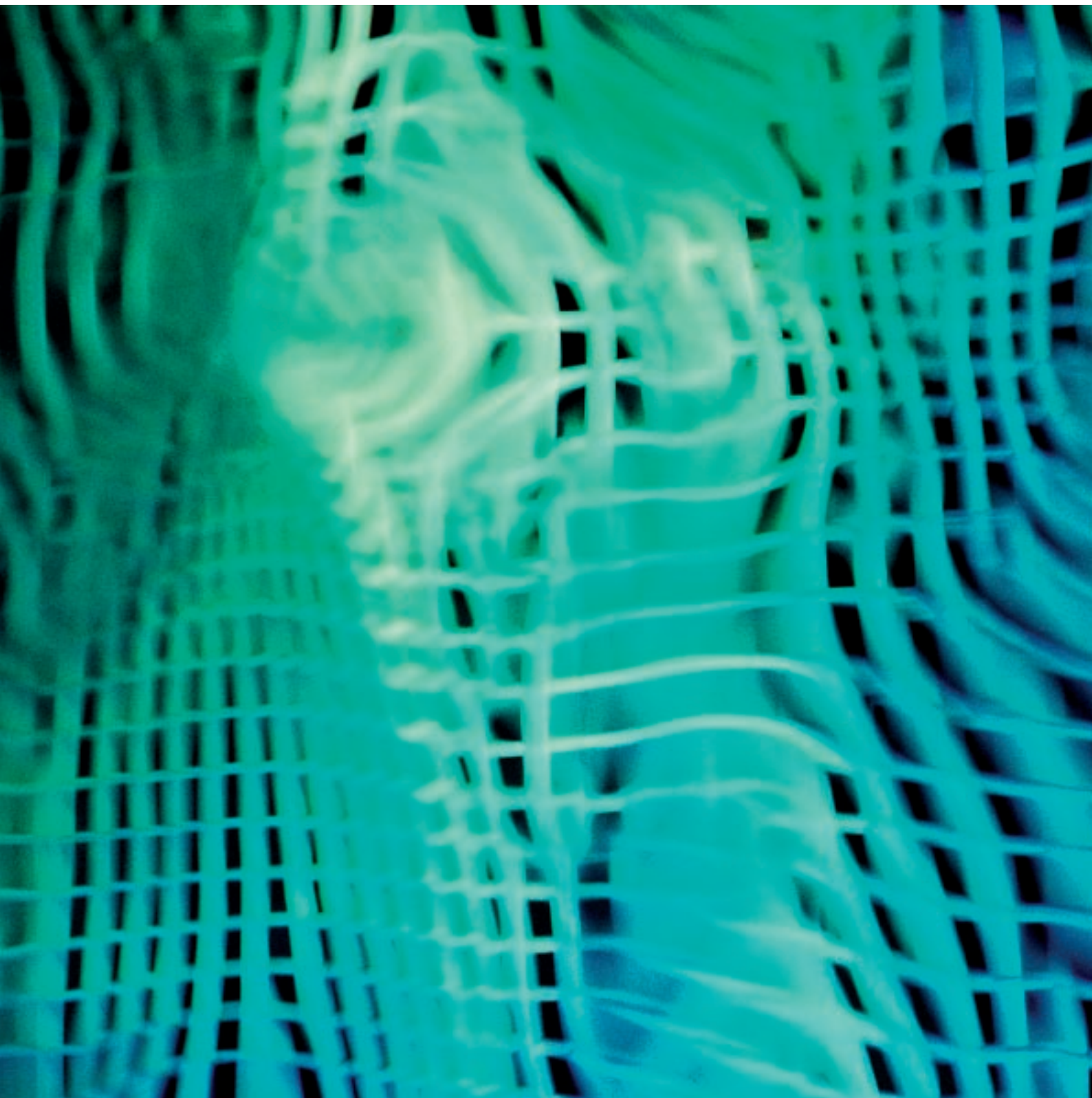


**AP3** Third Swedish National Pension Fund



# 2001-2009

## AP3 in 30 seconds

### Mission

AP3 is one of five so-called buffer funds in the Swedish national pension system. We are mandated by Parliament to generate maximum possible benefit for the pension system by managing our fund capital so as to deliver strong investment returns at a low level of risk.

### Targets

- + Generate a real return (adjusted for inflation) of at least 4% per year over the long term.
- + Achieve high cost-effectiveness in our asset management.

