


Sustainability and Corporate Governance Report

July 1 2013 – June 30 2014



Taking the next step!

Since the Fund started in 2001, we have carried out a range of activities in the field of sustainability, many times playing a pioneer role. We were among the world's first institutional investors to sign up to the UN's Principles for Responsible Investment (PRI), and we were one of the first to invest in green bonds. We analysed our portfolio's carbon footprint as early as 2009 and have campaigned from the very start for greater diversity on the boards and in the executive managements of publicly quoted companies. And the list of the Fund's activities and commitments can be made still longer. Now we're ready for the next step in our sustainability programme, powered by each and every Fund employee.

During the year, we have worked on developing a more comprehensive strategy for sustainability, pointing the way to how we can achieve our vision 'World-class asset management', but also with a view to further prioritizing and focusing our efforts. Our intention is to focus our sustainability efforts to a number of areas. Areas we consider crucial in enabling us to better achieve the environmental and ethical targets established for our investment activities by Riksdagen (the Swedish Parliament), without compromising the required return on investment. These areas will be presented in more detail in our Annual Report.

The Second AP Fund is tasked by the Parliament with maintaining consistent pension levels even during economic downturns or periods when the number of retirees peaks. This means that we must adopt a long-term approach when making our investments sustainability issues form a natural and important part of this long-term investment strategy. The environment, ethics and corporate governance issues are having a growing impact on the return generated by our portfolio companies – and we are convinced these factors will acquire increasing significance in future. Companies that take sustainability issues seriously and act responsibly are likely to prove the best long-term investments. If society at large fails to deal with climate change in an effective manner, for example, it could prove difficult for the Fund to generate the return required necessary to maintain the pension system and meet the needs of future pensioners.

Divest holdings in a large number of energy companies

The Fund's sustainability efforts have mostly focused on the climate issue during the year. One consequence has been to conduct a comprehensive risk analysis of all the Fund's holdings in fossil-fuel based energy companies, based on climate impact. In light of this analysis, we have decided to divest our holdings in a large number of companies in the energy sector in October 2014. We have identified several energy companies that feature high relative exposure in high-cost projects such as oil-extraction from oil sands. The Fund believes such assets could be at serious risk of being stranded, and that this risk not yet is priced in the market. A number of companies with significant coal-mining assets have also been deemed to pose considerable risks, given the fact that coal is the most carbon-intensive energy source.

We shall continue to assess any additional climate impacts that might derive from the Fund's holdings.

The portfolio's carbon footprint

As early as 2009, the Second AP Fund conducted an extensive project to analyse the carbon footprint of portfolio companies. By gathering data from all the companies in the portfolio, based on its holdings in each company, it was possible to calculate the total carbon footprint generated by its combined holdings. This analysis contributed to a more profound knowledge and understanding of the cost of carbon emissions, and has formed the basis of our ongoing efforts to address climate issues. We are now once again in the process of analysing the portfolio's carbon footprint, and shall be publishing the result in the Fund's 2014 Annual Report.

Over several years now, through its membership of the Carbon Disclosure Project (CDP), the Second AP Fund has required portfolio companies to report on their greenhouse emissions and other data related to how they are dealing with the challenge of climate change. This will come to form an important element in our continuing efforts to persuade companies to address the climate issue seriously, while enabling us to determine the carbon impact of our investments.

Diversity

Since 2003, in its annual Women's Index, AP2 has been measuring the proportion of women represented on the boards and executive managements of Swedish publicly quoted companies. The idea is to promote a balanced debate as to how the percentage of women can be increased. For the first time in three years, the Index revealed that the number of women on publicly quoted corporate boards had risen from 22.3 to 24.7 per cent, while the number of women in executive management positions continued to note a steady rise. The trend is in the right direction. But there is still much to do in accelerating the rate of this increase and better utilizing all available competence. Stakeholders and nomination committees share a particular responsibility here. We are determined to shoulder ours and hope that many others will elect to follow the same path. AP2 is actively committed to increasing the diversity and quality of corporate boards. One aspect of this commitment is to conduct analyses of the work and results of nomination committees and to conduct dialogues on this issue with these same nomination committees and companies. We believe recruiting from a fact-based and broadened pool of talent that embraces competent candidates found beyond the nomination committees' normal networks of con-

tacts, offers companies the best conditions of developing in an optimal way. This is why it is such an important question for us to pursue.

Reporting

Reporting / transparency is of fundamental importance in ensuring a smoothly functioning financial market. This is how we, as investors, can gain a relevant understanding of a company's situation and thereby acquire the data necessary to make as accurate an assessment as possible of a company's potential. This said, it is also important that we ourselves are also open and transparent in how we operate, since the task with which we have been entrusted is on behalf of the entire Swedish population.

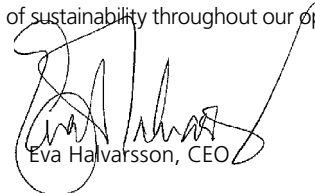
When it comes to openness concerning our own internal operations, we received a certain amount of criticism last year in a report from Swedwatch, for failing to cite the precise locations of the Fund's farmland investments in Brazil. We have taken this criticism to heart and have subsequently worked actively on improving transparency. During the coming year, we shall see to it that audits of our Brazilian farmland investments are conducted by an external party to determine how the Principles for Responsible Investment in Farmland, to which the Fund subscribes and which now form an integral part of the PRI framework, have been implemented.

In a move to achieve greater transparency and improve our reporting, we have also made a number of changes in this year's Report. As well as devoting more attention to the question of sustainability, we have also restructured the Report to better distinguish between those sections that are straightforward reports and those that are articles on subjects we believe need to be highlighted. We hope our readers will approve these changes.

Ongoing integration in asset-management process

During the year, we have continued our in-house programme to make sustainability an integral part of the asset-management process. Our goal is to integrate sustainability into all the Fund's analytical and investment processes. In the Swedish Government report on the performance of AP Funds in 2013, one area addressed was progress on integrating sustainability. The report confirmed that the AP Funds continue to extend the process of integrating sustainability throughout their operations and that they "...compare favourably internationally with other pension funds selected for having made considerable strides towards integrating sustainability. The progress achieved so far by the AP Funds in the field of sustainability is positive. They should continue to serve as role models for others engaged in the task of making sustainability an integral part of the asset management process". Referring specifically to the Second AP Fund, the report highlighted its approval of the fact that the Fund assigned explicit targets for the integration process of sustainability.

Personally, it gives me great pleasure to note that this process is being moved forward by all Fund employees, whose great commitment and thirst for knowledge is ensuring the natural and self-evident integration of sustainability throughout our operations.



Eva Halvarsson, CEO



Photo: Nils-Olof Sjöden

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The Second AP Fund adopts a long-term approach in creating a capital buffer for the Swedish national pension system

The Second AP Fund is one of northern Europe's largest pension funds, managing assets totalling more than SEK 280 billion of Sweden's national pension assets, which are invested worldwide. The Fund is the largest of the Swedish National Pension (AP) Funds.

You could say the mission is to achieve the best of both worlds. The Fund is tasked with generating a solid return on investment, while implementing a consistent policy of responsible and sustainable investment.

The Fund enjoys a solid return and a high degree of cost efficiency compared to similar funds in Sweden and elsewhere. Key factors are the Fund's long-term asset management strategy and a consistent focus on efficiency in all its activities.

The Second AP Fund is an attractive employer, numbering about 60 members of staff, all of whom work in Gothenburg. The Fund employs some of the foremost in their respective fields, including portfolio managers, analysts and other specialists.



Sustainability at AP2

The Second AP Fund's sustainability programme comprises the environment, ethics and corporate governance. The sustainability programme is designed to create and protect values. As an asset manager, the Fund is determined to address a range of factors involving the environment, ethics and corporate governance, as they either provide a better basis for analysis and investment decisions or promote diversification. Our goal as an asset owner is to generate confidence by promoting a solid ethical and environmental approach while also contributing to the development of sound practice in fund management issues.

By actively addressing and integrating environmental, ethical and corporate governance issues in its operations, the Second AP Fund can generate value. The collective term that the Fund uses to embrace these issues is sustainability. Investors also use the acronym ESG (Environmental, Social and Governance).

The Fund believes sustainability to be important, convinced that a commitment to sustainability issues can generate and protect value. Integrating sustainability factors into analyses and investment processes generates broader and better decision data.

The Second AP Fund's framework

The Second AP Fund is a state agency whose operations are governed by the National Pension Insurance Funds (AP Funds) Act (2000:192). One of the AP Funds' key tasks is to maximize return while maintaining a low level of risk. The investment strategy shall accommodate the impact of pension disbursements while addressing the level of reserves that will be required to service these outflows.

The AP Funds shall take ethical and environmental concerns into account, but without ignoring the overall aim of an enhanced return on investment. Business and economic policy considerations are to be ignored.

Governance policy

The Second AP Fund's operational approach to sustainability and corporate governance issues is based on the Fund's governance policy and its nine investor principles. These principles comprise structural matters, corporate governance, the environment – and ethics. The governance policy also defines the Fund's core values, and details the guidelines and initiatives to which the Fund is a signatory, or which it employs in pursuing its sustainability aims. This governance policy is determined annually by the board of directors and is published on the Fund's website at www.ap2.se

During the report period, this governance policy has been revised with a view to clarifying the Fund's various standpoints, by stating what it expects of its portfolio companies, as well as what these same companies may expect of the Fund as an investor.

The Second AP Fund's engagement in corporate governance issues is founded on regulations and conventions such as the OECD's

Guidelines for Multinational Enterprises and Principles of Corporate Governance, the UN's Global Compact, the Swedish Companies Act and the Swedish Code for Corporate Governance.

