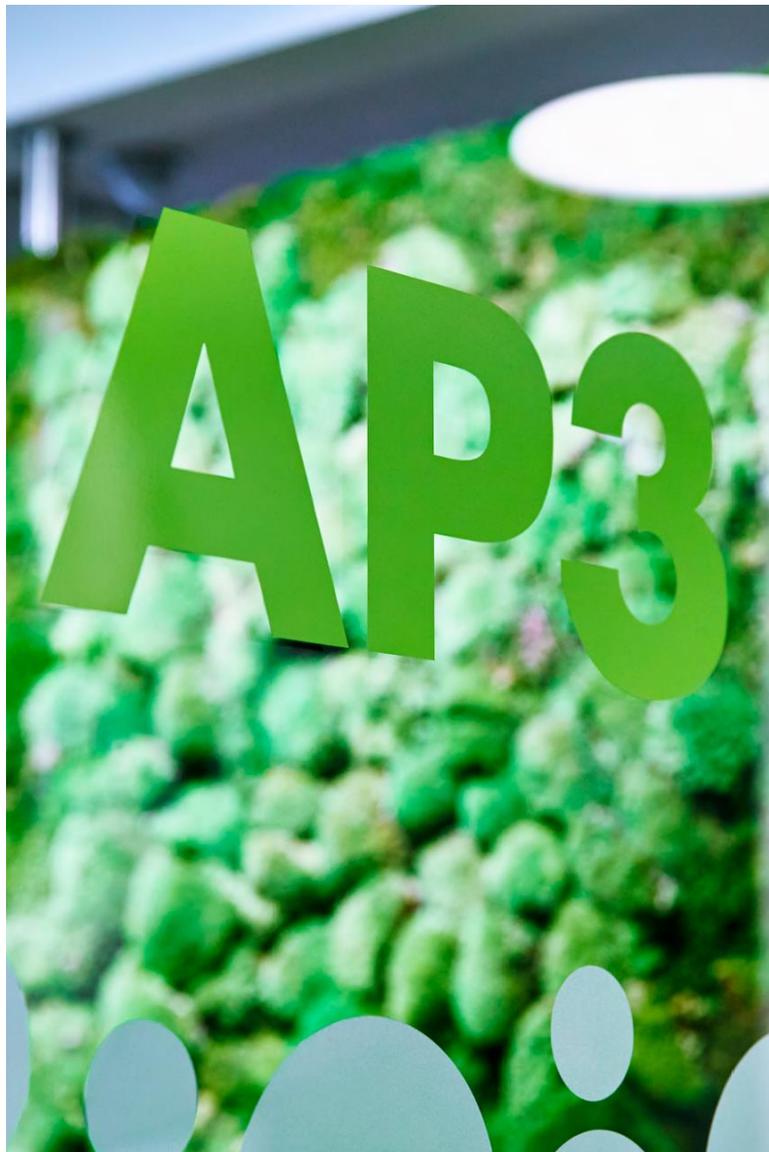


## STEWARDSHIP REPORT 2018



**AP3** Third Swedish National Pension Fund  
LONG-TERM ASSET MANAGEMENT ACROSS GENERATIONS

## BETTER VALUE GROWTH THROUGH ACTIVE STEWARDSHIP

Corporate stewardship is a cornerstone of AP3's commitment to sustainability. The Fund believes that well managed companies which adopt a responsible approach to climate challenges and social issues deliver superior investment returns over time. Our stewardship focuses on areas and companies where we are best able to exert a positive influence, which in our case means the Swedish equity market. At international level, the AP funds work closely together via a joint Ethical Council and also joins forces with other large institutional investors for maximum impact.

As an institutional investor with a prominent role in the Swedish equity market in particular, we have the opportunity to engage proactively and place demands on investee companies. Across the corporate governance spectrum, AP3 is a committed owner that uses proactive stewardship to encourage investees to embrace positive change. The AP3 stewardship policy is the foundation of this engagement. The policy is approved by the board of directors and updated when necessary. It is available on the AP3 website at [www.ap3.se](http://www.ap3.se). The stewardship policy sets out the Fund's principles in areas such as shareholder rights and responsibilities, investee capital structure, board structure, audit and internal control, remuneration issues and information disclosure. The policy also defines the Fund's views on investees' social and environmental responsibilities.



