



# Annual Report 2004

THIRD SWEDISH NATIONAL PENSION FUND





## About AP3

AP3 is one of five national pension funds (known as AP funds) that manage the so-called buffer assets of the Swedish pension system. The combined funds of AP1, AP2, AP3, AP4 and AP6 correspond to about 10% of the state's future pension commitments. At year-end 2004, AP3's assets under management totalled SEK 160.3 billion.

<b>AP3's business philosophy</b>	Innovative asset management that inspires respect through a professional and responsible approach based on a long-term mandate.
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# The year in brief

› **AP3's fund capital** totalled SEK 160.3 billion (142.5)<sup>1</sup> at the end of 2004. During the year the Fund recorded a net capital inflow of SEK 1.7 billion, largely due to a positive balance between paid-in pension contributions and disbursed pensions.

Read more on page 38

› **Net profit** in 2004 amounted to SEK 16.1 billion (19.8), which represented a total return of 11.2% (16.2) after expenses and adjustments for net capital flows. Active return on the portfolio before expenses totalled 11.4%. In terms of SEK, Swedish equities performed best during the year, recording a 20.1% return. The return on European equities was 11.9%, on Asian equities 11.1% and on index-linked bonds 11.3%.

Read more on page 23

› **Asset management expenses** totalled SEK 314.2 million (234.9) in 2004.

Read more on page 39

› **Currency risk in AP3's portfolio** rose from 9.0% to 18.7%. For the reference portfolio, currency risk was 19.3% (10.8) at 31 December 2004.

Read more on page 36

› **During the year** AP3 expanded its real estate investments to include holdings of forest properties.

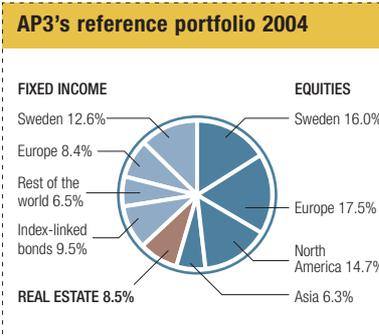
Read more on page 37

› **An updated asset liability modelling analysis** was performed in 2004 and resulted in some adjustments being made to the 2005 reference portfolio. For 2005, currency risk was lowered, the weighting in index-linked bonds was reduced, the weighting in European fixed income bonds was increased and the term to maturity of the fixed income portfolio was shortened.

Read more on page 12

› **During the year Kerstin Hessius** was appointed as new CEO. A new position of Head of Corporate Governance was created.

Read more on page 10



In 2004, AP3's reference portfolio structure was 54.5% equities, 37.0% fixed income assets and 8.5% real estate. The Asian equity weighting was increased and the weighting in US equities reduced. For fixed income assets, the weighting in index-linked bonds was increased at the expense of fixed income bonds.

<sup>1</sup> 2003 figures in brackets.

## Financial indicators

	31 Dec 04	31 Dec 03	31 Dec 02	31 Dec 01
<b>Fund capital (SEK bn)</b>	<b>160.3</b>	<b>142.5</b>	<b>120.2</b>	<b>132.7</b>
Net transfers from Swedish Insurance Office and phase-out/special asset management funds (SEK billion)	1.7	2.6	5.0	4.5
Net profit for the year (SEK billion)	16.1	19.8	-17.5	-5.8
Return on total portfolio before expenses (%)	11.4	16.4	-12.4	-4.1
Return on total portfolio after expenses (%)	11.2	16.2	-12.6	-4.2
Return on market-listed assets before expenses (%) <sup>1</sup>	11.4	17.2	-12.9	-4.4
Active return on market-listed assets before expenses (%)	0.0	-0.1	0.6	0.2
Active return on market-listed assets after expenses (%) <sup>2</sup>	-0.2	-0.2	0.4	0.1
Active risk for market-listed assets (std deviation) ex post (%)	0.5	0.9	0.8	1.0
Currency exposure as % of reference portfolio	19.3	10.8	9.6	7.7
Share of active management incl. enhanced (%)	87.8	80.6	84.8	73.9
Share of external management incl. investments in venture capital firms (%)	30.8	28.8	28.4	23.2
Asset management cost ratio incl. external management costs (%)	0.21	0.18	0.14	0.08
Asset management cost ratio excl. external asset management costs (%)	0.10	0.10	0.10	0.08

<sup>1</sup> AP3's liquid portfolio, which excludes real estate and private equity.

<sup>2</sup> Excluding expenses for private equity. Return figures determined according to annual government review.

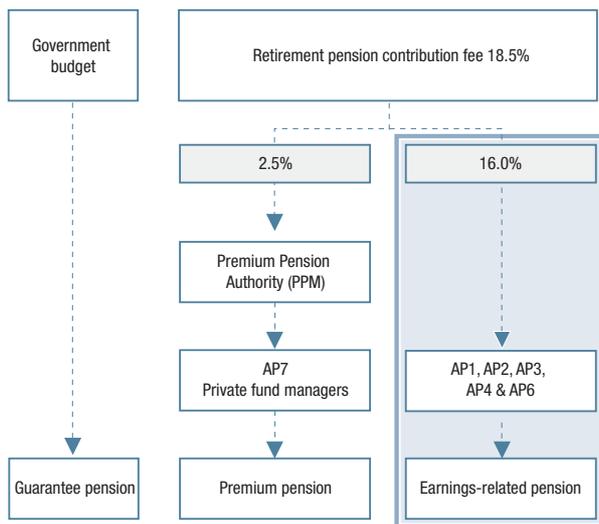


# AP3's role in the national pension system in brief

- AP3 is one of five so-called buffer funds in Sweden's national pension system.
- At the end of 2004, AP3 had fund capital of SEK 160.3 billion.
- AP3's objective is to generate the maximum possible benefit for the pension system.
- The Fund's portfolio consists of equities, fixed income assets and real estate. More than half of the capital is invested in equities. Just under one third is invested in Sweden and the remainder abroad.
- AP3 manages 70% of its assets itself, while remaining parts of the portfolio are managed by leading international institutions. US and Asian equities are under foreign management, as are some of AP3's European equity holdings.
- The Fund had 46 employees on 31 December 2004

Read more about AP3's role and mandate on page 6.

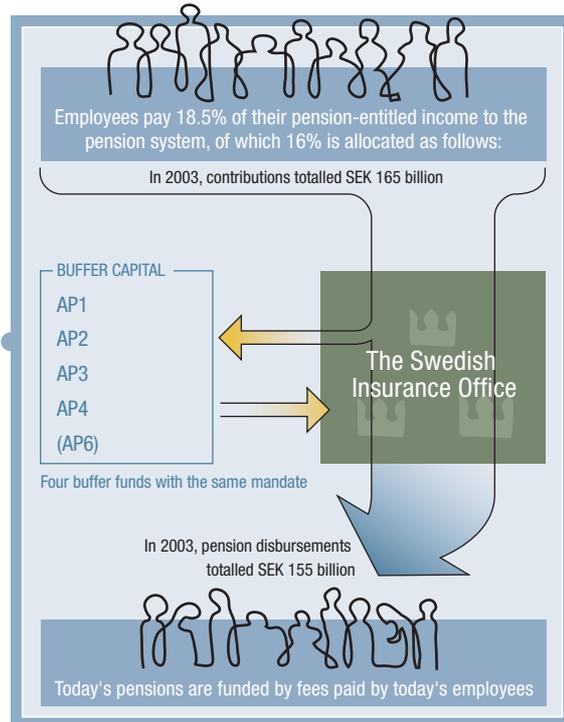
## The new pension system came into force in 2001



The primary role of AP3, together with the other buffer funds, is to manage the surplus arising from contributions to Sweden's pension system. This involves portfolio management aimed at guaranteeing the value of future pensions.

The chart gives an overview of payment flows within the pension system.

## AP funds' share of the pension system





# Taking the next step

Our final accounts for 2004 reveal a strong asset management performance for AP3. The total portfolio recorded a return of 11.2% after expenses. Market conditions were favourable, with falling interest rates and rising equity markets.

AP3's portfolio was well positioned to benefit from market trends. We had a substantial exposure to small-cap equities, corporate bonds and index-linked bonds, which all performed strongly in 2004.

Net profit totalled SEK 16.1 billion, taking AP3's total net profit in 2001-2004 to SEK 12.6 billion. For this four-year period, the return on fund capital was 8.2%, or an annual average of 2.0%. This low return should be viewed in the context of the reformed pension system's poor start following the equity market slump in 2001 and 2002.

During this difficult period, AP3 managed to outperform the other national pension funds by maintaining a lower level of risk in its portfolio. Nevertheless, there are grounds for self-criticism. What is the best way to manage long-term pension capital? Over the very long term, short-term market swings have less effect. However, heavy capital losses in individual years take a long time to recoup. We must, therefore, find ways to reduce the risk of heavy losses.

## Debate on risk measurement

A lively debate about how to measure risk is currently under way among pension managers around the world. The traditional method of measuring risk as deviation from a market index does not reflect total portfolio risk in relation to pension liabilities, but only in relation to

*"The challenge is not so much to outperform the market index as to generate strong, stable growth in value."*

markets. This is not necessarily a problem so long as markets generate a positive return. But we know this does not always hold true. Therefore, this type of relative risk measurement must be enhanced by methods that measure the portfolio's absolute risk, and this risk must also be actively managed and controlled.

Sweden's national pension funds have a well defined liability side in terms of future pension disbursements. The greater their capital, the stronger is their function as a buffer – and the more likely they are to be able to preserve pension values. AP3's primary challenge is not so much to outperform the market index as to generate strong, stable growth in the value of its buffer capital.

In order for AP3 to manage the pension assets of the Swedish people in an optimum way, it is crucial we have professional and highly qualified staff. In recent years, we have established a strong position as a leading fund manager. Confirmation of this status came in November 2004, when we were voted European market leader in portfolio management by Investment & Pensions

Europe magazine. This was one of a series of awards that AP3 has won in the past few years.

## Taking the next step

We are now preparing a comprehensive effort to raise our asset management to the next level. Together with the new executive management group, I have initiated a review of AP3's risk and return targets with the aim of identifying new benchmarks that better reflect our liabilities in the pension system. As part of this, we are also reviewing the Fund's investment philosophy, investment process and risk control organisation. Throughout the organisation, we will be looking for new ways to make our asset management operations more efficient and to improve conditions for strong and stable investment returns.

Since taking over as CEO in September 2004, I have recruited a number of key people to strengthen our asset management operations. At the time of writing, a new Head of Asset Management and a new Head of Equity Management have taken up their positions. AP3's new executive management group



consists of AP3 veterans combined with new faces with experience from other financial institutions.

I am proud of the team we now have in place. All AP3's fund managers have extensive experience of position-taking and risk management in financial markets.

#### **Responsible ownership**

The Swedish corporate governance landscape has been transformed in recent years. Today, there is a healthier balance between shareholders, board and management. The rules of the new Swedish Code of Corporate Governance are aimed at creating clearer divisions of responsibility.

At AP3, we strive to exercise constructive and responsible governance that takes account of every company's unique characteristics.

#### **Difficult market climate**

Following two dismal years in 2001 and 2002, we have now experienced two years of high real returns in our balanced portfolio. However, we expect it will be more difficult to generate equally high returns in the next few years. Less favourable markets will make higher demands of us as asset managers. Success in identifying investment opportunities that offer potentially good returns requires a combination of experience, systematic analysis and creativity.

The strength of AP3's expertise leaves us well equipped to be at the forefront of current developments in the pension management sector.

Stockholm, 15 February 2005

Kerstin Hessius  
*Chief Executive Officer*



# Long-term mandate

From 2010, pension disbursements from the earnings-related national pension scheme are forecast to exceed contributions, at which point the national pension funds will intervene to cover this deficit. This section explains the Funds' role as a pension system buffer and their importance for future pensions.

In 2000, parliament established a new mandate and investment rules for the national pension funds (also known as the AP funds). The new rules, which came into force on 1 January 2001, mandate the AP funds to manage their fund capital so as to generate the maximum possible benefit for the national pension system through strong returns on investment at a low level of risk.

Besides acting as a buffer to cover future pension liabilities, the AP funds generate returns that help maintain a balance between pension system assets and liabilities. Some basic knowledge of the Swedish pension system is needed to understand how this works.

### Today's pensions are paid by today's employees

The basic concept is that people currently in employment fund the pensions the state pays today.

The Swedish system is known as a defined contribution system, which means that we set aside money for our future pensions by paying an annual contribution to the system. This contribution amounts to 18.5% of pension-entitled income, of which 2.5% goes into a premium pension account and 16% towards the earnings-related pension.

The premium pension option allows us to invest the 2.5% we pay into the premium pension system in funds of our choosing.

*The goal of the AP funds is to generate high returns at a low risk.*

Funds in a premium pension account may be freely invested in a range of funds by the account holder, while the 16% contribution is paid into the pension system and confers a "pension entitlement" for the future. Current contributions by those in employment today are used to pay for the pensions of today's pensioners.

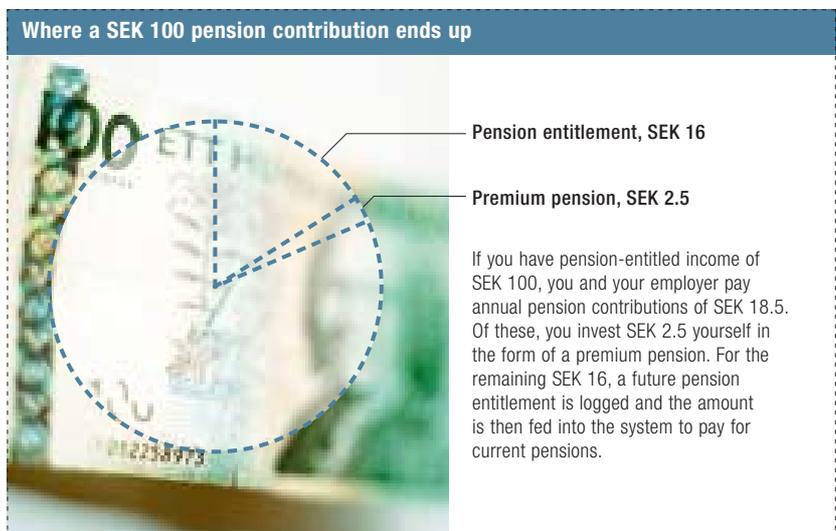
### What is a buffer?

AP3, together with AP1, AP2, AP4 and AP6, is part of the national pension system. The AP funds' capital is used to balance any temporary deficits that arise between payments of pension contributions and pension

disbursements. Such deficits may occur if the number of people in employment falls at the same time as the number of pensioners rises, since a higher number of pensioners increases the payment burden on people in work today.

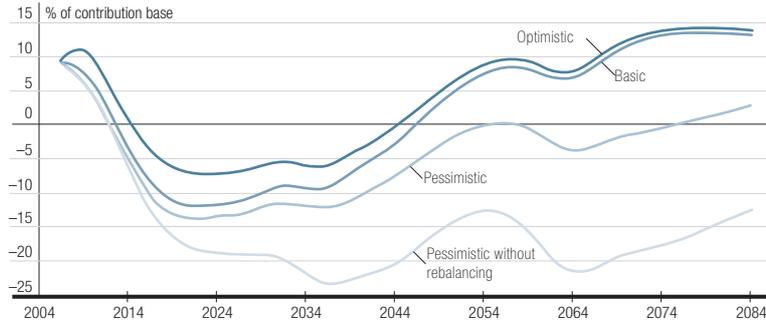
Many other factors also influence the future balance between contributions and disbursed pensions, and these are described in the diagram on page 8.

Already today, we can see that pension disbursements will probably exceed contributions after 2010. This is because the large number of people born in the 1940s will have reached pensionable age by that





**Difference between pension contributions and disbursements by scenario**



The size of pension disbursements is a function of the system's rules and how these combine with demographic and economic trends. Since the number of people born – and the period of time they spend in employment – differs from one year to the next, pension contribution income and disbursements will fluctuate over time. Surpluses and deficits are managed by the system's buffer funds.

Net contributions are initially positive but turn negative from about 2010, when the "baby boom" generation born in the 1940s enters retirement. An improvement occurs from about 2020, and by 2040 contribution income exceeds disbursements according to optimistic scenarios. However, net contributions remain negative according to the pessimistic demographic scenario. Automatic rebalancing limits the size of the deficit.

Source: The Swedish Insurance Office

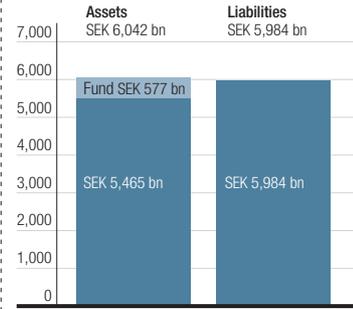
point. The AP funds will at that time use their fund capital to offset the deficit. Current forecasts suggest the funds will manage this task successfully and without the so-called automatic rebalancing mechanism being activated. Indeed, the funds' capital is expected to continue growing.

**How is your pension affected?**

The size of your future pension depends on the number of "pension entitlements" you have amassed. Pension entitlements are indexed upwards annually in line with wage growth so that pensioners' standards of living remain in line with those of Swedes in general.

**Pension system balance sheet**

31 Dec 2003



Source: The Swedish Insurance Office

The Swedish national pension funds, or AP funds, hold about 10% of total pension system assets. These assets fall into two categories: At the start of 2004, the AP funds had combined capital of SEK 577 billion and contribution assets (the value of future contributions) of SEK 5,465 billion. At the end of 2003, liabilities, or future pension disbursements, totalled SEK 5,984 billion.

The AP funds received total capital of SEK 536 billion when the new pension system was introduced in 2001. This equated to SEK 134 billion per fund. By the start of 2004, combined fund capital had risen to SEK 577 billion due to returns from the Funds' asset management operations and pension contribution surpluses.



*"The AP funds' role is to help preserve pension values. The higher the return we can generate, the lower the risk of deficits."*



It is vital for the health of the Swedish pension system that liabilities in the long-run are balanced by assets. Assets consist largely of the value of future pension contributions, while a minor part (about 10%) are the AP funds' capital. Liabilities are the value of future pension disbursements. At present, there is a small surplus of about 1% of pension system assets compared to liabilities.

If liabilities should exceed assets, an automatic rebalancing mechanism is activated that results in the value of pension entitlements being indexed upwards at a lower rate until assets and liabilities return to equilibrium. This concept means the pension system regulates its own finances and avoids the government having to intervene to raise contributions or borrow money to fund pensions.

In the event that there is a risk of automatic rebalancing occurring, the size of the AP funds' capital takes on great significance for the size of your pension. If investment returns are favourable, the risk of a



deficit decreases. One may say that the AP funds' role is to reduce the risk of automatic rebalancing and to ensure that pension values are preserved.

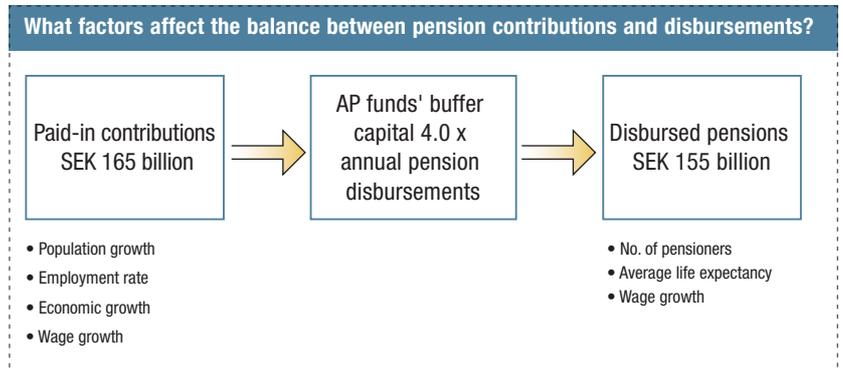
The funds have rules stipulating that their asset mix must be based on rigorous analysis of what is best for the pension system. The rules stress the importance of maintaining a long-term investment perspective that caters for the interests of all generations. There should be a good level of risk diversification,

which means that the funds are able to invest in a diverse range of assets.

**Mandate**

The funds' activities are regulated by the Swedish National Pension Funds Act (1999:2000:46), whose provisions include:

"The First, Second, Third and Fourth Swedish National Pension Funds are charged with managing assets to provide the maximum benefit for the income-based retirement pension system.



In 2003, contributions to the pension system totalled SEK 165 billion and pension disbursements totalled SEK 155 billion. The SEK 10 billion surplus was distributed as investment capital between the four AP funds. The combined buffer capital of the AP funds was equal to approximately four years' pension disbursements. Contributions and disbursements vary over time in accordance with the factors described above.



### Respect for our mandate

*Our mandate is largely about trust and respect. The people whose pension capital we manage have not had the opportunity to choose between different fund managers. Our aim is to earn respect by being a world-class pension manager that delivers a strong and stable return on fund capital.*



At the chosen risk level, the funds' assets should be invested so as to secure a high long-term high return. The funds' overall investment risk should be low." (Ch 4, §1, Swedish National Pension Funds Act.)

### How do the funds invest?

The funds' investment rules are set by the Swedish parliament. They are highly flexible and are based on a core requirement: that the securities in which the funds invest must be liquid. This means that it must be possible to buy or sell them.

#### The primary investment rules are:

- ›At least 30% of each fund's assets must be invested in low-risk fixed income securities.
- ›A maximum 40% of assets may be exposed to currency risk.
- ›Each fund may own shares corresponding to no more than 10% of the voting equity in any single listed company.
- ›No more than 5% of a fund's assets may be invested in unlisted assets. Such investments must be made

indirectly via venture capital firms or mutual funds.