The governance policy also describes the principles to which the Second AP Fund subscribes and that it employs as a framework in its efforts to promote sustainability, both within its portfolio management organization and in a range of governance activities. The Second AP Fund supports and actively promotes implementation of the UN's Principles for Responsible Investment (PRI). It signed up to these Principles as early as 2006, when they were first established. PRI provides various instruments and activities to support investors in implementing the Principles and to facilitate cooperation between investors. By the end of June 2014, more than 1 200 investors had signed up to these Principles. PRI conducts an annual questionnaire, in which all signatories report on how they are implementing these principles in practice.

The Second AP Fund has also undertaken to implement the Principles for Responsible Investment in Farmland. These were drawn up by the Second AP Fund in association with a group of international investors, all of which are PRI signatories. The Principles provide institutional investors who invest in agricultural assets with a framework for dealing with environmental, ethical and governance issues. They are also intended to increase transparency in connection with such investments. For this reason, it is incumbent on all investors who have signed up to these Principles to report annually on how they have been implemented during the past year. The Second AP Fund's report on the implementation of these Principles may be found on page 14.

Over the past year, with a view to reaching more investors and increasing transparency about agricultural investments, the steering committee for the Principles has striven to include them within the PRI organization. As of September 2014, PRI acquires administrative responsibility for the Principles. Consequently, from 2015, reporting on implementation of the Principles will be conducted as part of PRI's standard reporting procedures. To increase transparency, PRI will compile a special report on agricultural investments.

Further details of the Principles for Responsible Investment in Farmland are available at www.unpri.org

Organization and responsibilities

The Second AP Fund's board of directors determines guidelines and policies pertaining to governance issues, entrusting day-to-day management of these issues to the Fund's CEO. The CEO is backed by an ownership group featuring members of the Fund's executive management, the head of Swedish equities and the sustainability analyst. This group is responsible for the strategic and operational aspects of the Fund's corporate governance activities. The ownership group targets and drafts action plans and monitors progress on an ongoing basis. At every board meeting, a report on the Fund's governance, ethics and environmental activities is submitted to the board of directors.

Environmental and ethical core values

When it comes to the environmental and ethical aspects of business activities, the Second AP Fund's core values are based on principles that highlight

- commitment
- action
- change

with a view to making a difference. The Fund strives to make a difference by working proactively for sustainable development in areas that promote a high long-term return on investment, while at the same time becoming actively involved in companies where problems have been identified, been deemed as significant and are well substantiated. This is a responsible and ethical approach.

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Part of the Swedish State's core values

As part of the Swedish national pension system, the Second AP Fund's principles of engagement, active ownership and change are based on the same core values as those espoused by the Swedish State. Democracy, the belief that all men and women are equal, the individual's right to freedom and respect and the importance of sustainable development – these principles are all central to Swedish thinking – and all in compliance with the terms of the Swedish Constitution Act.

Conventions Sweden has signed

The core values of the Swedish State are also given expression through the international conventions to which Sweden has been a signatory, including conventions concerning the environment, human rights, labour rights, corruption and inhuman weapons. These values are further reflected in the support Sweden provides to initiatives such as the UN's Global Compact and the OECD's Guidelines for Multinational Enterprises, as well as Sweden's stated position on human rights issues. In conjunction with the core values espoused by the Swedish State, these international conventions provide the Fund with powerful instruments in its focus on environmental and ethical considerations.

In its work, the Second AP Fund operates on the assumption that all conventions to which Sweden is a signatory shall be observed and afforded equal importance. This position is also supported by the decisions made and statements issued by various UN agencies, which note that human rights are universal, indivisible, mutually dependent and interrelated and may not be assigned different orders of importance. The Fund believes that the companies must themselves be responsible for ensuring that international conventions are not contravened, irrespective of whether these are directed at sovereign States, individuals, companies or organizations. Furthermore, this responsibility shall apply even when countries in which the companies operate are signatories to conventions or feature less stringent legislation.

Implementing PRI principles

The implementation of PRI principles is an ongoing process, one which requires that the Second AP Fund shall consistently address sustainability issues, both in its role as asset manager and as asset owner. The Principles are about the following: integrating sustainability issues as part of investment analyses and decision processes (First Principle); acting as active owners (Second Principle); encouraging better sustainability reporting by companies (Third Principle), collaborating with other investors (Fourth and Fifth Principles) and reporting on progress (Sixth Principle). Integration, dialogue, collaboration and reporting are key words for these Principles and for the Second AP Fund's efforts.

PRI principles

Examples of what the Second AP Fund does

1	We will incorporate environmental, social and corporate governance (ESG) issues into investment analysis and decision-making processes.	Includes ESG data in analyses and decision making processes in our active internal asset management. Works on developing models and tools for ESG that are geared to different investment strategies. Includes ESG in the analyses of new funds and portfolio managers. Questions about ESG form part of the yearly evaluation of external asset managers.
2	We will be active owners and incorporate ESG issues into our ownership policies and practices.	Incorporates ESG factors as part of its Corporate Governance Policy. Conducts dialogues regarding ESG issues with Swedish and foreign companies. Exercises its vote at Swedish and foreign AGMs. Participates in nomination committees. Monitors portfolios to detect violations of international conventions and guidelines.
3	We will seek appropriate disclosure on ESG issues by the entities in which we invest.	Supports a range of initiatives geared to improving corporate reporting procedures, including the Carbon Disclosure Project, the Extractive Industries. Transparency Initiative, the Global Compact and the Sustainable Value Creation Initiative. Asks all external managers to respond to questions concerning ESG in its annual review.
4	We will promote acceptance and implementation of the Principles within the investment industry.	Encourages external fund managers to become signatories of the PRI. Participates in conferences. Includes questions pertaining to PRI in procurement tenders, where relevant.
5	We will work together to enhance our effectiveness in implementing the Principles.	Collaborates with the First, Third and Fourth AP Funds in the joint Ethical Council, which is responsible for conducting dialogues with foreign companies. The Ethical Council also collaborates with international investors in pursuing dialogues with companies and proactive initiatives.
6	We will each report on our activities and progress towards implementing the Principles.	Publishes an annual Sustainability and Corporate Governance Report and also reports on PRI in the annual report and on the website. Reports on dialogues with foreign companies in the joint annual report of the Ethical Council. Responds to the PRI's annual survey and makes it available public at the PRI web site.

AP Funds' investment regulations

Investments may be made in any market-listed and negotiable financial instruments offered on the capital market.

No more than five percent of an AP Fund's assets may be invested in unquoted securities. Investments in unquoted equities must be indirect, via private equity companies, securities funds or similar.

At least 30 percent of the assets of each AP Fund shall be invested in fixed-income securities, at a low credit or liquidity risk.

Equities held in publicly quoted Swedish companies by each AP Fund shall not exceed two percent of the total value of the Swedish stock market.

Each AP Fund shall control no more than ten percent of the voting rights in an individual publicly quoted company. The corresponding limit for unquoted private equity companies is 30 percent.

The AP Funds may not invest in options, forwards or other financial instruments where commodities constitute the underlying assets.

A maximum of 40 percent of a Fund's assets may be exposed to exchange risk.

No more than ten percent of a Fund's assets may be exposed to an issuer or group of issuers.

At least ten percent of each Fund's assets shall be placed under external management.

A photograph of a dense, lush green forest. Sunlight filters through the thick canopy of various trees and plants, creating a dappled light effect. The scene is vibrant and natural, with a variety of green shades and textures.

Sustainability in the investment process

Integrating sustainability into asset management is about factoring sustainability issues into analytical and decision processes. This also enables the Fund to reduce risk and increase its potential for increased return. The Fund believes that companies focused on long-term sustainability will also generate a solid return in the long term.

Companies with long-term sustainable business models generate a higher long-term value for their owners. Such investments also incur less risk. Even though a sustainable business model features many relevant and critical factors, ethics, the environment and corporate governance are also important to success. Companies able to integrate such factors into their long-term business development will have an advantage over their competitors and are more likely to generate long-term value for their owners. Similarly, investors who integrate these factors into their analytical and decision models will be able to achieve their goal of a solid risk-adjusted return.

New sustainability strategy

During the year, the Second AP Fund has start working on developing a more comprehensive strategy for sustainability, to define and better utilize resources and thereby realize the Fund's vision: World-class asset management. The Fund's overall objective is that sustainability must form an integral part of all analytical and decision processes. This process has been ongoing in a structured form for some years now and will take several years to achieve.

Focus areas

To obtain the best possible result from the sustainability programme, the Fund will decide on some focus areas which it considers essential to achieve a better long-term return. The idea is to focus the Fund's resources on a number of areas that define its commitment in areas of financial relevance. For each focus area the Fund will establish short and long-term goals, as well as to implement measures to attain these goals.

Sustainability integral to asset management

The Second AP Fund believes that a responsible long-term approach to the environment, ethics and governance enhances the value of companies. This is why corporate governance, ethics and the environment also play an important role in the Fund's asset management activities, as they provide a more comprehensive basis for analyses and investment decisions. By encouraging portfolio companies to address ethical and environmental issues, the Second AP Fund can help them identify the opportunities and risks, at an early stage, which can affect long-term return.

During the year, the Second AP Fund arranged a number of seminars and training sessions to create better understanding and awareness of sustainability issues among its staff. This is important in facilitating the integration of sustainability factors in the Fund's everyday activities. For example, the asset management attended a special day-long seminar, focused on sustainability and how to integrate it into the investment process.

” To obtain the best possible result from the sustainability programme, the Fund will decide on some focus areas.

Integration of sustainability in the investment process

Asset class	Analysis	Implementation 1. Integration in analytical and decision processes	2. In-house monitoring/external reporting
Equities			
Swedish equities	●	●	●
Foreign equities (excl. emerging markets)	●	●	●
Equities emerging markets	●	●	●
Fixed income			
Fixed-income securities	●	●	●
Fixed-income securities, emerging markets	●	●	●
Alternative investments			
Real estate			
Farmland	●	●	●
Forest	●	●	●
Commercial properties	●	●	●
Private equity funds	●	●	●
Alternative credits	●	●	●
Alternative risk premiums	●	●	●
Chinese A-shares	●	●	●

- Yes
- Partially
- No

Analysis – The Fund has conducted a situational analysis and identified viable growth potential.

