6.3 percentage points, reflecting the depreciation of the Swedish krona.

Strategic positions made negative contributions

In 2008, strategic positions contributed -2.0 percentage points. Fixed income positions accounted for just over half of this fall in value, with foreign currency and equity positions each accounting for about a quarter each. Our positions versus the US dollar had a positive impact of 0.4 percentage points.

Negative active return

Active return¹ was -1.4 percentage points and below the Fund's target. Equities and fixed income made negative contributions to active return¹ of -0.8 and -0.4 percentage points respectively. The contribution of alpha mandates¹ was 0.2 percentage points.

¹ See Glossary



Systemic crisis tested AP3 severely in 2008

A systemic crisis hit global financial markets in 2008. At the start of the year a number of banks, notably in the US and the UK, reported problems in their businesses at the same time as corporate profits hit record heights in many areas. An economic slowdown was expected in 2008, while overheating pressures remained from previous years. Inflation and energy prices rose prior to the summer, after which the economy ground to an abrupt halt when Lehman Brothers filed for bankruptcy on September 15.

Crisis of confidence in the banking system

If a major bank can collapse, then others can too – a realisation that prompted banks to lose confidence in each other, and for their customers to lose confidence in them. Confidence is the foundation of the banking system, and acute liquidity problems are likely to arise if this confidence evaporates and savers withdraw their deposits simultaneously. A crisis of confidence in a single bank might not necessarily have major consequences, but a systemic collapse would result if the jitters hit banks around the world at the same time. This is what happened when Lehman Brothers filed for bankruptcy, with confidence draining from bank to bank and continent to continent as the US and UK subprime mortgage crises threatened to engulf the entire global financial system.

Sharp rise in risk premiums

Investors, lenders and savers responded by rushing almost simultaneously to re-evaluate risk. Refinancing risk and counterparty risk, both of which are relatively easy to calculate under normal economic conditions, were repriced at extremely high levels.

During the year we worked intensively to diversify risk, purchasing real estate and investing in new areas such as secured bank loans, agricultural land and insurance-related securities. This involved reducing our exposure to the equity market in favour of other investments. We also moved to divide asset management responsibilities between passive exposures and active risk to enhance our risk profile and generate greater scope for higher returns.

Risk diversification did not help

Though well-founded, our strategy did not bear fruit in 2008: risk diversification is little help during a mass flight from risk. It is very difficult to construct a portfolio that can withstand a systemic failure, and we can merely acknowledge that the AP3 portfolio was not designed to handle the crisis. Systemic collapses are rare because they require such a comprehensive failure by all financial decision-makers.

When Lehman Brothers declared bankruptcy we did not realise quickly enough that it presaged a systemic crisis capable of causing a worldwide recession. Initially we focused on limiting counterparty risk. Counterparty risk offers low returns and losses cannot be recouped by retaining the investment for the longer term. It thus differs from equities, where investors can recover losses when times improve (assuming the company does not go into liquidation). We incurred no pure counterparty risk losses but did make losses on equities and bonds issued by companies that filed for bankruptcy. These investments are unlikely to be recoverable but involve limited sums of money.

Our primary losses in 2008 were on equity portfolio investments and credit bonds. Here, we underestimated



“2009 will be no less challenging in terms of exploiting opportunities while limiting risks.”

the risk of a mass flight from equities and other securities. In retrospect, we should have reduced portfolio risk further in order to limit losses. Nevertheless, a long-term investor like AP3 has the opportunity to recover losses when the market turns.

Turnaround may take time

Global economic activity is declining rapidly and the outlook for the near term is unfortunately not very encouraging. Despite massive interventions by central banks and governments around the world it will take time for the real economy to turn the corner. It is very difficult to gauge how long this process will take.

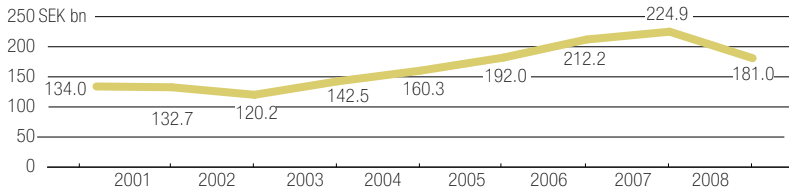
At AP3 we have a lot of hard work in front of us as we seek to diversify risk, capitalise on new openings and limit the risks that offer the lowest rewards over time. We expect 2009 to be another major challenge in our drive to be a successful pension manager. Naturally, we will do our utmost to ensure we achieve the portfolio risk profile that best positions us to generate strong returns and create value on behalf of the pension system.

All AP3 staff worked extremely hard in 2008. This did not produce the desired results, but in difficult times these efforts go beyond what is reflected in the bottom line.