### Different ways to achieve impact

AP3 has a diversified portfolio that spans multiple asset types and includes both listed and unlisted investments. The Fund diversifies extensively in each asset category: the equity portfolio, for example, consists of shares in 3,000 companies. As at 30 June 2018 the equity portfolio had a market value of SEK 158 billion. SEK 12 billion of this was invested in unlisted equity. AP3's holdings of Swedish shares are worth SEK 41 billion and accounted for about a quarter of the portfolio's value at 30 June. The Swedish equity portfolio is highly diversified, comprising holdings in more than 180 different companies.

The total equity portfolio has a so-called home bias owing to the fact that the weight of Swedish equities exceeds Sweden's market weight in a global equity index. As a result, the portfolio's percentage holdings in Swedish investee companies far exceed those in foreign investees, averaging around 1.2% of the equity and a slightly lower percentage of the voting rights. These figures vary considerably from case to case, however. In one in five companies, AP3's equity holding is less than 0.1%; in one in ten companies AP3's equity holding exceeds 3%.

AP3 tailors its stewardship strategies to the size of each holding and targets contexts where we believe we can achieve maximum influence and impact.

- In cases where we own all or a large share of the equity – notably in the unlisted real estate companies Vasakronan, Hemsö, Trophi, Regio and Trenum – we can exert direct influence over corporate strategy through board membership.
- In foreign investees, our smaller size limits our ability to make our voice heard. For this reason we often join forces with other institutional investors, working primarily through the AP funds' joint Ethical Council.
- Our voting rights are larger in Swedish companies and here we engage investees in direct dialogue and exercise governance by voting at AGMs and serving on nomination committees.

### **Broad-based engagement**

AP3 engages in most stewardship issues, working proactively to influence the structure of executive remuneration packages and to promote greater diversity on corporate boards. We engage directors, management and investors in dialogue, serve on nomination committees and vote at company meetings. Sometimes the effects are immediate, but usually stewardship is a gradual process that takes time. For example, AP3 and other investors have long campaigned for increased female board representation. Major progress has been made in this area, but it has nevertheless taken longer than expected to achieve a better gender balance.

In recent years AP3 has applied the same type of proactive stewardship to part of our global equity portfolio. Here we focus on a number of issues including remuneration policy, where we have opposed proposals for share-based incentive schemes lacking clear and measurable performance criteria and whose dilutive effect is excessive. We oppose resolutions to elect boards without female directors and actively encourage our investees to separate the roles of chairman and CEO. AP3 also votes against share offerings that are too large and threaten excessive dilution.

We engage actively to advance our climate agenda by requiring investees to have a climate strategy that measures and reports on carbon footprint and guides the organisation towards reducing climate impacts.

## VOTING AT SWEDISH AGMS IN 2018

AP3 aims to report stewardship activities as openly as possible. However, it is not always practicable to disclose the details of discussions with other investors, nomination committees and corporate managements and boards as confidential dialogue is often the best way to achieve results. Nevertheless, transparency and clarity are important and are our motivation for publishing this stewardship report and disclosing how we exercised governance during the 12 months ended June 2018.

The size of AP3's Swedish equity portfolio varies over time in line with equity market movements and how we allocate our investment capital. The Swedish equity portfolio holds shares in approximately 180 companies. Most of AP3's equity holdings track a broad market index, which results in most of our major holdings in kronor terms being in the largest corporations listed on the Stockholm stock exchange. We also own shares in small cap companies. Indeed, our largest percentage holdings are in this category: the wind power operator Arise and medical technology company Karolinska Development (10% holding); helmet safety specialist MIPS (8%) and medical technology companies Bonesupport and Boule Diagnostics (8% and 7% respectively).

For practical reasons it is impossible to physically attend and vote at the AGMs of all the companies in the Swedish equity portfolio. Often it is not cost-effective to prioritise extensive stewardship engagements in investees where we only own a minor equity stake. For this reason, we focus our efforts on selected investees that are either major companies in which we hold a large stake or smaller firms in which our capital investment may not be especially large but where our equity holding is more significant.

