Ethics, environment and pensions

Report by the Committee on ESG-issues for the Swedish National Pension Funds

Stockholm 2009

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To Minister Mats Odell

In November 2007, the Government authorised Minister Mats Odell to appoint a committee of inquiry to examine how and to what effect the First-Fourth AP Funds and the Seventh AP Fund had over the years dealt with the requirement, imposed in 2001, whereby environmental and ethical considerations are to be taken into account in all investment operations.

Minister Odell appointed Ulla-Carin Giertz, former head of the asset management department at the Swedish Legal, Financial and Administrative Services Agency, to chair the committee, and Professor Hans De Geer and lawyer Bertil Villard to serve as members. Economist Hans Bäckström was appointed Committee Secretary.

The official title of this body is the Committee on the Ethical and Environmental Responsibility of Swedish Pension Funds.

A group of experts was attached to the Committee, comprising investment consultant Märtha Josefsson, Director Kajsa Lindståhl, Head of Department Irene Wennemo (until 31 May 2008), economist Åsa-Pia Järliden Bergström (from 1 June 2008), and Senior Adviser Lars Gavelin. Altogether, the Committee and the Expert Group held seven meetings.

In addition, at the Committee's request, researchers and consultants have produced five studies examining a number of important issues in closer detail. These are included with the report in the form of annexes. The analyses and conclusions outlined in each of these five texts are the authors' own. How the material has been used by the Committee is explained in the report.

The Committee has been in contact with numerous bodies and individuals, and several meetings have been held with actors both at home and abroad who in our view were in a position to supply relevant information and interesting views. This naturally applies to the AP funds themselves and to the Ethics Council jointly run by the First-Fourth AP Funds, but also to other Swedish and inter-

national institutional investors, consultants and analysts. The Committee has also taken part in a joint seminar with Norwegian agencies, one of the reasons being that a similar assessment of the Norwegian national pension fund is currently under way in Norway.

The conclusions we have drawn and the recommendations that the work has led to are described in this report, *Ethics, Environment and Pensions* (SOU 2008:107), which is hereby submitted to the Government. This concludes the work of the Committee.

Stockholm, November 2008

Ulla-Carin Giertz *Hans De Geer* *Bertil Villard*

/Hans Bäckström

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Summary

The Swedish Government and Riksdag (parliament) have stated that the National Pension Funds – the AP funds – are to administer allocations in such a way as to ensure the greatest possible benefit to the pension system. The aim is a high rate of return in the long term in relation to the investment risk. The funds are not to be used for the achievement of industrial policy or economic policy goals. The AP funds are, however, required to take environmental and ethical considerations into account in their investment activities without deviating from the overall objective of a high rate of return. The task of the present committee has been to evaluate both how the funds have lived up to their obligations in this respect and the extent to which this has been reflected in their corporate governance.

In our view, the AP funds have dealt commendably with this task. However, their remit needs to be more closely defined and their working methods improved. In future, the funds should work more proactively and seek to integrate sustainability aspects into the investment management process. To consolidate and strengthen public trust, the funds' governing boards should adopt, follow up and communicate a set of basic values or principles for how the funds should operate. Further resources need to be set aside for the purpose of analysing and following up the funds' own governance practices. Finally, the AP funds' governing boards should be appointed on the basis of a professional nomination process.

In recent years, interest in what is usually referred to as "sustainable" or "responsible" investment has increased significantly among institutional investors both in Sweden and abroad. Extensive international cooperation has ensued, not least within the UN, where the AP funds have played an active role. A wide range of terms and designations are used in this sphere. We have chosen to confine ourselves principally to the term ESG *(Environ-*

ment, Social, Governance), which is internationally established and which in our view best encompasses both the role of the AP funds and our own remit.

This area of activity is still developing rapidly. Nevertheless, fairly extensive research has been conducted internationally on ESG impact and it appears that the consideration of ESG factors is more likely to boost than to reduce returns, although it is difficult to draw any unequivocal conclusions in this respect. The various funds have to some extent chosen different approaches and profiles when working in this area, and have developed methods and procedures both jointly and separately. The efforts of some of the funds have attracted international attention. Returns on the AP funds' investments have not had any demonstrably adverse effects, and administrative costs have been kept down. In a number of cases, the activities of the AP funds – and of other investors – have led to improvements in the companies owned by the funds and also to closer consideration of environmental and ethical issues in these companies.

While the AP funds have worked well in this sphere, there is potential for further growth and improvement in some respects. The committee would, however, like to begin by making clear that the basic task of the funds – to help ensure good pension levels through high financial yields, which in turn ensures the wellbeing of pensioners both present and future – is in itself a fundamental ethical objective.

The committee proposes the following:

1. The funds' overall objective is to create security in the national pension system. This is to be achieved by means of high rates of return in the long term. Without deviating from this overall objective, the funds are also required to consider environmental, ethical and other sustainability aspects. This can be made clear by incorporating the provisions regarding ESG considerations – which have hitherto been present only in the preparatory material – into the relevant *law*, i.e. the Public Pension Funds Act (2000:192).
2. The problems that have beset the international financial markets in the autumn of 2008 have made abundantly clear the

important role played by trust and confidence in financial activities. For the AP funds, too, *public trust* is crucial. Pensions management is a complicated field of activity that most people are unable to follow and assess in detail. Where understanding fails, trust must take over, and trust is built on factors such as knowledge and expertise, transparency and integrity. The funds must proceed from this perception in their working methods, organisation and communication.

3. The funds must define a set of principles or *basic values* on which to base their activities, incorporating *ESG* aspects. This will involve formulating clearly and coherently the key values that are to inform the way they proceed in their investment activities. For the AP funds – which act on behalf of all Swedish citizens – these basic values must be communicable and must have broad public support. A natural starting point for the development of such values is the agent's perspective reflected in the Swedish Constitution's Instrument of Government – aiming to promote the freedom and wellbeing of citizens so as to enable them to act independently, and to support them in this endeavour. This also includes ensuring a good environment for present and future generations. The international conventions that Sweden has signed represent a practical expression of these basic values and may therefore be viewed as further starting points for the funds' work on developing a set of fundamental principles. The funds should actively communicate their basic values to the public and describe how these govern their investment activities.

4. We take the view that ESG aspects represent both risks and opportunities that can be confronted and exploited respectively by *integrating* them into ongoing analytical and management processes as far as possible, instead of treating them as a separate issue. This presupposes for instance that the AP funds explicitly require the companies concerned to provide relevant information. The funds have formulated such requirements in an exemplary manner in their ownership policies. The next step, proceeding from the information acquired in this way, is to develop strategies for future investments taking into account ESG aspects. One such course might be to develop a strategy for the fund portfolio's total carbon emission count. Developing methods for analysing and applying ESG aspects in invest-

ment activities and corporate governance is in many respects a complicated endeavour that necessarily proceeds by stages. What is important is to ensure that there is a clearly defined target to work towards and that there are strategies for reaching it. How quickly and by what precise means progress is to be made in this direction must be up to the AP funds themselves to decide, although they must be able to show why they have chosen a particular course in this respect.

5. It should be the *task of the governing boards* to adopt a set of fundamental values for fund activities and on the basis of these principles to establish and follow up how the funds are to operate.
6. The boards' remit also covers the question of how their members are recruited, how they work and how they are paid. In future, the Government should appoint board members on the basis of recommendations from a government-appointed, professionally active and broad-based *election committee*. Boards must be allowed to have fewer than the nine members currently stipulated by law.
7. The provision requiring a given number of board members to be nominated by trade unions and employers' organisations (the social partners) should be abolished.
8. External *evaluations of the boards' work* should be undertaken regularly, in line with standard practice in the business sector in recent years, and should serve as a basis for the work of the election committee.
9. Sufficient *resources* should be set aside for the purpose of securing the requisite procurement skills and quality in work with ESG issues. This applies to information gathering, analysis, dialogue and follow-up.
10. Opportunities should be created for broadening *cooperation and interaction* between the AP funds on ESG issues without this conflicting with the independence of each individual fund, as called for by central government. This applies for instance to ESG dialogues with Swedish companies.
11. *Ownership* is the foundation on which the influence of the AP funds rests. This should be exploited as effectively and determinedly as possible. A well-developed ownership policy – which

each of the First-Fourth AP Funds has formulated separately – is essential in this respect. Ownership and investment policies embracing ESG aspects should be considered for all types of assets, not just listed shares, and must be followed up regularly.

12. The restriction imposed on the *Seventh AP Fund's right to vote* in respect of its shareholdings should be removed. Other regulatory constraints preventing the funds from playing an active ownership role should be reviewed. The funds' ownership role should otherwise be defined in such a way as to strike a balance between an investor perspective and a long-term ownership perspective.

13. The principles governing *board and management remuneration and compensation* are ownership issues with important trust-related implications, for the funds themselves, for the companies concerned and for the business sector as a whole. The funds must continue to actively encourage the development of a remuneration system that is moderate and transparent and provides incentives for well-judged risk-taking. The way incentives for the funds' own employees are constructed will also have an impact on how ESG aspects are dealt with and on the extent to which public trust is maintained.

14. The funds' ESG work should be *evaluated* regularly. The Government's annual evaluation process, therefore, should also encompass these aspects of the funds' operations. This is consistent with the idea that ESG analyses need to be integrated into the work of the funds.

15. We propose that the Public Pension Funds Act (2000:192) be revised on five counts:

    - The preparatory text requiring the funds to take environmental and ethical considerations into account is incorporated into the text of the law.
    - An election committee is responsible for recruiting the members of governing boards.
    - The restrictions concerning the Seventh AP Fund's voting rights are removed.
    - The number of board members is to be nine *at the* most.
    - The provision requiring four board members to be proposed by the social partners is abolished.

Background

1.1 Time for assessment

When the national pension scheme was reformed in 2000, the AP funds were tasked with seeking a high rate of return on the money deposited so as to help achieve healthy pension levels. In the preparatory material on which the new law was based, it was also stated that the funds were to take environmental and ethical considerations into account in their investment policies, without deviating from the overall objective of a high rate of return.[1] In 2005, the Riksdag's Parliamentary Committee on Finance pointed out that the AP funds' experience of working with ethical and environmental aspects needed to be evaluated.[2] As part of its annual review of the AP funds' operations the following year, the Government announced that a public inquiry was to be set up to carry out such an evaluation. It is also worth noting that in 2007 the Trade Union Confederation (LO) wrote to the Government and the Riksdag urging them to establish a framework for the AP funds' ethical guidelines and corporate governance.

This led to the government remit that is the subject of the present report.

1.2 Terms of reference

Under the government remit, the inquiry is to "evaluate the First-Fourth AP Funds' guidelines regarding the environmental and ethical dimensions and the guidelines regarding corporate governance". Within this framework, it is also to describe how capital investments based on such premises are undertaken by asset

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[1] The Role of the National Pension Fund in the Reformed Pension System (Govt. Bill 1999/2000:46).

[2] Report on the Activities of the AP Funds, 2003 (2004/2005:FiU 6).

managers today, both in Sweden and abroad. In addition, the Committee is to assess whether, and if so how, considerations of this type have affected the AP funds' principal objective, i.e. financial yield, and also whether and how they have affected the companies in which the funds have invested. The inquiry is furthermore to discuss the requirement whereby the AP funds are to proceed in their work in such a way as to promote public trust. This partly concerns how they should exercise their role as owners, and what prerequisites are needed for them to do so. Finally, the inquiry is to propose changes in the funds' guidelines should it find such a course warranted, given the AP funds' remit as prescribed by law and expressed in the preparatory material, where the basic objective is a high rate of return in the long term, and given that the conditions for evaluating the funds' activities do not deteriorate.

In undertaking an assignment of this kind, different approaches may be adopted and different aspects given priority. The Committee has focused principally on a number of general aspects relating to "environmental and ethical consideration". It has not, however, felt the need to go through and evaluate individual cases, enter into technical discussions on methodology, or to formulate operational advice or guidance.

As regards corporate governance issues – which in the Government's instructions are mentioned in general terms, and where remuneration issues are cited as examples in point – the Committee felt it natural to focus on aspects that would seem to have an explicit connection with the way companies handle the requirement that they take environmental and ethical considerations into account, or that specifically affect public trust in the AP funds. The Committee has not, however, felt called upon to examine the corporate governance issue in all its many dimensions, particularly since a broad analysis of this kind was recently provided in a report by the Commission on Business Confidence.[3]

Finally, it should be noted that the term "AP fund guidelines" can be interpreted to mean either the guidelines established for the funds by the Government and the Riksdag, or the guidelines developed by the funds themselves for their work on the ethical and environmental aspects of their investment activities. In our view, both these dimensions are very definitely relevant, while at

[3] The Business Sector and Confidence *(Näringslivet och förtroendet*, SOU 2004:47).

the same each can be described as a condition of the other. Consequently, we will be discussing both. The context will show which aspect is being discussed in each particular case.

1.3 Greater focus on ethics and the environment

The fact that several years have passed since the AP funds were given a partially new remit is in itself reason for evaluating the way in which they have performed their task, and what the impact has been. Issues such as human rights, environmental consideration and corporate governance have all attracted much greater attention in recent years, not least at international level. The closer focus on issues like child labour, corruption and various forms of discrimination has affected perceptions and agendas. In the case of environment, the climate issue has come to play a key role on the political front. Also, the past decade has featured a number of "corporate scandals", both in Sweden and elsewhere, in which senior company managers have more or less arbitrarily promoted their own interests at the expense of other stakeholders. This has focused attention on corporate governance issues in general and on the importance of being an active owner.

All these issues has sparked public reaction and led to steps being taken by companies, international organisations, states and non-government organisations (NGOs). In the business world, the term Corporate Social Responsibility (CSR), has become a focus of attention. It implies that companies should themselves take responsibility – at their own initiative, and over and above what the law requires of them – for the role they play and the impact they have on society. This may for instance mean the company concerned ensuring that its activities do not conflict with human rights imperatives, or that working conditions are decent even in manufacturng countries where labour legislation is weak or is not respected. It may also mean ensuring that the company engages in active efforts on behalf of the environment etc.[4] CSR is the most widely used designation, although there are variations that also reflect the main points in this approach.

[4] Nowadays, state-owned companies in Sweden are required to report on their efforts in respect of ethics, environment and gender equality etc. It is worth noting that Sweden and China recently concluded a unique agreement on CSR cooperation.
(se:www.swedenabroad.com/Page____20803.aspx)

The corresponding term in the investment sphere is *Socially Responsible Investment (SRI)*, which is the designation usually applied. The key components here are usually designated “ESG”, which stands for *Environment, Social, Governance*. Thus environmental consideration, issues concerning human rights and labour conditions, and corporate governance, are the three pillars on which responsible investment behaviour is based.[5]

At multilateral level, these issues have been discussed and also codified in a number of different contexts: in the UN and its agency, the ILO, and in the OECD and the EU in connection with international partnerships, but also in organisations such as the ICC (International Chamber of Commerce) and the ISO.

In 1999, nine principles (later increased to ten) were put forward in the UN by the secretary-general at the time, Kofi Annan, based on a number of key conventions. Targeting companies, this set of principles was entitled the *Global Compact* (see fact box). The idea is for individual companies to commit themselves to compliance with these principles by signing an agreement with the UN and its secretary-general. The unique aspect of this approach is that companies agree to comply with key UN conventions that *per* se only target national governments.

[5] Sometimes, reference is made simply to “responsible” or “sustainable investments”. The abundance of kindred terms and expressions could be said to illustrate the situation in a field that is still seeking its proper form and structure, its demarcations and precise definitions, but also reflects a degree of competition between different perceptions and interpretations.

The Global Compact is a voluntary UN initiative designed to encourage companies to abide by ten universally established principles in conducting their activities. These ten principles are based on international conventions in the fields of:

- human rights
- labour legislation
- environment
- corruption.

To join the Global Compact, companies are required to

- send a Letter of Commitment from the CEO – preferably endorsed by the board – to the Secretary-General of the United Nations expressing support for the Global Compact and its principles.
- incorporate these principles into their corporate strategy and seek to make them an integral part of business strategy, day-to-day operations and organisational culture.
- agree to publicly endorse and advocate the Global Impact and its principles.
- integrate in its annual report (or in a similar public document, such as a sustainability report) a description of the ways in which it supports and implements the ten principles

More information about the Global Compact is available at www.unglobalcompact.org.

Eighteen Swedish companies that have signed the Global Compact agreement have joined the Swedish Ministry for Foreign Affairs in establishing a special group, Global Responsibility (Globalt Ansvar). The group is the result of a government initiative in 2003 aimed at encouraging Swedish companies in their work on human rights, basic labour conditions, the fight against corruption, and environmental improvement. It proceeds in its activities from the international conventions and business standards formulated in the OECD's guidelines for multinational companies and expressed in the ten principles of the UN's Global Compact.

Further information about Global Responsibility is available at www.regeringen.se/sb/d/2657/a/14557.

In 2006, the six "*Principles for Responsible Investment*" (PRI) were established, targeting investors.

By May 2008, these had been signed by 362 financial companies, including the AP funds. Together, these companies manage assets worth over USD 14 trillion.[6] Less than six months later, in October 2008, the number of signatories had grown to 441. The PRI framework also provides the signatories with a joint forum. For instance, a joint, Internet-based "clearing-house" has been established for discussions, exchanges of experience and the development of contacts.

Principles for Responsible Investment

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

– – –

In signing the Principles, we as investors publicly commit to adopt and implement them, where consistent with our fiduciary responsibilities. We also commit to evaluate the effectiveness and improve the content of the Principles over time. We believe this will improve our ability to meet commitments to beneficiaries as well as better align our investment activities with the broader interests of society.

We encourage other investors to adopt the Principles.

The emergence of investment networks and alliances

Responsible investing is an area in which both practical activity and theoretical and methodological thinking have featured for some years. Nevertheless, experience in this sphere is still relatively limited, the information base is sometimes defective and the

[6] PRI Report on Progress 2008, UNEP Finance Initiative. The report notes that not only has the number of signatories grown rapidly but implementation of the principles has also been swift and successful.

methodology is by no means “fully rounded”. As a result, there is a considerable need for exchanges of information and experience between investors. Also, there is often a distinct need for cooperation between investors for the purpose of exerting influence on the portfolio companies. This is not confined to the ethical/environmental sphere alone – institutional investors are typically minority part-owners, and they generally need to cooperate in order to exercise ownership influence.

In light of this, it is not surprising that a number of more or less formalised partnerships between large or small groups of investors have developed in recent years. These often involve cooperation between investors and portfolio companies, since the latter, too, stand to gain from the development of uniform standards etc.

Besides the PRI, there are a number of international initiatives in which one or more of the AP-funds participate. These include the *Carbon Disclosure Project* (CDP), which is a joint project designed to make companies more aware of the climate change issue. Via this project, institutional investors can persuade companies to report more transparently on their strategies for dealing with climate issues and to document indicators that can show what improvements are being made. The purpose of the CDP is to streamline the data collection process by getting a large number of investors to collectively sign a joint set of questionnaires concerning data on greenhouse gas emissions and the reporting of them. On 1 February 2007, a fifth round of questionnaires was sent out to 2 400 companies by 280 institutional investors representing over USD 41 billion. The responses are made freely available on a website, and the response rate in recent years has been around 80–90 per cent.

Another international initiative supported by the AP-funds is the *Extractive Industries Transparency Initiative* (EITI), which targets oil companies in particular. Together with some 70 other investors, the funds have formally expressed their support for the EITI, which sends a message to both countries and companies with extractive operations that owners expect them to account for their incomes clearly and transparently. This is particularly important in the case of countries that are rich in natural resources but have weak governments. Clearer income reporting by host countries, and clarification of how much companies are paying, makes for greater transparency in society and helps improve conditions for economic governance.

1.4 Hidden agendas?

Our values and the values of others

Is it fair and reasonable to demand that companies in other countries submit to Swedish or Western rules and values if they wish to be accepted? What right, one might ask, does Sweden, the US or any other country have to determine – and decree to the rest of the world – what is right and proper? Shouldn't this be viewed as an arrogant or ethnocentric behaviour?

One way of dealing with the problem may be to base one's approach on the kinds of rules and conventions that are accepted by a large group of countries, from all continents, preferably within the UN framework. With rules in place that are globally endorsed, the problem could be said to have been solved, at least nominally. On the other hand, much of the philosophical and ideological basis on which international conventions are built is rooted in Western thought, in its broadest sense. Also, international conventions can be perceived, interpreted and applied differently. If norms and rules are only genuinely acknowledged and accepted in the rich, white, Christian world, a latent problem of legitimacy may persist.

So it is important to remember that the application of global principles at global level is a complex matter, although this does not necessarily mean that value relativism is the only possible approach. Societies, like individuals, can stand up for their own values while at the same time acknowledging and respecting those of others. There are, however, certain values and principles that everyone in the global business community ought to have good reason to embrace.[7]

Protectionism

A closely related problem is the risk that ethical and environmental imperatives may in reality be used as an excuse for hindering competition and free trade. The history of trade policy is full of instances where foreign or non-desirable competitors' allegedly

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[7] Thomas Donaldson and Thomas W. Dunfee have discussed the concept of "hypernorms", described as "- - - *principles so fundamental that they constitute norms by which all others are to be judged. Hypernorms are discernible in a convergence of religious, political and philosophical thought…* (see also "When Ethics Travel: The promise and peril of global business ethics" by Thomas Donaldson and Thomas W. Dunfee, California Management Review, Summer 1999; 41).

unsound or unjust business practices have been portrayed as "unfair" competition that needs to be countered through political action. It is important to distinguish between properly justified, ethically based demands and demands that are simply self-interest in disguise.

The interests of the state

The risk that ethnocentric and protectionist behaviour may ensue if Swedish investors demand that other countries' companies adapt to Swedish/Western values has recently acquired a new dimension with the development of what are termed *Sovereign Wealth Funds.* These capital investors are partly or wholly state-owned, come mainly from non-OECD countries, and on the strength of their very considerable assets are increasingly raising their level of ownership of large, strategic companies in the US and Europe. While it may be natural and desirable for these capital assets to be put to productive use and to help finance economic development, fears have been expressed that the funds' investment policies may be governed not just by financial criteria but also by political objectives.

This touches on the question of how the funds' basic ethical principles are to be formulated, and by whom, which will be discussed in Chapter 5. Also at issue here is the extent to which the funds are nominally and *de facto* independent, non-political entities, and whether in light of the above, in the international arena in particular, they could be thought to be operating under a political agenda.

"Window Dressing"

Phrases such as "ethical standards", "environmental awareness" and "sustainability" used by companies when describing themselves and their activities may simply be attributes that they have incorporated into their marketing and brand-building activities for opportunistic reasons. The principal aim, then, is to give the *impression* that the company is ethically and environmentally aware, rather than to make a serious effort to change and improve the way it operates. In such cases, the result is a show of political

correctness and “corporate bullshit”, not real development. It is important, therefore, to formulate and communicate clearly defined norms, terms and guidelines and to develop transparency and auditability. Here, initiatives such as the GRI *(Global Reporting Initiative)* may have an important role to play. Active media are also crucial to the achievement of the kind of transparency that is essential if serious efforts in this sphere are to be distinguished from less serious ones.

2 Global developments

The Committee's assessment: Combined, the AP funds are among of the six largest state-owned pension managers in the world. A small but growing share of the capital held by the European pensions industry, which in itself is growing, is managed in a way that specifically takes sustainability aspects into account. As yet, this line of activity is not fully developed. Lessons learned and information about good practices are disseminated via international networks, such as the one that has developed around the UN's Principles for Responsible Investment. The fact that the AP funds are involved in such networks is to be commended.

2.1 Growing global capital markets

Over the past 10–20 years, globalisation has made a marked impression both on the real economy and on the financial economy. It brings major economic benefits but also brings greater risk. Institutional investors and others are under increasing pressure to assess and address these risks in an appropriate manner – and developments in the autumn of 2008 showed this to be easier said than done. A fundamental problem for investors is that for obvious reasons it is harder to monitor and assess developments in a large number of companies in a large number of countries than simply to monitor those operating in the domestic market. And since "domestic companies" are increasingly active outside Sweden, the information and assessment problems are growing in their case as well. A rapidly multiplying array of often complex financial instruments, which under normal circumstances may be highly efficient, can under times of stress add to the transparency problems and making the future situation even more difficult to assess.

Collecting, collating and evaluating information on companies all over the world is no easy matter, but where technical, legal and financial matters are concerned there is nevertheless a fair amount of factual information, documentation and statistics available. In the case of ESG-related issues, however, the difficulties are usually greater. Insofar as reasonably reliable data exist at all, the problem has been the lack of measurement and valuation methods. In recent years, however, some important initiatives have been taken, particularly perhaps the *Global Reporting Initiative* (GRI), which has established an international platform for the reporting of such data.[1] Nevertheless, there is much to be done before data and information on environmental conditions and human rights compliance etc reach the same level of reliability and comparability as traditional financial data. In other words, the AP funds are facing a considerable challenge – as are other investors seeking to bring such aspects into their objectives, both in terms of developing a suitable approach and of finding practical, cost-efficient ways of dealing with this issue.

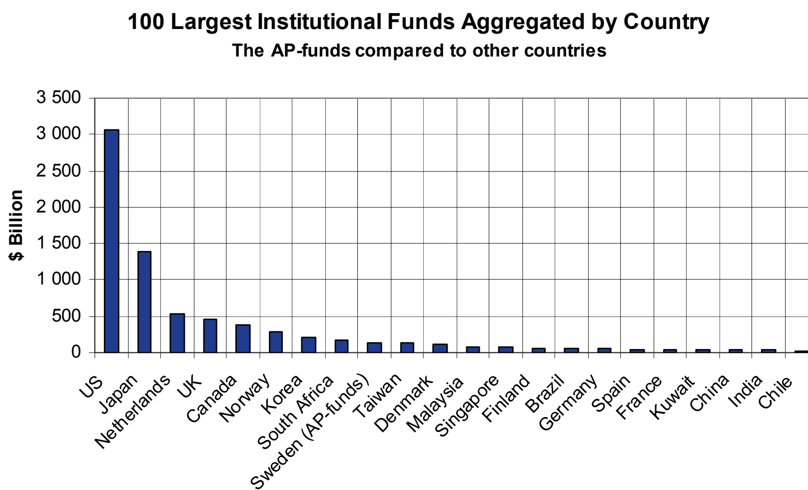
On 1 January 2008, the First-Fourth AP Funds' total assets were almost SEK 900 billion.[2] So very considerable financial resources are involved. This, however, is only a tiny share of the global capital market. This market can be defined and demarcated in a variety of ways, which means researchers tend to arrive at differing sums. According to the study commissioned for the purpose of this report[3], the total global capital market – in principle the sum value of outstanding shares, bonds and other securities – was worth USD 123.6 trillion[4] on 31 December 2007. Divided into two main categories of shares and debt instruments respectively, 31 per cent comprised the former and 63 per cent the latter. The study also presents two alternatives estimates, from the management consulting firm McKinsey and the New Zealand Superannuation Fund, that put the total global portfolio at USD 167 and 74 trillion respectively.

[1] The *Enhanced Analytics Initiative* is also worth a mention. This is a joint initiative for research into "extra-financial" data (www.enhancedanalytics.com) . For further details of the GRI, see *http://www.globalreporting.org/Home*
[2] Report on AP fund activities up to 31 December 2007 (Govt. Comm. 2007/08:130).
[3] Mercer: "Capital Markets Size and Participants and Responsible Investing for Large Institutional Investors". (Annex 4 to the report).
[4] One trillion = 1 000 billion.

At the end of 2006, the aggregate volume of "pension assets" – representing both public and private pension holdings – was estimated at USD 26 trillion dollars, i.e. just over 20 per cent of the total assets portfolio, based on the first of the above total figures. Of this, what are known as public pensions – i.e. the category to which the AP funds belong – accounted for two-thirds, or USD 17 trillion. This ratio has been stable for some time.

As regards the relative sizes of the various institutions operating in this market, US actors are easily greatest in number – 46 altogether – and largest overall. Their total management volume is over USD 3 trillion, compared with approximately USD 135 billion in the case of the AP funds (including the Sixth and Seventh Funds). In terms of investment management institutions operating in this sphere, the First-Fourth AP Funds are among the 100 largest in the world, at somewhere between 81st and 91st place on the list. Counting assets as a whole, they are in eleventh place in relation to their size.

Figure 2.1 The 100 largest institutional investors in the world, by national origin



Source: Mercer.

Going a step further and considering *public pension managers*, the Japanese pension fund was by far the largest actor in December 2006, managing an estimated USD 937 billion dollars. It is worth noting that the Norwegian pension fund[5] was the second largest, with some USD 286 billion dollars at its disposal. Individually, the AP funds are not among the ten largest public pension managers in the world, but if they were to be counted as a single entity they would rank sixth. Moreover, the report shows that Sweden is the only country with more than one public pension fund.

2.2 Some structural development features

Increased institutional ownership

In recent decades, financial markets have experienced vigorous growth and undergone a structural metamorphosis – what used to be a mainly national, protected and strictly regulated market is now international, competitive and controlled by market forces. Product development has been rapid, as has the development of the technology required to handle and distribute the services involved.

The increase in what is termed institutional ownership is one reflection of this change process. In the US in 1970, around 20 per cent of listed shares were owned by institutions. By 2005, the figure was over 50 per cent. A corresponding process has taken place in other developed countries, and Sweden is no exception. In 1950, approximately 75 per cent of the total stock exchange value was owned by private individuals and 25 per cent by institutions. In 1985, the figures were reversed. Private ownership then continued to decline towards the 15 per cent level. Since the turn of the century, it has stabilised at around 13–14 per cent. This is partly due to the internationalisation of the markets – foreign ownership rose dramatically from 1990 onwards and was to a great extent institutional in character. It is also due to changes in basic savings patterns in society, such as increased saving in various types of unit trust funds and mixed funds and by a move to insurance saving, all of which has added to the institutionalisation of stock ownership.

This development has meant that the basic conditions for managing companies has changed. The debate on corporate

[5] In essence, however, the Norwegian pension fund may, despite its name, be regarded as a Sovereign Wealth Fund, since it is concerned with the funding of oil revenue.

governance and corporate codes pursued in recent years has largely been about the need for active ownership. At the same time, unlike private individuals, institutions – such as an insurance company, a unit trust or a pension fund – do not manage or risk their own money but that of their customers and beneficiaries. Another fundamental aspect is that institutions are seldom majority owners, and are usually not interested in acquiring a controlling interest.