- ›At least 10% of each fund's assets must be managed by external managers.
- ›Funds may not invest in commodities.
- ›Funds may invest in derivatives to make their operations more effective and to manage risks.

Funds must also take environmental and social considerations into account when investing, without this impinging on the primary goal of high investment returns. Investments must be independent of economic or business policy considerations.

### Government evaluations

The AP funds' performance is reviewed each year by the Ministry of Finance on behalf of the government. The main benchmarks are returns, risk, asset management costs and level of portfolio activity.

AP3 is a government agency but differs from other such bodies in the following respects:

- ›AP3 has its own Board of Directors, appointed by the government. The Board establishes the Fund's strategy in areas such as investment policy, governance policy and risk management.
- ›AP3 is more independent than most government agencies because its activities are regulated by legislation alone. The government may not, for example, issue directives on the Fund's day-to-day operations or asset management activities.
- ›The Fund has external auditors, appointed by the government.

*Read about the Swedish pension system at the Swedish Insurance Office website:*

*[www.forsakringskassan.se](http://www.forsakringskassan.se).*

*Resources there include the Swedish Pension System Annual Report 2003.*



# AP3 as an employer

It is AP3's aim to be an attractive employer capable of recruiting and retaining skilled staff. The combined knowledge, skills, commitment and effectiveness of our employees are important factors in our performance.

It is important for AP3 to identify, nurture and develop the unique know-how of every staff member for the benefit of the whole organisation. All employees are encouraged to utilise opportunities for taking on greater responsibilities, for instance by entering management or a more senior position.

## Skills development

AP3 strives to offer its staff challenging work and continuous skills development. Each employee's individual need for training is evaluated annually during appraisal talks. Training develops an individual's resources, helps to raise the Fund's overall competency level and increases the individual's ability to perform more challenging tasks.

Employees are encouraged to suggest training courses and initiatives. Also, AP3 has constant contact and interaction with other pension funds, managers, analysts and other partners.

## Equality

AP3 regards non-discrimination in the workplace as natural and fundamental and strives to create conditions that enable male and female employees alike to combine their work with family responsibilities. Particular measures in this area include flexible working hours, part-time working and opportunities for working from home. It is important that male employees use their

<b>Administration</b> SVEN ASKENBERGER	<b>Risk Management</b> ERIK VALTONEN	<b>Asset Management</b> KERIM KASKAL
<b>Corporate Governance</b> PERNILLA KLEIN	<b>CEO</b> KERSTIN HESSIUS	<b>Fixed Income and Foreign Exchange Management</b> LARS OREST
<b>Communications</b> CHRISTINA KUSOFFSKY HILLESØY	<b>External Management/ Alternative Investments</b> BENGT HELLSTRÖM	<b>Equity Management</b> ANDERS OLSSON

As of 2005, the executive management group has nine members, each of whom has a specific field of responsibility.

opportunities to take parental leave and AP3 supports and encourages them to do so. Two female and two male employees took parental leave in 2004.

AP3 has a good ratio of male to female staff, as well as a wide range of experience among its personnel. At 31 December 2004, 19 out of the Fund's 46 employees were female. One-third of the executive management group is female.

## Pay structure

AP3's pay structure is based on individual salaries that reflect the nature and complexity of the job and the employee's qualifications and performance. In 2004 there was no bonus system for employees.

## Health

Health and exercise are important to employees' wellness. AP3 provides regular check-ups to staff and offers subsidised forms of exercise. The rate of sickness absence is very low

and there were no protracted absences from work for health reasons in 2004.

## Ethical standards

AP3 maintains high ethical standards and aims to be a model in such issues.

A wide variety of legislation and statutes apply to AP3 and its employees in this area, as well as regulations and guidelines from regulatory authorities. Employees have clear guidelines in relation to outside employment, conflicts of interest, gifts and entertainment of guests. AP3's rules for staff members' securities transactions are based on those of the Swedish Securities Dealers Association, though in some cases are more far-reaching.



## EXECUTIVE MANAGEMENT

**SVEN ASKENBERGER**

Chief Operating Officer  
AP3 since 2000  
Executive management group since 2000

**Previously:** Business Controller at Industrifonden 1999-2000, self-employed consultant 1996-1999

**Year of birth:** 1956

**BENGT HELLSTRÖM**

Head of External Management/Alternative Investments  
AP3 since 2000  
Executive management group since 2002

**Previously:** Partner (investment manager) at EQT Partners AB 1994-2000, Vice President Corporate Finance at Investor 1988-1994

**Year of birth:** 1959

**KERSTIN HESSIÜS**

CEO  
AP3 since 2004  
Executive management group since 2004

Member of Council for Swedish Code of Corporate Governance

**Previously:** CEO of Stockholm Stock Exchange 2001-2004, Deputy Governor of the Swedish Central Bank 1999-2000

**Year of birth:** 1958

**KERIM KASKAL**

Head of Asset Management  
AP3 since 2004  
Executive management group since 2004

**Previously:** Partner at Brummer & Partners 1997-2004, Head Trader at Stora Finans in Brussels 1995-1997

**Year of birth:** 1965

**PERNILLA KLEIN**

Head of Corporate Governance  
AP3 since 2000  
Executive management group since 2002

**Previously:** Macroeconomics Analyst at Handelsbanken Markets Research 1994-2000, political adviser at the Ministry of Finance 1991-1994

**Year of birth:** 1965

**CHRISTINA KUSOFFSKY HILLESØY**

Communications Manager  
AP3 since 2005  
Executive management group since 2005

**Previously:** Communications Manager TRR Trygghetsrådet 2004, Communications Manager TurnIT 2001-2004

**Year of birth:** 1964

**ANDERS OLSSON**

Head of Equity Management  
AP3 since 2005  
Executive management group since 2005

**Previously:** Senior Relationship Manager Nordea 2004, Portfolio Manager Nordea 2001-2004

**Year of birth:** 1958

**LARS OREST**

Head of Fixed Income and Foreign Exchange Management  
AP3 since July 2000  
Executive management group since 2004

**Previously:** Currency reserve management at the Swedish Central Bank 1985-2000 (Head 1990-2002), 1990-2000, mutual fund department at Sparbankernas Bank 1985

**Year of birth:** 1960

**ERIK VALTONEN**

Head of Risk Management  
PhD in mathematics, Stockholm University 1989  
AP3 since 2000

Executive management group since 2002

**Previously:** Head of Quantitative Analysis at Handelsbanken Markets 1998-2000, Fixed Income Analyst at Handelsbanken Markets (London) 1997-1998

**Year of birth:** 1960



# Strong and stable returns: how AP3

AP3 aims to generate the maximum possible benefit for the pension system over a 30-40 year time frame. Achieving this goal requires strong investment returns that offer long-term stability. The portfolio must therefore be continually adapted to current financial market conditions. This is the foundation of AP3's investment policy.

The investment process comprises a number of structured steps in which the Fund's liabilities as a buffer fund are translated into an actively managed portfolio.

The first step is to determine the optimum structure of the Fund's reference portfolio in order to achieve the investment goals. This takes place via a process known as asset liability modelling (ALM), which is based on a long-term analysis combined with a medium-term assessment of market valuations.

The next step involves determining the right manager structure as well as risk budgeting. The reference or theoretical portfolio is drawn up at this point by allocating concrete asset management mandates in different markets. Here, the aim is to create optimum conditions for value creation through active asset management. AP3's investment process

is in continual development and targets and risk measurement are currently being reviewed.

### AP3's goal

AP3's goal is to generate strong returns on fund capital at a low level of risk.

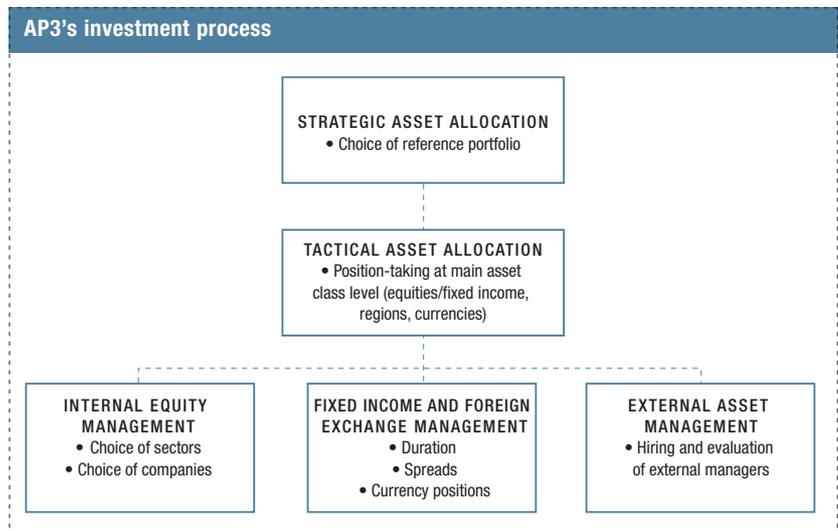
There are two aspects to low risk. The first is that it is more important, from the average pensioner's perspective, to reduce the risk of pensions being lower than expected than to increase the chance of pensions being higher than expected. The damage of having SEK 100 less in one's pocket is greater than the benefit of having SEK 100 extra. For this reason, the sensitivity analysis included in AP3's ALM study focuses on the most negative possible scenarios for the pension system and the investment returns that would then be required to guarantee pension levels.

The second aspect is that the investment returns of the buffer funds should be stable over time to avoid any risk of the automatic balancing mechanism being activated. At present, the pension system has a surplus of about 1% and is sensitive to sharp short-term swings in buffer fund value.

Historical experience tells us that financial asset prices may fluctuate extensively during certain periods. Losses incurred during such periods can take a long time to recoup. AP3 therefore strives to find analytical tools for forecasting asset returns over a time frame of three to five years.

### Investment process

Identifying a long-term mix of financial assets whose risk/return profile matches AP3's obligations to the pension system is a key aim of





# works to achieve this goal

an ALM analysis. The analysis forms the basis of the Fund's yearly decisions on how to structure its reference portfolio.

In the short term and medium term, AP3 conducts active management aimed at achieving outperformance in relevant markets. This investment process has the following components:

### Tactical asset allocation (TAA)

TAA involves being overweight or underweight in specific assets in response to short-term market forecasts (six to 12 months).

### Equity management

AP3's internal equity management manages all holdings of Swedish equities and the main portion of the European equity portfolio. The investment style is value-focused, which means that corporations with low valuations and stable earnings potential dominate the portfolio.

### Fixed income and currency management

AP3's fixed income asset management takes positions based on

### Asset management structure (total portfolio)



The part of AP3's portfolio under active management has grown steadily since the Fund received its new mandate in 2001. Index management is conducted only in markets considered to offer no opportunity for outperformance through active management. The major part of the portfolio is managed internally (i.e. by AP3's own portfolio managers).

yield curve, duration\* and on yield spreads between countries and between government, mortgage and corporate bonds. For corporate and mortgage bonds, positions are taken on the basis of spreads between credit ratings and sectors. Currency risk is also managed actively.

### External asset management

A special group of portfolio managers handles the recruitment and evaluation of external managers for markets in which AP3 lacks

in-house expertise. In certain cases, external mandates are also assigned to augment the Fund's internal management. AP3 aims to assemble portfolios with an optimal combination of skilled managers focused on different management styles. At present, 21 external asset management mandates are assigned to 14 fund managers. The portfolio management group is also in charge of the Fund's investments in private equity and real estate.

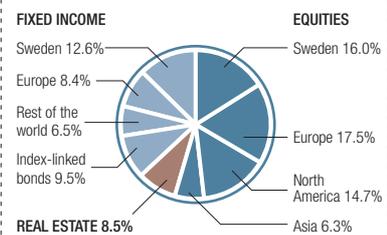
\*See glossary on page 60

### How AP3's market-listed assets are managed

	Active	Passive	Internal	External
Swedish and foreign bonds	•		•	
American corporate bonds	•			•
Currency risk	•		•	
Swedish equities	•		•	
European mid-cap and small-cap equities	•		•	•
European large-cap equities	•	•	•	•
American mid-cap and small-cap equities	•			•
American large-cap equities		•		•
Asian equities	•			•

In markets in which AP3 lacks top in-house management expertise, management is contracted to leading international managers. This management is active, except for American and European large-cap equities.

### AP3's reference portfolio 2004



In 2004, AP3's reference portfolio had a 54.5% weighting in equities. 57.7% of portfolio capital was invested in foreign assets.



## Higher returns using medium-term forecasts

AP3's medium-term forecasting is done by Chief Economist Bengt Hansson and is a key component in structuring the portfolio through the process known as strategic asset allocation.

Bengt explains: "In recent years, particularly after the stock market slump, many portfolio managers have revised their view on the possibilities to make forecasts. This is rooted in the belief that best forecast is no longer equal to the average historical return, i.e. the expected return is no longer considered to be a random walk. We now know that it's possible to make medium-term forecasts within a time frame of, say, three to five years.

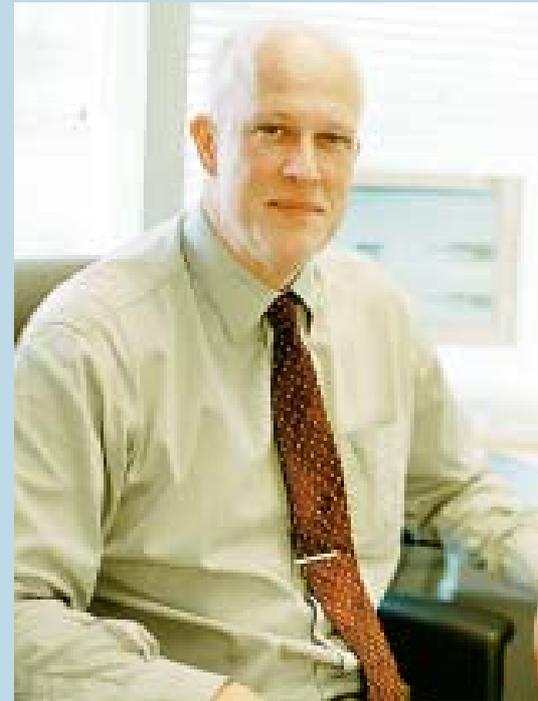
"This is because risk premiums vary over time and asset prices are often determined by a herd mentality that can be irrational and fickle. As a

result, asset prices can for several years at a time remain higher or lower than their fair value based on fundamentals such as earnings, dividend yields and other macroeconomic variables. Stock market or currency bubbles can occur in such circumstances."

### Good forecasts can yield higher returns

The hope is that AP3 can increase returns over time by using medium-term forecasts to predict peaks and troughs in asset prices.

"We can better assess future asset price performance by gaining access to research about asset pricing carried out at universities and central banks and by tracking the variables that we know from experience are valuable for forecasting purposes," Bengt Hansson says. "These variables include price/earning ratios and direct equity yields, the yield curve,



Bengt Hansson, AP3 Chief Economist, is in charge of medium-term forecasting.

and macroeconomic variables such as household assets in relation to private consumption."

### Government bond yields



The graph shows yields for a range of government bonds since the start of 2003. The total return of Japanese bond has been almost zero. A rise in interest rates in Japan resulted in falling bond prices and the current yield was only just enough to offset these capital losses.

The underlying cause of this situation was a faster economic recovery in Japan than many observers had expected, resulting in higher interest rates. In turn, this led to Japanese bonds becoming overvalued. AP3's ability to forecast this chain of events enabled it to close its positions on 10-year Japanese government bonds at a good profit.

### Japanese bonds – a good example

More than 90% of the volatility in portfolio returns during recent years has stemmed from the choice of reference portfolio. Active trading in equities and fixed income securities has accounted for a relatively minor share.

"One good example of a successful forecast was when AP3 withdrew from the Japanese bond market in 2003 (see adjacent graph)," says Bengt. "We saw in our forecasts during the second half of 2002 that the Japanese economy appeared to be recovering faster than expected. This meant that interest rates would rise in the medium term and that



Japanese bonds were overvalued, so we opted to reweight our bond portfolio in January 2003 and sold our entire holding of Japanese bonds.”

### No crystal ball

It is important to remember that forecasting is not a crystal ball. Forecasts increase our ability to gauge whether asset prices are at unrealistically high or low levels at different points in time. They do not foretell the future.

“This isn’t an instrument that tells us exactly when the stock market will start to fall,” Bengt Hansson says. “Medium-term forecasts are viable for market players who can be patient and afford to wait. A lot of it is to do with the probability of price ‘distortions’ being corrected during certain time frames. We’re still only able to explain a small proportion of price swings in this way; most remain unexplained.”

But he stresses: “They remain a valuable tool for us in our drive to create high returns on Sweden’s pension capital at a low level of risk.

“There are good reasons today to suggest that we’re witnessing a bubble in the global bond market. Bond prices are at unsustainably high levels and interest rates are unsustainably low. Public spending deficits in the OECD and rising consumption in Asia will push up interest rates in due course. Through effective analysis and understanding of how these factors interlink, AP3 can produce higher and more stable returns on fund capital.”

### Manager structure

Effective decision-making processes relating to manager structure and risk budgeting are essential when building a portfolio designed to generate value through active management. AP3 works continually to develop its strategy in these two areas.

In determining the right manager structure, we address the following questions: How should the theoretical reference portfolio be invested in various markets? And in which markets is it possible to outperform the market – in other words where is active management profitable? Finding the answers to these questions involves deciding how to allocate assets between internal and external management.

In risk budgeting, we set targets and limits for the financial risks permissible within the various management mandates.

### ALM – choice of reference portfolio

The Fund has performed an annual ALM analysis since 2000 and the latest exercise was therefore the fifth. Carrying out a new study each year enables AP3 to benefit from any new information or data pertaining, for example, to demographics or asset prices. This approach also facilitates continual improvement of our analytical tools.

We follow a two-step analysis in the reference portfolio selection process:

#### ALM step 1: Long-term analysis

Here, we examine the link between the Fund’s assets (return on fund capital) and liabilities (the effect of the buffer funds on future pensions). A statistical simulation is used to

analyse what effect different asset mixes would have on the long-term development of the pension system in a variety of demographic and economic scenarios. At this point, it is assumed that asset prices will perform in line with historical patterns.

The purpose of the analysis is to identify a portfolio that meets three key targets:

*Target 1. Maintain the relative size, or fund strength, of the buffer funds in relation to annual pension disbursements.* Fund strength is currently just below four, which means that the buffer funds are in a position to pay almost four years’ pension disbursements if no new contributions are paid. Maintaining fund strength requires an equity weighting of at least 50%.

*Target 2. A good expected outcome for the pension system’s balance figure.* With an equity weighting of 50%-60%, the balance figure for 2030 is highly likely to exceed 1.1. A government report (SOU 2004:105) has suggested that a balance figure of more than 1.1 will lead to surpluses being paid out by the pension system.

*Target 3. Minimised risk for substantial pension shortfalls caused by automatic balancing.* If demographics develop in line with Statistics Sweden’s main scenario, the risk of balancing occurring is forecast to be negligible. However, if demographics develop in line with Statistics Sweden’s pessimistic scenario there is a considerable risk that balancing will occur. AP3’s analysis shows that an equity weighting of 50%-60% is required to minimise the risk of large pension shortfalls in this scenario.



AP3's most recent ALM analysis confirms the findings of earlier studies, namely that a portfolio with an equity weighting of 50%-60% best equips the Fund to meet its targets.

**ALM step 2: Medium-term market analysis**

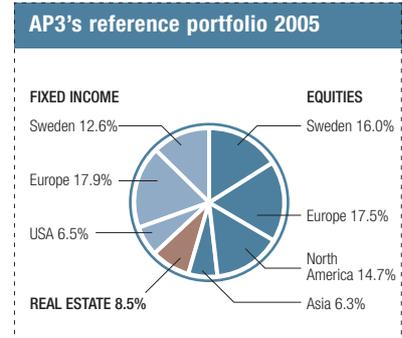
Markets are not always correctly valued at any one point in time. Hence, assets in the short term may not generate the return and risk they are expected to generate in the long term. Step 2 therefore includes a macroeconomic assessment of the extent to which current asset prices deviate from long-term equilibrium. AP3 has since 2002 considered long-term and medium-term factors

when allocating its reference portfolio and in 2005 accorded primary weight to medium-term analysis.

**Reference portfolio 2005**

Based on its medium-term market analysis, AP3 made a number of changes to the reference portfolio at the end of 2004. AP3 believes that interest rates at their currently very low rates are not sustainable and predicts that bond prices are likely to fall in the next few years. We also foresee a high likelihood that the Swedish krona will continue to strengthen, particularly against the US dollar. This market view of events caused us to make the following portfolio changes:

1. *Shorter maturities in the fixed income portfolio.* The duration of AP3's benchmark index for fixed income assets was halved by excluding bonds with longer maturities from the benchmark index.
2. *The allocation to inflation linked bonds in the reference portfolio was reduced from 9.5% to zero* and the European nominal fixed income bond weighting increased by the equivalent amount. Within European bonds, the geographical allocations were set at 22% for the UK (formerly 16.6%) and 78% for the eurozone.



Based on medium-term forecasts of returns in different markets, AP3 made a number of changes to the reference portfolio for 2005. The weighting in index-linked bonds was set at zero, while the weighting in equities was unchanged at 54.5%. Foreign assets account for 62.9% of the portfolio.