### State-owned pension fund

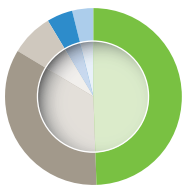
AP3 is a state-owned pension fund with a government-appointed board of directors. We are more independent than most government agencies because the AP funds are regulated solely by statute and not by government directives. The Ministry of Finance reviews the AP funds on an annual basis.

### Investments

AP3 manages a diversified global portfolio of listed equities, fixed income assets and alternative investments. Alternative investments comprise private equity, real estate, timberland, infrastructure assets and new strategies.

The portfolio stood at SEK 206.5 billion on 31 December 2009.

### Breakdown of total assets 31 Dec 2009, %



Equities	49.7
Fixed income	34.0
Real estate	7.7
Private equity	4.8
New strategies	3.8

## Fund capital has grown by SEK 72.5 billion

### Fund capital has grown by SEK 72.5 billion

High returns on listed equities enabled us to recoup much of the decrease in fund capital incurred during 2008 due to the financial crisis. The Fund launched in 2001 with capital of SEK 134 billion, a figure that had risen to SEK 206.5 billion by 31 December 2009. AP3 has generated a total investment return of SEK 55.2 billion since inception 2001. Including net inflows, fund capital has risen by SEK 72.5 billion in this period. As of 2009, AP3 is a net contributor to the pension system.

### Active return contributed SEK 2.1 billion

From 2001 to 2009 AP3 generated an active return of SEK 2.1 billion. In 2008 the Fund decided to separate investment decisions on market exposure (beta) from active position-taking (alpha). After an interim transitional period during 2009, we have discontinued our traditional active management model as of 2010. Active positions in terms of strategies to deliver absolute returns have contributed significant value over time and will continue to form part of our management strategy.

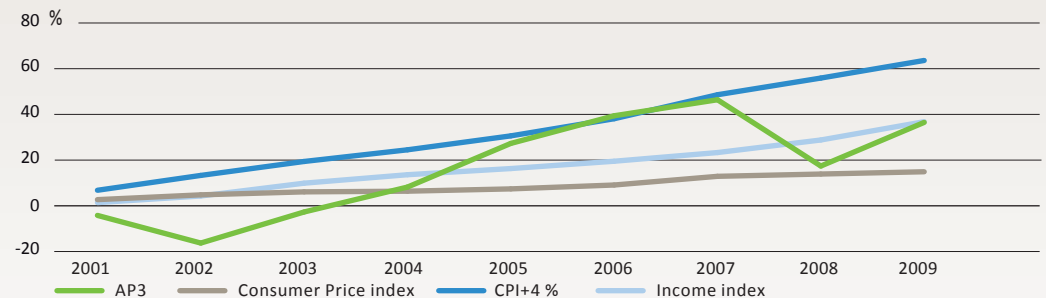
### Alternative assets add value

AP3 was early to spot the potential of alternative investments and we have compiled a diversified portfolio that accounted for 16.3% of fund capital at 31 December 2009. Alternative investments generated a return of SEK 6.1 billion from 2001 to 2009.

### Return equal to pension indexing

AP3's long-term target is a real return (adjusted for the effects of inflation) of 4% per year over time. Our average annual real return stands at 1.9% since inception and 3.2% in the last five years. Returns for the entire period correspond to the "income index" – the rate at which pension entitlements are indexed.

### Cumulative nominal and real return 2001-2009, %



# 2009

## Strong result development in 2009

### Profit of SEK 29.4 billion

AP3 recorded a profit of SEK 29.4 billion in 2009, the highest in our history. This strong result enabled us to recover much of the decline in asset values from the year before.

### Total return of 16.3%

The total return was 16.4% before expenses and 16.3% after expenses. Listed investments posted a gain of 21.1% and alternative investments recorded a return of -2.1%. In alternative investments, private equity and real estate made negative contributions while new strategies made a positive contribution.

### SEK 2.9 billion in active return

The active return was 2.2 percentage points, or SEK 2.9 billion, the highest in AP3's history. Active management in 2009 combined traditional active management with absolute return strategies as part of the alpha management.

