

Annual Report 2017



AP3

The logo consists of the letters "AP3" in a large, bold, white sans-serif font. The letters are slightly shadowed, giving them a 3D appearance. They are positioned in front of a blurred background of green foliage and a building with a grey roof. At the bottom of the image, there are several stylized, light blue human figures in various poses, some walking and some standing.

AP3 Third Swedish National Pension Fund

ASSET MANAGEMENT ACROSS GENERATIONS

The AP Funds in the Swedish pension system

Why are there AP funds?

Sweden has built up a state pension system to ensure that all workers receive a pension. The funds AP1, AP2, AP3, AP4 and AP6 manage fund capital which helps create security and stability in the income pension system. AP7 manages assets in the premium pension system.

AP3 – together with AP1, AP2 and AP4 – constitute "buffer funds" in the income pension system which level off annual surpluses and deficits and manage the assets to consolidate the pension system by adding value over time. AP6 plays a separate role of managing private equity and constitutes part of the buffer capital.

Why are there more than one buffer fund?

The reason for setting up four funds was to create a healthy competition among the funds and to diversify risks in how the assets are managed and to prevent a single fund becoming too dominant. It was thought that smaller funds would have better conditions for active asset management and would minimise problems arising from political influence on business and industry.

Is it possible to choose to have one's pension savings in AP3?

No, only the premium pension system provides the option of choosing an asset manager. Everyone who works and lives in Sweden has an account with the Swedish Pensions Agency where pension contributions based on income up to a certain level are registered as pension credits. For 2018 this income level is SEK 468,750. The value of these pension credits is indexed to the income index and subsequently determines the amount of income pension paid out to the individual recipient. When the system is in rebalance, the pension capital and pensions are indexed upwards in line with the balance index instead.

Who decides where the AP funds place their investments?

The AP funds are governed by the National Pension Insurance Funds Act, passed by the Swedish Parliament in 2000. In addition to restrictions stipulated by law, the board of directors of each AP fund is responsible for determining how the asset management is to be organised. As an overarching goal, the law stipulates that fund assets must be managed "to provide the greatest possible benefit to the Swedish state pension system for an income-based retirement pension".

More information

Sweden's public pension system and the role of the buffer funds are described more in detail on p. 74. Further details about the pension system are found on pensionsmyndigheten.se.

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Financial information

Updated information on the operating activities and investment holdings and all annual reports and interim reports, in both Swedish and English, are found on ap3.se.

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Annual Report 2017 of the Third Swedish National Pension Fund

This annual report describes AP3's activities during 2017, including AP3's sustainability report. AP3 adheres to the Global Reporting Initiative's guidelines and GRI Standards and the Fund reports at "core" level pursuant to the sector-specific addendum "Financial Services" (Finansiella tjänster).

The annual report is supplemented by a separate GRI report on the AP3's website, ap3.se. Please also refer to annual reports of the AP funds' Council on Ethics on etikradet.se.

AP3 – 2017 in brief

SEK 345.2 bn

The fund capital as at 31 December 2017 was SEK 345,239 million.

8.8 %

The return after expenses was 8.8 per cent.

SEK 28.2 bn

The net result amounted to SEK 28,239 million.

0.10 %

The management expense ratio, including commission expenses, amounted to 0.10 per cent (0.06 per cent excluding commission expenses).

➔ Higher efficiency through digitalisation and cooperation

AP3 moved into smaller premises and took steps towards digitalisation at the same time. The cooperation among the AP funds was further strengthened through new collaborative groups. Read more on p. 37.

➔ More modern investment regulations

An update of the National Pension Insurance Funds Act is in process. It will widen the scope of investments and at the same time incorporate sustainability into the rules and regulations. Read more on p. 11.

➔ Sustainability targets show results

AP3 is well on its way to achieving the four sustainability targets set for 2018 where investments in green bonds have tripled since 2014. Read more on p. 26–31.

➔ Ten years with the AP funds' Council on Ethics

In 2017, the Council on Ethics under the Swedish National Pension Funds concluded ten successful years of engaging in dialogue with and influencing hundreds of companies and sectors relating to important sustainability issues. Read more on p. 25.

Key figures: five-year overview

| | 2017 | 2016 | 2015 | 2014 | 2013 |
|--|-------|-------|-------|-------|-------|
| Fund capital at 31 Dec., SEK bn | 345.2 | 324.4 | 303.0 | 288.3 | 258.5 |
| Net flow to the pension system, SEK bn | -7.4 | -6.6 | -4.9 | -5.1 | -6.9 |
| Net result, SEK bn | 28.2 | 28.0 | 19.6 | 35.0 | 32.4 |
| Return before expenses, % | 8.9 | 9.5 | 6.9 | 13.8 | 14.2 |
| Return after expenses, % | 8.8 | 9.4 | 6.8 | 13.7 | 14.1 |
| Management expense ratio, % | 0.10 | 0.12 | 0.12 | 0.12 | 0.13 |
| Management expense ratio, excluding commission expenses, % | 0.06 | 0.06 | 0.06 | 0.07 | 0.07 |

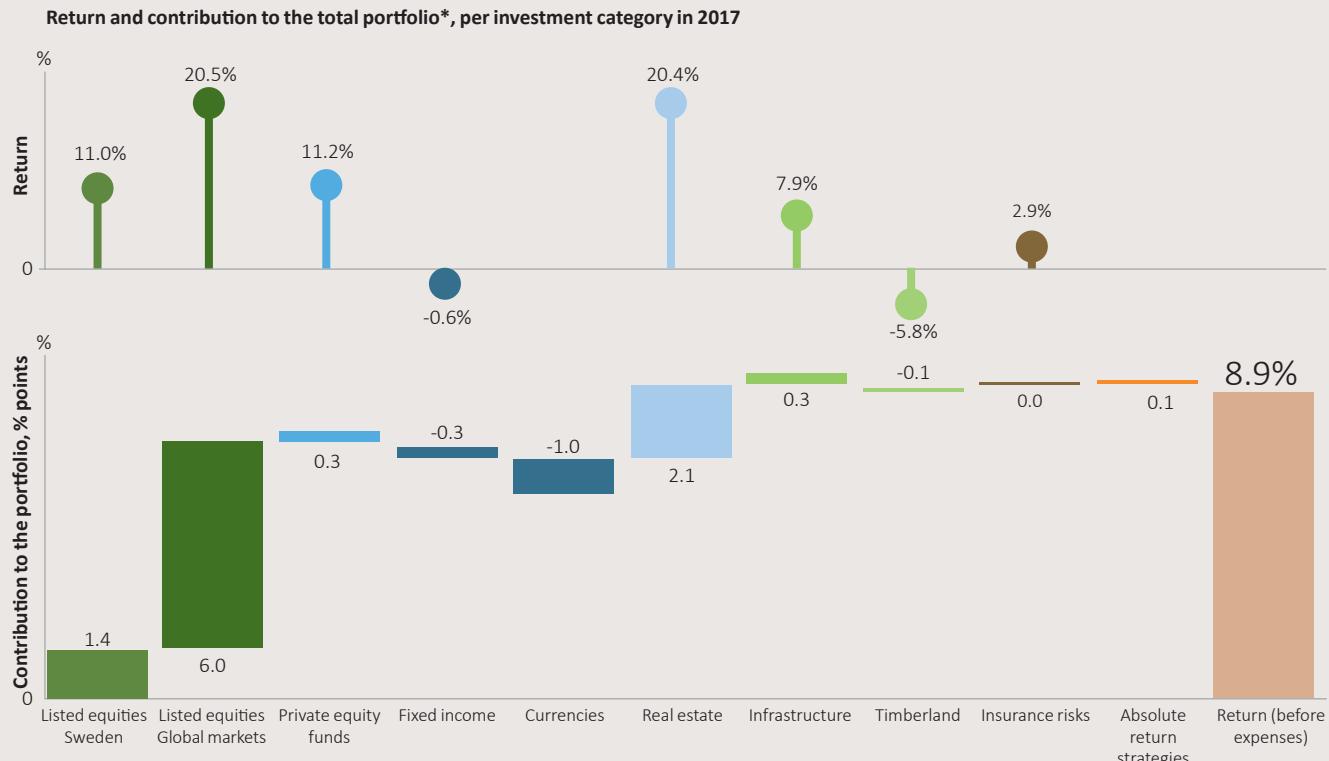
Stable development benefits portfolio in 2017

Low volatility was the year's biggest surprise. There was not a single month of negative returns for global equity markets – something that we have not seen in modern times.

Portfolio developments

The portfolio continued its strong growth in 2017, with the most significant contribution coming from positive developments in global equity markets. AP3's equity portfolio (aggregate holdings of listed Swedish and global equities and private equity funds) had a 17.0 per cent return and contributed a full 7.7 percentage points to AP3's currency-hedged return. Real estate and infrastructure also continued to generate solid

returns (20.4 per cent and 7.9 per cent respectively). Interest rates rose somewhat, from a very low level, resulting in a negative return from the bond portfolio. The Swedish krona, virtually unchanged on a trade-weighted index basis, weakened against the euro. Overall currency exposure had a negative effect on return due to the weakening of other major currencies (e.g. the US dollar) against the Swedish krona.



* For currencies and absolute return strategies, only the overall contribution to the portfolio's increase in value is shown. The returns (except for timberland) are currency hedged.

The markets

The biggest surprises in 2016 – Brexit and Trump – continued to dominate the news cycle but did not heighten market unrest in 2017. Positive factors (e.g. low interest rates, rising growth with stable inflation, and underlying geopolitical stability) outweighed these events and kept the markets calm. Low volatility became the surprise of the year with not a single month of negative returns for global equity markets – something that we have not seen in modern times.

Global real GDP growth was over 3 per cent,¹ stronger than anticipated and around 0.5 per cent more than in 2016, without inflation gaining momentum. Monetary policy remained very expansive, not least in Sweden, despite the US Fed's

continued interest rate hike (from 0.75 per cent to 1.50 per cent). The strong global economic growth paved the way for corporate profits, which were up 14 per cent² globally in 2017. The IT sector, which rose a full 40 per cent globally, led the bull market. Emerging markets also saw strong overall returns.

Bond markets were calm, with firm short-term rates in the US and minor movements elsewhere. Credit markets continued to develop positively in this environment.

In Sweden, commercial real estate continued to show positive growth. Meanwhile, housing prices were down with increased production meeting demand and the market increasingly worried about rising household debt levels.

1) Non-PPP adjusted (PPP adjusted becomes higher as countries like China tip the scales with their higher growth)
 2) IBES MSCI (in USD)

AP3's portfolio composition as at 31 December 2017, breakdown by market value*



* Indicates the total net exposure for absolute return strategies

Portfolio strategy

Over the year, AP3 maintained an equity exposure of close to 50 per cent. The fixed income portfolio's interest rate sensitivity (duration) was further reduced at the beginning of the year. This was based on AP3's assessment that the expansive monetary policy would result in higher growth and that inflation may continue to rise, with the inflation development potentially resulting in a tighter monetary policy. This assessment was particularly applicable for Sweden.

Bond markets did not develop in line with AP3's expectations, primarily as a result of continued low inflation pressure. The strategy during the year was to reduce exposure to Euro-

pean interest rates and slightly increase exposure to US interest rates, as the Federal Reserve had nevertheless taken the initiative to raise the interest rate.

AP3 maintained its assessment that the credit markets have benefitted the most from monetary policy and therefore constitute the most expensive financial investments with a low expected return. AP3 therefore chose to further reduce allocations to credit.

AP3's real estate companies continued to use a cautious rate of investment, as the market offered few attractive investment opportunities.

Currency strategy

AP3's currency strategy was underpinned by a belief in a stronger Swedish krona, which led to lower currency exposure than in previous years. Exposure was reduced early in the year, primarily against the euro and US dollar. The US dollar was weaker at mid-year, providing AP3 an opportunity to buy back the dollar exposure. The euro, on the other hand, developed relatively strongly, which resulted in a continued low level of exposure.

Currency exposure, development 2015–2017



High returns in a “deceptively” calm market

2017 was characterised by stable markets and declining volatility. The calm may seem deceptive in the light of heightening geopolitical risks, not least through the increasingly bitter tone between North Korean leader Kim Jong-Un and US president Donald Trump.

In 2017, the financial market resembled Ferdinand the Bull, where monetary policy is his cork tree and the increasingly stronger growth are the flowers he enjoys. No red cape can frighten Ferdinand. At the time of writing, however, we have seen that the bee (inflation) has sneaked in among the flowers.

2017 became a strong year, with AP3 reporting a rate of return of almost 9 per cent. An additional SEK 20 billion was added to the fund capital after nearly SEK 7 billion was paid to cover outgoing pension payments and the expenses of managing the state income pension system. AP3's fund capital now amounts to SEK 345 billion.

We have had several consecutive years of positive results, and the average nominal return over the past five-year period amounts to 10.5 per cent per year and the real rate of return to 9.8 per cent per year. The last time we had five consecutive years of upswing was 2003–2007, and back then the average comparable figures were actually somewhat higher: 11.8 per cent and 10.2 per cent respectively on an annual basis. We now know that this upswing was a bubble, considering the turn of events the following year, and a decade has passed since the last market peak. AP3's return during this period has outperformed the target of 4 per cent after inflation by just over one percentage point, despite the fact that the 2008 financial crisis had a significant impact on the Fund with a loss of almost 20 per cent.

Continued good return in the real estate portfolio

Looking at AP3's portfolio today as compared with 2007, the big difference is the share of unlisted investments – primarily a significant increase in property holdings. AP3 made its largest real estate investment in Vasakronan and Hemsö in 2008, in the midst of the crisis. Those were brave decisions which a long-term pension fund like AP3 needs to be capable of making. The best investment decisions are often those that seem difficult at the time.

AP3's real estate portfolio has generated an excellent return during this period. During the last half of 2017, however, parts of the Swedish property market became shakier. Housing-development companies started having problems when the supply of completed upmarket housing units was not met by demand. AP3's exposure to that niche in the property market

is limited, but the best period for Swedish real estate appears to have come to an end. Our assessment is that the Fund's real estate investments will continue to generate healthy cash flows but the era of sharp increases in value is likely over this time around.

New rules for increased flexibility

The good news also arrived in 2017 that the Pension Group proposes that the AP funds' investment rules will be modernised. The purpose is to increase opportunities for AP funds to invest in unlisted assets. In AP3's comments to the proposal, we have emphasised the parts that need to be modified for the proposal to make a real difference compared to current rules and regulations. The most significant change is that the Pension Group proposes reducing the lowest limit for fixed income assets with a low credit risk from 30 to 20 per cent of the portfolio. This would free up capital and make the allocation process more flexible. We expect the proposal to take effect in 2019.

Lower costs for external management

During 2017, AP3 focused on reducing exposure to hedge funds and bringing back assets to be managed internally by the organisation. This has further reduced our total expenses.

In terms of sustainability, AP3 is getting closer to achieving the targets set for 2018. The carbon footprint of the portfolio was further reduced, and our investments in green bonds have now reached SEK 13 billion. In 2017, the AP Funds' Council on Ethics celebrated a decade of joint company engagement. This has made a positive contribution to preventing problems,

“Over the past five years, the average nominal return reached 10.5 per cent and the real return 9.8 per cent per year.”



violations and occupational accidents at different companies and in different sectors. Long-term value is created in sustainable companies.

The last half of 2017 was marked by the #metoo movement, which has had a great impact on the ethics debate. I think that most organisations in Sweden have been affected by it and have reviewed their own activities to determine whether there are any grievances of this nature. In my opinion, #metoo is a protest against power abuse. Such abuse of power should obviously not occur, as it does not create lasting sustainable companies. I consider this to be a management issue, and that a credible, thoroughly prepared process is needed to investigate and take steps to combat any abuse of power.

The future demands more

The most important strategic issue for AP3 in the year ahead is making the portfolio more resilient, i.e. further improving the quality of our internal processes and modifying the profile of our risk-taking somewhat. Global growth is more synchronised than ever before and may be occurring at a pace that is too fast to be sustained in the long term. Monetary policy

“The cooling shade provided by Ferdinand's cork tree may be a thing of the past.”

will probably be tightened, which itself may cause more turbulence in the next five years than we have seen in the five years that are behind us. The cooling shade provided by Ferdinand's cork tree may be a thing of the past. Driven by technological innovation and new investment requirements, the financial markets still have good potential to deliver – and this trend calls for relevant, high-calibre expertise.

I value and thank our employees for their constructive efforts and the board of directors for their genuine commitment. Your contributions will become increasingly valuable going forward.

Kerstin Hessius
CEO

Developments since inception in 2001

The Fund's developments

Accumulated development of portfolio and comparative figures

since 2001 (percentage)

After the strong value growth of recent years, AP3's return outperforms the long-term target of a real rate of return of 4 per cent. The Fund's average added value since the year of our inception now comprises 5.9 per cent, which equates to a real value growth of 4.6 per cent. During the period on the whole, inflation rates have been low and amount to 1.3 per cent per year, which is below the National Bank of Sweden's target of 2 per cent. At the same time, the average growth of the income index has been 3.0 per cent. AP3 contributes to the stability of the income pension system when the return exceeds the income index.



5.9%

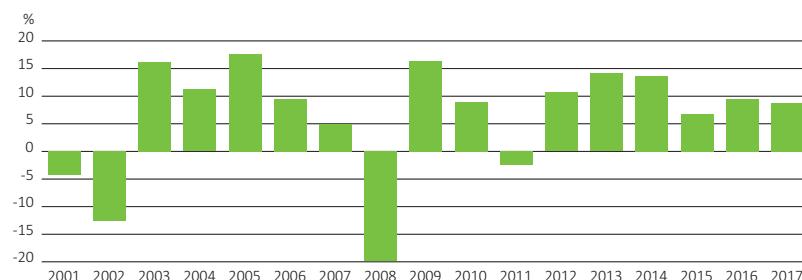
annual nominal return

4.6%

annual real return

Return after expenses, 2001–2017

Both the IT crash early in the new millennium and the financial crisis of 2008 caused sharp drops in the value of AP3's capital. However, since 2009, the recovery has been remarkable and the value of our investments has been increasing for six consecutive years. The compounded interest impact and the stability of market developments during the period leads to a sharp increase of the overall value of the portfolio, which has a positive impact on the income pension system's key figures.

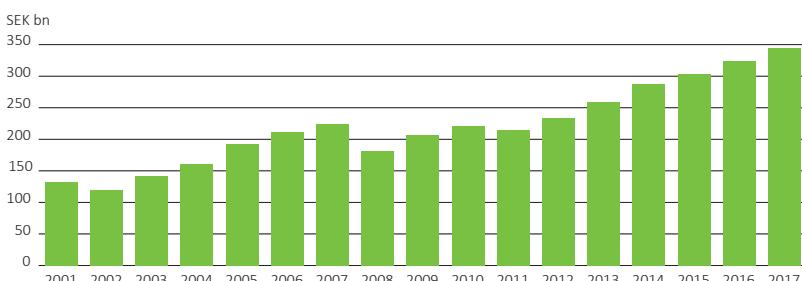


6 years

of stable and positive returns

Fund capital development

The fund capital has continued to grow, despite higher net outflow to the income pension system.



SEK 211 bn

in increased fund capital since inception in 2001

Contributions to the income pension system

AP3 increases its net payments to the income pension system

As buffer funds, AP3 – along with AP1, AP2 and AP4 – are tasked with managing the surpluses and funding the deficits that annually occur between the incoming and outgoing payments in the pension system. Since 2009, AP3 has disbursed SEK 43.9 billion to cover the deficit in the pension system. In the next decade, the deficits are expected to amount to roughly 2.0–2.5 per cent of the buffer capital per year. Therefore, we expect the buffer capital to increase at a slower rate during the upcoming decade, with a risk that it declines in the event of strains on economic and financial developments.

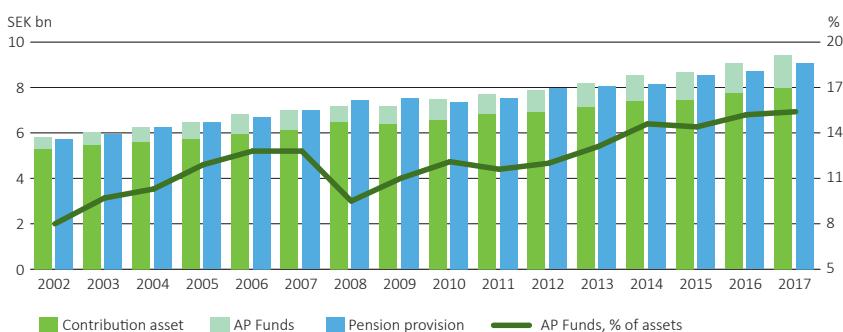


SEK 7.4 bn

AP3's net payment to the pension system in 2017

The income pension system's developments over time – the share of buffer capital out of total assets has increased

The sharply increased value of the buffer funds' capital has contributed to their representing an increasing share of the income pension's total assets, from 10 per cent in 2001 to 15 per cent in 2017. This is despite the fact that trends were also favourable for the majority of contribution assets, the development of which is a function of the income index and the employment rate in Sweden. Consequently, the buffer funds have so far had the stabilising impact on the income pension system that was intended.



15%

The AP funds' share of the income pension system's assets

AP3's mission

AP3 is tasked with managing part of the buffer capital in a manner that over time provides the greatest possible benefit to the state income pension system.

AP3 is a government body that differs from other government bodies in its autonomy from the government. Therefore, the AP funds are regulated by separate legislation. This enables the buffer funds to take a long-term approach to investing and provides the best possible conditions for achieving the mission.

The funds are tasked with performing two functions:

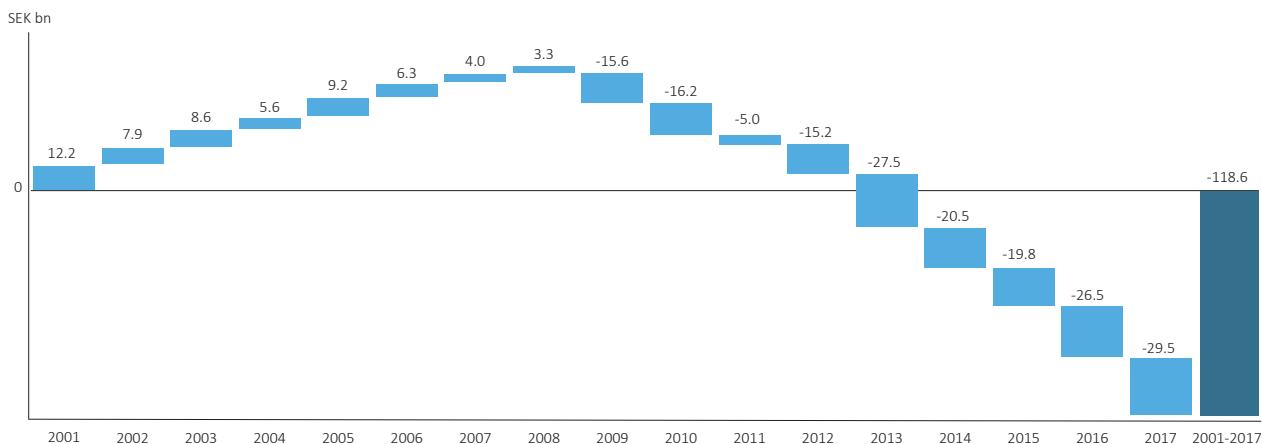
1. Balancing the surpluses and deficits between pension contributions and pension payments that arise in the income pension system over time
2. Contributing to the stability of the income pension system by generating a return on investments

The mission includes a requirement of generational neutrality, which means that AP3's asset management must consider the effect of value developments on pensions, both over the short and long-term. Therefore, the risk-taking is a balancing

act between investing in risky assets to generate a good return in the long-term and to avoid significant falls in value in the short term. AP3's assessment is that it is in line with its mission to work with a long-term real return target of 4 per cent and at the level of risk this represents. If the long-term return equates to 4 per cent plus inflation, it is highly likely that it will outperform the income index and that, as a result, AP3 will help consolidate the income pension insurance system.

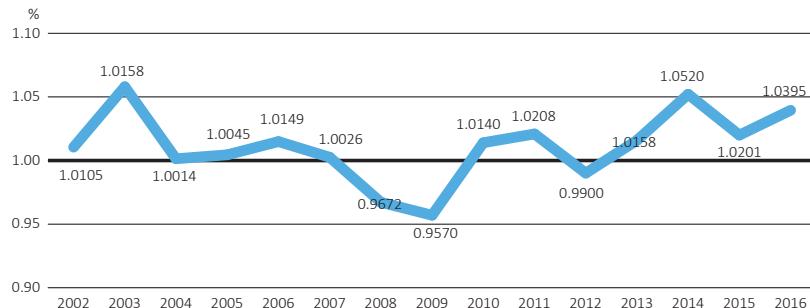
The assets managed by AP3 are included in the public pension system for the benefit of existing and future pensioners. The point of departure for AP3's investments is to always act as responsible investor and owner. In its efforts to fulfil its mission, the basis for AP3's actions are the Swedish Constitution, the state's values and international conventions which have been signed by Sweden.

The AP funds are now funding the deficit in the income pension system



As a result of Sweden's demography, the income pension system has transitioned from showing annual surpluses to showing annual deficits. Over the past decade, pension contributions have not been sufficient to pay the annual pensions, meaning that the buffer funds – AP1, AP2, AP3 and AP4 – are now net payers to the income pension system.

The balance figure's long-term trend shows how the income pension system's total assets behave in relation to the total liabilities.



If the balance figure drops below 1.0, the system's automatic balancing mechanism is activated to restore the financial position. During the automatic balancing process, the income index is replaced by the balance index. The most recent balancing period is now completed, which means that pension capital and pensions are back to following the income index. The balance figure for 2016 is applied to the balancing year of 2018. For further details, see p. 74.

AP3's operational conditions

AP3's mission and other operational conditions contribute to the Fund's distinctive features in several ways. They constitute an important basis for AP3's investment model.

→ **AP3 is part of the Swedish government** – AP3 is a Swedish government body, and Sweden is currently one of the ten or so countries in the world with the highest credit rating (AAA). The stable situation supports a long-term approach, but it also provides a good negotiating position with counterparties and makes AP3 an attractive partner all over the world. This makes it possible for AP3 to be an effective global investor from its offices in Stockholm.

→ **AP3 has an effectively dimensioned portfolio and organisation** – With less than 60 employees, AP3 currently manages over SEK 345 billion. The size of the portfolio is sufficient to benefit from economies of scale which make it possible to pursue a cost-effective asset management strategy. The internal organisation is relatively small, which means more employees are directly involved in the decision-making process and each employee is delegated with significant responsibility, which puts them under an obligation to perform well and requires them to have extensive knowledge and experience.

→ **AP3 is governed by the National Pension Insurance Funds Act** – the activities of the AP funds are governed by a legislation that is widely supported across the political spec-

trum, which promote stable conditions. The National Pension Insurance Funds Act enables flexible and long-term action, which is particularly beneficial when the market is under stress. These opportunities comprise a relative benefit compared with many other players, who may be forced to sell assets when market risks increase.

→ **AP3 is a long-term investor, as the mandate for the pension system is extremely long-term** – There is no specific end date to AP3's mission. This is manifested by the fact that the Fund can buy illiquid assets where value is created over a long period of time. Illiquid assets have a relatively high expected return, as they are not suitable for all investors. It is also important for AP3 to be able to exploit the market cycles and invest when financial assets have a relatively low valuation.

→ **AP3 is based in Sweden** – AP3 focuses on Sweden, as this is the Fund's domestic market, the staff is based in Sweden, and the Fund's greatest expertise is around Swedish market conditions. Over many years it has been advantageous to invest in Sweden, but it has also been valuable to take a Swedish perspective out into the world to make contacts and global investments.

More flexibility with new rules and regulations

Current investment rules in brief:

- At least 30 per cent fixed income investments with low risk
- Maximum of 5 per cent unlisted investments (which are not real estate companies)
- Maximum of 40 per cent currency exposure
- Requirement of 10 per cent external management
- Derivatives with commodities as underlying asset are not permitted

The proposed changes are primarily:

- The minimum share of fixed income low risk investments is reduced from 30 per cent to 20 per cent
- No more than 40 per cent of illiquid assets (including real estate companies) and removal of 5 per cent limit on unlisted investments
- Abolish the external mandate requirement
- Incorporate sustainability into the National Pension Insurance Funds Act



Cornerstones of AP3's investment model

The AP3 board of directors has operationalised the task of achieving the greatest benefit to the state income pension system by setting a real return target of 4 per cent over time. The relatively high return target indicates that the investments largely focus on risk assets with the potential to generate a return at this level.