Active ownership is vital for both companies and for the business sector as a whole. If companies are increasingly owned by institutions, and these adopt a passive stance, there is a risk that senior executives will command too strong a position and therefore be less accountable, as illustrated by the "corporate scandals" revealed in different parts of the world in recent years.

"Universal Owners"

Active ownership is also becoming increasingly important for other reasons, especially for the large institutions. In contrast to small investors, these institutions cannot simply adopt a "buy-and-sell" approach in their operations, since their actions often have a direct impact on equity prices. Given this situation, a wiser course for a major actor may be to exploit its position as owner and seek to influence the company concerned, and in doing so improve the returns on its portfolio.

Another basic condition that distinguishes large institutions from small investors is that due to the size of volumes, the former find it difficult to apply a stockpicking strategy, i.e. to put together a portfolio by handpicking a fairly limited number of individual shares. Normally, an institutional investor is not inclined to become a majority owner of a company. Since the sums involved are very considerable, the money must necessarily be spread over a large number of companies – thus the term "universal owners".

Engaging in the active management of all these investments is seldom considered an attractive proposition from a cost viewpoint. Instead, the major institutional investors have chosen to focus increasingly on index portfolios, i.e. a broad selection of securities for, say, a country or a region. Also, larger or smaller shares of the total holding are often managed externally, i.e. they have been outsourced to other fund managers.

The rate of return obtained by an investor when "buying the whole market" will be determined by macroeconomic rather than company-specific developments. This also means – which is of considerable relevance to the sustainability debate – that if a company in the portfolio produces high returns but does so by operating in an environmentally harmful manner, this could mean that the costs are passed on to other companies in the portfolio, which then yield less and give investors smaller returns. Expressed in terms of economic theory, then, it could be said that a major institutional owner with broad ownership interests is motivated to take into account, or "internalise", what are known as external effects in a way that otherwise only the state would have reason to do.

The private equity market is growing

Another development that has significantly impacted on the capital market as a whole in recent years is the growth of what is termed the *private equity* market. Roughly speaking, the equity market can be divided into two parts: the public part where shares are traded on exchanges and on other organised market places, and the unlisted, private part. The latter involves firstly the typical, small family businesses, where the owners/entrepreneurs, their families and others close to them provide the venture capital, secondly it involves "venture capitalists" or venture capital companies seeking possibilities to finance companies in order to exploit restructuring and development opportunities. The key goal is to inject management and market expertise, and to optimise the borrowing ratio and the use of capital. Thus it may be considered expedient to invest in relatively small companies on the verge of a broader market breakthrough ("venture capital"). They can also engage in so called buy-outs, i.e. to purchase companies and, if they are listed, to de-list them. It is the latter type of activity in particular that has attracted attention in recent years, and it is often this that is actually meant when people use the term private equity.[6]

A number of different factors have driven the growth of the private equity market. In recent years, legislators and supervisory authorities have increasingly required public companies and marketplaces to be open and informative. While greater transparency is in itself a positive development, it not only entails

[6] In terms of volume, it is by far the dominant part. See for instance Annex 4.

administrative costs but also means that fleet-footed action may become more difficult, for instance when seeking to bring about structural change.

An active and efficient private equity market is crucial to the proper development of business and the economy as a whole, not least in providing a catalyst for vital structural changes. Private equity affords opportunities for what is termed alignment, i.e. identical aims between owners, governing boards and senior managers, which in certain situations can prove very valuable. At the same time, however, "privatisation" of the equity market makes it harder for investors and others to find out what companies are doing and planning, for instance in relation to ethics and the environment. It is interesting to note, however, that in response to growing pressure from the general public and the media, the industry – both in Sweden and elsewhere – is showing a greater willingness to improve transparency vis-à-vis the outside world and society, e.g. in respect of ESG issues. In the international market, moreover, there are a number of private equity funds with an explicit environmental or ethical profile.[7]

Since operating conditions differ, investors wishing to pursue a sustainability policy have to use partially different methods. They may for instance need to formulate demands and terms/conditions at the right point in the process, which is usually the investment point. Thereafter, they will have little opportunity to influence developments.

2.3 The scale of "responsible" capital

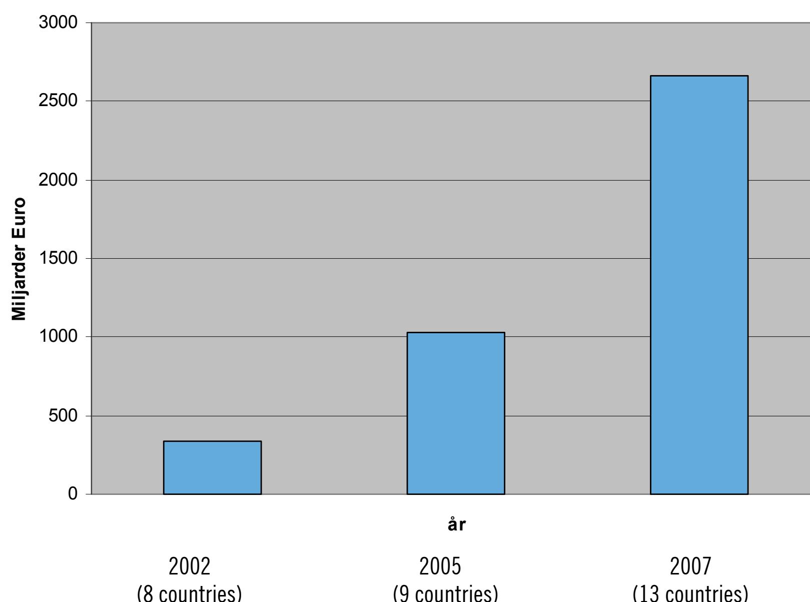
Mercer's report shows that in global terms, there has been a distinct increase in the volume of assets managed in accordance with explicit sustainability criteria of one kind or another. The two national markets in which activity is greatest are the Netherlands and the UK. Public shares are the asset category most frequently spotlighted, although sustainability criteria are also being applied more widely for other types of assets as well. As we have indicated, this is an important development in the ESG sphere – in time, consideration of ethical and environmental aspects may apply not only to listed shares but also to such areas as property investment. As regards private equity, in order to focus specifically on

[7] See Koedijk-Ter Horst (Annex 5).

sustainability aspects, the Dutch pension funds ABP and PGGM have established a new company, Alpinvest, that has rapidly become an important, large-scale investor in the market.

A report from Eurosif[8] shows that the volume of capital managed on the basis of “SRI criteria” amounted to almost USD 2.7 trillion in December 2007. This includes both what is termed “broad SRI”, which is easily the greatest proportion and which largely reflects the activity of institutional investors, and “core SRI”, which largely represents different types of ethical funds etc that mainly target private individuals.

Figure 2.2 Responsible investments in Europe, 2002–2007



Note that the levels in different years are not fully comparable, since additional countries have entered the picture over time.

Source: Eurosif.

As the figure shows, growth has been rapid. It should be noted, however, that the Nordic countries are included in the data for 2007, which was not the case in 2005. In comparisons between the same countries in 2005 and 2007, however, growth is still very

[8] “European SRI Study 2008”.

significant: 102 per cent in the space of two years. As a share of total fund assets, Eurosif estimates that this represents almost 18 per cent, in terms of the thirteen countries under review combined.[9] In the "broad SRI" category, the largest markets are in the UK, the Netherlands and Belgium. This category includes both outright exclusion strategies, engagement/dialogue and integration (of financial factors and ESG factors). Some actors use a combination of these approaches.

As we have observed, precise and fully comparable data are difficult to obtain as regards both the magnitude of investments incorporating sustainability factors, and trends in this respect. The main features, however, are fairly clear. On the one hand, it is still true that only a limited share of the investment volumes in the world and in Europe are managed in such a way that sustainability aspects are explicitly taken into account. On the other hand, the rate of increase is significant, both in absolute and in relative numbers, whether in terms of actors or of the sums involved.

In Sweden's case, Swesif has compiled data for the Swedish market, partly as supporting material for the European study mentioned above. Based on interviews with 73 companies/organisations, it has found that the sum of investments involving some kind of SRI approach was just over SEK 2 400 billion in December 2007, of which the overwhelming bulk (93 per cent) came from institutional investors. Over 60 per cent of the amount invested concerned listed shares, of which just under a half were Swedish. It is worth noting that a great majority of the funds interviewed said they had experienced a growing customer demand for investments based on sustainability criteria.

2.4 Swedish and international comparisons

As we have seen, the AP funds are far from being the only asset/pension fund managers to have begun working systematically with ethical and environmental aspects in recent years. In fact, trade analysts say that to a great extent it is the institutional investors who have driven growth in recent years.[10] It should be remembered, however, that all operate in more or less different

[9] Austria, Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland and the UK.
[10] See Annex 4.

ways and under different conditions. While comparisons are always interesting and often relevant, they must always be approached with a degree of caution. Sweden, for instance, as we have observed, is the only country with four public pension funds, while the public pension funds established in other parts of the world are dissimilar in many respects. Besides differing in size, they operate under differing degrees of political influence and different investment rules etc.[11] It should also be borne in mind that many countries do not have public pension funds of the same type as the Swedish AP funds. This of course reflects the fact that different countries have chosen to construct and organise their pension schemes in different ways.

Sweden

The institutions that are closest to the AP funds, in terms both of the amount of capital at their disposal and of the type of tasks they perform, are the occupational pension funds *Alecta* and *AMF*. One point on which they differ appreciably is in their investment approach. Unlike the AP funds, they do not concern themselves with index management to any great extent. Recently, both Alecta and AMF have begun working more actively with ESG issues as part of their investment policy. Their approach and attitude is very similar to that of the AP funds: that good returns are explicitly the overriding objective, and that investments in activities which conflict with fundamental ethical and environmental demands may endanger both long-term yields and the institution's own legitimacy as an investor. The funds draw on international conventions as a basis for their ethical and environmental considerations. They argue that since a very large percentage of the population are stakeholders in the fund, the values expressed in their ethics and environment policy must be broadly endorsed in society.[12] They differ from the AP funds primarily in that it was only in the last 1–2 years that they began working on these aspects.

Ethical funds of various kinds have long been operating in the Swedish savings market. These primarily target private individuals

[11] See for instance "Governance and Investment of Public Pension Reserve Funds in Selected OECD Countries" by Juan Yermo (OECD Working Papers on Insurance and Private Pensions No.15, 2008).

[12] Thus this is the same philosophy as that which the AP funds are guided by. (See Chapter 4).

and non-profit organisations. Funds such as *Robur* and *Banco* offer a variety of investment arrangements for different customer groups, each with a separate profile, and also produce customised solutions for organisations and others. Thus while their remits and their activities differ considerably from those of the AP funds, there are nevertheless similarities in the way they identify, analyse and utilise various types of "sustainability information". They work, for instance, with screening, both when searching out companies that do not meet requirements in environmental and ethical terms and when identifying companies that are industry leaders in terms of environmental endeavour, human rights and social responsibility.[13] They also work actively with ESG issues as part of their corporate governance activities.

Non-Swedish actors

An important actor – and one that has an explicit sustainability profile – is the *Norwegian Pension Fund* Utland (previously known as the oil fund). Strictly speaking, despite its name, this is not a pension fund – its revenue is derived from oil extraction and in contrast to the AP funds has nothing whatsoever to do with work income, labour market participation or the like. It has invested considerable resources in ESG activity, both in its analyses and in its corporate governance, and the fact that it is one of the world's largest institutional investors has of course strengthened its impact.

Since December 2004, the fund has been working with ethical guidelines laid down by the Ministry of Finance. It has adopted a three-pronged strategy comprising (i) active corporate governance based on the UN's Global Compact, the OECD guidelines for multinational companies and the OECD guidelines for corporate governance, (ii) negative filtering of companies that either themselves or via entities under their control produce arms which when used normally are in breach of fundamental humanitarian principles, and (iii) the option of excluding companies by their behaviour would represent an unacceptable risk in that the investor might be complicit in "particularly serious breaches of basic ethical standards", e.g. gross or systematic violations of human rights, serious damage to the environment, or severe corruption. In

[13] This is typically referred to as "negative" or "positive" screening, or "best-in-class". See Chapter 3.

August 2008, there were 27 companies on the blacklist. Since the fund does not invest locally in Norway, corporate governance is only practised in the case of foreign companies.

The Norwegian fund is not managed and organised in the same way as the AP funds. It is the Ministry of Finance that formulates the investment guidelines and excludes companies on the recommendation of an independent *Ethics Committee*. Corporate governance and the fund management work is the remit of the Norwegian central bank, *Norges Bank*. The Norwegian government has decided that the ethical guidelines will be evaluated in 2008 and that the outcome will be presented to the Storting (Norwegian parliament) in the spring of 2009.

Two pension funds that are frequently identified as leaders in the sustainability field are the Dutch *ABP* and *PGGM*. The ABP principally manages the pensions of Dutch civil servants, while the PGGM mainly targets health care service employees. Together, these two are responsible for managing about 40 per cent of all Dutch pension insurance capital. PPGM also sells services to other, smaller funds. In management terms, they adopt slightly different approaches. The ABP strategy is more stockpicking-oriented, while PGGM places the emphasis on index funds. Both funds, however, make active efforts in connection with ESG-related issues, working on both exclusion and corporate governance. They have their own resources for issues of this type (6–8 people), but also use consultants. Recently, they established a joint company – Alpinvest – through which to channel investments in private equity with an ESG profile.[14]

There are also a number of private or more independent funds that in managing assets on behalf of their customers – such as pension foundations – maintain an explicit sustainability profile. Two trend-setting examples are the British companies *Hermes* and *F&C*. Hermes is a subsidiary of British Telecom's pension fund and manages both its pension money and that of a dozen other major institutional customers. F&C has produced a wide range of ethical fund concepts, targeting both the "retail" market and the institutional market. Both companies invest quite significant internal resources – about 20 people each – in their work on ESG issues. One reason for this is that the quality of the data available for sale on the market is said to be sometimes poor. Also, as fund managers

[14] For a more detailed account, see "Today is Tomorrow", ABP Responsible Investment Report 2007, and Pensioenfonds Zorg & Weltzijn, Annual Report 2007.

they feel better placed to seek out information than independent analysts. As part of their management duties they are particularly concerned with pursuing dialogues on ESG issues. In the spring of 2008, for instance, Hermes engaged in active dialogues with over 200 companies.

3 The Toolkit

Over time, a number of methods and approaches have been developed that investors can use, either individually or in combination. The development of working methods in this sphere represents a learning process, which does not mean, however, that the most recently developed method or any specific method is "best" and should therefore be used by everyone in every situation. Together, the various methods represent a steadily expanding toolkit, and investors can use and apply whichever tool they feel is most appropriate for dealing with a given situation.

3.1 "Screening"

A common method for dealing practically with ethical and environmental factors in investment contexts is *screening*. This can be undertaken either by the investors themselves or, as is more often the case, by independent consultants. Briefly, it involves systematically searching through large amounts of information to find companies that manufacture products – such as liquor or arms – or use production or business methods – such as child labour or corrupt practices – that investors want nothing to do with. The search is based on information from companies, public agencies, the media, voluntary organisations and others that is constantly compiled, structured and updated. The AP funds for their part seek out companies that have violated or been accused of violating the international conventions to which Sweden is a party (conventions on such subjects as corruption, child labour, certain types of arms, discrimination, certain types of environmentally hazardous activity etc). The companies identified via this kind of filter can then be looked into further, and subsequently be targeted for lobbying/dialogue or for exclusion by the investor.

3.2 Excluding and including

Subjecting financial investments to ethical or other demands besides a high rate of return is nothing new. As early as the 1920s, the first ethical funds were set up by the American temperance movement. No investments were to be made in companies involved in the liquor or tobacco trade. A few decades later, similar demands were imposed, but this time focusing on companies that traded with the apartheid regime in South Africa or that manufactured arms used in the Vietnam War. In the 1980s and 1990s, the environment issue and environmental consideration began to come to the fore.

The principal line of approach in all these efforts was to financially boycott companies that manufactured or supplied products of a certain type, that used certain kinds of production methods or that operated in a certain country.

It is hardly surprising that the *"negative selection"* model was the first to be established and is still the most popular of all, especially among ethical funds, church communities, non-profit organisations etc. It is easily understood, transparent and, for many people, instinctively appealing. A natural reaction when faced with a company that is deemed to be producing harmful products or engaging in production methods you dislike is to not buy its products, to not own its shares and in general to have as little as possible to do with it. Blacklisting by an ethical fund or some other investment fund sends a clear – and public – message to the company concerned, and with luck can mobilise public opinion and initiate a process of change in the company. It can also have repercussions in the industry as a whole or in the market in which the company operates.

There are, however, certain problems and limitations involved. Actors who sell or refrain from buying shares firstly deprive themselves of the opportunity to exert influence on the company either individually or together with others – in practice, it is more like washing one's hands of the problem than trying to improve matters.[1] Secondly, it is not always easy to know where the line is to be drawn. How, for instance, are you to treat a company that only engages to a limited extent, or indirectly, in the kind of

[1] The negative selection approach adopted by most Swedish ethical funds is the subject of a critical study entitled *The Ethics of Investing. Making Money or Making a Difference? by Joakim Sandberg, Department of Philosophy, Göteborg University.*

production you dislike? Or a bank that extends credits to undesirable companies, or to these companies' suppliers? Investors wishing to keep their reputations totally unblemished may have to drastically reduce their range of options.

In parallel with the use of negative selection, increasing interest has been focused in recent years on ways of finding companies that stand out *positively* in one way or another, in terms of desirable values. These may be companies that actively encourage the development of gender equality, or that produce interesting environmental technology or the like. In recent years, a number of different methods and approaches have developed. One such is the method known as "best-in-class". It involves going through various risks and problem areas industry by industry and then trying to systematically determine which companies manage ESG-factors best. This is then used as a starting point when building up the portfolio. Without exception, it seems, investors applying the positive selection principle expect this method to yield additional returns.[2] Alternatively, the opposite approach can be used. Investors can move into "bad" companies where they perceive a potential and opportunities for improving ethical and environmental standards, which in turn creates the potential for higher returns – in other words, basically the same approach as is often adopted by venture capitalists.

3.3 Establishing dialogue and exercising influence

Responsible investment can also be encouraged by other means besides simply excluding or including companies in portfolios.

Owners of companies are usually said to have two principal courses of action open to them – "voice" or "exit".[3] Those who quite simply sell their shares if they are dissatisfied are applying the exit principle, i.e. voting with their feet. "Voice" implies active ownership – you vote for instance at the annual meeting or put forward your views in bilateral dialogues (the forum in which ethical and environmental issues are often raised) and seek to

[2] One example is Generation Investment Management, a company whose founders included former US vice president Al Gore. Its explicit business idea is that investing in a modest selection of companies with high environmental and ethical profiles will bring high returns.
[3] Economist Albert Hirschman, who coined the terms, also spoke of a third alternative that is highly relevant in this context, namely "loyalty", i.e. not taking any action at all,remaining loyal to the status quo. In other words, remaining passive.

persuade the company to alter course if you feel that something is wrong. Which route you take in a given case depends firstly on whether you see your holding as a purely financial investment or view it as a long-term commitment. Secondly, it is a question of whether you believe you genuinely have a chance of exercising an influence and what costs may be associated with such a course. Large shareholders, for instance, would probably find it more worthwhile to act at annual meetings than small shareholders.

This is also reflected in the way responsible investment is tackled. Ownership can be used as a platform for improving corporate activity in terms of ethics and/or the environment, and also perhaps, indirectly and in time, as a way of boosting your own rate of return as an owner. This approach is usually called *"engagement"* or *"dialogue"*, and in recent years it has become increasingly popular among investors wishing to invest "sustainably" or "responsibly". Where environmental and ethical issues are involved, such dialogues are often conducted with the portfolio managers concerned, and the annual meeting is used as an alternative should the dialogue not prove fruitful. Generally, dialogues are considered more cost-efficient and less combative than annual meetings as forums for exercising influence. Since dialogues with companies necessitate a degree of confidentiality, engaging with them individually in private may prove more effective than discussing the issues in a public forum, as long as the exchanges are felt to be sufficiently constructive. This is the approach that Swedish (and other) investors seem to prefer when interacting with portfolio managers on ESG issues. Occasionally, though, Swedish investors have used the annual meeting to raise environmental and ethical issues in a more general way – for instance in connection with a change at the top – so as to show that they consider them important.

In the US, for instance, in contrast to Sweden, it is fairly common for environmental and ethical issues to be raised at annual meetings, at least in the case of large companies. There, investors frequently bring pressure to bear on the company by means of "shareholder resolutions", which force the matter to a vote.

In discussing ethical and environmental issues with portfolio managers, investors are able both to engage individual companies on individual issues – by asking for instance why Company A lacks a long-term plan for reducing carbon emissions in its production – and to influence norms and standards relating to corporate

responsibility in a more general way, at industry level. Investors were active participants in the change process that caused companies to begin extending their CSR responsibilities so as to embrace their suppliers as well *(supply chain liability)*, a development that was not self-evident in the early 1990s.

Often, however, “exit” or exclusion is the only remaining alternative if a dialogue process appears doomed to failure. So this remains the last resort-option for the First-Fourth AP Funds.

3.4 Integration

Another aspect of responsible investment concerns the extent to which, and how, the outcome of traditional financial analyses and the assessment of ESG factors are brought together. In practice, investors who mainly apply the negative selection/exclusion principle have a blacklist of companies, industries or countries in which investment is prohibited and are then free to invest in whatever other company they choose, based on traditional financial criteria. Thus no integration is involved. ESG analyses and financial analyses are two separate processes.

The advent of positive selection principles and dialogues has highlighted the need to analyse what are termed the extra-financial aspects more closely and to merge this part of the analysis with the financial part. Thus interest in the *integration* of financial and non-financial analysis has increased, as has the motivation for moving in this direction. The trend towards greater integration also reflects the way perceptions of sustainability aspects in investment activities have changed and developed. From once having been seen as an annoyance or a burdensome task undertaken to keep the media at bay or to establish a moral or ideological position on a given issue, the inclusion of these aspects is now seen as a chance to secure business, to limit risks and to improve yields.

3.5 Traditional corporate governance

Being shareholders, the AP funds are able to directly influence companies, unlike environmental organisations and others seeking to exercise influence. Usually, owners practise corporate governance by taking part in annual meetings, at which they put

forward and vote for (or against) proposals concerning the various ownership issues on the agenda, such as the election of boards and auditors, dividend payments and other capital issues, and changes in articles of association etc. This could be described as the core element in corporate governance. As we have seen, investors wishing to address sustainability issues have not found that action at annual meetings or in election committees is the best course, for a number of reasons. This may be partly because dialogue, which involves meeting on a one-to-one basis, tends to be regarded as a more effective way of persuading companies to consider environmental and ethical issues. Alternatively, it may reflect a tendency to view these issues as being outside the range of subjects traditionally dealt with at annual meetings or in corporate governance. As these issues become increasingly important for the companies and for their image/value, there is reason to believe that this will also be the case as regards the tools they use. Over time, for instance, sustainable auditing is likely to become a self-evident, integral part of regular ongoing corporate governance and thereby have a natural place when owners come to evaluate a company's activities and elect the board.

3.6 Responsible investments and investment styles

In the field of financial portfolio management, investors have developed a number of approaches for selecting investment objects and putting together portfolios. These are commonly referred to as investment styles.

Choice of style is dependent on a number of factors: whether the investor is large or small, whether it is a private or a public institution, whether it has many customers, few customers or no customers, whether it maintains a high or a low risk profile, whether it has access to expertise of its own, and so on. To determine whether explicit consideration of sustainability aspects when investing is compatible, so to speak, with the investment styles currently established in the market, the Committee has ordered a special study.[4]

In theory, there are countless ways of managing a portfolio. A number of common approaches are described in the following.

[4] "Förvaltning av aktieportföljer" (Managing Portfolios), by Erik Sjöberg. Annex 2 to the report.

Traditional, basic, non-systematic investment management

Managing a portfolio by selecting a small number of shares without giving much thought to what the comparative index looks like or what kinds of systematic risks may develop could be described as "traditional, basic, non-systematic management". This style of management is particularly common in the case of small companies, where many investors are deeply suspicious of the market indexes available.

This approach is highly suitable for weighing in SRI criteria. A well-known example is Generation Investment Management, which takes the view that compliance with SRI criteria boosts returns.

Traditional basic analysis combined with a degree of risk control

The first departure from the above approach came when funds began to keep track of index levels on an ongoing basis, i.e. monitoring how each company was performing in the index. This information was subsequently worked into internal portfolio systems, which meant that funds were constantly aware of whether they were overrated or underrated in comparison with the index. This approach has gained ground among numerous funds, including most of the major Swedish ones, as a result of which portfolio managers have become keenly aware of what the index looks like at any given time, and adjust their positions accordingly. This has led to a decidedly index-like style of management.

A relatively unsystematic approach such as this, however, is also suitable for applying SRI criteria. One good example in Sweden is Robur, which operates relatively close to the index and which has internal SRI analysts on its regular staff.

Traditional analysis of systematic factors ("top down")

Traditional analyses of systematic factors can take different forms. One approach is to build analyses on a traditional macroanalysis of economic cycles, interest rates and prices, and on the basis of this to choose different weights for different markets or sectors. Another alternative is what is termed thematic investment, which involves identifying global themes that may impact on different sectors. An example in point might be "rising commodity prices".

The focus in this approach is on macrotrends or thematic trends, so little effort is put into analysing individual companies.

Normally, managers adopting this approach have little interest in individual companies except as representatives of a specific sector or market. This means it is sometimes difficult to bring SRI criteria into the equation, especially if the manager works with pure index instruments. Probably, however, those applying this method will be able to blacklist a limited number of companies.

Systematic portfolio management based on traditional analysis

Nowadays, a growing number of the leading international investment funds are combining traditional basic analysis of companies with an extremely systematic and quantitatively based portfolio construction.

The task of the analysts is to continuously rate the performance of the companies under review by awarding grades. These grades are then passed on to the portfolio constructors, who are often engineers well versed in the ins and outs of risk and optimisation systems. The grades are fed into these systems.

Funds adopting this approach in their work include Fidelity Institutional, Citigroup and JP Morgan Chase. If SRI criteria are to be taken into consideration using this type of approach, there are primarily two courses of action to choose between: (i) blacklisting, which is simple and cheap to apply, or (ii) weighing SRI criteria into the share analyst's grade, which probably – in what are often very large analytical organisations – is both expensive and extremely demanding in scope.

Quantitative management focusing on stock selection

Managing active global and regional portfolios using a quantitative, computer-based approach has become increasingly popular in recent years. One of the advantages of this approach is the possibility to examine many more companies than a traditional, basic analysis organisation has time for. One is also forced to work systematically in your analyses. Many of the managers working in this way have regularly obtained yields above the index level.

The quantitative factors employed in such contexts vary considerably. Some are associated with basic corporate data such as profit growth, substance and so on. Others may be more in the nature of technical analysis and have to do with momentum – i.e. a share that has begun to move continuing in the same direction. Indicators based on what is termed behavioural finance can also be used as quantitative alpha signals.

The largest actors in the field of quantitative management are also the largest in the index management field, i.e. Barclays Global Investors (BGI), State Street Global Advisers (SSGA)and Goldman Sachs. Among Swedish actors, quantitative methods are used in the management of both SEB's and Skandia's global funds.

SRI criteria can be applied in a fully integrated way. SSGA, which for instance manages a European portfolio quantitatively, is a case in point. Besides the usual financial, quantitative alpha signals, it adds in an SRI rating from the consultants Innovest. SRI criteria thereby become a fully integrated alpha factor when portfolio decisions are made.

Passive management – index management

Passive management means that the manager only tries to emulate the index, not to surpass it. The investment fund industry is fairly unique in that it represents a highly cost-efficient way of achieving precisely the average rate of return industry-wide. Often, it yields slightly higher returns, after costs.

In the US, index funds have secured a relatively large share of the market, while in Sweden they have only a very limited share. Among large capital owners (such as the AP funds and life insurance companies), however, indexing is a fairly common practice.

When engaging in index management, choice of index is obviously crucial. MSCI World Developed Markets, for instance, which is the global index in general use, covers about 1 500 of the 40 000 fund management companies currently operating around the world. In terms of market value, however, it has only about 70 per cent of the total global sum, based on the index. Consequently, indexing against this widely used index leads to severe underexposure vis-à-vis smaller companies, especially in growth markets.

Where SRI criteria are concerned, it is usually fairly simple to implement an outright blacklisting approach, whereas a "best-in-class" approach is virtually impossible, due to the fact that it is basically incompatible with an index approach.

Passive management – plus "enhanced indexing"

Over the past 5–7 years, indexing customers have become increasingly interested in trying to derive a certain amount of added value by a limited, controlled deviation from the index. Enhanced indexing could be regarded as quantitative management with a lower rate of deviation from the index. A typical aim here is to seek to surpass the index by one per cent with an active risk of the same size, one per cent. In this type of management – as in regular quantitative management – SRI criteria could be implemented.

As we have seen, there is an almost infinite variety of approaches to use when managing portfolios. Some conclusions are as follows:

- A traditional, basic, non-systematic management approach is eminently suitable for SRI criteria
- A traditional, basic approach with a degree of risk control is also suitable for SRI criteria
- A top-down approach is less suitable for SRI criteria, since the focus is not on company analysis
- Systematic management based on fundamental analysis is less suitable since the injection of SRI criteria would probably be both expensive and demanding
- Quantitatively based management is eminently suitable for SRI criteria
- Index-based management presents difficulties, especially with a "best-in-class" SRI strategy
- An enhanced indexing strategy could implement SRI criteria in the same way as quantitative management.

4 The AP-Funds and sustainability

The Committee's assessment: There are similarities in the way the various funds tackle sustainability issues, but also differences. The attitude of senior management has been crucial in determining the extent to which the funds have focused attention on ethics and the environment. The Ethics Council has made a valuable contribution in that activity vis-à-vis foreign portfolio companies has increased while at the same time environmental and ethical issues have acquired greater internal legitimacy in the funds. The lack of internal resources for dealing with ESG issues, however, may prove a problem, as may the funds' dependency on consultants.