3. *Lower currency risk.* Currency risk in the reference portfolio was cut from 19.3% to 15.6% by reducing exposure to the US dollar and sterling.

**Development of AP3's strategy**

In autumn 2004, AP3 launched a review of its investment strategy, investment process and risk control organisation. This focused on three main areas:

**Review of risk measures**

It has long been standard practice in the asset management industry to measure risk and return in terms of deviations from a market benchmark. Under this approach, investment in an index portfolio is considered to involve zero risk. However, experience shows that risk in relation to a fund's liabilities far exceeds the risk of deviation from the index. New approaches are currently being developed to identify new and more accurate measures of risk and return. AP3 is following this trend with great interest and is developing new measures of

Currency hedging ratios for the reference portfolio in 2005 (2004 figures in brackets)			
	Gross exposure as % of reference portfolio	Currency hedge ratio (%)	Net exposure as % of reference portfolio
Foreign bonds	24.6 (14.9)	100 (100)	0 (0)
Foreign equities	38.5 (38.5)	62 (52)	14.6 (18.3)
Swedish equities with foreign domicile	1.0 (1.0)		1.0 (1.0)
<b>Reference portfolio total</b>	<b>64.1 (54.4)</b>		<b>15.6 (19.3)</b>

AP3's currency hedge ratios are decided annually as part of the Board's reference portfolio strategy. The decision takes account of exchange rate forecasts and what is best from a long-term portfolio perspective.



## Prestigious IPE award in 2004

Every year, Investment and Pensions Europe magazine awards prizes to Europe's top pension managers. In 2004, AP3 was named best pension fund in the portfolio management and portfolio construction category.

Erik Valtonen, AP3 Head of Risk Management, says: "We at AP3 are extremely proud to have won this award. It allows us to compare ourselves to our European colleagues and by coming first we have confirmed that we are a leader in our field."

AP3 was recognised for its work in ALM analysis, asset management structure and risk budgeting. Combined, these steps produce a portfolio that discharge the Fund's pension system obligations in an optimal way.

### IPE awards 2001-2004

- ▶ 2001 AP3 wins best Swedish pension fund award.
- ▶ 2002 AP3 voted top pension fund in Sweden and Europe.
- ▶ 2004 AP3 named European leader in portfolio management and portfolio construction.



"Through close cooperation between the various parts of the organisation we developed a structured way to translate our obligations stepwise into a concrete

portfolio," Erik Valtonen adds. "The award means a great deal to us because it underlines that we are one of Europe's leading pension funds."

absolute risk and absolute return to complement the traditional relative measures.

### Review of investment philosophy

AP3 will be reviewing its decision-making structures and investment philosophy throughout its investment process. As part of this review, we will explore possibilities for expanding asset management based on absolute return targets – in other words, management that is more independent of the market index. Rapid developments in this area in recent times have seen the emergence of new management

approaches and products, for instance derivatives that make it possible to hedge the portfolio against falls in value by transferring returns above a certain level to a counterparty with a different risk profile.

### Review of risk control organisation

Since its inception in 2001, AP3 has prioritised the measurement of risk in its portfolio. Risk and return reports are produced each day. Models and routines for risk measurement have developed continuously and are today of a high international standard. Once new risk and return

targets have been set it will be necessary to adjust the risk monitoring system to reflect them. The decision-making structure relating to risk management limits and risk monitoring will also be reviewed.



# Risk management essential for strong

AP3 has special responsibilities as a custodian of Swedish pension capital and therefore places great emphasis on identifying and analysing the risks attached to our sphere of work.

AP3's mandate from parliament states that the Fund's overall investment risk level should be low and that risk should be assessed in terms of future pension disbursements. AP3's annual ALM analysis uses sensitivity analysis to determine the effect of changes in demographics, asset prices, growth and inflation on the chosen reference portfolio. The Board then uses this analysis to allocate reference portfolio assets. Read more about the ALM analysis on page 15.

## Market risks

All asset management is associated with risk. Risk is necessary to generate returns and it is therefore essential for AP3 to take financial risks in order to fulfil its mandate.

Market risks relate primarily to forecast changes in portfolio value during specific periods of time, for example one day or one year. Risk measures cover a full spectrum of potential returns, though the focus is often on the downside rather than the upside. Risk can be measured in absolute terms and as a percentage. AP3 uses two different but mutually complementary ways of viewing risk: absolute risk and relative risk. Absolute risk quantifies the total risk level in the portfolio (for example, the Fund's total portfolio or a specific mandate). Relative risk quantifies the consequences of deviations in value between a portfolio and its reference index.

Absolute risk indicates the

extent to which portfolio value may change given a certain level of probability and time frame. It is often measured in terms of the standard deviation of return (volatility) or as value-at-risk (VaR). VaR may be expressed in as a figure or as a percentage and quantifies the likelihood of the portfolio losing a specified amount in value.

The other aspect of market risk is active, or relative, risk and describes the risk of deviation from a reference index. Active risk applies to the relative changes in portfolio value measured against a market index (which for AP3 is its reference index). In other words, AP3's active risk arises from the active management of parts of its portfolio against the reference portfolio. Active risk is measured usually as tracking error, which is the same as the standard deviation of active return. The level of active risk depends largely on by how much the Fund decides to deviate from its reference index but is also influenced partly by general market volatility.

As noted above, AP3 uses both absolute and relative risk measures. These measurements are performed by the Risk Management group and are published in daily risk reports.

AP3's portfolio of market-listed assets had an absolute risk, measured as volatility, of 5.4% in 2004. Tracking error for the same portfolio amounted to 0.5%. Hence, the Fund's total risk stems principally from its choice of strategic portfolio.



AP3 takes a three-step approach to market risks.

- › The first step is to establish a ceiling for combined absolute market risk and limits on deviation from the weightings for the various asset categories in the reference portfolio.
- › The second step is risk budgeting and relates chiefly to active risk. It



# performance



involves allocating overall risk limits to the various asset categories, sub-portfolios and management mandates.

- › The third and final step consists of continual monitoring to ensure that risk limits and other restrictions are not breached. Control takes the form of daily reports.

The Risk Management group is in charge of analysing the Fund's market risks and makes risk allocations in cooperation with asset management units. The group ensures compliance with risk limits and produces and reviews risk bulletins.

In organisational terms, the Risk Control function comes under Risk Management but reports directly to the CEO and Board.

### Operational risks

Operational risks also arise as part of the asset management process. They may surface through incidents or events in AP3's daily operations that can cause direct portfolio losses or undermine the Fund's credibility as an asset manager. Operational risks arise, for example, from human error, defective systems or external factors such as criminal acts or disasters.

AP3 manages such risks via thorough documentation of routines and by ensuring it has sufficient staff with the right qualifications and skills. Important elements include maintaining adequate backup in terms of computer systems and human resources and being well prepared for out-of-the-ordinary events.

The Chief Operating Officer is in charge of most of the processes involved in operational risk management and the Compliance department makes sure they are followed.

### Ethical guidelines

AP3's work is subject to internal ethical guidelines set by the Board.

These stipulate that the Fund must operate in such a way that parliament, the government and the Swedish public have full confidence in its activities. Read more about our ethical guidelines on page 10 or at [www.ap3.se](http://www.ap3.se).

### Next step: a new portfolio system

AP3 strives continually to improve risk management. In 2005, for instance, a new portfolio system will be introduced that will strengthen control over internal processes and improve risk control.



# Every company is unique

AP3 strives to play an active and clear governance role in the companies in which it is a major shareholder. According to parliamentary guidelines, the Fund should use its shareholders' rights to help achieve its goal of maximum returns on fund capital. Constructive governance requires a flexible application of the corporate governance policy that takes account of each company's different circumstances. Every company is unique.

Sweden's corporate governance landscape has undergone a transformation since AP3 began operations in 2001. Institutional shareholders have become more active and visible, thereby improving the balance of power between shareholders, boards and management. Most listed companies now have nominating committees with shareholder representatives. The options schemes that are proposed today are less extensive than their predecessors and more closely linked to performance. In 2004, Sweden gained a formal Code of Corporate Governance that mirrored many of the provisions of AP3's governance policy.

### Focus on nominating committees

This new landscape changes AP3's own corporate governance activities. AP3's work now focuses on the nomi-



nating committees in which the Fund is represented. The most important aspect is ensuring that companies have effective boards with the will and capacity to run the business in line with shareholders' interests. AP3 promotes the view that nomination processes should be based on systematic evaluations of the board's performance. It is often necessary for the nominating committee to conduct its own analysis in this regard, for instance holding interviews with individual directors. It is becoming more common to perform board evaluations in partnership with an external, independent party, and AP3 is positive to this trend.

The Fund is also working to change attitudes to what board membership entails. Directorships are not honorary positions to be held for life and boards should be refreshed more

frequently. The process of identifying new board candidates should be subject to certain quality standards. One way might be to commission an external recruitment consultant to draw up a broad list of potential names. AP3 promotes an expansion of the recruitment base for boards. Each board should have directors with different skills and backgrounds. AP3 also promotes a more even balance between male and female directors.

### Swedish Code of Corporate Governance

AP3 welcomes the new Swedish Code of Corporate Governance as a model of best practice. At the same time, it is important to preserve diversity. The best interests of shareholders vary from company to company. Important flexibility is provided by the code's principle of "comply or explain",

Representation of AP3 on nominating committees	
<i>Prior to AGMs in 2004</i>	<i>Prior to AGMs in 2005</i>
<ul style="list-style-type: none"> <li>• Alfa Laval</li> <li>• Cardo</li> <li>• Elekta</li> <li>• Haldex</li> <li>• Höganäs</li> <li>• Munters</li> <li>• Nobia</li> <li>• Orc</li> <li>• SKF</li> <li>• SwitchCore</li> </ul>	<ul style="list-style-type: none"> <li>• Alfa Laval</li> <li>• Cardo</li> <li>• Castellum</li> <li>• Haldex</li> <li>• Höganäs</li> <li>• Nobia</li> <li>• SwitchCore</li> <li>• Telelogic</li> </ul>



which allows shareholders to judge whether a company's explanation for its failure to follow the code is acceptable. AP3 intends to push for straightforward and easily digestible corporate governance reports that are free from overly complex or legalistic explanations. It is important that information is provided to the market in cases when a company has opted not to follow the code.

#### Actions in 2004

In 2004, AP3 attended 47 annual general meetings and 11 extraordinary general meetings. Prior to the AGM season, the Fund was represented on ten nominating committees. In 2005, AP3 is represented on eight nominating committees (see box, previous page).

In conjunction with last year's

first-half results, the Fund published a report on its corporate governance initiatives during the AGM season. Significant events included our decision to vote against the options scheme proposed by the board of the investment company Investor. AP3 also participated in a campaign by institutional shareholders for introduction of a performance-related component in the options scheme of SEB bank. At the AGM of Swedish Match, AP3 proposed that the company publish its ethical code of conduct, which it later did.

AP3 aims to have close relations with the 10 to 15 corporations in which it is a major shareholder. AP3 invites the executive managements and boards of these companies to regular meetings at which AP3 explains the Fund's approach to

corporate governance and gains a closer understanding of the company and its operations.

#### Corporate governance working group

AP3's Board sets the corporate governance policy, while day-to-day management of governance issues is handled by a working group consisting of the CEO, Head of Corporate Governance and Head of Equity Management. In late 2004 Pernilla Klein was appointed Head of Corporate Governance. This is a new post within the Fund and underlines AP3's commitment to governance issues.

Corporate governance issues are addressed in close cooperation with portfolio managers in AP3's Swedish equities department, who have expert knowledge about the companies concerned.



#### AP3's governance mandate

The 1999/2000:46 government bill on the AP funds' role in the reformed pension system states:

- "The aim of the corporate governance policy is to contribute to the overarching goal of high investment returns."
- "Each fund may own no more than 2% of the capitalisation of the Stockholm Stock Exchange."
- "The funds may control a maximum 10% of the voting equity in any one company."
- "The funds by their actions may not serve as instruments of business or economic policy."



# AP3 promotes corporate codes of conduct

The legislation governing the AP funds states that “environmental and social considerations shall be taken into account in investment activities without impinging on the overall goal of a high return on capital”. AP3 promotes standards of environmentally and socially responsible investment through active governance. Rather than using screening to exclude individual companies or sectors from the Fund’s portfolios, AP3 believe we can make more of a active engagement.

Observance of good environmental and social practices is essential if companies are to be run in shareholders’ long-term best interests. AP3 believe adherence to such standards improves long-term returns. These issues are therefore an important part of AP3’s corporate governance activities. AP3 seeks to ensure that the executive managements of companies in which we have shareholdings identify and manage social and environmental risks in a way that creates shareholder value.

### System for integrating ethics

AP3 has developed a two-step system for integrating environmental and social considerations into its investment activities:

*1. Ethical corporate analysis.*

This involves analysing corporations’ exposure to environmental and social risks, and how well they manage them.

*2. Active shareholder engagement.* By this, AP3 seeks to persuade companies to introduce appropriate social and environmental risk management procedures.

This process is designed to ensure that AP3 is well aware of the environmental and social risks that apply to companies in which it is a major shareholder. It is primarily Swedish corporations that are relevant in this regard. Where deficiencies appear, AP3 initiates discus-

sions with the company in question and in collaboration with the UK consultancy Core Ratings. In 2004, we held such discussions with three Swedish corporations.

### What is a corporate code of conduct?

AP3’s strategy of active governance on environmental and social issues relies on the companies in which it invests having corporate codes of conduct. These are especially important for companies whose business operations have a substantial environmental impact, or those that have production and/or conduct purchasing in countries where there is a lack of government will or ability to ensure compliance with basic international rules and regulations on human rights, worker rights, corruption and environmental standards.

A corporate code of conduct means a group-wide framework of rules and systems to manage environmental and social concerns. It should meet the following requirements:

*1. Transparency.* The basic principles of the code should be communicated openly to shareholders and other stakeholders. It is also important that guidelines are clearly communicated to all employees within the group.

*2. Monitoring and control.* Compliance must be monitored regularly if a code of conduct is to be effective and credible.

### Ethics at AP3

AP3 assumes that the companies in which it owns shares comply with international conventions and agreements ratified by Sweden. It also assumes that companies with operations in Sweden abide by Swedish law. AP3 attaches particular importance to the following international agreements:

- The OECD’s guidelines for multinational corporations.
- The ILO’s core conventions (relating to forced labour, child labour, working conditions, equality and freedom of association).
- The UN Declaration on Human Rights.

AP3 approves of companies undertaking to abide by the principles of the UN Global Compact.

*3. Reporting.* For the code to be properly evaluated by shareholders and other stakeholders, the company must demonstrate satisfactory external reporting of the code itself and of follow-up routines and appropriate data. A good model for such reporting is the Global Reporting Initiative (GRI), a UN scheme to develop an international environmental and social reporting standard. AP3 encourages companies to report according to GRI guidelines.



# Strong returns on fund capital in 2004

AP3's fund capital increased by SEK 17.8 billion to 160.3 billion in 2004 as a result of capital inflows, active investment decisions, a favourable stock market climate and declining interest rates. The equity portfolio was adjusted during the year to include a higher weighting in Asian equities and a lower weighting in US equities. The weighting in index-linked bonds was increased in the fixed income portfolio at the expense of fixed income bonds.

From 2001 to 2004 the Fund has successfully generated positive returns after expenses compared to the reference portfolio. Return after expenses for AP3's market-listed portfolio for the entire period was 8.0%.

## Fund capital

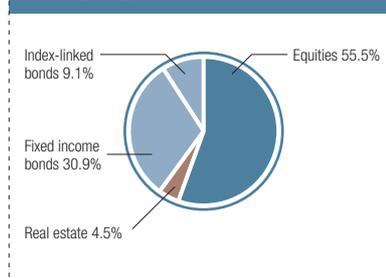
Fund capital increased from SEK 142.5 billion to 160.3 billion at 31 December 2004. The increase was attributable to a return of SEK 16.1 billion and net capital inflows of SEK 1.7 billion.

The Fund capital structure was 55.5% equities, 40% bonds and 4.5% real estate at 31 December 2004.

## Return on total portfolio 2004

The market trend shaped by rising equity markets and declining long-term interest rates had a favourable impact on return on AP3's fund capital.

### Allocation of fund capital at 31 Dec 2004



Return on the total portfolio was 11.4% before expenses and 11.2% after expenses. Return in 2004 on the market-listed component of the portfolio, which excludes real estate and private equity, was 11.4% before expenses and 11.2% after expenses. Return on the reference portfolio was 11.4%.

The best-performing asset classes in SEK terms were Swedish equities with a return of 20.1%, European equities at 11.9%, Asian equities at 11.1% and Swedish index-linked bonds at 11.3%.

The reference portfolio outperformed the Fund in 2004 and active return was -0.2% after expenses. The most significant positive contributions came from tactical asset allocation and external fund managers, which outperformed their benchmark index. Interest management and currency management also made a positive contribution, while the Fund's internal management of European and Swedish equities underperformed the benchmark indices.

Active risk measured as tracking error was 0.5%.

### Active return per asset class at 31 Dec 2004

%	Portfolio	Index	Active return
<b>Equities<sup>1</sup></b>	<b>12.2</b>	<b>12.5</b>	<b>-0.3</b>
Sweden	20.1	20.8	-0.7
Europe	11.9	12.9	-1.0
USA	3.8	3.6	0.2
Asia	11.1	11.0	0.1
<b>Fixed income<sup>2</sup></b>	<b>8.1</b>	<b>7.9</b>	<b>0.2</b>
Nominal	5.1	4.9	0.2
Index-linked	11.1	11.0	0.1
<b>Total market-listed assets<sup>3</sup></b>	<b>11.4</b>	<b>11.4</b>	<b>0.0</b>
<b>Real estate<sup>4</sup></b>	<b>12.5</b>		
<b>Private equity</b>	<b>8.9</b>		
<b>Total</b>	<b>11.2</b>		

<sup>1</sup> SEK excluding currency hedging

<sup>2</sup> Including currency hedging

<sup>3</sup> Including currency hedging, excluding expenses

<sup>4</sup> Including investments in forest properties

### Active return for the market-listed portfolio at 31 Dec 2004

%	
Portfolio	11.4
Reference portfolio	11.4
<i>Active return</i>	<i>0.0</i>
Expenses	-0.2
<b>Total active return after expenses</b>	<b>-0.2</b>
Relative contributions to active return	
Tactical asset allocation	0.2
Swedish and foreign fixed income	0.1
Currency	0.1
External mandate	0.2
European equities (internal management)	-0.2
Swedish equities	-0.1
Other	-0.3
<b>Active return</b>	<b>0.0</b>
Expenses	-0.2
<b>Total active return after expenses</b>	<b>-0.2</b>



**Tactical asset allocation**

AP3 lowered the general level of risk within tactical asset allocation in 2004 and this area made a positive contribution to active return during the year.

Tactical asset allocation is an active management approach aimed at enabling AP3 to generate an active return.

Management is on two levels: long-term and short-term. At the long-term level, longer positions are taken in terms of the weighting of equities contra bonds. The short-term level follows prevailing market sentiment through active changes in asset allocation and management of incoming and outgoing capital flows. It also performs the rebalancing that may be required when returns on certain asset classes vary.

In early 2004, AP3 switched to "semi-fixed" weightings in the reference portfolio. This significantly reduced the need to rebalance asset classes compared with the previous year, which in turn lowered transaction costs.

**Positions and performance in 2004**

Tactical asset allocation in 2004 took a favourable view of equities compared to other assets. The overweight in equities relative to the underweight in bonds varied from 0.5-1 percentage point.

With these holdings, AP3 gained exposure to equities in a number of Asian markets. Tactical asset allocation contributed 0.2% to overall return.

**Reference portfolio and current portfolio including risk limits at 31 Dec 2004**

	Portfolio weight	Reference portfolio weight	Active weight	Permitted difference weight (% points)
<b>Equities</b>				
Sweden	17.1	16.0	1.1	+/-5
Europe	17.8	17.5	0.3	+/-5
USA	14.5	14.7	-0.2	+/-5
Asia	6.2	6.3	-0.1	+/-5
<b>Equities total</b>	<b>55.6</b>	<b>54.5</b>	<b>1.1</b>	<b>+/-7</b>
<b>Fixed income</b>				
<i>Fixed income bonds</i>				
Sweden	15.4	12.6	2.8	+/-5
Eurozone	7.7	7.0	0.7	+/-5
UK	1.4	1.4	0.0	+/-5
USA	6.3	6.5	-0.2	+/-5
<i>Index-linked bonds</i>				
Sweden	4.2	5.2	-1.0	+/-5
Eurozone	3.0	2.4	0.6	+/-5
USA	1.9	1.9	0.0	+/-5
<b>Fixed income total</b>	<b>39.9</b>	<b>37.0</b>	<b>2.9</b>	<b>+/-7</b>
<b>Real estate<sup>1</sup></b>	<b>4.5</b>	<b>8.5</b>	<b>-4.0</b>	<b>+/-5</b>
<b>Cash<sup>2</sup></b>				
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>0.0</b>	
Level of currency hedging foreign equity investments				
	51.2	52.5	-1.3	+/-20 <sup>4</sup>

<sup>1</sup> Note that in this table AP3's holdings of real estate (via shares in the property company AP Fastigheter) are reported in gross terms. This means that the holdings are assessed based on the value of the company's properties and financing is considered separately.

<sup>2</sup> In this table cash corresponding to forward positions has been distributed to the respective asset classes.

<sup>3</sup> With reference to notes 1) and 2), the tables are not fully comparable with the balance sheet.