The investment model is based on AP3's conditions for achieving the target in a responsible manner and comprises the following main elements:

- Investing in assets that generate risk premiums
- Adapting the portfolio's different risks to changed conditions (dynamic allocation)
- Diversifying and spreading the risk, thus creating value by reducing vulnerability
- Effectively applying corporate stewardship to ensure responsible asset management
- Applying cost-effective solutions

To maintain a high level of ambition in these areas, AP3 has made a number of choices which characterise how asset management is conducted:

➔ Different investment horizons: strategic and tactical asset allocation

In the long run, the overall allocation of capital is the most important factor for AP3's investment returns and overall portfolio risk. Effective risk allocation is achieved through

diversification and by making dynamic changes to the allocations over the medium term in response to financial market conditions. This strategic allocation is based on a medium- to long-term perspective in which portfolio risks are primarily adjusted in accordance with macroeconomic forecasts and projected returns.

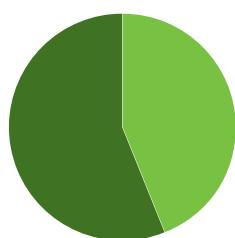
Tactical asset allocation has a shorter investment time frame and uses quantitative or qualitative methods to identify overvalued or undervalued assets in the market. Over time, AP3 believes that a combination of diversification and strategic investment across different investment horizons will enable the Fund to meet its target at a reasonable level of risk.

➔ Focusing on Sweden but investing globally

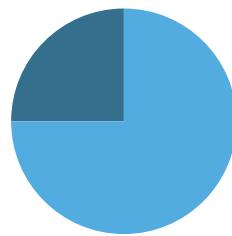
Whereas AP3 invests globally to build up a diversified portfolio and maximise the exploitation of opportunities that are available on the global markets, the Fund is focused on Sweden and investments based here. AP3's prime area of expertise is the Swedish market, and the Fund has a mainly Swedish contact network and a history of forming real estate companies in Sweden. For these reasons AP3 makes most of its direct investments and focuses its corporate governance in Sweden.

AP3's portfolio from three perspectives

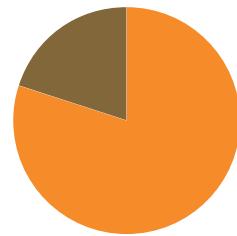
Sweden/World



Internal/External Asset Management



Listed/Unlisted Investments



Investments in unlisted assets, 2001–2017

AP3 has a strategic goal of increasing the percentage of unlisted investments. In recent years, this has primarily been achieved through infrastructure investments.

→ **Manages most assets internally, complemented by a global network of specialists**

AP3's assets are managed from the Stockholm office, where nearly 60 employees directly handle most investments. Assets are primarily managed internally. This provides sound insight into the investments, in-depth understanding of ongoing events, effective corporate governance and, not least, a high level of cost-effectiveness. This requires that the AP3 staff is widely experienced in both assessing investments and ongoing management. In selected areas, investments are made with an external asset manager wherever specialised expertise is required in areas beyond AP3's core business, such as active portfolio management in emerging markets and venture capital.

→ **Investing in unlisted companies for diversification and return**

AP3's characteristics and long-term perspective have made the Fund an attractive, demanding investor both in Sweden

and abroad. This provides AP3 with opportunities to cooperate with specialists to make direct investments in real estate, infrastructure and timberland. The most important reason for forming our own companies is that they provide a cost-effective way of investing. Direct ownership also provides better insight and better prospects for responsible corporate governance, which improves control of value creation in the long term while also reducing exposure to stock market volatility. AP3 also has a long-standing experience in investing in private equity funds.

→ **Cost-effective investments**

Cost-effectiveness is a key trust issue, particularly considering the fact that AP3 determines its costs autonomously. AP3 therefore sets stringent requirements for having effective solutions, which underpin the choice of investment model, forms of co-operation and the demands placed on suppliers (see follow-up pp. 36–37).

Read more about AP3's investment categories on the following pages

Listed equities
p. 14 →

Private equity
p. 16 →

Real estate and infrastructure
p. 18 →

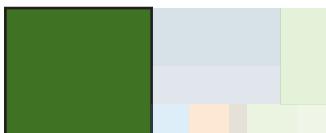
Fixed income and currencies
p. 17 →

Insurance risks
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Absolute return strategies
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Listed equities

AP3 invests in global growth and innovative capacity



44% of AP3's overall portfolio is invested in listed equities.

The five largest listed equity holdings, market value, SEK billion

- Volvo AB, SEK 3.6 billion
- Nordea Bank AB, SEK 3.1 billion
- Atlas Copco AB, SEK 2.8 billion
- Swedbank AB, SEK 2.3 billion
- Hennes & Mauritz AB, SEK 2.0 billion

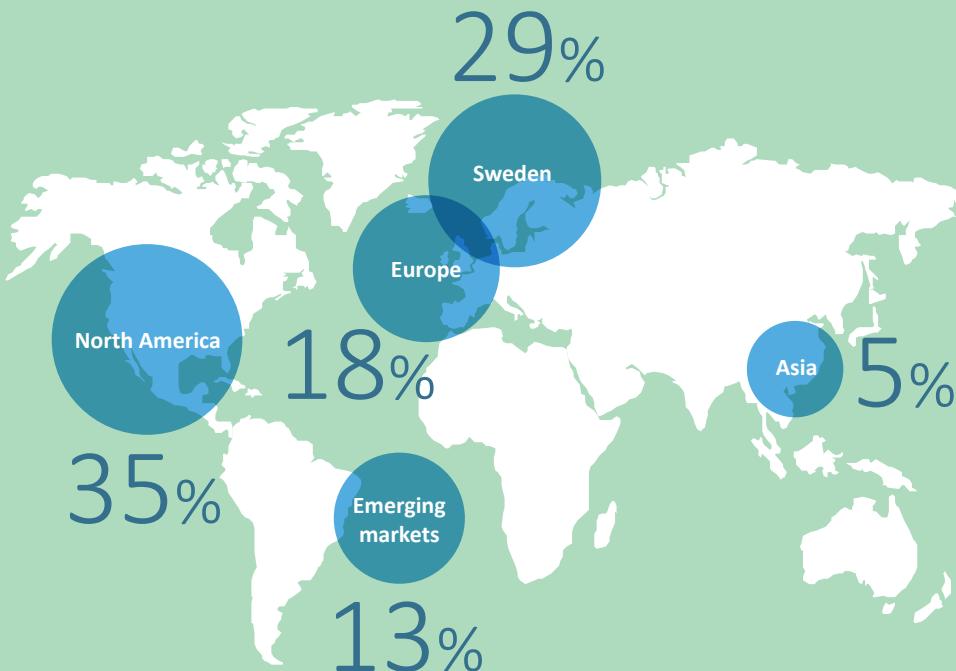
Listed equities comprise a substantial part of AP3's investment portfolio. Through the equity market, AP3 is able to invest in financial growth and innovative capacity throughout the world. Returns can be high during long periods of favourable economic and financial conditions, but can also be periodically volatile. Returns are also highly dependent on market behaviour.

AP3 applies several different methods to enable cost-effective investment of its assets on a global scale. Asset management is based on the following strategies:

- Analysis-based internal management of assets in Sweden and the rest of Europe
- Strategic allocation to small-cap companies
- Quantitative modelling
- Tactical asset allocation
- Active corporate governance

Fund capital is also managed passively or semi-passively. This ensures effective low-cost market exposure through index exposure or the application of techniques that produce low levels of tracking error.

Focus on Sweden and the rest of Europe



Nearly half of the equity portfolio is invested in Europe, which vastly exceeds the percentage invested in global stock markets. During 2017, AP3 also chose to strengthen its organisation by recruiting employees with solid expertise and experience in managing Swedish companies. Historically, Swedish companies have proven to be excellent investments in an international perspective.

Analysis-based investments

The management of listed equities in Sweden and the rest of Europe is largely analysis-driven. AP3's asset managers have a long-standing experience in evaluating these markets and the companies based here. At the same time, this requires working together with external analysts and having a strong network all over the world to effectively monitor developments.

AP3 uses external mandates in remote markets where the required expertise lies beyond the Swedish horizon. This currently applies primarily to emerging markets.

Small-cap exposure expected to give higher returns

Over time, the small cap portfolio is expected to generate higher returns than the large cap portfolio. This is the primary reason for AP3 having investments in nearly 3,000 companies. In Sweden and emerging markets, the small-cap portfolio is actively managed, as the added value is expected to be substantial compared to the costs. In Sweden, assets are managed internally. Small-cap exposure in North America and Europe is managed through external mandates.

Quantitative modelling of risk premia

AP3 applies quantitative strategies to access the benefits of the investment opportunities available in the global equity market.

AP3 currently conducts its own quantitative analyses, which are focused on constructing effective portfolios that generate specific exposures to certain risk premia or risk factors. This is primarily used on the broad and efficient US market, where quantitative analysis has proven to be very effective.

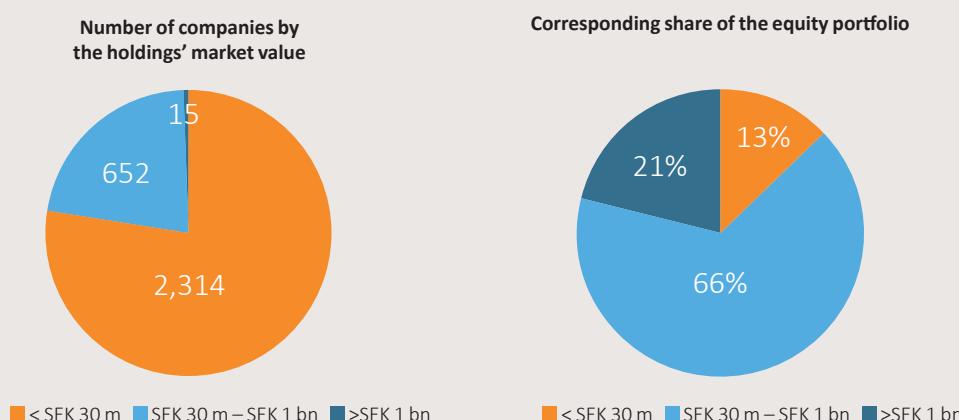
Tactical allocation is done by delegatet internal mandates

AP3's overall stock market exposure comprises the single most important risk decision. The Fund's overall risk exposure can be effectively adjusted by changing this exposure, initially by using derivatives such as forwards and options on various stock market indexes. The market also offers options of taking tactical positions based primarily on fundamental evaluations.

Corporate governance

AP3's assessment is that well-run companies that act responsibly with climate and social issues have a higher risk-adjusted return in the long term. AP3 concentrates its efforts in Sweden, as the Fund has more influence where it has a large ownership and believes that AP3 can have the most positive impact here. In its efforts at the international level, the AP funds cooperate via the Council on Ethics and with other major investors to bring increasing pressure to bear.

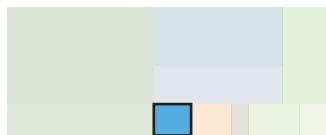
AP3's application of multiple investment strategies means that the equity portfolio has many small holdings.



AP3 has holdings in 2,314 companies with market values below SEK 30 million; these represent only 13% of the equity portfolio. 652 companies have a market value of SEK 30 million–SEK 1 billion and comprise 66% of the equity portfolio. The remaining 15 companies have a market value of more than SEK 1 billion and comprise 21% of the equity portfolio.

Private equity

Demanding and highly specialised investments



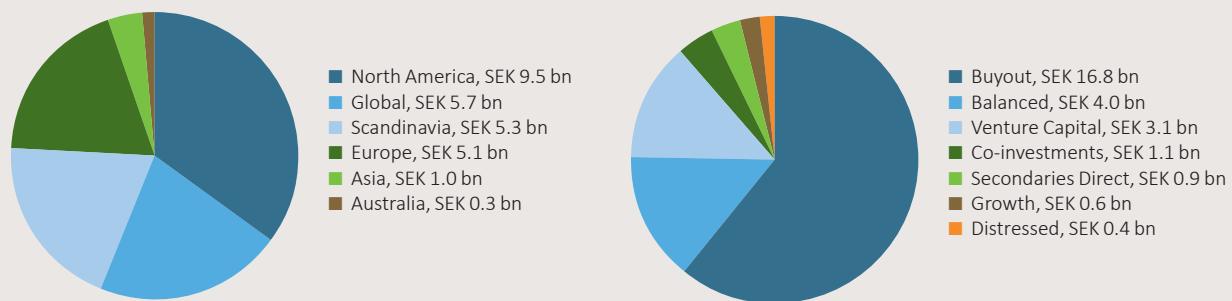
3% of AP3's portfolio is invested in private equity funds.

AP3 has built a strong platform for investing in private equity funds. Experience shows that value is only created by investing with the most skilled and experienced managers.

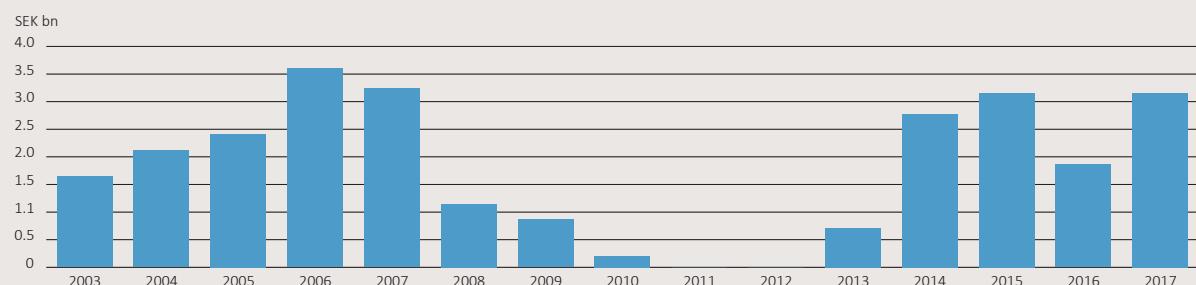
AP3 has been investing in private equity funds since 2001. The Fund's investments in this segment are aimed at achieving a return higher than that of listed equities as well as a certain degree of diversification. The funds in which AP3 invests in turn invest in unlisted companies. The fund managers create value by developing the business model as well as the company finances. This makes it crucial to choose the right managers. AP3 carries out due diligence of managers before investing and requires that they take a long-term perspective and consider the sustainability elements of the undertaking.

At present, AP3 has a mature private equity portfolio, which means that the Fund annually receives capital from previous years' investments. The investments are made through a number of different managers, each of whom often manages several different "vintage years" of funds. AP3 prioritises placing investments with managers who over time have provided a significant, lasting return to the Fund.

Holdings in private equity funds, geographical distribution and type of private equity, respectively



Vintage years – when the commitment was made



Fixed income and currencies

To stabilise returns

Fixed income investments and currency exposure have historically contributed to diversifying risks in the portfolio, which otherwise is comprised of different types of equity investments. This has reduced AP3's total portfolio risk. At present, however, the Fund cannot count on getting the same diversifying effect from fixed income and foreign currencies. Interest rates are at historically low levels and the value of the Swedish krona is already relatively low.

According to current investment rules, at least 30 per cent of AP3's portfolio must be invested in investment grade bonds. The total percentage of fixed income securities in the portfolio is close to this level, which means that AP3 almost exclusively invests in bonds with a high credit rating. Projected returns on fixed income securities have declined significantly due to the prevailing monetary policy. Accordingly, AP3 currently has a low exposure to credit bonds as the compensation for credit risk is low.

Instead, the fixed income portfolio helps create value in other ways:

- Risks relating to economic developments around the world are discounted in the fixed income markets. AP3 can exploit this by adapting the portfolio's duration exposure, which in turn helps reduce the risk for the portfolio as a whole.
- Actively managed fixed income strategies which exploit the relative pricing between different markets to generate a return.
- Investing in green bonds, which is a rapidly growing market, where the capital effectively works to achieve sustainable development.

Today, AP3 manages its entire fixed income portfolio internally through active management in primarily liquid markets in Europe and North America. AP3's portfolio of green bonds is primarily invested in SEK, EUR and USD.

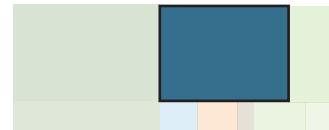
Currency exposure

Nearly half of AP3's portfolio is invested outside Sweden, whereas the National Pension Insurance Funds Act allows a maximum 40 per cent currency exposure. Accordingly, AP3 must hedge a certain amount of the currency risk.

At the same time, there are good reasons not to fully eliminate all currency exposure, as:

- Currency exposure has historically proved to reduce the total portfolio risk, not least during periods of declining economic activity when the Swedish krona has weakened.
- Actively managed currency exposure is a value-creating strategic opportunity, primarily targeting the Swedish krona.
- In AP3's experience, currency trading is one of the most significant sources of alpha, i.e. returns from short-term absolute return strategies.

AP3 manages all currency exposure internally.



35% of AP3's portfolio is invested in fixed income.

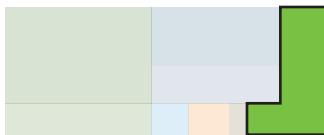
Diversification – a challenge

Like several other central banks, Sweden's Riksbank has pursued an expansionary monetary policy in recent years, through low repo rates and by purchasing bonds. This has contributed to rising asset prices but also decreased future options for diversification through fixed income and currency exposure. At present, bond yields cannot fall significantly and the value of the Swedish krona is already low. At year end, AP3's portfolio had low duration (2.2 years) and low currency exposure (15 per cent).



Real estate and infrastructure

Value creation for the future



16% of AP3's portfolio is invested in properties, infrastructure and timberland.

AP3 invests in several types of real estate, such as commercial real estate, infrastructure and timberland. Real estate and infrastructure are increasingly important components of AP3's portfolio.

Real estate and infrastructure investments provide good opportunities for relatively stable returns and provide some protection against rising inflation. AP3's distinctive features as investors make the Fund excellent owners of this type of long-term asset. The strategy has been to focus on Sweden primarily through majority holdings in real estate companies. Here, AP3 can exploit its strength in the Swedish market as a responsible long-term owner.

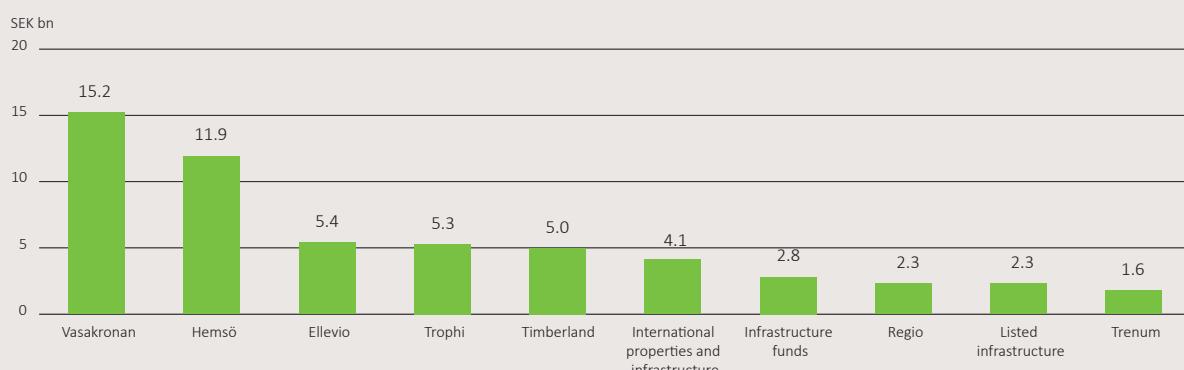
The most important reason for forming our own companies is that they provide a cost-effective way of investing. Direct ownership means that AP3's costs are considerably lower than they are for a fund investment. The companies that are formed also become scalable according to AP3's needs, with low marginal costs.

AP3 is already active in building the infrastructure of the future through the real estate companies that the Fund owns and develops. Real estate also provides a strong link between energy management, customer value and profitable investments.

Infrastructure investments are well-suited for AP3's long-term mission for several reasons:

- AP3's long-term commitments are matched by assets where undertakings are often under long-term contracts.
- The assets are illiquid and adapted to a specific need, providing a risk premium that gives a higher return.
- Infrastructure primarily constitutes real assets where both ongoing returns and value trends are connected to inflation trends, thereby reducing the risk that inflation will reduce the value of the investment.
- Infrastructure constitutes an important component of sustainable development.

Real estate and infrastructure companies, portfolio value:



AP3's Swedish real estate and infrastructure companies – an increasingly important component of AP3's portfolio

Vasakronan

Vasakronan is wholly owned by the four AP funds – AP1, AP2, AP3 and AP4 – in equal shares. Vasakronan is the biggest real estate company in Sweden, with a property value of SEK 127 billion. The properties are 179 centrally located office and retail properties in Stockholm, Gothenburg, Malmö, Lund and Uppsala. The company's focus is to manage and develop commercial properties in urban areas in Sweden. Read more about Vasakronan's sustainability efforts on page 31.

Hemsö

Hemsö is Sweden's biggest owner of public properties, such as nursing homes, schools, hospitals and legal buildings. The building stock comprises 346 properties with a total market value of SEK 38.9 billion. Hemsö is owned by AP3 (85%) and Sagax (15%). Read more about Hemsö on page 20.

Trophi

Trophi is Scandinavia's leading owner of retail properties for the retail trade, with enterprises in Sweden and Finland. The activities comprise of owning, managing and developing retail properties. As at 31 December 2017, the market value amounted to SEK 12.3 billion. Seventy-one (71) per cent of the value is found in Sweden and 29 per cent in Finland. Coop is the biggest tenant, holding 22 per cent of the rental value, followed by ICA (20 per cent). Axfood represents 17 per cent and includes shops where Trophi has a direct agreement with the retailer. Trophi is 100 per cent owned by AP3.

Regio

Regio's business concept is to generate a stable low-risk return through long-term, active ownership of office and retail properties in regional towns and metropolitan suburbs. Today, Regio owns around 50 properties in 19 cities in Sweden, with a property value of SEK 4.6 billion. Through collaborations with municipalities and local property owners, Regio works to develop the community in which the undertaking is located. AP3's equity shareholding in Regio is 97 per cent. The company is jointly owned with, and managed by, Brunswick Real Estate.

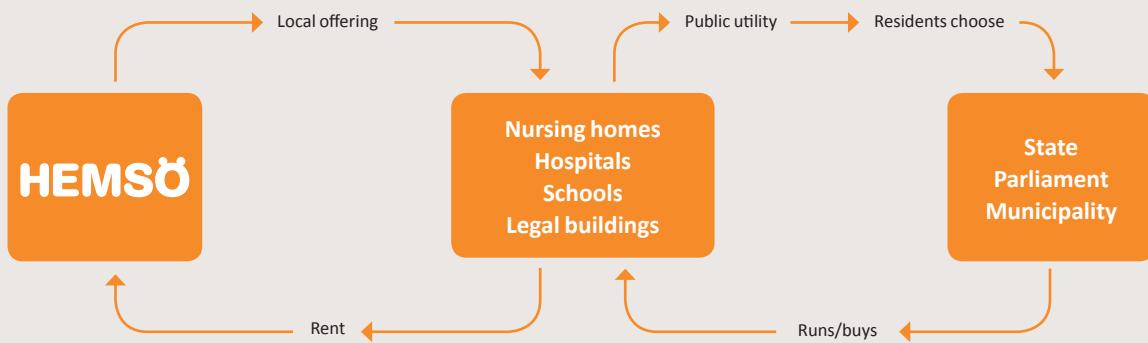
Trenum

Trenum's business concept is to invest in the new production of rental apartments in urban areas in Sweden. Today, Trenum manages properties with a market value of SEK 4.2 billion. The company is owned by Balder (50 per cent) and AP3 (50 per cent).

Ellevio

Ellevio owns, runs and develops regional and local power grids and distributes electricity to nearly 934,000 customers in Sweden. The customers are dispersed across Dalarna, Hälsingland, Gästrikland, Värmland, Närke, Bohuslän, Halland and the metropolitan Stockholm area. Most of the power grid is found in the countryside whereas most of the customers are found in Stockholm. The company is owned by a consortium comprising AP3 (20 per cent), Folksam (17.5 per cent) and AP1 (12.5 per cent), as well as OMERS Infrastructure (previously Borealis Infrastructure Management) (50 per cent), which invests in infrastructure for OMERS, one of the biggest pension funds in Canada.





Hemsö meets the needs for social infrastructure

Hemsö is a good example of how AP3 invests in infrastructure. There will be an enormous need for public properties for elderly care and schools in the near future. The opportunity to invest in Hemsö arose in the wake of the financial crisis and was implemented on the basis of AP3's real estate experience.

Hemsö focuses on public properties, i.e. social infrastructure, and it is the largest investor in this sector in Sweden. The infrastructure is distinguished by being specifically adapted to various forms of public service, which are primarily tax funded. Hemsö currently owns properties valued at SEK 38.9 billion and invested SEK 4.9 billion in 2017.

With the combination of AP3 as a long-term owner, Hemsö's project development expertise, and a society with a large need for education, healthcare and elderly care infrastructure, Hemsö is an investment that is well positioned to create value far into the future.

In AP3's assessment, Hemsö as a real estate investment distinguishes itself from other commercial properties due to a lower vacancy and rent level risk, and to significantly longer lease contracts. The greatest risk today, including for public properties, is higher long-term profitability requirements.

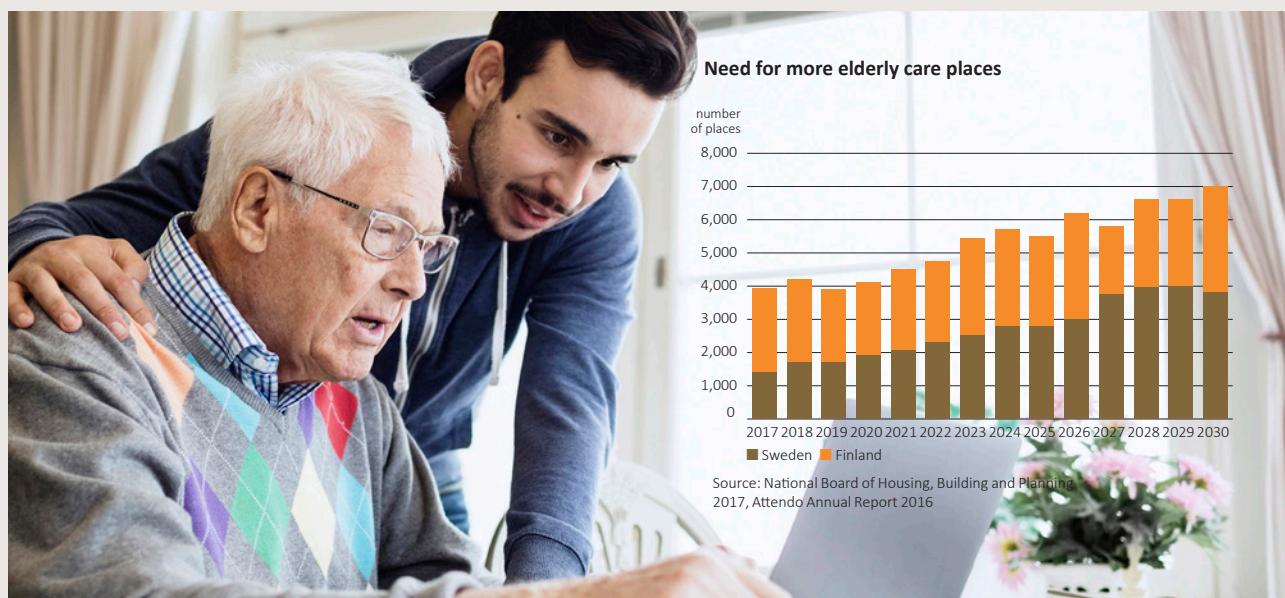
Hemsö creates substantial value by investing in energy efficiency, choosing sustainable materials and efficient waste management. With AP3 as owner, Hemsö naturally endeavours to comply with strict requirements for business ethics and with a high degree of social involvement. These initiatives also help build a stable, strong trademark.

Hemsö is also growing in Finland and Germany where the company chose to introduce its successful concept.

The investment in Hemsö has the following characteristics:

- creditworthy customers
- non-cyclical activities with stable earnings
- earnings protected against inflation
- growing demand for services is long-term and stable
- helps meet the needs of society

→ Further details are found on hemso.se



Insurance risks

Systematic, effective strategy

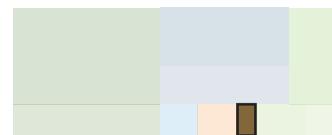
Since 2008, AP3 has been investing in various types of insurance-related, climate-related and weather-related securities. The Fund invests, for example, in catastrophe bonds, securities that are traded outside the more traditional financial markets. The return has a low correlation to other investments and helps stabilise the Fund's long-term return.

Investments in insurance risks are strategic and long-term. They contribute to making the insurance markets more efficient and, in the case of pandemic insurance, also help combat outbreaks of pandemics by promptly providing capital for emergency responses.