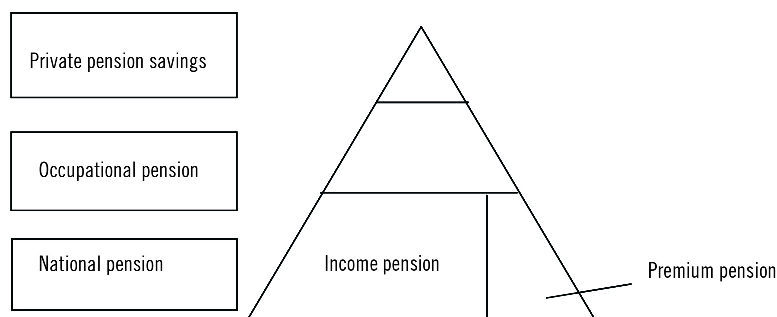
It is difficult to draw any firm conclusions as to how consideration of environmental and ethical factors may affect returns or affect the portfolio companies' work in this area. There is, however, more to suggest that it would impact positively on returns than negatively. An ESG-oriented management approach, therefore, cannot be said to conflict with the overall objective of a high rate of return. The AP funds' work on ESG issues does affect the behaviour of the portfolio companies, but to a limited extent. However, the funds, along with other institutional investors, are helping to move developments forward.

4.1 The function and role of the AP funds in the pension system

The First-Fourth AP Funds

The Swedish pension system is usually described as a three-tiered pyramid. At the base is the national pension, which in turn is divided into two, with the greater part in the form of income

pension and the lesser part in the form of premium pension.[1] The middle section comprises occupational pension and the top section pension savings.



The AP funds are active in the bottom third, where the First-Fourth AP Funds (and also the smaller Sixth AP Fund) deal with income pensions and the Seventh AP Fund deals with premium pensions, primarily on behalf of those who have not chosen another, private manager under the PPM (Premium Pension Authority) scheme.

Every month, the country's employers contribute 18.5 per cent of their employees' pensionable income to the system. Of this, 16 per cent goes to the First-Fourth AP Funds, in four equal shares, and 2.5 per cent to the premium pension. In money terms, this amounted to SEK 190 billion and SEK 28 billion respectively in 2007. Thus the amount paid in on behalf of each individual – and which decides how much pension that person will ultimately receive – depends on his/her income.

Where the greater part is concerned, i.e. income pension, the money is not left lying in an account – under the Swedish system, incoming contributions finance current pension payments. This is usually referred to as a "Pay As You Go" – system. Thus today's labour force pays for today's pensions.

[1] In addition, for individuals who have had either no income or very little, there is a public guarantee pension financed out of tax revenue.

The money paid in is translated into pension rights, representing a claim on a future pension. The size of the pension subsequently received depends partly on the size of the contribution paid in on the person's behalf and partly on an annual adjustment of the sum, based on general wage growth. Thus a basic principle of the system is that pensions and wages grow at the same pace over time.

If the number of gainfully employed declines, due for instance to a lengthy recession or for demographic reasons, problems may arise: the system's expenditure may outstrip revenue and pensions and wages will no longer be able to keep pace. In the long run, of course, this is untenable, which may force the triggering of an automatic balancing process, rather flippantly referred to as "the brake". This involves reducing the upward adjustment of pensions and pension rights to whatever extent is needed to redress the balance between assets and debts.

One of the principal tasks of the First-Fourth AP Funds is to channel the regular flow of contributions to the social insurance offices for distribution among the country's pensioners. The funds' other main task – which is the most important of all – is to act as a financial buffer in the system. This buffer – totalling almost SEK 900 billion – is designed to parry the fluctuations in the balance between incoming contributions and pension payments.[2] In 2007, pension payments totalled SEK 187 billion, i.e. slightly less than the contributions paid in. In other words, the buffer grew somewhat in 2007, interest on capital not included. When large cohorts retire, however, the buffer will have to be used. Within a year or two, or perhaps a little later, current payments in the system are going to exceed incoming contributions when the large post-war generations begin drawing their pensions.

The principal task of the First-Fourth AP Funds (and of the Sixth AP Fund) is to manage this financial buffer so as to ensure as high a rate of return as possible and thereby ensure both stability in the pension system and good pensions. The returns achieved to date have meant that no automatic balancing has been needed, although such a move was placed on the agenda on a number of occasions.[3]

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[2] This corresponds to just under 13 per cent of the system's overall assets (SEK 7 014 billion) on 1 January 2008. During the first half year of 2008, the four major buffer funds' total managed assets fell to SEK 806 billion, chiefly because of the international stock-market slump.

[3] Govt. Comm. 2007/08:130, p 228.

To ensure good returns, the money is invested in a range of different assets. These investments must comply with certain rules laid down by the Riksdag (Swedish parliament), as follows:

Summary of the First-Fourth AP Funds' investment rules

Type av instrument	*Permitted investments*
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.

The Seventh AP Fund

The Seventh AP Fund does not manage "buffer money". In principle, premium pensions are a traditional, individualised form of (funded) savings, primarily for citizens who have not chosen private fund managers in the PPM system. The aim, however – achieving a high rate of return on the money invested – is the same as for the buffer funds. On 1 January 2008, total capital invested in the Premium Savings Fund was just over SEK 87 billion. The Seventh AP Fund also administers another fund, the Premium Choice Fund, which can be chosen by customers in the same way as other funds in the PPM system. Invested capital in the Premium Choice Fund was SEK 2.6 billion. Of all capital invested in the PPM system, the Seventh AP Fund's two funds accounted for almost 30 per cent at the end of 2006.

As we have seen, there are five funds in all, each managing a part of the buffer in the income pension system. In principle, this task could be performed by one or possibly two of the funds, which would probably reduce overall management costs. For various reasons, however, the Government and the Riksdag have chosen to spread the task among a greater number.[4] When there are several funds, and their investment outcomes and costs can be compared, this forces management to be efficient. Secondly, where there are a number of funds working and investing in different ways, this spreads the risk in the system to some extent.[5] Thirdly, dividing the task between several funds makes it less likely that an unwanted concentration of financial power will develop.

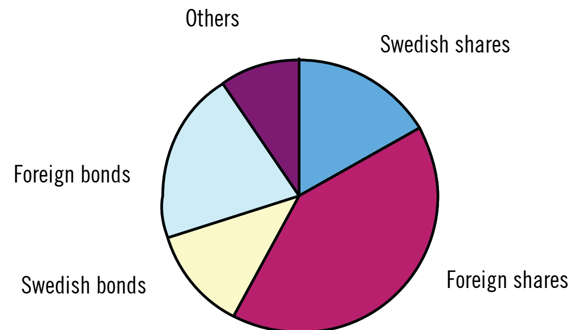
Which assets?

The First, Second, Third and Fourth AP Funds, then, have identical tasks, and all manage mixed, widely dispersed, global portfolios of shares, interest-bearing instruments and other assets. In terms of the types of assets, shares dominate, while in terms of market volume, foreign holdings are larger than Swedish holdings.

[4] Managing unlisted shares in a separate fund is common practice in the private market, and may therefore be appropriate here as well.
[5] In a study commissioned as a basis for the Government's evaluation of the AP funds' activities up to 31 December 2007, it was argued that in practice the degree of risk diversification was too little, due largely to the general investment rules being too retrictive. The author felt, therefore, that the investment rules should be significantly liberalised. (Govt. Comm. 2007/08:130, Annex 8).

Different funds focus on different types of assets – which in fact is the point, the aim being to achieve a degree of risk diversification. It is worth remembering, however, that the differences are not very great. The proportion of shares varies between approximately 59 and 65 per cent.[6] The composition of the portfolios, however, is highly varied. Management approaches are also fairly dissimilar.

Figure 4.1 Assets of the First-Fourth AP Funds, by type (31 December 2007)



Source: Government communication 2007/08:130.

Table 4.1 Rate of return on buffer funds, after costs, 2003–2007 (per cent)

	2003	*2004*	*2005*	*2006*	*2007*
Nominal rate of return	16.4	10.9	17.4	10.7	4.2
Real rate of return	14.9	10.6	16.4	9	0.7

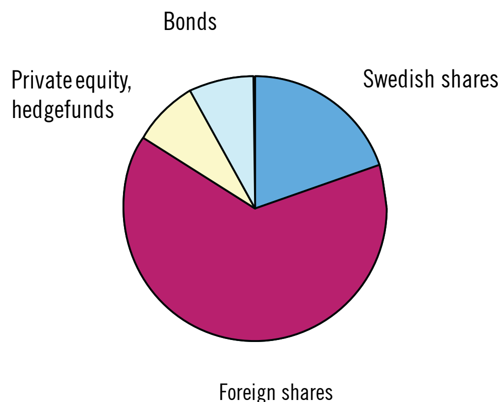
The buffer funds are the First-Fourth AP Funds, the Sixth AP Fund and the two “phaseout funds”.
Source: Government Communication 2007/08:130.

The Seventh AP Fund does not invest in the same way as the buffer funds, since its remit is different and it operates under different investment rules. In practice, this means that its portfolio

[6] Govt. Comm. 2007/08:130, p 230.

is totally dominated by shares. In comparing returns, other funds in the PPM system are a more natural alternative than the buffer funds.

Diagram 4.2 The Seventh AP Fund's normal portfolio (Premium Savings Fund), 31 December 2007



Source: Government Communication 2007/08:130.

Table 4.2 The Seventh AP Fund's rate of return (Premium Savings Fund), after costs, 31 December 2007 (per cent)

	2003	*2004*	*2005*	*2006*	*2007*
Premium Savings Fund	18.7	10.1	25.1	10.5	4.7
PPM index	16.2	8.8	32.4	13.0	5.8
Difference	2.5	1.3	-7.3	-2.5	-1.1

NB The PPM index gives the average rate of return for all funds in the premium pension system.
Source: Annual report of the Seventh AP Fund, 2007.

4.2 Organisation and governance

Each buffer fund is managed by a nine-strong board, each member of which is appointed by the Government. Of these nine, four are appointed on the recommendation of the social partners – two by the trade unions and two by the employers. On principle, however, the employers do not formally nominate any members. Instead, they offer the Government informal guidance as to who they

consider suitable candidates. The posts of chair and deputy chair are reserved for representatives not affiliated with any organisation. The board appoints the CEO. The same procedure is used in the case of the Seventh AP Fund, except that none of its members are nominated by the social partners.

Besides appointing board members (and auditors), the Government has no formal means of influencing the day-to-day activities of the funds. It does, however, evaluate the funds' operations and results, and brings them before the Riksdag. The Government is also required to formally sanction the funds' income statement and balance sheets.

One of the tasks of the board is to plot the fund's strategic course. A key part of this strategy is the choice of what is called the reference portfolio (or normal portfolio). In determining which reference portfolio to use, the board takes advantage of asset and liability (ALM) analyses, which study the correlation between a fund's commitments and various portfolio structures. Another aspect to be determined by the board is which guidelines to apply when the strategy is implemented. The law requires each of the First-Fourth AP Funds to adopt a business plan each year containing guidelines both for their investment activities and for the way they exercise their vote in individual companies, and also containing a risk management plan. The risk management plan must describe the principal risks associated with the investment operations and how these are dealt with. In addition, internal instructions must be available for the management of these risks. The board must also follow up the risk management plan and the instructions on a regular basis.

In addition, the board decides questions concerning the administrative structure for the implementation of the strategy. A further part of the board's remit is to establish the objectives and tasks of senior management in terms of asset distribution between categories and markets, to decide what proportion of the fund's assets are to be outsourced or managed internally, and to determine the extent to which assets are managed actively or passively. While retaining overall responsibility, the board largely delegates actual implementation to senior management. Based on the board's guidelines, senior management then decides how the day-to-day work is to be carried out.

Internally, the funds are organised slightly differently, but they are similar in their overall structure, partly comprising a number of

units that invest and manage holdings and partly comprising business support units. In 2007, the First-Fourth AP Funds employed 188 people and internal costs totalled SEK 570 million. The Seventh AP Fund had 17 employees and internal costs of SEK 113 million. All fund management offices are situated in Stockholm, except for those of the Second and Sixth AP funds, which operate from Gothenburg.

4.3 Security, returns and other goals

The Swedish National Pensions Fund Act states that the AP funds *"…. are to manage their fund capital so as to ensure maximum benefit for the insurance of income-related retirement pensions. The funds' investments are to maintain a low level of risk. The fund capital is to be invested, at whatever level of risk is chosen, in such a way that a high rate of return is achieved in the long term".*

While the law itself says nothing about ethical or environmental considerations, these aspects are raised in the preparatory documents, in the government bill and in the report of the Parliamentary Committee on Finance dealing with this subject.[7]

The government bill states for instance that the AP funds must *"in the long term maximise the return in relation to the investment risk"* and that *"the total level of investment risk must be low".* The bill further states that *"Given their role as managers of public pension funds, the (AP) funds must act in such a way as to promote public trust. Ethics and environment are to be taken into consideration in investment activities without deviating from the overall objective of a high rate of return".* There is nothing in the text to show what considering ethics and environment actually means specifically, or what it might mean.

The Parliamentary Committee on Finance states in its report that the AP funds *"…should take environment and ethics into consideration"… "without however deviating from the overall objective of maximum return".* Responding to motions from the Left Party and the Greens calling for more specific guidelines on how the objectives concerning ethics and environment were to be interpreted and applied, the committee stated that *"responsibility for carving out the funds' profiles should lie primarily with the individual fund boards".*

[7] 2000:192 Swedish National Pension Funds Act (AP Funds), Govt. Bill 1999/2000 The AP Funds in the Reformed Pension System, FiU 1999/2000:19.

It also added that this *"does not prevent the Government, in its annual evaluation of progress…from clearly defining its views on how the ethics and environment objectives should be formulated and realised".*

Responding to the Government's evaluation of the funds' activities up to 2003, the committee returned to the question in a report[8], noting that it *"…assumed that in future evaluations the Government would…also evaluate the impact of the funds' ethics and environment guidelines".* The Government discussed the issue in a later evaluation study[9] in which it declared that an evaluation such as the one called for by the parliamentary committee would be undertaken by a public inquiry.

Based on what has hitherto been a fairly limited discussion of the matter, it is clear that the Government and the Riksdag have explicitly defined a high rate of return as being the fundamental operative objective for the AP funds. They are not expected to forgo potential returns for the purpose of realising ethical, environmental or any other goals. Nor are they expected to weigh these goals against one another. The phrase *"without deviating from"* cannot be interpreted in any other way. In fact, this is what the funds themselves have taken it to mean. Thus ethical principles and environmental aspects are to be taken into consideration *as part* of the objective of a high rate of return, not as an alternative to it.

It is also worth noting the considerable extent to which the fund boards are given responsibility for formulating policy and strategy in general. The bill states for instance that:

> the pension system is autonomous and is to maintain a high level of independence vis-à-vis the Government. The boards of directors are to be fully responsible for investment activities. Activities should only be regulated by law. The Government should not be given the opportunity, whether through instructions, appropriation directions or the allocation of funding, to control the funds, over and above what follows from the right to appoint boards. It goes on to state that "The amount of invested capital and the nature of the activity also imposes a heavy burden of financial responsibility on the fund boards....the arrangement whereby the board has full and sole responsibility for the activity should be retained...[10]

[8] Report on the Activities of the AP funds, 2003, 2004/05:FiU 6.
[9] Govt. Comm. 2005/2006:210.
[10] Govt. Bill 1999/2000:46, p 121 f.

Consequently, much is required of the board members. The bill states *that "all members are to be appointed on the basis of their personal skill in promoting fund management"*. This is qualified in the case of four of the nine board members, however, since they are nominated by the social partners.

4.4 How the AP funds engage with ESG issues

The AP funds were instructed to take ethics and the environment into consideration in their investment policies when the new pension system and the new fund structure were introduced in 2000. The Seventh AP Fund began working with policy on the basis of this new remit, and developed what has come to be known as the convention basis (see below). Each of the First-Fourth AP Funds has since come to work on this basis as well. Today, in working on their international portfolios, the First-Fourth AP Funds have established a form of cooperation via the Ethics Council. When working with Swedish companies on sustainability issues, however, the funds act individually, since they are required by the Government and Riksdag to be independent and also, in a sense, to compete with one another.

Different methods and procedures

Naturally, there are clear similarities in the way the funds deal with sustainability issues, but there also dissimilarities in their work approaches and in their ambitions in certain areas. To some extent, these differences are due to the fact that they had – and still have – slightly different profiles in their allocation of assets of various types. In the case of the Seventh AP Fund, the situation is different in that, unlike the others, it is a buffer fund with mandatory membership, and that due to the way its rules are formulated it has no voting rights in respect of its Swedish shares. In addition, it is fair to say that not all the fund boards and senior managers have shown the same interest in sustainability issues, nor the same level of commitment. This of course has affected what has been done and what has not been done. It would seem, however, that there has been some convergence in this respect over time, fuelled by a rising level of ambition.

The following chart gives a rough idea of how the funds are working today and what instruments they are using:

SWEDEN	AP1	AP2	AP3	AP4	AP7
Own ESG analysis	Limited	Yes	Limited	No	Limited
Purchased screening/analysis, no of consultants	Yes, 1	Yes,2	Yes, 1	Yes, 1	Yes,2
Dialogue with enterprises	Yes	Yes	Yes	Yes	Yes (usually ent's initiativ
ESG follow-up unlisted ents	No	Yes, in new agreements		No	
Vote at AGMs (no. of times 2008)	47	52 (07)	42	67	No
Public ownership policy	Yes	Yes	Yes	Yes	
Public reporting of ESG action	Yes	Yes	Yes	No	
Policy on remuneration	Yes	Yes	Yes	Yes	Yes
"Lobbying" on shareholding issues	Yes	Yes	Yes	Yes	Yes
EXTERNAL					
Own screening	No	No	No	No	No
Purchased screening	Yes	Yes	Yes	Yes	Yes
Dialogue with enterprises	Yes (via the EC*)	Yes (via the EC)	Yes (via the EC)	Yes (via the EC)	Yes
Exclusion of enterprises	Yes	Yes	Yes	Yes	Yes
Votin, Foreign enterprises	Yes, to a ltd ext	Yes	Yes	Yes, to a ltd ext	No
ESG follow-up, unlisted ents	No		Yes, i new agreement	Yes (in ags)	No
ESG follow-up, external managers	No	Yes	Yes, to some extent	Yes (in ags)	No
"Lobbying" on shareholdng issues	Yes, via ER and PRI	Yes	Yes	Yes, via ER	No
INTERNAL					
Policy/programme for integrated management	Under discussion	Yes	Yes, to some extent	Under development	No
Participation in international networks	PRI, CDP	PRI, ICGN, GIGN, CDP, informal networks	PRI, CDP, amnesty Business Group, informal networks	PRI, ICGN, CDP	PRI, CDP

Basic values and conflicting objectives

Where basic principles are concerned, none of the funds has developed an “individual” set of values defining its investment activities and embracing ESG issues. On the contrary, the funds have been unanimous in viewing themselves as part of the Swedish state, and therefore regard the “ethics of the state” as theirs, too. This has been operationalised in the form of the convention basis, which means that all consideration of the funds’ financial commitments from a sustainability viewpoint is to be based on the international conventions to which Sweden is a party.

The funds, like other institutional investors, argue that while responsible investment as an approach has grown rapidly and is accelerating, it is still at an early stage of dynamic development. In their view, by international standards the Swedish funds are well to the fore in tackling these issues. This view, however, is not fully shared by the international actors with whom the Committee has been in contact. Some have felt that the AP funds maintain a lower profile and play a more anonymous part than they are capable of. It is primarily the Seventh AP Fund and the Second AP Fund that have established external profiles – the Seventh AP Fund as something of a “first mover” in this sphere and the Second AP Fund as an active participant in both international cooperation efforts and the international discourse.

The convention basis

In their work with environmental and ethical aspects of investment, whether this involves exclusion/negative selection or dialogue with companies, the AP funds proceed from and are guided by the international conventions that Sweden has signed and that are relevant in this connection. There are approximately 140 international conventions to which Sweden is a party. Some of the more important ones are:

- Child labour (ILO Convention 138, Recommendation 146, 182 and the UN Convention on the Rights of the Child)
- Forced labour (ILO 29 and 105)
- Health and safety (ILO 155 and Recommendation 164)
- Freedom of assembly and the right to organise (ILO 87, 98 and 135)
- Discrimination on the grounds of gender, race, age or religion (ILO 100 and 111, and the UN's Universal Declaration of Human Rights)
- Working hours (ILO 1, 14 and 106)
- Convention on Long-range Transboundary Air Pollution
- The Montreal Protocol 8 (8)
- The UN Climate Convention
- The Helsinki Convention
- The OSPAR Convention
- The Convention on Biological Diversity
- Conventions on the use of certain weapons
- The OECD Convention against Bribery and Corruption
- The UN Anti-Bribery Convention
- The UN's Universal Declaration of Human Rights.

On the whole, it is the attitude of senior management that has determined how and to what extent the AP funds have dealt with ethical and environmental issues. In our opinion, the boards have shown an interest and kept abreast of developments, but except in the case of certain committed individual members, we have the firm impression that it is not they who have carried the issue forward. On the other hand, the managers have yet to assimilate these aspects into their regular analyses and investment decisions. Moves are, however, being made in this direction, and some funds

seem to have progressed further than others. Another common feature is that very few resources have been set aside internally for work on ESG issues – such activity is confined more or less to a part-time task for a handful of people in each fund. In practice, all the investigative and analytical work – with the exception of the Second AP Fund, which specifically devotes analytical resources to this task – is largely in the hands of a single consultancy firm that all the funds use.

Methods and tools

As we have seen from the above, the funds use a number of instruments, or tools, in their efforts to implement a responsible investment policy. All the buffer funds, i.e. the First-Fourth AP Funds, play an active ownership role at annual meetings and on election committees. They have developed and documented ownership policies and published owners' reports. We have noted, for instance, that in recent years, based on their ownership roles, they have frequently been proactive in seeking to bring remuneration issues onto the agenda, together with other investors.[11]

The amount of corporate governance work undertaken in the various company bodies, however, varies quite considerably. It depends in part on how many companies (especially Swedish ones) the fund has a shareholding in, how large that holding is and to what extent the fund is active in managing it.

As we have seen, there are basic similarities and basic dissimilarities in the methods and procedures of the four buffer funds on the one hand and the Seventh AP Fund on the other, due in part to differences in their regulatory frameworks. As already noted, they are the same in that all base their endeavours on what is known as the convention basis. They differ in that the First-Fourth AP Funds engage in – and have placed greater emphasis on – dialogues with companies that they consider problematic in some respect, based on the conventions, while the Seventh AP Fund applies an exclusion strategy. It should be pointed out, however, that neither of these approaches is totally coherent. There are, for instance, elements of dialogue in the Seventh AP Fund's communi-

[11] The Seventh AP Fund has also developed an ownership policy that deals with such issues as compensation, despite the fact that it has no voting rights at annual meetings. Its representatives are, however, allowed to attend and to express their views, which they have made a point of doing.

cation with blacklisted companies or companies threatened with exclusion, where these are told what they need to do to avoid being excluded or to be restored to the Seventh AP Fund's "universe". The First-Fourth AP Funds, for their part, use exclusion as a last resort in cases where dialogue is deemed fruitless.

The funds take an active part in the PRI and other international investment networks. In specific cases, they seek to build alliances with other investors.

Their strategies vary somewhat as regards the dissemination of external information, depending partly on what procedures they have chosen in this respect. For an investor like the Fourth AP Fund, for instance, which devotes considerable resources to election committee work, acting via the media is not a natural part of its strategy. For the Seventh AP Fund, which under current regulations is not permitted to participate in election committees, opinion-making efforts are a more natural course.

All funds report their activities as part of their corporate governance reports and/or their annual reports. The First-Fourth AP Funds also include the reports provided by the Ethics Council to foreign companies. As regards the question of how "offensive" the funds are supposed to be in their external information, this largely depends on their strategies and approaches, which differ. One of the principal strategies could be described as "silent diplomacy" and is represented most markedly by the Third AP Fund and the Fourth AP Fund. The aim here is to engage in discussions with the company concerned, based on mutual trust, in order to bring about improvements. The other main strategy may be labelled "name and shame". This is used principally by the Seventh AP Fund, the idea being to force the company to improve its behaviour by threatening to publicly blacklist it or exclude it. It is difficult to say which course is best. The funds do, however, stand to gain by trying out different approaches and strategies. As time passes, this will help them arrive at firm conclusions as to what is the most appropriate course of action in a given situation.

4.5 The Ethics Council

In 2006, the First-Fourth AP Funds decided to coordinate their procurement of ethics consultancy services. Initially, the purpose was to make the procurement process more efficient and save

costs. During the process, however, the realisation grew that more far-reaching cooperation would be useful. The funds also concluded that such cooperation would not conflict with their parliamentary remit, according to which they are to compete internally. Here, it should be noted that the Ethics Council only concerns itself with the funds' foreign holdings – ethics and environment issues relating to Swedish companies are dealt with exclusively by the funds themselves on an individual basis. Here, too, however, all are served by the same consultant as works for the Ethics Council.

The committee is comprised of one representative from each fund and each member is entitled to a deputy. The chair alternates between funds. The Ethics Council has no administrative resources of its own and does not engage in any analytical work. The individual members, however, work actively, and each is responsible for pursuing certain specific dialogues. Background documentation is produced by the consultant (GES) brought in for the purpose, and the consultant also has a secretariat function for dialogues and for other kinds of communication with companies.

The analytical work is in three stages. The first step involves systematically gathering intelligence about a large number of companies – some 3 500 in all. Sources include the media, stakeholder organisations and UN agencies. The overwhelming bulk of companies monitored or "screened" in this way are listed companies. Unlisted companies are, almost by definition, much harder to monitor, at least using a method such as this. To the extent that the AP funds invest in foreign private equity companies, they impose ethics and environment demands on them as well, but it is more difficult to obtain information from them and to influence them.

The second stage involves selecting about a hundred companies for a more in-depth scrutiny, based on reported claims that they could be violating international conventions. In the third stage, 20–25 companies are identified as having definite, well-documented problems. The Ethics Council then chooses 10–15 with which to engage in active corporate governance work and dialogue. The list is reviewed once every six months. To ensure that the information is of the required standard, industry experts are brought in when needed. However, no previously allocated resources are available for this. Instead, the funds have to finance input of this kind each time it is required.

The selection process is based on an assessment of how serious the reported incidents are, rather than on the size of the holding. Another factor is the question of whether it is felt the incident is a one-off occurrence or a result of more systematic behaviour.

In early 2007, the Ethics Council chose to focus attention on twelve companies. Later, a further two were added to the dialogue. In a number of cases, the Ethics Council collaborated with other investors, both Swedish and foreign, in order to increase the pressure on the companies targeted.

Three corporate dialogues undertaken by the Ethics Council:

BHP Billiton Plc – union activity

Occurrence: The company has been linked to violations of the right to sign a collective agreement in Australia, which is in breach of the ILO Right to Organise and Collective Bargaining Convention.
Goal: To persuade BHP Billiton to alter its recruitment procedures so that instead of requiring people to sign an individual agreement as a precondition of employment it allows them to sign a collective agreement.
Comment: Under Australian law, companies are allowed to sign individual contracts with employees. The law has been criticised by the ILO for years as allegedly being in breach of the organisation's core conventions. The change of government in 2007 boosted expectations that labour law in Australia would be amended so as to reflect international rights.

Bridgestone Corporation – the Convention on the Rights of the Child

Occurrence: The company has been linked to the use of child labour at its rubber plantation in Liberia.
Goal: To persuade Bridgestone Corporation to take concrete steps to prevent the use of child labour and to implement a review mechanism to ensure compliance. As a precautionary measure, the company should adopt a policy against child labour for its entire operation.

Chevron Corporation – human rights

Occurrence: The company has been linked to human rights violations in Nigeria in breach of the UN's fundamental principles on the use of force and weapons by officials of crime-fighting agencies.
Goal: Chevron has adopted a framework programme, known as the Voluntary Principles on Security and Human Rights, to protect and uphold human rights in connection with the work of its security staff. The aim is for the company to report how it is implementing its policy in practical terms in order to ensure compliance.
Comment: The funds holding Chevron stock at the time of the shareholders' meeting voted in favour of a resolution tabled by US shareholders urging the company to produce a clearer and more robust human rights policy. The resolution gained almost 27 per cent of the votes at the meeting, which sent a very strong message from the owners that the company needs to address the issue.

Source: Annual Report of the Ethics Council, 2007.

In April 2008, the Ethics Council published its first annual report, concerning its activities in 2007.[12] In it, the Council published the names of the companies with which it was conducting active dialogues and described the goals it wished to achieve in each case. No details of the dialogues were given, however, since the success of such exchanges is said to rest on them being conducted in confidence. As long as the Ethics Council feels there is a real chance that it will be able to influence the company, it keeps up the dialogue. Should no process of change evolve, the committee can advise the AP fund concerned to dispose of its holding in the company. However, each fund decides for itself if it wishes to do so or not.

Some conclusions

In the Committee's view, the appointment of an Ethics Council was a good move. Mobilising resources in this way has led to the establishment of a more systematic process that lends weight to the funds' dealings with the various companies. It also makes them more interesting as partners in the eyes of other international investors. The creation of the Ethics Council also appears to have given efforts on behalf of sustainability more weight and greater legitimacy within the funds themselves.

At the same time, the fact that the funds lack analysis and administrative resources of their own means it is sometimes difficult to assess and assure the quality of the material they receive from their (lone) consultant.

We note that the assessments in the Ethics Council's report have the appearance of being (and perhaps are) those of the consultant rather than those of the committee. This certainly does not mean that these analyses are necessarily poor or wrong, but the fact that the Ethics Council and the individual funds lack the resources to independently adopt well-founded positions on the material they receive, on the basis of their own analyses and values, does constitute a problem. The problem is further aggravated by the fact that these consultants have only modest analytical resources themselves. It is also worth considering whether placing one's trust in documentation and assessments from one consultant alone is adequate or acceptable. In matters as complex as these

[12] Ethics Council: Annual Report 2007.

frequently are, a second opinion is surely extremely valuable. Although there are only a limited number of consultants dealing with this type of work in Sweden, there are several elsewhere.