<sup>4</sup> Relative to the reference portfolio's currency hedging ratio for equities.

**Index structure at 31 Dec 2004**

Main asset class	Benchmark index
<b>Equities</b>	
Sweden	SIXRX (SIX Return index)
Europe	FTSE Developed Europe Large Cap
	FTSE EuroFirst 300
USA	FTSE Developed Europe Mid Cap
	FTSE Developed Europe Small Cap excluding investment companies
Asia	FTSE AW North America Large Cap
	FTSE North America Mid Cap excluding REITS
Asia	FTSE North America Small Cap excluding REITS
	FTSE AW Developed Asia Pacific excluding Japan
	FTSE AW Japan
<b>Fixed income</b>	
Sweden	Merrill Lynch Swedish Government Bonds
	Handelsbanken Mortgage Bonds Index
Europe	Merrill Lynch EMU Direct Government Index
	Merrill Lynch Jumbo Pfandbriefe Index
	Merrill Lynch UK Gilts Index
	Merrill Lynch GBP Corporates Index
USA	Merrill Lynch US Treasury Master
	Merrill Lynch US Agencies Bullet Structures
	Merrill Lynch Global Large Cap Corporate Index – USD Large Cap
Index-linked bonds	Merrill Lynch Swedish Inflation Linked Government Bonds
	Merrill Lynch Inflation Linked French Government
	Merrill Lynch Inflation Linked US Treasury

The list shows only indices included in the Fund's benchmark index.



## Equity management

AP3 holds equities under internal and external management. In 2004, the combined internally and externally managed equity portfolios had a value of SEK 89 billion and generated a return of 12.2% before expenses.

The sustained strong economy and low global interest rates contributed to a favourable year for equity markets in 2004, though gains were restrained somewhat by the weaker US dollar and rising oil prices.

All US markets posted gains in 2004 and the FTSE All World USA index gained 11.6%. The energy sector was the year's big winner, while the pharmaceutical sector was the loser.

The Swedish SIXRX index rose by 20.8% in 2004. Ericsson shares were the primary engine, rising 64.3%.

### European economy lagging

The growth rate in Europe increased in the first half of 2004, due mainly to strong exports from the eurozone to the rest of the world. Growth for the full year was revised downwards in response to weaker than expected performance in the third quarter.

The European FTSE Eurofirst 300 index rose by 12.0% in euro terms in 2004.

### Sustained growth in Japan

The Japanese economy grew for the fourth consecutive year. Exports, investments and private consumption surged and the FTSE All-World Japan index rose by 10.7% in local currency.

## AP3'S INTERNAL EQUITY MANAGEMENT

*The internal equity management group manages a Swedish equity portfolio of SEK 27 billion and a European equity portfolio of SEK 14 billion. These portfolios produced positive returns in 2004 but underperformed their respective benchmark indices.*

The Swedish equity portfolio delivered a return of 20.1%, while the benchmark index gained 20.8% after expenses. Calculated in SEK, the European equity portfolio rose 9.0%, which compared to an 11.1% increase in an internal mixed index.

AP3's internal equity management team is made up of an equities manager, a sector strategist, a group of sector managers, quantitative analysts and an execution function. The sector managers are divided into a Swedish group and a European group. About 70% of investments in

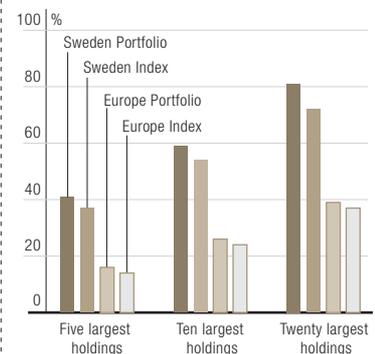
large-cap European companies are managed internally, with the remaining 30% managed externally. Some of the investments in European mid-cap and small-cap equities also fall within the internal mandate.

### Investment philosophy

The Swedish portfolio has a long-term investment philosophy that is clearly manifested in investments in small and medium-sized companies. In these cases, AP3 often becomes a major shareholder and must accord-

ingly attach greater importance to the company's potential than to short-term share price performance. The Fund prefers companies with high, predictable and sustainable earnings potential to turnaround companies.

Portfolio concentration of internally managed equities at 31 Dec 2004





### Positions in Sweden

The Swedish reference index rose by 20.8% in 2004. Slightly more than half of the increase took place in the second half of 2004. The Fund was overweight during the year in the banking and engineering sectors at the expense particularly of forestry and investment firms. The largest contributors to the portfolio's active return were Assa Abloy, Nobia, H&M and Castellum. The weakest performers were Tele2, Alfa Laval, Gambro and SCA.

#### Five largest equity holdings AP3's internally managed equity portfolios at 31 Dec 2004

Fair value (SEK million)

#### Sweden

Ericsson	3,491
H&M	2,347
SHB	1,911
Nordea	1,789
TeliaSonera	1,478

#### Europe

BP	513
Vodafone Group	509
HSBC Hldg	451
Total	361
Novartis	358

The active risk level remained relatively constant during the year and on a par with 2003.

### Positions in Europe

For most of 2004, AP3's internally managed European equity portfolio was essentially sector-neutral. The five most significant overweight and underweight positions at year-end in relation to index are shown in the adjacent table.

#### Turnover rate

%	2004	2003
---	------	------

#### Internally managed equity portfolios <sup>1</sup>

Swedish equities	44	53
European equities	73	76

<sup>1</sup> Excluding derivatives and trading portfolios.

#### Five largest ownership stakes (votes) AP3's internally managed equity portfolios at 31 Dec 2004

Company	Stake, %
Munters	8.5
Nobia	8.2
Alfa Laval	7.7
Haldex	7.1
Höganäs	7.0

#### Benchmark coverage for internally managed equity portfolios at 31 Dec 2004

	Sweden	Europe
Number of companies in the benchmark	274	311
% of companies in the benchmark included in the portfolio	20.1	76.8

#### Largest active positions at 31 Dec 2004

%	Portfolio weighting	Index weighting	Active weighting
<b>Sweden</b>			
<i>Most significant overweight</i>			
Alfa Laval	3.4	0.4	3.0
Assa Abloy	4.5	1.5	3.0
SHB	7.1	4.4	2.7
Höganäs	2.0	0.2	1.8
H&M	8.7	7.0	1.7
<i>Most significant underweight</i>			
Sandvik	0.2	2.6	-2.4
Volvo	2.8	4.2	-1.4
TeliaSonera	5.5	6.8	-1.3
Investor	1.1	2.4	-1.3
Industrivärden	0.0	1.2	-1.2
<b>Europe</b>			
<i>Most significant overweight</i>			
Telekom Austria	0.7	0.1	0.6
Vodafone Group	3.6	3.0	0.6
TDC	0.6	0.1	0.5
Reckitt Benckiser	0.8	0.4	0.4
Roche Holdings	1.8	1.4	0.4
<i>Most significant underweight</i>			
BT Group	0.1	0.6	-0.5
Deutsche Telekom	0.8	1.2	-0.4
Unilever	0.7	1.1	-0.4
British American Tobacco	0.1	0.5	-0.3
Tesco	0.5	0.8	-0.3



## AP3'S EXTERNAL EQUITY MANAGEMENT

At year-end 2004, the value of the external equity portfolio was SEK 45.4 billion, apportioned between 18 equity mandates in Europe, the US and Asia. External management assignments in SEK, excluding currency hedging, posted a return of 9.1% and outperformed the benchmark index, which generated a return of 8.6%.

AP3 has no internal management organisation for non-European equity markets and instead uses external fund managers. External fund managers are also partly used in the European equity market. AP3's external equity management aims to contribute to active return through an optimum selection of fund managers. A combination of fund managers with varying strategic orientations and investment styles is chosen to enhance risk diversification.

### European equities

European equities are divided into three segments: large-cap, mid-cap and small-cap. About 30% of investments in large-cap European equities are passively managed by State Street, with the remainder managed internally.

As in the preceding year, European small and mid-cap equities were managed externally. The Fund adopted a new reference index in 2004 and consequently split the management of small-cap and mid-cap equities, which are now under two separate mandates. Two of the original fund managers, Pictet and JP Morgan, will in future focus on managing small-cap equities, while Axa Rosenberg and Kempen concentrate on mid-caps. AP3 elected to include BNP Paribas as a new mid-cap equities manager with the objec-

tive of achieving a favourable mix of fund managers. All European small-cap and mid-cap equities are under active management.

The European mandate generated a return of 16.6% in 2004 compared to the index return of 15.8%.

### US equities

All US equities are externally managed within the three market segments: large-cap, medium-cap and small-cap.

As in the past, the US large-cap equity portfolio was managed by Merrill Lynch, in part through a passive mandate and in part through an enhanced management mandate. Under the latter approach, the fund manager may depart somewhat from the benchmark index in order to generate higher returns.

As with Europe, AP3 adopted a new reference index for the US and separated the mandates for small-cap and mid-cap equities. AP3's original US fund managers, Batterymarch and Axa Rosenberg, were both retained after this change. Axa Rosenberg now concentrates on mid-cap equities, but its mandate has been expanded. Batterymarch now has mandates for small-cap and mid-cap equities, and shares the small-cap segment with a new fund manager, Dimensional Fund Advisors.

The US mandates posted a return

### Managers with which AP3 has entered into contracts

These managers may be assigned future management mandates.

Equities	
Japan	Deutsche Asset Management
	Fidelity Pensions Management
	Morgan Stanley Investment Management
Asia-Pacific	Schroder Investment Management
	Baring Asset Management
	Credit Agricole Asset Management
Europe small/ mid-cap equities	Fidelity Pensions Management
	Morgan Stanley Investment Management
	Scottish Widows Investment Partnership
USA small/ mid-cap equities	Harris Investment Management
	Mazama Capital Management
	New Amsterdam Partners
Global index management	Times Square Capital Management
	Barclay Global Investors
Fixed income	
Corporate bonds	BlackRock International
	Western Asset Management

of 11.7% in 2004 compared to the benchmark, which generated a return of 11.1%.

### Asian equities

The Fund's Asian equity portfolio is divided into two segments, Japan and Asia-Pacific. Following the 2003 ALM analysis, 2.5% of the portfolio was reallocated from US to Asian equities.

In response to the increased asset



allocation, two new fund managers for Asia, APS and Schroders, were added to supplement JP Morgan. The Asia-Pacific mandate posted a return of 29.7% and the index returned 29.0%.

Funds were also allocated to the Japanese mandate owing to the

change of reference portfolio. A reallocation within the mandate was carried out in parallel, which involved the replacement of Schroders by a combination of Nomura and JP Morgan. The aim was to assemble a combination of fund managers with complementary

investment styles, which reduces the risk in the mandate.

The Japanese mandate generated a return of 10.5% in 2004, slightly lower than the benchmark return of 10.7%.

**External management assignments at 31 Dec 2004<sup>1</sup>**

Fund manager	Region	Mandate type	Active/Passive	Fair value (SEK million)	Portfolio return, %	Benchmark return, %	Active return, %	Assignment start date
<b>Equity mandate</b>								
Capital International Ltd	Japan	Large cap	Active	2,415	9.0	10.7	-1.6	2 Aug 2002
JP Morgan Fleming Asset Management	Japan	Large cap	Active	1,210	12.5	10.2	2.3	1 Feb 2004
Nomura Asset Management	Japan	Large cap	Active	1,199	11.5	10.2	1.3	1 Feb 2004
<b>Total Japan</b>				<b>4,825</b>	<b>10.5</b>	<b>10.7</b>	<b>-0.2</b>	
JP Morgan Fleming Asset Management	Asia-Pacific	Large cap	Active	2,121	31.6	29.0	2.6	1 Aug 2002
Schroder Investment Management	Asia-Pacific	Large cap	Active	1,357	19.2	20.5	-1.3	6 Mar 2004
APS Asset Management	Asia-Pacific	Large cap	Active	660	18.5	20.5	-2.0	6 Mar 2004
<b>Total Asia-Pacific</b>				<b>4,138</b>	<b>29.7</b>	<b>29.0</b>	<b>0.7</b>	
Merrill Lynch Investment Managers	North America	Large cap	Enhanced	4,713	9.6	9.4	0.2	30 Aug 2002
Merrill Lynch Investment Managers	North America	Large cap	Passive	10,883	9.3	9.4	-0.1	31 Dec 2000
Axa Rosenberg Investment Management <sup>3</sup>	North America	Mid cap	Active	2,603	22.0	18.6	3.4	22 Jun 2004
Batterymarch Financial Management	North America	Mid cap	Active	1,692	10.5	10.3	0.2	22 Jun 2004
Batterymarch Financial Management	North America	Small cap	Active	1,392	14.9	19.8	-4.9	31 May 2003
Dimensional Fund Advisors Inc.	North America	Small cap	Active	1,388	27.0	26.7	0.3	13 Aug 2004
<b>Total North America</b>				<b>22,672</b>	<b>11.7</b>	<b>11.1</b>	<b>0.6</b>	
State Street Global Advisors	Europe	Large cap	Passive	5,819	10.8	10.9	-0.1	31 Dec 2000
BNP Paribas Asset Management	Europe	Mid cap	Active	1,417	11.5	10.5	1.0	27 May 2004
Kempen Capital Management <sup>3</sup>	Europe	Mid cap	Active	962	17.9	19.2	-1.3	27 May 2004
Axa Rosenberg Investment Management <sup>3</sup>	Europe	Mid cap	Active	2,313	19.6	19.2	0.4	27 May 2004
JP Morgan Fleming Asset Management	Europe	Small cap	Active	1,983	22.4	22.1	0.3	29 Aug 2003
Pictet Asset Management	Europe	Small cap	Active	1,309	26.1	23.5	2.6	29 Aug 2003
<b>Total Europe</b>				<b>13,801</b>	<b>16.6</b>	<b>15.8</b>	<b>0.8</b>	
<b>Fixed income mandate</b>								
Prudential Investment Management	North America	Investment Grade	Active	2,041	6.1	5.2	0.8	3 Jun 2002
Prudential Investment Management	North America	High Yield BB	Active	149	1.0	1.2	-0.2	1 Dec 2004
Prudential Investment Management <sup>3</sup>	North America	High Yield B	Active	148	11.0	10.2	0.8	1 Dec 2004
<b>Total</b>				<b>2,338</b>	<b>6.6</b>	<b>6.3</b>	<b>0.3</b>	
<b>Total externally managed<sup>2</sup></b>				<b>47,773</b>	<b>8.6</b>	<b>8.1</b>	<b>0.5</b>	

<sup>1</sup> Returns are stated in base currency and refer to 2004.

<sup>2</sup> Returns are stated in SEK excluding currency hedging.

<sup>3</sup> Performance figures include accrued performance from previous management assignments.



## Optimum mix enhances risk diversification

About 30% of AP3's capital is managed by managers other than AP3 through external management. Spread over 21 mandates, AP3 has entrusted 14 institutions with managing the pension funds of the Swedish public.

### Larger share of active management

"AP3's unwavering objective is to improve external management performance and we have adopted a multi-manager model wherein we constantly strive to assemble the right mix of managers," says Cecilia Sved, portfolio manager in charge of traditional externally managed asset classes.

"We do not believe that any single fund manager is capable of outperforming the index throughout all parts of a business cycle, so our approach is to combine managers that deliver strong performance in diverse market situations aimed at achieving high but stable returns while lowering risk."

Several changes took place within the external management mandates in 2004. Some 2.5% of fund capital was reallocated from the US to Asia following a strategic decision by the Board based on the outcome of the



2003 ALM analysis. Other changes were implemented in response to the new index structure.

All regional mandates – Japan, US, Asia (ex. Japan) and Europe – were modified in 2004 with respect to size and the number of active managers.

"We replaced one fund manager in our Japanese mandate with two new managers, Nomura and JP Morgan, to create a more favourable combination of asset management styles," says Cecilia Sved. "As more capital was allocated to Asia owing to the ALM change, we decided also to increase the number of managers from one to three, adding APS and Schrodgers to JP Morgan."

### New segment

She continues: "We introduced a new segment for mid-cap equities in Europe and the US and moved some of our small-cap managers to the new segment. We also strengthened the mix, taking on a new European mid-cap equities manager, BNP Paribas, and Dimensional Fund Advisors as a new US small-cap equities manager."

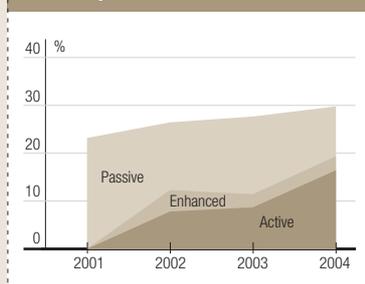
When AP3 combines fund managers within the various mandates, it selects managers with complementary management styles.

"AP3 wants at least two managers for actively managed mandates in order to reduce risk. In terms of size, we want the Fund to be an important but not the dominant client of each manager," Cecilia says.

"We work closely with all of our active fund managers, meaning we track their portfolios and returns on a more or less daily basis. In 2004, AP3 began to achieve a favourable structure in the mix of external managers and the benchmark index against which they will be measured. For this reason, we are not expecting changes in 2005 as significant as those during 2004.

"AP3's assets under management are not large enough for us to build up a world-class internal management organisation for all the financial markets and instruments available globally. Aiming to be the best 'manager of managers' is a much more effective approach and allows us to concentrate on what we are best at – long-term portfolio strategy and risk management – while our external fund managers use their expertise on our behalf to generate higher returns in individual markets. This model is a key aspect of AP3's ability to create high returns on its fund capital at low risk."

Externally managed assets as % of total portfolio





## PRIVATE EQUITY

At 31 December 2004, AP3 had private equity commitments of SEK 5.7 billion, of which slightly less than SEK 2.1 billion was invested. At the same date, AP3's commitments corresponded to about 3.6% of fund capital.

AP3's target is to have private equity commitments corresponding to about 5% of Fund capital within a couple of years. The aim is to compose an optimally diversified portfolio by geographic area (Scandinavia, Europe and the rest of the world), investment stage (buyouts, venture capital) and vintage year. As the AP funds are not permitted to own private equity directly, all investments are in funds that invest in private equity or in fund-of-funds.

The Fund's private equity investments are managed by two portfolio managers who assess 80-100 investment opportunities every year. About 20 are analysed in greater

### Externally managed assets and performance at 31 Dec 2004

SEK million	Market-listed assets			Unlisted assets
	Actively managed	Passively managed <sup>1</sup>	Total	
Return	3,324	1,258	4,582	148
<i>of which active return</i>	171	-12	159	
Total fees	93	4	97	66
Performance	3,231	1,254	4,485	82
Assets under management	26,358	21,415	47,773	Commitments 5,728
				Invested 2,092

<sup>1</sup> Including enhanced.

depth and ten or so are usually selected for investments.

#### Market trend 2004

Following a few years of weak performance, the private equity market

improved in 2004 in terms both of commitments to new funds and the capital repaid to investors when the funds sell their positions. Higher activity was also recorded in 2004 with regard to new investments and the volume of capital injected into new funds in the form of commitments. Commitments to these funds approximately doubled compared to 2003.

#### Performance

In 2004, AP3 made a total of nine new commitments to funds that invest in private equity. Along with the 28 commitments made in 2001-2003, the Fund now has 37 commitments in this asset class.

Total private equity commitments were SEK 5.7 billion, of which slightly less than SEK 2.1 billion had been invested as of year-end 2004. These commitments corresponded to approximately 3.6% of fund capital.

New commitments in 2004 were





mainly to funds that invest in relatively mature companies and industries. The sole exception was an investment in the Norway-based venture capital fund NeoMed IV, which is focused on life sciences. The other commitments were allocated among various geographical regions: Scandinavia through Ferd, Europe through Keyhaven, Legal & General, Alchemy, Greenpark and HarbourVest, and the US through Kelso and GS Vintage.

Private equity investments are long-term in nature, often with investment horizons of five to ten years. Accordingly, AP3's private equity portfolio is still at an early stage and encumbered by management fees while realised gains are small or non-existent. Reported return for the portfolio in 2004 was 8.9% in terms of SEK before expenses and excluding currency hedging. Return after expenses (management fees) was 4.8%.

### Investments in private equity

At 31 December 2004, AP3 had made the following commitments or investments in private equity via venture capital firms and fund-of-funds. All amounts are stated in millions in local currencies.