Implementation

1. Integration in analytical and decision processes – The Fund’s estimate of the extent to which integration has been achieved. In the case of externally managed assets, sustainability shall form an integral part of the agreements.

2. In-house monitoring/external reporting – Monitoring of the Fund’s sustainability measures (incl. external asset managers).

The portfolio’s carbon footprint

As early as 2009, the Second AP Fund conducted an extensive project to analyse its portfolio’s carbon footprint. By gathering data from all the companies in the portfolio, based on its holdings in each company, it was possible to calculate the total carbon footprint generated by its combined holdings.

For the Fund this analysis contributed to a more profound understanding of the cost of carbon emissions. If companies are forced to pay for their emissions, this will impact on their profits and cash flow. If these costs are realized, the market value of these companies will be affected by the impact they are expected to have on future profits.

Over several years now, through its membership of the CDP (Carbon Disclosure Project), the Second AP Fund has required the world’s largest publicly quoted companies to report on their greenhouse gas and other related data on how they are tackling the challenge of climate change.

Fossil energy

Since the autumn of 2013, the Second AP Fund has had an in-house working committee dedicated to addressing questions relating to fossil energy and climate change. During the year, the group has been engaged in gathering data on market opinion about

future growth in the price of energy, society’s energy requirement and technological advances, as well as on the various climate policy measures currently being implemented in different parts of the world. This work is intended to provide a basis for the Fund’s approach to investments in fossil energy.

Fossil energy is a vital commodity in contemporary society and will continue to be so for some considerable time. Conversion to a carbon-efficient society has already started, however, and it is not unlikely that the demand for fossil energy may well decline, in the wake of new regulations, economic controls and/or technological advances. There is a risk that the oil and gas extracted from high-cost projects could become unprofitable. The Second AP Fund has identified eight energy companies with a high relative exposure to high-cost projects. The Fund believes such assets could be at serious risk of being stranded, and that this risk not yet is priced in the market. Companies with significant holdings in coal mines have also been identified as posing a risk, given that coal is the most carbon-intensive energy source. For this reason, the Second AP Fund has decided that it will no longer invest in a total of 20 energy companies, 12 of which are involved in coal production. The decision was taken after the close of the report period.

Work on determining the climate risks associated with the Fund’s investments will continue.

Equities

Progress on integrating sustainability issues into the active in-house management of Swedish equities continued during the year, based on a specially developed model that analyses the relative position of portfolio companies from the viewpoint of global mega trends. The sustainability analysis assesses how the individual company organizes its work with sustainability, the policies adopted and the way they are implemented, as well as how each company manages the opportunities and risks associated with pursuing a policy of sustainability. The work of including a growing amount of sustainability data in analyses and investment processes continues.

All companies included in the Second AP Fund's portfolio of equities are screened twice yearly, to identify those that contravene international conventions and guidelines. This analysis is conducted by an external consultancy. The results are analysed by the Fund.

Private equity funds

The Fund has a structured process for analysis, evaluation and follow-up which, as well as sustainability, embraces economic, risk and performance analysis. This process can also be applied to the Fund's investments in non-listed real estate, as well as forest and agricultural assets.

During the year, the Second AP Fund asked all private equity funds to report on how they were working with sustainability. Given the fact that reporting on sustainability measures is new for most private equity funds, the Second AP Fund, at the request of certain funds, developed a report template. About half of all the funds reported in some form on their sustainability efforts. The Second AP Fund's work on evaluating and following up the private equity funds' sustainability reports is ongoing.

One of the private equity funds in which the Second AP Fund has invested is Riverstone. Riverstone is among the world's largest managers of private equity in the field of renewable energy. Its investment portfolio, which includes solar energy, wind power and geothermal power generation, features the Pattern Energy company. The company develops and operates wind farms, mainly in North America. In the USA, the company ranks as one of the largest developers in this field. Riverstone also invests in the conventional fossil-based energy sector. More on Pattern Energy at www.patternenergy.com

Another example is private equity fund TPG Star, which has invested in the company Elevance Renewable Science. Elevance has developed a process for producing renewable chemical products, which offer a whole range of potential applications. The company's patented technology (based on work that led to the Nobel Prize in chemistry in 2005) enables everything from lubricating oils, surface treatment chemicals and chemicals used in skin-care products to be produced from organic plants. The

company is the first to have successfully established itself as a renewable alternative in the chemical industry. More on Elevance Renewable Science at www.elevance.com

Green bonds

The Second AP Fund made its first investment in 'green bonds' in 2008. Green bonds are intended to finance projects that help mitigate climate change or aid countries in their attempts to adjust to it. The market for green bonds continues to expand and the number of players issuing these types of bond will grow still further. This form of investment suits the Second AP Fund well, as it coincides with the Fund's approach in climate change, contributes to a diversification of the portfolio and is attractive to long-term investors.

Over the past twelve months, the Second AP Fund has increased its investment in green bonds and, as at June 30 2014, held bonds to a value of SEK 1.9 billion.

Commercial real estate

A multitude of sustainability issues are of importance in the real-estate sector. Energy is a central issue, since commercial real estate accounts for a high percentage of a country's energy consumption. In Sweden, this amounts to 40 percent. To better monitor and evaluate progress on sustainability within its real-estate investments, the Second AP Fund joined the Global Real Estate Sustainability Benchmark (GRESB) in the spring of 2014.

GRESB is an organization that conducts an annual questionnaire to assess how real-estate companies and real-estate funds address seven aspects of sustainability. These are management, policy and reporting, risks and opportunities, follow-up and environmental management systems, environmental indicators (energy, greenhouse-gas emissions, water and waste), building certification and dialogues with stakeholders. In 2014, more than 600 companies participated in the survey. The companies were then compared with their competitors and classified under four categories: Green starters, Green talk, Green walk and Green stars.

In spring 2014, the Second AP Fund asked its non-listed real-estate companies, as well as its Swedish listed real estate companies, to respond to the GRESB questionnaire. Three of the five non-listed companies responded. Two of fourteen listed companies responded. As a member of GRESB, the Second AP Fund can access companies' answers via a web-based system, allowing the Fund to compare the real-estate companies in which it has interests with various benchmark groups.

Three companies are classified as Green stars, confirming that they have policies and management systems in place and are actively engaged in their implementation and in reducing their environmental impact. Two companies are classified as Green starters,

meaning that the companies need to develop their commitment to sustainability. Next year, the Second AP Fund will follow up on the GRESB questionnaire results, company by company.

Investments in forest real estate

During the period 2013/2014, the Second AP Fund decided to expand its investments in forest assets. As an asset class, forest offers both diversification and a stable, long-term return. The Fund's first investments in forest were made in 2010 in the Australia/New Zealand Forest Fund, managed by New Forests in Australia, and in the Molpus Woodlands Fund II, managed by Molpus, which focuses on forest real estate in the USA. As of June 30 2014, 0.27 percent of the Fund's total capital was invested in forest assets.

Over the past year, the Second AP Fund has undertaken to invest in two additional funds handled by these managers. As previously, the focus is on Australia, New Zealand and the USA. With a view to further diversifying the portfolio, the Fund has also decided to invest in Global Timber Resources, a company owned jointly with TIAA-CREF and other institutional investors. This company will be investing in Europe, Latin America and the USA. Investments will be made in biomass as well as conventional forest real estate for the traditional production of pulpwood and saw timber.

The day-to-day management of the forest assets held by joint-owned Global Timber Resources is handled by GreenWood Resources Capital Management, in which TIAA-CREF is a majority shareholder. GreenWood was founded in 1998 and is intensively involved in the development of plant materials, with the emphasis on fast-growing tree varieties such as poplar.

Where possible, the Second AP Fund makes it a condition that fund managers should certify forest real estate in compliance with one of the international sustainability certification systems, Forest Stewardship Council (FSC) or the Programme for Endorsement of Forest Certification (PEFC). If the forest assets cannot be certified – as in the case of biomass plantations not covered by FSC or PEFC certification – they will be managed in compliance with the certification principles implemented by these organizations.

New Forests, a fund manager founded in 2005, specializes in forest assets. It is also engaged in finding markets for the ecosystem services the forest offers. Right from the start, sustainability issues have been central to New Forests' business concept. New Forest has a declared ambition to achieve a leading position in sustainability. Consequently, the fund has sustainability policies and management systems in place and ensures that its forest assets are certified sustainable by independent agencies. The fund also collaborates with various stakeholders concerning the environment and social sustainability. New Forests' sustainability reports are available at www.newforests.com.au

The Second AP Fund has invested in two New Forests funds that focus on Australia and New Zealand. The predominant tree varieties are eucalyptus and pine.

Molpus has been managing investments in forest real estate in the USA since 1996 and has a long tradition of sustainable forestry. Molpus also has policies and management systems for promoting sustainability. It applies the Sustainable Forest Initiative (SFI), which is the American certification programme within the PEFC. Since 2011, the fund has adopted multisite certification, which means that an independent agency conducts an annual audit of approximately a third of the real estate assets and that new real estate is included as it is acquired. In some cases, Molpus can also choose to certify its assets in compliance with the FSC. These audits are available on the SFI website at www.sfiprogram.org

Molpus also conducts analyses to determine whether forest real estate might be appropriate for inclusion in 'carbon projects'. If the anticipated regrowth significantly exceeds felling volumes, the fund calculates the value of directly extracted forest products relative to the value of the forest as a carbon sink (that the forest naturally lowers the carbon dioxide content). In order to be able to sell the carbon credits that the forest generate, a functioning market and regulatory system is needed. The USA operates the Climate Action Reserve (CAR), a national programme for managing carbon credits.

