

The 2010 PRI Academic Conference Mainstreaming responsible investment

Influence strategies in shareholder engagement: A case study of five Swedish national pension funds

This is a work in progress. Please do not cite without permission of the authors.

Ian Hamilton*
Umeå School of Business
Umeå University
SE-901 87 Umeå
Sweden
ian.hamilton@usbe.umu.se

Jessica Eriksson
Umeå School of Business
Umeå University
SE-901 87 Umeå
Sweden
jessica.eriksson@usbe.umu.se

Abstract

Investors spend money and resources trying to reduce the environment, social and governance risk in companies they own. If unattended these risks may cause reputational damage not only to the portfolio firm but also its owner. In this paper we study five Swedish national pension funds and the influence strategies used in shareholder engagement. This is important because successful shareholder engagements can lead to more sustainable corporate behaviour and a lower risk to the investor. Our findings show that besides traditional power and legitimacy dependencies which has been reported as influential in deciding stakeholder salience we present five additional factors in determining influence strategies in shareholder engagement. We provide a conceptual model showing how these factors interlink with choices of influence strategies offering a practical use of this study. Stakeholder theory has been used as our theoretical frame of reference building on extant influence strategy literature taking the stakeholder-firm perspective.

*) This author would like to thank participants and faculty of oikos PRI Young Scholars Finance Academy 2010 for providing valuable comments upon presenting this work in progress. A special thanks goes also to Céline Louche and Pontus Cerin for providing appreciated advice.

1. Introduction

Responsible investment (RI) has become a widely recognised and spread practice in investment management, as indicated by a growing market share for RI in particular in the US and in Europe (SIF, 2008; Eurosif, 2008; UK SIF, 2007; Sparkes and Cowton 2004). Responsible investment covers approaches that bring environmental, social and governance (ESG) factors into investor's financial objectives and overall investment decision making. It is becoming increasingly important for institutional investors like pension funds to realize their options and act as responsible fiduciaries in a legal and practical sense (UNEP FI, 2009). In trying to influence company management decision making in a more responsible direction, pension funds use their ownership position alone or in collaboration with others (Clark and Hebb, 2004). The literature on engagement is however divided under two main labels. On the one hand, the literature refers to *shareholder activism* as it is used to describe a conflict of interest between managers and shareholders (Gillian and Starks, 2000; Smith, 1996; Becht et al, 2009). This literature usually centres on traditional corporate governance activities such as board composition and compensation issues (Gifford, 2009b). On the other hand, the literature refers to *shareholder engagement* and then it also includes environmental and social drivers with an overall objective of steering portfolio firms towards more sustainable practices (Gifford, 2009b). Shareholder engagement, which is the term used in this paper, encompasses a whole range of investor activities such as informal discussions with management and the voting of proxies, to more strategic approaches as launching a shareholder resolution campaign or public exclusion of firms (Clark and Hebb, 2004).

In addition to divestment, a wide range of possible investor activities to influence companies are necessary; as pension funds have become increasingly large shareholders, their widespread investment in index funds have resulted in difficulties to sell stocks in the market without experiencing short-term losses. When divestment in underperforming firms is not a financial attractive option, pension funds are better off engaging with firms trying to influence behaviour in a more responsible direction (Clark, 2000; Hawley and Williams, 2000; Monks, 2001; Kim et al, 2009). Even though institutional investors claim that company engagement on ESG issues may bring added financial value over the long-term, the literature also report risk management as a potential driver for engagement (Gifford, 2009b; Clark and Hebb, 2004). While pension funds try to increase control of social and environmental standards among portfolio firms they are not only responding to societal demands but rather attempting to mitigate reputational risk of owning ESG underperforming portfolio firms (Clark and Hebb, 2004; Clark and Hebb, 2005). Attacks on brand images and corporate reputations combined with name and shame campaigns are common ways used by non-government organisations or other special interest groups to bring attention to corporate ESG violations (Rayner, 2003; Waygood, 2006). However, as the reputation of the portfolio firm is damaged, the reputation of the shareholder is also negatively affected. Here lies a strong incentive for owners like pension funds to improve environmental and social standards on a portfolio firm level to reduce risk of having their own reputations damaged.

Overall then, the choice of engagement strategy needs to be considered against reputation and financial risk associated with the chosen strategy. The pension fund may therefore chose to apply a combination of different influence strategies to mitigate risk. In the area of such influence strategies, Gifford (2009a) provides institutional investors with practical tools on how to deliver effective shareholder engagement strategy, seeking to determine factors that contribute to shareholder

salience. Little research has however focused on how such shareholder influence strategies, or engagement, are developed and why (Gifford, 2009b; Sjöström, 2010), as the field mainly is practitioner led (Gifford, 2009b). For instance, there is limited knowledge about how investors choose between shareholder engagement, divestment, or other forms of influencing strategies used by institutional investors relative their portfolio firms, or on what influence strategies shareholders need to consider when engaging with portfolio firms to ensure that portfolio reputation risk is minimized. In this paper, we turn to influencing strategies within stakeholder theory (Frooman, 1999; Frooman & Murrell, 2005; Mattingly and Greening 2002) to develop a framework for describing and analyzing the approach taken by pension funds to influence their portfolio firms. Specifically, the purpose of this paper is to describe how and why different influence strategies are used by pension funds in their interaction with portfolio firms. This study will explore underlying factors for the choice of influencing strategies stemming from reputation risk management and target audience analysis.

In our quest to develop a model of shareholders' influencing strategies, this paper reports on case studies of five Swedish national pension funds' (AP funds) use of shareholder engagement to integrate ESG standards of the firms in which they invest. Unlike many countries, the AP funds have since 2001 been governed by a government directive to apply ethical and environmental considerations in the investment process. Following the implementation of this directive, two different paths for how to influence portfolio firms emerged (Hamilton, 2009). While one pension fund adopted an exclusion strategy, other pension funds advocated an engagement strategy. In analyzing the influence strategies used by the pension funds, we are able to extend the research on influencing strategies by applying it to pension funds and identifying a set of influencing strategies which are closely entwined with the funds' risk reputation management.

The paper proceeds in the following manner. In the next section, we describe our theoretical frame of reference using stakeholder theory. In section 3 research methodology is discussed followed our research context and findings (section 4&5). Thereafter, in section 6, we interpret our findings by constructing a conceptual theoretical model. In conclusion (section 7) we draw implications from our framework for understanding shareholder influence strategies' outcomes and what motivates them.

2. Theory

The government ESG directive guiding the AP funds can be seen as a timely response to societal expectations of the responsibility to be taken by national pension funds (Hamilton, 2009). Such developments in relation to corporate social responsibility, corporate governance, environmental and social stewardship and sustainability can be readily explained by stakeholder theory (Zambon and Del Bello, 2005; Carroll, 1979). Stakeholder theory argues that managers of firms have obligations not only to shareholders but towards a broader group of stakeholders. In his landmark work Freeman (1984) focused on enabling managers to understand who their most important stakeholders are and set strategies on how to manage them.

Although much scholarly attention has been devoted to stakeholder analysis and the construction of a universally accepted definition of the term "stake", most researchers have utilised a variation of Freeman's definition (Andriof and Waddock, 2002). Regardless of the definition used, research using stakeholder theory assume that organisations or firms are required to address a set of stakeholder expectations and as part of the process of meeting these expectations they may find themselves

engaging with stakeholder groups. Consequently, stakeholder research has focused on who a firm's stakeholders are and what type of influence these stakeholders exert (McGee, 1998). Stakeholder management requires firms to understand the stakeholder influences and learn how to respond to those influences. However, even though stakeholder theory declares that firms must pay attention to all constituents that can affect the value of the firm, there exists a value maximisation challenge since there is a trade-off between stakeholder demands to be managed (Jensen, 2002).