Fund/Venture capital firm	Currency	Total commitment	Invested amount <sup>1</sup>	Distributions	Valuation	Vintage year
Swedestart Tech	SEK	80	45	0	30	2000
Swedestart Life Science	SEK	50	28	0	18	2000
Goldman Sachs Vintage Fund II	USD	25	16	5	13	2001
HIPEP IV – European Venture Partnership	EUR	20	3	0	2	2001
Litorina Kapital 2001	SEK	150	55	0	118	2001
EQT Scandinavia I <sup>2</sup>	SEK	180	156	111	68	1995
Legal General Venture 2	GBP	7	5	4	3	2001
Candover 2001 Fund	EUR	25	20	2	15	2001
Vision Capital III	USD	10	4	0	3	2002
PETP III (Adveq)	USD	20	7	0	5	2001
Warburg Pincus Private Equity VIII	USD	35	24	3	21	2001
InnKap 1 <sup>2</sup>	SEK	64	62	0	93	1997
InnKap 2 <sup>2</sup>	SEK	95	74	0	21	1999
Carnegie BiotechBridge Fund	EUR	5	5	0	5	2002
Legal General Ventures 3	GBP	5	5	1	4	2002
CapMan Equity VII B	EUR	20	10	0	9	2001
IT Provider Fund IV	SEK	200	31	0	20	2002
InnKap 3 <sup>2</sup>	EUR	14	6	0	4	2000
Paul Capital Partners Top Tier Inv. II	USD	30	8	2	7	2002
European Secondary Development Fund III	EUR	15	2	1	1	2003
Altor 2003 Fund	EUR	25	10	2	8	2003
Polder – Greenpark Co-Investment	EUR	10	10	4	7	2003
Electra European Fund <sup>1</sup>	EUR	20	16	5	14	2000
Crown Private Equity European Buyout	EUR	30	3	0	3	2003
Auda Secondary Fund	USD	25	7	3	5	2003
Rhône Offshore Partners II	USD	20	10	7	9	2002
Four Seasons Venture IV	NOK	100	75	21	67	2003
GS US Middle Market Buyout Fund	USD	80	4	0	3	2003
Keyhaven Capital Partners I	EUR	25	1	0	0	2003
Kelso Investment Associates VII	USD	25	1	0	0	2004
Legal & General Ventures – LGV 4	GBP	5	1	0	1	2004
Alchemy Investment Plan	GBP	6	0	0	0	2004
Greenpark International Investors II	EUR	20	0	0	0	2004
HarbourVest 2004 Direct Fund	USD	30	2	0	2	2004
NeoMed Innovation IV	EUR	10	1	0	1	2004
Goldman Sachs Vintage Fund III	USD	20	2	0	2	2004
Ferd Private Equity	NOK	200	71	0	71	2004

<sup>1</sup> Relates to the de facto amounts invested or received by AP3 excluding commitments acquired on the secondary market. Amounts stated correspond to the total investment amount during the life of the commitment, i.e., amounts invested by AP3 and previous owners.

<sup>2</sup> Holdings acquired on the secondary market.



## A small but vital part of the AP3 portfolio



Mikael Huldt, Portfolio Manager, and Bengt Hellström, Head of External Management/Alternative Investments, explain AP3's approach to private equity.

### Why does AP3 invest in private equity?

**Bengt Hellström (BH):** There are many advantages to these investments. Private equity has historically generated higher returns than listed equities and the best managers can produce returns that are five to six percentage points above average market return. Accordingly, AP3 can achieve higher returns through investments in private equity while enhancing the portfolio's risk profile.

### What is AP3's approach to private equity investment?

**Mikael Huldt (MH):** Bengt and I analyse 80 to 100 private equity funds every year. Of those, we take about 20 to the next step and usually select a handful for an investment commitment.

We concentrate on assessing private equity firms' expertise, as we never invest directly in individual companies and try to remain as uninvolved as possible in the investments made by the managers. Our return requirement for private equities is to stay at about five percentage points above the listed market long-term, which means over a five to ten year horizon.

### What is the extent of AP3's private equity investments?

**BH:** At present, we have commitments of approximately SEK 5.7 billion, of which we have invested about SEK 2.1 billion. We don't use all the capital at once but progressively as the managers make their investments.

**MH:** At any one time, AP3 may have 5% of fund capital invested in private equity, which gives us room for another

couple of billion kronor. We should also keep in mind that only about 70-80% of a commitment is normally used, since we receive ongoing returns from investments in private equity funds.

### Performance thus far?

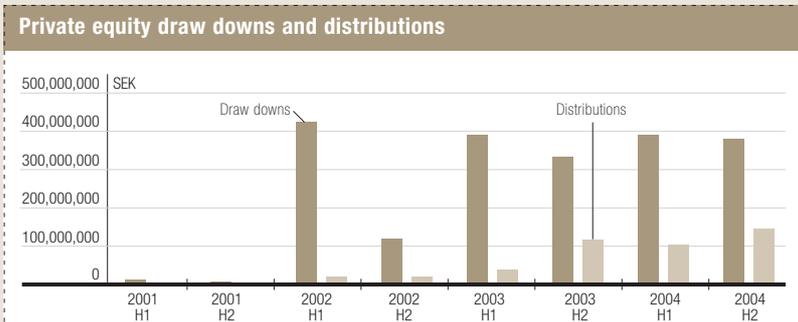
**MH:** It is still too early to assess our investments. Most private equity funds invest and manage their investments with a ten-year horizon and a relevant evaluation isn't really possible until after seven or eight years. Generally speaking, though, we can say that our investments have thus far developed as expected.

### How does AP3 select venture capital funds?

**BH:** We carefully evaluate every investment opportunity. The key aspects we look at are strategy and market conditions, performance and investment history, the investments selected by managers, the Fund's experience with ownership and divestitures, how they have created value in the past and the quality of reporting, administration and service to investors.

### What are the trends in the segment?

**BH:** The private equity market has developed strongly in recent years and the climate in Europe and Scandinavia has opened up. This means competition for the prime investments is getting fiercer all the time, so AP3 must remain an appealing and professional partner to ensure that the top-level private equity firms and fund managers regard us as an important investor.



Draw downs are investments including expenses. Distributions are returns on the investments. AP3's private equity investments also generate short-term positive cash flow, known as distributions.



## Fixed income management

AP3's fixed income portfolio had a market value of SEK 66.7 billion at 31 December 2004, of which 77% was in nominal bonds and 23% in index-linked bonds. Fixed income bonds were distributed as follows: 58% government bonds, 27% mortgage bonds and 15% corporate bonds. The geographical distribution of the index-linked bonds was 47% Sweden, 33% eurozone and 20% US.

The fixed income portfolio comprises Swedish and foreign securities and is managed internally, though the Fund also cooperates with US fund manager Prudential (see page 35 for more information). The internal fixed income group regularly allocates capital to Prudential for active management in the US corporate bonds segment. At year-end 2004, SEK 2.3 billion had been allocated externally, equivalent to 4.5% of the nominal fixed income portfolio.

### Investment philosophy

AP3's fixed income portfolio is actively managed, i.e. through active position-taking aimed at generating added returns relative to the reference portfolio. The fixed income portfolio consists of nominal and index-linked bonds.

Positions are taken on the basis of factors including duration, yield



curve, yield spreads between government, mortgage and corporate bonds, credit rating categories and securities selection.

### Fixed income market in 2004

Long-term fixed income bond rates did not rise during the year despite strong economic growth and interest hikes in the US and the ten-year yield remained stable at about 4.2%, while short-term yields rose strongly. The two-year yield in the US rose from 1.8% to 3.0% during the year, which severely flattened the yield curve by 130 basis points.

Swedish ten-year bond rates declined during the year from 4.8% to 3.9%. A similar trend was recorded in the eurozone, where the 10-year yield dropped by about 0.6 percentage points during the year to 3.7%.

The strong economy, low interest rates and increasingly healthy corporate balance sheets resulted in sharply reduced yield spreads for corporate bonds in 2004, particularly in the US. As a result, the yield spread between investment grade government and corporate bonds also declined from 95 to 83 basis points in 2004. The yield spread for

#### Credit structure for the nominal fixed income portfolio at 31 Dec 2004

%	Portfolio	Index	Active
Government bonds	58.5	57.4	-1.1
Mortgage bonds and agencies	26.9	36.6	-9.7
Corporate bonds			
Investment grade	12.2	6.0	6.2
High yield	2.4	0.0	2.4
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>0.0</b>



high-yield corporate bonds declined from 418 to 318 basis points.

### Fixed income management in 2004

Following the interest rate upturn in spring 2004, AP3 neutralised its positions for higher rates, which reduced risk in the portfolio and sharpened the focus on securities selection.

Positions that made the greatest positive contribution to performance include:

- › A large position for curve flattening in the US in two-year and five-year bonds relative to 30-year bonds. The yield curve for these bonds flattened by 150 basis points and 60 basis points respectively during the year.
- › Overweights in Swedish and European index-linked bonds, which both posted a return of 11.3%. US bonds returned 8.5%.
- › Heavy overweight in high-yield corporate bonds in the US, the UK, the eurozone and Sweden. These bonds generated superior returns

#### Modified duration for the fixed income portfolio at 31 Dec 2004

Modified duration for the fixed income portfolio (including externally managed portfolios)

	Portfolio	Index	Active
<b>Fixed nominal bonds</b>			
Sweden	3.6	3.4	0.2
Eurozone	4.6	4.9	-0.3
UK	6.7	8.0	-1.3
USA	4.2	5.0	-0.8
<b>Total nominal fixed income</b>	<b>4.1</b>	<b>4.2</b>	<b>-0.2</b>
<b>Index-linked bonds</b>			
Sweden	9.1	11.0	-1.9
Eurozone	7.2	9.2	-2.0
USA	6.6	8.6	-2.0

#### Five largest corporate bond holdings in the internal fixed income portfolio at 31 Dec 2004

Holding	Rating (S&P)	Submarket	Equivalent value (SEK million)	Share, % of fixed income portfolio
AP Fastigheter		SEK	485.7	1.0
Scania	A-	SEK, EUR	451.5	0.9
Ericsson	BB+	EUR, GBP, USD	370.8	0.8
Investor	AA-	SEK, EUR	363.4	0.7
Vattenfall	A-	SEK, EUR	346.3	0.7

during the year of up to 20% depending on submarket and credit rating.

One position that had a negative impact on performance was a short duration in fixed income and index-linked bonds in the US and Sweden, which became unfavourable when interest rates fell.

### External fixed income management

AP3's external fixed income management is assigned to Prudential and encompasses two mandates: US investment grade and high yield corporate bonds.

Prudential's management achieved returns that outperformed the index for both mandates.

The return on investment grade corporate bonds was 6.1% in local currency compared to the index return of 5.2%. High-yields posted a

return of 10.7% compared to the index, which generated a return of 9.9% in local currency.

### Performance

Calculated in local currency, fixed income assets generated strong returns in 2004. Generally speaking, returns were significantly better on index-linked bonds than on fixed income bonds, while corporate bonds outperformed government bonds.

The asset classes that generated the highest returns in the Fund's fixed income portfolio were Swedish (11.3%) and European (11.3%) index-linked bonds and US high-yield corporate bonds (9.9%). US government bonds performed worst, with a return of 3.5%. Regionally, government bonds in Sweden and the eurozone delivered the best returns at 8.6% and 7.7% respectively.

#### Distribution per rating category (S&P) in the credit portfolio at 31 Dec 2004

	% of portfolio Sweden	Eurozone	USA	UK	Total
AAA	0.4	53.7	3.9	96.1	13.9
AA	62.4	8.6	0.5	0.0	44.1
A	22.1	14.9	24.8	0.0	20.2
BBB	8.9	15.1	50.3	0.0	13.9
High-yield	0.0	7.7	20.4	3.9	3.6
Unrated	6.3	0.0	0.1	0.0	4.3
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>



## Enriching partnership with external fund manager

About 42% of AP3's assets of approximately SEK 160 billion are invested in fixed income securities such as government, mortgage and corporate bonds. Since its inception in 2001, AP3 has been committed to creating a diversified fixed income portfolio aimed at generating high returns at a low level of risk. Lars Orest, Head of Fixed Income and Foreign Exchange Management, explains the fixed income portfolio and the successful partnership between AP3 and its external fund manager Prudential.

Initially, AP3's fixed income portfolio consisted almost exclusively of Swedish government securities but is now a global portfolio extending to everything from Greek index-linked bonds to high-yield US corporate bonds.

Since corporate bonds are issued by companies, investing in them requires great skill and expertise in the market and credit assessment. Building up an in-house management operation would have been a costly endeavour, so AP3 elected instead to

carry out a public procurement process to find the best managers in the field.

"That gave us the opportunity to study several managers," Lars Orest explains. "We looked at factors like past performance, investment philosophy and style, fee levels and risk reporting. We finally selected three managers including Prudential, which was assigned the first mandate for US and UK corporate bonds."

### Expanded mandate

Prudential was initially allocated USD 200 million, which was gradually increased to USD 718 million at the peak in January 2003. The partnership has been successful so far. AP3 had USD 354 million under management at Prudential at year-end 2004, with the Merrill Lynch US Corporate Investment Grade Index as the benchmark.

Says Lars: "We work very closely together and Prudential has utilised its mandate for US corporate bonds superbly. The partnership was expanded in 2003 and Prudential was also entrusted with managing our new man-

### Some 42% of AP3's total portfolio in 2004 was in bonds

Fixed income nominal bonds accounted for 33% and index-linked bonds for 9%.

The fixed income bonds portfolio contained 59% government bonds, 27% mortgage bonds and 14% corporate bonds.

The regional distribution of AP3's fixed income portfolio was 18% US, 24% euro-zone, 4% UK and 54% Sweden.

AP3's fixed income portfolio was changed after year-end. See page 16 for more information.

date in high-yield US corporate bonds. The mandate is small but has great potential. Compared to ordinary US government securities, which generated a return of 4%, high-yields have returned 26% since April 2003."

He continues: "One of the greatest advantages to working with Prudential is the knowledge transfer and the fact that we've gained a valuable discussion partner. Our own market assessments are improving and we've gained access to a market that would have been costly and difficult to manage internally".

According to Lars, the major trend within portfolio management today is the debate on absolute return versus relative return.

"I believe fund managers are increasingly going to move towards a larger share of absolute return. After all, index management means that you are carried along when the market sags. And focusing on return in absolute figures is getting more significant to our capacity to deliver on our mandate as a buffer fund in the Swedish pension system."



*"The partnership with Prudential gives us access to the finest expertise available in the corporate bond market."*

Lars Orest, Head of Fixed Income and Foreign Exchange management.

## Foreign exchange management

AP3's total currency risk for the portfolio was 18.7% at year-end and the currency risk for the reference portfolio amounted to 19.3%.

Foreign exchange management is active and internal. Internal currency mandates are structured as possible deviations from a reference portfolio in terms of differences from open total exposure against the Swedish krona and between currencies.

AP3's currency weightings and hedging levels for the reference portfolio are determined annually as part of the ALM process (see page 15 for more information about ALM analysis). The currency reference is achieved with 100% hedging of fixed income instruments and 30%-65% hedging for equities, depending on the currency.

### Currency market in 2004

Volatility was low in the currency market during the first three quarters. Japan's central bank started the year with massive interventions to prevent the yen strengthening

against the US dollar, but discontinued the measures in the latter part of the year. Focus at the end of the year returned to the US deficit, which led to widespread selling of the US dollar against essentially all currencies. The US dollar fell during the year by about 8% against the euro and 5% against the yen.

The TCW (Total Competitiveness Weights) index for the Swedish krona oscillated between 122 and 129 during the year. The weak US dollar also effected the Swedish krona, lifting it to its highest levels against the US currency since 1997.

### Currency positions and performance

The Fund elected to increase the currency risk in the reference portfolio from 10.8% to 19.3% in 2004, which was still a lower exposure than the 30% maximum allowed by law.

Active foreign exchange manage-

ment delivered a positive contribution of about 10 basis points (0.1%). The positions that made the greatest contribution to overall return were the overweights in Swedish kronor and the Australian dollar at the expense of underweights in the US dollar and euro.

#### Currency exposure per asset class at 31 Dec 2004

Currency-exposed assets per currency (SEK million)	EUR	GBP	JPY	USD	Other	Total
Shares and investments	14,585	9,174	4,817	23,398	8,358	60,332
Exposure through SEK-listed companies with foreign domicile <sup>1</sup>	63	873			0	936
Bonds and other fixed income securities	14,464	1,906		6,793		23,163
Derivatives	-19	12	6	9	0	8
Other investment assets	2,464	236	43	4,295		7,038
Gross currency exposure	31,557	12,201	4,866	34,495	8,358	91,477
Currency hedging	-24,959	-9,395	-1,579	-23,240	-1,900	-61,073
<b>Total currency exposure</b>	<b>6,598</b>	<b>2,806</b>	<b>3,287</b>	<b>11,255</b>	<b>6,458</b>	<b>30,404</b>

<sup>1</sup> For legal reasons, this exposure is classed as exposed to currency risk.



## Real estate

AP3's real estate exposure consists mainly of a holding in AP Fastigheter, an unlisted property company. AP3 broadened its real estate investments in 2004 to include forest properties. At year-end, investments in real estate amounted to 4.5% of the portfolio. The Fund's holdings generated a total return of 12.5%, including property holdings in AP Fastigheter and forest properties.

AP Fastigheter, the Fund's largest real estate holding, is primarily oriented towards commercial and residential property in Stockholm, Uppsala and Gothenburg.

AP3 expanded its real estate investments during the year to include forest properties. At present, AP3's investments in forest properties are made up of shares in a Swedish company, Bergvik Skog, and commitments to the international timber funds Global Timber Investors 7 and Viking Global Timber Fund.

### Real estate market in 2004

The trend since year-end 2001 in the commercial property market in Stockholm has been one of declining

rents, occupancy rates and price/value levels. A similar but less pronounced trend has also been noted in Uppsala and Gothenburg over the past year or two.

Lower demand for office space has been the primary driver of the negative trend in rents and vacancies. However, the decline in the number of people employed in offices in Stockholm has slowed considerably. There are also signs that the occupancy rate in central Stockholm has bottomed out and begun to improve somewhat.

### Performance

At year-end 2004, the appraised value of AP3's holdings in AP

Fastigheter was SEK 6.8 billion, of which SEK 3.1 billion was the value of the Fund's equity holding based on the value of AP Fastigheter's property portfolio. The appraised value of AP3's forest property holdings was SEK 0.4 billion. AP3's holdings in AP Fastigheter generated an investment return of 13.4% in 2004. Return on real estate including forest properties was 12.5%.



# Report of the Directors 2004

Report of the Board of Directors and Chief Executive Officer of the Third Swedish National Pension Fund (AP3) for the financial year ended 31 December 2004.

Net profit in 2004 totalled SEK 16.1 billion (19.8), which represented a total investment return of 11.2% (16.2) after expenses and adjustments for net capital flows. At year-end, AP3's fund capital amounted to SEK 160.3 billion, compared to SEK 142.5 billion at the start of the year. During the year the Fund recorded a net capital inflow of SEK 1.7 billion (2.6).

## Change in fund capital 2004

SEK million	
Fund capital at 1 Jan 2004	142,536
Pension contributions	42,904
Pension disbursements <sup>1</sup>	-41,195
Administration fee to Swedish Insurance Office	-312
Transfers from phase-out funds	254
Net profit for the year	16,067
<b>Total fund capital at 31 Dec 2004</b>	<b>160,254</b>

<sup>1</sup> Includes payment of full and final settlement to the Swedish Insurance Office for 1999-2002.

The positive increase on fund capital was attributable to a combination of capital inflows, active investment decisions, rising equity prices and falling long-term interest rates. Equity holdings accounted for 54.5% of the reference portfolio.

## Change in fund capital 2001-2004

SEK million	2004	2003	2002	2001
Fund capital at 1 Jan 2004	142,536	120,211	132,724	133,975
Net inflow	1,397	2,143	1,984	3,062
Phase-out funds	254	424	3,017	1,461
Net profit/loss	16,067	19,758	-17,514	-5,774
<b>Fund capital at 31 Dec 2004</b>	<b>160,254</b>	<b>142,536</b>	<b>120,211</b>	<b>132,724</b>

## Change in fund capital excluding earnings 2001-2004

SEK million	
Pension capital at 1 Jan 2001	133,975
Net inflow 2001-2004	13,742
<b>Total</b>	<b>147,717</b>

## Return on fund capital since AP3's inception



The equity market recovery in 2003 and 2004 meant that the losses sustained in 2001-2002 have now been more than fully recouped.

## Choice of reference portfolio

AP3 performs annual asset liability modelling (ALM) studies to ascertain the optimal allocation of assets for the long-term benefit of the national pension system. An ALM analysis was conducted prior to the Board's decision on the structure of the reference portfolio for 2004. Based on this analysis, the Board made changes to the reference portfolio at the start of 2004. These included a higher weighting in index-linked bonds and Asian equities and reduced weightings in nominal bonds and American equities.

The ALM analysis was updated in the autumn of 2004 and featured a stronger emphasis on medium-term asset return forecasts. Macroeconomic tools were used to assess whether specific asset classes were overvalued or undervalued. Based on this analysis, the Board made a number of changes to the reference portfolio for 2005. The most significant of these were the withdrawal from index-linked bonds and reductions in the average maturity of the fixed income portfolio and in currency exposure. The alterations aimed to ensure greater long-term stability in portfolio returns.

## Active return in 2004

The Fund's portfolio of liquid market-listed assets (which excludes real estate and private equity) posted a return of



11.2% in 2004 after expenses. This was a slight underperformance against the reference index, which yielded a return of 11.4%. Active return totalled -0.2 percentage points.

The accumulated active return, before expenses since the Fund's new asset management mandate came into effect four years ago, is 0.8%. This compares to the Board's long-term target that return should exceed the reference portfolio by an average of 0.2-0.8% per annum (after expenses) over a rolling five-year period. So far, the annual active return amounts to 0.05% after expenses.

### Securities lending

Like most other fund managers, AP3 engages in securities lending. These operations consist of short-term loans of equities and bonds to counterparties with good creditworthiness and that provide full collateral. The lending programme is managed by AP3's custodian bank, Northern Trust. Total income from securities lending in 2004 amounted to SEK 40.0 million (35.1). This income is reported as interest income in the income statement.

Income from securities lending		
SEK million	2004	2003
Bonds	5.2	1.6
Equities	34.8	33.5
<b>Total</b>	<b>40.0</b>	<b>35.1</b>

### Total operations expenses

Operating expenses totalled SEK 314 million, an increase of SEK 79 million from the previous year. Expenses for external management and investments in private equity increased due to the development of AP3's operations. The decision to purchase a new portfolio system and the abolition of bonus-related remuneration pushed up IT and personnel costs.