In recent years, AP3 has been more active at Swedish company meetings. In 2018 we voted at 70 AGMs – 58 in person and 12 by proxy. Even though the Swedish equity portfolio has grown in size, we vote at a higher percentage of investee AGMs than in the past. AP3 attended a number of extraordinary general meetings during the year. Higher meeting attendance resulted in us voting on more agenda items than previously. In total, we voted on 1,800 agenda items in 2018, compared to 1,600 in 2017.

	2018	2017	2016
No. of AGMs of Swedish companies at which AP3 voted	70	62	53
AGMs at which AP3 as percentage of Swedish portfolio	40%	39%	35%
No. of Swedish AGM agenda items on which AP3 voted	1,800	1,600	1,300
No. of nomination committees on which AP3 held a seat	5	5	4

The Swedish equity portfolio had a total market capitalisation of SEK 41 billion at 30 June 2018. The 70 companies at which AP3 voted had a combined market value of SEK 37 billion on that date, meaning that our voting engagements covered around 90% of the portfolio. Extending our voting to all 180 or so companies in the portfolio would require us to attend and/or vote at the AGMs of numerous small-cap companies over which we have limited influence.

### Advance discussion of resolutions yields quieter AGMs

In the run-up to the AGM season, AP3 is given the opportunity to meet the managements, boards and nomination committees of many investees. Sometimes these meetings are private and sometimes we participate with other institutional investors. AP3 attended around 30 such meetings prior to this year's AGM season. At these gatherings, investees presented draft resolutions that they planned to submit to the

AGM. Some of these resolutions were for new or updated incentive schemes. In almost all cases, the resolutions complied with AP3's incentive programme criteria and it was noticeable that no controversial proposals were presented at the meetings. In a handful of cases, investors provided feedback that prompted the companies concerned to adjust their resolutions before the AGM.

Certainly, companies have become better at giving advance notice of resolutions to large institutions prior to AGMs. As a result, these meetings are now less stormy than on some occasions in the past. This year's AGM season was relatively low-key, doubtless aided by the robust health of the stock market. The Stockholm equity market rose 10% in 2017 and continued to gain ground in the early part of 2018. Strong corporate profits generally mean rising share prices and contented shareholders – and less discord at AGMs. That is not to say that all AGMs are immune from controversy. In the run-up to this year's AGM season, several large corporations found themselves on the defensive, especially from the media. Nordea was criticised for proposing to relocate its headquarters from Stockholm to Helsinki. Criticism of Ericsson's board and management for low profitability culminated with the company appointing a new chairman at the AGM. Telia Company's planned acquisition of TV4 was called into question by its largest shareholder, the Swedish government. In general, however, companies and their shareholders succeeded in focusing on the bread and butter issues of business activity and profitability.

Several trends can be observed from the AGMs of the last few years. Sustainability has moved ever-higher up the agenda of corporations and investors. A sound approach to environmental, social and ethical issues is essential for companies to remain competitive and maintain long-term profitability. For many firms, it is a matter of basic survival. Virtually all stakeholders – the general public, customers, political decision-makers, investors and companies themselves – are driving the sustainability agenda.

Transparency is another trend that is becoming increasingly important to businesses and their shareholders. Companies today are much more open in their reporting than they were a few years ago. Investors have played a central role in the development of sustainability and corporate governance reporting and auditing. The introduction of a new EU directive on shareholder rights will further increase corporate transparency going forward. The draft directive requires companies to publish an annual report on senior management remuneration and to give shareholders the right to vote on the report at the AGM.

Another trend is the growing pressure on company boards and managements to embrace diversity and be more reflective of society at large by striking a more equal balance between male and female members and between people from different backgrounds and areas of experience.

Some further reflections from AP3 on this year's AGM season:

### **Reduced focus on executive remuneration**

Executive remuneration is a subject that almost always attracts attention in and around the AGM season, especially in the media. AP3 has noted considerably less focus on this topic in recent years. Share-based incentive schemes remain widespread, but only rarely fail to meet the requirements of AP3 and other institutional investors. Nowadays schemes almost always include a performance-based component, and the cost to shareholders is invariably known and limited. Typically, plans contain a ceiling and an element of risk in the form of a personal investment by the beneficiary. Also, proposals are normally well-argued and include an analysis of prior schemes where applicable. Occasionally a company will propose a new incentive programme or recommend changes to existing plans that fall short of our requirements. In such cases, we urge the board to withdraw or amend the proposal prior to the AGM. Companies are often willing to listen to us on these matters.