A basis for understanding the importance of a stakeholder influence can be found in the well-known model by Mitchell, Agle, and Wood (1997), which focuses on stakeholder identification and why managers should pay attention to and prioritise certain stakeholders. They suggest that stakeholders become salient to managers as they are perceived by three attributes, *power* to influence firms, *legitimacy* of the stakeholder's relationship with the firm, and *urgency* of the stakeholder's claim of the firm. Our paper is concerned with how influencing strategies are used by pension funds. The literature on stakeholder influencing strategies largely builds on Frooman's (1999) model of different stakeholder influence strategies which constitutes "*a significant contribution to stakeholder theory by modelling stakeholder influencing strategies to help management understand and manage stakeholder relation*" (Friedman and Miles, 2006; p. 110). Frooman (1999) assumes the perspective of the stakeholder instead of the more common management perspective of the firm (Hendry, 2005) and introduces the idea that stakeholders can influence firms indirectly through the use of prevailing intermediaries. Frooman believes that Mitchell et al. (1997) fail to show the relative strengths of their three attributes (power, legitimacy and urgency) in their stakeholder salience model, and holds that power is the dominant attribute in determining the stakeholder-organisation outcome (Freidman and Miles, 2006). Frooman (1999) combines resource dependency theory and stakeholder theory to explain determinants of how stakeholder influence strategies are used. He argues that a resource relationship exists between a firm and its stakeholders, and focuses on who is dependent on whom for resources (Pfeffer and Salancik, 1978). In essence, "*the stakeholder can either be dependent on or not dependent on a firm, and a firm, in turn, can either be dependent or not dependent on the stakeholder*" (Frooman and Murell, 2003 p.1). Four propositions were suggested in deciding type of stakeholder influence strategy:

- "When the stakeholder is dependent on the firm, the stakeholder will choose a cooperative strategy to influence the firm.
- When the stakeholder is not dependent on the firm, the stakeholder will choose a coercive strategy to influence the firm.
- When the firm is dependent on the stakeholder, the stakeholder will choose a direct strategy to influence the firm
- When the firm is not dependent on the stakeholder, the stakeholder will choose an indirect strategy to influence the firm." (Frooman and Murell, 2003)

A key contribution of focusing on influencing strategies is that it adds a structural component which opens up for new understandings of power in stakeholder relations. The research on influencing strategies is however only emerging, and Frooman's early work has been expanded upon (e.g. Hendry, 2005; Gifford, 2009; Mattingly and Greening, 2002). Such research has confirmed the merits of the Frooman model, but has also found it to be too simplistic to explain the variety of stakeholder-firm relationships encountered. Hendry (2005) departs from Frooman (1999) but arrives at an alternative model, adding factors beyond power dependencies in influencing strategy selection.

Hendry's factors are: a) experience and expertise in using a particular strategy (see also Frooman and Murell, 2003), b) the actual opportunity to use a particular strategy c) the effectiveness (maximum result for minimum input) of a particular strategy, and, d) the existence potential alliances in support of a particular strategy. Further, Hendry suggests that the choice of alliance partners is more complex than suggested by Frooman (1999). In addition to the power, number and type of these other stakeholders, the communicative ability and the potential to actually form an alliance is important to consider.

In an application of stakeholder theory and influencing strategies to shareholder engagement, Gifford (2009a) offers a range of shareholder influence factors in improving the environment, social and governance (ESG) performance of investee companies. Gifford also identifies moderating factors such as coalition-building, size, manager values, in addition to the legitimacy, power and urgency of stakeholders (drawing upon Mitchell et al, 1997). Mattingly and Greening (2002) base their model of stakeholder action on Frooman's ideas and use Mitchell et al. (1997) three attributes to determine a salient stakeholder. To add explanatory power to the model Mattingly and Greening introduces a number of conditions that help explain stakeholder action between firms and public interest groups: a) stakeholder culture, b) firm response, c) relationship with firm, d) third-party relations. It appears Frooman's typology of stakeholder influence strategies is a useful starting point but depending on whether the research context is non government organisations (NGOs), shareholders or some other stakeholder we need to introduce underlying factors to fully be able to explain influence strategies between stakeholder-firm relationships.

Both Hendry (2005) and Mattingly and Greening (2002) have extended the work of Frooman in the study of interaction between firms and public interest group stakeholders. Based on the above studies, influencing strategy offers a promising framework to understand the interlinkage between an investor's choice between engagement and exclusion relative the portfolio firm. In section five, analysis, we will develop a model on stakeholder action and determining factors explaining influence strategies used by pension funds to try and change firm behaviour.

3. Research methods

This paper is based on a qualitative case study approach. The case study method was selected as it lends itself to study real-life contemporary phenomenon and brings understanding to complex issues while the number of respondents adds incremental understanding (Yin, 2003, Eisenhardt, 1989). Case studies offer a systematic descriptive way of documenting large number of events and to analyse actions taken by individuals or organisations and the possibility to observe responses and effects on other participants which contribute towards drawing an analytical conclusion (Hancock & Algozzine, 2006; Merriam, 1988). Such a contextualised and open approach was deemed necessary to explore and analyze the influencing strategies used in these particular cases and to arrive at an understanding of why they were used. We used a combination of interviews and secondary data in the case studies. A first interview round was conducted with five AP fund organizations (AP1-4 & AP7) between February 2007 and November 2007. The aim of this round was to study how AP funds interpreted the government directive and what type of influence strategies were used and why when the directive had been implemented. Twenty-three (23) Interviews were conducted with individuals at different levels within the organizations and their boards: (1) Chairman of the board, (2) Chief

Executive Officer, (3) Corporate Governance Officer, and (4) Investment Manager or Chief Analyst. Each AP fund was approached via the Corporate Governance function acting as liaison between the researcher and the respondents. Respondents holding these work responsibilities were selected as they are the responsible personnel actively involved in interpreting and implementing the ESG directive. The representatives from category 4 (Investment Manager or Chief Analyst) were decided by the AP funds themselves but all other respondents were requested by the first author. All interviews were semi-structured, conducted face-to-face, recorded and lasted approximately one hour each. Findings that could be traced to an individual respondent are only disclosed if the information is already publically available as anonymity was granted all respondents.

The second round of interviews with seventeen (17) respondents was conducted between January 2008 and April 2008. The decision to extend the interview material to also include key individuals representing external AP fund stakeholders was based on the opportunity to increase understanding while being able to crosscheck and verify underlying influence strategies used by AP funds. These AP fund stakeholders represent engagement consultants, screening companies, institutional investors, portfolio firms, government and academia. These respondents typically had a good working knowledge into different aspects of the AP funds' operations. Further, engagement consultants and screening companies play an important role in the Funds' engagement or divestment decisions as they supply the AP funds with portfolio firm ESG research data. In Table 1, the total number of 40 respondents from the two interview rounds are listed based on their type of work responsibility.

Table 1: List of respondents

Type of work responsibility	Type of organization(s)	No of respondents
Chairman of Board of Directors	AP 1,2,4 & 7	4
Chief Executive Officer	AP 1,2,3,4 & 7	5
Corporate Governance Officer	AP 1[two],2,3, & 4[two]	6
Investment management	AP 1,2,3,4 & 7	5
Fund administration	AP 3 [two] & 7	3
SRI consultant	SRI consulting firm	5
SRI analyst	Screening company / Bank	5
Corporate Environmental (CSR) Manager	Portfolio firm	2
Owner representative	Government	2
Financial Manager	Institutional investor	1
Investment Manager	Fund company	1
Researcher	Academic	1

In addition, secondary data sources evidencing how the AP Funds engaged with their investees and interacted with other stakeholders were collected from academic literature searches, news archives, AP fund annual reports and AP fund web sites. In particular concerning AP 7, which employed media as part of their overall influencing strategies, the information was plentiful. However, due to the public nature of the AP funds, there is in general quite substantial media coverage and scrutiny concerning their activities, which facilitated the collection of relevant data from different points in time.

The primary data analysis was performed in six steps as described by Creswell (2009). First, all interviews were transcribed. Second, all data was carefully read while thematic labels were written in the margin and indicating passage length. In order to establish a more detailed analysis a coding process was undertaken in the third step. The purpose of coding is to organize data into segments and similar topics were clustered together. Topics identified by a short description were entered into an Ms Excel sheet marked by pension fund and assigned by the exact quote. In step four, the Excel sort function proved useful as themes were analysed for each individual case and between different cases in search for both commonality and differences. Through several iterative steps, we refined the themes by comparing them with each other, by searching for patterns between the themes and by comparing with existing literature. In the fifth step conceptual models were developed and drawn to depict a process for increased understanding (see figures in section five analysis). The sixth and final step involved making sense of data. Frooman's model and the theory extensions of his model discussed earlier provided a useful framework and offered meaning to the data.

Another reason for engaging in the second round of interviews was to be able to validate the answers received from AP fund respondents. This option appeared useful as research data grew and consisted of more sources of information it became more reliable. Further, data validity was ensured during a workshop targeting AP fund respondents and presenting research findings. The purpose of this activity was to validate research findings as well as introduce conceptual models to a practical audience. There are drawbacks using the case study method. It is time consuming and the research approach attracts large amounts of both primary and secondary data which may be difficult to handle (Yin, 2003). Another weakness of the research approach is that the researcher brings subjectivity into the study as interpretation of findings may be reflected by researcher background (Creswell, 2009). In our case a strong reliance on maintaining orderly documentation, procedures and a case study protocol (Yin, 2009) is a good safeguard against some drawbacks of the case study method.