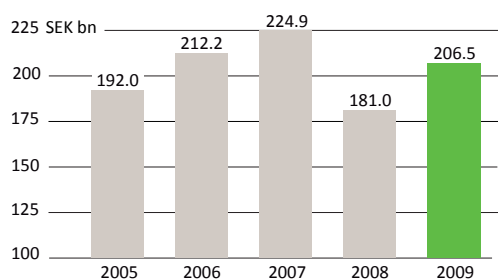
### Fund capital up by SEK 25.5 billion

Fund capital stood at SEK 206.5 billion at year-end, an increase of SEK 25.5 billion from the start of the year. AP3 became a net contributor to the pension system in 2009, making a payment of SEK 3.9 billion.

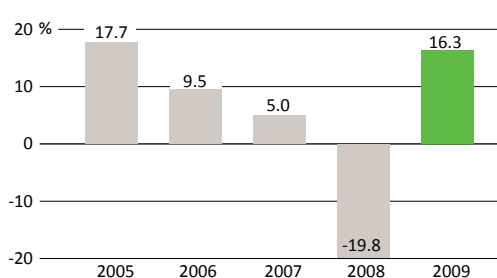
### Dynamic management model for increased flexibility

In 2009 we shifted the management model focus from traditional asset classes to risk categories. The new model offers greater management flexibility with the aim of reducing major fluctuations in investment returns and giving added scope for raising the risk-adjusted return.

Development of fund capital 2005-2009, SEK bn



Total return after expenses 2005-2009, %



# Perseverance pays off

## Strong recovery in 2009

**It is gratifying to note that a long-term approach pays off. AP3 delivered a record profit in 2009 and our highest active return since launching in 2001. This excellent result has restored our return on capital to parity with the income index, on which indexation of pensions and pension entitlements is based. The assets of the AP funds rose strongly in value during the year, which will help to release the current brake on pension payments.**

Our job is one of the most important in Swedish asset management, affecting virtually all income earners. The Swedish public must feel confident that we are managing their assets for the maximum long-term benefit of the pension system. This is a challenge that we take most seriously. It is therefore essential that we constantly strive to develop and improve our asset management. This is about learning from events in the financial markets and ensuring that we raise the quality of our asset management while maintaining maximum cost efficiency.

### Lessons from 2008

The dramatic fall in the value of our assets in 2008 taught us that a good risk diversification strategy is insufficient to insulate the portfolio. In a financial crisis, everyone abandons risk and takes refuge in secure investments. Anyone with exposure to any form of risk is adversely affected, no matter how diversified those risks are. Yet perseverance pays off when investing in financial assets, as our experiences in 2009 confirmed. During the year we recouped a large portion of the value we lost in 2008, both in our total portfolio and in our active management. However, we are not content to rest on our laurels and have continued to enhance our investment strategy. Our aim is to ensure that we are even better prepared to reduce the risk of major portfolio losses and also to take advantage of opportunities. We are allocating more resources to analysing total

portfolio risk and during the year developed a method for dynamic asset allocation. We have also compiled a portfolio of alternative investments that have grown to more than 16% of the AP3 portfolio. Our intention here is to increase risk-adjusted return over the longer term. We have also strengthened our alpha management through an improved risk budgeting process. These changes are not dramatic but are steps in a never-ending process of improvement. We must stay focused on our long-term mandate even when panic grips the market.

### Cost-effective management

Our aim is to be at the cutting edge in asset management and to work hard to ensure cost effectiveness throughout the investment process. Merely focusing on lower fees can be counter-productive and deliver lower costs at the price of reduced income. Cost-effective management demands more: that every krona of cost should generate the maximum possible risk-adjusted return. Investment costs vary. Internal management can be more cost-effective, but only if we have the asset management skills. We should not or cannot manage certain assets – for instance alternative investments – internally. Increased exposure to alternative investments often leads to higher management costs, but risk-adjusted returns are also likely to be higher over the longer term, which benefits the pension system.

I can say with absolute confidence that we are cost-effective in the context of our chosen management strategy as we keep a close eye on expenses and commission an external consultant to benchmark our costs against similar pension funds worldwide. This analysis shows that our costs are lower than average and that our portfolio management generates added value. In 2009 we renegotiated contracts, closed non-cost-effective management mandates and extended our cooperation with the other AP funds in a quest for further cost savings.