For AP3, this entails systematically bearing various insurance risks, e.g. the risk that hurricanes, earthquakes or floods will cause great damage. If no or only a few natural catastrophes occur, the Fund can expect a good return – but losses may be considerable during catastrophic years. AP3 is paid returns for bearing this risk. Over time, the Fund expects a sound, risk-adjusted return.

AP3 has built up expertise and an effective network in this field, not least through collaborations with universities, research institutions and strategic partners. The strategy is tailored to help stabilise the Fund's returns over time and is a good example of AP3's long-term approach and capacity to build up effective internal management within complex financial instruments. This strategy has proved its effectiveness, particularly during catastrophe-intensive years such as 2011 and 2017.

By analysing climate trends and relevant weather risks, such as the risk of a hurricane hitting land at a specific site, AP3 can make well-balanced investment decisions. The analysis also provides AP3 with good information about the actual short-term impact of climate change. Although today's climate is changing rapidly in a geological time perspective, it is changing more slowly in a financial perspective. The instruments in which AP3 invests have an average term of three years, which means that the pricing of insurance risks is adjusted significantly faster than the risk scenario for climate change itself.



1.2% of AP3's portfolio is invested in insurance risks.

In June 2017, AP3, as a leading investor, invested in a new type of catastrophe bonds to combat pandemic outbreaks in the world's poorest countries.

The investments are part of the Fund's strategy to spread exposure and stabilise returns, particularly in the event of a declining stock market. Investments also support efforts to achieve the UN Social Development Goals (SDG) to improve health.

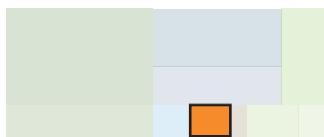
→ Read more about the UN goals on p. 33



2017 was a catastrophe-intensive year as hurricanes Harvey, Irma and Maria caused widespread devastation. AP3's strategy of direct, effective market access weathered these storms well. By analysing climate trends and various weather risks, such as El Niño, the Fund was able to take a well-balanced investment decision. Photos: NASA

Absolute return strategies

Return that differs from other investments



2.5% of AP3's portfolio is invested in absolute return strategies.



"During 2017, we significantly reorganised our portfolio of alternative risk-premia strategies. The portfolio is now structured entirely within our organisation and it is optimised with support from internal models," says Claudia Stanghellini, Head of External Management.

Through absolute return strategies, AP3 strives to generate a return that differs from other investments in terms of the way it is generated. The objective is to obtain a return that has a low correlation to the rest of the portfolio.

The strategies are generated both internally and externally and are designed to have return targets that resemble the rest of the portfolio. This means that the category per se must be able to deliver on a par with AP3's long-term return targets. Requirements are higher for external strategies, however, as these entail higher costs and less control for AP3, compared to internal strategies.

The most important aspect for AP3 is to evaluate the interrelationship of different types of absolute return strategies to enable the Fund to build an effective portfolio. AP3 rarely invests capital in these strategies, but rather assigns them a discretionary risk. However, the discretionary risk can be defined as an amount of capital, which is normally done when making allocations to external funds. Rather than using invested capital, derivative instruments and long/short strategies are frequently applied.

AP3's absolute return strategies

→ Internal absolute return strategies

For years, AP3 has been successfully using internal risk mandates based on a highly specialised strategy in the area of shares, fixed income and currencies.

→ External absolute return strategies

AP3 has been involved for many years with external hedge funds in different categories. The group of suppliers has been revised in recent years along with changing market conditions, while the total cost of hedge funds has been reduced.

→ Alternative risk premia strategies

Since 2011, AP3 has been applying strategies that are exposed to alternative risk premia. These risk premia are included in AP3's traditional investments only to a small extent. Value creation can be increased by pursuing dedicated strategies based on risk premia such as value, quality, momentum or volatility.

Example of evaluation of individual strategy in terms of projected risk and return



For strategy 1, the projected return is 6.5% per year and the expected scope for results is defined as plus/minus one standard deviation of 5.7% around this trend.

— Strategy 1 — $\mu = 6.5\%$ — $\sigma = 5.7\%$ — $\sigma = -5.7\%$

Evaluating absolute return strategies

- Return and risk for each strategy
- Contribution of risk to the entire portfolio of absolute return strategies
- Correlation between strategies
- Risk factor analysis of individual strategies



“Dialogue and engagement for long-term value creation”

AP3 has a long tradition of working with sustainability issues as an integral part of its investment model. Mårten Lindeborg, Deputy CEO and Chief Investment Officer, has the issue high on the agenda.

What does it mean for AP3 to be a responsible investor?

“For us, responsible investments mean long-term value creation that takes future generations into account. Our aim is to strengthen the pension system without sacrificing returns. This does not prevent us from having ambitions in the field of sustainability, since this is instrumental in securing the investment. Human rights, anti-corruption as well as the environment and climate change are examples of areas that are given special consideration in our stewardship.”

Can you give some examples from the past year?

“We have increased our investment in green bonds, which now amounts to SEK 13 billion. We've also entered into a new insurance instrument as a leading investor, developed by the World Bank to limit the spread of pandemics.”

What is the most important sustainability issue facing AP3?

“Ultimately, it's a question of trust. As owners, we must be able to rely on companies, and they must be transparent. A key issue is therefore that there's no corruption at any level of the business. AP3's experience is that companies that take an active approach to climate change and social issues are often well-run, which means that they are in a better position to

deliver high returns at a lower level of risk compared to other companies.”

Is it a good idea to set specific sustainability targets?

“Yes, I think so. People usually say that what is measured gets done. It is important to us to focus on the areas where we have the most impact. That has been the basis for our four sustainability targets.”

How does AP3 work with sustainability issues in relation to the portfolio's close to 3,000 listed companies?

“The basic principle is that AP3 demands more from large and established businesses than from small companies and startups. We have many holdings in our portfolio, and this means that corporate governance is pragmatic, which in turn means that it is adapted to the invested capital in question. In Sweden, where AP3 has a large presence, we are in continuous dialogue with the companies. In the international portfolio for large companies, we also cooperate with other investors - mainly through the AP funds' Council on Ethics - to pursue sustainability issues. In our international portfolio of small businesses, which in terms of numbers dominate AP3's shareholding, we work with systematic tools such as screening, which makes the portfolio more sustainable.”

Well-managed companies – pivotal to AP3's corporate governance

AP3's corporate governance is grounded in three principles: engagement, action and positive change. As an institutional investor with a major presence in the Swedish equity market, we can engage proactively and urge companies to embrace positive change.

12,000

In 2017, AP3 voted on 12,000 issues

Involvement in many different governance issues

AP3's corporate governance policy includes a number of basic principles for stewardship and specifies the way the Fund responds to the companies' social and environmental responsibilities. AP3 uses a variety of methods and tools to exert influence. These include exercising the right to vote and speak at company general meetings, to hold seats on nomination committees and to engage in dialogue. Sometimes the impact is apparent, such as when investors act to make changes at board level. But often the process takes time. AP3 has a long track record of working with other investors to moderate the remuneration of senior executives and to achieve greater gender diversity on company boards.

It is important to provide feedback to the companies in order to explain the Fund's viewpoints in various investor matters. For example, as part of the Fund's climate strategy, AP3 tries to influence portfolio companies through active corporate governance. The companies are asked to develop their own climate strategy – to measure their carbon footprint and adapt and develop their activities to reduce their climate impact.

AP3 focuses on 100 of the world's "dirtiest companies", i.e. companies with a big carbon footprint, and urges them to embrace positive change. During 2017, the commitment was increased to include more companies and to include more sustainability issues such as greater gender diversity on company boards.

837

In 2017, AP3 participated in 837 shareholders' meetings outside Sweden

62

In 2017, AP3 participated in 62 Swedish annual general meetings

Different lobbying strategies

AP3 has holdings in close to 3,000 companies, 190 of which are Swedish. We have different strategies for exerting influence depending on our shareholdings, and we focus on areas where we believe we can have the most influence and achieve maximum impact.

- In wholly owned companies or companies in which AP3 is a major investor, such as our unlisted real estate companies, we can directly influence company strategies through representation on the companies' boards of directors.
 - In foreign listed companies, our shareholdings are smaller and we have a more limited impact on our own. In these companies, we often exert influence in collaboration with other owners.
 - In Swedish listed companies, we have larger holdings and we engage actively mainly through dialogues, voting at general meetings or participation in nomination committees.
- In 2017, AP3 participated in five nomination committees.

Active corporate governance is AP3's method for promoting long-term sustainability practices and influencing portfolio companies to move in the right direction.



The AP funds' Council on Ethics – ten years of collaboration for dialogue and influence

The collaboration in the AP funds' Council on Ethics was established ten years ago and much has happened since 2007. Initially, the work focused primarily on reactive dialogues, i.e. dealing with companies where something had gone wrong in various sustainability issues. Today, increasingly more time and resources are spent on preventive work.

The mission of the Council on Ethics is to encourage companies to address sustainability issues in a structured and systematic manner, to become more transparent about the risks and options available and to act responsibly.

Through the Council on Ethics, the AP funds have developed a shared value system for sustainability, which signifies that the funds act based on the principles of engagement, action and positive change. The objective is to make a difference. The Council on Ethics' work consists mainly of identifying companies that are associated with breaches of the international conventions signed by Sweden. Moreover, the Council on Ethics works through dialogue in various forms to try to influence companies to deal with challenges. Further, the Council on Ethics works with external assistance to introduce preventive systems and measures to hinder future convention breaches. The Council on Ethics also participates in industry and investor initiatives to influence companies to increase transparency and act more responsibly.



"In 2017, the Council on Ethics continued to focus on company dialogues, preventive projects and strengthening collaborations," says Peter Lundkvist, Senior Strategist and Head of Corporate Governance at AP3 as well chairman of the Council on Ethics in 2017. During the year, we have also drawn attention to the Council on Ethics' development and work during the past ten years by holding seminars with leading role models such as Al Gore and Johan Rockström as catalysts. They expressed the view that the Council on Ethics is working admirably to move the issues forward.



The Council on Ethics visited Guatemala in 2008 and 2010 to collect information and later evaluate the result of intensive lobbying activities relating to human rights. The work produced good results and provided lessons for other mining companies.



Over the years, seminars and training courses have been important in driving positive change. Examples include the financing of low-fossil initiatives, the issue of taxation and the UN guiding principles on human rights.



Dialogues are held and influence is exerted in various ways, and the Council on Ethics has often influenced issues by being present in different parts of the world.

Collaboration for dialogue and influence

The Council on Ethics is a collaboration arrangement between AP1, AP2, AP3 and AP4 to influence companies through dialogue to make improvements and thereby better investments. The Council on Ethics aims to contribute positively to the AP funds' long-term return by influencing companies to become responsible businesses regarding environmental and social issues.



Council on Ethics
Swedish National Pension Fund

AP3's sustainability targets focus on climate change

In 2014, AP3 chose to set climate-related sustainability targets for 2018 with the conviction that measurable objectives drive actual change.

Climate change makes demands on society's use of resources and impacts our portfolio performance. In 2014, AP3 decided to increase the level of ambition for the fund's sustainability work by setting specific targets for 2018. We have therefore chosen to focus specifically on climate pressures by setting specific targets. We have a high level of ambition for sustainability work, and setting targets to drive change has proven effective.

The four overall sustainability targets highlight the key areas where we can make the greatest impact and where we have the best prospects of influencing society to move in a sustainable direction, without compromising our investment returns. The targets were set to reduce the portfolio's carbon footprint, increase investment in the field of sustainability and to operate real estate companies that are even more climate smart.

AP3's sustainability targets for 2018

Follow-up 2017

| | | |
|---|---|---|
|  | Halving the carbon footprint The carbon footprint of our listed equity and credit holdings will be halved by 2018 compared to 2014. AP3 encourages all investees to report their carbon footprint by 2018. | At 31 December 2017, the carbon intensity had been reduced by 45%.  Read more on page 27 |
|  | Tripling green bonds In accordance with COP21, AP3 seeks to promote the development of the green bond market by more than tripling our holdings of green bonds from SEK 4.5 billion in 2015 to SEK 15 billion by the end of 2018. | At 31 December 2017, AP3 had invested SEK 13 billion in green bonds.  Read more on page 29 |
|  | Doubling strategic sustainability investments AP3 aims to double its strategic sustainability investments from SEK 10 billion to SEK 20 billion by the end of 2018. | At 31 December 2017, AP3 had committed a total of SEK 25 billion to strategic sustainability investments. The target has thus already been achieved.  Read more on page 30 |
|  | Working for green buildings AP3 works to ensure that Vasakronan, in which AP3 owns a 25% equity stake, will continue to lead the way in sustainability in the real estate sector in Sweden. We also make it a priority to ensure that our other real estate companies (Hemsö, Trophi, Regio and Trenum) adopt ambitious sustainability policies modelled on Vasakronan. | Vasakronan was designated the most sustainable real estate company in Sweden in 2017 by Sustainable Brand Index™ B2B.  Read more on page 31 |

A filled circle means that the target for 2018 has been achieved.

Sustainability target

Halving the carbon footprint



Climate change is a serious global challenge requiring large changes in how we use the world's resources. Investors play an important role in managing related risks. In its climate strategy, AP3 has chosen different ways to manage the risks caused by climate change.

Investors have several different strategies for reducing the climate impact that their investments usually cause:

- Influencing companies to reduce the climate impact of their activities.
- Reducing the carbon footprint in the portfolio by refraining from investing in companies and sectors assessed to have the greatest impact on climate change.
- Investing in new solutions that will help reduce climate impact.

In recent years, AP3 has chosen not to invest in companies that are active in coal production, a decision made purely on investment grounds. On the other hand, AP3's basic view is not to disclaim responsibility for emissions by divesting from companies with climate challenges, as this is not the most effective solution.

Instead, we try to influence investees to embrace positive change through active corporate governance and engagement. This is primarily a matter of convincing companies to measure their carbon footprint and then adapt their operating activities to reduce it. AP3 has ongoing dialogues with the portfolio companies



- that have big carbon footprints and aims to ensure that they reduce their climate impact over time. We also invest in assets that reduce the climate footprint. An example of this is green bonds, in which AP3 is a major investor in Sweden.

Continuous reduction of carbon dioxide emissions in the portfolio

Measuring and reporting the carbon emissions from our investments is part of AP3's climate work. The carbon footprint provides important information about the climate risk in the portfolio and forms the basis for our dialogue with the portfolio companies. By the end of 2018, our target is to have halved the carbon footprint of our listed equity and credit holdings from 2014 levels.

Our climate impact continued to decrease in 2017, although the absolute carbon footprint decreased less due to an increase in the market value of the equity portfolio during the year. When adjusted for the increase in value, the carbon footprint reduction was 8 per cent compared with 2016 and 45 per cent compared with 2014. At 31 December 2017, AP3's carbon footprint was 45 per cent lower than that of the benchmark index.

Timberland investments have a positive impact on climate change

Thanks mainly to the timberland portfolio, the portfolio was carbon-neutral when we first measured its carbon footprint in December 2014. Our timberland holdings are certified by the Forest Stewardship Council (FSC), which guarantees that they are managed sustainably. Forests bind carbon dioxide, and AP3's timberland portfolio is a key component in reducing our carbon footprint and climate impact.

An analysis of our timberland holdings, equivalent to 208,000 hectares of forest, shows that a total of 40 million tonnes of carbon dioxide is stored in the forests. If we include the carbon dioxide stored by biomass below ground, the amount is even higher. Taking only forest growth into account, the amount of annual sequestration equals the amount of carbon dioxide produced each year by companies in our listed equity portfolio.

| AP3 carbon footprint of listed equity | 2017 | 2016 | 2015 | 2014 |
|--|-------|-------|-------|------|
| The equity portfolio's absolute emissions of greenhouse gases (Scopes 1 and 2) (million tCO ₂ e) ¹ | 1.2 | 1.2 | 1.4 | 1.7 |
| AP3 compared with MSCI ACWI (at 31 Dec 2017) | -45% | -47% | -44% | -27% |
| Carbon intensity related to share of the companies' market value (tCO ₂ e/SEK million) ² | 9.4 | 10.2 | 12.2 | 17.1 |
| Carbon intensity related to share of the companies' turnover (tCO ₂ e/SEK million) ³ | 15.7 | 15.9 | 18.5 | 25.3 |
| Carbon intensity, weighted average (tCO ₂ e/SEK million) ⁴ | 14.8 | | | |
| Market value of the Fund's portfolio covered by CO ₂ e data (SEK billion, at 31 Dec 2017) | 126.1 | 120.5 | 141.4 | 94.9 |
| Percentage of total share capital for which data is available (%) | 83 | 78 | 81 | 76 |

1) CO₂e (carbon dioxide equivalent) is a unit of measure that makes it possible to compare the climate impact from various greenhouse gases.

2) The sum of the Fund's share of the companies' emissions divided by the total market value of the Fund's listed shareholdings.

3) The sum of the Fund's share of the companies' emissions divided by the sum of the Fund's shares of the companies' turnover.

4) The sum of the companies' share in the portfolio (based on market value) multiplied by the companies' carbon intensity in relation to turnover.

The formulas for the above indicators can be found on AP3's website.

Source: Trucost

Sustainability target

Tripling green bonds



As one of the first investors, AP3 invested SEK 450 million in the World Bank's very first green bond in November 2008. Since then, more than USD 350 billion¹ has been borrowed through green bonds. Green bonds have thus played a decisive role in directly involving financial investors and borrowers in the climate issue worldwide.

AP3 has now invested 11 per cent of its bond portfolio, totalling SEK 13 billion, in green bonds with a target of reaching SEK 15 billion by the end of 2018. In 2014, a consortium of banks drafted the Green Bond Principles² to specify the definition of a green bond. The most important principle is that capital from a green bond must be used for projects that will benefit the environment.

AP3 regards green bonds as a financial instrument that has a direct impact on the borrower's behaviour. The option of attracting capital through green bonds affects the borrower's focus and commitment to environmental issues. Funding itself is an important area, and one in which AP3 deems it can exercise sound judgement and make the best contribution to a sustainable development.

We have built a diversified portfolio of bonds for the benefit of projects in Sweden and worldwide by investing in borrowers such as the World Bank, Kommuninvest, City of Gothenburg, Asian Development Bank, African Development Bank, Nordic Investment Bank, Hemsö and Fortum Värme. In late 2017, AP3 decided, in line with our ambition to promote the development of the green bond market, to invest in a green bond fund in emerging markets.

We contribute to the development of the green bond market as both investor and issuer through our real estate companies Vasakronan and Hemsö. Vasakronan was the first in the world to issue green corporate bonds, which is now a very fast growing market.

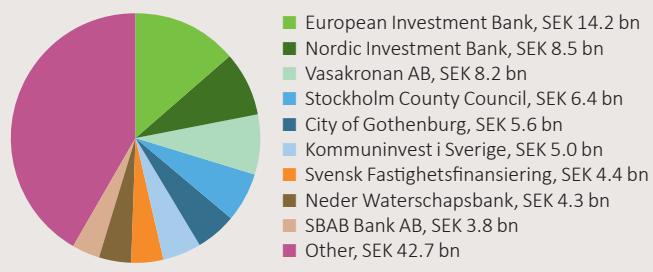
SEK 13 bn

AP3's holding of green bonds is now SEK 13 billion.

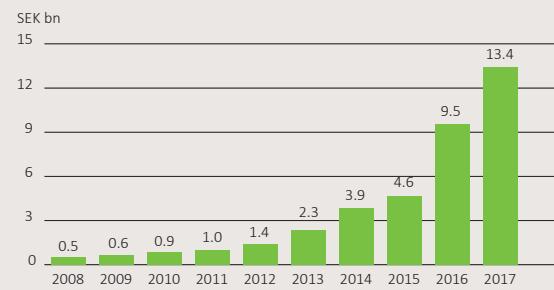


The City of Gothenburg is an example where projects such as electric cars and water treatment have been financed by green bonds. In accordance with the GBP, the City of Gothenburg produces an impact report on the projects financed by green bonds.

Green bonds issued in Swedish kronor during 2017



AP3's portfolio of green bonds



1) Source: SEB

2) Today, the Green Bond Principles (GBP) are updated by the International Capital Market Association (ICMA) in cooperation with a steering group of international investors, issuers and banks.



Sustainability target

Strategic sustainability investments focusing on water treatment

AP3 has invested SEK 4 billion in water treatment and water-related infrastructure, and continues to work to achieve the target of doubling strategic sustainability investments by 2018. In these efforts, AP3 maintains focus on water treatment and water infrastructure. AP3 has invested a total of SEK 25 billion in strategic sustainability investments.

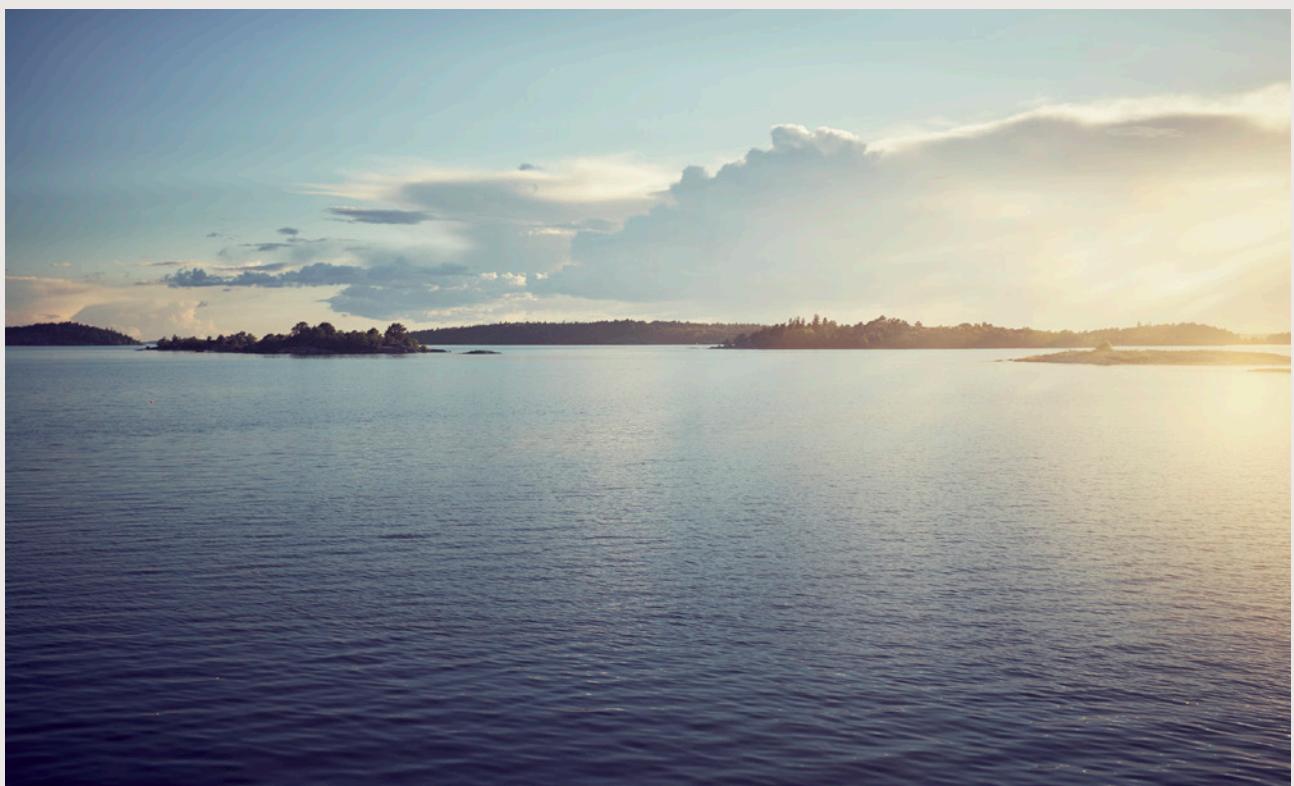
SEK 4 bn

From 2014 to 2017, AP3 invested SEK 4 billion in water treatment and water-related infrastructure.

Water is essential to our everyday lives, to many industrial processes and to the production of food. Water-related crises are among the top sustainability risks in the world and can lead to diseases and conflicts and bring industries to a grinding halt - which in turn affects economic growth.

All investments in companies and structures that are able in various ways to counteract or mitigate these risks are important. It is also important to understand the real impact of these investments.

In the coming decade, multi-billion dollar amounts need to be invested in solutions to global climate change and water problems. During 2017, AP3 participated in a working group with other investors, which developed a feasibility study on the need for water investments in Sweden and the measures that would be needed to promote them. Collaboration between various stakeholders is essential to meet the challenges posed by climate change and transform them into good investment opportunities.



Sustainability target



A green real estate sector, with Vasakronan serving as a model

Inspired by Vasakronan, Sweden's largest property company, AP3's other real estate investees are developing their sustainability policies.

Vasakronan's properties are packed with sustainable solutions – from solar cells on the roof to charging bays for electric cars in the basement. Other real estate companies have copied Vasakronan's solutions – resulting in a more sustainable real estate sector. At the same time, tenants are increasingly requiring "green buildings" to address carbon footprint reduction ambitions. Moreover, profitability is positively affected by lower energy costs.



Green walls and roofs boost energy savings.

Vasakronan develops its properties and the local environment step by step

On rooftops, solar energy is received and biodiversity is maintained

The properties have green walls and roofs. They handle storm water, clear the air, cool and heat the buildings and contribute to biological diversity. Beehives, insect hotels and bird-houses are put up to further strengthen the biodiversity of the city.

Focus on effective energy consumption in the properties

Approximately 84 per cent of the property portfolio is environmentally certified, and the buildings use half as much energy as similar buildings in Sweden. From 2017, 100 per cent of new rental agreements are green.



Solutions for environmentally friendly means of transport are found underground

There are 700 charging bays for electric cars, and just over 50 per cent of the tenants have access to a carpool at their own or a neighbouring property. One hundred per cent of the buildings have recycling stations, and bicycle sheds and bike services are available at several of the properties.

Electric vehicles are used locally, and building materials are reused

Forty tonnes of construction materials were reused in connection with the rebuilding of the Sergel house, and deliveries and goods are brought to the tenants by electric vehicles through the "Beloved City" project. This reduces congestion, noise and emissions.

What do the AP fund stakeholders think about sustainability?

AP3's investments have an impact on people, the environment and society. To identify the most important sustainability issues, the AP1, AP2, AP3 and AP4 funds carried out a stakeholder dialogue during the autumn to discover what stakeholders consider the most important sustainability issues for the funds in the future.

Stakeholder dialogue in 2017

In November, a dialogue with representatives of our most important stakeholder groups was organised. The dialogue took place in workshop format, with approximately 60 participants representing employers (the Ministry of Finance and the Pension Group), beneficiaries, society, industry colleagues, suppliers, employees and portfolio companies. The workshop was focused on identifying stakeholders' expectations and priority issues, receiving feedback on current sustainability work, and hearing stakeholders' thoughts on continued sustainability work.

According to all stakeholder groups, the most important issue is the way the AP funds make and manage their investments, as the most significant impact can be made in this area. Achieving good returns over the long term was considered a more general, overarching goal rather than a specific sustainability target.

Three issues were given top priority

While the choice of prioritised sustainability issues varied among the AP funds' investee companies and funds, three issues were highlighted as being particularly important and were given top priority:

- indirect environmental impact
- indirect impact on climate change
- human rights

An ethical approach to business was considered by many participants to be an operational prerequisite. Business ethics and compliance were also given high priority. Other issues considered essential were a sustainable supply chain, diversity and gender equality, and anti-corruption.

The concept of human rights was discussed, and the view was expressed that human rights may be a wider concept that also includes diversity, gender equality and working conditions.

Wish for transparency and communication

The stakeholder groups emphasised that the AP funds could instil more confidence through greater transparency and more active communication. This would particularly make future beneficiaries feel secure. Demonstrating the positive relationship between sustainability and long-term return would reinforce credibility.

The importance of cooperation - which is necessary for achieving good results - was also highlighted. Cooperation may take the form of partnerships with other owners or with other players, with synergies achieved in various ways.

Each AP fund intends to refine its prioritisation of sustainability targets on the basis of each fund's own characteristics. This work is continuing in 2018.



Considering the UN Sustainable Development Goals

The UN's 17 Global Sustainable Development Goals are a guide for global cooperation between governments, civil society and businesses. The goals were adopted by 193 member states in September 2015.

AP3 and the other AP funds support the UN's Sustainable Development Goals (SDGs) and have joined some of Europe's largest pension funds in signing a statement stressing the importance of institutional investors investing in businesses and solutions that actively promote these goals. For this cooperation, the group received a Responsible Investor Award for Innovation & Industry Leadership in the category Collaborations: Leading Institutional Investors Committing to the SDGs.

The following are examples of AP3's activities that are directly linked to the SDGs:

Goal 6. Clean water and sanitation

During 2017, AP3 made additional investments in water infrastructure, this time with a focus on both water supply and purification. We also cooperate with other investors to create more investment opportunities in water.