The forest real estate assets in Molpus' funds feature a mix of coniferous and deciduous varieties, with oak, maple, poplar, spruce and pine predominating.

Agricultural real estate

Sustainability factors are central to the Second AP Fund's investments in farmland. The Fund's strategy is to invest in large-scale agricultural real estate in countries that possess clearly-defined legal structures. This disqualifies many geographical regions for investment. At present, the Second AP Fund invests in Australia, Brazil and the USA.

The Second AP Fund's agricultural investments

Investment in agricultural real estate forms part of the Second AP Fund's strategy for diversifying the overall portfolio. As of June 30 2014, 1.2 percent of the Fund's capital assets were invested in agricultural real estate.

The Second AP Fund has elected to invest in agricultural real estate by establishing joint ventures with other investors, a form well suited to the Fund's long-term investment approach. The Fund has invested USD 100 million in Teays River and USD 450 million in TIAA-CREF Global Agriculture. It has also undertaken to invest USD 750 million in TIAA-CREF Global Agriculture II. As of June 30 2014, this company had made no investments.

The Second AP Fund's representative on the board of TIAA-CREF Global Agriculture is actively engaged in improving the company's work with sustainability. The Fund's representative is, among other things, a member of the ESG committee. The board has asked the committee to draft a proposal during the coming year for third-party audits of its agricultural assets, with regard to implementation of the Principles for Responsible Investment in Farmland.

TIAA-CREF Global Agriculture owns agricultural real estate in Australia, Brazil and the USA, while Teays River invests exclusively in the USA. As of June 30 2014, these two companies had invested in agricultural estate totalling some 473 000 hectares. The Second AP Fund's share of this agricultural estate corresponds to an area of farmland covering approximately 83 000 hectares. In a breakdown of the Second AP Fund's total portfolio of agricultural investments, USA accounts for 50 percent, Brazil for 29 percent and Australia for 21 percent. As illustrated in the diagram below, cereals and oil-yielding plants are the largest crops.

The Second AP Fund cultivates no land. The land is leased either to local farmers/companies or administered by external managers for the joint-venture companies. Where farmland is leased to a tenant farmer, the farmer decides which crop is to be cultivated

and is responsible for both its production and sale. If the farmland features a more permanent form of cultivation, such as an orchard, it is looked after by an agent, appointed by the external manager. The majority of the acreage owned by the joint-venture companies is leased out to tenant farmers. Most of the investments made in Teays River, however, are managed directly by the operative companies.

Integration of Farmland Principles in PRI framework

The Farmland Principles were launched in September 2011 by the Second AP Fund and ABP (Netherlands), APG (Netherlands), ATP (Denmark), BT Pension Scheme/Hermes EOS (Great Britain), PGGM (Netherlands) and TIAA-CREF (USA). These Principles are intended to provide institutional investors with an ESG (Environmental, Social and Governance) network for agricultural investments, and to increase transparency concerning such investments. Some 20 investors are signatories to these Principles. It is a requirement that all signatories of the Farmland Principles shall also be PRI signatories.

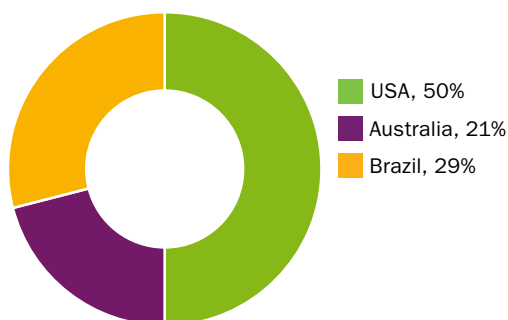
Until September 2014, the Farmland Principles have been administered by a steering committee, comprising representatives from the investors that developed the Principles. During the year, to strengthen and ensure the continued observance of these Principles, the steering committee has collaborated with the PRI organization on transferring their administration to the PRI. Now that the Principles are incorporated into the PRI, it will be easier for investors to discuss how they should respond to other initiatives, such as the various commodity initiatives, IFC Performance Standards, the FAO/CFS Principles for Responsible Agricultural Investments and the UN's Global Compact Food and Agriculture Business Principles.

As a consequence of the transfer to the PRI, the Farmland Principles have evolved into 'Guidance for Responsible Investment in Farmland'. The PRI urges all signatories with farmland investments to implement this Guidance. As part of this integration, reporting on the implementation of the Principles will not be separate, but will be included in the PRI reporting tool. To facilitate transparency, the PRI will compile a separate agricultural report, entitled the 'Farmland Transparency Report'. It is hoped this will simplify monitoring and evaluation of the degree to which individual investors are implementing the PRI's 'Guidance for Responsible Investment in Farmland'. The PRI working committee on investment in farmland is responsible for monitoring and revising the Guidance.

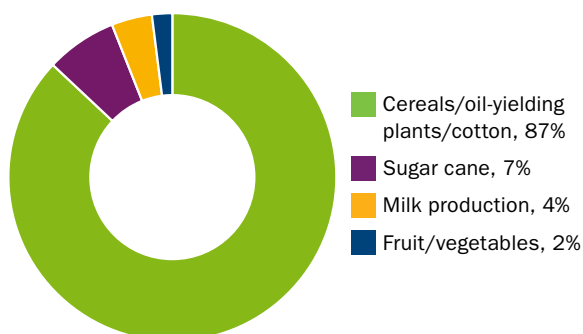
Implementation of Farmland Principles

The Second AP Fund maintains an ongoing dialogue with its managers, as well as visiting its agricultural assets several times a year. Every year, with a view to gaining a comprehensive impression of the way managers are applying the Principles in practice, they are

Geographic distribution



Type of crop



All figures as at June 30 2014.

required to respond to a questionnaire about how they are implementing the Farmland Principles. A summary of these responses is provided below. This year, the Fund has asked them to report on certain key indicators.

The **First Principle** concerns the need to support environmental sustainability by promoting measures that, for example, reduce the risk of soil erosion and ensure improved water management. The water issue is crucially important, both in environmental and economic terms. This year, one of the managers has stressed the degree of effort involved in securing access to water and what is being done to achieve greater efficiency in water management, citing the construction of water storage tanks and the introduction of more effective irrigation techniques.

A key requirement linked to this principle is the performance of an environmental assessment, before agricultural real estate can be

acquired. These assessments are conducted by an external party. The use and storage of insecticides and fertilizers is believed to constitute the greatest risk. In the case of agricultural real estate in the USA, managers emphasize the importance of protecting wetlands and of respecting US water protection legislation. The consultant commissioned to conduct the audit, if required, shall propose measures to reduce the risk of environmental impact. If this audit determines that the agricultural asset features a medium to high risk in terms of environmental impact, the fund manager shall conduct six-monthly checks to ensure that corrective measures are being implemented as planned.

In Brazil, several of the tenant farmers are affiliated to various sustainability initiatives related to different crops, such as Bonsucro (sugar cane), the Round Table on Responsible Soy Association, the Better Cotton Initiative and the Brazilian Responsible Cotton Program.

Farmland Principles, key indicators, %

Principle 1 Promoting environmental sustainability		
Environmental audit	Percentage of farmland accurately assessed.	94
Chemicals management	Percentage of farmland featuring detailed information on insecticides and fertilizers.	93
Soil quality	Percentage of farmland subject to regular testing for quality, pH and nutrients.	86
Sustainable agricultural practices	Percentage of farmland managed according to research-based techniques such as those featured in Good Agricultural Practices (GAP).	100
Water (referring to farming that relies on irrigation)	Percentage of farmland featuring detailed data on water consumption.	82
	Percentage of these farms that implement water conservation techniques.	100
Energy and fuel consumption	Percentage of farmland that employs different approaches to cut energy and fuel consumption.	100
Land protection	Percentage of farmland that only uses land previously developed for agricultural purposes.	99
Principle 2 Respecting labour and human rights		
Labour compliance	Percentage of tenant farmers/operators that observes national labour legislation.	100
Health and safety	Percentage of farms inspected in past year to ensure that health-and-safety regulations are being observed.	100
Principle 3 Respecting existing land and resource rights		
Ownership and local land rights	Percentage of investments featuring a formal registration of title to land and where an investigation has been conducted to verify previous ownership history.	100
	Percentage of agricultural activities operating in compliance with legislation for the protection of native rights.	100
Principle 4 Upholding high business and ethical standards		
Investment ethics	Percentage of investment staff to have participated in an annual course in business ethics.	83
Principle 5 Reporting on activities and implementation		
	See section below.	

The **Second Principle** addresses respect for labour and human rights. In precisely the same way as for the environment, an assessment is conducted by the Fund's managers to determine any risks or impact associated with the operations. This forms an integral part of the evaluation process prior to the acquisition of agricultural real estate. Areas of interest identified by these assessments in Brazil include the need for a safe work environment and living conditions. Audits are conducted at the farms to ensure that conditions are in compliance with national legislation and the managers' own policies. Another area of potential risk is the conditions experienced by migrant and/or seasonal workers.

The **Third Principle** addresses the use of, and rights of ownership to, land and other natural resources. Such issues are often especially important in developing countries, where systems that determine who is formally entitled to farm and/or own the land may not always exist. In those countries where the Second AP Fund has agricultural investments (Australia, Brazil and the USA), Brazil is the only one where it can be difficult to determine who is the rightful owner of an agricultural property. For this reason, TIAA-CREF's operators in Brazil conduct thorough research to establish the rightful owners of the land from the present day all the way back to its original sale by the government. Techniques utilized in this process include geo-references (GPS coordinates) and satellite images. The asset manager also engages in a dialogue with representatives from the local community and land-owners. Prior to acquisition of an agricultural property in Brazil, the manager will have assured that the investment will have no negative impact on the local environment and that no uncertainties exist concerning the rightful ownership of a property.

Since 2000, Brazil has instituted a requirement that, in the case of a transfer of ownership, all properties shall be registered using GPS coordinates.