Another general problem is that to a certain extent, as we have implied, you have to look for your information where information is possible to get, which means that, in practice, you will look at listed companies. But, after all, they represent a fairly limited share of the companies that could be described as potential investment targets.[13] Moreover, listed companies can reasonably be assumed to maintain a higher ethical and environmental standard precisely because of their public nature. Also, companies in developed, democratic countries tend to have a better supply of "screenable" information at their disposal than those in less developed countries and/or in countries under authoritarian rule. So to state matters a little baldly, perhaps, you can keep a fairly good check on listed companies in developed countries, where presumably the fewest problems are to be found, but much less of a check on unlisted companies and companies in developing countries where presumably the greatest problems are to be found.

A possible solution might be to invest only in companies that can be kept under full surveillance – but this is likely to reduce your range of investment opportunities considerably, which would conflict with the overall objective of a high rate of return. On the other hand, investing in companies that either cannot or do not wish to provide any substantial information on ESG aspects is equally unacceptable, to say the least. In the long term, this can be partially solved by better analytical methodology, more efficient information gathering and tougher reporting requirements. But as an outsider you are unlikely to acquire anything like a full understanding of the situation. Decisions on whether to invest or not must therefore be reached under uncertainty, to a greater or lesser degree, where ESG factors (too) are concerned. It is also a matter of balanced risk-taking – a constant trade-off between risks and opportunities. Here, the boards have overall responsibility for deciding what the funds' general strategy should be.

[13] Under present investment rules, however, the funds' "universe" is largely restricted to listed companies.

4.6 The effects so far

Impact on returns?

All the AP funds agree that the role of responsible investor can be combined with the overall objective of a high return on investments. Especially since they operate in the long term, the funds see no conflict between the two. On the contrary, they tend to emphasise the value-raising and risk-reducing effects of such an approach, and the prospect of good yields, which they feel outweigh any adverse effects that might be generated should the investment universe shrink.

At the same time, they stress that this is not something they can "prove" – at least not yet. There is no unequivocal statistical evidence in favour of one outcome or the other. It is of course difficult to measure and evaluate this fairly, particularly since the time frame in practice is quite short and the number of companies that have been excluded or engaged in ESG dialogues is not very large. In 2004, however, the Seventh AP Fund attempted to quantify the effects, based on the yields reported by the companies they had excluded relative to those of the companies in the portfolio. This comparison showed that, up till then, the impact on returns had been largely negligible, while the risk level had increased slightly.[14]

Internationally, quite a few academic studies and other studies have been conducted where the aim has been to assess and analyse how the application of ESG or sustainability factors in investment policies has impacted on returns.

In one of the studies commissioned by the present inquiry, the author has gone through a variety of investigations and reports that sought to assess impact in this area by one means or another.[15]

The study notes that most of the research into this type of impact is based on studies of securities funds rather than institutional investors such as pension funds. According to the authors, one of the reasons is that it is generally more difficult to obtain data from institutional investors of this kind. Another factor that makes assessments and comparisons more difficult is that while many securities funds have long been developing ethical

[14] "Evaluating Ethics Policy", Board presentation, 2004-08-30. Seventh AP Fund.
[15] "Doing well While doing Good", by Kees Koedijk and Jenke Ter Horst (Annex 5 to the report).

profiles, interest and activity among institutional investors has only grown substantially in recent years. The AP funds are one example among many. Conclusions regarding the impact on securities funds are not readily applicable to institutional investors, one of the reasons being that the latter normally give precedence to the high-yield objective, which, as we have seen, is not necessarily the case where ethical funds are concerned. Nevertheless, comparisons are of course of some interest in this connection, as long as they are approached cautiously.

Regarding actual impact on returns, a number of studies are cited, based on different markets and time periods. One study describes a comparison between a large number (320) of conventional funds and a relatively large number (32) of "SRI funds" in the US. Its main conclusion was that ethical funds that had long been on the market yielded higher returns than conventional funds, while the reverse applied for more established funds with an ethical profile.[16] In neither case, however, were the differences statistically significant. Another study compared funds in the US, the UK and Germany during the 1990s. It found that the British SRI funds performed slightly better than conventional funds, while the American ones performed slightly worse. In the German case, no difference was evident. A third study compared trends in 17 different countries, in all of which the claim was that ethical funds yielded smaller returns. The difference, however, was statistically significant in only two of these countries – of which Sweden was one.

The study concludes that it is generally difficult to prove the existence of any significant difference in returns between securities funds with an ethical profile and those without.

Another way of approaching this question is to examine how share prices for companies addressing ESG issues develop, based on the hypothesis that the stock market disregards or at least underprices this type of information. Investors who better understand the value of this – relative to the rest of the market – and invest accordingly should be able to obtain higher yields as a result. The question, then, is whether this type of erroneous pricing is actually present or not.

Reference is made to two studies that focus on how analysts in the market perceive ESG information and share evaluations. A

[16] For reference to the original reports/articles, see Annex 5

study undertaken in 2007 concluded that most analysts felt ESG issues had a favourable impact, especially over time, but that this was not fully reflected in share prices. Another study found that even in cases where companies provided information on ethics- and environment-related matters, none of the analysts were particularly interested in exploiting it.

The report also describes a study that employed what are termed eco-efficiency ratings[17] which were related to company value as expressed by Tobin's Q.[18] For the period under review – 1995–2003 – the results showed that a portfolio of companies with the highest rating yielded distinctly higher returns than a portfolio of companies with the lowest rating. This may be a sign that the market underprices this type of information. Another study has examined what impact environmental scandals of various kinds have had on the companies involved, based on 142 such scandals during the period 2003–2006. The conclusion here is that this has had a significantly adverse effect – but only on European companies, not on American ones.

Researchers have also looked at the situation regarding corporate governance – the G factor in ESG – and how this affects share prices and yields. A study of the situation in the US found that an investment strategy under which companies were selected on the basis of whether or not they were deemed well-governed yielded distinctly better results. A similar study on European soil arrived at similar conclusions, although the picture varied from place to place around Europe. On the basis of this and other studies, the author of the report concludes that a portfolio based on a positive selection of companies reflecting ESG aspects can yield a better financial outcome.[19]

A further aspect concerning yield effects is the question of whether a dialogue approach by investors is more fruitful than a "traditional" exclusion strategy. Here, the main conclusion is that for the time being this must be considered an open question, although there are a number of empirically based arguments suggesting that "activism" may have a favourable effect on share prices.

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[17] Eco-efficiency aims to measure how value is created with the least possible environmental impact. This type of data has been developed by British-American analysts Innovest.

[18] Tobin's Q is the ratio between the combined value of all the companies on the stock market and their replacement cost. A high Tobin Q ratio should act as an incentive to greater investment, and vice versa.

[19] Annex 5, p 12.

The picture drawn in the overview ordered by the Committee is rounded out by a general study undertaken by Mercer[20]. It systematically went through thirty different studies – both academic and others – using different methodology during different periods and in different countries. Three of these showed a negative outcome in respect of ESG factors and yield, fourteen were found to send a neutral message, and thirteen generated a favourable assessment. Two of the general conclusions reached in the report, on the basis of the various studies, are that there is no simple linkage between ESG activity and financial outcome, and that working with ESG must be viewed as part of a wider endeavour. A further conclusion is that consideration of ESG aspects is not an investment style *per se* (which according to the author many believe) but instead something that can be integrated into almost all investment styles.[21] However, it is argued, a basic dilemma in this connection is the short-sightedness that tends to characterise the investment culture.

If we attempt to summarise this somewhat disparate picture of the situation, we can begin by noting that generally speaking it is difficult to quantify the impact of ESG consideration on investment policy in any precise way. Secondly, to date there are no clear indications of either negative or positive effects in the case of the AP funds. And thirdly, that international studies point more often to positive than to negative effects. Given the above, it could at least be claimed that there is no evidence that "sustainable" financial investing would be systematically *worse* from a yield viewpoint than "conventional" investment.

General impact on company behaviour

As we have noted before, it is clear that in recent years companies in general have focused more closely on ethics and environment issues as part of their CSR (Corporate Social Responsibility) work. Probably, pressure from various investors has had an impact in this respect, but the extent to which this development may be specifically attributed to the efforts of investors as a group – or even to individual investors – as opposed to the media, churches, trade

[20] "Demystifing Responsible Investment Performance". The report was compiled by Mercer in collaboration with the UNEP Finance Initiative.
[21] Cf Erik Sjöberg's study (Annex 2).

union or non-governmental organisations etc is impossible to say with any degree of certainty. However, a certain amount of anecdotal evidence is available in connection with a number of cases where individual or groups of investors have clearly influenced proceedings. Where the AP funds are concerned, for instance, the Ethics Council reports a number of instances where contact with companies has led to improvements.[22] The Seventh AP Fund, which does not participate in the work of the Ethics Council since it is not legally authorised to be an active owner, claims that many companies are very anxious not to be on its blacklist, since this is considered extremely harmful to the brand.

How Swedish companies have been affected by the AP fund dialogues

Each of the First-Fourth AP Funds conducts its dialogue with Swedish companies individually. They engage in talks with the companies about the risks and business opportunities its operations involve, and follow these discussions up over time. In some cases, they may follow up negative developments reported in the media, such as the use of child labour or other problems, but the day-to-day work of pursuing company dialogues is proactive rather than reactive.

On the question of how the AP funds *influence* the CSR and sustainability efforts of the Swedish portfolio companies, it is clear that the funds play an important role in that they lend these issues greater legitimacy within the company. According to a study commissioned by the inquiry, several companies testify that it makes a difference when important actors such as the AP funds ask questions and assess the way CSR is treated. The interest shown by owners is confirmation that these issues need to be on company agendas, and showing an active interest can help to ensure that they are discussed to a greater extent by the management group and the board of directors.[23]

Frequently, discussion of these issues with the portfolio companies takes place at bilateral meetings at which the AP funds follow up what the companies have written in their sustainability

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[22] See the 2008 report of the Ethics Council.

[23] "The influence of the AP funds on the ethical and environmental activities of the portfolio companies", by Emma Sjöström (Annex 5).

reports. Usually, the AP funds ask about the company's objectives regarding ethics and the environment, what they are doing to achieve these objectives, whether the companies have analysed the risks associated with the integration of ESG factors, what systems they use for dealing with such risks, and how codes of conduct are implemented and followed up etc.

The study shows that the AP funds' direct influence on the Swedish portfolio companies as regards their CSR and sustainability activities is mainly in the field of information provision – many companies are still beginners at producing sustainability reports, and the AP funds and other investors are actively encouraging greater transparency on such issues. Clear and careful reporting is essential if the owners are to carry out a proper analysis of the companies, and is also an important tool in the companies' own follow-up, as well as a vital component in constructive sustainability work. When companies are forced to address target scenarios and risk assessments in various spheres, this can make the issues more visible to them and encourage them to deal with ESG concerns proactively.

The study also shows that the AP funds have only a marginal direct influence on the portfolio companies' sustainability efforts, i.e. the work that is subsequently reported. In other words, the AP funds are not seen to be taking a proactive role in persuading companies to focus more on certain issues (such as reducing their carbon emissions more than they had originally planned) or to engage with issues not previously addressed (a company in the textile industry, for instance, could follow up water consumption in its production process if it has not previously done so). Ultimately, however, the pressure exerted by the AP funds on the companies regarding their provision of information on these issues may lead to such results. A company might, for instance, begin reconsidering the goals it has established for its activities in relation to ethics and the environment and so begin developing a strategy for the achievement of these goals.

A general conclusion is that the AP funds' dialogues with the portfolio companies on environmental and ethical issues do make a difference: they encourage the companies to expand and improve their external reporting in this sphere, which in turn has a favourable impact on the actual work undertaken and gives the issues greater prominence within the companies.

One of the conclusions of the study is that managers should focus on environmental and ethical issues to a greater extent than at present, although such a development is already under way within the funds. Besides helping to make the issues an integral part of the companies' strategic and commercial activities, this would help managers gain a better understanding of the issues.

On the question of how dialogues with companies should be conducted, one recent development is that in one or two cases companies have chosen to gather together a number of owners and hold joint meetings. This could be a cost-efficient alternative both for the companies themselves and for the funds, as well as for other participating investors. Probably, it would also help reduce the risk of insider situations arising when the funds meet with companies on a one-to-one basis. It should be noted, however, that there is currently no evidence whatsoever that the funds have been placed in an insider situation as a result of the dialogues they have initiated.

In other words, in the Committee's view, the AP funds would do well to work together on ESG issues vis-à-vis Swedish companies. This would probably enhance the impact on the companies while at the same time being cost-efficient both for the funds and for the portfolio companies themselves. The Committee believes that it is possible to pursue such a course without coming into conflict with the official government stipulation that the various funds are to work independently.

Summing-up

Two fundamental questions that arise when evaluating the AP funds' investment guidelines on ethics and the environment are, firstly, whether and in what way these issues have affected the funds' prime objectives, i.e. high returns, and secondly, whether the companies' efforts to assimilate environmental and ethical factors has had an impact in that the companies have been persuaded to attach greater importance to sustainability issues and to the task of remedying shortcomings that the AP funds have drawn attention to.

Where effects on yields are concerned, there is no clear evidence that these are present. One reason is that the companies that have been excluded, or which the funds have chosen not to participate

in, or have engaged in dialogues with on environmental and ethical and environmental aspects, are still so few in number that the overall impact is necessarily only marginal. Elsewhere, too, determining both which yield effects stem from some form of ethics/environment policy on the part of the AP funds and which are attributable to other factors presents considerable problems in terms of methodology. It is clear, however, that the various studies undertaken to date, primarily abroad, point to positive yield effects more often than negative ones. In any event, it can reasonably be claimed that there is no empirical evidence to suggest that taking sustainability factors into consideration would result in systematically lower returns than if companies refrained from embarking on such a course.

Nor is it easy to give an unequivocal answer to the question of how the companies' behaviour has been affected, for a variety of reasons. One is that efforts to achieve these objectives have only been under way for a few years, and the impact of companies' behaviour in the market may take a relatively long time to determine with any degree of certainty. Another and more fundamental reason is that purely methodologically it is almost impossible to prove that a given change in behaviour can be specifically attributed to the actions of the AP funds or of an individual AP fund. As we have seen, a rapidly growing group of investors worldwide is now working actively on these issues. Furthermore, of course, there may be other reasons and other kinds of impetus behind a change in behaviour besides demands from investors and fund managers. What can, however, be stated is that (i) it is now widely accepted that companies have generally become more sensitive to sustainable issues, and that the study we commissioned shows the AP funds were instrumental in this development, and (ii) in a number of cases, the AP funds – either on their own or together with other investors – have had a tangible impact.

5 Returns, ethics and confidence – some issues

The Committee's assessment: Confidence and trust presupposes credibility, which in turn is founded on expertise, transparency, integrity and benevolence. Each of these factors should guide the funds in their work in general and in their work on ethics and the environment in particular.

To help ensure a good situation in life for the country's pensioners is in itself a fundamental ethical objective. The aim is to combine this ambition with that of not imposing restraints on the freedom or wellbeing of others. To this end, balanced assessments and sometimes complicated trade-offs are required, based on explicit ethical values. The convention basis on which the AP funds have hitherto built their environmental and ethical work is an *expression* of democratically endorsed values, but does not represent a basic value in itself. The funds need to develop a common set of basic values themselves, based on the Constitution's Instrument of Government. This does not prevent them from basing their actions on international conventions, but it does give the conventions a perceptible, ethical basis.

Since their ownership of Swedish companies is limited under the law, the AP funds do not have the same chance as other institutional investors of being active owners. This applies in particular to the Seventh AP Fund, which is not entitled to vote in respect of its Swedish shares.

Among institutional investors, engaging in dialogues with representatives of the portfolio companies is a popular means of exercising influence. There is a need to develop clear-cut ground rules for how such dialogues are to be conducted. Remuneration issues are of considerable relevance for public trust in the

companies and their owners. Here, the AP funds have well-prepared guidelines that can serve as a basis for active efforts in the future as well.

5.1 Earning public confidence

Dependency, trust and control

The government bill on the new, reformed national pension scheme, brought before the Riksdag in 2000, stressed the importance of public trust in the AP funds. This was echoed in later official documents concerning the AP funds. Government texts on the funds' ethical and environmental work often stress the importance of consolidating public trust in the funds.

Why is trust so important? Generally speaking, trust is a decisive factor in all financial activities, and particularly where long-term savings are concerned. The reason is that it is difficult – not to say impossible – for individual citizens to keep track of and assess the work of a fund manager, and even more difficult to determine whether the manager is going to perform well in the years to come. Where knowledge ends, trust takes over. The situation is even more precarious when the manager is one you have not chosen yourself and are unable to drop in favour of another.

The relationship between two parties, such as a pension manager and a pensioner (or future pensioner), could be described as a balance between weak and strong. Which party has the upper hand at any give time is determined by differences in economic resources, differing levels of knowledge and information supply, and differences in the ability to exit the relationship etc.

Being in a weak position makes you dependent. The more important the issue is to the weaker party, of course, the more important it is to be able to manage the risks involved. Basically, a state of dependency can be dealt with in two ways: either by means of *control*, in the broadest sense, or by means of *trust*.[1] Trust could, therefore, be viewed as a residual item – everything you are unable

[1] One way of reducing dependency on a strong actor – and thereby reducing the need for either trust or control – is to find alternatives. If there are several suppliers of a product, i.e. if there is an efficient market, dependency on a single actor is reduced since an alternative is always available.

or unwilling to do, or do not have the time or energy to do, is left to trust. This means that to a certain extent you accept being vulnerable to the actions of the other party.[2]

The AP- funds are a part of the Swedish financial system. The fact that financial services are often both complex and crucial to the wellbeing of the individual, as noted earlier, is the principal reason why the finance sector is so trust-sensitive – as was clearly demonstrated, incidentally, during the turmoil that swept international financial markets in the autumn of 2008. But it also applies to other areas, such as health care, which offers the same combination of complex services that are difficult for the individual to assess yet crucial to individual wellbeing – in this particular case, sometimes a matter of life and death.

Also, particularly in the economic sphere, a lack of basic trust between actors pushes up costs – if they do not fully trust one another they may feel obliged to protect themselves by means of agreements that are more detailed and complex agreements than would otherwise have been necessary, or to obtain guarantees or insure themselves etc. In other words, greater control entails higher costs and thus means less efficiency. By the same token, trust is not just something that increases the general sense of wellbeing in a society – it is also very effective.

Trust is a manifestation of a *relationship* between two or more parties rather than being a quality in itself. The quality that underpins trust is credibility. If you build up your *credibility*, greater trust is likely to follow. If, however, your credibility is eroded, you lose the other party's trust.

Greater credibility means greater trust

One can act in a variety of ways to boost credibility. Researchers Mayer, Davis and Schoorman, who worked on assignments for the South Africa Truth Committee, listed four dimensions that actors

[2] The South African Truth Committee, which was appointed to heal the wounds in the aftermath of apartheid, defines trust as follows: "The willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor or control that other party". (Mayer, R., Davis, J. and Shoorman, F.: "An integrative model of organizational trust", *Academy of Management Review,* Vol. 20 No.3, 1995).

could focus on in order to boost credibility and eventually gain or retain the trust of those around them.[3]

- expertise
- transparency
- integrity
- benevolence

The first dimension, then, is *knowledge and expertise*. Knowing your job, delivering in time, maintaining constantly high standards, having good work procedures and an efficient organisation, all build credibility and establish trust.

The more *openness and transparency* companies, organisations or public authorities show in their activities, the greater their credibility. They need to decide what can be made public, how information should be provided and how the quality of the information can be maintained. Proper external openness is contingent upon a good, systematic internal communication process.

The third dimension is *integrity*. This means both having principles that guide you in your actions and having the ability to apply them – not to be too easily influenced by circumstances or the wishes of others, not to be tempted into unlawful shortcuts, and not to succumb to temptations that give you an advantage. In other words, having integrity means not letting yourself be corrupted. This is obviously linked to credibility.

The fourth dimension in pursuit of credibility is what in the South African context was termed *benevolence*, and which means wishing another well or being well disposed to another. This involves such factors as the way you treat people: companies wishing to gain in credibility have to treat their customers and other stakeholders benevolently, i.e. by genuinely seeking to make the encounter a fruitful one. The customer must be satisfied while at the same time the company does good business. A serious company seeks win/win situations as a natural course. An intrinsic element in benevolence, and a good starting point, is what is called *decency* – abiding by the rules, behaving honestly, and not misleading or acting to the detriment of customers, employees or other stakeholders.

[3] Ibid.

Strengthening credibility

Measures aimed at consolidating and strengthening trust in the AP funds and their activities can be discussed using these four criteria as a framework – what kinds of steps might be relevant for building credibility on the basis of each point?

- expertise

This means the skill and expertise shown by fund managers, senior executives and the board of directors in performing the investment task at hand. Such expertise also includes an awareness of sustainability aspects. Measures that boost knowledge capital in one way or another also help boost credibility.

- transparency

Openness and transparency are about the ability to describe clearly and comprehensibly – to the media and the general public, the Government and the Riksdag – what you have in mind and how you are proceeding in your work, e.g. on sustainability issues. It also includes how you follow up and evaluate your activities.

- integrity

This has to do with factors such as the professional and personal qualities of those working with the funds, especially the board and the senior executives. There are also more specific aspects, such as how you avoid “loyalty risks” or insider risks when working with corporate dialogues. It further involves the ability to withstand pressure from politicians and other stakeholders by setting boundaries.

- benevolence

The First-Fourth AP Funds do not handle money from individuals and therefore have no “customers” to relate to or to treat in one way or another. Their duty is to the Swedish public as a whole. Emphasising and working seriously with sustainability issues on the basis of democratic values could be described as a manifestation of benevolence – seeking a win/win situation in terms of both pension returns and sustainability.

5.2 Which ethics – and whose?

Value-driven or values-driven?

In a financial context, “ethical” has in practice usually meant not supplying capital to companies whose production and activities are thought to conflict with the ethical standards and values that the financiers represent.

Hitherto, the most common and widely known manifestation of ethically based capital investment has been what are termed ethical funds. They have operated in the market for decades, in one form or another and to varying extents. Usually, their approach has involved avoiding investments in companies producing or selling goods such as weapons, alcoholic beverages, tobacco and pornography. Ethical funds seek to promote the norms, standards and values they have adopted in principle in a fairly straightforward way. When investing, a fund states which principles it espouses and invites customers sharing its convictions to participate with their savings. Those who do not share the fund’s values will not participate, and anyone who is disappointed with the investment outcome can withdraw his or her money and invest it elsewhere.

The AP funds, however, have a different task. They are not and can never be “ethical funds”. Everyone in gainful employment in Sweden could be said to have assets invested in the AP funds and thus to be stakeholders, while at the same time no-one can move their money elsewhere. This means special care has to be taken over how ethical and environmental requirements are formulated and applied, and sustainability policies need to be widely accepted.

It is important to note that there is also another clear, fundamental difference in the target scenario of an investor such as the AP funds – with their explicit objective of high returns – and that of more “activist-oriented” investors such as ethical funds, churches, unions and NGOs. The basic purpose of their activities is not to ensure a financial return but to influence society as far as possible, in one or another, based on the values they hold. In their case, therefore, return is secondary. Or, to put it another way, an investor can be either *value-driven* (e.g. a pension fund) or *values-driven* (e.g. an NGO).[4]

[4] This does not mean that a “values-driven” organisation necessarily lacks ambition regarding financial yield or professional investment management – on the contrary. NGOs may differ in the extent to which they actively use their financial resources as a means of exerting pressure, but in contrast to the AP funds, for instance, such a course is always open to them.

Starting points for a discussion on ethics

Ethics refers to the philosophical study of good and bad, right and wrong. In part, it concerns itself with theory – moral philosophy – while in other parts it is clearly action-oriented. When ethics is applied to certain areas of activity, it is called *applied* ethics. This is found, for instance, in health and social care (care ethics), in science (research ethics) and in commerce (business ethics). In financial markets, too, a code of ethics has emerged over the years, expressed for instance in guidelines and operational norms. As a rule, applied ethics is specifically associated with *action* or behaviour, and discusses the grounds on which people decide to act in a certain way. If you simply want to describe how different actors think and behave, this is known as *descriptive* ethics. If you advocate a specific type of behaviour, this is called *normative* ethics.

Ethical principles of conduct or behaviour and norm-based theories differ in form and content. While there are numerous variations, two main approaches emerge. One is known as *deonthology* and rests on the principle that you should act in accordance with certain norms that you have a moral (and perhaps also a legal) obligation to comply with, regardless of the situation or the consequences. In so doing, you may cite authorities of various kinds, such as legal or religious imperatives, in support of your actions. Duty may also be derived from conceptions of rights, e.g. human rights or ownership rights, which would of course be meaningless if you did not expect them to be respected unconditionally by others. A third source of duty relates to agreements of various kinds that you have entered into, or promises you have made, whether these are ambitious and overarching "social contracts" or more everyday commitments.

The second main approach is *consequentialism*. Here, the emphasis is on what *impact* your actions may have, either on yourself *(egoism)* or on other groups *(particularism)*. If you seek to include the whole of humanity in your perspective, this is called *universalism*. If you are seeking to calculate positive outcomes of various kinds (various "goods") using quantitative measures, this is *utilitarianism*. This may involve the maximisation of material welfare, improvements in health or the environment, or the attainment of "happiness" in general. In considering the ethical grounds of relevance to pension fund managers, elements of both principal

approaches may be said to be present. The goal of ensuring as much "good" as possible for pensioners via a high rate of return is an approach informed by consequentialism . But distinct elements of deonthology are also involved; references to authorities such as Swedish law or international conventions are an expression of this. *Deonthology* could be said to define *"bounds of decency"*. The investment management toolkit we presented in Chapter 3 includes courses of action inspired by one kind of norm-based theory or another. Negative screening resulting in exclusion is clearly built on deonthology. Equally, dialogues for the purpose of changing a company's behaviour in a given respect is a type of action inspired by consequentialism. Those who are interested can look at *dialogue-based ethics, virtue-based ethics* and other norm-based theories that we are unable to discuss further here, for reasons of space.

An approach emphasising consequentialism, then, is an inadequate ethical platform for a pension fund manager. A high rate of return leading to good pension sums must be combined with a realisation that there are other values, too, which cannot be compromised in pursuit of a sound financial outcome.[5]

Values and basic principles

Defined simply, values are that which we find important in life or in a certain activity. Determining which values are at stake in a given activity can be a rewarding task in itself. As a next step, these values can be listed in order of importance and you can then discuss whether they are mutually supportive or not, if so in what way, and what their specific implications are for the activity in question. Different values can be important to a greater or lesser degree in different circumstances without this necessarily affecting their worth as basic principles. Ranking values in this way can result in a hierarchy of values, or a *value order*, that can provide a starting point when establishing priorities, for instance.

This kind of value order represents an ethical basis, a *set of basic principles,* on which an activity or operation may be built. Thus such a basis is not important for its own sake but as a means of stabilising an activity, in terms of both goals and methods. In other

[5] Professor Per Bauhn discusses in closer detail how this may be combined with proactive behaviour in Annex 2 to this report.

words, a set of basic values is more than just a list of positively charged words. It can help you explain and communicate the reasons why strategies are formulated in a certain way or why an operational activity is conducted in a certain manner. When the business community talks about the holy trinity of *vision – mission – values,* this is what it is referring to. The three hang together and are mutually explanatory.

Agencies and organisations all need to formulate and communicate their own sets of values if they are to function properly. The AP funds for their part must put together and articulate a carefully considered system of values to be used as a starting point for their activities and in a sense as a statement of their objectives. For government agencies such as the AP funds, the values expressed in the Constitution's Instrument of Government are a natural point of departure, as are the conventions to which Sweden is a party and to which the funds are already giving prominence as a basis for their activities. It is then a matter of initiating a process both internally and externally to establish a viable set of values of their own. Finally, they will need to "walk the talk", i.e. to actually apply these values. The document expressing a fund's basic values must be treated dynamically. It must not be allowed to gather dust on the shelf – or in a gilded frame on the wall.

A set of basic values for the AP funds

The AP funds must base their activities on fundamental ethical values that enjoy broad democratic legitimacy. Basic notions and principles concerning how the country is governed, civil rights etc are expressed in a number of public documents.[6] A natural starting point in this respect, as we have noted, is the Instrument of Government, which is one of Sweden's four constitutional laws. This document contains rules on how democracy is to be realised in Sweden and how power is to be distributed between the Riksdag, the Government, the municipalities, the county councils and the law courts. It also sets out the constitutional freedoms and rights that apply in this country.

[6] See also the government report "In the Service of Democracy" (I demokratins tjänst, SOU 1997:28), by Lennart Lundquist. In this annex to the inquiry entitled Public Administration in the Service of Democracy, the author discusses issues such as ethical guidelines for government administration as a whole in terms of "a public ethos".

The basic premises in value terms are defined in the first two articles of the opening chapter.

Chapter 1. Basic principles of the form of government

Art. 1. All public power in Sweden proceeds from the people.

Swedish democracy is founded on the free formation of opinion and on universal and equal suffrage. It shall be realised through a representative and parliamentary polity and through local self-government.
Public power shall be exercised under the law.

Art. 2. Public power shall be exercised with respect for the equal worth of all and the liberty and dignity of the private person.
The personal, economic and cultural welfare of the private person shall be fundamental aims of public activity. In particular, it shall be incumbent upon the public institutions to secure the right to health, employment, housing and education, and to promote social care and social security.
The public institutions shall promote sustainable development leading to a good environment for present and future generations.
The public institutions shall promote the ideals of democracy as guidelines in all sectors of society and protect the private and family lives of private persons. The public institutions shall promote the opportunity for all to attain participation and equality in society. The public institutions shall combat discrimination of persons on grounds of gender, colour, national or ethnic origin, linguistic or religious affiliation, functional disability, sexual orientation, age or other circumstance affecting the private person.
Opportunities should be promoted for ethnic, linguistic and religious minorities to preserve and develop a cultural and social life of their own.
Act (2002:903).

The points that are most relevant to investment policy are the first and third paragraphs in Article 2. The general outlook and the philosophy expressed in these paragraphs, and in the others, may be summed up in terms of seeking to *strengthen people's capacity to conduct themselves as active individuals by promoting their freedom and wellbeing.*[7] People must have the right and opportunity to take steps to realise their goals and satisfy their needs as long as this does not jeopardise the rights and opportunities of others to do the same. These should be considered key elements in the construction of a relevant set of basic principles on which the AP-funds can base their actions.