Goal 7. Affordable and clean energy

Solar energy continues to grow in importance in pace with technological developments and efficiency improvements. This energy source is therefore increasingly attractive to real estate companies, and a growing number of these companies – including Vasakronan, which is owned jointly by the AP funds – are increasing their focus on solar energy. AP3 also invests in private equity funds and listed companies geared towards sustainability, including renewable energy.

Goal 8. Decent work and economic growth

AP3 safeguards occupational health, safety and working conditions. The Fund engages in continuous dialogue with companies to combat unsafe working conditions, accidents, discrimination and child labour. The aim of these dialogues is to establish decent working conditions and to protect all work-

ers' rights. The AP funds' Council on Ethics plays an important part in these processes.

Goal 9. A well-functioning and sustainable infrastructure

Infrastructure generates positive effects that promote economic growth and development. AP3's investments and corporate stewardship contribute to more efficient use of resources, increased production capacity and sustainable economic growth, i.e. innovations and solutions for adapting to a changing world.

Goal 11. Sustainable cities and communities

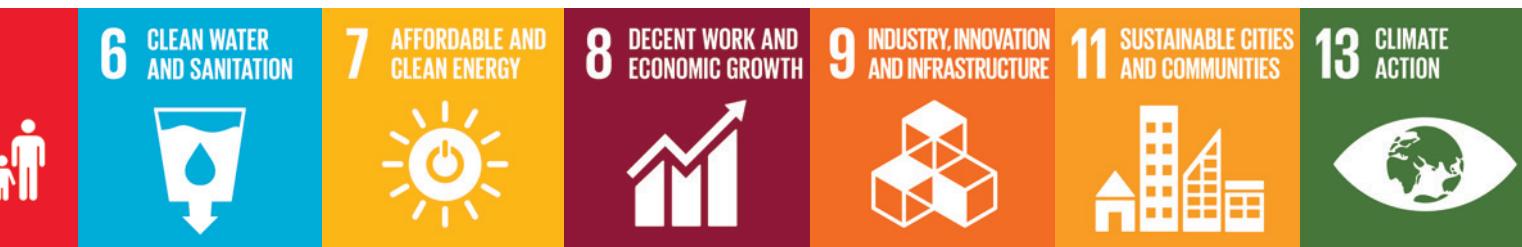
AP3 is a strong advocate of sustainable cities through our shareholdings and corporate stewardship. The Vasakronan real estate company is a leader in energy efficiency and efficient office spaces, and serves as a model for AP3's other real estate companies.

Goal 13. Climate

AP3 has the goal of halving the carbon footprint of the listed equities and credits portfolio by the end of 2018 over 2014 levels. When looking at all asset types, AP3's portfolio is carbon neutral thanks to significant investments in timberland and green bonds. We have a long-standing focus on green bonds and intend to increase this portfolio to SEK 15 billion at the end of 2018. Investment decisions also take account of companies' carbon footprint and climate impact.

Human rights

AP3's ambition is that the concern for human rights must always come first with respect to our investments. In 2018, the Fund will further emphasise the importance of human rights through various projects.



AP3's activities are directly linked to six of the SDGs.

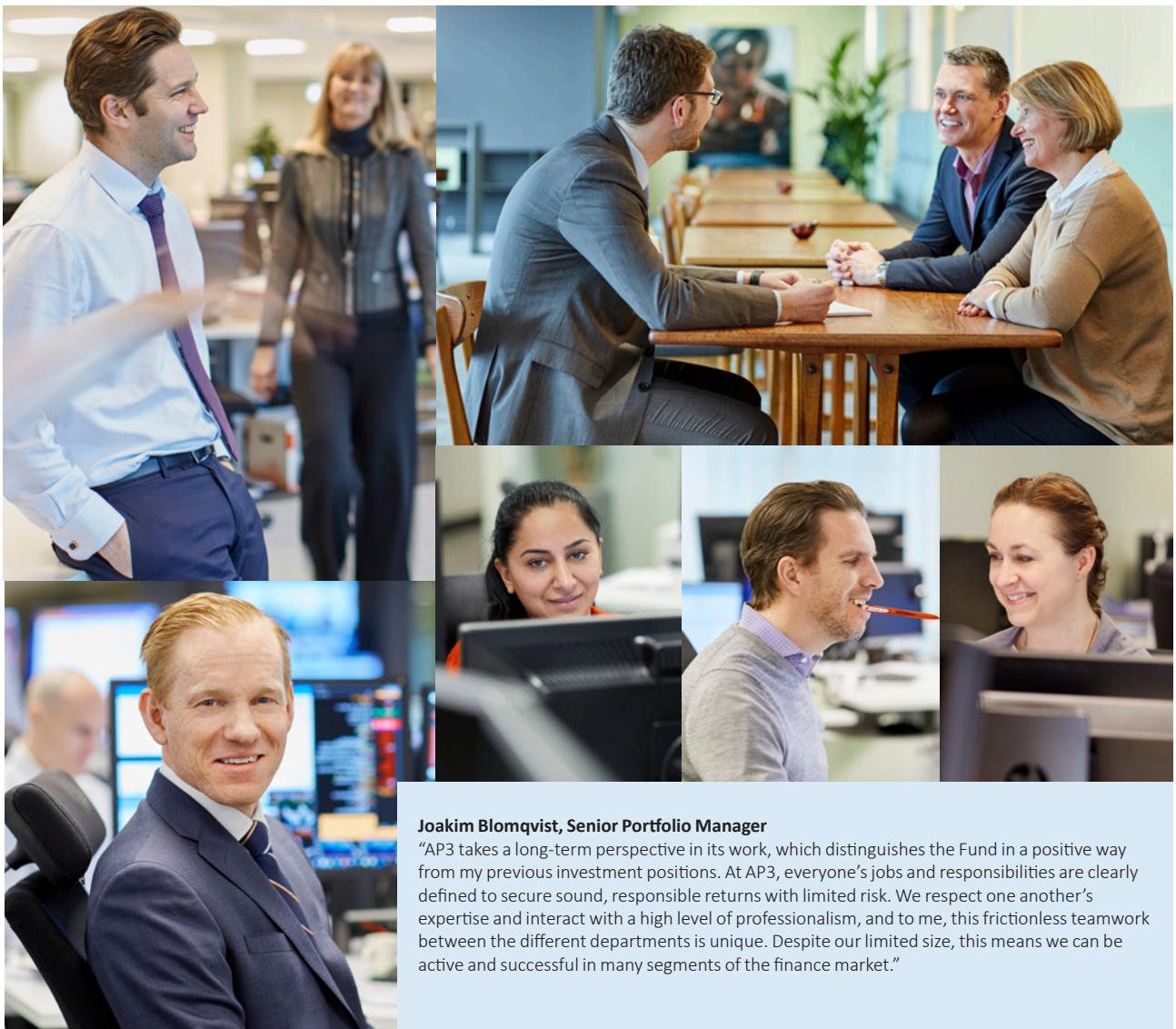
With a mission to manage the buffer capital

AP3's mission requires professional performance and the consideration of factors in multiple areas to ensure that the investment activities achieve results and is done responsibly. With the Swedish state's basic principles as the starting point, AP3's fundamental values build on accountability, professionalism, transparency and a long-term perspective.

AP3 has highly experienced employees who work together to provide and secure both asset management and analyses of risks and returns. Less than 60 employees work to manage a global investment portfolio of SEK 345 billion. AP3's ambition is to ensure that our asset management is cutting edge, which requires the continuous development of know-how and constant cultivation of a global contact network. It is equally important to develop a strong operational infrastructure comprising business systems and other support functions.

To be able to attract and retain expert employees, AP3 aims to provide:

- Clear-cut assignments to specialists in a professional asset management environment
- Contacts, sharing and exchange with other investment organisations throughout the world that are at the very cutting edge of economic and financial development
- A working environment that promotes personal development by encouraging initiative and creativity



Joakim Blomqvist, Senior Portfolio Manager

"AP3 takes a long-term perspective in its work, which distinguishes the Fund in a positive way from my previous investment positions. At AP3, everyone's jobs and responsibilities are clearly defined to secure sound, responsible returns with limited risk. We respect one another's expertise and interact with a high level of professionalism, and to me, this frictionless teamwork between the different departments is unique. Despite our limited size, this means we can be active and successful in many segments of the finance market."

Diversity and gender equality are critical factors in enabling AP3 to achieve its goals. This is based on the Fund's conviction that diversity creates added value and contributes to the fulfillment of its mission. As an employer, AP3 strives to take a proactive approach to these matters.

Focused actions for cutting-edge activities

A cutting-edge undertaking needs to continuously develop its employees and processes. Employees are developed through training, education, seminars and conferences.

During the year, the AP3 Academy hosted lectures held by external and internal speakers on digitalisation and sustainability issues.

A modernised way of working requires and is contingent on leadership that can lead and support this change process. AP3 conducted a training programme in 2017 aimed at enhancing executives' communication skills and consolidating the corporate culture, increasing efficiency and improving teamworking skills. In addition, AP3 – along with AP1, AP4 and AP7 – began a training programme for specialists aimed at developing and retaining specialist expertise within the funds.

AP3 is strongly positioned as an attractive employer. Several employees with excellent experience and expertise were recruited in 2017 to further consolidate AP3's operations.



Kamilla Burman, Head of Compliance and company lawyer

"Since its inception, AP3 has had a keen focus on regulatory issues. The finance sector's regulatory framework has become much more comprehensive over the years, and fewer errors are tolerated today than was previously the case. The Compliance department plays an important part at the Fund, particularly in light of the many new rules and regulations that have been introduced recently. The department is tasked with ensuring that relevant regulations are known, understood and applied throughout the organisation. This includes giving the organisation the support and tools it needs to operate in compliance with prevailing laws and regulations. In my position I can help enhance employees' understanding of the importance of regulatory issues, to create a culture in which employees take responsibility and understand the importance of doing things properly. This is very satisfying and stimulating!"

Systematic evaluation for continuous learning

The AP3 board of directors continuously evaluates investment performance over an extended period of time. The evaluation has four subcomponents that monitor asset management activities and serve as a learning process for development.

1. Returns relative to the real return target of 4 per cent

AP3 evaluates achieved return as compared with the portfolio's target across two time metrics: since inception in 2001, and in running 10-year periods. Since inception, the real return has increased by 4.6 per cent per year. Over the past 10-year period, the real return was somewhat higher (5.1 per cent per year).

2. Returns benchmarked with a long-term static portfolio (LSP)

In this comparison, AP3's results are benchmarked with the return of a portfolio that is the lowest-cost asset management alternative available. LSP includes only listed equities (50 per cent) and fixed income securities (50 per cent). LSP is rebalanced on a monthly basis but is not encumbered with transaction costs. The static portfolio represents an investment that should be capable of generating a real rate of return of 4 per cent in the long term.

The benchmarking aims to evaluate whether AP3's decisions to use resources to implement a more complex investment strategy and a more active asset management strategy are valuable. During 2017, AP3's portfolio rose by 8.8 per cent compared with 6.7 per cent for LSP, equating to SEK 6.4 billion more than LSP. Since the benchmarking was introduced in 2012, AP3 has had a 22 percentage points

higher return after expenses than LSP. This equates to SEK 43 billion, which has thus helped further consolidate the pension fund system.

3. Key figures benchmarked with a peer group

AP3 is tasked with achieving a high standard of asset management on an international level, and measures its performance against an international benchmark group of asset managers. The external consulting firm CEM Benchmarking has identified funds with a profile similar to AP3 in terms of mandate, assets under management and return targets. In 2016, CEM research found our costs to be 31 per cent lower than the average fund in this international peer group. Between 2011 and 2015, the peer group recorded a median annual return of 7.6 per cent, compared with 9.3 per cent for AP3.

4. Self-assessment of allocation decisions

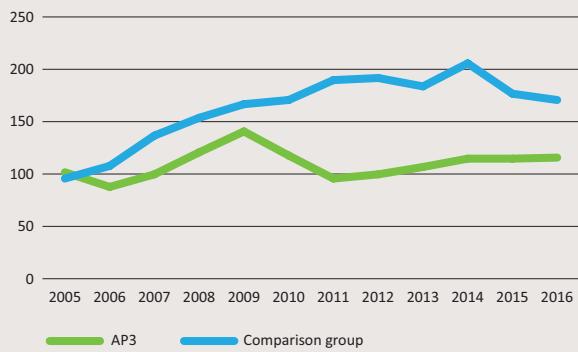
The fourth part of the performance model is a self-assessment of the quality of AP3's investment management process, and covers analysis, strategy and implementation. The management process also includes the sustainability strategy and objectives set by AP3 for 2018. The self-assessment enables the board of directors and management to monitor the asset management team's ability to assess financial market developments correctly.

AP3 compared with LSP, 2012–2017, indexed development



Since the long-term static portfolio was introduced as a benchmark in 2012, AP3's returns have outperformed LSP by 22 percentage points.

Costs, indexed, 2005–2016



Since 2005, AP3 has participated in an annual international study carried out by the Canadian consulting firm CEM Benchmarking. In the study, AP3 is benchmarked with other international pension funds with a similar mandate and size. The most recent study covered 2016 and shows that AP3's costs are 31% below the costs of similar international funds.

Cooperating to increase resource efficacy

Cost-effectiveness is a key component in instilling trust, particularly considering the fact that AP3 determines its costs autonomously. Projected return, risk and costs are considered whenever the Fund makes an asset management decision.

Cost effectiveness more important than low costs

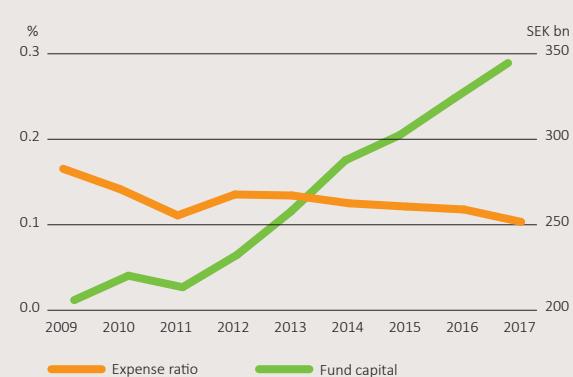
To assess the costs of asset management operations, costs are usually compared with the assets managed to produce a "management expense ratio". With its high level of expertise, and due to the fact that managed assets have grown over time, the Fund has succeeded in reducing its management expense ratio. This ratio was 0.10 per cent in 2017 – a highly competitive ratio for AP3's asset management activities in an international perspective.

The key reasons for AP3's cost-effective investment model are:

1. Assets are primarily managed internally, which builds internal expertise to maximise AP3's ability to create value through active stewardship and quantitative modelling.
2. AP3 forms its own companies in unlisted undertakings such as real estate.

3. Economies of scale are achieved by focusing on areas that have potential to impact the results of the portfolio as a whole, and by restricting investments in small subsegments that require new resources and new expertise.
4. Cooperating with other asset managers, not least the other AP funds.

AP3's fund capital and expense ratio



Cooperating with other AP funds

The structure of four autonomous buffer funds has nurtured healthy competition and supported a cost-effective investment model. The funds cooperate to reduce costs and efficiently use resources in areas that do not jeopardise inter-fund competition.

One of the most important areas of teamwork is within

the framework of the AP funds' Council on Ethics, which conducts dialogue with listed companies to influence companies in environmental and ethics issues. Nine other collaborative groups standardise and streamline the AP funds' administration, share expertise and experience, and engage in joint procurement.

The ten collaborative groups:

- ➔ Council on Ethical of the AP funds
- ➔ CEO meetings
- ➔ Cooperation council
- ➔ Accounting group
- ➔ HR manager group
- ➔ IT manager group
- ➔ Business control
- ➔ Legal group
- ➔ Communications manager group
- ➔ Risk & performance group



Fund governance report 2017

The fund governance report was prepared in conformity with the Annual Accounts Act and relevant provisions of the Swedish Code of Corporate Governance. It includes information about governance, board administration, work and remuneration, as well as a summary of focus issues for board work over the year.

Government body

AP3 is a state pension fund that differs from other government bodies in its autonomy from the government. The Fund's operations are almost entirely regulated by statute and the government has waived its regulatory oversight.

Board of directors

The AP3 board has nine members, all appointed by the government. Two directors are appointed from nominees of employee organisations and a further two from nominees of employer organisations. The chairman and deputy chairman are appointed from among the members who are not nominated by staff or employers.

The government's "Policy for Governance and Evaluation of the AP funds" stipulates that a time limit on board membership of eight years is considered reasonable.

Board administration

The National Pension Insurance Funds Act gives the board of directors full and collective responsibility for AP3's administration within the parameters set by parliament for the Fund's organisation and the management of its assets. Board responsibilities and activities not prescribed by statute are set out in the board's work plan which is approved annually by the directors.

The National Pension Insurance Funds Act also requires the board to approve an annual operating plan. The operating plan must contain guidelines for investment activities and for exercising AP3's voting rights in portfolio companies. It must also contain a risk management plan. Beyond this, the board's primary tasks are to set operating targets, to recruit and monitor the performance of the CEO, to manage strategic documents and to make decisions on overall Fund strategy, including risk levels, exposure and risk thresholds, results of operations, budget approval and monitoring and resource allocation.

At every board meeting, the directors discuss current allocations and any potential changes to the portfolio. Effective control and monitoring are necessary to ensure that board decisions are implemented, that risk management is effective and that the Fund operates in an appropriate manner. The risk management plan sets the framework for control and compliance. In addition to approving the corporate governance policy, the board also manages other corporate governance policy issues, such as areas of focus during the upcoming AGM season. Day-to-day corporate decision-making is delegated by the board to the CEO, although decisions to exclude a company from AP3's investment universe are taken by the board.

In addition to board members, the CEO and other AP3 employees also attend board meetings as experts or in a reporting capacity.

Review of board administration

The board of directors conducts an annual review of its own performance. The 2017 review takes place in the spring of 2018 and will be carried out by external consultants.

Board committees

The board of directors has two committees: the remuneration committee and the audit committee.

The remuneration committee is tasked with ensuring that salaries and other remuneration are market-based, competitive, appropriate and reasonable. The committee oversees and monitors the implementation of government guidelines for senior managers at the AP funds. It also reviews the CEO's salary and benefits. The committee approves the salary and benefits of senior executives on the basis of recommendations by the CEO. The remuneration committee also prepares the remuneration framework for other employees on behalf of the board and evaluates the Fund's performance-based remuneration system. In 2017, the committee members were Pär Nuder (chairman), Lars Ernsäter and Peter Hellberg. The CEO serves as a co-opted member in all issues not relating to the CEO's own remuneration.

The audit committee has an advisory and oversight role on behalf of the board. The committee oversees financial reporting and monitors the audit process. AP3's auditors attend the audit committee meetings at which the final audit and audit management are discussed. The audit committee also monitors the efficacy of internal control and risk management. This includes preparing proposals for the board to approve on the risk management plan, follow-up of the Fund's annual operational risk evaluation, decisions on specific internal audits and ensuring that such audits are completed and reported to the committee and the board, and ensuring that any reminders or deficiencies that emerge are corrected. The committee also acts to ensure the impartiality and independence of the auditors. In 2017, the committee members were Björn Börjesson (chairman), Kerstin Lindberg Göransson and Inga-Lill Carlberg, who was replaced by Malin Björkmo during the year.

Remuneration of directors

The government sets the fees and other remuneration payable to directors. Board fees are SEK 100,000 for the chairman, SEK 75,000 for the deputy chairman and SEK 50,000 for other directors. These fees have remained unchanged since 2000. The government also has an annual fund of SEK 100,000 to remunerate directors for committee work and other special assignments. In 2017, the board used this fund to pay fees of SEK 26,520 to the chairman of the audit committee and SEK 21,220 to other audit committee members, and fees of SEK 10,300 to all remuneration committee members (including the chairman).

Board of directors in 2017

The board held six scheduled meetings during 2017. In addition to finalising the annual accounts, budget, operating and risk management plans, the board also dealt with the following areas and issues:

New AP Fund regulation

In early July, the government presented its previously announced proposal for changes to the AP funds' regulation. Under the proposal, the lower limit of fixed income securities with low credit and liquidity risks is changed from 30 per cent to 20 per cent, and the restriction on unlisted securities is removed and replaced with a maximum percentage (40 per cent) of illiquid assets. The rules also propose that the AP funds must manage fund assets in an exemplary manner through responsible investments and responsible ownership. The board has thoroughly discussed the AP3's position on the proposal and which issues the Fund should discuss and the details of the comments to be submitted by the Fund.

AP3 welcomes the government's proposal for amending the investment rules to provide more favourable conditions for effectively meeting the Fund's targets. The Fund therefore largely approves of the memorandum's proposals and lines of reasoning. In some areas, however, AP3 does not agree with the proposal or considers that it needs to be adjusted or supplemented in order to produce effective investment guidelines. AP3 draws particular attention to the need for better infrastructure investment options.

AP3 has an essentially positive view of rules and regulations that incorporate sustainability aspects and provide

favourable conditions for making responsible investments. However, AP3 proposes a set of rules that, in keeping with the AP funds' regulations in general, are based more on principles and less on micromanagement. With respect to responsible investments, the consultation comments include specific alternative wording of the statutory text and preparatory work. Finally, AP3 proposes that the government's annual evaluation of the AP funds be supplemented with a parliamentary hearing, which could include an evaluation of the development of the state pension system as a whole, to enhance transparency and provide knowledge about the pension system.

Increased focus on regulatory compliance.

As state pension funds that solely manage state-owned assets, the AP funds are not normally covered by rules and regulations governing financial institutions, although these regulations often form a natural basis for what is considered best practice. Some rules and frameworks governing all financial market players, however, are significantly enlarged, e.g. market abuse regulation. Other regulatory frameworks comprise interventions that are so drastic that they impact the entire market, and thus also indirectly impact AP3 – these include Dodd Frank in the US, and EMIR and MiFID I and II in the EU. Overall, this has gradually intensified the board's focus on regulatory issues. This was particularly evident in 2017, during which, for instance, the board's compliance report was substantially enlarged and a new internal auditing policy was established.

Board meetings in 2017

| | Board meetings | Remuneration committee | Audit committee ¹ |
|--|----------------|------------------------|------------------------------|
| Pär Nuder, Chairman | (6 of 6) | Chairman (4 of 4) | |
| Björn Börjesson, Deputy Chairman | (6 of 6) | | Chairman (4 of 4) |
| Malin Björkmo | (6 of 6) | | Member from June (2 of 2) |
| Inga-Lill Carlberg (<i>left in 2017</i>) | (2 of 2) | | Member until May (1 of 1) |
| Peter Englund | (6 of 6) | | |
| Lars Ernsäter | (6 of 6) | Member (4 of 4) | |
| Peter Hellberg | (5 of 6) | Member (4 of 4) | |
| Kerstin Lindberg Göransson | (5 of 6) | | Member (3 of 4) |
| Christina Lindenius (<i>joined 2017</i>) | (4 of 4) | | |
| Elisabeth Unell | (5 of 6) | | |

¹) The audit committee had a vacancy at the meeting in June.

Risk issues

Understanding and managing different types of risk is fundamental to AP3's investment activities. At its strategy meeting, the board discussed the low real rate of return and how it affects various assets, the consequences of AP3's strategy in a low-interest environment with the expected new investment rules, and the Fund's home bias. The board also considers specific risks, including risk in the Swedish real estate market, and the wording of the Fund's risk management plan. AP3 annually reviews the Fund's total risks to identify and measure risks in all parts of the organisation with a view to taking action where appropriate. The risk analysis is based on self-assessments conducted internally throughout the organisation. The Fund also annually evaluates the risks associated with its main counterparties. The risk analysis and risk assessments are discussed by the audit committee and the board of directors.

Corporate governance issues

Strategy and policy issues are considered separately by the board. The board also discusses certain company-specific issues. During Sweden's AGM season, discussions continue to focus on board composition and gender diversity. For years, AP3 has argued for increasing the percentage of women on listed company boards. The Fund is very satisfied to note that the positive trend is continuing, with an increase again this year in the percentage of women on the boards of listed Swedish companies.

At the international level, AP3 continued to highlight its key

points of view on corporate governance. For example, AP3 opposed proposals that would limit board composition to male members, and voted against proposals that would merge the role of CEO and chairman of the board. AP3 also voted against proposals for overly extensive share options programmes, and opposed share-based incentive programmes that are not linked to clear and measurable performance criteria and that entail excessive dilution risk for shareholders.

Investment costs

Cost-effective asset management is always high on the agenda at both board and organisational level, and there is a high level of cost awareness. Costs are also addressed in the government's review of the AP funds and in the official response to this review issued by the Parliamentary Committee on Finance. The board evaluates cost-effectiveness on a quarterly and annual basis and also approves and monitors the budget. The board receives a yearly report on the external peer group study drafted by CEM Benchmarking, in which the Fund has been participating for several years. The CEM study compares AP3 with 18 global fund managers of equivalent size. The comparable funds are based in Finland, the Netherlands, the US, Canada, the UK, Australia and New Zealand, with average funds under management of SEK 326 billion. The most recent CEM study, from 2016, showed AP3's expenses to be 31 per cent lower than the benchmark group average. This was largely because AP3 pays less for its external mandates than the benchmark group and also because the Fund has a higher ratio of internally managed assets.



Internal and external control

According to the National Pension Insurance Funds Act, the board of directors is responsible for AP3's administration, organisation and overall activities. These responsibilities include ensuring that the Fund has effective internal controls. AP3 has a governance framework that defines its fund management systems, risk management and control structure. The board of directors issues general policies and guidelines that are operationalised via directives from the CEO. All management documents are revised at predetermined intervals.

One key document in the governance framework is the risk management plan, which is approved annually by the board. The risk management plan defines, among other things, the division of responsibilities within the AP3 organisation. The division of responsibilities and authority is designed to support the internal control structure to ensure that the internal control remains fully autonomous from the rest of the organisation. This binary structure is reflected in the access authorisation in the AP3's systems environment.

Control departments

The Fund's two control departments are Risk Control & Performance, which focuses on financial risk, and the Compliance department, which primarily addresses regulatory compliance and operating risk. Risk Control & Performance is tasked with defining, identifying, monitoring and controlling risks arising from asset management operations. It also identifies and reports any deviations from set limits. Limits are set at several levels to ensure that AP3 operates within statutory guidelines and the rules set by the board and CEO. The Chief Risk Officer (CRO) is responsible for the financial reporting.

The Compliance department is responsible for ensuring that AP3 operates within applicable external guidelines and in conformity with internal policies, guidelines and directives. This includes ensuring that the organisation is aware of relevant rules and applying them throughout the organisation. As part of these efforts, the Compliance department follows up on identified action plans relating to AP3's annual review of operational risk.

Reporting

Analysis and control are based on transparent daily reporting within the organisation of positions, risk and financial results. Management reports monthly to the board (and more frequently if required). Any breach of legal limits or limits set by the board is reported immediately to the board. Other incidents, including infringements of internal limits, are reported to AP3's Audit Committee. Significant incidents must be reported to the board as soon as they occur. The Compliance Officer and CRO both report directly to the board as required.

Internal audit

The task of internal audit is to control and evaluate whether AP3's governance systems, internal control mechanisms, processes and practices are appropriate and effective and whether these activities conform to decisions taken by the board in accordance with set policy. Completed internal audits are examined by the audit committee and reported to the board. In 2017, Transcendent Group reviewed the process for outsourcing. Transcendent Group concluded that AP3 is generally assessed as having good routines for the handling of outsourcing and identified a few areas of improvement which AP3 subsequently addressed.

Legal limits

During 2017, AP3 held shares in Karolinska Development that temporarily surpassed a voting share of 10 per cent. AP3 took part in a conversion of a convertible debt instrument, which was intended to dilute the Fund's voting shares. When the majority holder of convertible debt instruments declined to convert these into shares at the last moment, this caused AP3's voting shares to exceed 10 per cent. The holding was subsequently reduced back to a voting share of under 10 per cent.

External auditors

AP3's auditors are appointed by the government, which selected PwC as auditor after a public procurement process. The auditors in the Fund are Helena Kaiser de Carolis and Peter Nilsson. Peter Nilsson is also responsible for coordinating the audit process involving all AP funds. The auditors' tasks include reviewing AP3's ongoing operating activities, including internal control, administration, annual financial statements and the annual report. The auditors express an opinion of the accounting records and the administration based on their audit. Their mandate also includes verifying that AP3 follows the accounting and valuation policies agreed jointly by the AP funds and that the accounting records give a true and fair view of AP3's operating activities. The auditors report orally to the board a minimum of once a year and submit written reports on their audit of the annual financial statements and management audit. The auditors normally meet with the audit committee twice a year. The auditors are also responsible for reviewing compliance with government regulations on employment terms and conditions for senior managers at the AP funds. The auditors report verbally to the Ministry of Finance once a year.