KERSTIN HESSIUS
Chief Executive Officer

Fund capital back at 2005 level

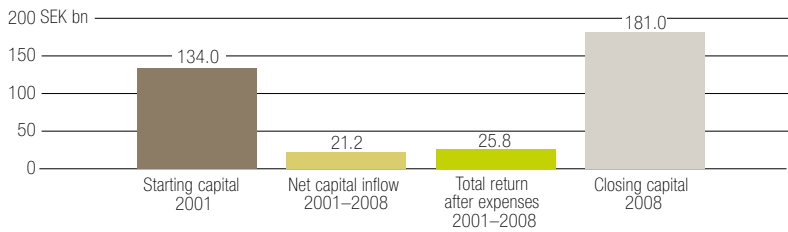
Fund capital 2001-2008



Fund capital has grown but not enough...

AP3 received SEK 134 billion of assets to manage when the new-style pension system was introduced in 2001. Fund capital totalled SEK 181 billion at 31 December 2008, an increase of SEK 47 billion since inception. The financial crisis has sharply affected the value created by the Fund, although asset diversification has tempered losses.

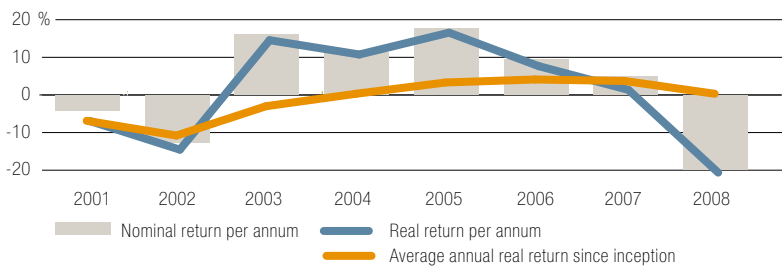
Total returns including net inflows 2001-2008



...despite growth from positive returns and inflows

Returns generated by the Fund account for SEK 25.8 billion of the SEK 47 billion growth in AP3's fund capital in 2001-2008, with the remainder arising from pension system inflows.

Nominal and real returns 2001-2008



Real annual return of 0.4%

AP3's target is a minimum real return (minus inflation) of 4% per year over the long term. Nominal returns in 2001-2008 averaged 2% per year, while inflation averaged 1.6%. Thus, the average annual return in real terms was 0.4%.

Strategic allocations have made a positive contribution overall, despite recording a negative return in 2008

The decision to change the normal portfolio by taking strategic positions added SEK 5.0 billion to returns in 2001-2008. The change had two elements: expansion into new asset classes and market segments with the aim of improving portfolio diversification, and adoption of an ongoing portfolio adjustment process based on medium-term forecasts for asset risks and returns.

Examples of strategic allocations

- ❖ 2002 investment in US corporate bonds
- ❖ 2003 investment in US and European small cap and mid cap equities
- ❖ 2003 sale of Japanese bonds
- ❖ 2005 shortened duration in fixed income
- ❖ 2005-2007 reduced currency exposure
- ❖ 2006 investments in emerging-market equities
- ❖ 2007 regional fixed income positions with US overweight
- ❖ 2008 reduced exposure to small cap and mid cap equities and US equities

... but active management was hit hard by the financial crisis...

Active return (portfolio returns compared to index returns) is measured over three-year periods. Active return declined sharply in conjunction with the start of the US subprime mortgage crisis in 2007, and fell further in 2008. For 2006-2008, active return was negative at -0.7 percentage points. The restructuring of the asset management structure and separation of alpha and beta mandates has created greater scope for improved returns going forward. Active risk (the variation in deviation from the index) measured as tracking error was low, averaging 0.6 percentage points. The information ratio (active return divided by active risk) was negative in 2006-2008.

Cumulative active return



... positive impact from diversification of alternative investments

Our long-term mandate enables us to invest in asset classes generally restricted to investors that can sign long-term undertakings. The risk and liquidity premiums of these investments offer high returns compared to liquid assets. We measure the portfolio's performance over three-year periods. In 2006-2008 alternative investments generated a return¹ of SEK 5.5 billion after expenses, corresponding to an annual return of 15.1%. Alternative investments posted a return¹ of SEK 7.2 billion in 2001-2008.

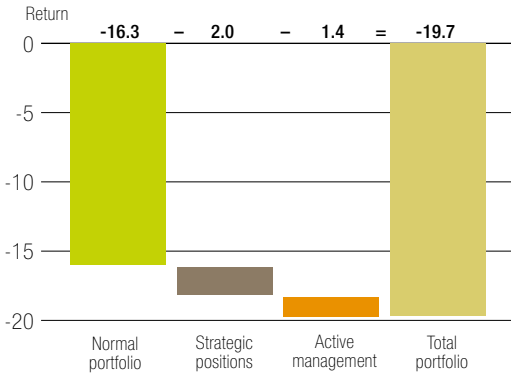
Diversification in alternative investments

- ❖ 2001 first investment in private equity
- ❖ 2004 first investment in timberland
- ❖ 2005 first investment in infrastructure
- ❖ 2005 construction of life science portfolio begins
- ❖ 2006 first investment in Asian private equity
- ❖ 2007 first investment in international real estate
- ❖ 2008 first investment in secured bank loans and insurance-related securities

¹Based on the latest valuation as of 30th September 2008.