Major expenses				
SEK million	2004	% of total	2003	% of total
<b>Total expenses</b>	<b>314</b>		<b>235</b>	
of which				
External managers	97	31	56	24
Personnel	70	22	63	27
Private equity management expenses	66	21	54	23
IT	30	10	7	3
Custodian bank	22	7	20	9
Suppliers of market information	9	3	10	4
Premises	5	2	6	3

### External asset management expenses

Some 52% of total operating expenses are related to costs for external management mandates and private equity investments. At 31 December 2004, 30% of fund capital was externally managed. Of funds under external management, 45% were under passive management and 55% under active management. The change in the mix of actively and passively managed capital is shown in the graph on page 29.



Fees paid to external managers have both a fixed and a performance-based fee, with the latter linked to relative performance. The higher the relative return generated by the manager, the higher the performance-based fee. Risk budgeting work has revealed that increasing the proportion of active mandates produces higher returns. Thus, returns from active management increased in 2004 but also increased external management expenses from SEK 56 million to SEK 97 million. This was due to a higher share of actively managed assets in Asia, increased active management in the mid-cap segment in the US and Europe, and higher performance-related fees to external managers.

In 2004, fixed fees totalled SEK 62 million and performance-fees were SEK 35 million.

Investments in private equity funds increased as planned during 2004 and the Fund's private equity commitments amounted to SEK 5.7 billion at year-end. The value of completed investments was SEK 2.1 billion at 31 December 2004. Management expenses for private equity investments rose 22%, from SEK 54 million in 2003 to SEK 66 million.

#### **Internal operating expenses**

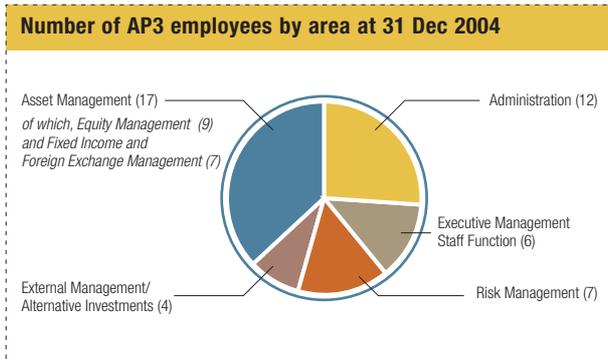
AP3's internal operating expenses (i.e. operating expenses excluding management fees paid to external managers and private equity funds) rose from SEK 125 million to SEK 151 million during 2004. This increase was primarily due to the abolition of performance-related compensation, which resulted in higher fixed salaries, and costs arising from a new portfolio system.

#### *Personnel expenses*

During its first three years of operation, AP3 had a very low rate of staff turnover. In 2004, however, the rate rose sharply, reflecting increased recruitment and labour movements in the financial markets. AP3 recruited 11 new employees. Three employees moved to new positions within the Fund, while ten people left the organisation. At year-end, AP3 had 46 employees, of whom two were on fixed-term contracts. A further three persons were due to join the Fund in the first quarter of 2005.

In spite of these substantial changes, the Fund succeeded in preserving the focus and quality of its portfolio management thanks to flexible working practices and the





reallocation of some tasks and functions. The sickness absence rate remained low and was 0.6% during the year. Moreover, there were no cases of protracted sickness absence.

From its inception in 2001, AP3 operated a performance-based compensation system for employees. However, new guidelines published by the government in 2003 led to this system being abandoned in 2004. Fixed salaries were increased by 20.3% in average to compensate the abolition of the bonus system.

The former system remains in place in respect of a few long-term bonus components that extend beyond the 2004 financial year. For these bonuses to be payable, certain targets must be exceeded and the recipients must remain employed by the Fund. Provisions for pre-existing bonus schemes will remain until these expire. SEK 4.4 million of bonus provisions were reversed in 2004, leaving total outstanding provisions of SEK 1.5 million.

#### *IT expenses*

In 2003, AP3 commenced the procurement of a new portfolio system. The goal was to identify a system that met the Fund's high demands on flexibility and reliability, that could handle new types of financial instruments and that promoted straight through processing efficiency and improved risk control. These objectives place high demands on AP3's own system and those of its counterparties, custodian bank, financial data suppliers and other parties. The contract for the new system was signed in March 2004 and training courses, workshops and implementation work have been in progress since April. Approximately one third of Fund employees have been wholly or partly involved in this effort, alongside our supplier and consultants. The new system is expected to go live during the second quarter of 2005.

The bulk of the costs for the new system was taken in the 2004 accounts and totalled SEK 25.3 million. This sum included purchase of system hardware and software, consultancy fees for implementation, interface construction and project management.

AP3's IT expenses will also be higher in 2005 than during a normal year because of the transition to the new system.

Introduction of the new system will reduce operational risk, increase our ability to invest in a wider range of financial instruments and promote more effective monitoring of external mandates. As part of the transition, new contracts have also been signed with providers of financial information.

#### **Corporate governance**

AP3 strives to play an active and clear governance role in the companies in which it is a major shareholder, and involvement in nominating committees is AP3's primary vehicle in this regard. Prior to the 2004 AGM season, the Fund was represented on ten nominating committees. Prior to the 2005 AGM season, AP3 is represented on eight nominating committees. AP3 believes nomination processes should be based on regular evaluations of board performance. Each board should have directors with different skills and backgrounds.

The Fund also supports higher turnover of board members to ensure renewal and a more equal balance between male and female directors.

During the year, AP3 created a new position of Head of Corporate Governance. Together with the CEO and Head of Equity Management, the Head of Corporate Governance is a member of the Fund's corporate governance working group.

AP3 aims to be an active participant in the Swedish and international corporate governance debate. In 2004, the Fund provided formal comments on the government's proposed Swedish Code of Corporate Governance and the report by the Government Commission on Business Confidence.

During the autumn, a Board review of the corporate governance policy resulted in a number of minor changes. Sixteen of the 39 requirements contained in AP3's current corporate governance policy accord with the provisions of the new Swedish code. AP3 will revise its policy when the code comes into effect during 2005.

**Broker selection in securities trading**

AP3 places great emphasis on ensuring that clear principles are observed when allocating securities trades between brokerages. Managers of equity, fixed income and foreign exchange portfolios use a ranking system whereby brokerages are assessed on the basis of set criteria, including the quality of their analysis. The rankings are used as the basis for allocating trading volumes. The brokers that received the largest commissions from AP3's internal equity management and the highest volume of fixed income and foreign exchange trades are shown in the table below. Total commission expenses for external management were SEK 63.6 million.

**Brokerage statistics – equities**

Top five recipients of broking commissions from AP3's Swedish and internal European equity management and rebalancing activities in 2004.

In alphabetical order

Alfred Berg/ABN Amro
Credit Suisse First Boston
Enskilda Securities
Handelsbanken Capital Markets
UBS

The above brokers received approximately 54% of total commissions.

Total commissions (SEK million)	26.0
Total number of brokers for equities transactions	27

**Brokerage statistics – fixed income**

The five brokers that handled the largest volumes of AP3's fixed income trading in 2004.

In alphabetical order

Danske Bank/ Consensus
JP Morgan Chase
Nordea
SEB
UBS

**Brokerage statistics – currencies**

The five brokerages that handled the largest volumes of AP3's currency trading in 2004.

In alphabetical order

Danske Bank
Deutsche Bank
Morgan Stanley
SEB
UBS

**Government evaluation**

The government conducts an annual review of the AP funds' operations and submits this in a report to parliament. The review of the 2003 financial year was presented in May 2004 and praised AP3 for our sensitivity analysis of the choice of reference portfolio and for the fact that we take note of valuation of markets when deciding strategic asset allocations. However, the government noted that the Fund had fallen short of the Board's target for active return in relation to the benchmark index.

The government also observed that the asset management of all AP funds was focused largely on index tracking and involved relatively low levels of relative risk, while asset management expenses were at a level commensurate with a higher level of active asset management. The government also said that a comparison of the funds' returns since 2001 showed that only limited risk diversification had been achieved by apportioning the buffer capital between four funds.

The AP3 Board agrees that it is desirable to increase relative risk levels within the Fund's portfolio management. During the autumn, the Fund's new executive management group initiated a comprehensive review of the investment strategy, investment process and risk control organisation. The review aims to examine possibilities for a gradual increase in relative risk in portfolio management and for a transition to portfolio management that is more independent of market indices. The introduction of such an approach is likely to increase the difference in risk and return between AP3 and the other AP funds.



When it comes to AP3's cost base, the Board will continue to monitor the Fund's operations to ensure they are cost-effective in comparison to similar fund management institutions in Sweden and abroad.

#### **Board activities**

In February, CEO Tomas Nicolin announced to the Board that he planned to take up a new position outside the Fund, having successfully piloted it through the reform of the state pension system. Recruitment of his successor was conducted by a working group appointed by the Board and supported by an external consultant. Kerstin Hessius was named new CEO at the end of May. Chief Operating Officer Sven Askenberger carried out the CEO's duties between May and September, when Kerstin Hessius took up her new position.

In 2004, the Board invested particular effort in the proposed Swedish Code of Corporate Governance and AP3's formal consultation response to this document.

An extended strategy meeting was held to expand understanding of the ALM analysis and reference portfolio and their implementation within the organisation. The management philosophy and strategy will continue to be key focus areas for the Board.

Other important issues in 2004 included the changes to the remuneration system and the increase in staff turnover. Both are covered in detail earlier in this section.

During the year the Board held eight meetings, one of which was an extended strategy meeting. Two training seminars were held, one to discuss the proposed Swedish corporate governance code and the other to address international trends in pension management.

The Board has a remuneration committee and an audit committee. The former addresses issues relating to the remuneration of the CEO and other employees and in 2004 participated in the creation of a new employee remuneration system (see above).

The audit committee focuses chiefly on responsibility rules, internal and external audits and risk control. In 2004, it focused particularly on internal control and refined the format for Board performance reviews.

The Board's 2004 review concluded that strategic and asset allocation issues should continue to receive high priority and that training initiatives and/or seminars should continue to be held in areas of central importance to AP3's operations.



# Income statement and balance sheet

Income statement				Balance sheet			
SEK million	Note	2004	2003	SEK million	Note	31 Dec 04	31 Dec 03
<b>Revenue</b>				<b>ASSETS</b>			
Dividends received		2,063	1,918	<b>Investment assets</b>			
Net interest income	11	2,991	2,661	Shares and units:			
Net capital gains/losses	12	2,457	-2,958	Listed	2	86,548	78,584
Net currency gains/losses		-1,438	-764	Unlisted	2	2,853	4,303
Unrealised changes in value	13	10,308	19,136	Bonds and other interest-bearing assets	3	65,464	54,476
<b>Total revenue</b>		<b>16,381</b>	<b>19,993</b>	Derivatives	4	2,877	2,855
<b>Operating expenses</b>				<b>Total investment assets</b>		<b>157,742</b>	<b>140,218</b>
External asset management expenses	14	-163	-110	<b>Receivables and other assets</b>			
Staff expenses	15	-70	-63	Cash and cash equivalents		1,610	1,492
Other operating expenses	16	-81	-62	Other assets	5	36	35
<b>Total operating expenses</b>		<b>-314</b>	<b>-235</b>	Prepaid expenses and accrued income	6	1,199	1,172
<b>NET PROFIT FOR THE YEAR</b>		<b>16,067</b>	<b>19,758</b>	<b>Total receivables and other assets</b>		<b>2,845</b>	<b>2,699</b>
				<b>TOTAL ASSETS</b>		<b>160,587</b>	<b>142,917</b>
				<b>FUND CAPITAL AND LIABILITIES</b>			
				Derivatives	4	205	274
				Other liabilities	7	50	44
				Deferred income and accrued expenses	8	78	63
				<b>Total liabilities</b>		<b>333</b>	<b>381</b>
				<b>Fund capital</b>			
				Fund capital at 1 Jan		142,536	120,211
				Net payments from the pension system	9	1,397	2,143
				Transfers from special asset management and phase-out fund	9	254	424
				Net profit for the year		16,067	19,758
				<b>Total fund capital</b>		<b>160,254</b>	<b>142,536</b>
				<b>TOTAL FUND CAPITAL AND LIABILITIES</b>		<b>160,587</b>	<b>142,917</b>
				<b>MEMORANDUM ITEMS</b>	10		



# Notes to the accounts

## NOTE 1 Accounting and valuation principles

In compliance with the Swedish National Pension Funds Act, these annual accounts has been prepared according to generally accepted accounting principles. Taking into account the regulations that apply to comparable financial institutions, the four buffer funds have developed and put into practice a set of common accounting and valuation principles that are applied in these accounts with the exception of:

- › The interest component of futures is recognised as net capital gains/losses, and not as interest income.
- › Accrued effective interest on fixed income securities is recognised as net capital gains/losses and not as interest income.
- › Changes in the value of futures during the maturity period are recognised under capital gains/losses.

### Transaction day accounting

Purchases and sales on the money, bond, equity and currency markets are reported in the balance sheet on the transaction date, i.e. at the point when material rights, and therefore risks, are transacted between the parties. Receivables and liabilities that fall between transaction and settlement date are reported under other assets and other liabilities respectively.

### Foreign currency

Foreign currency-denominated assets and liabilities are stated at year-end exchange rates. Changes in the values of foreign currency-denominated assets are divided between those attributable to the change in value of the asset or liability and those caused by exchange rate changes. Realised and unrealised changes in value that arise due to exchange rate fluctuations are recognised in the income statement under net currency gains or losses.

### Shares and units

Listed shares and units are valued at fair value based on their market values at year-end. Equities are reported under their market of purchase. Private equity holdings are valued in accordance with EVCA principles. This means that holdings in normal circumstances are valued at acquisition cost for the first 12 months, and thereafter at conservative market value. Market cost is normally calculated on the basis of transactions with third parties, though other valuation methods may be used in certain cases. The averaging method has been used to calculate capital gains and losses.

### Bonds and other interest-bearing securities

Bonds and other fixed income assets are valued at fair value. The market value of fixed income securities is determined by the closing buying rate on the year's last day of trading or, alternatively, by the buying rate on the preceding day. Premiums and discounts are not amortised as income during the maturity period. Interest income consists solely of received and accrued coupon payments. The averaging method is used to calculate net capital gains and losses.

### Buy-backs

In a true buy-back, or repurchase, the asset remains on the balance sheet and cash received is taken up as a liability. The divested security is reported as a pledged asset under memorandum items in the balance sheet. The cash value difference between spot and forward legs accrues during the maturity period and is reported as interest.

### Derivatives

Derivatives are valued at fair value. Derivative transactions with a positive market value at year-end are reported as investment assets, while transactions with a negative market value are reported as liabilities. The difference between forward and spot rates is recognised as net capital gains/losses and not as interest income during the maturity period.

### Securities lending

Loaned securities are recognised in the balance sheet and are taken up as pledged assets under memorandum items. Received and accrued premiums are recognised as interest income.

### Equipment and computer programs

Investments in equipment and standard computer programs are recognised as an expense as they arise.

Expenditure on computer programs developed or significantly adapted on behalf of AP3 is recognised in the balance sheet as intangible assets if the probable financial value of the programs after one year exceeds their cost. This means that investments in computer programs are usually taken up as an expense as they arise.

### Items reported directly against fund capital

Payments to and receipts from the pension system, as well as transfers from the special asset management funds owned jointly by the four buffer funds, are reported directly against fund capital.

### Income taxes

The AP funds are exempt from all income tax on investments in Sweden. The tax liability on investments outside Sweden varies from country to country.

**NOTE 2 Shares and units**
**Listed shares and units**

SEK million	31 Dec 04		31 Dec 03	
	Fair value	Acquisition value	Fair value	Acquisition value
Swedish equities	28,331	26,693	24,220	26,471
Foreign equities	56,721	60,857	54,352	63,619
Swedish financial instruments	0	0	12	2
Units in foreign mutual funds	1,496	1,425	0	0
<b>Total equities</b>	<b>86,548</b>	<b>88,975</b>	<b>78,584</b>	<b>90,092</b>

**Unlisted shares and units**

Name	Corp. reg. no.	Number	Share of equity capital	Share of voting capital	Acquisition value 31 Dec 04	Acquisition value 31 Dec 03
<b>Swedish unlisted shares and units</b>						
AP Fastigheter Holding*	556650-4196	1,000,000	25%	25%	721	3,221
Bergvik Skog	556610-2959		5%	5%	173	—
Swedestart Life Science	969675-2337		11%		24	15
Swedestart Tech	969674-7725		11%		39	25
Litorina Kapital 2001	969682-2718		33%		46	25
Innkap 1	556541-0056		28%		115	101
Innkap 2	969661-4735		25%		48	43
EQT Scandinavia I	969677-7037		6%		61	62
IT Provider Fund VII	556539-5646		17%		21	8
<b>Total unlisted Swedish shares and units</b>					<b>1,248</b>	<b>3,500</b>

\* SEK 2,500 million of the capital increase in AP Fastigheter Holding was converted to promissory notes in 2004. Of these, SEK 500 million was amortised by AP Fastigheter Holding. The outstanding promissory note liability of SEK 2,000 million is recognised under bonds and other interest-bearing assets. The fair value of AP Fastigheter Holding was reduced to reflect a 20% discount to net asset value.

**Foreign unlisted shares and units**

<i>EUR</i>						
HVP European Venture			19%		22	17
Carnegie BiotechBridge Fund			29%		43	44
Candover 2001 Fund			1%		151	107
Cap Man Equity VII			8%		88	80
Innkap 3	969673-0333		10%		35	20
European Secondary Development Fund III			13%		7	13
Altor 2003 Fund			4%		71	40
Polder – Greenpark Co - Investment			13%		72	29
Electra European Fund			2%		104	62
Crown Private Equity - Eur. Buyout			20%		26	23
NeoMed Innovation IV			26%		4	—
Keyhaven Capital I			12%		2	—
Greenpark International Investors II			6%		0	—
<i>GBP</i>						
RT Group					0	—
LGV 2			5%		35	58
LGV 3			3%		53	17
LGV 4			3%		11	—
Alchemy			2%		0	—



### Unlisted shares and units / cont.

Name	Corp. reg. no.	Number	Share of equity capital	Share of voting capital	Acquisition value 31 Dec 04	Acquisition value 31 Dec 03
<i>USD</i>						
GS Vintage II			3%		83	65
Private Equity Technology Partners III			10%		53	37
Vision Capital III			19%		31	21
Warburg Pincus Private Equity VIII			1%		173	100
Paul Capital Top Tier Investments II			7%		65	40
Auda Secondary Fund			6%		38	21
Rhône Offshore Partners II			6%		38	26
GS US Middle Market Buyout Fund			29%		30	5
Kelso Investment Associates VII			1%		3	—
Harbour Vest 2004 Direct Fund			10%		12	—
GS Vintage III			2%		10	—
Viking Global Timber Fund LLC			20%		61	—
<i>NOK</i>						
Four Seasons Venture IV			17%		73	78
Ferd Private Equity			10%		69	—
<i>Total foreign unlisted shares and units</i>					<i>1,463</i>	<i>903</i>
<i>Total Swedish unlisted shares and units</i>					<i>1,248</i>	<i>3,500</i>
<b>Total unlisted shares and units</b>					<b>2,711</b>	<b>4,403</b>
<b>Total fair value</b>					<b>2,853</b>	<b>4,303</b>

The table on page 26 shows the five largest holdings in the Fund's internally managed equity portfolios. Commission expenses for the internally managed equity portfolio totalled SEK 26 million. See [www.ap3.se](http://www.ap3.se) for a complete list of security holdings.

### NOTE 3 Bonds and other interest-bearing assets

#### Bonds and other interest-bearing securities by class of issuer

SEK million	31 Dec 04 Fair value	31 Dec 04 Acquisition value	31 Dec 03 Fair value	31 Dec 03 Acquisition value
Swedish state	11,575	10,739	16,080	15,451
Swedish municipalities	37	37	—	—
Swedish mortgage lending institutions	13,359	13,262	11,623	11,559
Other Swedish issuers				
Financial institutions	1,626	1,589	1,753	1,731
Non-financial companies	7,310	7,118	4,879	4,726
Foreign states	14,554	14,443	8,747	8,839
Other foreign issuers	17,003	17,936	11,394	12,386
<b>Total</b>	<b>65,464</b>	<b>65,124</b>	<b>54,476</b>	<b>54,692</b>

#### Bonds and other interest-bearing securities by class of instrument

SEK million	31 Dec 04 Fair value	31 Dec 04 Acquisition value	31 Dec 03 Fair value	31 Dec 03 Acquisition value
Index-linked bonds	10,341	9,646	9,524	8,818
Other bonds	45,932	45,805	40,701	41,611
Certificates	293	292	—	—
Other instruments	8,898	9,381	4,251	4,263
<b>Total</b>	<b>65,464</b>	<b>65,124</b>	<b>54,476</b>	<b>54,692</b>

### NOTE 4 Derivatives

SEK million	Nominal value	Positive fair value	Negative fair value
<b>Equity-related instruments</b>			
Futures	585	14	1
<b>Total</b>	<b>585</b>	<b>14</b>	<b>1</b>
Of which cleared	585		
<b>Fixed-income-related instruments</b>			
Futures	Short	27	30
<b>Total</b>	<b>10,270</b>	<b>27</b>	<b>30</b>
Of which cleared	10,270		
<b>Currency-related instruments</b>			
Forwards	62,989	2,836	174
<b>Total</b>	<b>62,989</b>	<b>2,836</b>	<b>174</b>
Of which cleared	—		

AP3 is mandated to use derivatives to improve the effectiveness of its operations, hedge assets against risk and to change its risk profile. Futures are the main form of derivative contract used by the Fund. Generally speaking, their role is to effect rapid changes in exposure to specific markets or currencies at a low cost and market impact. Equity futures are employed to allocate funds between regions or segments and to offset movements therein interest rate futures agreements are used for regional allocation and also to change overall interest rate risk, the level of issuer risk in a particular case or the portfolio's position on specific yield curves. Currency forwards are used by the currency management group to maintain the Fund's currency hedging ratios and for currency position-taking. Other forms of derivatives are used on only a very small scale, though overall derivative use is expected to grow as AP3's management activities develop.