[7] The American moral philosopher Alan Gewirth argues that "freedom" is about the *form* that our capacity for action takes – the ability to act freely on the basis of informed choices – while welfare or "wellbeing" is about the *content* of this capacity, the substance involved: what we need in order to act, i.e. life, health, livelihood, security, education. (See Annex 2).

Environmental aspects and consideration for the environment fall naturally within the framework of such an outlook – in this general perspective, environment protection is also essentially an ethical issue. At a more operational level, however, assessments of environmental effects and how these should be dealt with are often technically more complicated, while at the same time awareness of linkages, effects and methods is steadily growing and must continuously influence how objectives are determined and how requirements and demands are formulated.

Some consequences for the AP-funds

To view people as decision-making and acting individuals is to adopt an *agent's perspective*. What would the agent's perspective expressed in the Instrument of Government mean if applied to the activities of the AP-funds? Today, it is first and foremost about striving, on the basis of democratic decisions, to promote the present and future welfare and ability to act of Swedish pensioners by ensuring a high rate of return on the funds' investments. Viewed in this light, the high-yield objective reflects a fundamentally important ethical ambition. Also, some basic rights are established that are crucial to human agency and which, in this case, the goal of high financial returns must be compatible with.

To protect or favour a limited group of people – in this case pensioners – does not mean that the objectives are in any regard to be seen as worth less from an ethical viewpoint. There are a number of other obligations arising from what may be termed "relationships of specific responsibility" and that do not extend to individuals outside these relationships. By bringing children into the world, parents assume a special responsibility for these children, one that they do not have for children in general and that no one else has for their children. Those who take a job as a bodyguard, doctor or police officer etc assume a responsibility for safeguarding other people's lives, safety and health that other individuals do not assume. Similarly, by making a promise or signing a contract we assume a responsibility for accomplishing a specific task or transaction, a responsibility that is not shared by those who have not given such a promise or signed such a contract.[8]

[8] See Annex 1.

The alternative would be to provide the funds with a more complicated target scenario that embraced more "activist" or far-reaching ambitions in terms of environment, social issues, disarmament, industrial policy and other political and ethical objectives, and where a balance would need to be struck in some obscure way with the high-returns objective. This, however, would conflict with the AP funds' remit and with the ethical foundation on which the system is built. In addition, it would probably have a detrimental effect on the funds' work in other ways. A more ambiguous target scenario would also entail risks from a transparency viewpoint; it might, for instance, lead to managers excusing weak investment outcomes by citing some kind of progress in the environment or ethics sphere that is difficult to measure. In such a situation, evaluating the funds' activities would be extremely difficult. This in turn may also generate crises of confidence.

Achieving high returns for the purpose of creating good/benefit for pensioners may thus be seen as the AP- funds' positive goal from an ethical standpoint. At the same time, however, this objective must be achieved through investments that do not in any way harm (other) people's "freedom and wellbeing"; as mentioned earlier, there are certain values here that cannot be compromised in pursuit of a sound financial outcome.

Two types of problems may arise in this connection. Firstly, a company may produce goods or services that in themselves jeopardise people's freedom and wellbeing, by for instance threatening the physical environment. Secondly, the company's production may take such forms that it establishes or enhances such threats, e.g. in terms of employment relationships, work environments or external environmental impact.

If the AP- funds are to base their investment work on the kinds of ethical principles outlined in the Instrument of Government, they must consider and assess a number of factors that govern how a product or a production method affects or may affect people's freedom and wellbeing. The question of when and under what conditions arms manufacturing and arms sales, for example, conflict with or encourage this must be considered in a balanced way. In such a perspective, products and production methods that may be considered "unethical" always and in all circumstances must be fairly few in number. There are also very few that are always and in all circumstances totally unproblematic. In between, there is a

broad zone in which problems may arise and which it is up to investors to identify, assess and relate to.

Working in this way – performing broad-based, detailed analyses of companies and their production, is of course significantly more complicated and intellectually demanding than simply excluding a company on the basis of some easily-observed criterion (the company produces weapons, alcohol etc). But the ethical approach is not a simple one and is not based on the rule of thumb. Application of the principles must correspond to the situation and take many factors into account. This means it is not always easy to adopt the "correct" position – investors may make different assessments and weigh in different aspects, and sometimes arrive at different conclusions. An open attitude is needed, along with the will and ability to publicly advocate and debate the positions you adopt.

What ultimately needs to be asked when pursuing an actor-oriented course is briefly this: *Does the company deliberately contribute, via its products or production methods, to a situation in which societies and individuals are deprived of freedom and wellbeing?* If the answer is yes, the company is not a worthy investment target for an AP fund.

In Annex 1, philosopher Per Bauhn pursues this line of reasoning thus:

> Likewise, we should take a more multifaceted view of weapons production and the arms trade. Certain types of weapons that seem specifically designed to wound non-combatants – for example, the butterfly mines that children easily mistake for toys – definitely make the manufacturer an unworthy investment target. By ignoring the distinction between the innocent and the guilty, between combatants and non-combatants, the company disqualifies itself from the ethical responsibility that is an essential characteristic of a worthy investment target. However, not all weapons are necessarily of this type.
>
> In other cases, it is not the weapon itself but rather its use in a particular conflict or by a particular agent that makes it problematic. Facilitating the armed defence of a democracy that upholds its citizens' right to freedom and wellbeing is not unethical. However, companies that sell weapons and equipment intended for the armed forces in a dictatorship where citizens' rights are ignored are a different case altogether, as is a dictatorship that wants to use force to subjugate a democracy or to expand its territory at the cost of that democracy. Such a company thereby militates against respect for the agent-related right to freedom and wellbeing.

Since ethics is not about applying simple rules of thumb or simple criteria, it cannot be reduced to a kind of competition where the aim is to be as "ethical" as possible, in the sense of being as restrictive as possible in your attitude to certain phenomena. As noted above, for instance, it is not necessarily "more ethical" to adopt a pacifistic approach and reject all forms of arms production than to accept such production in certain forms.

In the Committee's view, therefore, a natural ethical basis for AP fund activities is the agent's perspective expressed in the Instrument of Government and elsewhere – to promote people's freedom and wellbeing so that they may conduct themselves as active, independent individuals, and to support them in this endeavour. At the same time, the Instrument of Government is of course too general in character to be used as an operational document for the AP funds. Instead, together with the agent's perspective it represent a *basis* for the development and application of the principles and values that in our view must underpin the activities of the AP funds.

It should be emphasised that this does not conflict with the convention basis that has informed the AP funds' work up to now. Rather, it provides the convention basis with a visible, ethical foundation. Put differently, the fact that Sweden has signed various international conventions is basically a *reflection* of the fundamental ethical outlook that informs the Instrument of Government, but the conventions do not in themselves constitute "ethics". Laws, regulations and conventions reflect an ethical position, but ethics is in itself something more, a step further. Ethics cannot simply be about "abiding by the law" – it begins where the law ends. The conventions, however, may very well be regarded as both relevant and comparatively functional applications of the underlying ethical values, and thus as useful components in a set of basic values.

Also, there is a specific value in proceeding from international conventions in one's work, especially at international level. If investors such as the AP funds apply the conventions, they are signalling that it makes a difference whether or not one complies with these provisions. Investors can help legitimise the conventions and bring them more into focus, i.e. turn them into something other than sympathetic declarations of position in a document.

Fund management and integrity

As yet, the values and principles on which the AP funds' environmental and ethical work is to rest have not been officially defined. To identify certain basic values in the way we have discussed above is to establish a framework, albeit a general one, or perhaps more accurately to formulate a "directive" from the political system to the AP funds.

Naturally, a much more detailed and concrete directive from the Government and the Riksdag may be thought a democratic imperative in this connection. There are, however, clear disadvantages and risks associated with such a choice.[9] One reason is the danger of investment activities becoming – or being perceived as – an arena for political manoeuvring. If such were the case, public trust in the funds' activities could be seriously eroded. Another reason is that a more detailed directive would probably cause the funds' work on sustainability issues to become more reactive in character – things like developing basic values and policy positions, and performing more in-depth analyses etc would not appear relevant or necessary. A third reason is that detailed regulation always risks becoming obsolete and irrelevant soon after its introduction, and being circumvented. Finally, it must be remembered that the results of the AP funds' investments are a matter for the *population as a whole*, not for the political majority or for prevailing public opinion at any given time. Long-term, sustainable agreements that enjoy the support of broad sections of society are important in the pension sphere. A change of investment policy each time there is a change of government is not an attractive proposition. Policy change brought on by temporary swings in public opinion or media campaigns is even less so.

In this connection, we may draw a parallel with the Swedish central bank, the Riksbank, particularly since, like the AP funds, it has been accorded a more independent role vis-à-vis the Government than other agencies. The framework within which the Riksbank operates has been defined by the Riksdag on the basis of a broad parliamentary majority. The Riksdag also appoints the bank's executive board (General Council), which in turn appoints the management group, and requires the bank to furnish regular infor-

[9] These issues were among those discussed in principle in the OECD publication "Governance and Investment of Public Pension Reserve Funds in Selected OECD countries".

mation on how it is proceeding in its work. Within these bounds, the Riksbank operates independently. The political system is not allowed to intervene in the day-to-day workings of the bank and in its monetary policymaking, but does of course in the long term have unlimited power, should it wish, to alter the Riksbank's objectives, work procedures and organisation by legislative means. Operational independence and stable conditions, then, are fully compatible with clearly defined democratic control.[10]

Thus we may conclude that a more detailed shaping of the investment rules on the part of the Riksdag and the Government does not appear desirable, for a number of reasons. As we have indicated, however, there is good reason for them to specify and clarify the general principles governing this work. Besides making reference to the basic values reflected in the Instrument of Government, the Public Pensions Fund Act needs to specify that environmental and ethical considerations are to be taken into account in the funds' activities. This involves lifting the ethics and environment dimension out of the preparatory documentation, where it currently resides, and into the text of the law itself. No change or shift in emphasis regarding the AP funds' objectives is involved here. Such a move does, however, make clear that ESG considerations are to be an integral part of the funds' investment activities, and also provides a cohesive basis for future evaluations of their work in this area.

5.3 Costly or profitable?

Is there a conflict of goals?

There is an inherent conflict of goals between a high-yield objective and for instance ethical and environmental objectives if and insofar as this means that an investor is forced to exclude certain companies or industries from his/her universe of potential investment targets. It may for instance involve abstaining from investments that are in fact profitable and would help the manager achieve a higher rate of return in the overall portfolio. It may also involve limiting opportunities for diversification, i.e. risk spreading.

[10] In principle, the Swedish legal system has the same basic structure. The Riksdag passes the laws but the judiciary applies them without interference from the political system. Individual court cases and rulings are never discussed in the Riksdag.

Theoretically, it can be shown that given certain assumptions a fully diversified portfolio will produce the highest return between anticipated yield and risk.[11]

Criticism of a more fundamental kind has been levelled at companies that take on tasks and assignments not directly associated with the goal of maximising profitability. A classic example is the article written many years ago by Milton Friedman, claiming "The business of business is business", in which he argued that companies and managers were not empowered to use their shareholders' money for activities that did nothing to improve company profitability; nor should they concern themselves with what in principle were political matters. In the long term, he asserted, companies contributed most to the public good by concentrating on their basic task – producing whatever they produced efficiently and profitably.[12]

All else being equal, then, shrinking the "universe" would almost by definition harm returns. But this analytical condition does not necessarily reflect the actual situation, where "all else" is usually anything but equal. Maintaining high standards in terms of environmental and ethical consideration may also be risk-reducing and value-driving and thus compatible with profitability. Viewed in this perspective, it can scarcely be wrong – even from an "orthodox" economic viewpoint – for companies to broaden their horizons, think and calculate anew and incorporate factors that may previously have been ignored but are nonetheless relevant to their development.

Furthermore, having environmental/ethical goals does not mean that investors have to focus only – or even principally – on excluding companies or industries that fail to live up to these kinds of requirements. Instead they can, either individually or together with others, seek to persuade companies to remedy any deficiencies they may have in terms of environmental impact. Given such an approach, excluding companies can be something investors only resort to occasionally, in extreme cases. As a result, a shrinking "universe" would have only a marginal effect, if any. On the other

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[11] See Annex 5.

[12] Milton Friedman. "The Social Responsibility of Business is to Increase its Profits", *The New York Times Magazine* 1970. It is interesting to note, however, that Friedman also wrote in the same article about the need "…to make as much money as possible while conforming to the basic rules of the society, both those embedded in law *and those embedded in ethical custom*" (our italics).

hand, being an active/owner pursuing ethical and environmental issues naturally comes at a price.

A moving target

Whether it is a case of excluding companies or of bringing pressure to bear on them, the ethical and/or environmental demands that investors impose might be so costly that it would be virtually impossible for the company to meet them. If an investor were to make draconian demands as regards the environment – perhaps insisting on no environmental impact whatsoever – this would in practice preclude share investments of almost any kind, at least in the manufacturing sphere. Investment options would be severely curtailed, and returns with them. On the other hand, it is also clear that if investors were to make no ethical or environmental demands whatsoever, but instead invested freely in companies that profited by totally ignoring all environmental and social imperatives, such returns would be very unlikely to last. Such companies clearly risk attracting public intervention, union action, negative publicity and "badwill", to the detriment of both the portfolio company and the investor.

This means that somewhere between "everything" and "nothing" there should be a level of ambition corresponding to maximum anticipated yield. This element of "trade-off" is basically nothing unique to ESG-issues, but applies to all types of risk-reward reasoning: if you choose to take large, unmanaged risks, sooner or later you are sure to suffer severely in one way or another. If on the other hand you want to eliminate a risk altogether, extremely high costs are involved. So from an investor viewpoint ESG-factors could be considered as just one risk and one opportunity among many that investors have to deal with. In such a perspective a carefully defined and well managed ethics and environment policy could in itself be seen as an indication that the company is skilled at risk management and is otherwise well organised and well run in general.

Determining what might be considered the optimal level is not easy in quantitative terms. In practice, however, the most important determinant is likely to be which ethical values and outlooks a given society embraces at a given point in time. Thus the optimal level is not self-evident but changes over time, due for instance to

changes in norms and attitudes towards what may be considered reasonable, legitimate and acceptable.[13] In a particular situation, it may be extremely costly to meet an emission target, for example. On the other hand, what today is considered unrealistic may be completely realistic in a few years' time, with the advent of new, cost-efficient technology.

Thus it *may* be economically rational to be one step ahead in a sense and impose heavier demands than might be considered optimal at that particular juncture from a profitability and yield viewpoint. As an investor, you can choose to try to *anticipate* a certain development or improvement, whether in production methods, norms, attitudes or economic conditions. You may, for instance, believe that consumers will be prepared to pay more for environment-friendly products or for goods known to have been produced under ethically acceptable working conditions. Or you may be anticipating an imminent breakthrough in emission-curbing technology, or an x per cent rise in petrol tax within a certain number of years.

Predictions about the future, however, are famously unreliable. If matters do not work out as you had hoped or anticipated, both company profits and investment yields are reduced.[14] Every investment strategy has to strike balances and consider the odds in this way. Adopting an ethical or environmental profile is one fully legitimate strategy among others that the AP funds, for instance, might find attractive. If so, however, it must be assessed and viewed precisely as an investment strategy, i.e. on the basis of whether it yields high returns or not.

In sum, the question of whether there is a conflict between the high-yield objective and the ethics/environment objective cannot be answered by a simple yes or no. The answer is that such conflicts may arise under certain conditions and dissolve under others. One could perhaps make a case for the following: companies and investors that are explicitly or tacitly in tune with what most people in a society feel in terms of ethics and the

[13] This is not a reference to passing fluctuations in opinion prompted by the occasional "scandal", but to more fundamental attitudes and perceptions. The latter of course change, too, but the process is more lengthy.

[14] Many institutional investors working with sustainability issues are convinced that developments in the climate sphere will mean that companies basing their strategies on an understanding of these issues will be the winners in the future. This may be so. However, no-one can be absolutely sure. "Sympathetic" investment strategies, too, may represent a considerable risk.

environment probably stand the best chance of reconciling the two objectives.

The short run and the long term

In the short term, the high-yield and ethical/environmental objectives may well conflict, in that anyone focusing on reaping a profit as quickly as possible is hardly likely to spend much time and effort on sustainability aspects. A company that sponsors or initiates a gender equality project, for instance, can hardly expect to reap the profits in the space of a year; over a ten-year period, though, the situation may be very different. What may be of some interest even to short-term actors, however, is their reputation in the market. The prospect of being pilloried by the media for involvement in shady business deals is a worrying one, at least for actors who are far-sighted enough to want to remain in the market in the years to come.

In the case of actors like the AP funds and other pension funds who almost by definition explicitly adopt a long-term view, the circumstances are different. An organisation or operation that wants to work and act sustainably in the long term must not only abide by the rules and regulations but must also look after its resource base, i.e. the corporate population and the industries in which it has invested. When participating as an owner (or, in the case of interest-bearing securities, as a lender) in a company, you have to take into account the quality of factors affecting its long-term production capacity and its yield potential.

These may include the employees' health and the surrounding physical environment, or factors that affect the company's willingness and ability to uphold its legitimacy and preserve its brand. A company that ruthlessly exploits its workers or the environment, or otherwise operates close to or beyond the limits of morally acceptable behaviour, indirectly exposes both its owners and its financiers to substantial economic risks, especially if the company is large, well-known and exchange-listed. There is a clear danger that within the foreseeable future such a company will be "punished" in one way or another by consumers, suppliers, employees, the media, and ultimately the stock market. It may find it difficult to remain in the market for very long, and its stay will be

steadily shortened as information spreads and becomes increasingly available.

A long-term investor striving for high returns must bear this in mind when assessing such a company.

So as we have seen, a company's ability or inability to live up to fundamental and widely accepted ethical and environmental standards constitutes a risk/success factor among others in terms of anticipated yield. For a long-term investor, consideraton of this is – or should be – a natural, integral part of the corporate analysis.

Objective or constraint?

The question of "environment and ethics" or "sustainability" versus financial yield/profitability can be viewed from a rather different angle than simply in terms of two objectives to be ranked and weighed against each other. Instead, yield can be seen as the objective and (broadly speaking) the ethical principles or sustainability objectives as a constraint, or perhaps as a starting point or prerequisite when undertaking an investment in the first place, regardless of profitability or lack of it.

This means that certain investment options that in principle could be profitable – perhaps highly profitable, even – are eliminated. In this respect, you have thereby imposed a constraint on what is theoretically the maximum possible yield, which in principle means you have devalued the yield objective. Such constraints, however, have always existed and have always been applied, often as a matter of course; thus they may not even be perceived as constraints. For example, serious actors have never deliberately participated in or financed the illicit drug trade, however financially rewarding it may be. Nor do they purposely violate environment protection laws or bribe public officials. The great majority of companies abide by the law and basic standards of behaviour as a matter of course, not through economic calculation. Few want to make money out of just anything, just anyhow. From a philosophical viewpoint, this is a type of ethics, based on common, fundamental views on human rights and decency, or "deonthology" to speak more theoretically, inherent to most people and actors. The fact that the regulations governing the AP funds' activities do not refer to "maximum possible yield" but to "high" yield could be said to reflect this quality.

How “the bounds of decency” emanating from such ethical standpoints are to be defined is of course basically a question of what values an investor holds or feels authorised to represent. In the case of public actors such as the AP funds, the Committee takes the view, as noted in the previous section, that such a definition should reasonably be determined by the values and perceptions that enjoy wide, well-documented acceptance and approval and which are expressed in the Constitution’s Instrument of Government.

In sum, then, it is fair to say that in the case of long-term investors there is not usually a conflict between the high-yield objective and an ethical stance based on widely accepted rules and standards of behaviour. The reduced returns that may result from having slightly fewer investment options must be weighed against the potential that exists for better returns and lower non-financial risks. As shown by the accounts in the previous chapter of how sustainable investments fared in practice, the empirical results do not contradict this hypothesis.

5.4 The ownership role

The AP funds’ opportunities and constraints

In the case of the AP funds, corporate governance has two separate dimensions. One concerns how the state as owner realises its aims regarding the funds’ activities by introducing laws and regulations, by selecting and appointing executive board members and by evaluating investment outcomes. The second, which reflects current usage of the term corporate governance, concerns how the board in turn carries the process a step further by adopting policies and guidelines etc that fund institutions are required to follow in their dealings both with company managers and boards and with other owners.[15]

There are two basic questions here. One concerns the AP funds’ remit to participate as an active owner in general, while the second concerns whether active efforts to incorporate ESG aspects imply a different type of corporate governance than the traditional kind. If so, what does this mean for the funds’ approach to their task?

[15] Cf the expression “governance *of* and *by* financial institutions”.

The law governing the funds' activities does not explicitly refer to corporate governance as such beyond saying, in relation to the Swedish portfolio, that the Seventh AP Fund may only vote for its holding in what may be described as an emergency. As we have seen, the maximum extent of the First-Fourth AP Funds' ownership is regulated by law: two per cent of the overall market value and 10 per cent of an individual company's market value – which mean there is a limit to the amount of influence these funds can wield. While such constraints could actually be justified by the need to spread risk, there are indications in the preparatory documents to the law governing the AP funds' activities that limiting their voting power and influence is in fact the principal motive.[16] In the case of the Seventh AP Fund, the constraints on active ownership are more clear and specific, since the fund is expressly forbidden to vote at Swedish companies' general meetings. No official reason has been given for this, but presumably it, too, reflects a desire to limit state influence on company ownership. The logic is difficult to understand, however, given that the First-Fourth AP Funds together possess ten times as much capital as the Seventh AP Fund.[17]

The restrictive attitude reflected in the rules and in the preparatory documents concerning the ownership role of the AP funds has its historical roots in the debate on economic planning and socialisation that informed Swedish political life in various forms and with varying degress of intensity from the end of the Second World War and for the next 40 years. In practice, attitudes to active corporate governance have changed considerably in recent years, although this has yet to be codified.

There is always a risk that in some situations a body that both has considerable economic resources at its disposal and (in its capacity as a public authority) is ultimately under political control will be used for other purposes than simply capital investment for the benefit of pensioners. This could be cited as a reason for keeping such constraints in place. However, preventing an important owner from fulfilling the same regular ownership role as all the other owners is something of an anomaly. In the final

[16] Act 2000:192, Chapter 4, Section 6. See also the report of the Commission on Business Confidence (SOU 2004:47, p 185).

[17] Simulations commissioned by the Premium Pension Inquiry show that the Seventh AP Fund's share of the Stockholm Stock Exchange is expected to be less than one per cent in 2020 at current market share (30 per cent of the premium pension system), i.e. on a par with the First-Fourth AP Funds' ownership shares (SOU 2005:87, Annex 3).

analysis, it is a matter of weighing risks against costs. In our opinion, there would seem to be little danger of the funds being "politically misused", while moreover the risks involved are reduced as a result of our proposals on how fund boards are to be appointed and to operate.

Financial investors or active owners?

The preparatory documents describe a further constraint on active, responsible ownership that is fully relevant here, namely that an ownership role in which investors participate actively in the work of election committees and perhaps also of company boards may conflict with the high-yield objective – as an investor, you are less free to invest and re-invest your assets.

Determining where the line is to be drawn in this respect is impossible, and there are a number of contributory factors to take into account. One is the size of the holding. If you are among the 5–10 largest owners, it could be argued that you both can and should involve yourself fairly extensively in the management of the company.[18] Your aims as an investor are also important: you may have long-term, structural motives for possessing even a small holding, in which case it is only natural to take a responsible role. Inversely, a fairly large holding may be a purely financial investment.

This, too, must be taken into account when deciding the extent of one's involvement as an owner and what form such a commitment takes. Again, a high rate of return must be the overriding objective. Since the fonds are not supposed to be venture capitalists or "industrialists" in any way but institutional investors who may be expected to assume the degree of responsibility such a role imposes, there are limits to how far active ownership should go. It is worth discussing whether in practice, perhaps, the line should be drawn at participating in the work of the election committee, whereas joining the executive board might limit a fund's freedom of action.

[18] It has become standard practice in Sweden in recent years for the five largest owners in a company to sit on the election committee.

Dialogues – opportunities and problems

Regarding the ownership role and how it relates to ethics and the environment, we have noted that "ethical" investors around the world – including the First-Fourth AP Funds – are moving away from traditional exit strategies and increasingly entering into dialogue with company management. In pursuing the latter course, owners tend to actively elicit information from the companies and their line organisations, sometimes by their own efforts and sometimes via consultants.

There are two advantages to dialogue. One is that it can help a company to develop and improve, in terms of both sustainability and profitability. The other is that you can avoid exclusions and thus a shrinking investment universe, with the threats to yield this entails.

To begin with, for owners, or potential owners, it is no wrong to actively seek information on a company and its activities over and above the information made available through official company channels in the form of annual reports and the like, or via the media. It is worth asking, however, whether and to what extent it is necessary or appropriate to wear different hats in different contexts. Is it possible to be a "traditional" owner who is active both at annual meetings and in helping to elect boards, and at the same time be an "investigatory analyst" actively communicating with the line to examine, evaluate and formulate demands as to how the company is to operate. Does this mean bypassing the annual meeting and the board in an inappropriate way? Might insider problems arise?

It is, however, the portfolio company rather than the investor that risks committing formal errors in such a process, should it fail to ensure that both owners and the market are supplied with largely the same information, or if it succumbs, or is thought to be succumbing, to "pressure" from a particular owner. A company cannot have one kind of policy for dialogues with certain owners and investors in certain areas and another for other issues and owners. This would contravene the principle of equal treatement enshrined in the rules and regulations. Hitherto, however, there has been no sign of any insider situations arising where the AP funds are concerned.[19]

[19] See Annex 5.

Another problem is that when the funds enter into a negotiation-like process with a company, this cannot as a rule be reported publicly except to a very limited extent. The degree of discretion "required" is not specified, however, and it seems reasonable to assume that greater openness – here as in most other areas – ought to be the natural course. Nevertheless, a transparency problem arises in this connection. Bearing in mind that the AP funds are government agencies with a democratic remit and with public trust as a key aim, this may be a cause for concern. One solution to the transparency problem might be if the fund boards – which after all operate on a commission from the Government, and ultimately from the Swedish people – were to take on a special responsibility for the way corporate dialogues are formulated and dealt with. In Sweden as in many other countries, what are termed corporate governance codes have emerged in recent years, in which a common denominator is the need to create more explicit demarcation lines and divisions of responsibility between owners/annual meetings, executive boards and company management. A dialogue strategy does not in itself conflict with the aims and principles set out in these company codes, but such strategies must be formulated and handled with due care and attention so that the risks inherent in them do not materialise.

Ethics, corporate governance and remueration schemes

The Committee's terms of reference raise a specific issue closely connected with ethical principles and attitudes, and with public trust in the AP funds. It concerns how the funds, as owners, should proceed when dealing with what are called compensation, remuneration or incentive issues, i.e. the economic terms and conditions under which the companies' senior managers are to operate and which are normally established by the executive board. This includes pay awards and the principles governing them, and also concerns other benefits such as pensions and bonuses and how these are designed.

The considerable media attention usually accorded such aspects – in light of the various "scandals" that have been uncovered, and most recently in connection with efforts both in Sweden and abroad to deal with the international financial crisis – means that they tend to have an immediate impact on how the general public

perceives the funds' actions. As a result, they quickly climb up the agenda.

Designing transparent, rational compensation schemes that serve long-term corporate interests is known to be a complex task involving balanced appraisal and much weighing of pros and cons. Often, it is unclear how a given model will work under different circumstances. At the same time, owners can and must be guided by ethically accepted principles and premises in their work, and they must also be able to communicate them externally. It should be emphasised, however, that negotiating and formulating the actual agreements is the task of the boards, not of the owners. As an owner, an AP fund cannot shoulder responsibility for what individual agreements look like in individual companies. Part of their role as owners, though, is to give their views on the basic arrangements or setup – how matters are conducted in principle – and to elect board members who act in accordance with such principles.

The Commission on Business Confidence, assigned by the Government to find ways of restoring public trust in the wake of the notorious "compensation programmes" uncovered in the Swedish business community, identified a number of basic principles in its report that it felt should be included in all such programmes, reflecting both economic sense and legitimacy.[20]

The Commission found that the remunerations paid primarily to senior executives in some major listed companies had been one of the most damaging factors in terms of public trust. Within the business community, too, it noted, there was widespread criticism of what was perceived to be extravagant, badly constructed compensation models, and the Commission felt owners should take greater responsibility for such issues. It further established that it is up to the board to draft proposals for an appropriate compensation scheme for senior management. In performing this task, it is to be guided by the interests of the shareholders.

Accordingly, the Committee has proposed the following requirements for compensation schemes:

- They should be competitive in the relevant market for the most qualified individuals in each employment category/type of post.

[20] "The Business Sector and Confidence", SOU 2004:47, pp 221.

- They should serve their purpose correctly, in the sense that they reward actions and behaviour that both reflect the company's strategy and help realise its overall objectives.
- Remuneration should be clearly linked to performance.
- There should be well-defined ceilings for remunerations, and these should be no higher than what is considered relevant as an incentive for maximum performance on the part of the employee.
- Pensions should be premium-based (defined-contribution pensions) in form and the premiums paid should be based largely on the individual's regular salary. Also, the company's pension costs should be predictable and should be recognised in the income statement in conjunction with the work that generates the cost.

It was also felt that compensation issues should be dealt with by the board in a clearly defined, structured process aimed both at establishing the general principles for how reward schemes for senior managers are to be designed and at applying these principles in each specific case.[21]

Today, all the First-Fourth AP Funds have established the principles that they advocate in their role as owners and which are in line with the proposals of the Commission on Business Confidence. The policy of the First AP Fund, for instance, states the following:[22]

- *In order for a long-term share-related incentive scheme to have the desired effect, the following criteria must be met:*
- *The incentive scheme shall be part of a communicated long-term compensation strategy.*
- *The achievement of a pre-determined, clear and measurable target shall be required in order to qualify for allocation in share-related incentive schemes. As a rule, this achievement should be linked to the company's overall profitability. The*

[21] We note, for instance, that both the Trade Union Confederation and the Confederation of Swedish Enterprise have developed and published policies on this theme. The respective publications are "Ägaransvar och ägarmakt" (LO 2006) and "Vägledning avseende ersättningar till VD och ledande befattningshavare" (Svenskt Näringsliv 2006).
[22] The First AP Fund's Ownership Policy.

performance targets shall also be communicated to the shareholders.