### Debate is important

The AP funds are widely seen as having a large cost base and the strategy of having four different funds with the same mandate has been called into question, for instance in an ESO report<sup>1</sup> published during 2009. There are undeniable economies of scale to be had in asset management, and these were well known when the new pension system was designed. However, it is often forgotten that risk diversification across multiple managers can generate income. Most likely competition contributes to higher efficiency and drives a process of portfolio adjustment leading to increased average returns over time. Unfortunately, there is a tendency to focus on costs in isolation as income is harder to estimate. A simplistic debate undermines confidence in the pension system. Continuous monitoring and analysis of the pension system is paramount, but an informed debate is just as important.

In Norway, the government and the central bank (which supervises the Government Pension Fund – Global) have invested considerable resources in establishing a platform for an informed debate on pension management. Their analysis holds lessons for us and we intend to benefit from them.

### No variable remuneration to management

Debate on remuneration came into the spotlight in the wake of the financial crisis. Our remuneration system was already conservative and we paid no variable remuneration in 2008 when returns were negative. We introduced further restrictions in 2009 and now pay no variable remuneration to management. Other staff can qualify for a maximum bonus of two months' salary. Our excellent results in 2009 were due to the hard work of many staff and we more than reached our targets. For this reason, employees will receive a variable remuneration as agreed. As of 2010, we will introduce longer-term performance requirements for variable remuneration and be more restrictive with the timing of pay-outs. This is in line with

guidelines from regulatory authorities, though AP3 is not actually covered by these regulations. Our aim is to have a remuneration system that offers competitive terms and conditions to attract and retain skilled staff while meeting the high level of public trust required of us.

### Future challenges

What does the future hold? We will continue to build a leading, cost-effective management structure. We have come a long way in our strategic development. At inception in 2001 our aim was to outperform our benchmarks – a target we have since revised. Today our target is a 4% average real return per year over time, which is why we focus on total portfolio risk. By diversifying our assets and management strategies we have put in place a structure to generate strong risk-adjusted returns in line with this target. The method behind this is dynamic management of the total portfolio and cost-effective exposure to different assets.

The financial markets will pose a major challenge in the near term. With risk-free interest rates close to zero due partly to the size of central bank stimulus packages, we need a relatively high level of portfolio risk to generate the returns required by the pension system. And we need to achieve this while avoiding excessive volatility in those returns.

Last but not least, I would like to thank the Board of Directors for its support and work to develop the AP3 strategy during the year. I would also like to thank all employees for their great work in managing the Fund's assets to secure maximum benefit for the pension system.

KERSTIN HESSIUS

CEO

<sup>1</sup> ESO is short for "The Group of Experts in Studies of Public Economics".

# The return in 2009 is the highest so far

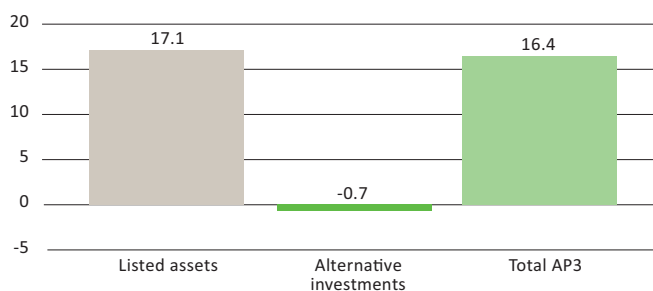
## Return before expenses of 16.4%

The listed portfolio achieved a return of 21.1% in 2009, the best performance since 2001. Equities were the main driver behind this strong showing. The three regions with the highest returns were emerging markets (60.5%), Asia excluding Japan (51.1%) and Sweden (49.5%). Fixed income investments also generated strong returns, thanks mainly to active positions in credit obligations in the US, Sweden and Europe. AP3 has operated a long-term strategy for these positions and we decided at an early stage to maintain our investments through the credit crisis. This proved to be the right call. As valuations rebounded in 2009 we considerably scaled back our active positions.

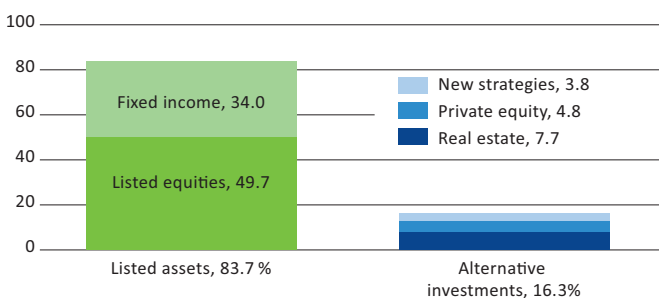
The total active return, including pure alpha strategies, of 2.2 percentage points of listed assets is the highest in the Fund's history.