The **Fourth Principle** addresses business ethics. Managers and operators shall respect and implement processes that combat all forms of corruption. Laws shall be respected even when weakly implemented. Employees have received training to deal with corruption issues. Managers shall require employees to observe the legislation and regulations devoted to good business ethics. The majority of managers and operators in the USA have attended courses on American corruption legislation, enshrined in the Foreign Corrupt Practices Act.

No misdemeanours or disputes have been reported in connection with the agricultural investments made by the joint-owned companies in the past year.

The **Fifth Principle** concerns reporting on activities and implementation of the Farmland Principles. This principle is relevant to managers who have signed the Principles. The Second AP Fund has elected to include this report in its annual Sustainability and Corporate Governance Report. This is now the third year that the Fund has reported on progress in the implementation of the Farmland Principles.

TIAA-CREF's reports on how it has implemented these Principles may be downloaded from www.tiaa-cref.org

Current progress at the FAO

The Second AP Fund continues to monitor progress on the formulation of the Principles for Responsible Agricultural Investment (rai), in the context of food security and nutrition. The Principles are developed by the Committee on World Food Security (CFS). As well as the member states of the FAO (Food and Agricultural Organisation), IFAD (International Fund for Agricultural Development) and WFP (World Food Programme), the CFS also includes representatives from NGOs and the private sector. The Principles are being drawn up by means of a consultative process, for approval by the CFS in the autumn of 2014.

These Principles are intended to contribute to the security of food supplies and nutrition. The Principles are intended for implementation by all those involved in or affected by investment in agriculture. They will be voluntary and non-obligatory, and shall be interpreted and applied in compliance with national and international legislation. The Principles will cover all types of investment in the process chain and food systems.

The Fund has submitted comments on numerous drafts of these Principles to Landsbygdsdepartementet (Swedish Ministry for Rural Affairs). The Second AP Fund has also let its views be known via the working group formed as a subcommittee of the steering committee for Farmland Principles.

Sustainable investments

The Second AP Fund invests more than SEK 10 billion in assets/funds that pursue a business strategy based mainly on sustainability.

Investments featuring sustainable strategies

	Strategy	Asset class
Generation Im Global Equity Fund	Invests in companies based on a sustainable approach	Unit trust
Generation Asia Fund	Invests in companies based on a sustainable approach	Unit trust
Generation Climate solution	Invests in companies based on a sustainable approach	Private equity fund
R/C Pattern Energy Feeder	Invests in renewable energy	Private equity fund
Riverstone Renewable (two funds)	Invests mainly in power production from renewable energy sources	Private equity fund
Khosla Venture (two funds)	Invests in innovations that have a positive impact on social development	Private equity fund
Khosla Venture Seed	Invests in innovations that have a positive impact on social development	Private equity fund
African Development Bank	Green bonds	Fixed-income securities
City Of Gothenburg	Green bonds	Fixed-income securities
Export-Import Bank Of Korea	Green bonds	Fixed-income securities
European Investment Bank	Green bonds	Fixed-income securities
International Bank For Recon & Develop	Green bonds	Fixed-income securities
Kommunalbanken As	Green bonds	Fixed-income securities
Nederlandse Financierings-Maatschappij Voor Ontwikkelingslanden Nv	Green bonds	Fixed-income securities
Nordic Investment Bank	Green bonds	Fixed-income securities
Nederlandse Waterschapsbank Nv	Green bonds	Fixed-income securities
Molpus Woodlands Fund	Forest assets	Real estate
New Forests Australia New Zealand Forest Fund	Forest assets	Real estate
New Forests Australia New Zealand Forest Fund II	Forest assets	Real estate
TIAA-CREF Global Timber	Forest assets	Real estate

Corporate governance



The AGM is the main forum where shareholders can exert their influence. As a shareholder, the ability to exercise one's voting right at the AGM offers the best way to influence a company – which is why the Second AP Fund is active at both Swedish and foreign AGMs.

A considerable portion of the Second AP Fund's capital is invested in Swedish and foreign equities, making the Fund a significant shareholder. The Fund is also non-political and independent, both in terms of ownership and of its special status among Swedish agencies regulated by law, allowing it to act as a committed and long-term investor. Shareholder commitment and interest in a company's long-term development is a crucial re-requirement for better value growth. As a long-term investor, the Second AP Fund fulfils an important function on the world's capital markets.

Consequently, the Fund is actively engaged in promoting good corporate governance, high ethical standards and an enlightened environmental approach, as well as best practice within asset management. In its contacts with publicly quoted companies, the Second AP Fund is active in the run-up to and during Swedish and foreign AGMs, as well as engaging in dialogue with the boards and executive managements of its portfolio companies.

” As a long-term investor, the Second AP Fund fulfils an important function on the world's capital markets.

In Sweden, the Second AP Fund works mainly with companies in which it is one of the largest shareholders or in which it has invested the most capital. In the case of companies outside Sweden, the Fund mainly addresses ethical and environmental issues via the Ethical Council. Other shareholder issues of special interest to the Fund, when related to foreign companies, are handled in collaboration with selected partners.

The Second AP Fund also promotes good corporate governance by collaborating with other investors on matters of principle and through active participation in the development of policies, regulations and standards.

Corporate governance in Swedish companies **Swedish AGMs**

The Fund has holdings in some 250 Swedish companies. It has decided that it is impractical to attempt to attend and vote at the AGMs of all the companies represented in its portfolio of Swedish equities. In determining which AGMs to attend, the Fund employs the following criteria

- Companies that are among the Fund's 20 largest holdings.
- Companies in which the Fund's voting rights exceed one percent of capital.
- Companies in which the Fund is among the ten largest shareholders.
- Companies with controversial issues on the agenda.

The Second AP Fund exercised its voting rights at a total of 52 AGMs of Swedish publicly quoted companies during the period 2013/2014. The Second AP Fund and other institutional investors have for many years enjoyed a positive and constructive dialogue with Swedish publicly quoted companies, which have included discussions about many of the issues raised at AGMs.

Even so, the Second AP Fund voted against discharging the previous CEO of TeliaSonera, Lars Nyberg, from liability. This was in response to the statement in the auditors' report that they could neither withhold nor grant discharge of liability. This derived from the fact that they had been unable to access "adequate and appropriate" audit data, due to the fact that transactions in Eurasia were still under inquiry. Given its opinion that not enough data was available, the Fund decided to vote against a discharge of liability.

Over the year, the Fund voted against proposals by nomination committees to increase the remuneration paid to the board members of AB Volvo and SCA, since it felt that the proposed increases were unjustifiably high. The SCA nomination committee proposed an increase of no less than 27 percent, for which justification was notably lacking in the notice convening the AGM. A similar proposal for increased remuneration to board members was also tabled by the AB Volvo nomination committee. Together with a number of other Swedish institutional investors, the Fund proposed that the remuneration paid to board members should instead be increased by no more than five percent, which attracted the support of more than 30 percent of the votes at the AGM.

Issues in focus

During the period, the Second AP Fund has maintained its focus on remuneration issues and engaged in a number of dialogues with corporate boards, concerning the formulation of incentive programmes, with a view to promoting improvements.

For several years now, the Second AP Fund has stressed the importance of increasing the number of women on the boards of publicly quoted companies and duly observes this principle when participating in the nomination process. The Fund also feels that nomination committees should draft a concrete plan to attain the most appropriate board composition, with respect to gender, age, background, experience and competence.

During this year's AGM season, the Fund has also placed special emphasis on diversity and, in particular, on the percentage of women on corporate boards. The Fund has both questioned companies' nomination committees before their AGMs, as well as commenting at AGMs. Among other things, the Fund has stressed that the Swedish Corporate Governance Code states that a nomination committee shall declare how it plans to achieve balanced gender distribution over time, but that in many instances this is notably lacking in many companies.

Read about the Second AP Fund's annual Women's Index at www.ap2.se

Nomination committees

The Second AP Fund favours having a representative on the nomination committees of portfolio companies, as this provides a valuable opportunity to exercise investor influence. The Fund practices a policy of accepting all invitations to participate in the nomination process. Its ownership group decides who shall represent the Fund on the various nomination committees, based on whoever is best qualified for the task. Since nomination committees commonly consist of the three to five largest investors in a company, the Second AP Fund's nomination committee assignments vary, depending on the size of its holding in the portfolio company.

Prior to the start of the 2014 AGM season, the Second AP Fund was represented on the nomination committees of Opus Group and Ratos, as chair, as well as on those of Semcon, Kungsleden and Flexenclosure.

Nomination committees in which the Second AP Fund participated during the period 2013/2014

Company	Women on board %	No. of newly elected women	Total change as per previous year
Ratos	28	1	0
Opus Group	20	0	0
Semcon	40	0	0
Kungsleden	57	2	2
Flexenclosure	16	0	0

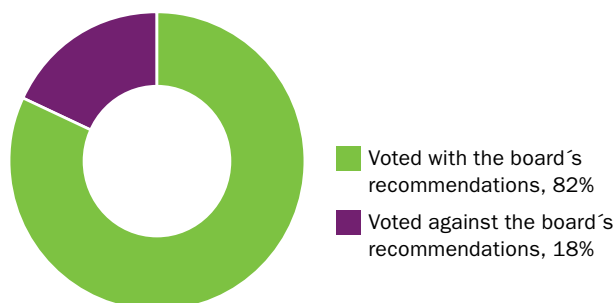
Corporate governance in foreign companies

Foreign AGMs

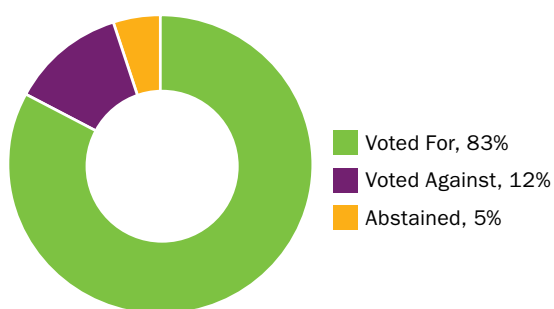
Since 2008, to improve the governance of its foreign investments, and in cooperation with the First, Third and Fourth AP Funds, the Second AP Fund has operated a joint electronic voting platform, based on the AP Funds' governance policies. Most issues are managed automatically via the voting platform, with the exception of matters such as remuneration issues, which are forwarded to the funds for individual assessment. Each fund decides individually as to how it will vote.