- *Long-term share-related incentive schemes expose the company to a risk for movements in the price of its own shares. Information about how the company intends to manage this risk, and the related costs, shall be put before the general meeting prior to decision. 7 (11).*
- *Share option schemes should preferably be relative, i.e. price development for the company's shares should be related to the general market trend, the trend for the industry or the share price trend for selected competitors.*
- *For share option schemes that are not relative, there should be an upper limit in the value of the scheme.*
- *An evaluation of costs and effects of previously implemented schemes should be used as a basis for decision on future schemes. This evaluation should be carried out from a shareholder perspective and should be presented to the shareholders.*

Thus today the funds have well-prepared policies and are focusing to a much greater extent on these issues at general meetings. Also, together with other institutional owners, they have pressed for the rejection or modification of certain incentive schemes presented for approval. The Committee is of the opinon that the AP funds have worked seriously in this area and that their efforts are worthy of respect. Bearing in mind the implications such matters have for the extent to which both companies and investors enjoy broad public trust, the development of transparent and relevant compensation schemes must be further encouraged and promoted.

6 Development opportunities for the AP-Funds

The AP funds have shown considerable enterprise in developing policies and methods for dealing with the somewhat vaguely worded demand whereby they are to take into account ethics and the environment in the performance of their task. Also, consideration of these aspects has been undertaken in such a way that no perceptible conflict has arisen between this objective and the funds' high-yield objective .

ESG, however, is an area in which progress is rapid and which is rich in development opportunities. In this final chapter, we discuss what we consider to be the five most important areas in a development perspective.

The Committee has identified two overarching approaches to ESG issues that may be summarised in two keywords: *integration* and *trust*.

In the Committee's assessment, everyone working with fund management at whatever level needs to devote more time and energy to ESG issues. It is vitally important to broaden and deepen skills and qualifications to ensure that sustainability aspects are *integrated* as far as possible into traditional financial analyses, administrative methods and procedures, and corporate governance. For the sophisticated investor, assessment of such factors as environmental risk, behaviour in conflict zones, accusations of corruption, child labour and the like should not be treated as a separate issue on the margin – a sort of optional extra – but as a natural, integral part of the corporate analysis and the company's market surveillance. A shift towards a more integrated approach is currently under way among the AP- funds. It is important that this should continue.

Trust is a vital factor in all financial activities, and especially where long-term savings are concerned. Skill, integrity and

transparency are key factors in building up the kind of credibility that engenders public trust. In the case of the AP funds, this means being a good, professional asset manager, adhering to the basic principles laid down for fund operations, and being able to communicate what is being done and why. The measures we propose in the following all relate to this in one way or another.

Finally, it is also important to ensure that consideration of ESG factors is defined in more formal terms. The wording in the preparatory documents concerning the need to take ethics and the environment into consideration should be incorporated into the text of the law itself. This in our view would make it clearer what applies here and would also provide a better basis for the evaluation of activities, besides sending an important message to the outside world.

6.1 The funds must formulate their basic values

The ethical principles expressed in our Instrument of Government – to promote people's freedom and wellbeing so that they may become active, independent individuals, and to support them in this endeavour – should be the key elements in the set of fundamental values and principles that fund boards need to establish for their activities. A well-defined set of values – and especially, perhaps, the process of formulating and implementing them – would enable the funds to adopt a more active approach to international conventions etc and would also pave the way for ethically and environmentally oriented priorities.

Responsibility for sustainable investment cannot be confined to simply complying with laws and conventions. If ethical responsibility is no more than this, there would seem to be little need for an ethics policy – in a sense, ethics begins where the law ends. International conventions cannot be used as divining rods. Rather, they are something one have to relate to actively. A further requirement is the ability to prioritise and re-prioritise the work between different areas – for a start, not all the 140 conventions to which Sweden is a signatory are of the same relevance to the AP- funds. To pursue such a course and establish the requisite priorities, you

need a specific set of ethical principles on which to base your actions.

The approach we recommend means applying the conventions on the basis of the values they represent, instead of proceeding simply on formal grounds ("Sweden is a party to...") as has often been the case in the past. Thus the funds will be required to formulate basic values and principles of their own as a basis for their actions. These are already in place to a certain extent, but need to be broadened to embrace ESG-aspects as well. Developing such values does not conflict with the convention basis for action described earlier – rather, it gives the conventions a manifestly ethical foundation.

The purpose of the AP funds' activities is, to quote the National Pension Funds Act, to "manage fund assets in such a manner as to achieve the greatest possible return on the income-based retirement pension insurance", or in other words to help ensure Swedish pensioners of a good living standard by means of high returns on investments. This in itself is an ethically-based objective. If, when an AP-fund is faced with two alternatives, both meeting the ethical and environmental requirements defined by the fund, an investor passes over the one with the greatest anticipated yield and instead chooses one that is expected to have a more favourable impact in, say, environmental terms, he has failed in his duty to pursue this fundamental objective. Thus neither on ethical grounds, nor on any other grounds, are the funds justified in deviating from their overall objective of a high rate of return. It is absolutely essential to ensure that the AP- funds are not used as a means to achieve other political goals, whether these relate to economic policy, industrial policy, environment policy or development cooperation policy.

6.2 Stronger boards

The fund boards need to adopt a more distinct and proactive role in tackling sustainability issues, and they must be furnished with the means to do so. This means the procedure for appointing board members will have to be improved and the work of the boards will have to be evaluated systematically and regularly.

In the steering documents governing their actions, the AP fund boards already have an explicit remit to shape fund strategies, and these of course encompass the ethics and environment sphere as well. When appointing board members, the Government should take account of invididivual expertise and personal/professional interest in the issues.

As owners, the AP funds rightly make specific demands on how *company* executive boards proceed in their recruitment work and in their other activities. The Second AP Fund, for instance, states the following in its corporate governance policy :

> It is important that every exchange-listed company has an effective board that is dedicated to the company's well-being.
>
> The election committee shall ensure that a structured assessment of the board is conducted on a regular basis. It shall also ensure that new board members are recruited from a broad base of potential candidates. The Fund considers it a matter of some urgency that the base from which board members are recruited shall be expanded. The (election) committee shall strive for a structured assessment not only of individual members but also of the chairman of the board.
>
> To create an effective board, it is important to establish an effective working approach for the work of the board. One important condition is that the board shall not be too large.
>
> Each board shall include representatives who are in no way dependent on major shareholders or the company's executive management. Each member of the board shall safeguard the interests of the company and thereby those of all its shareholders.

In our view, these principles are commendable and could be usefully applied to the fund boards as well.

Fund board members need to be personally and professionally qualified for the task of integrating ESG aspects into their asset management work. The Committee believes there are strong reasons for reviewing the current setup and seeking to establish a more clearly defined and more professional process for the appointment of AP fund board members. It also takes the view that a professional election committee appointed by the Government should be responsible for the recruitment procedure and should recommend suitable candidates. Preferably, such an election committee should be broad-based. In recent years, a special unit has been built up at the Government Offices to handle recruitment to state enterprises, and this unit could well have a role to play in the present connection as well.

In the case of the First-Fourth AP Funds, the principle is that the social partners (unions and employers) are represented on the boards. One of the reasons usually put forward for this arrangement is that the assets managed in the pension system are in a sense money that the partners have refrained from claiming in pay talks. Accordingly, their representatives are on the board to safeguard their interests. The Committee considers, however, that given the AP funds' clearly defined asset management remit, there would seem to be little need to safeguard the interests of one specific group as opposed to those of other groups in the community when managing pensions. It is also important that the Government has the freedom to appoint and compose a board without some seats being reserved for the representatives of certain parties. The latter operate under basically different conditions to those of other board members, in that these individuals do not belong to the board primarily because of their personal qualifications for the task but because they are *representatives* of an organisation or group.

Thus in our view there is no reason why the social partners should continue to nominate candidates to a certain number of seats on the board. We believe that transparency and integrity – and consequently trust – require that all members of the board are elected and appointed on the same premises.

There is of course much to be said for being responsive to values and currents of thought outside the financial market, not least since it helps the boards communicate to a broad public what they are doing and why. An election committee's task, therefore, should include considering the need for other kinds of knowledge and experience besides the purely financial.

Board members should be offered both an adequate introduction and skills enhancement training. The demands imposed on them, and their responsibilities, should be reflected in their pay. A reduction in the number of board members should also be considered. Finally, both the boards and the work they do should be subject to regular external assessment, in accordance with standard practice in the business sector in recent years. Such assessments represent an important basis for the work of election committees.

6.3 Quality and resources

> The funds need to invest greater resources in their work on ESG issues. They must build up a larger body of analytical skills of their own so as not to be too dependent on consultants. Corporate governance efforts, too, including dialogues with companies, require resources. It is vital that functions already in place – using the resources currently at the funds' disposal – deal with these issues actively and in a committed way. The key to success is the integration of financial analysis and sustainability aspects.

The AP funds must engage practically with sustainability issues in a way that is perceived as rational and competent. If they are to proceed from a set of values and principles based on an agent's perspective, a more in-depth type of information material and a more nuanced analysis will be required. This presupposes skills and resources.

Information supply and analysis in all the funds except the Seventh and Second are dependent on a single consultant, who uses screening to track down and evaluate developments and phenomena that either are or might be in breach of the ethical and environmental conventions. As long as internal capacity for dealing with these issues is as limited as it is at present, there is a clear danger that the consultants' assessments will have too great an impact.

Thus there is every sign that the funds would benefit from investing in the development of substantial analysis and procurement skills of their own so as to ensure that the input they receive from consultants genuinely meets the required standards. Such an arrangement would also enable them to undertake a certain amount of research work of their own. This can and should be supplemented by cooperation with others, partly other AP funds but also other investors both at home and abroad. The PRI, for instance, offers a forum for cooperation. Although comparisons are frequently hazardous, we have noted that many comparable institutions abroad – those harbouring "responsible" ambitions – invest considerably greater internal resources in this sphere of activity than do the AP funds.

6.4 The corporate governance perspective

The AP funds' platform for exerting pressure on companies is their shareholding. This platform must be purposefully and efficiently exploited and accord with the ownership policies adopted by the funds. The historical constraints that prevent the AP funds from taking a clear responsibility as owners should be phased out. This does not mean, however, that the AP funds should aim to be active owners in all the companies in which they own shares – they must, for instance, strike a balance between their role as owners and their role as investors.

Corporate dialogue on sustainability issues has emerged as an important working method for the AP funds, too. These must be structured in such a way that they do not create uncertainty in ownership roles and corporate governance.

The AP funds are to continue working actively vis-à-vis companies on improving remuneration schemes. Not least over the past half year, international turbulence in the financial markets has underlined the importance of having systems that reward responsible behaviour.

Ever since the advent of the ATP supplementary pension scheme in the late 1950s, the AP funds' ownership role has been a controversial, politically charged issue. To a great extent, this explains the restrictive rules currently in place concerning their role as active owners. In our opinion, there would seem to be little danger of the funds being "politically misused", while moreover the risks involved are reduced as a result of the proposals we have discussed concerning how the executive board is to be appointed and to operate. The constraints preventing the Seventh AP Fund from assuming an active ownership role are particularly well-defined and resolute, since this fund is not allowed to vote at general meetings, despite the fact that its shareholdings are about a tenth of those of the buffer funds. The constraints on the Seventh AP Fund are both illogical and anachronistic and should be removed.[1] Elsewhere,

[1] It is interesting to note that the Commission on Business Confidence (SOU 2004:47) made the same recommendation, as did the Premium Pension Inquiry (SOU 2005:87). The Commission also called for a general review of the AP funds' investment rules with a view to allowing them greater freedom of manoeuvre in their policies. All these proposals will be considered by the National Pension Group in the autumn of 2008.

there are also good grounds for reviewing the constraints – primarily in the investment regulations – that *de facto* are preventing the buffer funds from properly exercising their influence as owners.

Another aspect of ownership is the difficulty of combining the role of financial investor with the role of active owner. In practice, owners taking part in the work of the election committee, and perhaps also having a seat on the board, are not free to act as an investor, which means their work in this area may conflict with their efforts to achieve the high-yield objective. Here, too, yield must be the overriding objective. Since the funds are not supposed to be venture capitalists in any sense, there is a limit to how far active ownership should go.

The trend among "responsible" investors all over the world is towards a policy characterised by dialogue with business companies. This method has much to recommend it. One aspect that may be a problem is that such an approach goes beyond traditional corporate governance. From the companies' viewpoint, the question of equal treatment of owners arises. There is a risk that corporate governance will be unclear. This will require careful consideration.

The more proactive approach that has recently begun to emerge must include both carefully considered strategies and sufficient input of resources if the activicty concerned is to succeed. In the case of the former, the good corporate governance policies that each of the funds has developed represent a solid basis on which to build. These, of course, must be fully implemented and followed up. Both the work of the Ethics Council and cooperation with other investors have been valuable ways of exerting pressure on the companies and also of sharing costs. There are grounds for broadening cooperation between funds, e.g. when voting in respect of foreign holdings. The Ethics Council is currently engaged in reviewing this matter, and has made considerable progress. Closer cooperation would enable the funds to step up their activities as owners in the international arena, at a relatively low cost. They could also join in developing their work on basic values. Furthermore, they could, in our view, develop cooperation on "sustainability dialogues" with Swedish companies, without coming into conflict with the official requirement that each fund should be independent.

Methods need to be developed for assessing environmental and ethical aspects in connection with unlisted companies as well. The

same applies to other types of assets, such as real estate property. The AP funds, like most other institutional investors, have invested mainly in listed companies. This type of company is in fact the easiest to monitor for ESG compliance, due to the information and transparency requirements placed on it. As the importance of the unlisted or private equity market continues to grow, this may create problems. If the AP funds choose (and are allowed) to step up their presence in the market, perhaps taking part as direct owners etc, this may mean investing in companies that in reality they have little chance of monitoring for commitment to ESG issues. If, on the other hand, they refrain from becoming involved, they may in time find their "investment universe" steadily shrinking, with the attendant risk of less diversification, higher risk levels and lower yield. The funds are faced here with a complicated process of weighing pros and cons, where the answers are never self-evident. While it is important to constantly aspire to bring ESG aspects into the equation, it is not always possible to make the progress you want, nor to always give precedence to ESG-related issues. When this is the case, however, you must be prepared to accept responsibility for it and explain your stance – here, too, the principle of "comply or explain" can be applied. To quote Voltaire, the perfect is the enemy of the good. Or more colloquially, something is better than nothing.

The AP- funds have developed carefully considered policies and have cooperated actively with other owners on remuneration schemes. Given the importance of these issues from the viewpoint of public trust, the funds must continue to work proactively in this area. Not least over the past half year, international turbulence in the financial markets has underlined the importance of having schemes that reward responsible behaviour. Remuneration or compensation schemes must provide the right incentives, based on the fundamental values and principles that the funds represent.

6.5 Follow-up, evaluation and information

In future, the Government's annual evaluation of the AP funds' activities should also extend to sustainability issues. The development of communication strategies in this connection is also essential.

The funds' work on sustainability issues must be followed up and evaluated on an ongoing basis. Today, the Government provides an evaluation in the form of a written communication to the Riksdag, but ESG aspects have not hitherto been dealt with in this document. In the Committee's view, sustainability issues should be integrated into the regular analytical and investment management work. This means it should also be integrated in the general evaluation process. Where sustainable information is concerned, "good auditing standards" have yet to be developed, but efforts are under way in the auditing industry to improve matters in this respect, in response to growing market demand.

The AP funds' boards and senior managers need to work actively and pedagogically to explain and clarify their role in relation to the environmental and ethical imperatives, and how they engage with these aspects in their investment activities. Much has already been achieved in this respect, not least through the efforts of the Ethics Council, but it is the kind of work for which a long-term, sustained approach is required. Proactivity is also essential – you are unlikely to make a proper impact if you only furnish information "reactively", i.e. when something (usually unfavourable) has already occurred.

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The Agent's Perspective and the Ethics of the AP Funds

by Per Bauhn, Professor of Practical Philosophy

1 On ethical reasoning and the agent's perspective

There are two kinds of ethical reasoning. *Descriptive* ethics concerns the norms of right and wrong conduct that people actually follow or have followed at a specific time and in a specific society. Studies of ethics in this descriptive sense can occur in historical, anthropological or sociological guises. More common, though, is that we use the term "ethical reasoning" to refer to arguments about how we *should* act, i.e. what is right and what is wrong to do. Such normative arguments do not limit themselves to reporting people's opinions about right and wrong; they also seek to reach sustainable conclusions about ethical correctness.

So what do we mean by "sustainable conclusions" in normative ethics? One minimum requirement – that applies to all arguments and not just to normative ethics – focuses on the freedom from logical contradiction. Ethical reasoning must be consistent in the simple sense that the ethical principles or rules that we arrive at must not cancel each other out. For example, we cannot simultaneously claim both that "it is *always* wrong to take a person's life" and that "capital punishment can *sometimes* be justified".

However, the non-contradiction requirement is a formal condition. It merely states that we cannot simultaneously accept and deny one and the same assertion. It says nothing about which assertion we should support, nothing about the contents of our ethics. Thus, the non-contradiction requirement says nothing about whether capital punishment is right or wrong. It says only

that if we believe it is always wrong to take a human life then we cannot also support capital punishment.

So how do we approach the issue of normative ethics? How can we argue that some actions are morally right and others are morally wrong, that we have certain rights and obligations in relation to one another?

One possible way is to assert that there are some values or goods that are so self-evident that we neither can nor need to argue in favour of them, and that the best ethical course is to achieve as much as possible of these goods. This is the *ethics of maximisation*. Happiness tends to be a commonly occurring good in the ethics of maximisation, and is central to its best known formulation, utilitarianism. The basic concept is simple. Happiness must be better than unhappiness and more happiness must be better than less happiness. We should therefore maximise happiness, that is, ensure that as many people (or conscious beings, if we also want to include animals) become as happy as possible.[1]

The fact that happiness must be a good for each human being appears so intuitively self-evident that it does not seem to need any supporting argument. True, we can point out that there are people who deliberately choose an ascetic life of great privation, rejecting all luxury, all pleasures, all desires. But the answer from the viewpoint of ethics of maximisation is merely that this *is their* way of seeking happiness. Some people are happy to live a wild life and others to live a hermit's existence in the desert. But they are all seeking happiness.

However, the ethics of maximisation is not problem-free. What may appear reasonable on the individual level may be absurd on the

[1] This is how Jeremy Bentham formulates his "principle of utility": "It is the greatest happiness of the greatest number that is the measure of right and wrong". See his *"A Fragment on Government," in A Fragment on Government and An Introduction to the Principles of Legislation* (ed. Wilfred Harrison), Basil Blackwell, 1948 [1776], p. 3. For a modern and more sophisticated version of the theory of the maximisation of happiness, see Richard Hare, *Moral Thinking*, Oxford University Press, 1981. Hare distinguishes between two levels of ethical thinking. On the critical level we select our ethical principles based on a desire to maximise the satisfaction of our preferences. On the intuitive level, i.e. in our everyday actions, we then follow these principles, e.g. that we should keep our promises, that innocent people should not be punished etc, without taking a stand on whether or not these choices maximise the satisfaction of our preferences in each individual case. We thereby protect ourselves from the devastating mistakes that can result if – in a complex situation where there is a lot at stake – we start to speculate about what will lead to the greatest possible happiness in the long run. One problem here is of course whether a theory that accepts that we should not always strive for the greatest possible happiness in our daily actions is still a form of maximisation ethics.

collective level. It may be reasonable for me to strive for as much happiness as possible in my life. After all, I am the one who must be responsible for both the sacrifices and successes in my personal striving after happiness. But when we talk about maximising happiness for a collective, it is not a matter of balancing the pluses and minuses within an individual life but rather of doing so across the boundaries between individuals. Some individuals might have to be made unhappy in order that others can become more happy and thereby maximise the total amount of happiness in the collective as a whole.

According to the ethics of maximisation I may be right to save my life by giving my neighbour an anaesthetic and having his kidney operated into my body – if my continued life offers so much happiness to myself and others that it more than outweighs the unhappiness caused to my neighbour, his loved ones, and others affected by the intervention. Similarly, the ethics of maximisation can sanction departures from traditional principles of justice (e.g. that we must not punish any innocent person) if sufficient gains in happiness are involved. Suppose that an innocent man is imprisoned for a murder. The local police chief knows the man is innocent but no one else does, and outside the prison a mob is demanding that the man be hanged. The police chief must choose between hanging the man and thereby avoiding riots, or mobilising the national guard, which will mean that at least ten people in the mob will be shot and killed. Since no one other than the police chief knows that the man is innocent, trust in the justice system will not be damaged by the police chief hanging him. In this case, the conclusion of the ethics of maximisation appears to be that the innocent man should be hanged. This model gives no weight to the issue of guilt or innocence per se. In the final analysis, the issue is whether to kill one person or ten. If we presume that each casualty will cause an equally great loss of happiness, then we should sacrifice one rather than sacrifice ten.

Moral maximisation deals with the collective maximisation of happiness as if the collective were an individual. The theory presumes there is a total amount of happiness that can be added together across the boundaries between individuals in the same way as happy and unhappy events can be totalled up in an individual life. However there is no collective organism that experiences this total happiness – the only thing that exists are certain happy and

unhappy individuals.[2] And people who have their interests sacrificed to satisfy the greater interest of others may be fully justified in asking: “Why should we be sacrificed for their sake?” This is a question that deals with *justice* and the *rights* of individuals.

To claim that we have a right to a certain object is to claim that *no one else is allowed to deprive us of it,* and that at least certain other people (who have a certain relationship to us) *should also help us to acquire it* if we cannot do so ourselves. Thus, rights cannot apply to anything at all that we may want to possess; they must apply to something that is genuinely *necessary*. (The fact that I would very much like a cheap holiday in Tuscany does not make it my right. If my neighbour buys the one remaining last-minute trip to Tuscany he has not thereby set aside my rights even though I am frustrated by his behaviour.)

For a right to also apply as a *human* right (as distinct from customary law or outright legislation), it must also claim to be universally applicable. It must be able to claim validity over time and across cultural boundaries. It is these requirements of necessity and universality that Immanuel Kant bears in mind when he states that a law “must carry with it absolute necessity if it is to be valid morally”.[3]

Human action – *agency* – offers a starting point for just such a meeting between the universal and the necessary. As humans we are, at least normally, individuals who act or intend to act in the future. We have goals we want to realise and we plan and act to realise them. A life of action is also a natural starting point for moral reasoning since morality is about how we should or should not act. It is also a more fundamental starting point than the concept of happiness associated with the ethics of maximisation. Happiness means different things to different people but each person needs at least some degree of ability to act in order to achieve his or her idea of what happiness is.

All action also has a *normative dimension* since in our actions we express our ideas about what is good and worth striving for. We act because we *want* to achieve something. In this sense we can ascribe to each agent or acting individual a positive assessment of the goal

[2] Robert Nozick, *Anarchy, State, and Utopia*, Basil Blackwell, 1974, p. 32–33.
[3] Immanuel Kant, *Groundwork of the Metaphysic of Morals* [Grundlegung zur Metaphysik der Sitten], 1964 [1785], p. 57 [389]; 76 [408].

of his/her action. Individuals act on the basis of what at least *appears* to them to be good.[4]

Different agents have different goals and thereby place value on different things. Some people want to climb mountains while others content themselves with collecting stamps. But the mountain climber, stamp collector and all other agents share the fact that they must regard their ability to act successfully, plus the characteristics and conditions encompassed by that ability, as *necessary goods*. It would be a self-contradiction for them to claim both that they want to achieve their respective goals and that they can do without what they need to succeed in this endeavour.

What are these necessary goods? The American moral philosopher Alan Gewirth has summed them up as *freedom* and *wellbeing*.[5] Freedom involves the form of our ability to act: being able to exert informed control over our conduct, i.e. avoiding coercion and deception and being able to act based on our own informed choices. Wellbeing has to do with the *contents* of our ability to act – what we need when we act: life, health, safety and security, education, the ability to support ourselves, self confidence.

Freedom and wellbeing could be claimed as universal rights. Since we claim them in our capacity as agents with goals we wish to realise, we must also agree that all other agents have an equally valid right to make the same claim. We must therefore accept that all agents have the right to freedom and wellbeing.

The agent's perspective is thus a normative perspective. It is based on the fact that we, as beings who act, place value on the goals of our actions and on our ability to successfully realise these goals. From this perspective, we can evaluate actions, states of being, and political, social and economic conditions based on whether or not they are compatible with the freedom and wellbeing that all agents must claim in order to maintain their status as agents.

Different types of wellbeing can be classified according to how important they are for successful action. Murder and assault are worse attacks on an agent's rights than theft, since the loss of life and health can eliminate all further potential for action, while a theft does admittedly reduce an agent's level of assets and thereby his/her capacity for successful action, but without totally invalidating his/her ability to act. Likewise, infringements on freedom can

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[4] Aristotle, Ethica Nicomachea, III, iv, 1113 a15–23, in Richard McKeon (ed.), *The Basic Works of Aristotle*, Random House, 1941.
[5] Alan Gewirth, *Reason and Morality*, The University of Chicago Press, 1978, p. 48–63.

be classified according to whether they are permanent or temporary, and whether they are general or apply only to occasional actions. Being locked in and drugged is a worse attack on an agent's freedom than forbidding him/her to walk his/her dog in the park.

Rights are not absolute. If everyone has the right to freedom and wellbeing, there must be limits to the individual agent's right to freedom. For instance, this right cannot include the right to assault or enslave other agents. And an agent who has attacked others and thereby given himself greater freedom than he permits his victims can be deprived of his own freedom by a court, thus conveying that he has set aside the balance that should exist between his own rights and those of others.

There is also a link between the agent's claim to rights and the way a just society works. The state's most basic function is to protect the rights of individual citizens to freedom and wellbeing. This involves first and foremost a *capacity- preserving function*, with a justice system that prevents and punishes attacks on individuals' life, freedom and health. ("capacity" here means – from the agent's perspective – the *capacity to act* and the wellbeing associated with the preservation of fundamental prerequisites for goal-oriented action.) Capacity also involves a *procedural order* in which the agent-related right to freedom is expressed in a political decision-making process that relies directly or indirectly on the citizens' consent. That is how the democratic state is justified from the agent's perspective – the right to freedom of action is extended and becomes the freedom to shape with others the society whose laws we obey.

In Chapter 1 of the Swedish Constitution's Instrument of Government, the link between individual freedom and democracy is expressed in Article 1, which states that "All public power in Sweden proceeds from the people", and in Article 2 which states that public power is to be exercised with respect for "the liberty and dignity of the private person". The fact that the Swedish state is also required to protect each citizens' right to wellbeing is expressed in the same place, thus: "The personal, economic and cultural welfare of the private person shall be fundamental aims of public activity." The more specific political freedoms underpinning democracy are set out in Chapter 2, Article 1: freedom of expression, freedom of information, freedom of assembly, freedom to demonstrate, freedom of association, freedom of worship. These freedoms also include each citizen being "protected in his relations

with the public institutions against deprivation of personal liberty" (i.e. arbitrary imprisonment without trial). Further, the Constitution ensures each citizen's "freedom of movement within the Realm and freedom to depart the Realm." (Chapter 2, Article 8).

However, the freedoms expressed in the Instrument of Government are not absolute. Here there is a parallel to the agent's perspective, whereby if rights conflict we can assess the relative benefits of goods that are more or less essential. For instance, we can prioritise long-term freedom over short-term freedom. Similarly, the Instrument of Government notes that the statutory rights and freedoms it describes may be subject to limitations but "only to satisfy a purpose acceptable in a democratic society" (Chapter 2, Article 12). Freedom of expression and information may be restricted "having regard to the security of the Realm, the national supply of goods, public order and public safety, the good name of the individual, the sanctity of private life, and the prevention and prosecution of crime." (Chapter 2, Article 13). Further, "Freedom of assembly and freedom to demonstrate may be restricted in the interests of preserving public order and public safety at a meeting or demonstration, or having regard to the circulation of traffic." (Chapter 2, Article 14).

However, the state's protection of agent-related rights is not just a matter of preserving individuals' freedom and wellbeing, but also of the more dynamic goal of promoting and developing these goods for all citizens. Here we can talk of the state's *capacity-enhancing* function. All citizens cannot be assumed to have the capacity to act from the start, i.e to do the things they have a right to do according to the agent's perspective. It then becomes society's task to remedy this: "The public institutions shall promote the opportunity for all to attain participation and equality in society." (Chapter 1, Article 2). In this context the term "equality" should not be taken to mean that everyone should have the same amount of money or exactly the same standard of living, but rather describes a *civil* equality that allows everyone to be able to participate in social life. The subsequent lines on the need to combat different types of discrimination further support this interpretation. Also, compulsory school attendance and the statement that "The public institutions shall be responsible also for the provision of higher education" (Chapter 2, Article 21) can both be seen as a dynamic support of our capacity to act.

It is in this context that we should approach the issue of the AP Fund's investments. Based on the agent's perspective this involves taking steps today to promote future pension recipients' capacity to act by achieving the best possible return on their managed capital. As citizens in a democracy we assume a mutual responsibility for the societal prerequisites that will shape our long-term freedom and wellbeing. For the same reasons that we have to jointly finance our military defence, we must also ensure that there are enough resources to give us a secure old age. The yield requirement imposed on the AP funds can also be motivated by the fact that the funds' resources consist of money that employees and citizens have relinquished to the funds in compliance with political decisions. It is therefore reasonable to require of the political institutions that have taken upon themselves the task of managing citizens' money on their behalf (as opposed for instance to the citizens assuming full responsibility for their pension investments themselves) that they perform as well as possible.

Thus the yield requirement does not essentially differ from the ethical requirements now under discussion. On the contrary, it is in itself ethically motivated based on the agent's perspective and its focus on the long-term capacity to act.