Alternative investments recorded a return of -2.1% in 2009. The main reason was a heavy fall in the value of our private equity holdings during the first half of the year, after which we saw a stabilisation. Both private equity and real estate felt the impact of the financial crisis later than listed assets. Year-end valuations of private equity are based on the reported results of the underlying companies as of 30 September 2009 – in other words, with a three-month lag. The Fund's real estate portfolio recorded a return of -0.5%, due mainly to a write-down in the value of the Vasakronan holding. New strategies are investments aimed at exploiting temporary opportunities that arise in the market. They delivered a return of 34.7%, with investments in secured bank loans generating a return of 29.5% and life science equities producing a return of 51.6%.

## Contributions to total return 2009,%



## Market value by asset class 2009,%



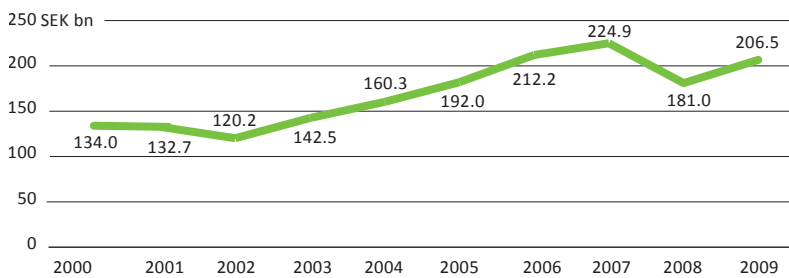
## Return by asset class 2009

	Total returns %	Of which active return, percentage points	Contribution to total return, percentage points
Equities <sup>1</sup>	29.9	-0.4	13.5
Fixed income <sup>1</sup>	8.1	3.2	3.0
Alpha strategies		0.8	0.7
<b>Listed assets</b>	<b>21.1</b>	<b>2.2</b>	<b>17.1</b>
Real estate	-0.5		-0.2
Private equity	-18.8		-1.3
New strategies	34.7		0.7
<b>Alternative investments</b>	<b>-2.1</b>		<b>-0.7</b>
<b>Total AP3 portfolio</b>	<b>16.4</b>		<b>16.4</b>

<sup>1</sup> The returns on foreign equities and fixed income include currency hedging.

# Fund capital has grown by SEK 72.5 billion since 2001

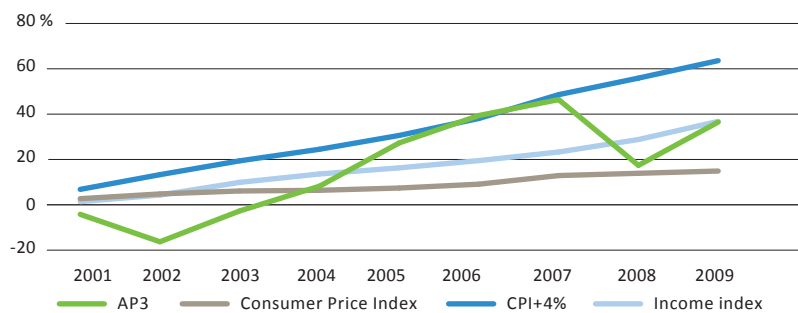
Fund capital 2001-2009



## Fund capital rose by SEK 25.5 billion to SEK 206.5 billion in 2009

The strong return on our portfolio investments in 2009 saw us recoup more than half the falls incurred in 2008. At the same time, we paid in SEK 3.9 billion to the pension system to help cover the deficit in pension flows. AP3 received SEK 134 billion of assets to manage when the new pension system was introduced in 2001. By 31 December 2009 fund capital stood at SEK 206.5 billion, an increase of SEK 72.5 billion.

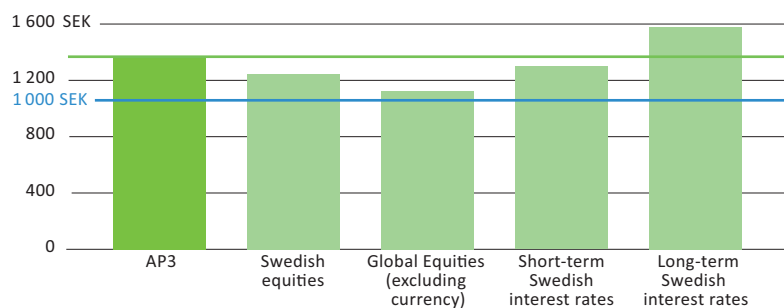
Cumulative nominal and real return 2001-2009



## Real return of 3.2% in last five years

Real returns have averaged 3.2% per annum in the last five years. AP3's target is a minimum real return (adjusted for inflation) of 4% per year over the long term. Between 2001 and 2009 we have seen two stock market crashes and the real return has averaged 1.9%. We have not reached our long-term target over this period but returns have nevertheless matched the rate at which pensions are indexed – the income index.