On foreign markets the Fund mainly votes in the following eleven countries: Australia, France, Italy, Japan, Canada, the Netherlands, Switzerland, Spain, Great Britain, Germany and

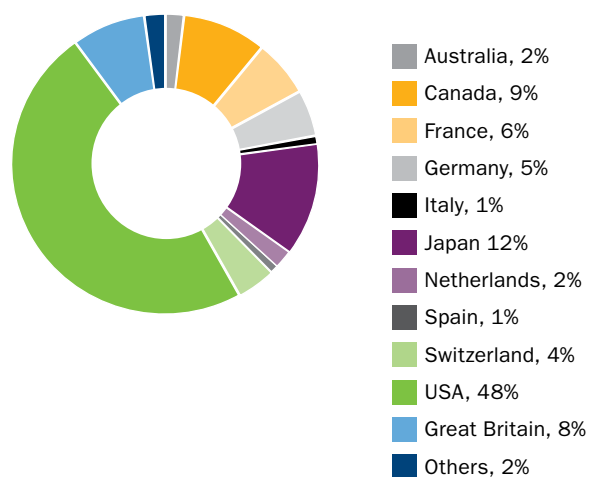
Voting in foreign companies 2014



Voting, agenda items 2014



Voting per market 2014



Board and investor proposals that the Second AP Fund voted on in 2014, number

Area	Board proposal	Investor proposal
Auditors, financial reporting, formalia etc.	786	0
Board	4 002	14
Remuneration issues	604	49
Capital structure	339	6
Group structure, agreements, acquisitions etc.	65	1
Shareholder rights/governance	53	187
Sustainability	1	55
Other	0	20
Total	5 850	332

Voting at foreign AGMs July 1 2013 – June 30 2014

	Number
No. of AGMs	483
Agenda items	7 021
Voted against board's recommendations	1 264

the USA. The criteria for determining the companies in which the Fund should exercise its voting rights derive mainly from the MSCI global index. There are other criteria too, such as when the Fund is engaged in a dialogue on a specific issue with a company and/or when the Fund has submitted a shareholder proposal for consideration by the AGM.

During the 2013/2014 season, the Second AP Fund exercised its vote at 483 AGMs. The Fund employs an external party for the practical voting process and submits a written vote (proxy voting) using the electronic voting platform.

” During the 2013/2014 season, the Second AP Fund exercised its vote at 483 AGMs.

Letters to foreign companies

During 2013/2014, with a view to further improving communication with its foreign portfolio companies, the Second AP Fund has written letters to some 50 of these companies, clarifying the Fund's views on active governance and the importance of exercising voting rights. In these letters, the Fund has also explained why it was unable to support the recommendations of the boards on specific proposals. In several cases, these letters

have resulted in further contact with the companies in question, sometimes by letter but also in the form of teleconferences.

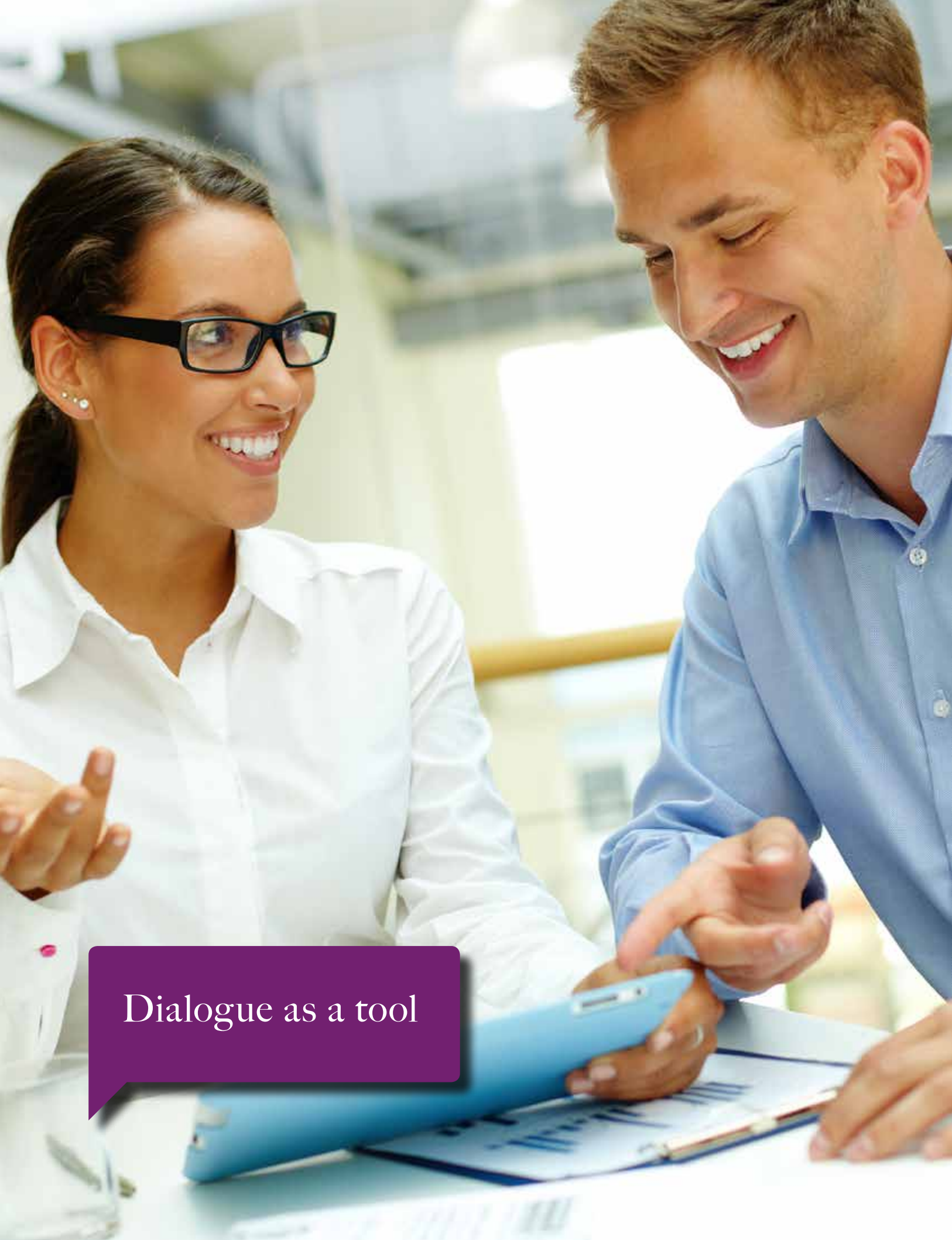
Further details of how the Second AP Fund voted on specific issues may be found at www.ap2.se/en/corporate-governance-/corporate-governance-reports/

Investor resolution at Motorola Solutions AGM

Over a period of several years, the Second AP Fund has been engaged in a dialogue with Motorola Solutions Inc. via the AP Funds' joint Ethical Council, because of the company's supply of a customized surveillance system to the settlements on the West Bank. These settlements, located on occupied Palestinian territory, are in conflict with international humanitarian rights.

The Ethical Council wants the company to terminate its supply and maintenance of surveillance systems and ancillary services to settlements located on occupied territory. Furthermore, the Council also wants the company to adopt a corporate policy that clarify that they not will contribute to violations of international human rights.

To place additional pressure on the company, the Second, Third and Fourth AP Funds, together with US investors, presented a resolution at Motorola Solutions' AGM that the company should review and improve its policy on human rights. The resolution received support from 6.3 percent of shareholders at the AGM.



Dialogue as a tool

As an active asset owner and manager of capital, dialogue is a vital tool, both in relation to companies and to society at large. The Second AP Fund engages in regular dialogues with its fund managers, as well as Swedish and foreign companies, concerning the environment, ethics and corporate governance.

Collaboration with other investors is important in ensuring that dialogues with portfolio companies are successful, as well as in encouraging a move towards more responsible investments. The Second AP Fund collaborates both with Swedish and foreign institutional investors.

The Ethical Council

Dialogues with foreign companies are coordinated through the AP Funds' joint Ethical Council. The Ethical Council is a collaboration between the First, Second, Third and Fourth AP Funds, which was launched in 2007. The companies with which the Ethical Council conducts dialogues are identified primarily in conjunction with each fund's biannual screening of its total shareholdings, with a view to determining whether any portfolio company is in contravention of an international convention. This screening is conducted by an external consultant. This work is based on the principles of commitment, action and change, with the intention of making a difference. The Ethical Council identifies companies that can be linked to breach of conventions and focuses on persuading such companies to deal with confirmed breaches and to implement systems and measures to preclude future violations. Dialogue is a vital tool in enabling the Ethical Council to influence corporate behaviour.

When companies in which the Fund has invested can be linked to the breach of an international convention, the Fund's core strategy is to exert its influence as an investor to ensure that such violations cease, that systems designed to prevent any recurrence are implemented – and that measures are taken to prevent any future violations. Through its commitment and by deploying its power as a major investor in reacting to breach of international conventions, as well as demanding change, the Fund can make a difference. Only in cases where this cannot be achieved the Fund will consider excluding its holdings in the company.

During 2013, the Ethical Council engaged in preventive and reactive investor dialogues with 133 companies around the globe. On behalf of the Ethical Council and other customers, the Ethical Council's service supplier also conducted dialogues with 100 additional companies.