4. Research context – the 2001 Swedish pension scheme

In 2001, the Swedish pension system was reformed to be self-financing and completely independent from the national budget. It is described as a three-tier pyramid. The bottom layer is the national pension, which is divided into income pension and premium pension. The middle section consists of occupational pension and the top section private pension savings. The AP funds are active in the bottom section. Sweden's employers each month set aside 18.5% of their employees' pensionable income to the national pension system. This income pension system is referred to as a 'pay-as-you-go' system, which means that pension contributions paid every month are disbursed to cover current income pension benefits of those who have retired (SOU, 2008). The contributions and disbursements in the pension system change over time mainly due to demographic changes and salary growth (Ministry of health and social affairs, 2000).

The role of First, Second, Third and Fourth National Pension Funds¹ (AP1, AP2, AP3 and AP4), referred to as "buffer funds", in the income pension system is to cushion temporary fluctuations in contributions and disbursements. The mission of these four AP funds is to maximize long-term return given a low risk level to benefit Sweden's pensioners (First National Pension Fund, 2008). The Seventh National Pension Fund (AP7) is responsible for the premium pension system within the national pension. In this system each individual is free to manage his or her future premium pension and can choose between in a large variety of mutual funds according to personal risk appetite. The mandate and investment guidelines of AP7 therefore differ from the buffer funds. The same investment rules apply to AP7 as to private actors competing in the management of pension premiums and their investments are completely dominated by shares.

The Swedish government requires its national pension funds to consider ethics and the environment in the investment decision making. The Swedish guidelines, similar to those of the United Kingdom, emphasize disclosure on how responsible investment considerations actually are integrated into asset management practice. In the preparatory work (Government Bill, 2000, p.2), one sentence summarizes the responsible investment requirement directing the five AP funds, "*Considerations shall be given to ethics and the environment without compromising the overall goal of attaining a high return*". The provision regarding ESG considerations has not been included into the relevant law, i.e. Public Pension Funds Act (2000:192). There is nothing in the text that offers additional explanatory guidelines as to what considering ethics and environment actually means. As such, the interpretation of this phrase has been very much up to the AP funds themselves.

AP7 shares the same government undertakings regarding ethics and environment as the other four AP funds except that AP7 is prohibited from exercising its voting rights in respect of its Swedish shares. It is likely this mechanism was originally created to limit state influence on company ownership. But in reality this constraint has little practical use as the buffer funds without any voting constraints manage about ten times as much capital as the Seventh AP fund (SOU, 2008). For more AP fund financial overview and investment rules please refer to Appendix 1 and 2.

¹ The smaller sixth AP fund, which invests in small and medium sized unlisted companies, is also part of the buffer fund system. There used to be a fifth AP fund but it has ceased to exist.

5. Research findings

In this section we will describe the AP funds' two main strategic approaches² to influencing strategies as part of shareholder engagement. On one hand we have AP7 and the use of exclusion as the main strategy to responsible investment and influence towards more sustainable company behavior. On the other hand AP1, AP2, AP3, and AP4 have adopted an engagement strategy where engagement is focused on influencing companies to improve their environment, social and governance standards mainly via dialogue and interaction. This section is organized so that we examine influence strategy AP fund 7 - Exclusion and then we will study influence strategy AP fund 1-4 - Engagement which was propagated by the four buffer funds. Each strategy is described and organized under four headings: a) management background and attitude towards ESG, b) policy formulation, c) the influence strategy applied and d) ESG positioning. This section ends with a table summarizing some main differences in deciding factors leading to the two different choices in influence strategy. Findings are supported with citations from respondents working in the AP fund organizations and in some case from respondents working as trustees and advisors.

AP Fund 7 - Exclusion

Management background and attitude towards ESG

The seventh national pension fund started to operate on 1 January, 2001 and it did not build on any preexisting organization. The CEO was recruited nine months prior to the start. The recruited CEO had experience from holding both government and private office, and was also familiar with ESG issues being former CEO from a smaller financial services company specializing in retail ethical mutual funds. Unlike other CEOs in the AP fund system, the CEO of AP7 handles the operational responsibility of the fund's ESG policy and implementation (AP fund Chairman). Findings show that the CEO, the Chairman and the Vice Chairman all shared personal interest in prioritizing and addressing ESG issues in parallel with developing an asset management organization in a short time. Prior to the AP7 launch the CEO recruited a consultant with experience in politics and social issues to undertake a benchmarking study on how consideration to ethics and environment (AP Fund CEO). A working committee consisting of CEO, Chairman, Vice Chairman and the consultant jointly interpreted the government directive and processed ideas into a workable ESG platform which involved and was presented to the rest of the Board in steps. As expressed by the ESG consultant:

"[The CEO] took the [ESG] directive seriously. This surprised everyone. AP7 asked me to do a benchmarking study on what was done by others. [The CEO] was very active in this work [ESG policy] but also some members of the board had prior experience from this area".

(ESG Consultant)

In an early ESG policy draft the idea was not to exclude entire controversial business sectors such as alcohol, gambling, weapon and tobacco which otherwise is common practice in so called negative screening of investment portfolios. The external consultant recommended a more stable platform to base policy decision on. The foundation for the policy was to be found in international conventions and UN principles that the Swedish government had signed (AP fund Chairman). There was also a

² These findings are based on interviews conducted during 2007. Much work involving AP funds and shareholder engagement has developed since. This case study does not attempt to describe AP funds approach to shareholder engagement beyond this time.

problem to exclude entire “unethical businesses” sectors since Sweden traditionally was a significant owner of companies producing or selling alcohol, gambling and tobacco products (AP fund CEO). The board decided to agree with these suggestions (AP fund Chairman).

The AP7 manages two funds in the premium pension system in competition with almost 800 hundreds private mutual funds. It may explain why the savings customer perspective is continuously reoccurring in interviews with the AP7 organization. The following are examples of how the customer perspective is present in interviews and the need to balance costs, profitability and transparency:

“If we do not show profitability our savings customers will leave us”.
(AP fund CEO)

“The average saving customer in the PPM system [Premium pension] saves for 33 years and therefore the cost must be very low”.
(AP-fund Chairman)

“You need to be able to communicate [your ESG policy], you must explain your actions. Almost always when you start to work with ethical issues there is a problem because it becomes difficult to explain”.
(ESG Consultant)

To develop an ESG policy that was easy to understand and possible to explain to customers appears crucial for the working committee and the board of directors. It is likely that this process was influenced by the prior experience the consultant had with supporting leading politicians in handling ethical misconducts which at times ended up in the press. His experience with reputational risk could prove useful as portfolio companies may end up in ethical dilemmas. Finally, respondents within AP7 emphasize its small size and their philosophy to outsource most of its investment management needs and negotiate external fees and costs to the limit (AP fund CEO, AP-fund Chairman). The idea of staffing AP7 with additional internal ESG competence appears not to be economically justifiable given their small size and reliability of external resources.

Policy formulation

The Seventh National Pension Fund was the only AP fund meeting the government deadline of having a public policy online addressing the ESG directive on 1 January 2001 (AP fund CEO). In the AP fund system the board of directors is responsible for the fund ESG policy. The board decided that the fund only shall invest in companies that comply in an acceptable way with the demands made by international conventions that Sweden has signed. In application of the policy AP7 “only uses the exit method” (Seventh Nation Pension Fund, 2010a). A norm based screening method is applied to monitor corporate activity that violates or threatens to violate global standards on environmental protection, human rights, labor standards, and anti-corruption as stated in a large number of international initiatives and guidelines (Ethix SRI Advisors, 2010). To assist AP7 in determining whether company violation to international convention has taken place, services that screen portfolio holdings are purchased from two separate screening and rating agencies. Unlike the buffer funds AP7 purchases this service from two separate suppliers to ensure that high quality is maintained. At one point in time only one service was left on the Swedish market. AP7 reacted against a monopolistic market situation and bought a 5% ownership stake in the other Swedish screening company in order for a competitive market alternative to exist (AP fund CEO). AP7, like many other fund managers, decided to outsource portfolio screening and its can be noted that they wanted to feel absolutely reassured about data reliability that they would actually become owner in such a company. As we can see not an uncontroversial issue for an AP-fund:

“[The CEO] wanted to create competition among screening companies. He feels GES [screening company] has improved because Ethix [screening company] is on the market. This caused a big discussion on the board whether it is the role of an AP fund to own screening company”.
(AP fund Chairman)