Board of directors



Pär Nuder, Chairman
Elected to the AP3 board in 2011
Industrial consultant
Chairman of the board of AMF Pension, Hemsö, Skistar and Öbergs Färghus. Director of Beijerinvest, Fabege, IP-Only and Färö Bergman Centre Foundation.
Previously: Minister of Finance, Minister for Policy Coordination, Member of Parliament, Under-secretary of State in the Prime Minister's Office, Chairman of Vasallen and Director of Vin & Sprit.
LLB, b. 1963.



Björn Börjesson, Deputy Chairman
Elected to the AP3 board in 2011
Deputy Chairman of Swedfund International and director of Åke Wiberg Foundation, Euroclear Sweden, Euroclear Finland, Ahlströmska Stiftelsen, SVCA's Oversight Committee and Credit Director at Cordet Capital Partners.
Previously: Executive Vice President, Handelsbanken LLB, b. 1951.



Malin Björkmo
Elected to the AP3 board in 2016
Corporate governance and financial regulatory advisor
Director of Handelsbanken Fonder, Falck Försäkring and Trygg-Stiftelsen. Deputy Chairman of the Nuclear Waste Fund and InsureSec Disciplinary Board.
Previously: Area Director at the Financial Supervisor Authority (Finansinspektionen), Head of State Ownership Department at Government Offices, CEO at Storebrand Liv Sverige branch, Head of Asset Management at Skandia Liv.
Lic. Econ. financial economics, Stockholm School of Economics, b. 1962.



Peter Englund
Elected to the AP3 board in 2013
Professor emeritus, Stockholm School of Economics and Uppsala University.
Director at Wenner-Grenstiftelsen and member of Swedish Fiscal Policy Council.
Previously: Professor at Uppsala University and University of Amsterdam.
PhD Economics, Stockholm School of Economics, b. 1950.



Lars Ernsäter
Elected to the AP3 board in 2010
Economist at the Swedish Trade Union Confederation
Previously: National Institute of Economic Research.
National economics and statistics at University of Stockholm, b. 1951.



Peter Hellberg
Elected to the AP3 board in 2010
First Deputy Chairman Unionen
Deputy Chairman of TCO, director of Unionen's membership insurance board, Klara Norra Fastigheter and the Council for Negotiation and Cooperation Education Foundation.
Studied Systems Science, b. 1962.



Kerstin Lindberg Göransson
Elected to the AP3 board in 2016
CEO Akademiska Hus
Previously: Director of Arlanda Airport, Finance Director and Deputy CEO of Scandic Group, Director of Jernhusen, Chairman of K2 National Knowledge Centre for Public Transport, Chairman of Svensk Bilprovning, Director at Grand Hotel, Swegon, OEM, Strömma Sjöfart and Turism AB.
BSc Commerce, b. 1956.



Christina Lindenius
Elected to the AP3 board in 2017
CEO Insurance Sweden and Employers Organisation for the Swedish Insurance Industry (FAO), as well as in charge of the "group" Svensk Försäkring i Samverkan (SFIS)
Chairman of Min Pension, Swedish Motor Insurers (TFF) and Svensk Insurance Sweden Administration. Director at the Association for Generally Accepted Principles in the Securities Market, ICC's Swedish National Policy Committee, FPK and the Swedish Foreign Trade Association.
Previously: Director General of the Swedish (Premium) Pensions Agency, Finance Council at the Ministry of Finance and CEO of Riksbanken (Central Bank of Sweden).
BSc Commerce, Uppsala University, and studies in the Masters of International Economics Programme, SAIS, Johns Hopkins University, Washington DC, b. 1964.



Elisabeth Unell
Elected to the AP3 board in 2012
Opposition leader on Västerås City Council
Director of SKL and Västerås Marknad & Näringsliv
Previously: Chairman of Västerås Municipal Executive Committee and Aroseken.
MPhil, BSc Sociology, civil engineer, b. 1962.

Executive management



Kerstin Hessius
CEO

Joined AP3 in September 2004

Other assignments: Director of Vasakronan, Hemsö, Trenum, Handelsbanken, Svedab and Öresundsbro Konsortiet.
Previously: CEO of the Stockholm Stock Exchange, Deputy Governor of Riksbanken (Central Bank of Sweden), CEO of Östgöta Enskilda Bank Asset Management, Nordic Head of Fixed Income Alfred Berg, CEO of Alfred Berg Transferator.
BSc Commerce, b. 1958.



Mårten Lindeborg
Deputy CEO and CIO

Joined AP3 in February 2009

Other assignments: Director of Regio.
Previously: Head of Asset Management, Head of Strategic Allocation AP3, and DNB and Skandia.
BSc Commerce, b. 1971.



Mattias Bylund
CFO and CRO

Joined AP3 in August 2002

Other assignments: Director at Ellevio.
Previously: AP3 Head of External Management and Quantitative Analyst.
MSc Civil Engineering, b. 1977.



Lil Larås Lindgren
Head of Communications

Joined AP3 in February 2014

Previously: Senior communications positions at Attendo, Hemfrid, Swedish Travel and Tourism Council, Ericsson, Tetra Pak, Philipson Bil and communications consulting.
Degrees from RMI Berghs and Uppsala University, b. 1962.

Administration report 2017

Net result

Net result was SEK 28,239 million (27,981), representing a return of 8.9 per cent (9.5) before expenses and 8.8 per cent (9.4) after expenses. Fund capital stood at SEK 345,239 million (324,375) at year-end, up by SEK 20,864 million from the prior year.

During the year AP3 had a net outflow of SEK 7,375 million (6,637) to the pension system. Since 2009 the Fund has paid SEK 43,931 million to the Swedish Pensions Agency to help cover the deficit between pension contributions and disbursements and the agency's administrative costs.

Income

Income after commission expenses was SEK 28,434 million (28,167) and consisted primarily of realised and unrealised changes in the value of financial assets, which are measured at fair value on the reporting date. Other income consisted of net interest income, dividends received and net currency income. Changes in foreign exchange rates, reflecting a strengthening of the krona primarily against the US dollar but also against many other currencies, had a negative impact of SEK -4,405 million (3,373) on income.

Commission expenses totalled SEK 152 million (180) and are recognised as a deduction from income because they are directly attributable to the cost of acquiring income. They comprised fixed management fees for external mandates, fund management fees, custody account fees and costs of holding collateral during clearing. Commission expenses totalled 0.05 per cent (0.06) of average fund capital.

Operating expenses

Operating expenses totalled SEK 195 million (186). The increase from the previous year is primarily related to the increased costs of market information services but also comprises one-off costs in connection with the move to new premises. Staff costs accounted for SEK 123 million (121) of operating expenses. Operating expenses were 0.06 per cent (0.06) of average fund capital.

Return in 2017

The AP3 portfolio delivered an overall return of 8.9 per cent (9.5) before expenses and 8.8 per cent (9.4) after expenses. Real return (adjusted for inflation) was 6.9 per cent (7.6). The inflation rate for the full year was 1.7 per cent (1.7). AP3 has a long-term target of an average annual real return of 4 per cent. In the last ten years the Fund has achieved an average annual real return of 5.1 per cent (4.6). The average annual nominal return for this period stands at 6.1 per cent (5.7), which is higher than the 3.0 per cent (2.9) increase in the income index (which is the benchmark used to keep pension entitlements in line with inflation). Hence, AP3 has both made a positive contribution to the pension system and outperformed its long-term target for real return.

Change in fund capital

| SEK m | 2017 | 2016 |
|---|----------------|----------------|
| Fund capital at 1 Jan | 324,375 | 303,031 |
| Pension contributions | 66,850 | 64,174 |
| Pension disbursements | -73,999 | -70,595 |
| Administration fee to the Swedish Pensions Agency | -226 | -216 |
| Net result | 28,239 | 27,981 |
| Total fund capital at 31 Dec | 345,239 | 324,375 |

Management expense ratio

| SEK m | 2017 | 2016 |
|---|------|------|
| Commission expenses, SEK m | 152 | 180 |
| Operating expenses, SEK m | 195 | 186 |
| Management expense ratio ¹ , % | 0.10 | 0.12 |
| Operating cost ratio, % | 0.06 | 0.06 |

¹⁾ Based on total commission and operating expenses as a percentage of average fund capital during the year.

Exposure and risk management

To achieve effective asset management and risk control, AP3 divides its investments into six risk categories: equities, fixed income, credits, inflation, currencies and absolute return strategies. The exposures to each risk category lay the foundation for risk control and asset management.

The division into risk categories provides an effective structure for analysing and projecting future returns and risk for different assets with similar risk profiles. Instead of the traditional approach of dividing assets according to the type of security, this classification is based on the types of risks to which they are exposed and how they react to different risks. This makes it easier to manage the portfolio from a risk perspective. These projections, combined with macroeconomic analysis, valuations and assessments of investors' risk appetite, form the basis for asset allocation. Exposure is defined as underlying value that is exposed to changes in value arising due to market movements. AP3 uses derivatives to manage risk and bring greater efficiency to asset management. The use of derivatives allows exposure to be greater or less than total fund capital.

At 31 December 2017, exposure totalled 100.8 per cent (109.1) of fund capital. Total portfolio risk is expressed using the value at risk¹ (VaR). A VaR with a 95 per cent confidence level indicates a 95 per cent probability that the daily negative change in portfolio value will not exceed the measured amount. As at 31 December 2017, VaR for the total portfolio stood at SEK 1,217 million (1,484). See Note 20 for further details. Equities were the main source of investment exposure and also the primary contributor to portfolio risk. The currencies, fixed income and credits risk categories showed negative covariance with equity risk, which restricted the overall level of portfolio risk. The diversification strategy that AP3 deploys between asset classes and geographic markets also helped to reduce overall portfolio risk during the year.

Return per risk category

Return in the equities and inflation risk categories was 17.0 per cent and 10.7 per cent, respectively and contributed to the overall return of 8.9 per cent (9.5) before expenses although the fixed income, credits and currency risk categories had a negative return in 2017. The Fund's active management strategies and strategic and tactical decisions generated a return that exceeded the benchmark long-term static portfolio (LSP) by 2.2 percentage points (2.4).

Equities

Equities consist of investments in shares that are both listed and unlisted. Equity exposure in 2017 varied from a minimum of 48 per cent to a maximum 51 per cent of fund capital.

Stock markets around the world had very strong and stable developments throughout the year. The MSCI All Country World Index rose a full 24.6 per cent. Stock exchanges in emerging markets saw the strongest development, with an increase of 37.6 per cent, followed by equity markets in Asia (excluding Japan) and the US, with increases of 26.2 per cent and 21.8 per cent, respectively (all foreign exchanges measured in USD). At 10.0 per cent, the Swedish equity market experienced the weakest development of the markets in which AP3 has its main exposures. Approximately a quarter of AP3's equity exposures are to the Swedish stock market. Equities delivered a return of 17.0 per cent (8.1) in 2017 and contributed 7.8 (3.8) percentage points to total return.

The private equity market continued to perform strongly in 2017, and new capital amounting to 450 billion USD was injected into the market, while, repayments to the investors fell for the second year in a row. However, the funds' investments did not increase at the same rate as capital was injected, pushing the available capital for new investment to a new record high. AP3 has been an investor in private equity funds since 2001 and has a mature and diversified portfolio. AP3's private equity assets posted a return of 6.1 per cent (11.0) for the year measured in Swedish kronor. During the year a number of attractive private equity funds invited investments, and AP3 made investment commitments to nine of these funds.

Fixed income

The fixed income risk category comprises investments in government bonds, government-backed bonds and supranational bonds. At year-end AP3's exposure to this risk

¹⁾ See Glossary, p. 72

category was 18.8 per cent (18.6), which is almost unchanged in comparison with the previous year. Holdings consisted primarily of US bonds, along with Swedish and UK bonds. AP3 has no bond exposures to high-debt countries in southern Europe. Average duration¹ fell sharply during the year to meet rising interest rates. All interest rates to which AP3 has exposures increased during the year, which explains why the risk category has a negative return. Some 31 per cent (39) of fixed income investments were in bonds assigned the top AAA rating by Standard & Poor's. A total of 88 per cent (98) of fixed income investments were in bonds with AAA or AA ratings. By law, AP3 must place at least 30 per cent of fund capital in low risk fixed income investments. These investments are made in the fixed income, credits and inflation risk categories. AP3's holdings in this category averaged 32.2 per cent (32.8) of fund capital in 2017.

The fixed income risk category recorded a return of -0.6 per cent (2.5), equating to a contribution of -0.1 percentage points (0.6) to overall portfolio return. AP3's reference index for fixed income recorded a return of -0.6 per cent.

Credits

Credits consist primarily of investment grade¹ Swedish mortgage bonds and corporate bonds. They also include secured bank loans. Credit exposure fell from 7.4 per cent to 4.1 per cent during the period. This includes the exposure to Swedish housing. The duration of the credits portfolio increased marginally and stood at 3.4 years (3.2) at year-end.

The credits risk category recorded a return of -3.1 per cent (3.8), equating to a contribution of -0.2 percentage points (0.2) to overall return. Generally, the credit markets developed positively in both the USA and Europe, but given the already very low credit spreads, the fund acted defensively, which contributed to the negative result. In comparison, AP3's reference index for credits delivered a return of 1.8 per cent.

Inflation

The inflation risk category includes investments in timberland, infrastructure (whose weight rose during the year), real estate and index-linked bonds.

These assets generated a return of 10.7 per cent (15.2), equivalent to a contribution of 2.3 percentage points (3.2) to overall return. Investments in real estate, including Vasakronan, Hemsö, Trophi, Trenum and Regio, generated a return of 20.5 per cent (26.7).

Vasakronan, which is owned jointly by AP1, AP2, AP3 and AP4, noted continued strong demand for office space, which led to growth in the company's rental income. AP3's investment in Hemsö recorded a return of 23 per cent, lifted by the company's strong operating results. The company continued

to focus on project development in Sweden and acquisitions in Finland and Germany. AP3's wholly owned property subsidiary Trophi, which is focused on food retail properties, made a few minor acquisitions during the year. At year-end Trophi's real estate holdings were valued at SEK 12.3 billion. Regio, which was established in 2015 and in which AP3 has an 80 per cent equity stake, also grew by acquisition and by year-end had a real estate portfolio worth SEK 4.6 billion.

During the year AP3 made a major infrastructure investment in a British water company and an investment commitment to an infrastructure fund. Returns on infrastructure and timberland were 8.7 per cent (7.8) and -5.8 per cent (9.8), respectively. The negative return on timberland is due to currency effects in foreign investments. Measured in local currency, timberland investments generated slightly positive returns. The return on index-linked bonds, whose value amounted to SEK 21 billion at year-end, was close to zero.

Currencies

The currencies risk category comprises AP3's exposure to changes in foreign exchange rates against the Swedish krona. These exposures relate to investments in foreign assets not hedged in Swedish kronor and in direct currency positions. Currency positions are taken to increase returns and reduce risk in the total portfolio.

During the year the Swedish krona strengthened against most major international currencies with the exception of the euro, which strengthened more than the krona. The largest change was against the US dollar, the krona strengthening by almost 10 per cent. The strengthening of the krona against Japanese yen and Swiss francs was 7 per cent and 6 per cent, respectively. On the other hand, the krona lost nearly 3 per cent of its value against the euro. The general strengthening of the krona led to a negative result for the currencies risk category, where AP3's investments in foreign currency decreased in value relative to the krona.

Currencies contributed negatively to total return by -1.0 percentage points (1.4).

Currency risk usually shows a negative covariance with equity risk and thus helps to diversify the portfolio. At year-end, currency exposure stood at 15.0 per cent (17.5).

Absolute return strategies

The absolute return strategies risk category covers mandates with an absolute return target as well as investments in insurance-related bonds and risk premium strategies. Return on these strategies in 2017 totalled SEK 425 million (838), equivalent to a contribution of 0.1 percentage points (0.3) to the total portfolio.

¹) See Glossary, p. 72.

Exposure per risk category

31 Dec 2017

| | Equities | Fixed income | Credits | Inflation | Currencies ¹ | Absolute return strategies | Total AP3 |
|-----------------|----------|--------------|---------|-----------|-------------------------|----------------------------|-----------|
| Exposure, SEK m | 172,401 | 65,066 | 14,221 | 77,615 | 51,863 | 13,591 | 348,021 |
| Exposure, % | 49.9 | 18.8 | 4.1 | 22.5 | 15.0 | 3.9 | 100.8 |

31 Dec 2016

| | Equities | Fixed income | Credits | Inflation | Currencies ¹ | Absolute return strategies | Total AP3 |
|-----------------|----------|--------------|---------|-----------|-------------------------|----------------------------|-----------|
| Exposure, SEK m | 167,109 | 60,478 | 24,080 | 68,736 | 56,801 | 33,352 | 353,756 |
| Exposure, % | 51.5 | 18.6 | 7.4 | 21.2 | 17.5 | 10.3 | 109.1 |

1) Currency exposure shows the ratio of assets held in foreign currency and cannot be added to total exposure.

Risk per category

31 Dec 2017

| | Equities | Fixed income | Credits | Inflation | Currencies | Absolute return strategies | Total AP3 |
|---|----------|--------------|---------|-----------|------------|----------------------------|-----------|
| Value at risk, SEK m | 1,388 | 74 | 23 | 157 | 563 | 259 | 1,217 |
| Value at risk, % | 0.40 | 0.02 | 0.01 | 0.05 | 0.16 | 0.08 | 0.34 |
| Contribution to total risk, percentage points | 106.0 | -1.1 | -0.1 | 6.2 | -14.0 | 2.9 | 100 |
| Realised volatility 12 m, % | 6.7 | 4.6 | 1.9 | 1.3 | - | - | 3.5 |

31 Dec 2016

| | Equities | Fixed income | Credits | Inflation | Currencies | Absolute return strategies | Total AP3 |
|---|----------|--------------|---------|-----------|------------|----------------------------|-----------|
| Value at risk, SEK m | 1,609 | 106 | 41 | 191 | 393 | 224 | 1,484 |
| Value at risk, % | 0.50 | 0.03 | 0.01 | 0.06 | 0.12 | 0.07 | 0.46 |
| Contribution to total risk, percentage points | 94.2 | 1.7 | -1.3 | 5.6 | -8.2 | 8.0 | 100 |
| Realised volatility 12 m, % | 13.1 | 2.7 | 1.9 | 6.8 | - | - | 6.2 |

Return per risk category

31 Dec 2017

| | Equities | Fixed income | Credits | Inflation | Currencies | Absolute return strategies ¹ | Total AP3 |
|---|----------|--------------|---------|-----------|------------|---|-----------|
| Return, % | 17.0 | -0.6 | -3.1 | 10.7 | - | - | 8.9 |
| Contribution to total return, percentage points | 7.8 | -0.1 | -0.2 | 2.3 | -1.0 | 0.1 | 8.9 |
| Share of total return, % | 87.5 | -1.4 | -2.4 | 26.1 | -11.5 | 1.6 | 100 |

31 Dec 2016

| | Equities | Fixed income | Credits | Inflation | Currencies | Absolute return strategies ¹ | Total AP3 |
|---|----------|--------------|---------|-----------|------------|---|-----------|
| Return, % | 8.1 | 2.5 | 3.8 | 15.2 | - | - | 9.5 |
| Contribution to total return, percentage points | 3.8 | 0.6 | 0.2 | 3.2 | 1.4 | 0.3 | 9.5 |
| Share of total return, % | 39.7 | 6.5 | 2.3 | 33.6 | 15.1 | 2.9 | 100 |

1) Absolute return strategies consist of risk mandates to which no capital is allocated and return can therefore not be fairly measured.

Expenses

Through its objective of delivering a diversified and cost-effective investment model, AP3 has achieved high risk-adjusted returns at low cost.

AP3's objective is to achieve a cost-effective investment model. Consequently, the relationship between projected return, risk and cost must be taken into account in every investment decision. All costs are followed up and carefully analysed both internally and externally. As of 2005, the Canadian consultancy CEM Benchmarking conducts an annual analysis to ensure that AP3's cost efficiency and cost base are commensurate with those of other successful international pension funds. The most recent analysis relates to 2016 and shows that AP3 has 31 per cent lower costs than the comparison group. The management expense ratio is defined as expenses in relation to assets under management, and is a key measure for better understanding expenses. AP3 has had a declining expense ratio for many years, and for 2017 the ratio was 0.10 per cent (0.12) of assets under management.

Expenses arise and for different reasons and are therefore recognised in different ways. In general, expenses can be divided into three categories: **operating expenses** are internal costs that arise from operating activities and are primarily related to the number of employees and the scale of the operations; **commission expenses** are costs of external asset management and are related to the value of the funds under management and the management style; **transaction cost** are the costs of buying and selling investment assets. In addition to the above categories, there are also performance-based fees for external management mandates. However, these fees are to be regarded more as a form of profit-sharing. All expenses are highly related to the value of the fund capital, the strategy chosen, the proportion of externally managed assets, turnover of the Fund's assets and exchange rate movements.

Another way to view expenses is by the way they are broken down in the income statement, which apportions them between income and operating expenses.

Cost items recognised in operating expenses

Internal costs that arise in conjunction with operating activities are recognised under operating expenses and consist of staff costs and other administrative expenses. These totalled SEK 195 million (186) in 2017.

Staff costs accounted for 63 per cent (65) of operating expenses and totalled SEK 123 million (121). The number of employees averaged 56 (55). While the number of employees was at the same level as in 2016, the proportion of internally managed assets increased from 71 per cent to 75 per cent, and the fund capital increased by slightly more than 6 per cent. To make this possible, internal competencies were

strengthened in the areas required by the selected management strategy.

Other administrative expenses were SEK 72 million (65). The increase is primarily related to increased costs for market information services, where lack of market competition resulted in significant price increases. During the year AP3 moved to smaller premises to keep down office rental costs over time. The move involved certain non-recurring costs, which is another contributory explanation for the higher administrative expenses for the year. These non-recurring costs in connection with the move are primarily found under office rental costs and IT costs. Operating expenses in relation to assets under management amounted to 0.06 per cent (0.06).

Operating expenses relate to pension system administration costs. Maintaining cost-efficiency in this area remains a priority.

Cost items recognised in income

Costs directly attributable to the external management of fund capital are recognised in income. They can be divided into two categories: those recognised as an expense under operating income (commission expenses) in the income statement and those that are indirect costs expensed directly in income and recognised under net result.

Commission expenses are fees paid for external management mandates of both listed and unlisted assets and costs for custody accounts and managing collateral. Most commission expenses arise in conjunction with external asset management. They are drawn as a percentage of the underlying portfolio and thus relate directly to the size of the funds under management. As management is largely carried out abroad, exchange rates also have a substantial bearing on commission expenses, as well as the management strategy selected. In 2017, commission expenses totalled SEK 152 million (180). The proportion of externally managed assets was 25 per cent (29) and these were primarily private equity and equities in emerging markets, North America and Asia. The AP funds are required by law to invest a minimum of 10 per cent of their assets with external managers. AP3 chooses external managers when it believes that external management will be more cost-effective than internal management or when the asset management structure is difficult to achieve internally. By reducing the proportion of externally managed assets, AP3 reduced commission expenses by 16 per cent since the previous year.

Costs arising from custody accounts and managing collateral totalled SEK 13 million (12). These costs relate to the management and storage of securities and derivatives. Performance-based remuneration and transaction costs are indirect costs subtracted directly from income.

Performance-based fees for external management mandates are a form of profit-sharing between AP3 and the fund manager that occurs only if the fund manager meets a pre-defined target. Profit-sharing is expensed directly against the returns on these investments and is recognised as net income from financial transactions in the income statement. Performance-based remuneration totalled SEK 118 million (183) in 2017. For certain types of management mandates relating to unlisted assets, such as private equity funds and property funds, agreements establish that management fees are a part of the acquisition value and must be repaid.

Transaction costs are expenses that arise directly from asset purchases and sales. They are added to cost or debited from income. In all securities trading, transaction costs are the difference between buying and selling rates. When buying equities, brokerage fees apply. These are recognised separately and in 2017 totalled SEK 59 million (78), of which 24 per cent (18) arose from external management. The decrease in brokerage fees from the prior year was due to reduced transaction volumes during the year. The tax expenses that AP3 is entitled to recover under double taxation agreements are recognised as a receivable in the balance sheet and do not affect the income statement.

None of the above expenses recognised in income affect the costs of administering the Swedish pension system; their sole impact is on the return on fund capital. Because they arise from AP3's assets and management approach, they can be characterised to some extent as costs of the production of goods.

Risk management

AP3's asset management operations expose it to different types of risk. The Fund's core activity involves managing financial risks to deliver investment returns and achieve specific targets.

Risk is defined as uncertainty over future outcomes arising from external events that affect the Fund's operating activities. Risk management is the process that identifies risks and measures and manages their positive and negative consequences. In other words, for AP3 risk management is the process that manages the Fund's risk and return profile.

Because risk-taking can generate positive and negative outcomes, risks taken must be conscious, calculated and within applicable frameworks. Ultimately, AP3 is exposed to a risk that the fundamental parameters of the pension system will shift, for example due to demographic changes. AP3 analyses these risks using asset liability management (ALM), and the board uses ALM findings to set long-term operating targets.

Operationally, the Fund takes positions in financial instruments in order to earn returns. This means that fund capital is always exposed to financial risk. Diversifying fund capital into different financial assets, geographic areas and risk premia – and varying investment time frames – enables risk to be limited.

The board of directors monitors total risk by setting a risk framework within which the asset management team must operate. This framework is set out in the risk management plan, the document that defines the Fund's approach to risk, roles and responsibilities, guidelines, frameworks and reporting.

General risk analysis

AP3 bases effective risk management on an annual analysis of overall portfolio risk. The analysis report sets a framework for identifying and measuring risk in all business areas and for making it possible to act to reduce risk as and when appropriate. Management is responsible for the Fund's risk analysis, which is based on self-assessment and seeks to promote high risk awareness and a prudent approach to risk throughout the organisation. The Fund uses the risk analysis when drawing up operating and resource plans for the coming year. The risk analysis report and action plans are submitted to the audit committee and board of directors on an annual basis.

Risk management

The CEO and responsible managers in the asset management organisation are in charge of identifying, analysing and prioritising risk, projecting returns and risk, and allocating risk mandates between different asset categories and strategies based on the Fund's return targets. Risk management is structured as follows:

- **Board of directors** – sets the overall risk level and general exposure and risk limits for the seven risk categories: equities, fixed income, credits, inflation, currencies and absolute return strategies.

- **Audit committee** – has an advisory and oversight role on the board's behalf in matters relating to financial reporting and accounting, internal control, risk management and audit. The audit committee reports directly to the board on a regular basis.
- **CEO (Chief Executive Officer)** – responsible for AP3's day-to-day management and compliance with the board's operating frameworks. The CEO is tasked with ensuring good governance of the Fund's asset management, risk management, risk control and reporting.
- **CIO (Chief Investment Officer)** – manages risk in the AP3 portfolio and delegates day-to-day asset management within the frameworks set by the board and CEO. Each portfolio manager is responsible for managing the risk attached to his or her mandate in order to achieve targets within specified limits.
- **CRO (Chief Risk Officer)** – responsible for monitoring and reporting of risk and return to management and the board of directors. The CRO makes sure that investment decisions are taken in compliance with the risk framework set by the board.
- **Compliance** – responsible for ensuring that AP3 operates within applicable legislation and internal rules. The Compliance department is also tasked with identifying, documenting and assessing compliance risks that may arise in the daily operations and reports directly to the CEO and the board of directors.
- **RMC (Risk Management Committee)** – the CEO appoints the members of the RMC. The RMC presently consists of the CEO, CRO, CIO, Head of Portfolio Strategy and one more representative from this group, Head of Alternative Investments, Head of Alfa Management, Head of Beta Management, Head of External Management and Head of Risk Control & Return Analysis. Moreover, the Head of Compliance participates as an observer. The RMC handles issues relating to general risk management and risk control on a preparatory basis for the board. The CRO chairs the RMC.

Three lines of defence

Day-to-day risk management and control are decentralised and follow the three lines of defence principle, which differentiates between departments that have primary responsibility for risk and regulatory compliance (first line), departments responsible for monitoring and control (second line) and those tasked with independent oversight (third line). Responsibility for the first line rests with the investment organisation, which includes all asset management department teams as well as the business control unit. Hence, responsibility for risk man-

agement is borne where the risk arises. The control process spans the entire transaction flow. Each employee manages risk in his or her own area of responsibility, but the CIO has overall responsibility for the first line of defence.

The second line of defence relates to the internal risk control department and the compliance department. The former carries out checks and monitoring to ensure that the risk management framework is adhered to. The risk control process makes sure that the Fund as a whole and in relevant areas stays within stipulated limits and complies with applicable restrictions and instructions. The department is independent and organisationally separate from the functions that execute investment decisions. Ultimate responsibility rests with the CRO. The compliance department is in charge of ensuring that the Fund abides by legal and ethical rules and regulations.