2 The agent's perspective and the AP funds' investments

On 13 March 2008 the online business magazine E24 wrote that the AP funds invested SEK two billion in "companies linked to nuclear weapons and cluster bombs".[6] The article in E24 states that the AP funds also increased their investments in these business activities in the second half of the year. The chairman of the Ethics Council created by the First-Fourth AP Funds, Carl Rosén, defended the investments in the following terms: "Our starting point is that we will abide by the international conventions to which Sweden is a signatory; we cannot provide our own interpretation. For example, Sweden has signed the nuclear non-proliferation treaty but within its framework the manufacture of nuclear weapons is permitted".

[6] http://www.e24.se/branscher/bankfinans/artikel_321613.e24

This is not a self-evident conclusion. If by ethics we mean simply that we intend to obey the law, we might just as well omit references to ethics altogether. We could simply cite general obedience of the law as the highest norm. If there is to be any point in adopting a specifically ethical stance, it must go beyond the purely legal. (And how confidence-building is it if we cite compliance with the law as the guiding norm for our actions? It is as though we had thought about breaking the law but then decided against it.)

However, the fact that ethics is something more than merely obeying the law does not mean that Carl Rosén's conclusion is essentially wrong. For instance, we could claim that if it is not wrong to manufacture a specific type of weapon, then nor is it wrong to invest in companies that earn money from such manufacture.

For the person who regards making cluster bombs as ethically problematic, there are other alternatives besides refraining from investing. We may, for instance, choose to direct our investments at the development of self-destructing cluster bombs that do not stay on the ground and wound civilians long after they were originally dropped. We may also choose to invest our profit from arms manufacturers into supporting movements and strategies that aim to limit the use of such weapons. Profit from an investment that in itself may be ethically dubious can thus be used for goals with a clearer ethical profile.[7]

In January 2004, at the request of the Swedish Consumer Agency and the Consumer Ombudsman, the Swedish Investment Fund Association's Ethical Council for Funds Marketing (ENF) issued an advisory statement describing what might be good industry ethics for ethical funds. ENF had problems with the term "ethical'. Based on a definition taken from the Swedish Academy's wordlist, ENF restricted itself to defining "ethics" as "the science of moral good and bad". This is not particularly useful, since such a definition describes what ethics as a discipline concerns itself with, not what is ethically right or wrong. The definition thus provides no guidance as to what characterises an ethical fund in terms of its investment policy.

Even worse, ENF uses its misleading definition as justification for complete relativism. The dictionary definition it uses does not

[7] This idea is suggested by Joakim Sandberg in the article "Vad gör dina pensionspengar just nu?', *Filosofisk Tidskrift* no. 1/2007, p. 45–56, see espec. p. 52–55.

distinguish between normative and descriptive ethics. ENF can therefore interpret "moral good and bad" in terms of what is *perceived* (in a specific society at a specific point in time) as being morally good or bad. Consequently, ENF asserts that what is ethical "is relative and subjective and its contents change over time." The gist is therefore that "[t]he assessment of what can be categorised as ethical must therefore be made by the individual from case to case". Consequently, ENF refrains from labelling specific investments as non-ethical.[8]

However, relativism is a problematic standpoint. If what is right is equated with what someone/the majority/everyone *believes* is right, then it becomes impossible to claim that anyone can be wrong in the context of ethical reasoning. We cannot even claim about ourselves that we were wrong when we, in earlier times, held that slavery is right even though we now argue that slavery is wrong. Instead we have to say, according to the relativist interpretation of ethics, that slavery *was* right yesterday but *is* wrong today (since right and wrong are related to our opinions on the issue). However, it is then impossible to explain moral development. We can never claim that we now realise our old standpoint was wrong and that is why we have abandoned it. Instead, our standpoint *becomes* wrong *because* we changed our mind. This is not a reasonable description of what moral arguments are about.

Nor is it a description that can explain moral disagreement. When we disagree with someone about what is right, for instance whether the death penalty should be allowed, we are saying that our disagreement concerns the nature of the death penalty, and that the other person is wrong because he has not realised something about the death penalty that we have realised. But to the relativist, there is no disagreement about the moral status of the death penalty itself, since nothing can in itself be right or wrong about the death penalty. The only thing that exists is one individual who says "I *believe* the death penalty is right" and another who says "I *do not believe* the death penalty is right". And the fact that one person has a certain belief is fully compatible with the fact that someone else does not share that belief. So it seems there is not even a conflict here. But we would argue that there is a conflict here, and that it is about the moral nature of the death penalty.

[8] Ethical Council for Funds Marketing, advisory statement issued on 19 January 2004 in Case 1/03 on the marketing of ethical funds
http://www.swedbank.se/sst/www/inf/out/fil/0,,469104,00.pdf

Relativism hides this conflict by not distinguishing between the question of what is right (which is a normative issue) and the question of what people believe is right (which is a descriptive issue: quite simply, a description of the state of opinion).

However, relativism is not a necessary conclusion. True, there is a significant variation when it comes to people's actual evaluations of what is good and bad, desirable and detestable, permitted and prohibited. But in our role as agents, however different and diversified our goals may be, we must nevertheless lay claim to certain general abilities and skills, without which we cannot successfully achieve these goals. We have summed up these general skills and abilities as freedom and wellbeing. And it is the maintenance or preservation of freedom and wellbeing that is subsequently used in this study as the criterion for ethically defensible investments.

We can conceive of two kinds of goals for ethical investment. One negative goal (where "negative" is not an evaluation but refers to what we are *not* permitted to do) is about *avoiding participating in causing harm.* Here, "harm" is defined in terms of the loss of freedom and wellbeing by individuals, groups or entire societies. One positive goal (in which "positive" is not an evaluation but is about what we must do) concerns *supporting development*, in which "development" is defined in terms of an increased level of freedom and wellbeing for individuals, groups or entire societies.

In his doctoral thesis in practical philosophy, which focuses on investment ethics, Joakim Sandberg advocates such an ambitious approach:

> Investments that fail to make a significant difference to people in great need … are clearly unethical and unjust. We can no longer keep on investing money we don't need in the stock market simply to slightly improve our standard of living. As long as people in other parts of the world are starving and dying when we could easily have helped them, our primary task should focus on their basic needs and not on our over-abundance.[9]

In the long term, the requirement that we should try to make a positive difference means not only that we should apply a specific

[9] Joakim Sandberg, *The Ethics of Investing. Making Money or Making a Difference?*, Acta Universitatis Gothoburgensis, 2008, p. 280. Sandberg's book, which is his doctoral thesis in practical philosophy, can be read in pdf format via the following link: http://gupea.ub.gu.se/dspace/bitstream/2077/10109/1/Sandberg%20-%20The%20Ethics%20of%20Investing.pdf

policy if or *when* we invest, but also that we *should* invest (i.e. if we are not already involved in some even more effective form of philanthropy). If we have funds available for good investment and refrain from investing at all, and nor do we choose any other, better way to alleviate suffering in the world, we have not fulfilled our duty to the world's needy. In Sandberg's words: "Perhaps *philanthropists should simply become capitalists* to a greater extent than has been the case recently, and capitalists should certainly become philanthropists to a greater extent than they are now."[10]

However, justice does not necessarily demand that we target all our investments in such a way as to help promote agency on a global level. Some investments have a more local and limited target group. This includes those of the AP funds, since the target group that stands to benefit from their earnings is Swedish pensioners, not the global population in general. This should not be controversial. There are frequent examples of obligations arising from what we might label *specific relationships of responsibility* and that are not extended to individuals outside these relationships.

By bringing children into the world, parents assume a special responsibility for these children, one that they do not have for children in general and that no one else has for their children. Those who take a job as a bodyguard, lifeguard, doctor or police officer etc assume a responsibility for safeguarding other people's lives, safety and health that other individuals do not assume. Similarly, by making a promise or signing a contract we assume a responsibility for accomplishing a specific task or transaction, a responsibility that is not shared by those who have not given such a promise or signed such a contract.

A particular kind of specific relationship of responsibility arises from democratic citizenship. As members of a collective of citizens with the right to political self-determination, we have a mutual responsibility for ensuring each other's right to freedom and well-being, a responsibility that we do not have for people in general. Institutions that provide education and health care as well as pension systems belong to this area of civic responsibility. The specific character of these institutions (with regard to their operations, funding, needs assessment etc) is a matter for the parliamentary process. But the *fact* that a community of citizens has the task of maintaining its members' agent-related rights to freedom

[10] Sandberg, 2008, p. 284 (original italics).

and wellbeing is central to the moral legitimacy of the democratic state. Based on an agent's perspective, the state and our duties to it must namely be justified by the fact that the state is necessary for maintaining our rights to freedom and wellbeing.[11]

Accordingly, it is the duty of Swedish citizens to provide education and healthcare for Swedish citizens as part of the realisation of our right to wellbeing. In contrast, we cannot demand as a right that American citizens should fund our education and health care (even if they could afford it and we could not). Nor do we have any duty to fund American citizens' education and health care (even if we could afford it and they could not.) States can of course agree to provide mutual aid and thereby assume international obligations. But in the absence of such agreements there is no positive political duty to promote freedom and wellbeing across national boundaries.

Let us therefore abandon the idea that to be ethically defensible the AP funds' investments must contribute to the development of freedom and wellbeing on a global level. The funds' clients are Swedish pensioners and they should act on their behalf and in their interests. This is what we described above as the positive goal of the AP funds. Instead we will now focus on their negative goal, i.e. to avoid contributing to harm when investing.

In this latter regard, investments can be problematic for at least two different reasons. Firstly, an activity that is a possible investment target may produce goods or services that in themselves constitute a threat to people's freedom and wellbeing. Secondly, a potential investment target may produce goods or services that do not in themselves jeopardise people's freedom and wellbeing, but

[11] The assertion that the state is justified, based on its role as a necessary means of ensuring citizens' freedom and well-being (even though the contents of these goods are variously described), is a recurring concept in the history of political philosophy. For instance, see Aristotle's *Politics* (in Richard McKeon (ed.), *The Basic Works of Aristotle*, Random House, 1941), 1252b28–30; Marsilius of Padua, *Defensor pacis,* Columbia University Press, 2001 [1324], p. 12–14; Thomas Hobbes, *Leviathan*, Hackett Publishing Company, 1994 [1651], ch. xiii; John Locke, *Second Treatise of Government*, in *Two Treatises of Government and A Letter Concerning Toleration* (ed. Ian Shapiro), Yale University Press, 2003 [1690], ch. viii; Jean-Jacques Rousseau, Du contrat social, Garnier-Flammarion, 1966 [1762], book I, ch. v–viii. In modern times, the concept of the social contract, and the use of such a concept in defence of the redistributive welfare state, has been advanced once again by John Rawls, *A Theory of Justice,* Oxford University Press, 1972, p. 17–22, 60–65, 100–108. Rawls' redistribution argument has been questioned by Robert Nozick, *Anarchy, State, and Utopia,* Basil Blackwell, 1974, p. 183–231. For an argument that, without reference to any social contract, legitimises a welfare state based on mutual and positive obligations between citizens, see Alan Gewirth, *The Community of Rights,* The University of Chicago Press, 1996, p. 31−91.

where the actual production process, work environment or employment conditions constitute such a threat. We will discuss both these categories of ethically problematic investments below.

2.1 Ethically problematic investments associated with what is produced

If we look at how ethical funds are actually marketed, the ethical content would appear to consist in the avoidance or limitation of investments in companies that manufacture or sell war materiel, pornography, gambling, alcohol or tobacco, or that use child labour, or that violate international conventions and human rights in some other way.[12]

However, these negative criteria are more in the nature of ad hoc conditions that reflect highly vocal Western opinions over the past century than the result of coherent argument based on principles. The harmful effects of alcohol prompted the emergence of the temperance movement and various limitations on the availability of intoxicating beverages (prohibition in the United States 1920–33, the ration book in Sweden 1917–55). The harmful effects of tobacco attracted attention in the decades following World War II, and in recent years have led to smoking bans in public environments in a number of Western countries. Pornography has long been regarded as a negative phenomenon – as a sin in the eyes of religious groups and as degrading to women according to a certain feministic perspective.[13] The arms trade, with its links to international aggression and large-scale destruction, has long been regarded as morally suspect and as a major source of human oppression and suffering.

Translating such opinions into general bans on investments is not without its problems. Is it really morally reprehensible to invest in a company that offers its customers good, high quality

[12] This is the case with e.g. Handelsbanken's ethical funds http://shb.ecovision.se/DocWeb/Funds/ProductSheet/sv/SEFN911533/REGULATIONS/Fondbestammelser_Sverige_Index_Etisk.pdf , SEB's ethical funds http://www.seb.se/pow/content/fonder/oevrigt/placeringskriterier_etiska_fonder.pdf Nordea's ethical funds http://www.nordea.se/sitemod/upload/Root/www_nordea_se/Privat/spara_placera/fonder/filer/Etiskgranskning_EtisktUrval.pdf , and Swedbank's ethical funds http://www.swedbank.se/sst/inf/spara-och-placera/0,,173182,00.htm

[13] One can, however, still be a feminist without rejecting all pornography. See Petra Östergren, *Porr, horor och feminister*, Natur och Kultur, 2006, p. 150–156.

wines just because there are people who abuse alcohol and thereby end up in severe distress? Should we not then also ban investments in companies that produce bacon, sausages, cream and cheese on the grounds that being overweight is a major health problem and that these foods promote excess weight? Should we not also ban investment in car manufacturing, given that motor vehicles contribute to poor quality urban air and attendant illnesses? And is the arms trade always detestable? If Finland were to be attacked by Russia once again, would it be equally bad to sell arms to Finland as to sell them to Russia? Would we not want to be able to buy arms ourselves if our country was attacked? Is it really the same thing to sell arms to a democracy that defends its freedom and to sell weapons to a dictatorship where the armed forces' main task is to tyrannise their own people (e.g. as in Myanmar)?

In the case of pornography, its commercial profits appear to lie in its distribution rather than its production. In direct contrast to common belief, the production of pornographic films does not in itself appear to generate much money. However, broadband suppliers or cable TV companies can get rich from customers who use their internet services to download and view pornographic films.[14] A discussion of ethical investment criteria that focuses only on the production of pornography is therefore easily misleading.

Is pornography itself unethical? From an agent's perspective we might view both the production and the consumption of pornography as problematic. The production of pornography is unethical if it exploits people's ignorance or dependency (e.g. on quick payment or on drugs) to persuade them to act in sex scenes where they portray various kinds of degradation, or if such scenes are filmed using coercion. The consumption of pornography can be ethically problematic if it leads to an abuse situation in which the consumer invests so much time and money in pornography that he or she loses the will or ability to work, for instance. Thus in the case of both production and consumption the ethical problem lies in people's loss of agency or in the exploitation of such loss.

However, as with alcohol and tobacco, it is equally inappropriate to make the sweeping claim that all pornography is incompatible with the freedom and wellbeing that are prerequisites of all agency. People may choose to be porn actors without being forced or exploited, just as they may choose to pursue many other

[14] Mattias Andersson, *Porr – en bästsäljande historia*, Prisma, 2005.

activities that the general public considers unattractive: clean public toilets, fight as a mercenary, live as a hermit etc. People may also consume pornography, as they consume alcohol and tobacco, without necessarily becoming dependent on it. We must distinguish between, on the one hand, our more or less subjective ideals concerning how people should and should not live and, on the other, activities that are genuinely incompatible with agents' retaining their capacity to act based on the individual's freedom and wellbeing.

Of course, there are *types* of pornography that must be deemed generally incompatible with freedom and wellbeing. These include pornography that features children or mentally challenged individuals, or recordings of actual assaults subjecting people to sexual violence. But even though morally reprehensible pornography does exist we cannot claim therefore that all pornography is morally reprehensible or that a work of pornography is unethical just because it is pornographic.

A fund may, of course, choose to refrain from all investment in companies that make or distribute pornography, tobacco, alcohol or weapons in order to avoid having to draw complicated lines between what is ethical and unethical and to satisfy current opinion. However, we should then be aware that it is precisely for these reasons – simplified management and the need to bow to public opinion – that we have followed such a course, not because ethical standards demand it. Moreover, we should be cautious about bowing to public opinion, since demands from that quarter are not always compatible with an ethical approach based on the rights of all agents to freedom and wellbeing. For instance, an investment strategy based on a desire to satisfy opinions deriving from religious or ethnic intolerance would inevitably result in ethically indefensible discrimination.

If, on the other hand, we are serious in saying that ethical considerations should form the basis of the pension funds' investments, we frequently need to weigh in factors relating to the actual impact a product has on people's freedom and wellbeing. In the case of alcohol and tobacco, for instance, we need to consider factors such as the consumer's degree of responsibility. This in turn is linked to the amount of information available to consumers on the risks of alcohol and tobacco use, and how availability and advertising are regulated in their society. Such an approach is directly based on agency, in that it also regards the consumer as an

agent who must take responsibility in his actions for his own freedom and wellbeing. But this also means that we must take into account the fact that the consumer's ability to possess such responsible agency is affected by social factors like education and access to factual information.

In concrete terms, this means that if a company produces alcohol and tobacco solely for consumption in countries that provide both factual health information and marketing regulations – countries where consumers are well educated and that protect against the damaging side-effects of consumption on non-consumers (e.g. by banning smoking in public places) – investing in it is not obviously unethical. (It is not *obviously* unethical in the sense of being completely out of the question, but if there is an equivalent investment alternative that does not involve the production and sale of alcohol and tobacco then that alternative would be preferable, since it then becomes possible to completely avoid contributing to harmful effects.)

On the other hand, a company in the tobacco or alcohol industry would be ethically controversial if, in order to make profits, it exploited such circumstances as a low educational level in a particular society combined with inadequate or non-existent health information and an absence of legislation concerning permitted marketing practices. By its actions, such a company shows that it is more interested in profit than in taking responsibility. The company is inevitably suspected of profiting from its customers' ignorance and from the shortcomings in their society – in brief, from the customers' lack of agency and their society's inability to protect that agency. Such a company is not a worthy investment object for funds that claim to be ethically responsible.

Likewise, we should take a more multifaceted view of weapons production and the arms trade. Certain types of weapons that seem specifically designed to wound non-combatants – for example, the butterfly mines that children easily mistake for toys – certainly make the manufacturer an unworthy investment object. By ignoring the distinction between guilty and innocent parties, between combatants and non-combatants, the company disqualifies itself from the ethical responsibility that is an essential characteristic of a worthy investment object. However, all weapons are not necessarily of such a kind.

In other cases, it is not the weapon itself but rather its use in a particular conflict or by a particular agent that makes it proble-

matic. It is not unethical to facilitate the armed defence of a democracy that maintains its citizens' rights to freedom and wellbeing. However, things are different with companies that sell weapons and equipment intended for the armed forces in a dictatorship where citizens' rights are ignored, or that sell arms to dictatorship that wants to use force to subjugate a democracy or to expand its territory at the cost of that democracy. Such a company thereby militates against respect for the agent-related rights to freedom and wellbeing.

We could also argue that such a company is guilty of a self-contradiction in its actions, since it helps to combat the same rights to freedom and wellbeing that it must claim for itself in its daily activities. Without freedom, a company cannot develop and market its products, and without security of life and limb (wellbeing) for its employees, it cannot successfully manufacture those products. Yet it is precisely these goods or values that the company's activities help to undermine.

Companies may be regarded as agent collectives. As such, they must claim the same rights to freedom and wellbeing as other agents. But companies are also obliged to respect the rights of other agents, including their freedom and wellbeing, which are affected by the companies' actions. Accordingly, from an agent's perspective, a company that chooses to make money by helping to deprive societies and individuals of their freedom and wellbeing is an unworthy investment object. But companies do not become unworthy investment objects just by making and selling weapons; they do so by placing their products in the service of dictators, religious fundamentalists or ethno-nationalistic extremists when those groups deprive individuals and entire societies of their freedom and wellbeing.

Real life does not often permit such clear-cut distinctions between worthy and unworthy investment objects. One and the same company can produce tobacco both for well-educated citizens in industrial countries and for illiterate people in developing countries. One and the same company can supply weapons to both democracies and dictatorships. An ethical investment strategy must take into account how the ownership of one company can be used to exercise an influence on the activities of another company. Conversely, investors must also remember that the way their ownership of a company is perceived may be coloured by what occurs in other businesses owned by the same company. We will

return to the issue of what an ethical investment strategy might look like in Section 3.

2.2 Ethically problematic investments associated with how something is produced

So far we have discussed the ethical nature of a company's *products*: tobacco, alcohol, arms. But even when the product itself appears to be ethically unproblematic its *production method* can be ethically controversial. For instance, if a company produces its products using child labour or exposes its employees to health risks at work, this *may* be enough to make it unworthy as an investment object. We say that it may be enough because here, too, we must take a more multifaceted view in our assessment. Exploiting children for labour is normally morally reprehensible since the practice deprives them of the time they need to attend school and to play, and gives them far too great a responsibility far too early. However, we must also ask ourselves what is the alternative in each specific case. If the alternative is that the children instead roam the streets, support themselves by begging and stealing, and are exposed to violence, drugs and the sex trade, this may not necessarily be morally preferable to paid work.

Sanctions and boycotts by Western importers against exporters in developing countries that use child labour have proved a blunt instrument. In a 1997 report, UNICEF depicted how the mere fear of being boycotted by American importers caused the garment industry in Bangladesh (which exported 6 per cent of its production to the US) to immediately fire the children, mostly girls, who worked there. Some of these girls, whose fate was monitored by international organisations, were forced to seek out more dangerous work with lower wages or to become prostitutes. In other words, as the report points out, the West's efforts to stop children being exploited as labour, as they are in many developing countries, via legislation, import restrictions, sanctions and boycotts are sometimes an example of "doing the wrong thing for the right reasons". Nor do such sanctions affect the great majority of child workers in the world since perhaps only five per cent of them work in the export industry (1997).[15]

[15] UNICEF, *The State of the World's Children 1997*, Oxford University Press, 1997, p. 23–24; 21. The report can also be downloaded from http://www.unicef.org/sowc97/report/

Child labour becomes an ethical issue for fund investors when they consider investing in activities that directly or indirectly (via subcontractors) use child labour. Given the reservations expressed in the UNICEF report about good intentions going wrong, it is clear that such investments should not be rejected out of hand.

However, if we do choose to invest in activities that directly or indirectly employ child labour, then we assume a responsibility for the children whose labour is a prerequisite for the return on our invested money. This responsibility must include using our ownership role to persuade the companies in question not only to phase out child labour but also to ensure that the children have the opportunity to attend school and to enjoy a healthy environment when growing up. Thus they are not only compensated for the time during which they were exploited as workers but are also given the chance to develop their own agency. Investors who are not prepared to shoulder such a responsibility should refrain outright from investing in companies that directly or indirectly use child labour.

Likewise, we must adopt a more multifaceted approach when assessing issues such as low wages and unhealthy workplaces. In societies where union activities are banned, the freedom to assemble is non-existent and employers can count on state support to suppress dissent among their employees, we cannot assume that people have freely accepted their working conditions. Companies whose employees fare badly and which operate in repressive societies should be regarded as ethically unworthy investment objects. But in cases where unions are allowed and democracy reigns, complete with freedom of assembly, association and expression, it should be possible to take a more flexible approach. Instead of refraining from investing in a company that is otherwise interesting but has problems with its work environment, or whose subcontractors have such problems, we can use our investment and our position as owners to help improve the employees' conditions over a given period of time. In this case the investor must seek to apply the democratic mechanisms available in the society in question and to cooperate with the employees to try to redress the problems it has identified.

If an investor cannot or does not want to assume such an agent-oriented ownership responsibility, it should refrain from making the investment in question. Likewise, the investor should signal that it will disinvest if the promised improvements fail to mate-

rialise. Otherwise there is a danger that the ethics associated with the responsibility of ownership will be diluted since the link between the investment and the improvement in conditions is broken.

The model presented here for the consideration of ethical aspects when investing is both more open and more restrictive than the criteria often used nowadays to guide investment decisions. It is more open in that it does not directly reject investments in a company due to its production of certain goods such as arms, alcohol or tobacco. Instead, the model requires us to look at how these products in each specific case affect the rights of those involved to freedom and wellbeing. Similarly, the model recommends a flexible approach to corporate production methods. This is not just a case of rejecting child labour or a bad working environment; it also involves looking at what improvement opportunities exist that can be implemented by the investor as owner.

The model is more restrictive in that it directly rejects investment in companies which in their production of goods and services serve repressive regimes in the exercise of that repression. A company that sells weapons or other war materiel to a regime whose armed forces are employed to repress the country's own population and thereby take away their freedom – and often, too, their wellbeing, given the link between the presence of starvation and the lack of democracy[16] – is an unworthy investment object for a fund that claims to adopt an ethical approach. The same holds true for a company that markets and sells tobacco, alcohol and other similar products requiring consumer knowledge about the boundary between use and abuse, and which does so in societies with inadequate legislation, education and health care expertise.

3 A model for ethical investments

Whether the product is tobacco, alcohol or weapons we must bear in mind the possible complication that the companies concerned cannot easily be divided into ethically acceptable and ethically unacceptable producers along the lines described above. A company can produce tobacco for both well-educated consumers in an industrial country and illiterate people in a developing country. A company can sell arms to both democracies and dictatorships. The

[16] This connection has been emphasised by Amartya Sen. See his *Development as Freedom*, Oxford University Press, 1999, p. 160–188.

same applies to the manufacturing process. A European company in which a fund intends to invest can be a model company in terms of its work environment and employee influence. But the company can also own shares in businesses in other parts of the world where manufacturing is undertaken in far worse conditions. What should be the ethical approach of a fund investor in such a case?

This is, of course, a matter of proportion, and we can envisage a range of different models for dealing with companies that are not easily pigeonholed. From an agent's perspective we can formulate a qualitative model that seeks to compare various investment alternatives according to how they affect people's access to freedom and wellbeing. Here we can conceive of three different categories of company or activity.

Category 1 includes companies and activities that neither directly nor indirectly (via subsidiaries, subcontractors etc) militate against people's freedom and wellbeing. Thus Category 1 consists of *ethically unproblematic investment objects.*

Category 2 includes companies and activities that directly or indirectly conrtibute to reduce people's level of freedom and wellbeing. This could involve a harmful work environment or the production of goods or services that may cause ill health. Category 2 consists of *ethically debatable investment objects*. The final assessment is affected by a number of considerations. Are the harmful effects temporary or structural? (Are there just occasional cases of a poor work environment or is this something that characterises the activity as a whole?) Are the harmful effects due to a lack of health knowledge or consumer knowledge? Are consumers' interests legally protected? Can we expect the situation to improve in the near future? Can we as investors and owners influence conditions favourably? Within what space of time? If the investment is being made in a Category 1 company but the poor conditions are to be found in another business owned and controlled by the same company, can we use our investment to force improvements in the second business? If not, can we use our ownership to force the Category 1 company to divest itself of the more dubious business? Whether we decide to invest in Category 2 companies or not will depend on the outcome of this assessment.

Category 3 includes companies and activities that either directly or indirectly contribute not only to reduce but in fact to remove people's freedom and wellbeing. Here we find companies that equip dictatorships with weapons and the other military products

they need to maintain a state of repression under which people are denied political, economic, religious and other freedoms and also risk being killed, tortured or imprisoned if they engage in opposition activities, even when these are peaceful by nature. Category 3 consists of *ethically reprehensible investment objects.* These should be avoided by any investor claiming to possess an ethical approach. To invest in such companies or in the owners of such companies is to help expunge the most basic components of human agency. Such investment is not ethically defensible, even when undertaken to only a limited extent or for a brief period.

An ethical investment strategy as described above necessitates a considerable amount of information gathering and an ability to analyse the information received. However, gathering information and analysing it is a regular part of the investment process, although it normally centres on market shares, economic trends, predicted yield etc. This process should also be accorded an ethical dimension. Given an interest in the ethical aspects of ownership and production, investors can rely on some assistance from the media and individual opinion-making groups in fields such as environmental law or human rights, where reports are published on how companies and states are meeting their ethical responsibilities. Companies themselves will be keen to describe what they are doing to satisfy ethical demands in hope of thereby winning the confidence of both consumers and investors.

In this connection we can also point to the UN initiative *Principles for Responsible Investment* (PRI), to which more than 360 pension funds and other institutional investors are currently affiliated. These principles encourage an active investment responsibility as regards environmental, social and governance (ESG) conditions in the intended investment objects. Investors are urged to request reports from companies that are potential investment targets. These should be clear and detailed enough to enable managers to assess whether their investment is ethically defensible. A failure to report or an inadequate report on the company's part may influence the investment decision. Reports in the media etc about poor conditions in one of the fund's investment objects can cause the fund to contact the company in question to determine what has happened and what it has done to correct the problem. The funds and investment institutions that are signatories to the PRI also exchange information and thereby make it easier for each

other to assemble the requisite facts prior to investment decisions.[17]

Acquiring such background information should therefore not be a problem. The problem lies rather in evaluating that information from the standpoint of sustainable and reasonable ethical criteria. The purpose of this study has been to provide a framework and the tools for such an assessment.

[17] See *PRI Report on Progress 2008*, UNEP Finance Initiative, 2008. The report can also be downloaded from http://www.unpri.org/files/2008PRI_Report_on_Progress.pdf

Managing equity portfolios

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This document describes the various stages of share portfolio management with special reference to international portfolios. It also describes a number of common and mutually disparate approaches in terms of investment methodology. For each method we also discuss the possibility of incorporating ethical, social and environmental aspects (referred to here as SRI criteria, i.e. Socially Responsible Investing) and what effects this may have on the management process.

One reservation: This report is based on anecdotal evidence (i.e. the author's observations from working as a consultant in the fields of asset management and financial economics) and is therefore not the result of any systematic study of the entire asset management market.

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1 Stages in the development of an active investment process

An active investment process is a type of management that aims either to exceed a market index or to exceed a risk-free investment by a specific percentage. The market index method is called relative return and the risk-free-plus method is called absolute return. In both cases an asset manager must go through a number of organisational management stages, which consist mainly of the following:

- Where in the global capital market are there opportunities for added value?
- In which financial instruments can the manager invest? (= the investment universe).
- What is the comparative norm (index or absolute) and what is the target return?
- Investment philosophy: The manager must have a fundamental philosophy that explains why he/she will be able to exceed the target return. This philosophy should be based on the fact that the market in which the manager is thinking of operating is in some way incorrectly pricing financial instruments and, not least, that there is some mechanism that will in time help bring this incorrect pricing to an end.
- Portfolio management:
  - Screening: how should the manager decide which companies to analyse? When there are more than 40 000 companies worldwide to choose between, there must be some defined method for deciding which companies are even worth investigating.
  - Analysis process (traditional fundamental analysis): definition of methods for company analysis. Which sources of information are especially interesting (i.e. ones that have not

already been exploited by the market)? How to make forecasts? Indicators of over-/under-pricing ("alpha signals").
- o Portfolio construction: how to translate alpha signals into actual portfolios? What is the risk profile? What is the investment horizon?
- o Risk management: How much allowance for risk? How to measure risk? How to accommodate risk for various results?