There was extra focus this year on directors' remuneration following a change in Swedish tax rules that means directors can no longer be paid by invoice. The change means that board members who are professional directors cannot bill as consultants but must join the company payroll. AP3 takes the view that the work of a director is increasingly time-consuming and that directors' fees do not always reflect the amount of work involved. In the long run, there is a need to raise directors' remuneration. Small and medium-sized companies, in particular, will find it difficult to recruit directors with requisite expertise unless this happens.

### **Slower improvement in female board representation**

For years AP3 has been calling on Swedish listed companies to appoint more female directors. We believe that companies with a low level of female representation at board and senior management level risk failing to make full use of the available skills – both internally and in the sector more broadly. AP3 takes the view that greater board diversity makes companies more attractive employers and leads to better decision-making and higher value creation over time.

The Swedish corporate governance code recommends that Swedish companies aim for an equal gender balance in the boardroom. In May 2014 the Council for Swedish Corporate Governance introduced phased targets for board gender representation: a minimum 35% of all directors of large companies – and 30% of small companies – to be of both sexes by the end of the 2017 AGM season, and a minimum 40% of all directors to be of both sexes by the end of the 2020 AGM season. In its latest report, the council says female board representation will again rise this year but at a slower rate than previously. The number of women elected to directorships rose by 1.1 percentage points to 34.3% this year. Female board representation at large companies was 39% (unchanged from 2017) and at small and medium-sized companies was 31.9% (up 1.6 percentage points from 2017). Large and small companies have thus reached the council's 2017 targets for female board representation. It is now up to nomination committees to work to ensure that the 40% target for both sexes is met by 2020.

All investors have a responsibility to ensure greater equality in boardrooms, but the primary responsibility falls on the committees that nominate directors. AP3 is seldom invited to play an active role in nomination committee work due to the small size of our shareholdings. In cases where we are invited to participate and deem it suitable to do so, we have worked to try and increase the number of women at board level. The fact is that AP3 and other investors that undertake nomination committee engagements have work to do to achieve the changes we seek.

AP3 served on five nomination committees ahead of the 2018 AGM season:

- Wind power generator Arise has the smallest board of directors on the Stockholm stock exchange, with four members, one of whom is female. No changes in board structure were made this year. The 25% ratio of female directors is below the Council for Swedish Corporate Governance's target but needs to be seen in the context of the board having only four members.
- Major changes at medical technology company Karolinska Development in recent years have also been felt at boardroom level. Shareholders voted at an extraordinary general meeting in 2017 to elect a female director and the nomination committee is aware of the need to raise female representation further in the years ahead.
- Property developer SSM Holding has six male directors and one female director. Its nomination committee has expressed its intention to raise the number of women board members in future years.

- Medcover, an international care and diagnostics company, proposed the re-election of all nine directors, two of whom are female. Twenty-five percent of the board members (excluding the CEO) are female, so the nomination committee has some work to do to reach the target level.
- The same applies to biopharmaceutical company BioArctic, where the female chairman is the lone woman among six male directors. Even though the CEO is also female, the company and its nomination committee need to identify more female board members.

Although the number of women directors has risen, many companies still have very few female board members. Twelve listed Swedish corporations have no female directors and 67 have only one female director. AP3 will join forces with AP1 and AP2 in advance of next year's AGM season to contact the nomination committees of these companies and urge them to do their best to improve diversity, to explain their decision-making in the context of the Swedish code of corporate governance targets and to report to the AGM on their efforts to achieve numerical parity between male and female directors.

The appendix to this report contains a more detailed presentation of AGM resolutions and how AP3 voted on them.