The third line of defence is internal audit, which in AP3's case is subcontracted to an external audit firm. The internal auditors are appointed by the board of directors via the audit committee and are independent of AP3 and its investment operations. The internal auditors report to the board via the audit committee. Each year a time-limited internal audit is performed on behalf of the audit committee. The areas to be examined to verify that the business and control departments fulfil their tasks may be suggested by the internal auditors themselves, by the audit committee or by AP3's employees, but the audit committee ultimately decides the area to be examined.

AP3 categorises risks as follows:

- **Enterprise level risk** – risks relating to AP3's mission, objectives and administration.
- **Financial risk** – financial risks arising from investing activities.
- **Operating risk** – risks relating to processes, systems, human resources, laws and regulations.

A probability and a consequence are assigned to each risk identified in each category. The consequence may be financial, reputational, affect sustainability or require extra work

Financial risks and financial risk management

Financial risk differs from other risks in that it is a necessary part of seeking to achieve returns. By contrast, other risks must be minimised as much as possible. Financial risk consists primarily of market, credit and liquidity risk.

■ **Market risk** is the risk that the value of an asset may fall due to changes in asset prices on the financial markets, for example changes in equity prices, bond prices and currency exchange rates. It can be shown in absolute or relative terms and can be forward-looking (ex ante) or backward-looking (ex post). The commonest ways of measuring risk include volatility,¹ value at risk (VaR),¹ tracking error,¹ sensitivity analysis and stress tests. AP3 monitors market risk on a daily basis, both at general level and for individual mandates, using the VaR metric, different types of stress

test and sensitivity analysis. Market risk is the main risk attached to the AP3 portfolio. By managing risk within specific limits, the Fund generates investment returns.

■ **Credit risk** is the general risk of incurring a loss due to the failure of a counterparty in a financial transaction to meet repayment obligations irrespective of cause. It can be divided into issuer risk, counterparty risk and settlement risk.

Issuer risk is the risk that the issuer of a financial security will default and be unable to meet repayment obligations on the maturity date. AP3 limits issuer risk by working within set limits for total credit risk in the portfolio. The Fund uses tools such as credit ratings to limit the exposure of specific mandates to specific issuers. The risk management committee regularly reviews AP3's risk relating to specific issuers and groups of issuers.

Counterparty risk is the risk of a party to a transaction being unable to fulfil obligations under a bilateral financial contract such as a derivative or currency transaction, deposit or buyback. AP3 actively seeks to minimise counterparty risk by selecting counterparties with a good credit rating. AP3 also requires counterparties to sign ISDA agreements¹ with the Fund that regulate how receivables and liabilities are to be managed if either counterparty can no longer fulfil its commitments. AP3 also insists on CSA agreements,¹ which require a counterparty with an outstanding liability to provide security in cash or securities.

Settlement risk arises when transactions are settled but the parties do not fulfil their commitments simultaneously. Where possible, AP3 eliminates settlement risks on currency transactions through CLS,¹ a system that permits simultaneous settlement of transactions through an independent third party.

■ **Liquidity risk** is the risk that AP3 cannot make intended or necessary changes to the portfolio structure without incurring excessive transaction costs (known as rollover risk). Generally speaking, the Fund's most liquid assets are listed equities and government bonds with a high credit rating, whereas corporate bonds, unlisted shares and real estate are usually less liquid. AP3 manages liquidity risk via a balanced mix of asset types with both high and low liquidity. For refinancing risk, the Fund monitors future payment obligations versus available liquidity to minimise the risk of excessive financing costs.

Mandate compliance

The Risk Control and Return Analysis team carries out AP3's independent risk control. It identifies and measures risks and ensures mandate compliance and that exposure and risk remain within approved guidelines and limits. Limits can be expressed as the size of a position, value at risk, tracking error or other measure relevant to the structure of the mandate. They can also be expressed as consultation levels and sometimes as stop loss¹ levels to limit the risk of loss on a specific mandate.

¹⁾ See Glossary, p. 72.

Income statement**INCOME**

| SEK m | Note | 2017 | 2016 |
|--|------|---------------|---------------|
| Net interest income | 2 | -1,112 | 773 |
| Dividends received | | 5,017 | 5,509 |
| Net income from listed shares and participations | 3 | 20,778 | 9,811 |
| Net income from unlisted shares and participations | 4 | 6,519 | 6,110 |
| Net income from interest-bearing assets | | 825 | 2,764 |
| Net income from derivatives | | 964 | 8 |
| Net income from currencies | | -4,405 | 3,373 |
| Net commission expenses | 5 | -152 | -180 |
| Total income | | 28,434 | 28,167 |

OPERATING EXPENSES

| | | | |
|---------------------------------|---|---------------|---------------|
| Staff costs | 6 | -123 | -121 |
| Other administrative expenses | 7 | -72 | -65 |
| Total operating expenses | | -195 | -186 |
| Net result | | 28,239 | 27,981 |

Balance sheet

ASSETS

| SEK m | Note | 31 Dec 2017 | 31 Dec 2016 |
|-------------------------------------|------------|----------------|----------------|
| Shares and participations | | | |
| Listed | 8, 19 | 161,494 | 151,229 |
| Unlisted | 9, 19 | 56,861 | 50,497 |
| Bonds and other fixed income assets | 10, 19 | 135,721 | 131,032 |
| Derivatives | 11, 19, 21 | 3,636 | 4,681 |
| Cash and cash equivalents | | 571 | 1,260 |
| Other assets | 12, 21 | 8,623 | 11,107 |
| Prepaid expenses and accrued income | 13 | 1,063 | 935 |
| Total assets | | 367,970 | 350,741 |

FUND CAPITAL AND LIABILITIES

Liabilities

| | | | |
|--------------------------------------|------------|---------------|---------------|
| Derivatives | 11, 19, 21 | 5,228 | 4,995 |
| Other liabilities | 14, 21 | 17,426 | 21,282 |
| Deferred income and accrued expenses | 15 | 77 | 89 |
| Total liabilities | | 22,731 | 26,366 |

Fund capital

| | | | |
|---|----|----------------|----------------|
| Fund capital at 1 Jan | | 324,375 | 303,031 |
| Net payments to the national pension system | 16 | -7,375 | -6,637 |
| Net result | | 28,239 | 27,981 |
| Total fund capital | | 345,239 | 324,375 |
| Total fund capital and liabilities | | 367,970 | 350,741 |

Memorandum items 17, 22

The Third Swedish National Pension Fund (AP3), corporate identity number 802014-4120, is one of the buffer funds of the Swedish pension system, domiciled in Stockholm. The board of directors approved the annual financial statements for 2017 on 23 February 2018. The income statement and balance sheet are subject to government approval.

■ NOTE 1 Accounting and valuation policies

The National Pension Insurance Funds Act (2000:192) requires the financial statements to be prepared in conformity with generally accepted accounting principles, which involves recognition of fund assets at market value. Against this background, AP1, AP2, AP3 and AP4 have agreed and applied shared accounting and valuation policies, as summarised below.

The AP funds are adapting their accounting and valuation policies to the International Financial Reporting Standards (IFRS). The IFRS are being developed and hitherto the funds have focused on adapting to IFRS 7 and IFRS 13. Full adjustment to IFRS would not significantly affect reported income and capital. AP3 meets the qualification requirements for designation as an investment company as per IFRS 10. The only difference as against currently effective IFRS is that AP3 does not prepare a statement of cash flows.

Transaction day accounting

Purchases and sales of securities and derivatives on the money, bond, equity and currency markets are recognised in the balance sheet on the transaction date, that is the point when material rights, and therefore risks, are transacted between the parties. Receivables and liabilities that fall between the transaction and settlement dates are reported under other assets and other liabilities, respectively. Other transactions, especially relating to unlisted shares, are recognised in the balance sheet on the settlement date, in conformity with market norms.

Net accounting

AP3 recognises assets and liabilities net in the balance sheet where there is a legal right to offset transactions and an intention exists to provide net cash consideration or to realise the asset and receive consideration for the liability simultaneously.

Foreign currency translation

Foreign currency transactions are translated into Swedish kronor at the exchange rate applying on the transaction date. Foreign currency assets and liabilities are recognised in Swedish kronor at the exchange rate on the balance sheet date.

Changes in the values of foreign currency-denominated assets and liabilities are divided into the change attributable to the change in the value of the asset or liability in local currency and the change caused by exchange rate movements. Exchange rate gains or losses arising due to exchange rate changes are recognised in the income statement under net income from currencies.

Shareholdings in subsidiaries and associates

Shareholdings in subsidiaries and associates are recognised at fair value, in conformity with the National Pension Insurance Funds Act. Fair value is measured using the same method as for unlisted shares and investments. There is no requirement to prepare consolidated financial statements.

Measurement of financial instruments

All AP3's investments are measured at fair value. Realised and unrealised changes in value are recognised in the income statement. Hence, items presented under net income per asset category include realised and unrealised income. The financial statements include references to benchmark indices. Details of these can be found at www.ap3.se. The method for measuring fair value for the fund's various placements is described below.

Listed shares and investments

Shares and investments traded on a regulated market or trading platform are measured using the price quoted by the relevant index vendor on the balance-sheet date. This price is often the mid-rate. Holdings not included in an index are valued at listed prices observable in an active market. Brokerage fees are recognised in net income for listed equities.

Unlisted shares and investments

Shares and investments not traded on a regulated market or trading platform are measured at fair value based on the valuation received from the counterparty or other external party. Valuations are updated when new valuations are received and are adjusted for cash flows up to the reporting date. AP3 may revise a valuation where strong grounds exist for believing that the valuation is wrong. Fair value measurement of unlisted shares and investments follows the International Private

Equity and Venture Capital Valuation (IPEV) guidelines or equivalent valuation principles and is generally based on transactions with third parties, but other valuation methods may be used.

Unlisted real estate shares are measured on the basis of their net asset value, provided they have not been transacted on a secondary market. Holdings in unlisted real estate companies are measured to reflect deferred tax liability and at the value applied in real estate transactions. This differs from the value that real estate companies apply in their financial statements.

Bonds and other fixed income assets

The fair value of bonds and other fixed income assets is measured using the official market price (usually the bid rate) quoted by the Fund's index supplier. Holdings not included in an index are valued at listed prices observable in an active market. Where an instrument is not traded on an active market and reliable market prices are unavailable, the instrument is measured using generally accepted valuation models, whereby cash flow is discounted to the relevant valuation curve.

Interest income is recognised using the effective interest method based on amortised cost. Amortised cost is the discounted present value of future payments, where the discount rate corresponds to the effective interest rate at the time of purchase. Acquired premiums and discounts are recognised as interest income until the coupon rate changes or the instrument matures. They are recognised in interest income. Changes in value arising due to movements in interest rates are recognised under net income from fixed income assets, while changes in value arising from exchange rate movements are recognised under net income from currencies.

Derivatives

The fair value of derivatives is measured using rates on the reporting date. If an instrument is not traded in an active market and reliable market prices are not available, the instrument is measured using generally accepted valuation models, whose inputs consist exclusively of observable market data.

Derivative contracts with a positive fair value on the balance sheet date are recognised as assets, while contracts with a negative fair value are recognised as liabilities. Changes in value arising from exchange rate movements are recognised in the income statement under net income from currencies, while other changes in value are recognised under net income from derivatives. The difference between forward and spot rates for currency forwards is allocated on a straight-line basis during the term of the contract and is recognised as interest income.

Buybacks

In a true buyback (repurchase), the asset remains on the balance sheet and cash received is recognised as a liability. The divested security is recognised under pledged assets in the balance sheet. The cash value difference between spot and forward legs accrues during the maturity period and is recognised as interest.

Securities lending

Loaned securities are recognised in the balance sheet at fair value and consideration received for the loan is recognised as interest income in the income statement. Collateral received for loaned securities may consist of securities and/or cash. Where AP3 has the right to dispose over cash collateral received, this is recognised in the balance sheet as an asset and a corresponding liability is created. In cases where AP3 does not have the right of disposal over the asset, the loaned security is recognised not in the balance sheet but separately under "Pledged assets, contingent liabilities and commitments". The value of loaned securities and the collateral paid to secure them is also recognised under this item.

Items recognised directly in fund capital

Payments to and from the pension system are recognised directly in fund capital.

Commission expenses

Commission expenses are recognised as a deduction from operating income in the income statement. They consist of external costs for asset management services, such as custody account fees and fixed commissions to external managers, and fixed commissions for exchange-traded funds. Performance-based fees, payable when a manager produces returns above an agreed level and where profit sharing applies, are recognised as a deduction from net income for the relevant asset class in the income statement.

Management fees for unlisted shares and investments deemed repayable prior to profit sharing, and where repayment is likely, are recognised in cost and included in unrealised income.

In other cases, they are recognised as commission expenses.

Operating expenses

All management expenses, excluding brokerage fees, fees to external managers and custodian fees, are recognised as operating expenses. Investments in equipment and proprietary and purchased computer software are normally expensed as they arise.

Taxes

AP3 is exempt from all income tax on investments in Sweden.

Dividend and coupon taxes payable in some countries are recognised on a net basis in the relevant income category in the income statement.

As of 2012, AP3 is VAT-registered and liable to pay value added tax on purchases outside Sweden. AP3 is not entitled to reclaim VAT outlays. VAT is expensed under the relevant item.

Rounding off

Minor discrepancies may occur in the tables in this report due to the rounding up or down of individual figures.

■ NOTE 4 Net income from unlisted shares and investments

| SEK m | 2017 | 2016 |
|--|--------------|--------------|
| Capital gains | 1,860 | 1,206 |
| Unrealised changes in value | 4,659 | 4,904 |
| Net income from unlisted shares and investments | 6,519 | 6,110 |

Recognition of external asset management fees in unlisted assets is in conformity with two different principles depending on whether or not the underlying management contract provides for repayment prior to the sharing of profit from future profitable disposals. Where the contract allows repayment, the fees are recognised under the cost of the asset and, therefore, under unrealised net income from unlisted assets. Thus, repaid management fees have a positive impact on unrealised income. Where the contract does not provide for repayment, management fees are expensed under commission expenses.

In 2017, SEK 220 million (204) was paid in management fees for unlisted assets, of which SEK 198 million (188) provided for repayment under the policy above. SEK 161 million (180) was repaid in 2017. The unrealised earnings for unlisted shares and investments were negatively affected by SEK 37 (negative by 8) million. Paid fees where the underlying contracts did not provide for repayment totalled SEK 23 million (16) and are recognised as commission expenses. See Note 5, "Commission expenses".

■ NOTE 2 Net interest income

| SEK m | 2017 | 2016 |
|-------------------------------------|---------------|--------------|
| Interest income | | |
| Bonds and other fixed income assets | 1,381 | 1,793 |
| Derivatives | 935 | 1,103 |
| Securities lending, equities | 84 | 159 |
| Securities lending, bonds | 59 | 60 |
| Other interest income | 23 | 20 |
| Total interest income | 2,481 | 3,135 |
| Interest expenses | | |
| Derivatives | 3,593 | 2,362 |
| Other interest expenses | 0 | 0 |
| Total interest expenses | 3,594 | 2,362 |
| Net interest income | -1,112 | 773 |

■ NOTE 5 Commission expenses

| SEK m | 2017 | 2016 |
|---|------------|------------|
| External commissions, listed assets | 116 | 152 |
| External commissions, unlisted assets | 23 | 16 |
| Other commissions expenses, incl. custodian bank costs | 13 | 12 |
| Total commission expenses | 152 | 180 |

Performance-based fees of SEK 118 million (183) are not recognised in commission expenses. An amount of SEK 113 million (164) of this figure relates to listed equities and SEK 5 million (19) to unlisted shares and investments. Performance-based fees are recognised in net income for each asset class.

Underlying fees for total return swaps (TRS)¹ are not recognised in commission expenses but as a change in value under net income from derivatives. In 2017, underlying costs for TRS were SEK 4 million (12).

1) See Glossary, p. 72.

■ NOTE 3 Net income from listed shares and investments

| SEK m | 2017 | 2016 |
|--|---------------|--------------|
| Income from listed shares and investments | 20,838 | 9,888 |
| Brokerage fees | -59 | -78 |
| Net income from listed shares and investments | 20,778 | 9,811 |

■ NOTE 6 Employees

| 2017 | | 2016 | | | |
|---|-------------------------------|---------------------------|---------------------------|---------------------------------------|--|
| | | total | female | total | female |
| Average no. of employees | 56 | 21 | | Average no. of employees | 55 |
| No. of employees at 31 Dec | 57 | 21 | | No. of employees at 31 Dec | 57 |
| No. in executive management at 31 Dec | 4 | 2 | | No. in executive management at 31 Dec | 4 |
| Staff costs in SEK thousand, 2017 | Salaries and remuneration | Variable remuneration | Pension plan expenses | of which salary sacrifice | Social security expenses incl. special payroll tax |
| Pär Nuder, Chairman of the board | 111 | | | | 35 |
| <i>Other directors</i> | | | | | 145 |
| Björn Börjesson, Deputy Chairman | 102 | | | | 17 |
| Malin Björkmo | 71 | | | | 22 |
| Inga-Lill Carlberg, resigned 2017 | 25 | | | | 8 |
| Peter Englund | 50 | | | | 8 |
| Lars Ernsäter | 61 | | | | 10 |
| Peter Hellberg | 61 | | | | 19 |
| Kerstin Lindberg Göransson | 72 | | | | 22 |
| Christina Lindenius, joined 2017 | 25 | | | | 8 |
| Elisabeth Unell | 50 | | | | 16 |
| Total | 628 | | | | 165 |
| CEO Kerstin Hessius | 3,597 | | 2,315 | 917 | 1,692 |
| <i>Total executive management excl. CEO</i> | | | | | 7,603 |
| Mattias Bylund | 1,912 | | 492 | | 720 |
| Mårten Lindeborg | 3,012 | | 897 | | 1,164 |
| Lil Larås Lindgren | 1,421 | | 486 | | 565 |
| Total executive management excl. CEO | 6,345 | | 1,875 | | 2,448 |
| Other employees | 54,580 | 4,076 | 24,399 | 1,940 | 17,398 |
| Total employees | 64,522 | 4,076 | 28,589 | 2,857 | 21,538 |
| <i>Other staff costs</i> | | | | | 118,725 |
| Total staff costs | 65,150 | 4,076 | 28,589 | 2,857 | 21,703 |
| | | | | | 122,733 |
| Staff costs in SEK thousand, 2016 | Salaries and remuneration | Variable remuneration | Pension plan expenses | of which salary sacrifice | Social security expenses incl. special payroll tax |
| Pär Nuder, Chairman of the board | 111 | | | | 35 |
| <i>Other directors</i> | | | | | 145 |
| Björn Börjesson, Deputy Chairman | 102 | | | | 32 |
| Malin Björkmo, joined 2016 | 25 | | | | 8 |
| Sonat Burman-Olsson, resigned 2016 | 25 | | | | 8 |
| Inga-Lill Carlberg | 72 | | | | 22 |
| Peter Englund | 50 | | | | 8 |
| Gunvor Engström, resigned 2016 | 25 | | | | 4 |
| Lars Ernsäter | 61 | | | | 19 |
| Peter Hellberg | 61 | | | | 19 |
| Kerstin Lindberg Göransson, joined 2016 | 46 | | | | 15 |
| Elisabeth Unell | 50 | | | | 16 |
| Total | 627 | | | | 813 |
| CEO Kerstin Hessius | 3,373 | | 2,216 | 917 | 1,597 |
| <i>Total executive management excl. CEO</i> | | | | | 7,187 |
| Mattias Bylund | 1,827 | | 427 | | 678 |
| Mårten Lindeborg | 2,935 | | 779 | | 1,111 |
| Lil Larås Lindgren | 1,374 | | 430 | | 536 |
| Total executive management excl. CEO | 6,136 | | 1,636 | | 2,325 |
| Other employees | 54,741 | 4,486 | 17,785 | 2,099 | 22,625 |
| Total employees | 64,250 | 4,486 | 21,637 | 3,016 | 26,547 |
| <i>Other staff costs</i> | | | | | 116,920 |
| Total staff costs | 64,877 | 4,486 | 21,637 | 3,016 | 26,733 |
| | | | | | 120,804 |

■ NOTE 6 cont.

Board of directors

The government sets the remuneration of directors. As of 2000, annual fees of SEK 100,000 are paid to the Chairman, SEK 75,000 to the Deputy Chairman and SEK 50,000 to other directors. The government has approved additional remuneration of up to SEK 100,000 for directors who sit on the remuneration committee and audit committee. Remuneration of SEK 100 thousand (100) was paid for committee engagements in 2017.

Committees

The remuneration committee had three members in 2017. It makes recommendations to the board on the CEO's salary and benefits and AP3's salary structure prior to salary reviews. The remuneration committee also makes recommendations to the board on the variable remuneration scheme. Decisions in these matters are made by the board. The audit committee has three members and its role is to monitor and issue recommendations to the board primarily within the areas of financial reporting, accounting, internal control, risk management and external audit.

CEO's remuneration

The board sets the salary and benefits of the CEO. Under the CEO's employment contract, AP3 pays retirement pension and sickness insurance premiums totalling 30% of gross salary. In the event of termination, the contractual notice period is six months for both AP3 and the CEO. In the event of termination on the part of AP3, 18 months' severance pay may be payable. Severance pay and benefits are to be offset against any income from new employment or business activity. No contract provisions exist for early retirement. In 2017, the CEO received taxable benefits of SEK 1 thousand (3). The CEO does not participate in the performance-based incentive scheme.

Executive management group excluding the CEO

The executive management committee consists of the CEO, the Deputy CEO and CIO, the Head of Business Support & Control and Chief Risk Officer and the Head of Communications.

AP3 has collective wage agreements with the Employers' Organisation of the Swedish Banking Institutions (BAO) and the JUSEK/Swedish Association of Graduates in Business Administration and Economics (SACO) trade unions. The CEO and the Deputy CEO/CIO are the only employees whose terms and conditions deviate from the collective wage agreements. The Deputy CEO/CIO has a notice period of six months that applies to both parties. In the event of termination on the part of AP3, 12 months' severance pay may be payable. Severance pay and benefits are to be offset against any income from new employment or business activity. No special agreements exist in respect of notice periods, severance pay or early retirement for other members of the executive management. Executive management committee members received taxable benefits ranging from SEK 0 (1) to SEK 6 thousand (7). Executive management committee members do not participate in the performance-based variable remuneration scheme.

Remuneration

AP3 follows the government guidelines for employment conditions in the AP Funds, which state that the level of remuneration should be competitive but not be higher

than in comparable companies. The board's remuneration committee is responsible to the board for making recommendations on remuneration. Remuneration and other terms of employment for AP3's chief executive officer (CEO) are decided by the board. Remuneration and employment terms for the other senior executives are approved by the remuneration committee based on the CEO's proposal. Moreover, the board decides the pay scale of other employees.

As in previous years, AP3 participated in Willis Towers Watson's mapping of market pay to compare the salaries of the employees with those of their counterparts in the financial market, where both private enterprises and public companies participate. The purpose of participating on an annual basis is to assess whether the level of remuneration is in line with the stipulations of the government guidelines. The result of the market salary analysis shows that the majority of AP3's employees are around the median level in relation to the levels of remuneration of the comparison market. The board of directors has therefore come to the conclusion that the remuneration structure and the levels of remuneration are on market conditions, competitive without being wage leading and reasonable and appropriate for the CEO, senior executives and other employees. The board also assesses that AP3 follows the government guidelines and that there are no exemptions to be reported separately.

Performance-based remuneration scheme

The board of directors has approved a performance-based incentive scheme modelled on government guidelines issued in April 2009 and adjusted for guidelines on remuneration in insurance and other financial entities issued by the Swedish Financial Supervisory Authority in March 2010. The programme applied in 2017 and gave employees in the asset management department the opportunity to receive performance-based remuneration of up to two months' salary on the fulfilment of specific agreed criteria. Sixty per cent of variable remuneration is not paid until three years after the year in which it was earned. Employees in administrative departments have the opportunity to receive variable remuneration of half a month's salary. AP3's net income must be positive before any variable remuneration can be paid to the employees. The CEO and executive management committee members do not participate in the performance-based variable remuneration scheme. The Fund reserved SEK 4.1 million (4.4) in the 2017 financial statements for the payment of variable remuneration contingent on the fulfilment of agreed targets. This sum was equivalent to the payment of an average of 0.9 month's salary (1.0) in variable performancebased remuneration to each employee covered by the scheme.

Sickness absence

Total sickness absence in 2017 was 0.8% (1.2) – 0.9% (0.5) for male employees and 0.7% (2.5) for female employees. Total sickness absence amounted to 863 hours. None of the employees of the Fund has been ill for more than 60 consecutive days in 2017.

Other

Under the guidelines of the Global Reporting Initiative, companies should disclose whether freedom of association and collective bargaining exists and if any employees are younger than 18. In compliance with Swedish law, AP3 allows freedom of association and collective bargaining. AP3 has no employees aged under 18.

■ NOTE 7 Other administrative expenses

| SEK m | 2017 | 2016 |
|--|-----------|-----------|
| Office rental costs | 13 | 11 |
| Communications and data costs | 43 | 36 |
| Services purchased | 11 | 11 |
| Other | 6 | 7 |
| Total other administrative expenses | 72 | 65 |

Services purchased include fees to auditors.

| SEK thousand | 2017 | 2016 |
|-------------------------------|------------|------------|
| Audit assignments | | |
| PwC | 738 | 719 |
| Total fees to auditors | 738 | 719 |

Services purchased include fees of SEK 0.8 million (0.6) for consulting services ordered by the Government Offices.

■ NOTE 8 Listed shares and investments

| SEK m | 31 Dec 2017 | 31 Dec 2016 |
|--|----------------|----------------|
| Swedish equities | 45,988 | 41,533 |
| Investments in Swedish funds | 1,213 | 1,998 |
| Foreign equities | 88,810 | 83,090 |
| Investments in foreign funds | 25,484 | 24,608 |
| Total listed shares and investments | 161,494 | 151,229 |

A list of the fund's five largest Swedish and foreign shareholdings, respectively, can be found on page 71. A list of all AP3's equity holdings is available at www.ap3.se. See Notes 1 and 17 for information on securities lending. Collateral received in relation to securities lending totalled an average of 103% of the market value of the assets lent.

■ NOTE 9 Unlisted shares and investments

As at 31 December 2017, AP3's investment commitments in unlisted securities via private equity firms and funds were as set out below. The schedule below shows the five largest holdings in terms of invested capital.

| | 31 Dec 2017 | 31 Dec 2016 |
|---|---------------|---------------|
| SEK m | Fair value | Fair value |
| Swedish shares and investments, subsidiaries and associated companies | 34,739 | 29,670 |
| Foreign shares and investments, subsidiaries and associated companies | 3,093 | - |
| Other unlisted Swedish shares and investments | 1,807 | 2,067 |
| Other unlisted foreign shares and investments | 17,222 | 18,760 |
| Total unlisted shares and investments | 56,861 | 50,497 |

| | Corporate identity no. | Registered office | Number of shares | Share of equity capital/votes | Fair value | 100% capital 2017 | 100% net result 2017 |
|--|------------------------|-------------------|-------------------------|-------------------------------|---------------|-------------------|----------------------|
| Swedish shares and investments, subsidiaries and associated companies | | | | | | | |
| Vasakronan Holding AB | 556650-4196 | Stockholm | 1,000,000 | 25% | 15,218 | 51,377 | 9,269 |
| Hemsö Fastighets AB | 556779-8169 | Stockholm | 70,000,700 | 70% | 8,358 | 10,795 | 2,591 |
| Hemsö Intressenter AB | 556917-4336 | Stockholm | 25,000 | 50% | 1,791 | | |
| Hemsö Norden KB | 969769-2961 | Stockholm | | 50% | 191 | 381 | 31 |
| Trophi Fastighets AB | 556914-7647 | Stockholm | 1,000,000 | 100% | 4,710 | 4,665 | 731 |
| Ellevio Holding 1 AB | 559005-2444 | Stockholm | 10,000 | 20% | 1,810 | | |
| Fastighets AB Regio | 559013-4911 | Stockholm | 4,000,003 | 97%/98% | 2,268 | 2,313 | 347 |
| Trenum AB | 556978-8291 | Göteborg | 500 | 50% | 393 | 874 | 594 |
| Total shares and investments in Swedish subsidiaries and associated companies | | | | | 34,739 | | |
| | Corporate identity no. | Registered office | Number of shares | Share of equity capital/votes | Fair value | 100% capital 2017 | 100% net result 2017 |
| Foreign shares and investments, subsidiaries and associated companies | | | | | | | |
| OMERS Farmoor 2 Holdings B.V. | | The Netherlands | 149 | 100%/49% | 3,093 | | |
| Total shares and investments in foreign subsidiaries and associated companies | | | | | 3,093 | | |
| | Registered office | Number of shares | Share of equity capital | Acquisition value 2017 | | | |
| Five largest holdings in other Swedish unlisted shares and investments | | | | | | | |
| Bergvik Skog AB | | Falun | | 5% | 174 | | |
| Valedo Partners Fund I | | Stockholm | | 20% | 124 | | |
| Altor Fund IV | | Stockholm | | 2% | 117 | | |
| Verdane Capital IX | | Stockholm | | 19% | 107 | | |
| Standout Capital I | | Stockholm | | 20% | 40 | | |
| Five largest holdings in other foreign unlisted shares and investments | | | | | | | |
| RMK GAC | | USA | | 100% | 756 | | |
| Innisfree PFI Secondary Fund 2 (ISF2) | | London | | 21% | 710 | | |
| Hermes Infra Spring II | | Guernsey | | 26% | 664 | | |
| Hancock GAC | | USA | | 100% | 404 | | |
| LLCP CO INVESTMENT FUND | | USA | | 26% | 388 | | |

A specification of all holdings, including the initial year of investment and the size of the investment commitment, can be found at www.ap3.se.