More on this at www.ethicalcouncil.com

Collaboration with other investors

In addition to cooperating with its fellow AP funds through the Ethical Council, the Second AP Fund also collaborates with other Swedish and foreign investors. During the year, the Fund has also exchanged ideas with Generation Investment Management and Investec about the integration of environmental, ethical and corporate governance aspects in asset management.

The Second AP Fund is also a member of and actively supports various Swedish and international initiatives focused on the environment, ethics and corporate governance. The Fund also collaborates with other investors on influencing new legislation, mainly within the field of corporate governance. These forms of collaboration are becoming increasingly important as a means to influence and effect change, and thereby improve share value over the long term.

In light of the growing focus on emerging markets, the Second AP Fund chose to become a member of ACGA (Asian Corporate Governance Association). ACGA is a non-affiliated, not-for-profit member organization that works with investors, companies and supervisory authorities to promote effective corporate governance throughout Asia. ACGA was established in 1999, based on the conviction that good corporate governance is fundamental to the long-term growth of Asia's economies and capital markets.

Collaboration on the climate issue

Through its membership of the IIGCC (Institutional Investors Group on Climate Change), the Fund collaborates with other European investors on climate issues. The idea is to make the voice of investors heard in the climate debate and to make companies, government agencies and other investors aware of the long-term risks and opportunities associated with climate change. The climate issue is important to the Second AP Fund as a long-term investor. At present, there is considerable uncertainty about the future regulations and framework for reducing the emission of greenhouse gases and stimulating alternative energy sources. This makes it difficult for companies to make profitable investments and for investors to calculate the potential risks and returns. The IIGCC provides an effective platform for communicating investors' wishes concerning climate issues. It is also a good way for the Fund to acquire the latest information on climate related investments. More at www.iigcc.org

More about the Second AP Fund's memberships and initiatives at www.ap2.se/en

Sustainability reporting

Demand for data on emissions

The Second AP Fund is also a member of the CDP (Carbon Disclosure Project). The CDP is an initiative whereby some hundred major fund managers require that the world's largest publicly quoted companies provide reports on their greenhouse emissions and other data related to how they are addressing the climate challenge. The CDP aims to make the data-gathering process more efficient by bringing together a large number of investors to sign a joint demand for the provision of regular data and reports on companies' emissions of greenhouse gases. More at www.cdproject.net

Transparency in the oil industry

The EITI (Extractive Industries Transparency Initiative) is an initiative sponsored by the extractive industries, especially oil companies. The need for transparent reporting and control is particularly important in countries that are rich in natural resources, but led by weak governments. More transparent reporting by the companies about what they pay and the governments of the host countries about the size of the revenues generated by the oil, gas and mining industries increases transparency within society and improves the prospects for economic control. In partnership with other international investors, the Fund supports EITI, sending a signal to countries and companies that are engaged in extractive operations that the shareholders place a value on the clear and open reporting. Read more at www.eiti.org

Reports from external asset managers

The Second AP Fund's annual review of external asset managers has addressed sustainability issues for some years now. These issues are also addressed when awarding new mandates. The Fund has, in collaboration with the private equity industry in eleven countries, has participated in developing a framework that investors can utilize when requiring portfolio companies to report on sustainability. The Second AP Fund has factored these issues into its evaluations of private equity funds.

Second AP Fund reports

It is important that the Fund report its own activities and its progress on sustainability in an open and comprehensible manner. In addition to its Sustainability and Corporate Governance Report, information is available in the Annual Report and on the website.

More detailed information on the work of the Ethical Council may be found in its Annual Report. Further details of how the Fund has implemented the PRI principles may be found in the responses to the annual questionnaire conducted by PRI. The Second AP Fund's responses are available on the Fund's and PRI websites.

Excluded companies

If the Second AP Fund has reason to suspect that any of the companies in which it has invested is acting systematically and seriously in contradiction of an international convention to which Sweden subscribes, or to which it has expressed an intention of subscribing, the facts shall be investigated. This investigation shall include a dialogue with the company in question. If the Fund's suspicions are confirmed, the company will be asked to provide an explanation and to draft an action plan. In evaluating the situation, the Fund shall consider the nature of the contravention and any action that may have been taken (or that may be planned), to ensure that a contravention of this type is not repeated. If contact with the company fails to yield a satisfactory response, the Second AP Fund shall determine whether the company is to be excluded from its investment universe, subsequent to a general assessment. The Second AP Fund may also decide to exclude a company if the Fund considers the circumstances to be so serious as to make exclusion unavoidable, even where no convention has or can be proved to have been contravened.

The Second AP Fund has decided to exclude twelve companies that are in breach of international conventions and where dialogue with these same companies has led to no improvements.

Excluded companies

Companies	Year excluded	Country	Violation
Alliant Techsystems Inc.	2008	USA	Can be linked to breach of Convention on Cluster Munitions
Elbit Systems Ltd	2010	Israel	Can be linked to breach of international human rights in contravention of the Fourth Geneva Convention
GenCorp Inc.	2008	USA	Can be linked to breach of Convention on Cluster Munitions
Freeport McMoran Copper & Gold Inc.	2013	USA	Can be linked to breach of UN Convention on Biological Diversity
General Dynamics Corp.	2008	USA	Can be linked to breach of Convention on Cluster Munitions
Hanwha Corp.	2008	South Korea	Can be linked to breach of Convention on Cluster Munitions
L-3 Communications Hlds	2008	USA	Can be linked to breach of Convention on Cluster Munitions
Incitec Pivot Ltd	2013	Australia	Can be linked to breach of UN's International Covenant on Civil and Political Rights and International Covenant on Economic, Social and Cultural Rights
LockheedMartin Corp.	2008	USA	Can be linked to breach of Convention on Cluster Munitions
Poongsan Corp.	2008	South Korea	Can be linked to breach of Convention on Cluster Munitions
Raytheon Company	2008	USA	Can be linked to breach of Convention on Cluster Munitions
Potash Corp.	2013	Canada	Can be linked to breach of UN's International Covenant on Civil and Political Rights and International Covenant on Economic, Social and Cultural Rights
Singapore Technologies Engineering	2001	Singapore	Can be linked to breach of Ottawa Anti-Personnel Mine Ban Convention
Textron Inc.	2008	USA	Can be linked to breach of Convention on Cluster Munitions
Walmart	2006	USA	Can be linked to breach of human rights



The world around us

Prize for thesis on finance and sustainability

The Second AP Fund's Finance and Sustainability Prize has been awarded for the second year in succession for a thesis submitted by students at Gothenburg University's School of Business, Economics and Law. This year, it was Anna Mattsson and Lina Sandström who were awarded SEK 20 000 for their paper "Comparison between the Performance of Ethical and Conventional US funds. Do different ethical characteristics matter?"

In their paper, the students examined whether differences could be ascertained between ethical and conventional US mutual funds in management approach and results during the period January 2004 – January 2014. The main ethical group was divided into subgroups, such as ESG (Environmental, Social and Corporate Governance), environment-friendly, responsible-religious and socially responsible funds. No statistically significant differences were determined between the two main groups, but analysis of the ethical subgroups revealed that the environment-friendly and ESG funds underperformed, while the responsible-religious funds generated surplus returns compared with conventional funds. The result indicates that ethical funds should not be treated as a homogeneous group when conducting research in this field, but should be broken down into subgroups.

Selected finalists

To qualify for entry for the Prize, a paper shall combine models/theories of business economy, asset management and corporate valuation with sustainability in general or some specific aspect (such as climate protection or corporate social responsibility). A jury at the School of Business nominates papers after assessing their academic quality. The winning paper is then selected by the Second AP Fund's Prize Committee.

This year's winner

This year's winning entry is well structured, is of high quality and its authors utilize theories and economic models in considering the question. The following is an extract from the jury's motivation for its selection: "Anna and Lina have done a solid job in

producing this paper. They have shown the importance of avoiding treating ethical/responsible funds as a homogeneous group and that the environmental, social and/or religious criteria addressed in a fund's asset management approach can impact both negatively and positively on return."

"Given that we at the Second AP Fund are actively engaged in making sustainability integral to our analytical and investment processes and are aware of the importance of working actively in this area, we hope that this Prize will inspire students at Gothenburg University's School of Business, Economics and Law to write theses that will stimulate an early awareness of how sustainability can make good business sense," says Eva Halvarsson, CEO of the Second AP Fund.

Inaugurated 2011, the Prize is designed to encourage more students at Gothenburg University's School of Business, Economics and Law to write papers on finance and sustainability. Papers shall combine models/theories of business economy, asset management and corporate valuation (e.g. asset pricing, portfolio selection theory, corporate finance, efficient market hypotheses) with sustainability in general or some specific aspect (e.g. pricing of external factors, climate, CSR, corporate governance). The Prize shall be awarded to the individual or individuals who has/have written a paper of special merit on finance and sustainability as part of undergraduate or postgraduate studies. The Prize amounts to SEK 20 000.

Nomination committees must communicate better

Given its role, status and nomination committees, the Swedish model is in many ways unique. Merely the fact that it involves a group of shareholders, appointed according to a decision reached at an AGM, which among other responsibilities proposes who are to be elected to serve on the board is, from an international perspective, unusual, giving shareholders considerable power. However, communication between the nomination committee and other shareholders needs to be improved. For one thing, proposals should be presented in greater detail.

From a corporate governance perspective, the fact that nomination committee members are given access to assessments of a board's performance and are often given the opportunity to discuss it with board members is of unique benefit and should be preserved. Naturally, this also improves the likelihood that the composition of the board will be a success. The nomination committee's responsibility is considerable, placing it under a solemn obligation.

A nomination committee's proposals for appointments to the board shall be supported in a written statement. Furthermore, at the AGM, at which auditors and board members are elected, to comply with the Swedish Code for Corporate Governance, the nomination committee shall report on its performance, pre-senting and justifying its proposals.