Despite the notion of modern portfolio theory that restrictions reducing investment universe will increase portfolio risk, AP7 believed they could compensate for exclusions without compromising the overarching government objective of attaining a high return. As long as the AP7 “black list” consists of no more than 30 companies the board believe that this may not challenge the superior objective (AP fund CEO). They were trying to create a “black and white” system:

“I believe our model [exclusion] is easier to implement because there are very few cases that fall into a grey zone”.
(AP fund Chairman)

A company that has violated any global standard signed by the Swedish Government and is convicted will eventually be sold according to the policy of AP7. The company will be suspended for five years, but sanctions can be lifted if company improvement is documented and backed by a trustworthy source. Once sanctions are lifted, it is possible for AP7 to reinvest in the company. The important distinction compared to other AP funds is that no engagement efforts are made prior to divestment. Many respondents outside AP7 believe that the rule forbidding AP7 to vote in Swedish companies was a contributing factor for not using engagement as strategy. If the law forbids you to use your ownership rights to vote you are automatically locked out from using engagement as a model of influence. However, this restriction does not apply for ownership in foreign companies. However, AP7 motivates its decision to use exclusion combined with negative publicity as preferred way to influence companies to more sustainable practices. According to the CEO of AP7, engagement as an influence strategy does not provide a good enough model and is therefore not viewed as an alternative for AP7. The AP7 CEO however denies that this legal restriction has influenced their choice of method in applying the ESG directive:

“Our exit strategy has nothing to do with the fact that we are not allowed to vote in Swedish companies”.
(AP fund CEO)

The influence strategy applied

In spring 2001 the first screening report was delivered. Esselte, a Swedish company in office supplies, are trapped in the screening. Apparently one of their subsidiaries in Mexico was forcing their female employees to take pregnancy tests each month. Those who were caught pregnant would be fired. This appeared to be a clear human rights violation. As a consequence AP7 sold Esselte’s shares and the company was placed on the “black list”. Media got hold of the story and the Esselte management, after checking the story, admitted it was true and that they would immediately set a stop to this type of discrimination (AP fund CEO). This is the normal exclusion procedure for how both Swedish and foreign shares are processed. Besides this case very few exclusions have involved Swedish companies. The CEO is satisfied with the procedures and in particular with the profile it has given AP7:

“It [exclusion strategy] has served us well. We have been recognized for a fairly aggressive ethical policy that the public understands. We have set a standard”.
(AP fund CEO)

More specifically, screening reports are received twice a year from both suppliers. The screening and rating agency handles the communication with the company and the critical verification of the supposed violation. AP7 annually issues a list of excluded companies which over time has contained between 25-55 companies.

As described the principal objective in the ESG directive is to secure a high return to a low risk to the pension savers in the premium pension system. But how does AP7 control for this? For example by avoiding excluding entire industry sectors diversification can be maintained. In 2005, AP7 checked in retrospect what would have been the result on performance if no exclusions were made at all. The

performance between the screened and the unscreened portfolio were the same, with a slightly higher risk in the screened portfolio (SOU, 2008).

ESG positioning

In our case material we can observe that the exclusion strategy is also supported with a strong ESG profile surrounding the fund. This type of marketing strategy creates synergies with the media and publicity intensive exclusion strategy. With leadership experience from an investment firm specializing in ethical funds it appears the AP7 CEO wanted to profile the fund as a responsible investor. This first mover advantage to fill an ethical leadership position among AP funds appears quite thought-out and adds value as it is imbedded in annual reports and other important stakeholder communication vehicles:

“We wanted to be seen as a private fund company competing with 700 competitors. We do not want too much to be associated with the buffer funds”.
(AP fund CEO)

We can assume that an ESG position on the premium pension market was seen a positive motivator for attracting and maintaining savings customers. Thus AP7 has chosen and maintained a strong ESG profile and are generally satisfied with the strategy;

“We have on the board said many times that it is very good that we have created this profile and we will continue doing so”.
(AP fund Chairman)

Much ESG publicity has been received by AP7 as the ESG operational responsibility lies with the CEO and because an AP fund CEO is considered a credible spokesperson in financial issues. There are examples of how AP7 strategically tries to maintain a strong ESG image. United States former vice president Al Gore’s dedication to sustainable development is well known and his association with AP7 is seen as positive for the fund (Seventh National Pension Fund, 2005). Each year AP7 hands out a journalism price “with the aim to enhance public knowledge about long-term saving and understanding of economic concepts...” (Seventh National Pension Fund, 2010b). This award targets the general public which also coincides with the target market for AP7’s funds. These few examples show how AP7 quite strategically uses media to portray its ESG position. Not surprisingly and in contrast to the buffer funds, AP7 uses traditional consumer marketing tactics like any other ethical mutual fund on the premium pension market.

AP Fund 1-4: Engagement

Management background and attitude towards ESG

Unlike AP7, three out of four buffer funds had existing organizations from the old pension system to rely on. One fund had experience of managing both Swedish and foreign equity (AP4), one fund had limited Swedish equity experience (AP3), one fund had only managed fixed income (AP1) and one fund organization, like AP7, was newly established (AP2). Thus, the background and asset management experience among the buffer funds differed. As of 1 January, 2001 they all shared identical investment guidelines and a capital base of \$19 billion. These organizations were all larger than AP7 with more internal fund management capacity. During the start up phase respondents representing the buffer funds recall that addressing the ESG directive was not among the most critical issues as there were several other pressing matters to address. Most notably, the need to establish an investment organization took priority (AP fund Corporate Governance).

Since AP7 was the first among AP funds to publically disclose their ESG policy, most respondents from AP1-4 refer to the AP 7 work. Some buffer funds also contacted AP7 for individual discussions and experience exchange:

“We looked at AP7. They were faster than us in formulating so that we should follow international conventions and during our discussions it became clear that this is how it should be handled”.

(AP fund CEO)

Some buffer funds also used consultants to help them interpret the directive. AP2 studied British asset manager Hermes approach to manage corporate governance issues (AP fund Corporate Governance). The purpose of having four buffer funds instead of one was to create competition between funds which then would hopefully lead to better performance. Initially, this triggered buffer funds to try and come up with their own ESG model, several respondents declare.

Like AP7, all buffer funds adopted the norm based screening method that rested on international conventions that the Swedish government had signed. But the AP7 exclusion strategy was not adopted. Our findings suggest a couple of reasons why this method was not considered an attractive alternative for the buffer funds. The initial attitude towards the ESG directive among AP fund 1-4 investment managers appeared somewhat skeptical. The ESG directive was initially perceived as a restriction to AP fund investment managers (AP fund Corporate Governance [4 respondents]). The AP7 exclusion method would have imposed and reduced the investment universe:

“Some investment managers were very reserved about the ESG directive. They felt it as a political mandate. All restrictions are negative and during this time we had an aggressive compensation structure based on performance”.

(AP fund Corporate Governance)

“When we decided to screen our portfolio we were not convinced [about engagement], but when we received the first report [screening] 10 percent [or 45 companies] of portfolio value would disappear if we excluded”.

(AP fund Corporate Governance)

In the study the choice of influence strategy in buffer funds rest on two assumptions. First, exclusion would reduce investment universe and potentially harm the principal objective to attain a high return, as described above. Secondly, from an influence point of view engagement was believed to be the best method in achieving a real influence on corporate behavior:

“Many in the organization were involved in looking at how this would affect performance and risk if we were to exclude. We thought that engagement [as an alternative to exclusion] would not affect performance negatively”.

(AP fund Corporate Governance)

Thus, all buffer funds ended up using engagement as a primary method to influence portfolio companies to avoid unsustainable corporate behavior, even though ambition and time devoted to these issues varied between buffer funds. For instance, AP1 took a lead in engagement practice towards foreign company holdings (AP fund Corporate Governance). Initially, and prior to the formation of the Ethical Council, little was communicated between the four buffer funds or externally regarding engagement method or results. Indeed, engagement is viewed as a practice performed in confidence with the portfolio firm and not to be disclosed to anyone outside this process and especially not the media (AP fund Corporate Governance [2]).

As with implementing the ESG directive, buffer funds learn that it is very difficult to apply the directive without involving and having investment managers supporting the idea (AP fund CEO). Within buffer funds the ESG responsibility is executed by the corporate governance function. This individual also handles corporate communication responsibilities in all four respective funds. All buffer fund CEOs appear serious regarding the importance of the directive and in all cases clearly express their full support to the corporate governance member in charge of implementing the directive.