## STEWARDSHIP IN THE FOREIGN EQUITY PORTFOLIO

The foreign equity portfolio is managed both in-house by the Fund's own managers and by external managers. AP3's stewardship at foreign investees includes voting at company meetings and supporting investor-led initiatives. AP3 has a diversified equity portfolio with relatively small holdings in a wide range of companies, so the extent to which we vote at company meetings involves striking a balance between the costs involved and the value that our interventions generate. AP3 holds shares in around 3,000 companies all over the world and this geographic spread makes it impracticable for the Fund to attend and vote at foreign AGMs. Instead, we vote by proxy using an electronic voting system provided by Institutional Shareholder Services (ISS), a global corporate governance consultancy. Nordic Investor Services, a Swedish corporate governance consultancy, monitors company meetings, analyses relevant paperwork and administers the voting process, but AP3 at all times comes to its own conclusions and decides independently how to vote. Indeed, the Fund votes differently from ISS's recommendations fairly often. In more than one in four cases in which ISS has issued a voting recommendation based on its own analysis, AP3 has opted not to follow the ISS guidance. Such instances often arise when ISS's recommendation is in conflict with AP3's corporate governance policy.

AP3 has been increasing voting activity for a number of years and now votes at around 750 foreign AGMs annually. In the 12 months ended 30 June 2018 AP3 voted at 780 such meetings. Outside Sweden, AP3 voted at investee AGMs in Australia, Bermuda, Canada, France, Germany, Ireland, Japan, Netherlands, New Zealand, Switzerland, the UK and the US. We also voted at a smaller number of companies registered in Belgium, the Cayman Islands, Curacao, Hong Kong, Isle of Man, Italy, Jersey, Luxembourg, Panama, Papua New Guinea, Singapore, Spain, South Korea and the Virgin Islands. Here we select investees based on their relative weights in the MSCI ACWI global share index, which means we vote at the meetings of our largest investee companies in the markets concerned. On occasion, we also vote at AGMs at which the AP funds are supporting specific resolutions or on which the Ethical Council has a special focus.

In recent years, our global voting has shifted away somewhat from European investees in favour of US and Japanese companies. This change reflects a gradual refocusing of AP3's European equity exposure from index-based management to a more concentrated portfolio comprising a smaller number of companies.

### **Foreign investees fall short of AP3's requirements**

In the 12 months ended 30 June 2018, AP3 voted on 9,800 resolutions at 780 foreign company meetings. Three times out of ten we voted against the board's recommendation. This relatively high ratio of "no" votes shows that foreign investees find it more difficult than their Swedish counterparts to meet AP3's governance requirements. It also indicates that foreign company boards and managements are less successful in winning over shareholders to their resolutions. Typically, Swedish companies inform institutional investors about proposed resolutions in good time before the AGM. Swedish resolutions also tend to enjoy broader consensus backing from shareholders by the time the meeting is held. The upsurge in no votes in recent years reflects a greater propensity from AP3's side to vote against male-only boards of directors, which also partly explains why we have voted against a higher percentage of ISS recommendations. Executive remuneration is another area in which major differences exist between Swedish and non-Swedish investees. On executive remuneration, we voted against more than half of the resolutions submitted by non-Swedish investees. Foreign companies clearly find it more difficult to meet our requirements in this area than Swedish companies do. AP3 has a reasonableness requirement for variable remuneration of senior executives. This is harder to enforce outside Sweden because remuneration at foreign investees is often set directly by the board of directors, with investors consulted only on an advisory basis.

AP3 voted yes to far more than half of the resolutions submitted by other investors, reflecting the fact that many institutions move their own resolutions at foreign AGMs and these are often of a high standard. Examples include resolutions for improved reporting of political donations and for separating the role of CEO and chairman.

A list of all the foreign AGMs at which AP3 voted and how we voted is available on the Fund's website at [www.ap3.se](http://www.ap3.se).

	2017/2018	2016/2017	2015/2016
No. of AGMs of non-Swedish companies at which AP3 voted	780	837	670
Ratio of foreign portfolio companies at which AP3 voted	28%	28%	22%
No. of agenda items at foreign companies on which AP3 voted	9,766	10,371	8,657
Ratio of agenda items on which AP3 voted in favour of board resolutions	70%	71%	75%
Ratio of agenda items on which AP3 voted against/abstained on board resolutions	30%	29%	25%