Analysis of the Fund's results in 2008

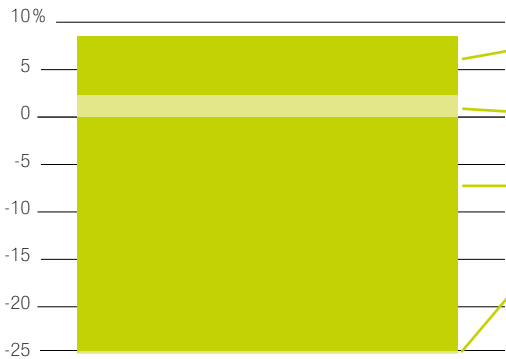
Return in AP3's portfolio



AP3's results can be divided into three steps:

- 1. The normal portfolio contributed -16.3%, including returns from alternative investments.
 - 2. Strategic positions contributed -2.0%.
 - 3. Active return contributed -1.4%.
- Total return for the year was -19.7% excluding expenses.

Relative contributions to normal portfolio



The normal portfolio contributed -16.3%

- Foreign currency assets in the normal portfolio are hedged to ensure net foreign exchange exposure of 20%. The depreciation of the krona in 2008 resulted in currency exposure making a positive contribution of 6.3% to the return on the normal portfolio.
- The normal portfolio's allocation to fixed income assets contributed 2.2% to overall return.
- Equity allocations in the normal portfolio contributed -24.8%. By region, the contributions were: Sweden -4.6%, Europe -4.5%, North America -4.0%, Japan -2.2%, Asia -0.9%, Global -6.4% and emerging markets -2.2%.
- Alternative investments contributed a return of -0.1% to the normal portfolio.

Relative contribution of strategic positions

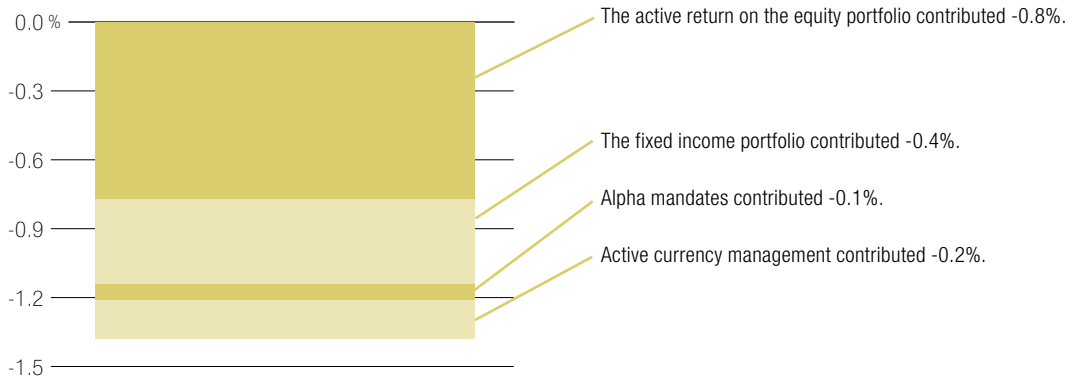


Strategic positions contributed -2.0%

- Shorter duration in the fixed income portfolio compared to the normal portfolio contributed -1.1%.
- Strategic currency exposure during the year was lower than for the normal portfolio and resulted in a negative contribution of -0.6%.
- In equities, position taking between regions and market segments generated a contribution of -0.4% to overall return.

Relative contribution of active return

Active management contributed -1.4%



AP3's portfolio per 31 dec 2008

Market value per asset class ¹	Market value	
	SEK bn	% of portfolio
Listed equities	83.2	45.9
<i>Swedish</i>	17.7	9.7
<i>foreign</i>	65.5	36.2
Fixed income	67.0	37.0
<i>Swedish</i>	19.1	10.5
<i>foreign</i>	47.9	26.5
Total listed assets	150.2	83.0
Real estate	16.2	8.9
Private equity	10.8	6.0
New strategies	3.1	1.7
Total alternative investments	30.2	16.7
Strategic positions	0.7	0.4
Total AP3 portfolio	181.0	100

Return	Return			Contribution to total return
	Beta	Alpha	Total	
Listed assets	-20.5	-1.4	-21.9	-17.7
<i>equities</i> ²	-37.6	-1.2	-38.8	-19.8
<i>fixed income</i> ²	6.4	-1.3	5.2	2.4
<i>overall alpha strategies</i>		-0.3		-0.3
Alternative investments				-0.1
<i>real estate</i>			2.0	0
<i>private equity</i>			8.0	0.3
<i>new strategies</i>			-31.6	-0.4
Strategic positions ³				-2.0
Total AP3 portfolio			-19.7	-19.7

¹ Cash used for position-taking in futures has been divided among the relevant asset categories.

² Returns on foreign equities and fixed income include currency hedging.

³ Return includes contributions from strategic positions taken by Asset Management.