Policy formulation

The completion of an owner policy, addressing ESG consideration and formulating engagement strategy, was activities that varied between buffer funds. Some funds worked more closely with a screening and rating agency and this appears to have generated more momentum and resources towards completing an internal ESG process. An outside screening provider would deliver a report twice a year filtering the complete portfolio, typically 3000-3500 companies for ESG violations. Approximately 100 companies are typically singled out based on media-, NGO- and UN-reports. A final list of 10-25 potential companies with well documented violations is then provided. Determining the final selection of engagement candidates is what industry the targeted company is operating in, from where the company originates, and what international convention or policy the accused company is violating (AP fund Corporate Governance [2]). It appears AP1 together with GES Investment Services developed the engagement model that later became the standard for all buffer funds to use (AP fund Corporate Governance):

“AP1 put down most time on ESG. They took the lead and it was AP1 engagement work that created a model for Ethical Council”.
(AP fund Corporate Governance)

As reported in 2007 the decision was taken in all buffer funds to collaborate on all foreign engagements and form the Ethical Council. Cost was an important driver for this decision but the combined size and added power was an important contribution factor as well (AP fund Corporate Governance). It appeared a logical decision that all respondents favored.

On the other hand, most buffer funds feel that engaging with Swedish companies is less demanding because an AP fund is usually a prioritized shareholder and access to company management is fairly easy (AP fund Corporate Governance [2], AP fund CEO). Reputation risk is also lower among Swedish companies (AP fund CEO). But in engagement with foreign companies AP funds are normally small owners and they are usually not known to the companies they approach (AP-fund Corporate Governance). Compared to exclusion engagement is more costly and time demanding. No buffer fund is able to specify how much resources that ought to be spent on engagement. It appears more based on gut feeling and what is accomplished today given the existing personnel resources:

“It is a balance. It is difficult to decide how much resources to dedicate. One has to balance high performance and low risk with the cost for ESG given the capital you have and how strong owner you are”.
(AP fund CEO)

Further, following the creation of the Ethical Council, more responsibility and resources was purchased from service provider GES investment Services. Board involvement for ESG issues is strong and committing, most buffer fund respondents declare. However, it is unclear whether buffer funds' trustees were as operational during the actual interpretation and policy development phase as in the case of AP7. The board is said to be concerned about and interested in how the ESG work is progressing (AP fund Corporate Governance [2]). Eventually, the board is responsible for the policy that governs the fund but like managing funds they shall not be involved in operational aspects (AP fund CEO).

“We have ESG as a separate issue during board meeting. We always have a briefing note but it might not have been sent out prior to the meeting”.
(AP fund Chairman)

The influence strategy applied

In 2002, a man is convicted in Costa Rica for pimping of minors at one of the hotel chain Marriott's hotels. The hotel staff failed to report this. In 2003, AP1 became aware of the incident through screening by GES Investment Services. Between 2003 and 2005 a number of letters are sent to

Marriot with the objective to hear the company's account of the event and to start a dialogue. No or very little response is received. In October 2005, a resolution is filed with the help of ICCR (Interfaith Center of Corporate Responsibility). Marriot reacts in late 2006 and the hotel chain adopts a new human rights policy that explicit addresses child sex tourism. The investor coalition withdraws the resolution once Marriott promise to address the problem and agrees to engage (First National Pension Fund, 2007). This example shows that the engagement takes time and that external coalitions can be a useful solution to ending the process:

"It [the engagement] involved a lot of work and follow up over years especially for an unknown Swedish Pension Fund. We also owned very little. In the beginning there was only us. Then we allied with ICCR to form a coalition".
(AP fund Corporate Governance)

There are engagement cases where portfolio firms never respond. If there is still no response from the portfolio firm in spite several attempts to engage with the company the final option is to exclude the firm. Compared to AP7 the list of exclusion made by buffer funds was the first couple of year quite limited. However, of the number of exclusions has increased with the establishment of Ethical Council. The shared attitude among all buffer funds is that engagement is a superior way to influence companies over time and in close cooperation with the company:

"I do not see the effectiveness in the dialogue if you [the investor] start to threaten to sell. Better instead to push the company for a reaction. 'We believe you [the company] should look this over. You will be questioned by others'".
(AP fund Corporate Governance)

The advantages of this influence strategy are that the AP fund system has a large capital base and that it is credible as a national pension fund (AP fund Corporate Governance). Further, the buffer fund engagement strategy is funded in the notion that dialogues should not be conducted through media. Buffer funds believe confidentiality brings value in the long term process, and cooperation is better than discrediting in the press (AP fund Corporate Governance). Another way to influence as an owner is through resolutions at companies annual general meeting, AP3 has been an active co-filer in 300 companies in foreign equity portfolio for 2009. Most of these portfolios are managed by external fund managers, to whom voting rights or so called proxy votes are delegated (Third National Pension Fund, 2009).

ESG positioning

In comparison with AP7's ESG profile, the buffer funds' relationship with media has been more complicated. The study shows that buffer funds feel that reporting on engagement should not be communicated, especially not during its active phase. Respondents state that portfolio firms are reluctant to discuss ESG performance because they fear media and the risk of negative publicity. To some extent this notion might also appear true for the buffer funds themselves and their relation with media. In the time period following the ESG directive launch they did not have very much to report as ESG activity were developing. However, our findings suggest a change in attitude might be taking place as they appear more confident as they joined collective forces in the Ethical Council:

"Companies are terrified to talk about ESG performance since they are afraid media will pick up the story. I mean, just look at us. This is the first year [2007] we write about it [ESG]. Now we are capable; we have the experience and confidence. We have the platform to stand on".
(AP fund Corporate Governance)

All buffer fund respondents are skeptical towards media. The opinion appears to be that the media is unreliable and they will probably create an unfavorable angle on the story which will most likely

cause negative publicity to the fund (AP fund CEO [3], AP fund Corporate Governance [3], AP fund Chairman). A key issue for the buffer funds is that they do not discuss the engagement activities and they rarely exclude companies. In combination, it becomes very difficult for the buffer funds to communicate their activities to the media in a simple and credible way and at the same time provide media with a good story:

“Swedish media has locked itself very much on the fact that you exclude companies. It becomes an interesting news story and it is turned into black and white. We have experienced that it is very difficult to communicate the other way of working [engagement] as there is little interest and attention from media”... “AP7 has formulated a strategy and they receive attention for it”. (AP fund CEO)

Some buffer fund respondents feel that there is a risk attached to maintaining a high ESG position as you are measured according to different standards (AP CEO, AP fund Corporate Governance) Partly, this was the reason why the buffer funds sought a less outspoken ESG profile.

“[We felt the AP7 CEO] is not in the business of creating value, rather in the business to determine what is right and what is wrong and making himself a judge of what is black and white. To say that you are more ethical than others is absolutely the most dangerous thing to do. Because there are many that would like to see you fall”. (AP fund Corporate Governance)

Unlike AP7, the customer perspective is totally different for the buffer funds. Their savings customers or beneficiaries are captive in the sense that they are prohibited to withdraw or move their money out of the pension system. For this reason beneficiaries become an audience less interesting to try to interact with as compared with the type of savings customer AP7 has.

The fact that the buffer funds are confidential and less outspoken helps them build relationship with portfolio firms (AP fund Corporate Governance). Companies appear to have complained to some buffer funds that private investment managers of smaller firms or ethical fund providers are more prone to discuss company concerns with media. An explanation that was mentioned is that financial services companies have a brand name to market and new customers to attract (AP fund Corporate Governance [3], AP fund CEO). The buffer funds, on the other hand, are not on the market selling funds (AP fund Corporate Governance):

“I am a little skeptical about those who profile their work in this area. I can see the business logic behind for some companies and for certain industries especially. But I am somewhat more critical towards those for example in asset management where it is tricky to have a high profile on ethical issues. It is not absolutely sure that they have been successful because the link between investment and result cannot always be claimed”. (AP fund CEO)

Even though, it has been stated that buffer funds are collectively maintaining a low ESG profile AP2 is the exception and they have made efforts to communicate their ESG view and activity level (Second National Pension Fund, 2007).³

A summary of factors behind the choice of influence strategy

In Table 2 below, we summarize the main differences between the influence strategies applied by AP 7 and AP1-4. The left column depicts the key factors behind the choice of influence strategy. A first factor is the *Management ESG experience and attitude*. Another is the *Directive interpretation*, as depending on how the superior objective of attaining high return is understood either exclusion or engagement may be preferred. Another important factor is the existence of *Dependencies*; either in terms of power or legitimacy. *Power dependencies* arise from the strength of connection between the fund and the portfolio firm and focus on the direct influence on behaviour in the relationship

³ AP2 not only addresses the risk aspect of ESG considerations they also focus on ESG as a value added investment opportunity. This notion is important but will not be further addressed in this paper.

between these two actors; an AP fund known by the portfolio firm, with a long-term investment horizon, and large size ownership can more effectively apply influence power firms and influence ESG behaviour. *Legitimacy dependencies* instead concerns influence deriving from the status of the fund; A national pension fund as a long-term investor, with large capital assets, and with good market reputation is highly influential in terms of financial commentaries made and investment activities performed. Legitimate claims made by AP funds may influence or guide portfolio firms ESG behaviour.