■ NOTE 10 Bonds and other fixed income assets

Bonds and other fixed income securities by class of issuer

| | 31 Dec 2017 | 31 Dec 2016 |
|----------------------------|----------------|----------------|
| SEK m | Fair value | Fair value |
| Swedish state | 12,499 | 16,873 |
| Swedish municipalities | 179 | 179 |
| Swedish mortgage lenders | 5,882 | 4,885 |
| Other Swedish issuers | | |
| Financial institutions | 2,416 | 2,373 |
| Non-financial institutions | 22,913 | 13,602 |
| Foreign states | 56,630 | 59,712 |
| Other foreign issuers | 32,536 | 28,517 |
| Total | 133,055 | 126,140 |
| Fixed income funds | 2,666 | 4,892 |
| Total | 135,721 | 131,032 |

Bonds and other fixed income securities by class of instrument

| | 31 Dec 2017 | 31 Dec 2016 |
|---------------------------|----------------|----------------|
| SEK m | Fair value | Fair value |
| Index-linked bonds | 20,573 | 20,381 |
| Other bonds | 92,625 | 90,453 |
| Certificates | 13,051 | 7,000 |
| Unlisted promissory notes | 6,806 | 8,306 |
| Total | 133,055 | 126,140 |
| Fixed income funds | 2,666 | 4,892 |
| Total | 135,721 | 131,032 |

SEK 9,163 million (10,841) of bonds and other fixed income securities relates to reinvested cash collateral received for securities lending. See Notes 1 and 17 for information on securities lending. Collateral received in relation to securities lending totalled an average of 103% of the market value of the assets lent.

■ NOTE 11 Derivatives, gross

| | 31 Dec 2017 | |
|--|------------------------|------------------------|
| SEK m | Positive fair value | Negative fair value |
| Equity-related instruments | | |
| Options, cleared | Held, buy | - |
| | Held, sell | 2 |
| | Drawn, buy | - |
| | Drawn, sell | -1 |
| Forwards | | 401 |
| Swaps | | 23 |
| Total | | 425 |
| - cleared | | 403 |
| | | -104 |
| Fixed income and credit-related instruments | | |
| Options, cleared | Held, buy | - |
| | Held, sell | - |
| | Drawn, buy | 6 |
| | Drawn, sell | 14 |
| FRAs/forwards | | 175 |
| CDS | | 759 |
| Swaps | | 548 |
| Total | | 1,501 |
| - cleared | | 195 |
| | | -91 |
| Currency-related Instruments | | |
| Options, OTC | Held, buy | 152 |
| | Held, sell | 282 |
| | Drawn, buy | - |
| | Drawn, sell | -251 |
| Forwards | | 1,276 |
| Swaps | | - |
| Total | | 1,709 |
| Effect of netting | | - |
| Total derivatives | 3,636 | -5,228 |

| | 31 Dec 2016 | |
|--|------------------------|------------------------|
| SEK m | Positive fair value | Negative fair value |
| Equity-related instruments | | |
| Options, cleared | Held, buy | 1 |
| | Held, sell | 20 |
| | Drawn, buy | 9 |
| | Drawn, sell | -3 |
| Forwards | | 134 |
| Swaps | | 36 |
| Total | | 200 |
| - cleared | | 163 |
| | | -198 |
| Fixed income and credit-related instruments | | |
| Options, cleared | Held, buy | 1 |
| | Held, sell | 52 |
| | Drawn, buy | - |
| | Drawn, sell | -0 |
| FRAs/forwards | | 35 |
| CDS | | 823 |
| Swaps | | 628 |
| Total | | 1,539 |
| - cleared | | 88 |
| | | -76 |
| Currency-related Instruments | | |
| Options, OTC | Held, buy | 416 |
| | Held, sell | 587 |
| | Drawn, buy | 0 |
| | Drawn, sell | -369 |
| Forwards | | 1,937 |
| Swaps | | - |
| Total | | 2,942 |
| Effect of netting | | - |
| Total derivatives | 4,681 | -4,995 |

According to the investment rules for AP3, derivatives may be used primarily to improve the efficacy of asset management or to manage risk.

Equity and interest rate derivatives are preferably traded on standardised markets through cleared products, which limits counterparty risks to the clearing house. Currency and credit derivative markets are over-the-counter, which means that trades executed there are not standardised or subject to clearing. Thus, counterparty or settlement risk generally arises. Counterparties for non-cleared transactions are limited and sanctioned by the board and all exposure to such counterparties is continuously monitored. AP3 uses standardised market contracts, including ISDA agreements, for OTC trading.

Drawn put options are positions in different options strategies taken to manage portfolio risk. Where a put option requires AP3 to deliver an underlying security, AP3 always holds enough of that security to meet its delivery obligation.

More information on AP3's risk management procedures for derivatives can be found in the risk management plan at www.ap3.se.

■ NOTE 12 Other assets

| SEK m | 31 Dec 2017 | 31 Dec 2016 |
|-----------------------------------|--------------|---------------|
| Securities settlement receivables | 1,189 | 1,310 |
| Buybacks | 1,908 | 4,142 |
| Reinvested cash collateral | 5,525 | 5,605 |
| Other current receivables | 0 | 50 |
| Total other assets | 8,623 | 11,107 |

■ NOTE 16 Fund capital

| Net payments to the pension system | | |
|---|---------------|---------------|
| SEK m | 31 Dec 2017 | 31 Dec 2016 |
| Fund capital at 1 Jan | 324,375 | 303,031 |
| Paid-in pension contributions | 66,850 | 64,174 |
| Paid-out pension disbursements this year | -73,999 | -70,595 |
| Transfer of pension credits to the EU | -2 | -1 |
| Settlement of pension credits | 1 | 1 |
| Administration fee to the Swedish Pensions Agency | -226 | -216 |
| Total net payments to the pension system | -7,375 | -6,637 |
| Net result | 28,239 | 27,981 |
| Fund capital at 31 Dec | 345,239 | 324,375 |

■ NOTE 13 Prepaid expenses and accrued income

| SEK m | 31 Dec 2017 | 31 Dec 2016 |
|--|--------------|-------------|
| Accrued interest income | 771 | 667 |
| Accrued dividends | 102 | 96 |
| Refunds | 131 | 113 |
| Prepaid expenses | 49 | 41 |
| Accrued premiums on equity loans | 10 | 17 |
| Total prepaid expenses and accrued income | 1,063 | 935 |

■ NOTE 17 Pledged assets, contingent liabilities and commitments**Pledged assets, contingent liabilities and equivalent collateral**

| SEK m | 31 Dec 2017 | 31 Dec 2016 |
|--|-------------|-------------|
| Pledged assets for buybacks | | |
| Collateral received | 7,433 | 9,747 |
| Collateral pledged | 1,543 | 3,542 |
| Pledged assets for derivatives trading | | |
| Cash collateral received | - | 713 |
| Cash collateral pledged | 739 | - |
| Loaned securities for which cash collateral received | | |
| Loaned securities | 14,695 | 16,435 |
| Cash collateral received | 14,688 | 16,438 |
| Securities loaned against collateral in securities | | |
| Loaned securities | 44,476 | 42,155 |
| Collateral received in securities | 47,705 | 43,697 |

Outstanding commitments

| SEK m | 31 Dec 2017 | 31 Dec 2016 |
|--|-------------|-------------|
| Unlisted equities | 8,936 | 6,076 |
| Real estate, infrastructure and timberland funds | 3,991 | 739 |
| Subscription commitments | 10,500 | 8,500 |

The collateral shown above is presented in Notes 10, 12 and 14.

■ NOTE 14 Other liabilities

| SEK m | 31 Dec 2017 | 31 Dec 2016 |
|-----------------------------------|---------------|---------------|
| Accounts payable | 9 | 14 |
| Securities settlement liabilities | 1,177 | 1,276 |
| Payroll taxes | 1 | 1 |
| Employee withholding taxes | 3 | 3 |
| Buybacks | 1,539 | 3,542 |
| Cash collateral received | 14,688 | 16,438 |
| Other liabilities | 9 | 9 |
| Total other liabilities | 17,426 | 21,282 |

■ NOTE 15 Deferred income and accrued expenses

| SEK m | 31 Dec 2017 | 31 Dec 2016 |
|--|-------------|-------------|
| Accrued external asset management costs | 52 | 32 |
| Other accrued expenses | 13 | 44 |
| Variable remuneration incl. social security expenses | 12 | 12 |
| Total deferred income and accrued expenses | 77 | 89 |

Forty per cent of a payment of variable remuneration earned in 2015 was made in 2016. The remainder will be paid in 2018. Forty per cent of a payment of variable remuneration earned in 2016 was made in 2017. The remainder will be paid in 2019. Forty per cent of a payment of variable remuneration earned in 2017 will be made in 2018. The remainder will be paid in 2020.

■ NOTE 18 Currency exposure

Assets subject to currency exposure at 31 Dec 2017

| SEK m | USD | NOK | JPY | GBP | Other currencies | Total |
|--|----------------|---------------|--------------|---------------|------------------|----------------|
| Shares and investments | 60,536 | 1,301 | 2,417 | 11,412 | 53,204 | 128,870 |
| Exposure to SEK-listed companies with foreign domicile | - | - | - | 664 | 1,642 | 2,306 |
| Bonds and other fixed income securities | 61,262 | 599 | 191 | 8,323 | 3,116 | 73,491 |
| Derivatives | -378 | -272 | 255 | -310 | -2,596 | -3,300 |
| Other investment assets | 4,245 | 5 | -166 | 3,149 | 1,290 | 8,524 |
| Foreign currency exposure, gross | 125,666 | 1,633 | 2,698 | 23,237 | 56,657 | 209,891 |
| Currency hedges | -89,284 | 12,043 | 4,357 | -17,534 | -65,303 | -155,721 |
| Total currency exposure | 36,382 | 13,676 | 7,054 | 5,703 | -8,646 | 54,170 |

Assets subject to currency exposure at 31 Dec 2016

| SEK m | USD | NOK | JPY | GBP | Other currencies | Total |
|--|----------------|---------------|--------------|---------------|------------------|----------------|
| Shares and investments | 59,838 | 698 | 4,445 | 10,234 | 47,296 | 122,511 |
| Exposure to SEK-listed companies with foreign domicile | - | - | - | 618 | 1,300 | 1,918 |
| Bonds and other fixed income securities | 59,869 | 128 | 205 | 8,101 | 2,380 | 70,684 |
| Derivatives | -470 | -77 | 68 | -572 | -2,938 | -3,990 |
| Other investment assets | 6,871 | 59 | 147 | 53 | 2,154 | 9,283 |
| Foreign currency exposure, gross | 126,107 | 809 | 4,865 | 18,434 | 50,192 | 200,407 |
| Currency hedges | -86,906 | 11,210 | -5,388 | -13,108 | -47,501 | -141,692 |
| Total currency exposure | 39,201 | 12,019 | -522 | 5,326 | 2,691 | 58,715 |

■ NOTE 19 Financial instruments, price and valuation hierarchy

Investment assets by valuation category at 31 Dec 2017

| SEK m | Observable prices in an active market | Valuation model with observable input data | Valuation model with non-observable input data | Total |
|-------------------------------------|---------------------------------------|--|--|----------------|
| Listed shares and investments | 161,494 | | | 161,494 |
| Unlisted shares and investments | | | 56,861 | 56,861 |
| Bonds and other fixed income assets | 128,534 | | 7,187 | 135,721 |
| Derivatives, positive market value | 597 | 3,039 | | 3,636 |
| Total investment assets | 290,626 | 3,039 | 64,048 | 357,712 |
| Derivatives, negative market value | -195 | -5,033 | | -5,228 |
| Total | 290,431 | -1,995 | 64,048 | 352,484 |

Investment assets by valuation category at 31 Dec 2016

| SEK m | Observable prices in an active market | Valuation model with observable input data | Valuation model with non-observable input data | Total |
|-------------------------------------|---------------------------------------|--|--|----------------|
| Listed shares and investments | 151,229 | | | 151,229 |
| Unlisted shares and investments | | | 50,497 | 50,497 |
| Bonds and other fixed income assets | 122,343 | | 8,690 | 131,032 |
| Derivatives, positive market value | 252 | 4,429 | | 4,681 |
| Total investment assets | 273,824 | 4,429 | 59,186 | 337,439 |
| Derivatives, negative market value | -274 | -4,722 | | -4,995 |
| Total | 273,550 | -292 | 59,186 | 332,444 |

■ NOTE 19 cont.**Change in assets under valuation model with non-observable input data, 2016 – 2017**

| SEK m | Listed shares and investments | Unlisted shares and investments | Bonds and other fixed income assets | Derivatives | Total |
|----------------------------------|----------------------------------|------------------------------------|---|-------------|---------------|
| Carrying amount at 1 Jan | - | 50,497 | 8,690 | - | 59,186 |
| Invested | - | 5,536 | 3,759 | - | 9,295 |
| Sold/repaid during the year | - | -2,647 | -5,262 | - | -7,909 |
| Realised change in value | - | 275 | - | - | 275 |
| Unrealised change in value | - | 3,200 | 0 | - | 3,200 |
| Transfer from level 1 or 2 | - | - | - | - | - |
| Transfer to level 1 or 2 | - | - | - | - | - |
| Carrying amount at 31 Dec | - | 56,861 | 7,187 | - | 64,048 |

Change in assets under valuation model with non-observable input data, 2015 – 2016

| SEK m | Listed shares and investments | Unlisted shares and investments | Bonds and other fixed income assets | Derivatives | Total |
|----------------------------------|----------------------------------|------------------------------------|---|-------------|---------------|
| Carrying amount at 1 Jan | - | 39,196 | 10,349 | - | 49,545 |
| Invested | - | 8,891 | 1,783 | - | 10,674 |
| Sold/repaid during the year | - | -3,102 | -3,540 | - | -6,642 |
| Realised change in value | - | -92 | - | - | -92 |
| Unrealised change in value | - | 5,604 | 98 | - | 5,702 |
| Transfer from level 1 or 2 | - | - | - | - | - |
| Transfer to level 1 or 2 | - | - | - | - | - |
| Carrying amount at 31 Dec | - | 50,497 | 8,690 | - | 59,186 |

AP3 measures all holdings at fair value using a hierarchy of price sources and measurement methods. Fair value is defined as the amount for which an asset could be sold or a liability settled in a normal transaction between market players on the valuation date.

Holdings shown in the benchmark indices that AP3 uses for liquid investments in equities and fixed income securities are measured initially at the valuation prices stated by index vendors. Where such holdings are not included in an index or the index vendor's price is not deemed to be reliable, measurement is at list prices observable in an active market. An active market means a market where prices are set more often than once a week. Observable prices are always the preferred measurement option and apply to the majority of AP3's assets. However, when such prices are not available, the next step in the valuation hierarchy is used for measurement.

Reliable listed prices are unavailable for some holdings, notably some fixed income securities and most derivatives not traded over an exchange or handled by a clearing house. In that case, measurements are based on generally acceptable models that use observable market data to establish fair value. The valuation risk for this group is regarded as limited. This group also includes certain types of transaction in which AP3 relies on price information from one or more external counterparties to determine fair value. In the case of assets whose price is deemed unreliable, for instance due to low market activity, AP3 obtains a third-party valuation to test the reasonableness of its own valuation.

Some holdings must be valued using models based on non-observable market data. These are subject to a higher degree of subjective assessment and hence higher uncertainty. In AP3's case, they relate mostly to holdings in private equity funds and of unlisted shares in real estate companies.

AP3 measures private equity fund holdings using valuations received from external managers. AP3 requires that fund managers comply with IPEV valuation principles and that their funds are reviewed by an established audit firm. Valuations from fund managers are usually received within 90 days after the end of the quarter, which means that the declared values of AP3's holdings as at 31 December are based on fund managers' reports dated 30 September adjusted for cash flow during the fourth quarter. AP3 assesses the reliability of these valuations to determine whether any adjustments are necessary to achieve a more accurate fair value. No adjustments were deemed necessary as at 31 December 2017. Valuations primarily reflect the underlying profitability of the investor but also how the equity market values comparable enterprises. Projected discounted future cash flow is of less importance from a valuation perspective because the AP3 private equity portfolio largely consists of buyouts.

The table shows all AP3's investment assets by valuation category. Some 82% (82) of these assets can be valued at observable prices in an active market. A 10% write-down of the hardest-to-value assets – those with a valuation model based on non-observable input data – would reduce AP3's fund capital by 1.9% (1.8). AP3 has limited valuation risk.

■ NOTE 20 Financial risks

Risk measured as value at risk for the AP3 portfolio

| SEK m | Min. level | Max. level | Average | 31 Dec | 31 Dec ¹ |
|-------|------------|------------|---------|--------|---------------------|
| 2017 | 921 | 1,828 | 1,375 | 1,217 | 1,536 |
| 2016 | 1,265 | 3,836 | 2,144 | 1,484 | 2,581 |

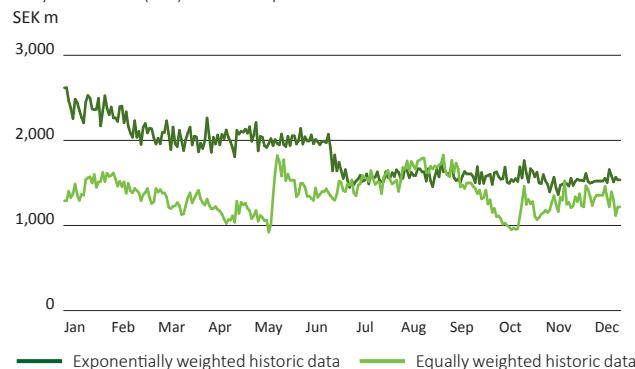
1) The column shows VaR for equally weighted historic data.

AP3's holdings are exposed to market and credit risks that can result in changes in value when equity prices, fixed income yields, credit spreads and currency rates change. AP3 uses value at risk (VaR) to aggregate risk across all risk categories. At year-end, risk measured as VaR totalled SEK 1,217 million (1,484) for the total portfolio. AP3 measures VaR with a 95% level of confidence and a horizon of one day, meaning that negative changes in value should not exceed VaR on 19 days out of 20, assuming that market conditions follow historical patterns. AP3 bases VaR estimates on historic market data dating back 360 days. Historic data are weighted exponentially, meaning that market events in the preceding 80 days have overriding influence. The measurement method used is known as Monte Carlo simulation and is a random simulation of changes in value based on historic data. The table shows VaR at 31 December. Historic data are equally weighted, meaning that every day has equal significance.

AP3's risk measured as VaR varied from SEK 921 million (1,265) to SEK 1,828 (3,836) million during the year. Changes in the level of risk were due primarily to changes in market volatility, and to a lesser extent to changes in portfolio structure.

The table above shows maximum and minimum VaR levels and both average risk and year-end risk for the AP3 portfolio. Risk exposure by risk category is shown on page 47.

Daily value at risk (VaR) for the AP3 portfolio 2017



Exposure to credit risk at 31 Dec 2017¹

| SEK m | CREDIT RATING | | | | |
|-----------------------|---------------|--------|--------|-------|--------------------|
| | AAA | AA | A | BBB | <BBB ⁻² |
| Government bonds | 35,258 | 48,599 | 519 | | |
| Mortgage bonds | 3,621 | 3,338 | | | 248 |
| Corporate bonds | 405 | 5,003 | 10,870 | 4,566 | 9,034 |
| Deposits and buybacks | | 785 | 6,099 | | |
| Derivatives, net | | 141 | 50 | | |
| Gross exposure | 39,284 | 57,866 | 17,538 | 4,566 | 9,282 |
| Collateral received | | | | | |
| Net exposure | 39,284 | 57,866 | 17,538 | 4,566 | 9,282 |

Exposure to credit risk at 31 Dec 2016¹

| SEK m | CREDIT RATING | | | | |
|-----------------------|---------------|--------|--------|-------|--------------------|
| | AAA | AA | A | BBB | <BBB ⁻² |
| Government bonds | 35,214 | 52,901 | 572 | | |
| Mortgage bonds | 2,628 | 3,260 | | | 253 |
| Corporate bonds | 708 | 6,355 | 5,617 | 5,049 | 3,170 |
| Deposits and buybacks | | 1,363 | 7,023 | | |
| Derivatives, net | | 249 | 1,346 | | |
| Gross exposure | 38,550 | 64,128 | 14,558 | 5,049 | 3,423 |
| Collateral received | | | 709 | | |
| Net exposure | 38,550 | 64,128 | 13,848 | 5,049 | 3,423 |

1) Includes: investments in listed fixed income securities; deposits and buybacks; non-cleared derivatives where AP3 has a claim on the counterparty; and repayments of collateral for securities lending.

The table only shows exposure versus credit risk and cannot be read against the balance sheet.

2) Also includes unrated securities.

AP3's liquidity risk is limited by the National Pension Insurance Funds Act, which requires the AP funds to hold at least 30% of their fund capital in fixed income securities with low credit and liquidity risk. AP3's holdings in this category averaged 32.2% (32.8) of fund capital in 2017. The comparative figures in the table of credit risk have been changed as the Annual Report 2016 contained errors in this table.

■ NOTE 21 Financial assets and liabilities offset in the balance sheet or subject to netting agreements

31 Dec 2017

| Assets, SEK m | Gross amount | Amount offset in balance sheet | Net balance in balance sheet | Offsetting of financial instruments per agreement | Collateral received | Net amount after offsetting | Other ¹ | Total in balance sheet |
|--------------------------|--------------|--------------------------------|------------------------------|---|---------------------|-----------------------------|--------------------|------------------------|
| | | | | | | | | |
| Derivatives | 3,039 | | 3,039 | 2,625 | | 414 | 597 | 3,636 |
| Asset repurchases | 1,908 | | 1,908 | 1,539 | | 369 | 5,525 | 7,434 |
| Non-settled transactions | | | | | | | 261 | 261 |
| Total | 4,947 | 0 | 4,947 | 4,164 | 0 | 783 | 6,383 | 11,330 |
| Liabilities, SEK m | Gross amount | Amount offset in balance sheet | Net balance in balance sheet | Offsetting of financial instruments per agreement | Pledged collateral | Net amount after offsetting | Other ¹ | Total in balance sheet |
| | | | | | | | | |
| Derivatives | 5,033 | | 5,033 | 2,625 | 739 | 1,669 | 195 | 5,228 |
| Debt repurchases | 1,539 | | 1,539 | 1,539 | 4 | 0 | | 1,539 |
| Non-settled transactions | | | | | | | 249 | 249 |
| Total | 6,573 | 0 | 6,573 | 4,164 | 744 | 1,669 | 444 | 7,017 |

1) Other instruments in the balance sheet not classed as subject to agreements that allow netting.

31 Dec 2016

| Assets, SEK m | Gross amount | Amount offset in balance sheet | Net balance in balance sheet | Offsetting of financial instruments per agreement | Collateral received | Net amount after offsetting | Other ¹ | Total in balance sheet |
|--------------------------|--------------|--------------------------------|------------------------------|---|---------------------|-----------------------------|--------------------|------------------------|
| | | | | | | | | |
| Derivatives | 4,429 | | 4,429 | 2,810 | 713 | 907 | 252 | 4,681 |
| Asset repurchases | 4,142 | | 4,142 | 3,542 | | 599 | 5,605 | 9,747 |
| Non-settled transactions | | | | | | | 1,310 | 1,310 |
| Total | 8,571 | 0 | 8,571 | 6,352 | 713 | 1,506 | 7,167 | 15,738 |
| Liabilities, SEK m | Gross amount | Amount offset in balance sheet | Net balance in balance sheet | Offsetting of financial instruments per agreement | Pledged collateral | Net amount after offsetting | Other ¹ | Total in balance sheet |
| | | | | | | | | |
| Derivatives | 4,722 | | 4,722 | 2,810 | 250 | 1,662 | 274 | 4,995 |
| Debt repurchases | 3,542 | | 3,542 | 3,542 | 6 | 0 | | 3,542 |
| Non-settled transactions | | | | | | | 1,276 | 1,276 |
| Total | 8,264 | 0 | 8,264 | 6,352 | 256 | 1,662 | 1,549 | 9,813 |

1) Other instruments in the balance sheet not classed as subject to agreements that allow netting.

■ NOTE 22 Related party transactions

Parties related to AP3 are companies in which AP3 has a shareholding that gives it significant or decisive influence, or in which AP3 employees hold leading positions. The following persons employed in AP3 served as directors of related parties in 2017: Kerstin Hessius at Vasakronan, Hemsö and Trenum; Bengt Hellström at Hemsö, Trophi and Trenum; Mårten Lindeborg at Regio; Klas Åkerbäck at Regio and Trophi;

and Mattias Bylund at Ellevio. These directorships were unpaid. The AP3 Chairman of the Board, Pär Nuder, also served as a director of Hemsö and in this capacity was paid a fee of SEK 420 thousand in 2017. AP3 rents its office space from Vasakronan AB at market rates.

| Related party, SEK m | 2017 | 2016 | Related party, SEK m | 2017 | 2016 |
|--|-------|-------|---|-------|-------|
| <i>Vasakronan Holding AB</i> | | | | | |
| Interest income | 9 | 147 | <i>Trophi Fastighets AB</i> | 36 | 81 |
| Rental cost of premises | -8 | -11 | Shareholder loans | 604 | 2,064 |
| Commitment to purchase, at the issuer's request, commercial paper issued by Vasakronan for a maximum amount of: | 4,500 | 4,500 | Commitment to purchase, at the issuer's request, commercial paper issued by Trophi Fastighets AB for a maximum amount of: | 2,000 | - |
| Shareholder contributions during the year | - | 3,000 | Shareholder contributions during the year | 140 | 1,436 |
| <i>Hemsö Fastighets AB</i> | | | | | |
| Commitment to purchase, at the issuer's request, commercial paper issued by Hemsö Fastighets AB for a maximum amount of: | 4,000 | 4,000 | <i>Regio AB</i> | 200 | 588 |
| <i>Hemsö Intressenter AB</i> | | | | | |
| Interest income | 88 | 88 | Shareholder contributions during the year | 294 | 301 |
| Shareholder loans | 1,470 | 1,470 | Shareholder loans | 3,558 | 3,598 |
| <i>Ellevio AB</i> | | | | | |
| Interest income | | | <i>Trenum AB</i> | 8 | - |
| Shareholder loans | | | Shareholder loans | 1,174 | 1,174 |
| | | | Shareholder contributions during the year | 50 | 25 |

Signatures of board of directors and CEO

Stockholm, 23 February 2018

Pär Nuder, Chairman

Björn Börjesson, Deputy Chairman

Malin Björkmo

Peter Englund

Lars Ernsäter

Peter Hellberg

Kerstin Lindberg Göransson

Christina Lindenius

Elisabeth Unell

Kerstin Hessius, CEO

Our auditor's report was submitted on 23 February 2018.

Peter Nilsson
Authorised public accountant
Appointed by the government

Helena Kaiser de Carolis
Authorised public accountant
Appointed by the government

Auditor's Report

For the Third Swedish National Pension Fund (AP3), Corporate Identity Number 802014-4120

Report on the audit of the financial statements

Opinion

We have audited the financial statements of the Third Swedish National Pension Fund for the 2017 financial year. The Fund's financial statements are included in the printed version of this document on pages 44 – 66.

In our opinion, the financial statements have been prepared in accordance with the National Pension Insurance Funds Act (2000:192) and present fairly, in all material respects, the financial position of the Third Swedish National Pension Fund as at 31 December 2017 and of its financial performance for the year then ended, according to the National Pension Insurance Funds Act.

The statutory administration report is consistent with the other parts of the financial statements.