**NOTE 4 Derivatives / cont.**

All positions taken in derivatives are monitored continuously and assessed on a daily basis. Prior to any new derivative being introduced, checks are made to ensure AP3 can handle the instrument from an administrative and risk management standpoint. To the extent that products subject to non-straight-line risk, such as options, are used, AP3 monitors volatility risk and the dynamic risks arising from positions taken.

Equity derivatives and interest rate derivatives are traded ideally on standardised markets through cleared products whereby counterparty risks can be limited to the clearing institution. However, the market for currency derivatives is over-the-counter, which means that trades there are not subject to clearing. On this market, credit and delivery risks arise in relation to counterparties. Counterparties for non-cleared transactions are sanctioned and limited by the Board and all exposure constantly monitored. AP3's risk management procedures in respect of derivatives are described more extensively in the Board's annual risk management plan.

At any one time, the vast majority of the Fund's derivative contracts have outstanding maturities of less than three months. The maximum permitted maturity period for currency forwards (which constitute the major part of all OTC contracts) is one year. Standardised, cleared products may have longer maturities (though seldom more than two years). Derivatives traded by the Fund are generally highly liquid and may be bought or sold at short notice.

**NOTE 5 Other assets**

SEK million	31 Dec 04	31 Dec 03
Trade receivables	36	35
Other current receivables	0	0
<b>Total other assets</b>	<b>36</b>	<b>35</b>

**NOTE 6 Prepaid expenses and accrued income**

SEK million	31 Dec 04	31 Dec 03
Accrued interest income	1,172	1,138
Accrued dividends	16	18
Tax reclaimables	6	11
Other prepaid expenses	5	5
<b>Total prepaid expenses and accrued income</b>	<b>1,199</b>	<b>1,172</b>

**NOTE 7 Other liabilities**

SEK million	31 Dec 04	31 Dec 03
Accounts payable	10	9
Trade payable	37	8
Payroll taxes	0	0
Employees' PAYE taxes	3	1
Other liabilities	0	26
<b>Total other liabilities</b>	<b>50</b>	<b>44</b>

**NOTE 8 Deferred income and accrued expenses**

SEK million	31 Dec 04	31 Dec 03
Accrued external management expenses	55	44
Bonuses incl. social security expenses	2	10
Other accrued expenses	21	9
<b>Total deferred income and accrued expenses</b>	<b>78</b>	<b>63</b>

**NOTE 9 Fund capital**
**Net payments from the pension system**

SEK million	31 Dec 04	31 Dec 03
<b>Fund capital at 1 Jan</b>	<b>142,536</b>	<b>120,211</b>

**Net payments from the pension system**

Paid-in pension contributions	42,904	41,271
Disbursed pension payments for 2004	-40,696	-38,852
Transfer of pension rights to the EU	-95	0
Settlement of pension rights	-4	5
Final regulation from 1999-2002	-400	0
Administration fee paid to Swedish Insurance Office	-312	-281
<b>Total net payments from the pension system</b>	<b>1,397</b>	<b>2,143</b>

Transfers from AP1's phase-out fund	129	394
Transfers from AP4's special asset management fund	125	30
<b>Total transfers from phase-out and special asset management funds</b>	<b>254</b>	<b>424</b>

<b>Net profit for the year</b>	<b>16,067</b>	<b>19,758</b>
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<b>Fund capital at 31 Dec</b>	<b>160,254</b>	<b>142,536</b>
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Capital under management in AP1's phase-out fund	4,924	5,214
Capital under management in AP4's special asset management fund	806	1,291

Annual reports for AP1's phase-out fund and AP4's special asset management fund may be obtained from the Funds themselves.

**NOTE 10 Memorandum items**
**Pledges and equivalent collateral to secure own liabilities**

SEK million	31 Dec 04	31 Dec 03
Pledged assets for buy-backs	2,135	2,690
Loaned securities for which collateral received		
Loaned securities	17,841	12,776
Collateral received for loaned securities	18,736	13,257

**Other pledges and equivalent collateral**

SEK million	Nominal amount	Nominal amount
For derivatives trading	892	1,021

**Commitments**

	Total commitments	Invested 31 Dec 04	Total commitments	Invested 31 Dec 03
Private equity	5,728	2,092	4,401	1,322

**NOTE 11 Net interest income**

SEK million	2004	2003
<b>Interest income</b>		
Bonds and other interest-bearing securities	2,865	2,044
Other interest income	126	617
<b>Total interest income</b>	<b>2,991</b>	<b>2,661</b>
<b>Interest expenses</b>		
Other interest expenses	0	0
<b>Total interest expenses</b>	<b>0</b>	<b>0</b>
<b>Net interest income</b>	<b>2,991</b>	<b>2,661</b>

**NOTE 12 Net capital gains/losses**

SEK million	2004	2003
Shares and units (Listed)	1,298	-5,219
Shares and units (Unlisted)	92	46
Bonds and other interest-bearing assets	912	1,693
Derivatives	155	522
<b>Total net capital gains/losses</b>	<b>2,457</b>	<b>-2,958</b>

**NOTE 13 Unrealised changes in value**

SEK million	2004	2003
Shares and units (Listed)	8,885	20,048
Shares and units (Unlisted)	269	3
Bonds and other interest-bearing assets	1,193	-1,362
Derivatives	-39	447
<b>Total net unrealised changes in value</b>	<b>10,308</b>	<b>19,136</b>

**NOTE 14 External asset management expenses**

SEK million	2004	2003
Listed assets	97	56
Unlisted assets	66	54
<b>Total external asset management expenses</b>	<b>163</b>	<b>110</b>

**NOTE 15 Employee information**

SEK thousand	2004		2003	
	Total	Women	Total	Women
Average no. of employees	46	16	44	13
No. of employees at 31 Dec	46	19	45	14
No. in executive management committee at 31 Dec	8	2	8	1

**Salaries and remuneration**

Chairman of the Board	100	100
CEO	2,711	2,253
Board of Directors excl. Chairman	504	400
Executive management excl. CEO	10,674	8,000
Other employees	30,424	23,755
<b>Total salaries and remuneration</b>	<b>44,413</b>	<b>34,508</b>

**Provisions for bonuses**

CEO	0	0
Executive management excl. CEO	-2,361	1,745
Other employees	-2,037	1,764
<b>Total bonuses</b>	<b>-4,398</b>	<b>3,509</b>

**Remuneration of Board members**

in addition to Board fees	0	0
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**Pension expenses**

CEO	761	686
Executive management excl. CEO	2,264	2,016
Other employees	6,736	5,210
<b>Total pension expenses</b>	<b>9,761</b>	<b>7,911</b>

**Social security expenses**

Chairman of the Board	33	33
CEO	1,071	906
Board of Directors excl. Chairman	165	131
Executive management excl. CEO	3,268	3,687
Other employees	10,828	9,394
<b>Total social security expenses</b>	<b>15,365</b>	<b>14,151</b>

Other personnel expenses	5,010	2,429
<b>Total personnel expenses</b>	<b>70,151</b>	<b>62,508</b>

**Board of Directors**

Remuneration of Board members is set by the government and is specified in the above table. In December 2004, the government approved additional remuneration of up to SEK 100,000 for individual directors who perform committee duties. A provision for these amounts was made in the year-end accounts and is included in remuneration to board members in the above table.

**Remuneration committee**

The remuneration committee is appointed by the Board and includes the Chairman and three other directors. The committee's main task is to make recommendations to the Board on salary levels and other remuneration of AP3 employees and to handle outstanding issues related to the former bonus system.

**NOTE 15 Employee information / cont****CEO**

The CEO's contract of employment, applicable from 1 September 2004, entitles her to a salary of SEK 245,000 per month and occupational pension and sickness insurance premiums totalling 30% of gross salary. In the event of termination, the contractual notice periods are 12 months for the Fund and six months for the CEO. There are no provisions for severance pay or for payment of an early-retirement pension.

Salary and remuneration to the CEO, as stated in the table on the previous page, includes the total amounts paid to former CEO Tomas Nicolin until May 2004, acting CEO Sven Askenberger for the period 1 May to 31 August and current CEO Kerstin Hessius from 1 September. Pension expenses and social security contributions are also shown as combined figures for the full year.

**Executive management committee**

At 31 December 2004, there were eight members of the executive management committee, including the CEO. Their remuneration (excluding that of the CEO) is shown in the table on the previous page. The Fund has collective wage agreements with the Employers' Organisation of the Swedish Banking Institutions and the JUSEK/CR/CF (SACO) trade unions. Apart from these agreements, no special arrangements exist in respect of notice of termination, severance pay or early retirement.

**Personnel**

The number of employees is shown in the table on the previous page. The figure does not include a temporary replacement employed to cover for one of the Fund's employees who is absent on parental leave. Moreover, three of the 46 have left AP3 since the start of 2005. Three persons have signed employment contracts that will see them join the Fund in 2005.

**Sickness absence**

The total sickness absence rate in 2004 was 0.6% (1.2%). The figures were 0.4% (0.6%) for male employees and 0.9% (2.9%) for female employees. Sickness absence rates by age group were as follows:

-29 years	0.8%
30-49 years	0.5%
50- years	1.0%

No employee was absent due to illness for more than 60 consecutive days.

**Bonuses**

From its inception in 2001, AP3 operated a performance-based bonus system for its staff. However, new guidelines published by the government in 2003 resulted in this system being abolished in 2004. Salaries were raised on average by 20.3% to compensate for this change.

The former bonus system contained a long-term component that has yet fully to expire. In 2002, a provision of SEK 3.4 million was made for a bonus payment in 2005 in the event that the Fund met its targets in 2002-2004. Since these targets were not achieved for the whole period in question, the bonus provisions were reversed in the 2004 year-end accounts.

The final outstanding part of the former bonus system relates to the long-term component of the 2003 bonus. A provision of SEK 2.6 million was made in the 2003 year-end accounts for bonus payments in 2006 in the event that the Fund met its targets in 2003-2005. For any payment to be activated, the recipient would need still to be an AP3 employee in 2006. Since several of the employees involved in this programme are no longer Fund employees, SEK 1.1 million was reversed in the 2004 year-end accounts. The remaining SEK 1.5 million will be paid in 2006 provided that relevant conditions, as described above, are met.

The figure for bonuses in the table on the previous page represents the net effect of the short-term provision made in 2003 and the reversal of the long-term provisions made in 2002 and 2003 as described above.

**NOTE 16 Other operating expenses**

SEK million	2004	2003
Cost of premises	5	6
Custody account expenses	22	20
Information and computer expenses	39	17
Services purchased	8	12
Other	7	7
<b>Total other operating expenses</b>	<b>81</b>	<b>62</b>

SEK 25.3 million of information and computer expenses relate to the investment in a new portfolio system.

Auditors' fees are included under services purchased.

SEK thousand	2004	2003
<b>Audit assignments</b>		
Öhrlings PricewaterhouseCoopers	1,068	781
KPMG Bohlins	262	250
<b>Other assignments</b>		
Öhrlings PricewaterhouseCoopers	34	227
<b>Total auditors' fees</b>	<b>1,364</b>	<b>1,258</b>



Stockholm, 15 February 2005

Claes de Neergaard  
Chairman

Rolf Andersson  
Deputy Chairman

Dan Andersson

Ingela Gardner Sundström

Karin Kronstam

Christina Liffner

Harriet Piscator

Christer Romilson

Dag Sehlin

Kerstin Hessius  
Chief Executive Officer

## Auditors' report

We have examined the annual accounts, the accounting records and the administration of the board of directors of AP3 for the financial year ended 31 December 2004. These accounts and their compliance with the Swedish National Pension Funds Act, along with the administration of the company, are the responsibility of the board of directors. It is our responsibility to express our opinion on the annual accounts and the administration based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in Sweden. Those standards require that we plan and perform the audit to obtain reasonable assurance that the annual accounts are free of material misstatement. An audit implies examining, on a test basis, evidence supporting the amounts and disclosures in the accounts. An audit also implies assessing the accounting principles used and their application by the board of directors and chief executive officer, as well as

evaluating the overall presentation of information in the annual accounts. We believe that our audit provides a reasonable basis for our opinion set out below.

The annual accounts have been prepared in accordance with the Swedish National Pension Funds Act and, thereby, give a true and fair view of the company's financial position and results of operations in accordance with generally accepted accounting principles in Sweden. The report of the board of directors is compatible with the other parts of the annual accounts.

The audit has given us no reason for qualification with regard to the annual accounts, the income statement and balance sheets contained therein, the accounting records, the inventory of assets or the administration of the company in general.

We recommend that the income statement and balance sheet be adopted.

Stockholm, 16 February 2005

Anna Hesselman  
Authorised Public Accountant  
Appointed by the government

Anders Bäckström  
Authorised Public Accountant  
Appointed by the government



## The government appoints AP3's Board of Directors

In 2004, the Board consisted of Claes de Neergaard, Chairman, Rolf Andersson, Deputy Chairman, Dan Andersson, Karin Kronstam, Christina Liffner, Harriet Piscator, Christer Romilson and Dag Sehlin. All were reappointed by the government at the end of May. The government also appointed Ingela

Gardner Sundström to the directorship that had been vacant during the spring.

The Board has overall responsibility for the Fund and its key tasks include allocating the reference portfolio and planning and monitoring the Fund's operations and annual accounts.

The Board held eight meetings during the year and also received regular operational reports from the CEO. A remuneration committee and audit committee come under the Board. Read more about the Board's operations in 2004 on page 42.



Standing, from left to right: Karin Kronstam, Rolf Andersson, Claes de Neergaard, Ingela Gardner Sundström and Harriet Piscator. Seated, from left to right: Dan Andersson, Christer Romilson, Christina Liffner and Dag Sehlin.

**CLAES DE NEERGAARD, CHAIRMAN****Year of birth:** 1949**Directorships etc:** Emerging Africa Infrastructure Fund, Access Capital Partners SA, Sydsvenska Kemi (Perstorp), AB Malmöhus Invest and AB Småföretagsinvest.**Academic background:** BSc in Business Administration and Economics.**Experience/previous employment:** Deputy CEO of the European Investment Bank, Executive Director of the European Bank for Reconstruction and Development (EBRD) and CEO of Nordbanken Luxembourg SA.**Significant other assignments:** CEO of the Swedish Industrial Development Fund.**Member of AP3 Board since:** 2003**INGELA GARDNER SUNDSTRÖM****Year of birth:** 1943**Directorships etc:** Centre for Molecular Medicine, Graninge/Roslags-energi and Director of the Executive Board of Österåker Municipality.**Academic background:** University legal studies.**Experience/previous employment:** Member of Parliament and member of the board of the Swedish Association of Local Authorities.**Significant other assignments:** Principal of Rydbo Independent School.**Member of AP3 Board since:** 2004**HARRIET PISCATOR****Year of birth:** 1957**Directorships etc:** Alfred Andersson bolagen AB.**Academic background:** BSc in Business Administration and Economics.**Experience/previous employment:** Controller and Director of Administration at ABB Treasury Centre Sweden.**Significant other assignments:** Head of Group Function Finance at ABB Sweden.**Member of AP3 Board since:** 2000**ROLF ANDERSSON, DEPUTY CHAIRMAN****Year of birth:** 1944**Directorships etc:** Trade Union Institute for Economic Research.**Academic background:** Bachelor of Arts.**Experience/previous employment:** Swedish Institute for Social Research, Swedish Confederation of Professional Employees, Swedish Trade Union Confederation, member of the board of the National Private Insurance Supervisory Service and AP5.**Significant other assignments:** Director of Research at the Swedish Municipal Workers' Union.**Member of AP3 Board since:** 2000**KARIN KRONSTAM****Year of birth:** 1950**Directorships etc:** Corporate Governance i Sverige AB (Chairman), GF konsult-koncernen, Lernia AB, Nordea Liv & Pension-koncernen, Pysslingen Förskolor och Skolor AB, Svolder AB, TurnIT AB and the Foundation for Technology Transfer in the Gothenburg Investment Committee (Chairman).**Academic background:** BSc in Social Studies and Master of Business Administration.**Experience/previous employment:** CEO and deputy CEO for a number of listed and state-owned companies.**Member of AP3 Board since:** 2000**CHRISTER ROMILSON****Year of birth:** 1945**Directorships etc:** Folksam SAK (Deputy Chairman), member of the board of Nationalmuseum and the Council of Nordic Trade Unions.**Academic background:** Qualified teacher.**Experience/previous employment:** Chairman of the Swedish Teachers' Union and Deputy Chairman of the Swedish Confederation of Professional Employees.**Significant other assignments:** Chairman of the Public Employees' Negotiation Council.**Member of AP3 Board since:** 2000**DAN ANDERSSON****Year of birth:** 1948**Directorships etc:** AMF-Pension and Trade Union Institute for Economic Research (Chairman), member of the board of FPG and AMFK.**Academic background:** BSc in Business Administration and Economics.**Experience/previous employment:** Under-secretary of State at the Ministry of Industry, Employment and Communications.**Significant other assignments:** Chief Economist of the Swedish Trade Union Confederation.**Member of AP3 Board since:** 2000**CHRISTINA LIFFNER****Year of birth:** 1950**Directorships etc:** Länsförsäkringar Bergslagen AB, Sveaskog AB, Svensk Adressändring AB (Chairman), AB Svensk Exportkredit and Vasakronan AB.**Academic background:** BSc in Business Administration and Economics.**Experience/previous employment:** Deputy CEO and CFO of AssiDomän.**Significant other assignments:** Swedish Endometriosis Association (Chairman).**Member of AP3 Board since:** 2000**DAG SEHLIN****Year of birth:** 1945**Directorships etc:** BTS Group AB (Chairman), D. Carnegie & Co AB, Carnegie Investment Bank AB, Proact IT Group AB and Telenor AB.**Academic background:** BSc in Business Administration and Economics.**Experience/previous employment:** Deputy CEO, CFO and Acting Group President of Posten AB and Deputy CEO of OM Gruppen.**Member of AP3 Board since:** 2001*Board members at 15 February 2005.*



# Employees

Short personal presentations  
of AP3's 46 employees are provided  
on the following pages.