Further, *Reputation Risk* is an important factor, depicting the risk for the fund by choosing a certain strategy. For example, a portfolio firm with underperforming ESG standards or even worse sentenced for breaching international ESG principles may damage its reputation and brand name. Indirect this risk can also affect its shareholders and more so if the investors are known and legitimate.) Therefore it becomes an important factor for AP-funds to become transparent and show media, customers, portfolio firms and other important stakeholders and exactly show what actions they (AP funds) do to influence portfolio firm behaviour to minimize reputation risk. The chosen influence strategy must be easily communicated and understood so that AP-funds can be measured on their reduction activities on reputational risk. Consequently, another factor behind the choice of influencing strategy is the *Target audience*. With target audience we mean the receiver of influence strategies outcomes used by AP funds. What audiences is a specific AP-fund seeking to influence or be considered credible and responsible by?

The following factors, *Third party intermediate* and *ESG positioning* does not motivate the type of influence strategy to chose but can rather be considered as a factor used to support the influence strategy. Third party intermediate may help leverage AP fund influence strategy when a) portfolio firm is not dependent on AP-fund (engagement) or b) portfolio firm receives negative publicity (exclusion), and are hence an important factor once influence strategy has been selected. The AP fund's ESG positioning is an important factor in deciding influence strategy. A high ESG position requires a clear and transparent system allowing little room for interpretation of selected strategy. A less outspoken ESG position is better to combine with an influence strategy that is less transparent and clear to concerned stakeholders.

Table 2 Factors determining influence strategies

Factors determining influence strategies	AP7: Exclusion influence strategy	AP1-4: Engagement influence strategy
Management ESG experience and attitude	<ul style="list-style-type: none"> - CEO, Chairman and Vice Chairman shared ESG interest and commitment. - CEO maintain operational responsibility for ESG issues. - Prioritised ESG and met government deadline to post ESG policy on time. 	<ul style="list-style-type: none"> - Little ESG experience following 2001 pension launch. - Corporate Governance responsible for ESG issues. - The ESG directive was not considered among the most pressing issues during pension launch.
Directive interpretation	<ul style="list-style-type: none"> - Exclusions can be controlled for without compromising the directive objective of high return and low risk. 	<ul style="list-style-type: none"> - Exclusion strategy is less attractive as it may interfere with the superior directive objective. - Engagement is the preferred strategy to influence portfolio firms to improve ESG standards.
Dependencies (Power & Legitimacy)	<ul style="list-style-type: none"> - AP7 relies less on power when there is no prior relationship between pension fund and portfolio firm. - AP7 legitimacy is more important as exclusions are accompanied with a negative publicity campaign aiming to influencing corporate behaviour. 	<ul style="list-style-type: none"> - A joint collaboration in <i>Ethical Council</i> result in stronger power and legitimacy dependencies in engagements with foreign portfolio companies. - Investor coalition adds power and legitimacy when AP1-4 engagement alone may result in little effect.
Reputation risk	<ul style="list-style-type: none"> - Exclusion strategy is more transparent, easier to communicate and understand and therefore superior in managing reputational risk. - Media is tied to reputation risk and used to (1) communicate the exclusion of the firm, (2) signal a high ESG profile to customers, and (3) lend legitimacy and power to the fund. 	<ul style="list-style-type: none"> - An engagement strategy is more difficult to explain to stakeholders especially when done in close confidence with portfolio firms. - Transparency towards media and other stakeholders otherwise reputation risk may increase.
Target audiences	<ul style="list-style-type: none"> - Portfolio firm are influenced in stronger ESG performance which then results in reduced reputation risk. - Savings customers as they are free to move with their savings money and there is an ESG branding opportunity and legitimacy to reward the fund. 	<ul style="list-style-type: none"> - Portfolio firm are influenced in stronger ESG performance which then results in reduced reputation risk.
Factors related to influence strategies		
Third party intermediate	<ul style="list-style-type: none"> - Media used as an amplifier and broadcaster of negative publicity on the portfolio firm. 	<ul style="list-style-type: none"> - Forming coalitions with other investors, resulting in improved leverage power.
ESG positioning	<ul style="list-style-type: none"> - Very important for AP7 as they want to be associated as a responsible investor mainly to attract and maintain savings customers. 	<ul style="list-style-type: none"> - Less important to AP1-4 as their engagement strategy mainly involves integrity and close collaboration with portfolio firms and their beneficiaries' pensions are captive.

6. Discussion

In this section we will study the factors behind the choice of influence strategy and first present a conceptual model explaining how these underlying factors link into each other and the choice of strategy. Then, we will end the paper by presenting a two-by-two matrix where we link theoretical implications with our empirical influence discoveries.

Factors determining influence strategies

Our findings indicate that apart from dependencies (power and legitimacy) which have already been reported in the literature as influential in deciding stakeholder salience we can add five additional factors in determining influence strategies in shareholder engagement, *third party intermediary*, *directive interpretation*, *reputation risk*, *target audience*, and *management background and attitude* (See figure 1). Power dependencies has been described from the perspective of the relationship as well as characterising the actor (Mattingly and Greening, 2002). In our findings we see mainly a situation of absent AP fund “relationship” or “actor” power vis-a-vis foreign portfolio firms. In general all AP funds own shares in some 3000 global companies. Their ownership is small and there is seldom a relationship between AP funds and portfolio firms. The situation is totally opposite for Swedish portfolio firms where each AP fund does their own engagement (or exclusion) based on an existing on-going relationship.

Therefore, lack of power dependency can be compensated by seeking *third party intermediaries* to amplify the missing dependency. To intensify influence strategies both AP7 and the buffer funds turn to different outside allies (media and investor coalition). The reason why AP7 do not primarily seek allies from the institutional investor community is because their exclusion strategy can still be effective done individually. AP7 complements its strategy with negative publicity which is amplified and spread through the use of mass media. Another determining factor is *directive interpretation*, limiting and guiding the behaviour of the AP Funds. Even though the same directive sentence applies to all AP funds it was interpreted differently by the funds. Maybe this was also the intention from the government since they created a system of multiple AP funds to compete and allow a diversity of approaches. We know from the study that AP7 believes that exclusions can be controlled for given a relatively small number of firms are excluded. But we are uncertain whether it is buffer funds ideology that makes them using engagement or if it is the threat of violating the superior directive objective (high return) that is guiding their choice of influence strategy.

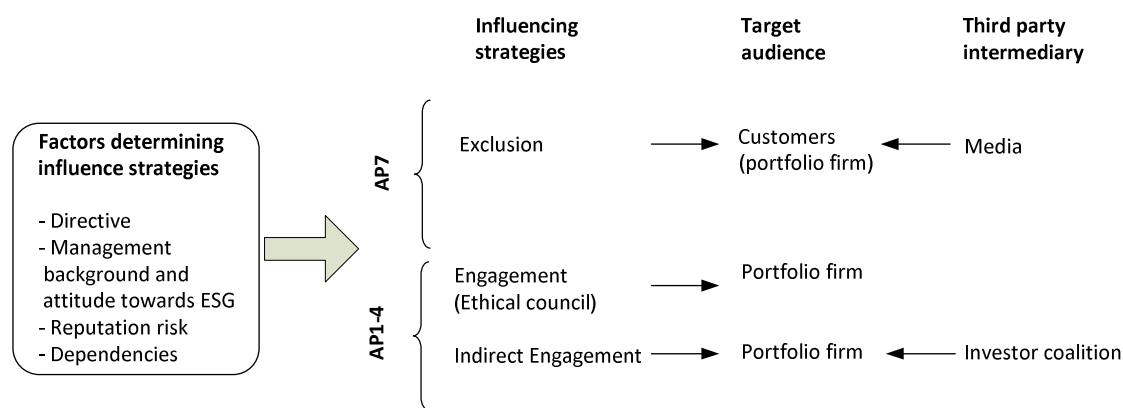


Figure 1: Factors determining influence strategies

Furthermore, a set of *reputation risk* factors intervene with other factors in shaping the influence strategies. Our study reveals that the ESG directive can help AP funds reduce their reputation risk by monitoring their ESG risk on a global portfolio basis. The ESG policy formulation among all studied AP funds is basically created addressing the risk aspect of ESG rather than focusing on ESG as a value opportunity. Reputation risk reduction appears a strong determining factor for AP funds as they chose type of influence strategy. This is a factor that was not mentioned in the models of Frooman (1999), Hendry (2005) and Mattingly and Greening (2002). It is somewhat surprising since damage to brand image can be the outcome of stakeholder-firm campaigning. In this paper we argue that the exclusion strategy of AP7 mitigates this risk more effectively than AP1-4 mainly because AP7's strategy discontinues (divest) any association with the firm.