The value at the end of 2009 of 1 000 SEK invested in 2001



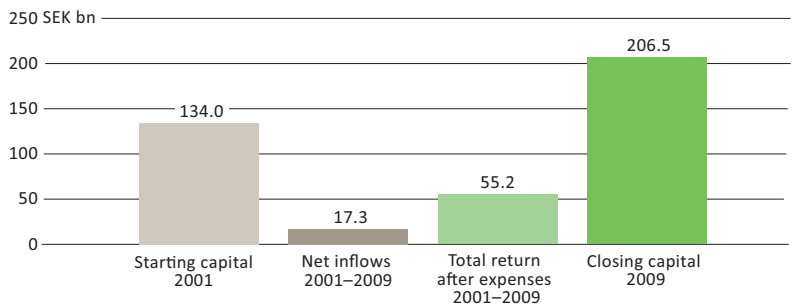
## Turbulent first decade of 2000s

Since inception in 2001 we have witnessed two stock market crashes. Risk taking has not generated the returns we expected during this period, though a diversified portfolio like AP3's has performed better than most other asset classes. An investment of SEK 1,000 in AP3 in 2001 was worth SEK 1,365 in 2009, which is a superior return compared to both equities and short-term interest rates.

**Return of SEK 55.2 billion**

AP3's investment returns have accounted for SEK 55.2 billion of the SEK 72.5 billion increase in fund capital in 2001 to 2009. SEK 29.4 billion of this figure was generated in 2009. The remaining SEK 17.3 billion relates to net inflows from the pension system. In 2009 the net balance between pension system inflows and outflows was negative for the first time since the pension reform in 2001. This resulted in AP3 having to pay SEK 3.9 billion during the year to help cover the deficit.

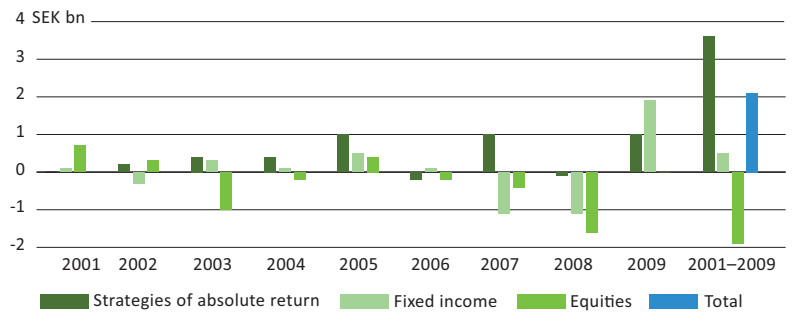
**Total return including net flows 2005-2009**



**Active return contributed SEK 2.1 billion**

Active return can be divided into two types of management: traditional active management and absolute return strategies. In 2008 we decided after an internal review to discontinue our traditional active equity management. In active fixed income management, the Fund has consciously deferred closing its positions while potential for positive returns has been good. By the end of 2009 our active positions in fixed income had decreased significantly. During the year, active positions generated a strongly positive return. Our absolute return strategies will continue to develop and is a diversifying risk class in AP3's portfolio as of 2010.

**Cumulative active return by type of management<sup>1</sup> 2001-2009**



<sup>1</sup> For the first five years the distribution is approximative.

**Diversification promotes a more stable risk and return profile**

AP3's long-term mandate enables us to invest in relatively illiquid assets. These assets helps to diversify risks and opportunities for higher returns via liquidity premiums. Investments consist of real estate, holdings in private equity funds and so-called new strategies of a more opportunistic nature. Our alternative investments have risen from SEK 3.8 billion in 2001 to SEK 33.6 billion in 2009. At year-end 2009, they totalled 16.3% of fund capital. Since inception, alternative investments have contributed SEK 6.1 billion to fund capital.

**AP3 diversification in alternative investments 2001-2009**