Staff Function

**BENGT HANSSON**

Chief Economist  
Macroanalysis, ALM  
PhD in Economics  
14 years in the financial sector  
Joined AP3 in August 2000  
**Previously:** SEB, Handelsbanken Markets  
Research



CEO

**KERSTIN HESSIUS**

CEO  
20 years in the financial sector  
Joined AP3 in September 2004  
**Previously:** CEO of Stockholm Stock  
Exchange, Deputy Governor of the Swedish  
Central Bank



Staff Function

**PERNILLA KLEIN**

Head of Corporate Governance  
11 years in the financial sector  
Joined AP3 in August 2000  
**Previously:** Handelsbanken Markets  
Research, Ministry of Finance



Staff Function

**CHRISTINA KUSOFFSKY HILLESØY**

Communications Manager  
15 years in marketing and communications  
Joined AP3 in January 2005  
**Previously:** Trygghetsrådet, TurnIT



Staff Function

**MIKAEL SEDOLIN**

Chief Legal Officer and Compliance Officer  
Associate Judge of Appeal  
11 years in the financial sector  
Joined AP3 in December 2000  
**Previously:** Ministry of Finance,  
Swedish National Debt Office



Staff Function

**ERIKA WESTLUND**

Assistant to the CEO/Communications  
3 years in communications and administration  
Joined AP3 in February 2003  
**Previously:** Gecko Ltd



Administration

**MARIA ANDERSSON**

Securities Administration  
18 years in the financial sector  
Joined AP3 in April 2004  
**Previously:** Carnegie



Administration

**SVEN ASKENBERGER**

Chief Operating Officer  
24 years in the financial sector  
Joined AP3 in September 2000  
**Previously:** Swedish Industrial Development  
Fund, Gota Bank



Administration

**OLLE BASTMARK**

Securities Administration  
1 year in the financial sector  
Joined AP3 in January 2004



Administration

**LINDA BERGMAN**

Receptionist  
1 year in office administration  
Joined AP3 in February 2004



Administration

**MIKAEL GUSTAFSSON**

IT Manager  
20 years in the IT sector  
Joined AP3 in February 2001  
**Previously:** Electrolux, Alcro-Beckers



Administration

**OLIVIA HAUET**

IT Systems Manager  
11 years in the IT sector  
Joined AP3 in August 2004  
**Previously:** Vattenfall AB Supply & Trading,  
Trema (Europe)



Administration

**LOTTA KARLSSON**

Securities Administration  
28 years in the financial sector  
Joined AP3 in June 1999  
**Previously:** Öhman Fondkommission,  
Jacobson & Ponsbach



Administration

**SEBASTIAN MOSSFELDT**

Securities Administration  
11 years in the financial sector  
Joined AP3 in September 2001  
**Previously:** SEB Fonder



Administration

**MARIA PRINSSTRÖM**

Securities Administration  
19 years in the financial sector  
Joined AP3 in August 2000  
**Previously:** Robur Kapitalförvaltning, ABB



Administration

**PATRICIA RYDÉN**

Accountant  
17 years in office administration  
and accounts  
Joined AP3 in January 2001  
**Previously:** WM-Data, SNS



Administration

**YVONNE THOMSON**

Chief Financial Officer  
23 years in the financial sector  
Joined AP3 in October 2000  
**Previously:** OM VPA, Gota Bank



Administration

**KERSTI WALDENHAGEN-TAXÉN**

Receptionist  
29 years in office administration  
Joined AP3 in August 2001  
**Previously:** Företagarhuset/Kontors-  
hotellet i Täby



Asset Management

**KERIM KASKAL**

Head of Asset Management  
20 years in the financial sector  
Joined AP3 in December 2004  
**Previously:** Brummer & Partners, Stora  
Finans

Fixed Income and  
Foreign Exchange**JANNIS ASDRÉS**

Portfolio Manager  
Credit bonds  
8 years in the financial sector  
Joined AP3 in March 2001  
**Previously:** ABN Amro Transferator,  
Handelsbanken Global Trading

Fixed Income and  
Foreign Exchange**MATTHIAS BUHR-BERG**

Portfolio Manager  
Foreign Exchange  
18 years in the financial sector  
Joined AP3 in August 2000  
**Previously:** Handelsbanken Markets,  
Stora Finans

Fixed Income and  
Foreign Exchange**HANS ERICSSON**

Portfolio Manager  
Fixed Income, asset allocation  
20 years in the financial sector  
Joined AP3 in October 2000  
**Previously:** Handelsbanken  
Kapitalförvaltning, Handelsbanken Markets

Fixed Income and  
Foreign Exchange**ANETTE HELLSTRÖM**

Portfolio Manager  
Execution, Foreign Exchange  
19 years in the financial sector  
Joined AP3 in April 2001  
**Previously:** SKF Treasury Centre,  
SEB Trading & Capital Markets

*Fixed Income and Foreign Exchange***LARS OREST**

Head of Fixed Income and Foreign Exchange  
21 years in the financial sector  
Joined AP3 in July 2000

**Previously:** Swedish Central Bank, Sparbankernas Bank

*Fixed Income and Foreign Exchange***DAVID STILLBERGER**

Portfolio Manager  
Quantitative analysis  
4 years in the financial sector  
Joined AP3 in July 2001

*Fixed Income and Foreign Exchange***MATS WIRDEFELDT**

Portfolio Manager  
Short rates  
7 years in the financial sector  
Joined AP3 in January 2002

**Previously:** SEB Asset Management, SEB Trading

*Equity Management***NALINI BONNIER**

Portfolio Manager Europe  
Sector manager for technology, media, and telecoms operators  
6 years in the financial sector\*  
Joined AP3 in September 2004

**Previously:** SEB Asset Management, Handelsbanken Markets

\* And a further 9 years as a financial journalist

*Equity Management***AXEL BRÄNDSTRÖM**

Portfolio Manager Europe  
CFA  
10 years in the financial sector  
Joined AP3 in January 1999

**Previously:** SHB Kapitalförvaltning

*Equity Management***SOFIE EMILSSON NILVALL**

Portfolio Manager Europe  
Sector manager for pharmaceuticals, oil & gas and chemicals  
9 years in the financial sector  
Joined AP3 in September 2001

**Previously:** Alfred Berg Fondkommission, Danske Securities

*Equity Management***URBAN ERIKSSON**

Portfolio Manager  
Execution equities, derivatives, and asset allocation  
19 years in the financial sector  
Joined AP3 in August 1999

**Previously:** Robur Kapitalförvaltning, Sparbankernas Bank

*Equity Management***ANNE-CHARLOTTE HORMGARD**

Portfolio Manager Europe  
Sector manager for retail, services and consumer goods  
AFA, CEFA

16 years in the financial sector  
Joined AP3 in April 1993

**Previously:** Bohusbanken FK, Folksam finance division

*Equity Management***ANDERS OLSSON**

Head of Equity Management  
18 years in the financial sector  
Joined AP3 in January 2005

**Previously:** Nordea Investment Management, LinkTech

*Equity Management***ULRIKA SLÅNE SENS**

Portfolio Manager Europe  
Sector manager for pharmaceuticals and medical technology  
AFA, CEFA

16 years in the financial sector  
Joined AP3 in February 1999

**Previously:** Aros Fondkommission, Enskilda Securities, Carnegie

*Equity Management***ESKIL SVENSSON**

Portfolio Manager Sweden  
16 years in the financial sector  
Joined AP3 in May 2000

**Previously:** Alfred Berg Kapitalförvaltning, Alfred Berg Fondkommission

*External Management/ Alternative Investments***LENA DJURBERG**

Portfolio Manager  
16 years in the financial sector  
Joined AP3 in September 2000

**Previously:** Posten Group Pension Fund, Posten Group Finance

**BENGT HELLSTRÖM**

Head of External Management/  
Alternative Investments  
Portfolio Manager  
20 years in the financial sector  
Joined AP3 in October 2000

**Previously:** EQT Partners, Investor

External Management/  
Alternative Investments

**MIKAEL HULDT**

Portfolio Manager  
4 years in the financial sector  
Joined AP3 in January 2004

**Previously:** The legal firm of Mannheimer Swartling

External Management/  
Alternative Investments

**CECILIA SVED**

Portfolio Manager  
Head of Traditional Asset Classes  
14 years in the financial sector  
Joined AP3 in December 2002

**Previously:** Länsförsäkringar  
Kapitalförvaltning, Wasa Kapitalförvaltning

External Management/  
Alternative Investments

**KLAS ÅKERBÄCK**

Portfolio Manager  
6 years in the financial sector  
Joined AP3 in September 2000

**Previously:** Alfred Berg Kapitalförvaltning

External Management/  
Alternative Investments

**MIKAEL BROBERG**

Quantitative Analyst  
Risk and performance  
6 years in the financial sector  
Joined AP3 in August 2004

**Previously:** Den Norske Bank, Skandia

Risk Management

**MATTIAS BYLUND**

Quantitative Analyst  
Risk and performance  
3 years in the financial sector  
Joined AP3 in August 2002

Risk Management

**STIG JONSSON**

Quantitative Analyst  
Equities, tactical asset allocation  
16 years in the financial sector  
Joined AP3 in July 1999

**Previously:** Handelsbanken Markets,  
Öhman Fondkommission

Risk Management

**MICHAEL SANDBERG**

Analyst  
Middle office  
7 years in the financial sector  
Joined AP3 in July 2001

**Previously:** UBS Warburg, Nordea

Risk Management

**CLAUDIA STANGHELLINI**

Quantitative Analyst  
ALM and risk  
7 years in the financial sector  
Joined AP3 in May 2002

**Previously:** Sun Life Financial

Risk Management

**NIKLAS SÖDERSTRÖM**

Analyst  
Middle office  
3 years in the financial sector  
Joined AP3 in July 2004

**Previously:** Nordea Bank, Aros Securities AB

Risk Management

**ERIK VALTONEN**

Head of Risk Management  
ALM and risk  
PhD in mathematics  
15 years in the financial sector  
Joined AP3 in May 2000

**Previously:** Handelsbanken Markets

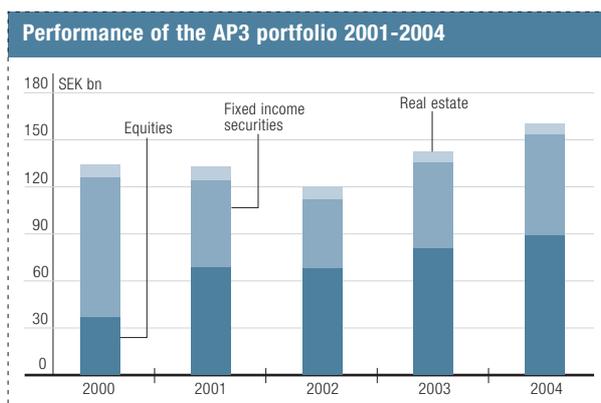
Risk Management



# Historical data

Historical record					
Key figures	2004	2003	2002	2001	2000
Fund capital (SEK bn)	160.3	142.5	120.2	132.7	134.0
Net inflows from Swedish Insurance Office and phase-out and special asset management funds (SEK bn)	1.7	2.6	5.0	4.5	
Net profit/loss for the year (SEK bn)	16.1	19.8	-17.5	-5.8	
Return on total portfolio before expenses (%)	11.4	16.4	-12.4	-4.1	
Return on total portfolio after expenses (%)	11.2	16.2	-12.6	-4.2	
Return on market-listed assets before expenses (%) <sup>1</sup>	11.4	17.2	-12.9	-4.4	
Index return (%)	11.4	17.3	-13.5	-4.6	
Active return on market-listed assets before expenses (%)	0.0	-0.1	0.6	0.2	
Active return of market-listed assets after expenses (%) <sup>2</sup>	-0.2	-0.2	0.4	0.1	
Index risk (standard deviation, %)	5.3	8.5	12.6	10.9	
Active risk for market-listed assets (standard deviation, ex post, %)	0.5	0.9	0.8	1.0	
Currency exposure (% of reference portfolio)	19.3	10.8	9.6	7.7	
Active management including enhanced (%)	87.8	80.6	84.8	73.9	
External management incl. investments in venture capital firms (%)	30.8	28.8	28.4	23.2	
Asset management cost ratio incl. external management expenses (%)	0.2	0.2	0.1	0.1	
Asset management cost ratio excl. external management costs (%)	0.1	0.1	0.1	0.1	
Information ratio	0.0	neg	0.7	0.2	
Sharpe ratio <sup>3</sup>	1.5	1.5	neg	neg	
Number of employees	46	45	41	34	29

<sup>1</sup> The Fund's liquid portfolio, which excludes real estate and private equity.  
<sup>2</sup> Excluding expenses for private equity.  
<sup>3</sup> Calculated as return on market-listed assets before expenses minus risk-free interest divided by standard portfolio deviation.



Tracking error and beta values for internally managed equity portfolios				
	2004	2003	2002	2001
<b>Tracking error</b>				
Sweden, %	1.6	1.9	3.1	5.6
Europe, %	0.7	1.6	2.4	4.1
<b>Beta value</b>				
Sweden	0.99	1.00	1.00	0.96
Europe	1.01	1.05	1.06	1.01

Return and risk for total portfolio (before expenses and excluding real estate and private equity)							
		2004	2003	2002	2001	Since inception	
						Annualised	Accumulated
Return %	Portfolio	11.4	17.2	-12.9	-4.4	2.1	8.6
	Index	11.4	17.3	-13.5	-4.6	1.9	7.8
	Active	0.0	-0.1	0.6	0.2	0.2	0.8
Risk (standard deviation) %	Portfolio	5.4	8.6	12.5	11.2	9.8	
	Index	5.3	8.5	12.6	10.9	9.7	
	Active	0.5	0.9	0.8	1.0	0.8	
Information ratio		0	neg	0.7	0.2	0.2	
Sharpe ratio		1.5	1.5	neg	neg	neg	

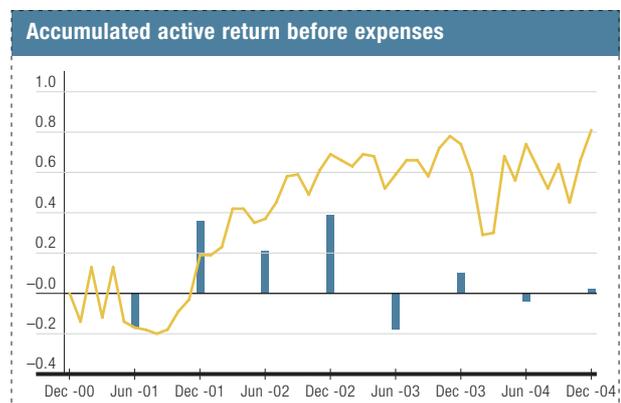
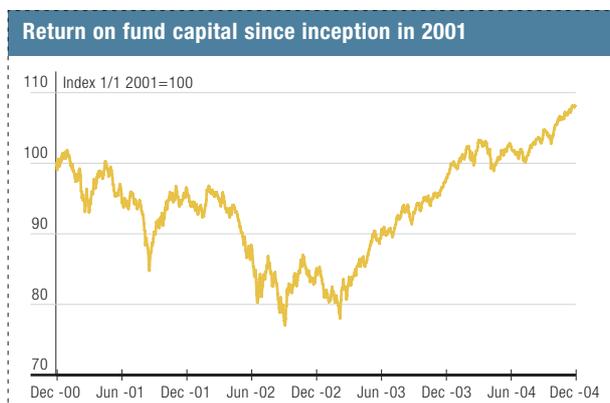


Fair value per asset class		31 Dec 04	31 Dec 03	31 Dec 02	31 Dec 01	1 Jan 01
SEK bn						
<b>Equities</b>	Sweden	27.3	23.8	19.4	23.8	33.1
	Europe	28.6	25.8	21.5	22.5	1.7
	North America	23.2	25.4	21.9	18.4	1.7
	Asia	9.9	5.8	4.8	3.7	0.0
<b>Total equities</b>		<b>89.0</b>	<b>80.8</b>	<b>67.6</b>	<b>68.4</b>	<b>36.5</b>
<b>Fixed income</b>						
Nominal	Sweden	24.7	21.5	15.1	18.5	45.9
	of which debt financing of AP Fastigheter	-3.7	-4.1	-4.6	-4.7	-4.9
	Eurozone	12.4	13.7	8.9	13.2	0.0
	UK	2.3	2.0	1.8	1.8	0.0
	USA	10.1	7.0	8.6	12.2	0.0
	Asia	0.0	0.0	0.2	0.6	0.0
Index-linked bonds	Sweden	6.7	10.2	9.8	9.5	9.0
	Eurozone	4.8	0.0	0.0	0.0	0.0
	USA	3.1	0.0	0.0	0.0	0.0
<b>Total fixed income</b>		<b>64.1</b>	<b>54.4</b>	<b>44.4</b>	<b>55.8</b>	<b>54.9</b>
<b>Real estate<sup>1</sup></b>		<b>7.2</b>	<b>7.3</b>	<b>8.2</b>	<b>8.5</b>	<b>8.3</b>
	of which shares in AP Fastigheter	3.1	3.2	3.6	3.8	3.4
	of which AP Fastigheter's debt financing	3.7	4.1	4.6	4.7	4.9
	of which forest properties	0.4	0.0	0.0	0.0	0.0
<b>Cash<sup>2</sup></b>		<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>34.3</b>
<b>Total</b>		<b>160.3</b>	<b>142.5</b>	<b>120.2</b>	<b>132.7</b>	<b>134.0</b>

<sup>1</sup> Note that AP3's real estate holdings (via shares held in the real estate company AP Fastigheter) are stated as gross amounts in this table. This signifies that the Fund values the holding based on the value of the properties owned by AP Fastigheter and treats financing separately.

<sup>2</sup> The funds used for position-taking in futures have in this table been divided among the relevant asset categories.

<sup>3</sup> Due to notes 1) and 2) the tables are not fully comparable with the balance sheet.



# Glossary

## **Absolute return**

The actual return, in SEK or percentage terms, generated by a portfolio during a specific period.

## **Absolute risk**

Variation in absolute returns. Often calculated as standard deviation and also known as volatility.

## **Active management**

Opposite of passive management, which involves investing in line with a benchmark index. Active management means taking underweight and overweight positions in assets relative to the benchmark index based on market analysis. The aim is to outperform the index.

## **Active positions**

Deviations from the index in order to outperform the market.

## **Active return**

Difference between the return on the reference portfolio and on the Fund's portfolio. If the Fund generates a positive active return it has succeeded in outperforming the overall market.

## **Active risk**

Relates to variations in active return and is also known as tracking error (see definition).

## **Asset liability modelling (ALM)**

Analysis of assets and liabilities, known as ALM analysis for short, and performed using statistical simulations of how portfolios with different asset mixes enable the Fund to discharge its pension system obligations. ALM analysis forms the basis of the Fund's selection of reference portfolio assets.

## **Automatic rebalancing**

Occurs if long-term deficits arise in the pension system. Rebalancing involves a lower rate of upward indexing of pensions until the system attains equilibrium.

## **Balance figure**

Total pension system assets (excluding premium pensions) divided by liabilities. If the balance figure drops below 1, the automatic rebalancing mechanism is triggered (see definition). This affects the indexing of pensions.

## **Benchmark index**

Also known as the reference index, it tracks the market performance of a specific asset and is the standardised market index against which a portfolio's returns are measured.

## **Beta value**

Sensitivity of a portfolio or equity to equity market movements. An equity with a beta value of  $>1$  is expected to outperform a rising market. An equity with a beta value of  $=1$  is expected to perform in line with the market.

## **Buffer fund/buffer capital**

The name for the First, Second, Third, Fourth and Sixth Swedish National Pension Funds. The role of the buffer funds is to use their capital to even out temporary variations between pension contributions and disbursements and to assist in the long-term financing of the pension system.

## **Buyout**

Investment in a mature company. Often entails acquisition of a controlling interest, for example by buying out the previous shareholder.

## **Corporate governance**

Term to describe issues relating to the Fund's role as an institutional shareholder.

## **Credit bonds**

Fixed income securities with a higher level of risk (but also higher expected returns) than government bonds. Issuers are corporations and mortgage lending institutions.

## **Duration**

A measure of interest rate risk through an approximation of the percentage change in the value of a bond in the event of a change of 1 percentage point in market interest rates.

## **Enhanced index management**

A management style that often has a quantitative orientation and that attempts to outperform the index with only a low level of active risk.

## **Fund strength**

Theoretical measurement of the number of years that the buffer funds can meet Sweden's pension needs in the absence of any inflow of pension contributions.

## **Global Compact**

At the World Economic Forum in Davos in 1999, UN secretary-general Kofi Annan urged business to take global responsibility for its actions. He launched the Global Compact, a programme spanning human rights, labour issues and environmental protection. The Global Compact is based on the OECD's guidelines for multinational corporations, the ILO conventions and the UN Declaration on Human Rights

## **Hedging**

Neutralisation of the risk of investing in currencies other than SEK by converting the exposure to such currencies into SEK using currency futures.

**High-yield**

Bonds with a credit rating of less than BBB. They have a higher credit risk than investment grade bonds (see definition).

**Index management**

Asset management in which a portfolio tracks a standardised index. Index management is not about outperforming the index but merely replicating its returns.

**Information ratio**

Measurement of how much the Fund benefits from active risk-taking and from deviating from the reference portfolio or benchmark index. It is measured as active return divided by active risk (tracking error).

**Investment grade**

Bonds which have a credit rating of BBB or higher. These are associated generally with low credit risk.

**Net contributions**

Difference between annual pension contributions to the pension system and disbursed pension payments.

**Overweight/underweight**

The weighting of an asset or security in relation to its weighting in the reference portfolio or market index. Active management involves attempting to identify price discrepancies in the market and taking overweight or underweight positions in assets considered likely to outperform or underperform that market.

**Passive management**

An alternative term for index management.

**Private equity**

Equity holdings that are not listed on the stock market.

**Rating**

An estimate of an issuer's creditworthiness.

**Reference portfolio**

This constitutes the Fund's long-term allocation of assets and is otherwise known as the strategic or normal portfolio. Its structure is determined by analysis performed by AP3 and is optimised to enable the Fund to discharge its liabilities to the pension system.

**Risk-adjusted return**

A means of evaluating management performance in which active return is considered in relation to the portfolio's level of risk, measured as deviations from the index. It is thus the active return (see definition) per unit of risk.

**Risk capital**

Generally refers to investments in a company's equity. In practice, it relates to investments in companies that are not market-listed, i.e. private equity.

**Sectoral allocation/sector strategy**

That part of the investment process that focuses on being overweight or underweight in different sectors of the equity market relative to the index.

**Semi-fixed weightings**

In a portfolio, these are weightings that are permitted to vary within specific limits. They reduce the transaction expenses that arise from portfolio rebalancing due to market movements.

**Sharpe ratio**

A measurement of a portfolio's risk-adjusted returns. It corresponds to portfolio return minus risk-free interest divided by the standard deviation of portfolio return.

**Tactical asset allocation**

The overweights or underweights of different asset categories (equities, fixed income securities and geographic regions) in relation to the reference portfolio with the purpose of attaining outperformance.

**Tracking error**

Measures the degree of uncertainty attached to active return and is calculated as standard deviation. It describes the level of risk that may be taken in order to achieve a certain level of return. Historic (ex post) tracking error describes the variation in realised active return and thus measures risk levels retroactively. Expected (ex ante) tracking error is a forecast based on estimates of historic standard deviations and correlations.

**Value at Risk (VaR)**

A common measurement of the probability of a portfolio losing a certain amount or more. The portfolio's structure can be modified to keep this risk of loss at an appropriately low level. VaR may be expressed in absolute terms (i.e. in SEK) and also in relative terms, e.g. the risk of underperformance versus an index.

**Venture capital**

Investments made at an early stage in a company's development and in which the capital injected is often used for product development.

**Yield curve**

A curve showing the relationship between market interest rates and maturities (or duration) of bonds with the same type of issuer and credit risk.



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