An additional important factor as is the intended *target audience* for the influence strategy. Obviously the portfolio firm is the target in a shareholder engagement based on dialogue and conducted in private as been reported from the buffer funds. However, it becomes more complicated in the case of AP7. Hence, AP7 is considering their influence strategy as a way of enhancing their reputation as a responsible investor and seeking a "high ESG positioning" by targeting primarily their customers which is basically all Swedish citizens. For this reason our figure consists of an audience factor and we feel the portfolio firm AP7 seeks to influence appears more as a secondary target. We argue that their non-interactive influence strategy which distances them from the portfolio firm is probably not their main audience. It is likely AP7's main concern is about their savings customers instead. Their customers are able to move with their savings and the premium pension system allows for switching mutual funds at no cost. The criticize that retail ethical funds in some occasions are about communicating a strong ESG commitment rather than actually showing it in practice have been reported in several studies (see Frankental, 2006; Haigh and Hazelton, 2004). However, we are not implying that AP7 *management background and attitude towards ESG* is not sincere or inferior of the other AP funds. On the contrary our findings show a strong commitment towards ESG on the part of AP7's management but this is only one among many factors determining what influence strategy to use in shareholder engagement that needs to interplay.

A model of AP fund influence strategies

Finally, we will develop a model of AP fund influence strategies in shareholder engagement with portfolio companies based on our findings. In order to understand the engagement behaviour of AP funds, we draw upon factors found important for influencing strategies in extant stakeholder literature. The underlying framework rest on the work of Frooman (1999) and Mattingly and Greening (2002) describing stakeholders’ influence strategies as a function of the power-dependence relationship between firm-stakeholder groups. Frooman (1999) and Mattingly and Greening’s (2002) models are especially useful to understand what determines interaction between a firm and its stakeholders and the use of influence strategies. With this model we are able to map four different influence strategies seen in the AP fund case studies.

The model’s two dimensions are *pathway of influence*, whether direct or indirect (See Mattingly and Greening , 2002 and Frooman, 1999), and *level of interaction*, whether high and low (see figure 2). Direct paths of influence mean that AP funds may interact (or chose not to interact) with the portfolio firm directly and put forward its claim as supposed to an indirect approach where the AP funds may opt to go through a third party intermediary to influence the firm. In this context, direct refers to the pension fund – firm relation regardless the outcome (dialogue or not). The level of interaction between AP fund and portfolio firm can range from high (dialogue) to low (little or no dialogue). When combined, the two dimensions distinguish between two direct influence strategies identified in our findings, *engagement* and *exclusion* and two indirect strategies, such as *investor coalition* and *proxy voting*.

		Level of interaction	
		Low	High
Pathway of influence	Direct	Exclusion	Engagement
	Indirect	Proxy voting	Investor coalition

Figure 2: A model of AP fund influence strategy (adapted from Mattingly & Greening, 2002)

- **Engagement.** The engagement work of the buffer funds is conducted in mutual confidence with the portfolio company. Both parties cooperate and try to reach a common objective of minimizing reputation risk. This reputation risk is ultimately shared by the pension fund until

fully mitigated by the portfolio firm. The asset owner and the firm negotiate to reach a solution to the ESG issue that both parties can benefit from.

- **Investor coalition.** Since 2007 the buffer funds conduct joint engagement in foreign portfolio firms through Ethical Council. The motivation for this was increased size and resource allocation between AP1-4. In situations where Ethical Council lacks recognition and influential power it may be more effective to collaborate with a third party investor. For asset owners like the buffer funds many times lacking both power and legitimacy in influencing foreign portfolio firms, an investor coalition influence strategy can gain political power by joining forces with large geographically better allocated investors which the portfolio firm is dependent on. In the future we predict investor services like the UN PRI Clearing House will be even more important as institutional investors need to combine direct and indirect influence strategies.
- **Exclusion.** This represents the influence strategy chosen by AP7. Their integration approach is low or not existing, AP7 do not seek a cooperative approach with the portfolio firm. They believe divestment is the preferred method to influence corporate behaviour. At the end of the prohibition period the firms has to prove that they have taken corrective measures for their past ESG inaction and then they become investable again.
- **Proxy voting.** This is a low interactive influence strategy where the shareholder has the formal right to submit their concerns about how firm level ESG risks are handled. The influence strategy indirect since the asset owner assigns the voting right to an external voting body. Shareholder resolutions can be filed directly but for practical reasons they are mainly managed and executed indirectly through a clearing house (proxy voting).

7. Conclusion

In our pursue to review and extend the work on influence strategies in shareholder engagement we have come across several factors linked to investors final choice of strategy. We have reported that reputation risk is a strong motivation for engaging with portfolio firms. Target audience is another important factor in determining influence strategy in our Swedish AP fund case findings. As the premium pension customer is free to switch fund manager the choice of influence strategy sees a need to target savings customers and not only the sustainable behaviour of the portfolio firm. We would like to have contributed to the shareholder engagement space by providing practitioners in the investment management arena with a new set of tools in selecting influence strategies. By offering a systematic mapping of influence strategies we believe there is practical benefits which can lead to less lengthy and more effective shareholder engagements. We would at the same time like to caution the reader with the fact that our findings have a geographic focus and that some of our findings are difficult to apply elsewhere. Our theorising in this paper has involved among other things reputational risk linked influence strategies. We encourage more work in this area and look forward to new research on reputation risk and shareholder engagement, an area we expect will grow in the future.

Appendix 1: Fund specific overview AP fund 1-4 (31 December, 2009)

	First AP Fund	Second AP Fund	Third AP Fund	Fourth AP Fund	Seventh AP fund
Fund capital 1 January 2001, Euro Bn*	13.8	13.8	13.8	13.8	n/a
Total asset under management , Euro Bn* (per 31 Dec 2009)	20.8	21.0	21.2	20.11	9,22
Average annual return 2001-2009 (after expenses)	3.2 %	3.3 %	3.5 %	n/a	n/a
Five year return on total portfolio after commission and operation expenses					
2009	34.6 %	20.6 %	29,2 %	21.5 %	35.1 %
2008	-48.0 %	-24.0 %	-44,8 %	-20.8 %	-36.2 %
2007	9.7 %	4.2 %	10.7 %	2.5 %	4.7 %
2006	18.2 %	13.0 %	18.6 %	10.5 %	10.5 %
2005	27.6 %	18.7 %	28.8 %	16.9 %	25.1 %
Asset class, Percent (per 31 Dec 2009)					
Global equities developed markets	36 %	52 %	49.7 %	42.5 %	52 %
Swedish equities	14 %			18.0 %	20 %
Global equities, emerging markets	8 %			3 %	10 %
Fixed income	34 %	37 %	34 %	35.0 %	8 %
Alternative investments	5 %	11 %	16.3 %	3.5 %	10 %
External management of total portfolio (31 Dec 2009)	42.4 %	24 %	40.7 %	21.1 %	n/a
Active management of total portfolio (31 Dec 2007)	n/a	n/a	n/a	57.7 %	n/a
No of employees (per 31 Dec 2007)	43	31	55	53	18

Source: Annual Reports 2009, AP1-4 & AP7 *Euro/SEK 9,73 (10 March , 2010)

Appendix 2: Summary of the First-Fourth AP Funds' investment rules

<i>Type av instrument</i>	<i>Permitted investments</i>
General	All instruments in the capital market. Shares and receivables must be admitted to trading in a regulated market.
Unlisted securities	A maximum five per cent of the fund capital may be invested in shares or receivables in venture capital companies that are not traded in a regulated market. Unlisted shares (property shares excepted) may only be owned indirectly, via a fund or a venture capital company.
Interest-bearing instruments	At least 30 per cent of the fund capital must be invested in low-risk, interest-bearing securities
Derivatives	Are to be used primarily to enhance management efficiency or reduce risks. May not have commodities as an underlying asset.
Credits	Bank borrowing and lending on the call loan market. Direct loans to self-owned property companies. Repos and securities borrowing primarily as a means of enhancing management efficiency.
Borrowing	Short-term borrowing to cover temporary needs. Option to borrow from the National Debt Office when funds empty.
Foreign currency	A maximum 40 per cent of the capital may be exposed to currency risk.
Major exposures	A maximum 10 per cent of the fund capital may be exposed to a given enterprise or group of companies that are internally linked.
Swedish shares	The market value of a fund's holdings in Swedish companies may not exceed two per cent of the total market value.
Number of votes	A maximum 10 per cent in individual listed companies, self-owned property companies excepted. A maximum 30 per cent in unlisted companies.
External management assignments	At least 10 per cent of the investment capital must be managed externally.