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

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (ISA) and generally accepted auditing standards in Sweden. Our responsibilities according to those standards are described in more detail in the Auditor's Responsibilities section below. We are independent of the Third Swedish National Pension Fund according to generally accepted auditing standards in Sweden and have otherwise fulfilled our ethical responsibilities according to those standards.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Other information than the financial statements

This document also contain other information than the annual report and this can be found on pages 1–43 and 69–76. The Board of Directors and the Chief Executive Officer are responsible for the other information.

Our opinion on the financial statements does not cover this other information and we do not express any form of assurance conclusion regarding this other information.

In connection with our audit of the financial statements, our responsibility is to read the information identified above and consider whether the information is materially inconsistent with the financial statements. In this procedure we also take into account our knowledge otherwise obtained in the audit and assess whether the information otherwise appears to be materially misstated.

If we, based on the work performed concerning this information, conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of the board of directors and the CEO

The board of directors and the CEO are responsible for the preparation of the financial statements and that they give a fair presentation in accordance with the National Pension Insurance Funds Act. The board of directors and the CEO are also responsible for such internal control as they deem necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the board of directors and the CEO are required to assess the Fund's capacity to continue its operations. They disclose, as applicable, matters related to such assessments and using the going concern basis of accounting. The going concern basis of accounting is, however, not applied if the board of directors and the CEO intend to liquidate the Fund or cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs and generally accepted auditing standards in Sweden will always identify a material misstatement when it exists. Misstatements can arise from fraud or error and are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As a part of the audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement in the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of the Fund's internal control relevant to our audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control.
- Evaluate the appropriateness of the accounting principles used and the reasonableness of the accounting estimates

and related disclosures made by the board of directors and the CEO.

- Conclude on the appropriateness of the board of directors' and the CEO's application of the going concern basis of accounting in preparing the financial statements. We also draw a conclusion, based on the evidence obtained, as to whether any material uncertainty exists related to events or conditions that may cast significant doubt on the Fund's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion about the financial statements. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Fund to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We must inform the Board of Directors of, among other matters, the planned scope and timing of the audit. We must also inform of significant audit findings during our audit, including any significant deficiencies in internal control that we identified.

Report on other legal and regulatory requirements

Opinion

In addition to our audit of the financial statements, we have also audited the inventory of the assets managed by the Third Swedish National Pension Fund. We have also examined whether there are any qualifications regarding the board of directors' and the CEO's administration of the Third Swedish National Pension Fund for the 2017 financial year.

The audit has resulted in no grounds for qualification regarding the inventory of the assets or the administration of the Fund.

Basis for opinion

We conducted our audit in accordance with generally accepted auditing standards in Sweden. Our responsibilities under those standards are further described in the Auditor's Responsibilities section below. We are independent of the Third Swedish National Pension Fund in accordance with professional ethics for accountants in Sweden and have

otherwise fulfilled our ethical responsibilities in accordance with those requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of the board of directors and the CEO

The board of directors and the CEO are responsible for the financial statements and for the administration of the Fund's assets according to the National Pension Insurance Funds Act.

The board of directors is responsible for the Fund's organisation and the administration of the Fund's affairs. This includes continuous assessment of the Fund's financial situation and ensuring that the Fund's organisation is designed so that the accounting, management of assets and the Fund's financial affairs otherwise are controlled in a reassuring manner. The CEO is responsible for the ongoing administration according to the board of directors' guidelines and instructions and must among other matters take measures that are necessary to fulfil the Fund's accounting in accordance with law and handle the management of assets in a reassuring manner.

Auditor's responsibilities

Our responsibility concerning the audit of the administration and, thereby, our opinion on discharge from liability, is to obtain audit evidence to assess with a reasonable degree of assurance whether there is any reason for qualification in respect any member of the board of directors or the CEO of the Third Swedish National Pension Fund for the 2017 financial year.

Reasonable assurance is a high level of assurance but is not a guarantee that an audit conducted in accordance with generally accepted auditing standards in Sweden will always identify actions or omissions that can give rise to qualification.

As a part of an audit in accordance with generally accepted auditing standards in Sweden, we exercise professional judgment and maintain professional scepticism throughout the audit. The examination of the administration is based primarily on the audit of the financial statements. Additional audit procedures performed are based on our professional judgment, with the starting point being risks and materiality. This means that we focus the examination on such actions, areas and relationships that are material for the operations and where deviations and violations would have particular significance to the Fund's situation. We examine and test decisions undertaken, support for decisions, actions taken and other circumstances that are relevant to our opinion on the administration.

Stockholm, 23 February 2018

Peter Nilsson
Authorised auditor
Appointed by the government

Helena Kaiser de Carolis
Authorised auditor
Appointed by the government

Five-year summary

| | 2017 | 2016 | 2015 | 2014 | 2013 |
|---|--------------|-------------|-------------|-------------|-------------|
| INCOME AND FLOWS | | | | | |
| SEK bn | | | | | |
| Net result | 28.2 | 28.0 | 19.6 | 35.0 | 32.4 |
| Net flow from pension system | -7.4 | -6.6 | -4.9 | -5.1 | -6.9 |
| Fund capital at 31 Dec ¹ | 345.2 | 324.4 | 303.0 | 288.3 | 258.5 |
| RETURN AND EXPENSES, TOTAL PORTFOLIO | | | | | |
| % SEK bn | | | | | |
| Return before expenses | 8.9 | 9.5 | 6.9 | 13.8 | 14.2 |
| Operating expenses | 0.06 | 0.06 | 0.06 | 0.07 | 0.07 |
| Commission expenses | 0.05 | 0.06 | 0.06 | 0.06 | 0.06 |
| Return after expenses | 8.8 | 9.4 | 6.8 | 13.7 | 14.1 |
| Inflation | 1.7 | 1.7 | 0.1 | -0.3 | 0.1 |
| Real return after expenses | 6.9 | 7.6 | 6.7 | 14.1 | 14.0 |
| Income (incl. commission expenses) | | | | | |
| Income (incl. commission expenses) | 28.4 | 28.2 | 19.8 | 35.2 | 32.6 |
| Operating expenses | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| Profit after expenses | 28.2 | 28.0 | 19.6 | 35.0 | 32.4 |
| ANNUALISED NOMINAL RETURN AFTER EXPENSES | | | | | |
| % 5 years (2013-2017) | | | | | |
| 5 years (2013-2017) | 10.5 | 10.9 | 8.4 | 8.8 | 9.3 |
| 10 years (2008-2017) | | | | | |
| 10 years (2008-2017) | 6.1 | 5.7 | 5.7 | 6.8 | 6.5 |
| RISK | | | | | |
| Risk (1-yr standard deviation) for total portfolio, % | 3.5 | 6.2 | 7.0 | 4.7 | 4.9 |
| Risk (1-yr standard deviation) for liquid assets, % | 4.0 | 7.2 | 8.0 | 5.2 | 5.7 |
| Sharpe ratio | 2.8 | 1.6 | 1.0 | 2.8 | 2.8 |
| Sharpe ratio liquid assets | 2.2 | 1.1 | 0.5 | 2.3 | 2.3 |
| Information ratio ² , active management | 1.9 | 1.4 | 0.9 | 1.4 | 1.8 |
| Risk (10-yr standard deviation), % | 7.6 | 8.0 | 8.1 | 7.8 | 7.9 |
| CURRENCY EXPOSURE | | | | | |
| % of total portfolio ² | 15.0 | 17.5 | 22.8 | 24.4 | 20.4 |
| EXTERNAL MANAGEMENT | | | | | |
| % of total portfolio | 25.0 | 29.0 | 31.0 | 33.2 | 35.2 |
| ASSET MANAGEMENT EXPENSES | | | | | |
| % of assets under management | | | | | |
| Operating expenses | 0.06 | 0.06 | 0.06 | 0.07 | 0.07 |
| Operating and commission expenses | 0.10 | 0.12 | 0.12 | 0.12 | 0.13 |
| No. of employees at 31 Dec | 57 | 57 | 51 | 57 | 53 |

1) Fund capital on 1 January 2001 was SEK 134.0 billion.

2) Excluding exposure to SEK-listed companies with a foreign domicile.

Change in fund capital

| SEK m | 2017 | 2016 | 2015 | 2014 | 2013 |
|------------------------------------|----------------|-------------|-------------|-------------|-------------|
| Fund capital at 1 Jan ¹ | 324,375 | 303,031 | 288,332 | 258,475 | 232,956 |
| Net flows | -7,375 | -6,637 | -4,944 | -5,120 | -6,880 |
| Income | 28,239 | 27,981 | 19,643 | 34,977 | 32,398 |
| Fund capital at 31 Dec | 345,239 | 324,375 | 303,031 | 288,332 | 258,475 |

1) Fund capital at inception in 2001 was SEK 133,975 million.

Market value per asset category

| SEK bn | | 2017-12-31 | 2016-12-31 | 2015-12-31 | 2014-12-31 | 2013-12-31 |
|---|--|--------------|------------|------------|------------|------------|
| LISTED EQUITIES ¹ | Sweden | 44.5 | 40.3 | 34.2 | 31.7 | 32.6 |
| | Europe | 26.9 | 23.7 | 29.2 | 27.6 | 26.6 |
| | North America | 54.0 | 50.4 | 43.9 | 50.1 | 41.8 |
| | Asia | 7.6 | 9.2 | 14.5 | 12.4 | 12.4 |
| | Emerging markets | 19.8 | 15.0 | 11.2 | 10.4 | 14.6 |
| Total listed equities | | 152.9 | 138.7 | 132.9 | 132.2 | 128.0 |
| FIXED INCOME ¹ | | | | | | |
| Nominal | Sweden | 45.8 | 45.2 | 35.9 | 37.8 | 50.7 |
| | Eurozone | 0.4 | 1.4 | 2.0 | 2.5 | 2.5 |
| | UK | 9.0 | 9.3 | 8.5 | 8.5 | 2.6 |
| | USA | 44.8 | 44.1 | 46.3 | 43.1 | 13.1 |
| | Asia | 0.0 | 0.0 | 3.1 | 3.1 | 0.0 |
| Index-linked bonds | Sweden | 4.8 | 4.8 | 5.8 | 12.5 | 14.5 |
| | Eurozone | 0.0 | 0.0 | 0.0 | 0.0 | 2.5 |
| | Japan | 0.2 | 0.2 | | | |
| | USA | 15.8 | 15.5 | 13.0 | 2.8 | 4.6 |
| Total fixed income | | 120.8 | 120.5 | 114.5 | 110.3 | 90.6 |
| ALTERNATIVE INVESTMENTS ¹ | | | | | | |
| Real estate and infrastructure | Vasakronan | 15.2 | 13.8 | 12.2 | 10.2 | 10.3 |
| | Hemsö | 11.8 | 10.1 | 8.2 | 6.7 | 7.0 |
| | Farmoor | 3.1 | | | | |
| | Regio | 2.3 | 1.7 | 0.9 | | |
| | Sagax | 1.1 | 0.9 | 0.8 | 0.5 | 0.3 |
| | Trenum | 1.6 | 1.3 | | | |
| | Trophi | 5.3 | 6.3 | 3.4 | 2.7 | 1.0 |
| | Ellevio | 5.4 | 5.2 | 4.8 | | |
| | Timberland and agricultural land | 5.0 | 5.7 | 5.5 | 4.8 | 4.3 |
| | International real estate funds ² | 6.2 | 7.0 | 6.6 | 8.5 | 5.6 |
| Total real estate and infrastructure | | 57.0 | 52.0 | 42.6 | 33.4 | 28.5 |
| Unlisted equities | | 10.3 | 10.0 | 10.2 | 10.6 | 9.8 |
| Other assets ³ | | 4.1 | 3.0 | 2.7 | 1.8 | 1.6 |
| Total alternative investments | | 71.4 | 65.1 | 55.5 | 45.8 | 39.8 |
| Total | | 345.2 | 324.4 | 303.0 | 288.3 | 258.5 |

1) Cash used for position-taking in forwards is divided among the relevant asset categories, which means the figures in the table are not fully comparable with those in the balance sheet.

2) Includes infrastructure funds.

3) Other assets include investments in convertible debentures and insurance-related risk.

Five largest holdings in Swedish listed companies

| Name | Number of shares | Share of equity | Share of voting rights | Market value, SEK m |
|---------------------|------------------|-----------------|------------------------|---------------------|
| Volvo AB | 23,251,518 | 1.09 | 0.53 | 3,551 |
| Nordea Bank AB | 31,381,042 | 0.77 | 0.77 | 3,116 |
| Atlas Copco AB | 8,608,108 | 0.68 | 0.44 | 2,840 |
| Swedbank AB | 11,478,979 | 1.01 | 1.01 | 2,272 |
| Hennes & Mauritz AB | 11,974,352 | 0.72 | 0.35 | 2,027 |

Ten largest recipients of brokerage fees in 2017

| | | |
|--------------------|---------------|-----|
| ABG/Sundal Collier | Deutsche Bank | SEB |
| Carnegie | JP Morgan | UBS |
| Citi | KGC Neonet | |
| Danske Bank | Nordea | |

Five largest holdings in foreign listed companies

| Name | Number of shares | Market value, SEK m |
|-----------------------|------------------|---------------------|
| Apple Inc | 1,027,535 | 1,424 |
| Royal Dutch Shell PLC | 4,118,336 | 1,126 |
| Alphabet Inc | 107,267 | 922 |
| BP PLC | 14,367,159 | 832 |
| Johnson & Johnson | 713,451 | 816 |

Five counterparties that handled the largest volumes of AP3's foreign exchange trading in 2017

| | | |
|-------------|-----------|-----|
| BNP Paribas | JP Morgan | SEB |
| Citi | Nordea | |

Five counterparties that handled the largest volumes of AP3's fixed income trading in 2017

| | | |
|---------------|-----------|-----|
| Danske Bank | JP Morgan | SEB |
| Handelsbanken | Nordea | |

Allocation of fund capital between internal and external management mandates at 31 Dec 2017

| Mandate | Market value, SEK m | Share of fund capital, % |
|---|---------------------------|--------------------------|
| EXTERNAL DISCRETIONARY MANDATES | | |
| Equity mandates | | |
| Passive mandates | | |
| BlackRock Investment Management | Europe – Small cap | 5,225 |
| BlackRock Investment Management | Japan | 2,408 |
| BlackRock Investment Management | Asia-Pacific | 5,117 |
| BlackRock Investment Management | North America – Mid cap | 7,447 |
| Enhanced mandates | | |
| BlackRock Investment Management | North America – Large cap | 17,854 |
| BlackRock Investment Management | North America – Small cap | 3,084 |
| | | 41,135 |
| | | 12% |
| FUND INVESTMENTS | | |
| Listed assets | | |
| Equity funds | | 19,936 |
| Absolute return strategies and hedge funds | | 7,157 |
| Unlisted assets | | |
| Private equity funds | | 13,123 |
| Real estate funds | | 1,018 |
| Timberland funds | | 4,974 |
| | | 46,209 |
| | | 13% |
| INTERNAL MANAGEMENT MANDATES | | |
| Listed shares and investments | | 95,231 |
| Fixed income and credits | | 106,991 |
| Insurance-related risk | | 4,139 |
| Unlisted holdings in real estate companies | | 44,775 |
| | | 251,135 |
| | | 73% |
| OTHER ASSETS AND LIABILITIES¹ | | |
| | 6,759 | 2% |
| TOTAL FUND CAPITAL | | |
| | 345,239 | 100% |

1) Consist primarily of cash and currency hedges.

Absolute return The actual return, in cash or percentage terms, that a portfolio generates over a specific period.

Active management Form of management based on taking active positions to achieve higher returns than the benchmark index. Active positions are taken by being overweight or underweight in assets relative to the benchmark index or reference portfolio based on the projected market outlook.

Alfa Returns that are higher than beta and achieved by taking active positions. See Beta.

Automatic balancing Method of restoring the financial balance between pension system assets and liabilities when the balance ratio falls below 1. Another way of putting it is that a “brake” is applied to pensions and pension credits which results in them following a balance index rather than the income index.

Balance index Key metric used to restore the pension system to balance. Results in pensions increasing at a lower rate or being reduced.

Balance ratio Total pension system assets (excluding premium pensions) divided by liabilities. If the balance ratio drops below 1, the automatic balancing mechanism is activated. This affects pension indexing.

Benchmark index Used to evaluate the return on a portfolio. Usually takes the form of a standardised market index and is also known as the reference index.

Beta Sensitivity of a portfolio or equity to equity market movements. Beta can also be expressed as the return generated by passive exposure to risks such as equity risk, credit risk and volatility.

Buffer fund The name for AP1, AP2, AP3, AP4 and AP6. The role of the buffer funds is to even out temporary variations between pension contributions and disbursements and to assist in the long-term financing of the pension system.

Buyout Acquisition by an entity of a controlling interest in a mature company.

CDS Credit Default Swap. See Credit swap.

Clearing All activities that take place after a transaction is completed in a market and prior to settlement. Includes reporting, risk measurement and netting.

Clearing house An institution with regulatory approval to conduct clearing operations. Most countries only have one or very few. In Sweden, clearing is via the Stockholm Stock Exchange. Stockholmsbörsen, the exchange operator, acts as counterparty for all derivatives traded on the exchange.

CLS Bank owned by currency market counterparties and used in most currency transactions for effective settlement.

Code of conduct Group-wide framework of rules and systems to manage environmental and social affairs.

Credit swap Derivative contract between two parties, A and B, in which A pays B an interest premium for a specific period of time. B only pays a premium to A in the event that a predefined asset-related event occurs. The size of this premium is the difference between the nominal underlying value of the derivative contract and the market value of the asset in question (credit default swap).

CSA agreement Annex to an ISDA agreement that regulates how an entity with an outstanding debt (unrealised loss) must provide collateral in the form of cash or securities.

Currency hedge Transaction to neutralise currency risk, that is the risk attached to making investments in currencies other than the Swedish krona.

Derivative Financial instrument whose price is determined by underlying value. Options, forwards and swaps are generally classed as derivatives. The value of a derivative depends on changes in the underlying value of the instrument.

Distribution Repayment of an invested sum plus capital gains.

Duration Used as a measure of interest rate risk and is expressed as the average fixed interest. It can be used to estimate changes in value based on assumed changes in interest rates.

Income index Key metric that measures average annual income growth in Sweden. Is used to track pension growth provided that automatic balancing has not been activated.

Index management See Passive management.

Information ratio Efficiency measurement for active management. Indicates how much AP3 earns from active risk-taking and from deviating from the strategic portfolio or index. Is measured as active return divided by active risk (tracking error).

Insurance-related bond Bond whose return is connected to exposure against disaster-related risks such as hurricanes and earthquakes.

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

IPEV The International Private Equity and Venture Capital Valuation Board is an international organisation for private equity and venture capital firms. It issues valuation guidelines based on IFRS and US GAAP, which are regarded as industry standards.

ISDA agreement Bilateral agreement between two OTC counterparties that regulates the events that could generally be expected to occur between them.

LSP The long-term static portfolio is a zero-cost portfolio against which AP3 benchmarks its asset management. Its portfolio is a 50:50 mix of listed equities and fixed income instruments comprising Swedish (25%) and global indices (75%) that are weighted as follows: equities (50%) and fixed income (50%). Currency exposure is 20 per cent.

National Pension Insurance Funds Act

Government act (2000:192) establishing and regulating the AP funds. The act was passed by Parliament in 2000 as part of a five-party agreement to introduce a new income pension system.

Option Entitles the holder to buy or sell an underlying asset at a predefined price and moment in time. The option issuer has equivalent obligations. Options may include currency options, interest rate options and share options.

OTC Short for over the counter. Refers to contracts agreed and settled between two counterparties without the involvement of a clearing house.

Passive management Asset management that aims to achieve an identical return to the benchmark index rather than to outperform the index. This is done by making investments that mirror a reference portfolio or index and is also known as index management.

Principles for Responsible Investment (PRI)

An international network of investors that promotes the implementation of six principles of responsible investment.

Private equity Collective term for equities that are not listed on an official or public market.

Rating A measure of creditworthiness that reflects the probability of a counterparty being able to honour its commitments. The rating may relate to the counterparty itself or a series of securities issued by the counterparty.

Real return Nominal return adjusted for inflation.

Realised volatility See Volatility.

Reference portfolio A portfolio of different assets whose composition is designed to facilitate comparisons.

Risk-adjusted return A means of evaluating asset management performance in which active return is considered in relation to the level of risk in the portfolio. The Sharpe and information ratios are two examples.

Risk budgeting Adjustment of risk levels across management mandates based on their projected return and correlation to optimise the total risk-adjusted return.

Risk capital Generally refers to investments in a company's equity. Relates in practice to investments in entities that are not listed on a market, that is, private equity.

Sharpe ratio Measurement of a portfolio's risk-adjusted return, that is, the efficiency of the portfolio. It equates to portfolio return minus risk-free interest divided by the standard deviation of portfolio return.

Stop loss A predetermined level of cumulative losses over a specific period of time resulting in the immediate closure of all positions.

Swap Contract in which counterparties agree to exchange flows based on an underlying asset and under prearranged terms and conditions. Often runs for periods of more than 12 months. Examples include interest rate swaps, currency swaps and total return swaps.

Tracking error Measures the variation in active return and is measured as the standard deviation of active 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.

Value at risk (VaR) A common measure of the maximum loss that a portfolio can incur for a given period and with a certain level of confidence. VaR is calculated daily for a period of one day and with a confidence level of 95%. Portfolio management often requires changes to the portfolio structure to keep this risk of loss at an acceptable level.

Volatility A measure of the variation in return. Measured as the standard deviation of return. Realised volatility is measured as historical return.

Measures of return and risk

Absolute return avkastning (r_p) Portfolio return

Absolute risk or volatility (σ_p) Standard deviation of portfolio returns

Information ratio (risk-adjusted active return) Active return divided by active risk = $\frac{r_p - r_f}{\sigma_{p,i}}$

Sharpe ratio (risk-adjusted absolute return) Portfolio return minus risk-free return divided by absolute risk = $\frac{r_p - r_f}{\sigma_p}$

The AP funds in the Swedish pension system



The assets of the public pension fund system total over 80 per cent¹ of Sweden's total pension assets, illustrating the importance of state pensions in Sweden.

AP3 - together with AP1, AP2, AP4 and AP6 - serves as a "buffer fund" in the income pension system.² AP1, AP2, AP3 and AP4 also act as buffers between years of surpluses and years of deficits between pension contributions and pension payments. The buffer capital also has the task of contributing to the stability of the income pension system by generating a high financial return over time at low risk.

The seventh AP Fund, on the other hand, constitutes an optional fund in the premium pension system.³ The premium pension system forms part of the public pension system, in which the employee chooses the fund in which the capital should be placed – the return is then determined by the choices made over time.

Presently, the financial position of the income pension system is good. Assets exceed pension liabilities so that the balance ratio between them is 1.0395. This is to a large extent explained by the high returns of the AP funds in recent years, and their share of the total assets now amounts to 15 per cent (compared with 10 per cent when the system was introduced in 2001). Other assets are the value of future pension contributions, referred to as contribution assets.

The public pension system in Sweden

Sweden has decided to have a public pension system that covers all employees. It is financed by pension contributions paid by all employers and employees. Individuals with low income-based pension may also receive a guaranteed pension, housing supplement and maintenance support for the elderly. These benefits are financed directly over the state budget.

Pension contributions are based on the employee's total pay, but pay over 7.5 income base amounts ($7.5 \times 62,500 = \text{SEK } 468,750$) is not pensionable, i.e. does not entitle the employee to more state pension. Instead, excess contributions are tax going directly to the state budget.

Contributions amount to 18.5 per cent of gross pay. The Swedish Pensions Agency registers 16 percentage points of the pensionable income as a pension credit on each employee's

personal account in the income pension system. A deposit of 2.5 percentage points is made into a personal account in the premium pension system. These state pensions are therefore personal – each employee saves for his or her own pension.

Pension savings performance

Provided that the income pension system is not in rebalance period, the value of pension capital and pensions increases in step with the income index to illustrate adherence with wage developments in society at large. When total assets are less than liabilities and the balance ratio is consequently less than 1.0, the balancing mechanism is activated to restore the financial position. During this period, the value of the pension benefits is written up by the change in balance index (income index multiplied by a dampened balance ratio). The balance period lasts until the balance index has caught up with the development of the income index.

A strong Swedish model

The Swedish state pension system has a few features that are usually regarded as strengths:

- It is self-financing and not a part of the state budget.
- Pensions and pension credits (pension liabilities) in the income pension system are indexed by the average wage developments (income index) in Sweden.
- At the same time, the inflation sensitivity of the system is low as pension contributions increase when pay rises.
- Each year, assets are compared with liabilities in the income pension system and if the ratio between them (the balance ratio) is less than 1.0, the balancing mechanism in the system is activated to restore the financial position. This keeps the financial assumptions stable regardless of demographic and economic developments over time.

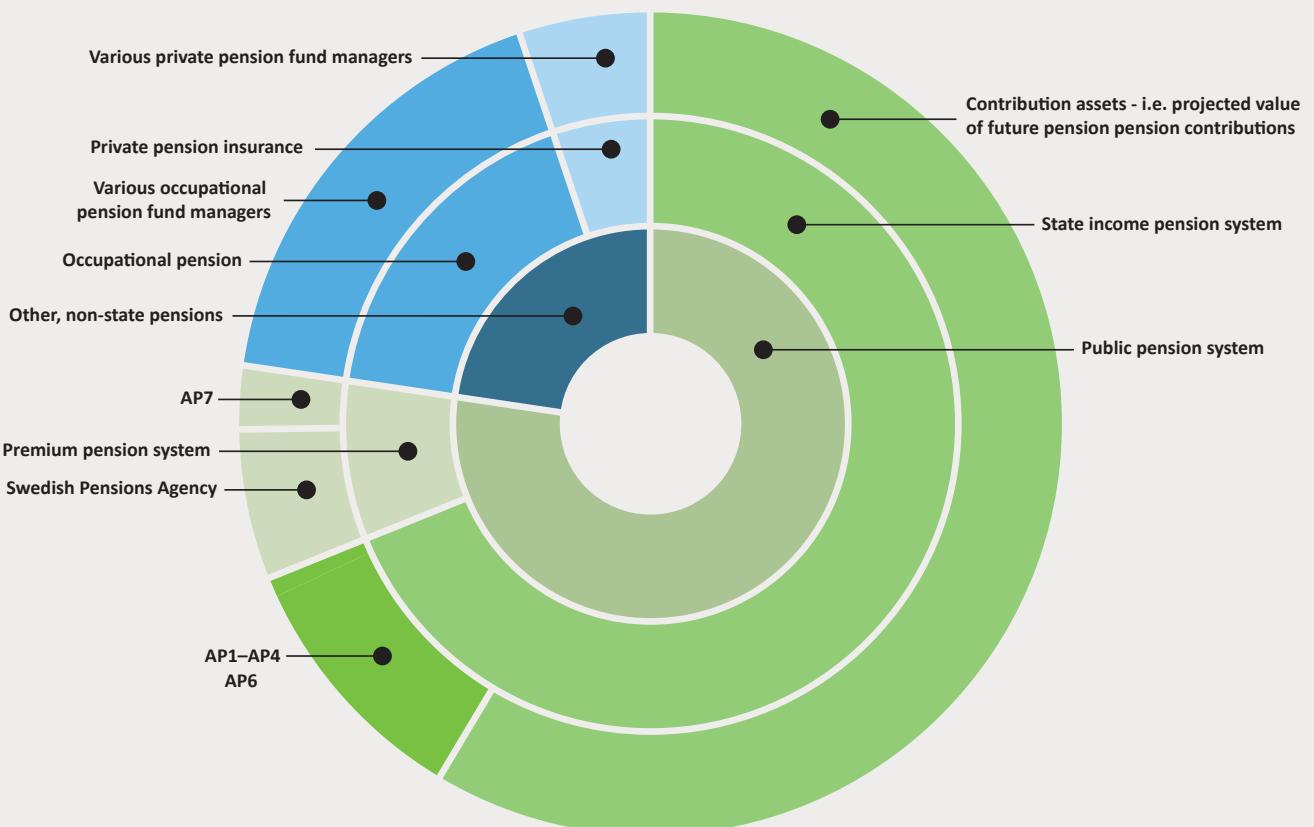
1) Based on the Swedish Pensions Agency's "Orange Report", 2016.

2) 'The income pension system' refers to 'income-based old age pension insurance'.

3) The premium pension system forms part of the state pension system, in which the employee chooses the fund in which the capital should be placed – the return is then determined by the choices made over time.

Sweden's pension assets

SEK 12,900 billion



The diagram illustrates the relative sizes between various parts of the Swedish pension system and covers both the general public pensions and various forms of occupational and private pension savings. In total, the assets amount to more than SEK 12,900 billion. All data is based on the Swedish Pension Authority's "Orange Report", 2016.

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