Better communication

In the Second AP Fund's experience, communication between nomination committees and other shareholders has not always been the best. The potential for shareholders to submit suggestions or table questions to the committee before it finalizes its proposals is seldom utilized.

The shareholders who often participate in the work of the nomination committee gain a thorough understanding of the issues to be addressed at the AGM. This is naturally not the case for the great majority of shareholders. Nevertheless, many of these shareholders are committed, responsible and determined to draw their own conclusions about agenda items at the AGM.

Thanks to the Swedish nomination committee model, there has been a significant increase in opportunities for shareholders to act responsibly. However, this assumes that communication from and to the committee functions effectively. The responsibility for ensuring this lies mainly with the committee, which is required to communicate with other shareholders – at least in the form of the statutory clarification of its planned proposals.

The nomination committee statement

The statement the committee is required to submit to clarify its proposals is a central element in the communication process between committee and shareholders. Not uncommonly, however, these statements can be standard in form and thin on content.

The nomination committee statement should be detailed and company specific. Based on the statement, shareholders should be able to make up their own minds before the AGM. It is very far from the norm that these statements look like this. In many instances, the Fund has noted that the written statement is significantly thinner than the information subsequently presented by the committee at the AGM. Here is a clear need for improvement. The Fund therefore urge all nomination committees to invest a bit more effort in clarifying the motivation for the proposals to be presented at forthcoming AGMs. This would enable more shareholders at AGMs to make decisions based on hard data. It would also further strengthen the status of the nomination committee in Swedish corporate governance.

“Dare to choose the right boards”

The Second AP Fund’s 2014 Women’s Index reveals that the percentage of women on the boards of publicly quoted companies has risen over the past year by two percent, to 24.7 percent. This is the largest increase since the Second AP Fund started its measurements in 2002. Even if things are moving in the right direction, much remains to be done to benefit from the diversity and competence that companies otherwise lose out on.

The Second AP Fund has interviewed two experts in this field, Monica Lagercrantz and Therese Reinfeldt, of Lagercrantz Reinfeldt AB, who assist large companies and organizations with board analyses and the recruitment of board members and CEOs. Here they share their expertise and offer advice on recruiting board members. It is not just a matter of increasing diversity. First and foremost, it’s about creating better boards.

Start at the right end

“Basically, it’s about having the right attitude and the courage to choose the right board. To succeed, you need to start at the right end, with a factual analysis of the board’s work, value creation and composition, and to identify the competence requirement based on the company’s challenges and opportunities in the short and long term,” notes Therese Reinfeldt.

“The need to conduct a factually based and structured board analysis in association with an external party should be the self-evident starting point for a recruitment process. It ensures greater control, which in turn assures greater reliability in identifying the right candidates. This promotes diversity,” says Monica Lagercrantz.

Logically, this development is good for the companies and good for owners too – which makes one wonder why more have not yet chosen to go this route.

“We are convinced that owners will increasingly be going this route, as these issues come more and more to the fore. Ultimately, the natural consequence will be an improvement in the quality of the recruitment process and more women will be elected to boards and executive positions,” states Monica Lagercrantz.

Underpin the process

Subsequently, the analysis should serve to underpin the rest of the recruitment process, as in the development of a job profile for the post to be filled. Otherwise, it is all too easy to revert to old habits.

“When no clear criteria are defined, it is natural to look at names already familiar to you in your own network, since this feels most comfortable. If so, it is no longer just a risk that the company will lose out on access to competent candidates: it becomes a certainty,” says Therese Reinfeldt.

“Start in plenty of time! An extremely common explanation for the fact that owners and nomination committees end up relying on their own networks – however good their original intentions – is that the process is initiated too late in the season, both in terms of the board analysis and the recruitment process itself,” states Monica Lagercrantz.

Facts better than myths

It’s important to ignore myths that can limit your choice. “One is that women often decline offers of board and executive positions. Another is that they lack the appropriate competence. Our experience, based on more than 300 board recruitments, featuring a large number of female directors and chairs, is that such claims lack any factual basis,” notes Monica Lagercrantz. Many still claim that a director or chair who lacks experience as a CEO cannot contribute as much. According to Therese Reinfeldt, this is not so.

“Actually, our board analyses sometimes indicate the reverse. The less experienced receive higher ratings than candidates with longer experience. This can derive from greater commitment, a determination to excel in the boardroom and up-to-date operative competence. This is something more nomination committees should understand and learn from.”



Therese Reinfeldt



Monica Lagercrantz

Five steps to the right board

1. **Start in time** – Lack of time can undermine the best intentions.
2. **Conduct a board analysis** – Identify the required competence based on the company's strategic needs.
3. **Base the job profile on the analysis** – Be consistent. Stick to the facts and conclusions derived from the analysis.
4. **Expand the selection of candidates** – Dare to seek candidates outside your own networks. You'll find more than you expect.
5. **Ignore the myths** – It is untrue that women are not interested in sitting on boards or that a board member must have experience as a CEO to succeed.

” ... identify the competence requirement based on the company's challenges and opportunities in the short and long term.

Courage and commitment steers change to a more sustainable future

Sustainability is one of the keys to growth and profitability. So claims Paul Polman, recipient of the 2014 Gothenburg Award for Sustainable Development. After he took over as CEO of global consumer goods company Unilever in 2009, the company commenced a pervasive change of course towards more sustainable operation. The rewards have not been slow in coming.

“It proved possible to implement the plan more rapidly and to generate more positive results than many had anticipated. Hopefully, it will encourage other corporate boards and CEOs to make sustainability central to their business operations,” says Paul Polman.

A vital element of this change in corporate focus was the launch of Unilever’s Sustainable Living Plan.

“It forms the core of our business model,” states Paul Polman.

His simple and logical thesis is that you cannot grow a healthy business in an unhealthy society. It is therefore in companies’ own interests to contribute to positive development in terms of sustainability, something that Unilever has taken to heart. Unilever’s Sustainable Living Plan aims to halve the company’s environmental footprint by 2020 and to increase its positive influence on global health, as well as prosperity and working and living conditions, while simultaneously promoting company growth.

Long list of improvements

Unilever is already well on the way to achieving these targets. Between 2008 and 2013, it cut carbon emissions from its production facilities by 32 percent per ton produced. During the same period, the company reduced overall water consumption by 29 percent and the amount of disposable waste by 66 percent. Furthermore, the 2013 Unilever Annual Report tells us that work safety is improving, as is the ratio of women in leading positions, and that the company’s managers are endorsing the Plan with increasing commitment. The list goes on.

Sales and profitability rising

And the economic fallout is positive too. In the five years 2009–2013, turnover grew by almost EUR 10 billion, while the operating margin rose from 12.5 to a new record level of 14.1 percent.



Michael Treschow, Chairman Unilever



Paul Polman, CEO Unilever

Furthermore, the company flagged unrestricted cash flow amounting to EUR 18.7 and gradually increased its dividend to shareholders, who saw an accumulated total return on investment of 98 percent over the five-year period.

“We are clearly demonstrating that sustainability and profitable growth are perfectly compatible, in contrast to what many claim. The really important thing is to decide what type of growth you want,” says Michael Treschow, who chairs the Unilever board.

“ Unilever’s Sustainable Living Plan aims to halve the company’s environmental footprint by 2020.

Sceptics welcome

When Paul Polman launched his plans, many were initially rather sceptical, both inside and outside the company. He doesn’t consider this strange at all.

“History is littered with companies and CEOs that have ignored their responsibilities. It seems only natural that people should express some doubts when we claim an ability to increase profitability while simultaneously contributing to a better society. I welcome this type of scepticism. Dealing with cynics who are not really interested in any solutions poses much more of a problem,” notes Paul Polman.

Cooperation important

Cooperation is vital to the success of the Sustainable Living Plan. This is particularly true of efforts designed to promote greater health in society. For example, by the close of 2013, company brands had helped 303 million people to attain better standards of health and hygiene, which in many instances can have a decisive impact – especially for children in emerging nations.

Unilever’s Lifebuoy soap brand plays a prominent role in this project. Lifebuoy was originally developed by William Hesketh Lever at the end of the nineteenth century. His aim was to create a product that was effective against bacteria, yet cheap enough for anyone to buy – even the poorest.

“This ambition informs our Lifebuoy brand even today, being the key to the commitment and passion that is so crucial to the company’s development. Our other brands also share this heritage which, of course, is an advantage,” notes Paul Polman.

No more quarterly reports

On several occasions over the past few years, Unilever and Paul Polman have acted firmly in combating the short-termism that is so prevalent in the financial sector and which infects publicly quoted companies and their leaders.

Exemplifying this phenomenon, Mr Polman cites a recent survey that showed that two thirds of the CFOs of top companies would postpone a positive NPV investment if it affected guidance for the quarter.

“Leadership within the financial sector needs to be more courageous, responsible and long-term. Luckily, there is a general awareness of these problems, and a number of broad international initiatives are being implemented to promote change. This will benefit society as a whole,” says Paul Polman.

Unilever, for example, has abolished traditional quarterly reports and financial guidance, as well as moving compensation to the long-term. These measures have seen the company lose some short-term investors, although attracting others with more long-term interests.

“Investors who are capable of seeing beyond the next quarter and who appreciate that the traditional key ratios need to be complemented, by calculations that also take into account the company’s impact on the environment and society at large, have much to gain,” says Paul Polman.

The Gothenburg Award for Sustainable Development

The Gothenburg Award for Sustainable Development is given each year to people or organizations for outstanding performance and achievements towards a sustainable future. The Award winners, all of whom have translated their words into actions, provide an important example to others. The Award, worth SEK 1 million, highlights what is possible and necessary for a brighter future. The Award is administered and funded by a coalition featuring the City of Gothenburg, Region Västra Götaland and thirteen other organizations, including the Second AP Fund.

Previous Award winners include Kofi Annan, Margot Wallström and Al Gore.



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