(Source: SOU, 2008)

References:

- Andriof, J. and Waddock, S. (2002). 1. Unfolding Stakeholder Engagement, in Andriof, Waddock, Husted and Rahman (Eds.) *Unfolding Stakeholder Thinking: Theory, Responsibility and Engagement*, Greenleaf Publishing. Sheffield, UK.
- Becht, M., J. Franks, C. Mayer and S. Rossi. 2009. Returns to shareholder activism: Evidence from a clinical study of the hermes uk focus fund. *Review of Financial Studies*, 22, no. 8: 3093-3129.
- Carroll, A. B. (1979). A Three-Dimensional Conceptual Mode of Corporate Social Performance, *Academy of Management Review*, 4: 497-505.
- Clark, G. L. (2000). *Pension Fund Capitalism*. Oxford University Press, Oxford
- Clark, G. L. and T. Hebb. 2004. Pension fund corporate engagement. The fifth stage of capitalism. *Relations Industrielles/Industrial Relations*, 59, no. 1:142-171.
- Clark, G. L. and T. Hebb. 2005. Why should they care? The role of institutional investors in the market for corporate social responsibility. *Environment and Planning A*, 37: 2015-2031.
- Creswell, J. (2009). *Research Design*. Sage Publications. Thousand Oaks, CA.
- Eisenhardt, K. M. 1989. Building theories from case study research. *Academy of Management Review*, 14: 532–550.
- Ethix SRI Advisors, 2010. Norm based screening. [Online] http://www.ethix.se/methodology_page1.pdf [2010, 18 January].
- Eurosif, 2008. European SRI Study 2008. [Online] http://www.eurosif.org/publications/sri_studies, (2009 31 March).
- First National Pension Fund, 2008. The web page of First AP fund. [Online] <http://www.ap1.se/en/Our-mission/> (2008, 6 May).
- First National Pension Fund, 2007. AP1 Annual Report 2006.
- Freeman, R.E. 1984. *Strategic Management: A Stakeholder Approach*. Boston. MA: Pitman.
- Friedman, A., Miles, S. 2006. *Stakeholders: Theory and Practice*. Oxford University Press.
- Frankental, P. 2006. Why socially responsible investment requires more risk for companies rather than more engagement. In *Responsible investment*, eds. Sullivan R and Mackenzie C, 241-246. Sheffield: Greenleaf.
- Frooman, J. 1999. Stakeholder influence strategies. *Academy of Management Review*, 24 (2): 191-205.
- Frooman, J. and Murrell, A.J. 2003. A Logic For Stakeholder Behavior: A Test of Stakeholder Influence Strategies. Academy of Management Best Conference Paper 2003 SIM:F1.
- Frooman, J. and Murrell, A.J. 2005. Stakeholder Influence Strategies: The Roles of Structural and Demographic Determinants, *Business Society*, 44 (3): 3-31.
- Gifford, E. J. M. 2009a. Effective shareholder engagement: The factors that contribute to shareholder salience. Working Paper, United Nations Principles for Responsible Investment. http://www.unpri.org/files/Gifford_PRI2009.pdf.
- Gifford, E. J. 2009b. Effective shareholder engagement – An analysis of the factors that contribute to shareholder salience. PhD Thesis. University of Sydney, School of Business.
- Gillan, S. L., & Starks, L. T. (2000). Corporate governance proposals and shareholder activism: the role of institutional investors. *Journal of Financial Economics*, 57, 275-305.

- Haigh, M. and Hazelton, J. (2004). Financial Markets: A Tool for Social Responsibility. *Journal of Business Ethics*, 52: 59-71, 2004.
- Hamilton, I. 2009. An ESG Directive as a Driver for SRI among Swedish National Pension Funds. Working paper presented at PRI Academic Conference in Ottawa 2009.
- Hancock, D. and Algozzine, B. 2006. *Doing case study research: a practical guide for beginning researchers*. Teachers College Press. New York.
- Hawley, J. and Williams, A. (2000). *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic*. Philadelphia, PA: University of Pennsylvania Press.
- Hendry, J.R. 2005. 'Stakeholder Influence Strategies: An Empirical Exploration', *Journal of Business Ethics*, 61: 79-99.
- Jensen, M. (2002). 3. Value Maximization, Stakeholder Theory and the corporate objective function, in Andriof, Waddock, Husted and Rahman (Eds.) *Unfolding Stakeholder Thinking: Theory, Responsibility and Engagement*, Greenleaf Publishing. Sheffield, UK.
- Mattingly, J. and Greening, D. 2002. 14. Public-interest groups as stakeholders: A 'stakeholder salience' explanation of activism, in Andriof, Waddock, Husted and Rahman (Eds.) *Unfolding Stakeholder Thinking: Theory, Responsibility and Engagement*, Greenleaf Publishing. Sheffield, UK.
- McGee, J. (1998). Commentary on Corporate Strategies in and Environmental Regulations: An organizing Framework by A.M. Rugman and Verbeke, *Strategic Management Journal* 19:377-87.
- Meriam S. (1988). *Case Study Research in Education*. Jossey-Bass. San Francisco
- Mitchell, R.K., Agle, B.R. and Wood, D.J. 1997, 'Toward a theory of stakeholder identification and salience: defining the principle of who and what really counts', *Academy of Management Review*, vol. 22, no. 4, pp. 853-886.
- Ministry of health and social affairs, (2000). Fact Sheet: Old Age Pensions in Sweden, no 4 July 2000.
- Monks, R. (2001). *The New Global Investors: How Shareowners Can Unlock Sustainable Prosperity Worldwide*. Oxford: Capstone.
- Pfeffer, J., & Salancik, G. R. 1978. *The external control of organizations*. New York: Harper & Row.
- Rayner, J. 2003. *Managing reputational Risk: curbing threats and leveraging opportunities*. New Jersey: John Wiley & Sons.
- Second National Pension Fund, 2007. Corporate Governance Report 2007.
- Seventh National Pension Fund, 2005. AP7 Annual report 2005.
- Seventh National Pension Fund, 2010a. Policy for Corporate Governance. [Online] <http://www.ap7.se/engelska/index.html>. [2010, 18 January].
- Seventh National Pension Fund, 2010b. AP7's journalist price. [Online] <http://www.ap7.se/> [2010, 18 January].
- SIF, 2008. 2007 Report on Socially Responsible Investing Trends in the United States. Social Investment Forum (www.socialinvest.org).
- Sjöström, E. 2010. Shareholders as norm entrepreneurs for corporate social responsibility. Forthcoming in *Journal of Business Ethics*.
- Smith, M. 1996. 'Shareholder Activism by Institutional Investors: Evidence from CalPers', *Journal of Finance* 51:227-52
- SOU, (2008). Swedish Government Official Reports, Ethics, Environment and Pensions, SOU 2008:107. Stockholm

Sparkes, R. and Cowton, C. I. (2004). The Maturing of Socially Responsible Investment: A Review Of The Developing Link With Corporate Social Responsibility, *Journal of Business Ethics* 52: 45-57.

Government Bill, 2000. Proposition 1999/2000:46 AP-fonden i det reformerade pensionssystemet. Swedish [Online], Available: http://www.riksdagen.se/Webbnav/index.aspx?nid=37&dok_id=GN0346&rm=1999/2000&bet=46, [2010, 18 January].

Third National Pension Fund, 2009. AP3 Annual Report 2008.

UKSIF, 2007. Responsible Business: Sustainable Pensions, How the Pension Funds of the UK's Corporate Responsibility Leaders are approaching responsible investment. (www.uksif.org).

UNEP FI, 2009. United Nations Environment Program Finance Initiative, Fiduciary responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment. A report by Asset Management Working Group.

Waygood, S. 2006. Measuring the effectiveness of investor engagement: Gsk and developing-country access to essential medicines. In *Responsible investment*, eds. Sullivan R and Mackenzie C, 206-214. Sheffield: Greenleaf.

Zambon, S., Del Bello, A. (2005). Towards a Stakeholder Responsibility Approach: The constructive Role of Reporting, *Corporate Governance: The International Journal of Business in Society*, 5/2: 130-41.

Yin, R. (2003). *Case study research; design and methods*. Newbury Park: Sage.