	2017/2018	2016/2017	2015/2016
No. of board resolutions	9,366	9,949	8,239
No. of shareholder resolutions	400	422	418
<b>Total no. of agenda items</b>	<b>9,766</b>	<b>10,371</b>	<b>8,657</b>
No. of votes in favour	7,100	7,216	6,714
No. of votes against	2,167	2,648	972
No. of abstentions	499	507	971
<b>Total no. of agenda items</b>	<b>9,766</b>	<b>10,371</b>	<b>8,657</b>
No. of votes in favour of board's recommendation	6,974	7,419	6,580
No. of votes against board's recommendation	2,792	2,952	2,077
<b>Total no. of agenda items</b>	<b>9,766</b>	<b>10,371</b>	<b>8,657</b>
No. of votes in favour of shareholder resolutions	223	235	230
No. of votes against shareholder resolutions	177	187	185
No. of abstentions on shareholder resolutions	0	0	3
<b>No. of shareholder resolutions</b>	<b>400</b>	<b>422</b>	<b>418</b>

### Investee feedback – a prerequisite for constructive dialogue

AP3 believes it is important to provide feedback to investees and explain our views on stewardship-related issues. Feedback is also a natural part of the successful dialogue process that AP3 pursues via the AP funds' joint Ethical Council.

As in previous years, AP3 contacted approximately 50 foreign investees to explain our reasons for voting against certain AGM resolutions. In line with established practice, we also advocated on a number of key corporate governance issues, for instance voting against proposals to elect all-male boards and to allow

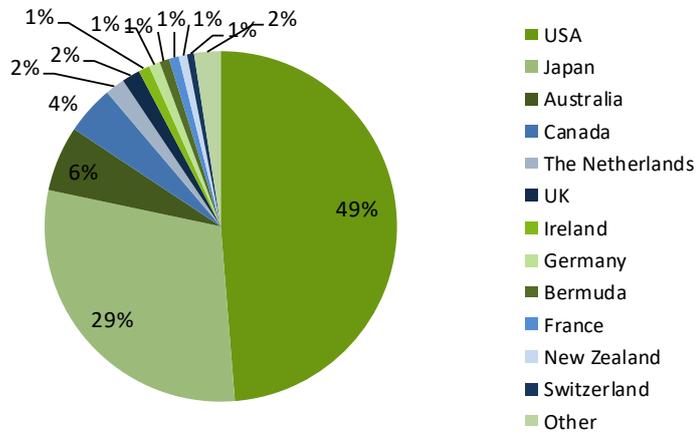
the same individual to serve as both CEO and chairman. We also voted against excessively large share offering mandates and against share-based incentive schemes lacking clear and measurable performance criteria and whose dilutive effect was excessive. The companies concerned often replied with questions or comments and AP3 hopes that these dialogues will develop over time and give managements and boards a broader understanding of our position.

### **Joint investor initiatives – an effective way to make a difference**

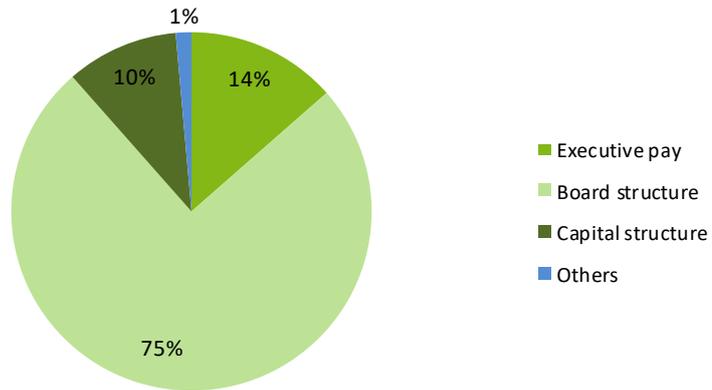
In many cases, AP3 exercises stewardship by engaging with companies directly and by voting at the AGMs of many of our global equity portfolio investees. However, our shareholdings in these companies are usually small and give us limited influence. We believe we can be much more effective in driving change by working with other investors. We cooperate closely, for example, with some of the largest pension funds in the Netherlands, Denmark, Sweden and the UK on executive remuneration in US companies. Here, we engage proactively with 10 or so large US corporations on pay levels and structures. There are many benefits to working together in such matters. It allows us to divide the work and share knowledge. It also adds clout to your message when you represent a larger share of the equity. The pension funds involved in this investor initiative together have more than US\$1.1 trillion of assets under management.

## Data on AP3's global voting in 2017/2018

### Geographic breakdown of company meetings 2017/2018



### Breakdown of board resolutions 2017/2018



### Breakdown of shareholder resolutions 2017/2018