2 Systematic risk factors

Modern risk analysis is based on the fact that the total risk in a portfolio can be broken down into various risk factors. These normally consist of what are known as systematic risk factors. Examples of these are:

- Sector
- Country/currency
- Company size
- Growth/value
- Volatility
- Labour intensity
- Export share

The remaining portion of the risk in a share portfolio consists of the additional risk resulting from the selection of stocks (known as company-specific risk or residual risk). Depending on the investment method selected, management will concentrate on choosing different types of risk in a portfolio – systematic or specific. The risk in a portfolio is often controlled with modern risk measurement systems such as Barra, Northwind or Style Analysis, or home-built systems that also contain portfolio optimisers.

3 Various ways of applying SRI criteria

There are a number of different ways to apply SRI criteria in a share portfolio. Some of the most common are described in the following.

One early method that was applied in what were known as ethical portfolios was to exclude entire industrial sectors that were regarded as "unethical", such as companies that produced alcohol,

tobacco, weapons, pornography, gaming etc. One problem with such an approach is that blacklisting of industries is inevitably fairly arbitrary. Also, the question arises why an activity that has been approved by the Government as being entirely lawful should be regarded as unethical for an investor (especially if that investor is a government-run pension fund). If the same country is also a large and profitable stakeholder in several of these industries the inconsistency is even more striking.

Today, one common approach (that can be combined with other approaches) is to exclude companies on the basis of a critical analysis (blacklisting) applying specific criteria.

Such social criteria might for instance be that the companies accept international agreements relating to labour law (ILO) and human rights (UN) etc. An environmental criterion could be the extent to which the company has an environmental policy and adheres to it. This kind of blacklisting has sometimes been criticised because it is mainly based on extensive company surveys (tick-box surveys) that focus on formalities, while more overarching issues may be ignored. Whatever the case, this is still a common approach.

One fund that uses this kind of method is the Seventh AP Fund. However, in practice this method has a very limited effect on the actual portfolio and yield compared with what would have been achieved without the SRI criteria, because the blacklisting normally applies to only 20–30 of the companies in the global index, which contains about 1 500 companies.

A more positive approach is to focus the selection of companies within each industry on those that best fulfil various SRI criteria (best-in-class). No industry is automatically excluded (although there is a minimum requirement that the industry is lawful). Some managers who use this method feel that the application of SRI criteria is a further source of additional yields (the alpha factor).

Yet another aspect is to what extent SRI analysis is integrated with the company's traditional financial analysis. Many managers buy their SRI analyses from external consultants, which begs the question to what extent these are integrated with the financial analyses. Even when managers undertake an internal SRI analysis there is a risk that the SRI part of the organisation has no significant impact on the actual portfolio selections.

4 Investment strategies

Theoretically, there are endless ways of managing an equity portfolio. This document describes some common methods, all of which differ from each other fairly markedly.

a. Traditional fundamental non-systematic management

Managing an equity portfolio by selecting a small number of stocks without paying much heed to the state of the comparative index or what systematic risks might arise could be labelled "traditional fundamental non-systematic management". Such an approach can often be likened to a type of management that aims to achieve a positive absolute return regardless of the broad market index trend. We could even compare this type of management with private equity managers, who adopt a similar approach although in their case unlisted companies are involved. This management approach is particularly common in dealing with small caps, since many managers are deeply suspicious of the market indexes in that sector.

An example in the Swedish market is the Carnegie Worldwide fund, which has a highly concentrated portfolio of about 30 shares and a strong underweight of American shares compared with the global index. Other examples are Odin Fonder, Lannebo and Skagen. The Skagen Global fund is a classic example. Despite having a well diversified portfolio with numerous shares – a full 50 per cent of which are invested in emerging markets – it has a considerable systematic risk due to its greatly divergent regional allocation compared with the portfolio's comparative index, MSCI World, where growth markets comprise just under 10 per cent.

This management method is very well suited to the inclusion of SRI criteria. One well-known example is Generation Investment Management, which believes that SRI criteria (or SI criteria, i.e. "Sustainable Investment") are a source of additional yield. Another example is the Danish manager Bankinvest, which works with stock picking and which has management products with an SRI profile for both global shares and growth market shares.

b. Traditional basic analysis combined with a degree of risk management

A first departure from the above method came when asset managers began to monitor market indexes – i.e. how much each company weighed – on an ongoing basis. The information was then incorporated into internal portfolio systems, which meant the managers always knew whether they were over- or underweight compared with the indexes. This method of comparing positions with the indexes does provide an overview of the total risk in the portfolio but is relatively primitive compared with a real risk measurement tool. Because this approach has been so widely adopted among portfolio managers, including most of the major ones in Sweden, many of them are now very aware of what the indexes are doing and are continually adjusting their positions in relation to them. The result is a style of management that follows indexes very closely, something that in the case of the AP funds has often been criticised in the Finance Ministry's annual report.

This relatively unsystematic method is, however, very suitable for applying SRI criteria. One good example in Sweden is Robur, with a management style that is relatively close to the indexes and internal SRI analysts who are part of the regular analysis organisation. In Robur's case, however, one might perhaps question the extent to which SRI criteria are in fact integrated, in that the fund has a basic "financially optimal" portfolio that is then adjusted to fit SRI criteria.

c. Traditional analysis of systematic factors (top down)

A traditional analysis of systematic factors can be designed in different ways. One way is to base the analysis on a traditional macro-analysis of economic cycles, interest rates and prices. The manager then selects various weightings for different markets and sectors. Another version is what is called thematic investment: identifying global themes that influence different sectors. Examples might include "rising commodity prices" or "increased luxury consumption among newly rich, emerging-market citizens". With this method the emphasis is on macro or thematic trends, so not much effort is invested in share analysis. Managers applying this

method can also use index instruments as actual investment objects, e.g. Exchange Traded Funds (ETFs).

One practitioner of theme-based management is the former Unibank in Denmark (now part of Nordea), which has used this method since the early 1990s. With its greater focus on economic cycles, this form of analysis has many parallels with what are called macro-based hedge funds, although the latter do not normally have the same underlying exposure to the stock market.

Managers adopting this approach usually have little interest in individual companies other than as representatives of a specific sector or market. It may therefore be difficult to integrate certain kinds of SRI criteria, especially if the manager works with pure index instruments. However, managers applying this method can probably blacklist a limited number of companies.

d. Systematic portfolio management based on traditional analysis

Nowadays, large international asset managers (particularly American ones) increasingly combine traditional fundamental analyses of companies with extremely systematic and quantitative portfolio construction. Organisations using Method b. above frequently hire young analysts, who after some years of experience go on to become portfolio managers. This is not normal practice in this kind of organisation, where being an analyst is a career in itself. An analyst should preferably have a lot of experience and for instance be able to discuss issues with the company management without being overwhelmed. Switching to being a portfolio builder is not a natural career path.

The analysts' job is to continually grade the companies they monitor (e.g. on a scale of 1–5). Subsequently, the additional value in each analyst's grade is followed up. Preferably, the higher the grade the higher the return, otherwise the analysts are in the wrong business. The grades are then used by the portfolio constructors, often engineers skilled in dealing with risk and optimisation systems. The grades are fed into these systems.

With portfolio optimisation, any systematic risks tend to be "locked" basically at zero. For instance, if analysts were to award IT shares high average grades and banks low average grades, the portfolio would end up with a considerable overweight in IT shares

and an underweight in banks unless optimisation was adjusted. This unintended systematic risk can be eliminated by "locking" the optimisation tool, in this case for sector allocation. The systems can also lock other systematic risk factors (e.g. small caps, regional allocation or growth/value stocks) so that the overwhelming majority of the risk in the portfolio is what is known as residual risk, i.e. purely company-specific risk.

Examples of managers who use this method are Fidelity Institutional, Citigroup, JP Morgan Chase and RCM (American, but part of the German Allianz group).

To weigh SRI criteria into this kind of management method there are basically two alternatives: (i) blacklisting, which is simple and cheap to implement or (ii) weighing the SRI criteria into the share analyst's grade, which probably – in what are often extremely large analysis organisations – is extremely demanding in scope and expensive. Implementing an SRI best-in-class approach would either require hiring new SRI analysts or "reprogramming" the share analysts already in place and giving them additional training.

e. Quantitative management focusing on share selection

Actively managing global and regional share portfolios using quantitative, computer-based methods has become increasingly popular in recent years. This method has many advantages, including the following:

- You can investigate far more companies than a traditional organisation employing fundamental analysis has time for.
- You are forced to apply a systematic approach in your analysis, as a result of which it can hopefully be repeated over and over.
- Quantitative management uses the same type of risk management as Method d. above, if not an even more advanced type.
- Many of these managers have had sustained yields that have outperformed indexes (i.e. a high excess returnin relation to deviations from the index, generally known as the information ratio).

The quantitative factors employed here can differ considerably. Some are linked to fundamental corporate data such as profit growth, book value etc. Others may be more in the nature of technical analysis and have to do with momentum – i.e. a stock that

has begun to move continuing in the same direction. Indicators based on what is known as behavioural finance, i.e. financial psychology, can also be used as quantitative alpha signals. Further, the stock market does not function in the same way over time, so quantitative strategies must be continually adapted and adjusted. At some point a specific alpha signal will stop working (indicating that the market has become efficient in this particular respect). This signal is then removed and is hopefully replaced by some new type of pricing inefficiency.

In the past two or three years, a new kind of portfolio has appeared. Called a 130/30 portfolio, it is often launched by managers engaged in quantitative asset management. According to Barclays Global Investors, which is one of the biggest managers in this field, investors lose approximately 1/3 of the potential excess return from the various alpha signals due to not being allowed to short-sell the shares in a traditional share portfolio. In the new 130/30 portfolios, the guideline is that managers can short-sell stocks worth up to 30 per cent of the portfolio's net worth, while at the same time being able to purchase shares up to 130 per cent. The net effect should be a market exposure of around 100 per cent. However, the idea is that with this approach the portfolio has a better chance of exceeding the index because it is better able to "go short" even in shares with a relatively small index weight.

Recently, a new type of systematic risk has appeared for quantitative managers to deal with. In many cases hedge funds use the same kind of active positions (in their case, longs and shorts in various stocks). In August 2007 many hedge funds were informed that their banks wanted to recall their loans. This forced them to close their positions (sell their long positions and buy back their short positions – i.e. margin calls). The result was that many "bad" shares did well and many "good" shares did badly. This led to very weak results even for quantitative managers running ordinary share portfolios. This illustrates the weakness of risk measurement systems: if a major systematic event has not occurred during the period over which you are estimating the risk patterns then you cannot predict such events. The outcome may call to mind a comment by Swedish satirist Tage Danielsson in describing a near-meltdown in a US nuclear power plant: "It's so improbable that it probably never actually happened". Things have been a little shaky since.

The biggest actors in quantitative management are also the biggest in index management, namely Barclays Global Investors (BGI) and State Street Global Advisers (SSGA). Other major actors are Goldman Sachs, Axa Rosenberg and Robeco. Among Swedish managers, both SEB's and Skandia's global funds are managed using quantitative methods.

As regards SRI criteria, these can be implemented in a totally integrated way. One example is SSGA, which quantitatively manages a European share portfolio. As well as using traditional financial quantitative alpha signals, SSGA also adds an SRI grade from the French consultancy Innovest. SRI criteria thereby become a fully integrated alpha factor in determining the portfolio.

5 Examples of systematic incorrect pricing that managers seek to exploit

Managers may not disclose all their secrets even when contacted by a potential client, but it is still possible to draw certain conclusions about how different managers try to discover alpha signals. For instance:

- Value companies give higher yields than growth companies (i.e. companies with low predicted growth and low valuation tend to give higher returns than companies with high predicted growth and high valuation, the exception being the IT bubble).
- Small companies have generated higher returns than might have been predicted based on theory (possibly what is called the liquidity risk premium).
- Earnings revisions: when companies alter their profit predictions, opportunities to outstrip the index may arise. This alpha signal was profitable during the 1990s but according to a number of managers that is no longer the case.
- Momentum: shares that have begun to do well continue to do well for a while, and vice versa. Even the academic researchers have begun to discover this phenomenon.
- Reversal: shares that have done well for a while (say 1–2 years) in accordance with the momentum theory will then do unexpectedly poorly and vice versa.
- Shares that have been dropped from or added to indexes: big index managers like BGI and SSGA are particularly adept at

earning a little extra from the substitution of companies in indexes.

6 Passive management

Passive management means that the manager tries only to mirror the index, not exceed it. The asset management industry is fairly unique in that it offers a highly cost-efficient way of achieving exactly the average yield industry-wide, or often – after costs – a somewhat higher return than the industry average.

In the United States, index funds have taken a relatively large market share while in Sweden their impact is insignificant. However, indexation is relatively common among the larger capital investors (e.g. the AP funds and life insurance companies).

In the indexation process, the choice of index is obviously a very important issue. For example, the ordinary global index MSCI World Developed Markets includes approximately 1 500 of the world's 40 000 companies in the world. However, in terms of market value – based on the base value for the index – MSCI World accounts for approximately 70 per cent of total global market value. The effect is that an indexation to this ordinary global index would lead to strong underexposure to small companies, especially in emerging markets.

As regards SRI criteria, straightforward blacklisting is, as usual, fairly simple, while a best-in-class method is almost impossible to apply in that it requires a much greater active deviation from the index.

7 Passive management plus, or "enhanced indexing"

As mentioned above, a number of the major index managers (not least BGI and SSGA, both with managed capital of about USD 2 000 billion) are among the biggest actors using Method e., that is, active, quantitative-based management. Over the past 5–7 years, indexing customers have become more interested in trying to create a "degree" of additional return at a very limited risk by deviating slightly from the index. Enhanced indexing may be regarded as quantitative management with a small deviation from

the index (= lower active risk or tracking error). A typical move of this kind is to try to exceed the index by 1 per cent with an active risk of the same amount, 1 per cent, i.e. with an information ratio of 1. As with ordinary quantitative management, it should be possible to apply SRI criteria when using this approach.

8 Institutional investors' portfolio management strategies

The market average is by definition to equal the market average . To exceed the market average you need to identify a market where you are likely to find many investors performing below the market average (i.e. you should find markets that are not fully efficient). According to the theory of market efficiency you cannot exceed the index in an efficient market. Many institutional investors took this to heart in deciding where and how they should take risks compared with the market. For instance, the market for large-cap companies in the United States (the S&P 500) is regarded as one of the most efficient markets in the world. Confirmation lies in the fact that active managers usually find it very hard to outstrip this index. In contrast, there are other markets, for instance in Asia, where active capital managers as a group seem to be able to exceed the index. Accordingly, investors often choose to be more active in these markets. The logical question in this context is of course which investors are the systematic losers here, i.e. which on average have a lower return than the index.

9 Conclusions

There an almost infinite number of ways of managing equity portfolios. This document has described some of the more common ones. It also discusses the extent to which SRI criteria can be met applying the different management methods. In this respect, certain conclusions can be drawn:

The basic, traditional, non-systematic method is eminently suitable for SRI criteria.

- The basic, traditional approach with a degree of risk management is also eminently suitable for SRI criteria.

- The top-down approach is less suitable for SRI criteria since the focus is not on company analysis.
- Systematic management based on basic analysis is less suitable since the addition of SRI criteria would probably be both expensive and demanding.
- Quantitative-based management is eminently suitable for SRI criteria.
- Index-based management presents difficulties, especially with a best-in-class SRI strategy.
- An enhanced indexing strategy could implement SRI criteria in the same way as quantitative management.

Capital Markets Size and Participants and Responsible Investing for Large Institutional Investors

MERCER

MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

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Introduction

This report was prepared by Mercer Investment Consulting at the request of the Kommittén för AP-fondernas riktlinjer om miljö och etik m.m. (The Committee). The report aims to provide the Committee with a good overview of sizes and participants in the current asset markets as well as providing insights of responsible investing for institutional investors.

The sections about sizes and participants in the asset markets cover the global aggregated asset markets, size and developments of the main asset classes for the last years, and a mapping of the largest institutional investors.

The section about responsible investments provides an overview of current situation with regard to who, where, and developments. Further the report looks at the latest finding regarding the performance of responsible investing.

1 Mapping of the global financial markets

1.1 Global wealth portfolios (GWP)

In this section we have outlined a so called Global Wealth Portfolio (GWP). It is a way of mapping the global financial markets and to give a view of their relative sizes. Constructing a GWP is complex. Among the many delicate tasks in the construction are identifying the relevant markets, limit the markets, identify fair representtations of the size of each individual market. The portfolio below is our best estimate.

This is our suggestion to a Global Wealth Portfolio (GWP) as per December 31, 2007. The GWP has been defined using a bottom-up strategy, trying to identify the best estimate for each asset class. Alternatives such as absolute return strategies/hedge funds are not included in the portfolio since we do not define them as separate asset classes. They are instead to be seen as alternative investment vehicles that invest in the asset classes listed below.

The Global Wealth Portfolio 2007-12-31

Asset Class	US$ trn	%	Source
Global Equity	33.6	27%	MSCI World mkt cap
Emerging Market Equity	4.3	3%	MSCI World mkt cap
Debt Securities	79.8	63%	Bank for International Settlements (BIS)
Bonds	67.2	84%	
Money Market	12.6	16%	
Global Property	4.8	4%	Investment Property Databank (IPD)
Private Equity	1.1*	1%	McKinsey
Infrastructure	3.0**	2%	Mercer Investment Consulting
Total	**123.6**	**100%**	

* 2006-12-31.
** 2007-03-31.

The complexity of the GWP construction is high and the numbers of definitions and interpretations are many. In order to give an example of its complex structure we include two other suggestions to the GWP in this report. It is McKinsey[1] and the New Zealand Superannuation Fund (NZSF) who has created these portfolios. And as the table shows these two have chosen very different approaches. McKinsey's estimate refers to the allocation of global financial assets by the end of 2006 and the NZSF report does the same thing for March 31, 2007.

[1] "Mapping Global Capital Markets Fourth Annual Report", January 2008.

Asset Class	McKinsey		NZSF	
	US$ trn	%	US$ trn	%
Global Equity	54	32	29.7	40.5
Emerging Market Equity	n/a	-	2.5	3.4
NZ Equity	n/a	-	0.1	0.1
Global Property	n/a	-	8.0*	10.9
Private Equity	n/a	-	1.3*	1.8
Infrastructure	n/a	-	3.0	4.1
Absolute Return	n/a	-	0.0	
Global Timberland	n/a	-	0.2	0.2
Commodities	n/a	-	0.0	
Securitized Private Sector Debt	43	26	11.5	15.7
Non-securitized Private Sector Debt	n/a	-	17.2	23.4
Government Debt	26	16	n/a	-
Bank Deposits	45	27	n/a	-
TOTAL	**167**	**100**	**73.39**	**100**

* As of December 31 2006.

1.2 GWP Sources

MSCI – is a leading provider of market indices to investment institutions world wide. According to MSCI their indices cover 85% of the underlying markets.[2] The market caps listed in the table above are adjusted for free float and recalculated to represent 100% of the market.

BIS – The Bank for International Settlements (BIS) is an international organization which fosters international monetary and financial cooperation and serves as a bank for central banks.[3] BIS debt securities market definition contains domestic and international bond and notes plus money market instruments.

IPD – independent, world leader in performance analytics for owners, investors, managers and occupiers of real estate. IPD along with NCI and NCREIF estimates the total value of the 22 most mature real estate markets to be $4.8 trillion. See chapter 2.3 to find out which these markets are.[4]

[2] www.mscibarra.com
[3] www.bis.org
[4] www.ipd.com

McKinsey – global management consulting firm.[5] The estimate of the private equity landscape is taken from their report "The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity are Shaping our Capital Markets". The Private Equity market cap includes investments in venture capital, mezzanine financing and leveraged buyout funds.

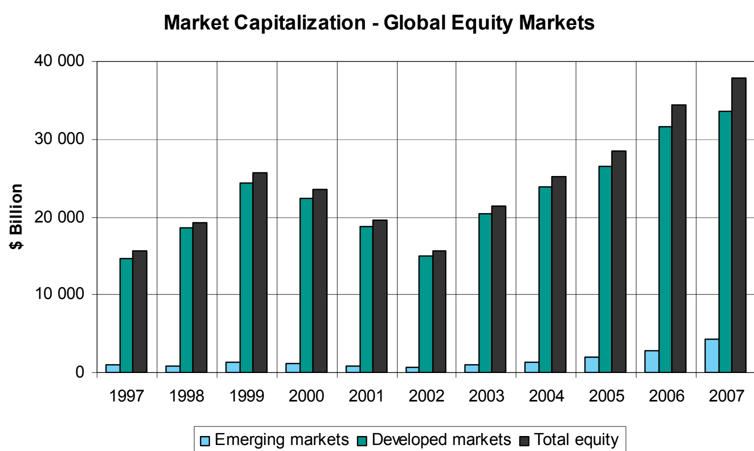
Mercer – Mercer's Investment Consulting business has made an estimate of global infrastructure assuming the market value of listed infrastructure equals unlisted infrastructure.

2 Asset Classes

In this section we present the major asset classes included in the GWP presented in section 2. The aim is to give an indication of their size and development over the last ten years.

2.1 Equities

The market capitalization for global equity was $37,900[6] billion by the end of 2007. Since 2002 equity markets have seen a steady growth. Emerging markets have nearly doubled their relative share of the global equity market.

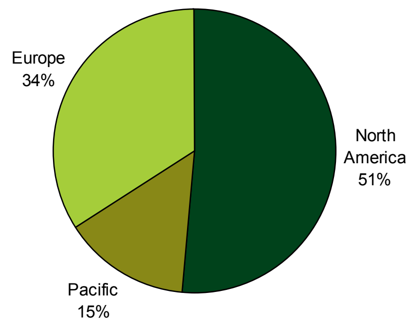


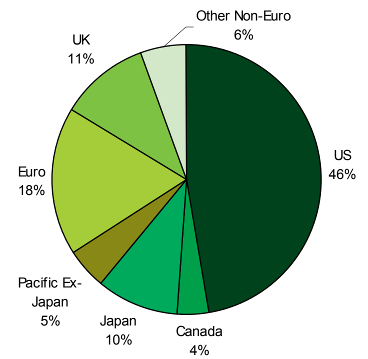
[5] www.mckinsey.com

[6] Market cap for MSCI World 2007-12-31 was $28 600 bn. MSCI state they cover 85% of the market. $28 600/85% gives our estimate of the global market cap.

MSCI World Index – membership countries (defined as developed markets)

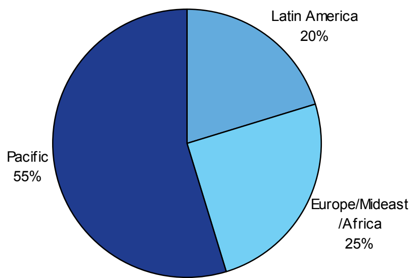
- Australia
- Austria
- Belgium
- Canada
- Denmark
- Finland
- France
- Germany
- Greece
- Hong Kong
- Ireland
- Italy
- Japan
- Netherlands
- New Zealand
- Norway
- Portugal
- Singapore
- Spain
- Sweden
- Switzerland
- United Kingdom
- United Kingdom
- USA

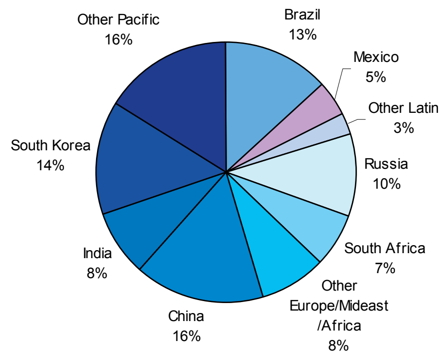




MSCI Emerging Markets – membership countries

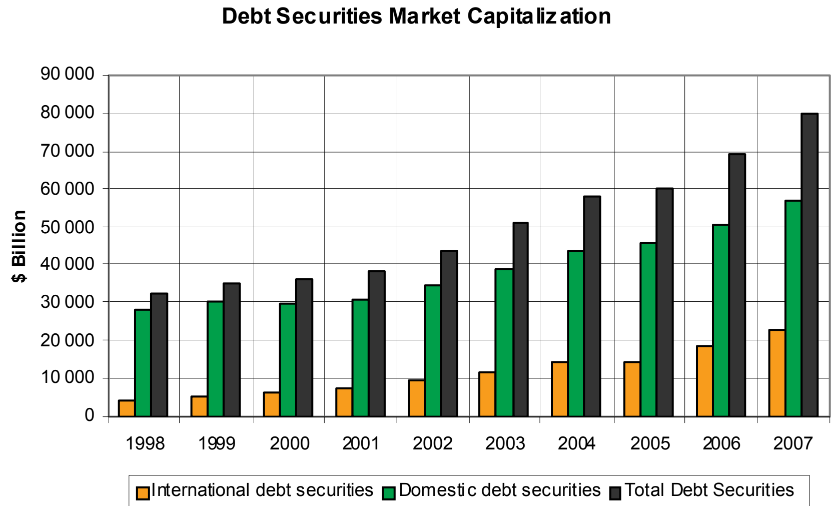
- Argentina
- Brazil
- Chile
- China
- Colombia
- Czech Republic
- Egypt
- Hungary
- India
- Indonesia
- Israel
- Jordan
- Korea
- Malaysia
- Mexico
- Morocco
- Pakistan
- Peru
- Philippines
- Poland
- Russia
- South Africa
- Taiwan
- Thailand
- Turkey





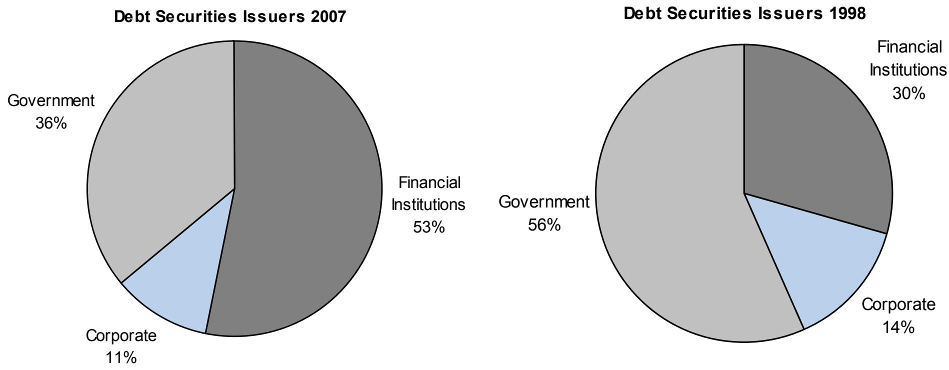
2.2 Debt Securities Market

By the end of 2007, global debt securities market totalled just under $80 trillion according to Bank for International Settlements (BIS).



From having represented over 50% of the bond issuances in 1998, governments have fallen back to represent only 36% of the market today. In 2007 financial institutions were the most frequent issuer of bonds.

In nominal terms the government related bonds have increased from a value of $18.2 trillion in 1998 to $28.6 trillion in 2007. That equals a rise of almost 160%. In the mean time, financial institutions issued bonds for a value worth $41.9 trillion in 2007. That corresponds to a growth of nearly 450% compared to the $9.5 trillion in 1997.



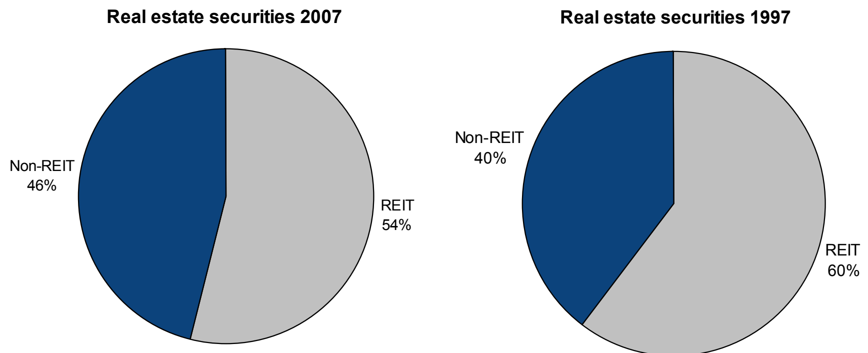
2.3 Real Estate

According to IPD the value of global real estate (22 most developed markets) was $4.7 trillion by the end of 2007. The markets defined by IPD as the most developed are:

- Australia
- Austria
- Belgium
- Canada
- Denmark
- Finland
- France
- Germany
- Ireland
- Italy
- Japan
- Netherlands
- New Zealand
- Norway
- Portugal
- South Africa
- South Korea
- Spain
- Sweden
- Switzerland
- United Kingdom
- United States

Compared to the MSCI world equity developed market index the global real estate index adds South Africa and South Korea while Greece, Singapore and Hong Kong falls out.

Cohen and Steers[7] presents the following numbers with regards to real estate securities.

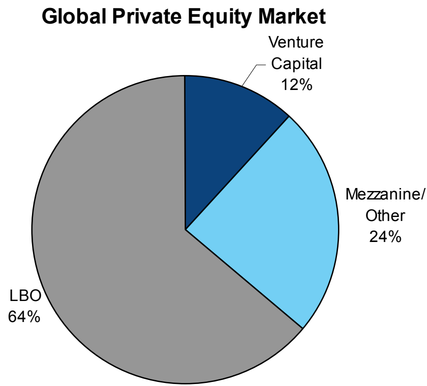


The charts show that non-REITs have seen a strong development over the last decade. These securities have grown from a market cap of $178 billion (REIT $272) in 1997 to $515 billion (REIT $599) in 2007. Total value of real estate securities market by year end 2007 was $1,114 according to Cohen Steers and S&P/Citigroup.

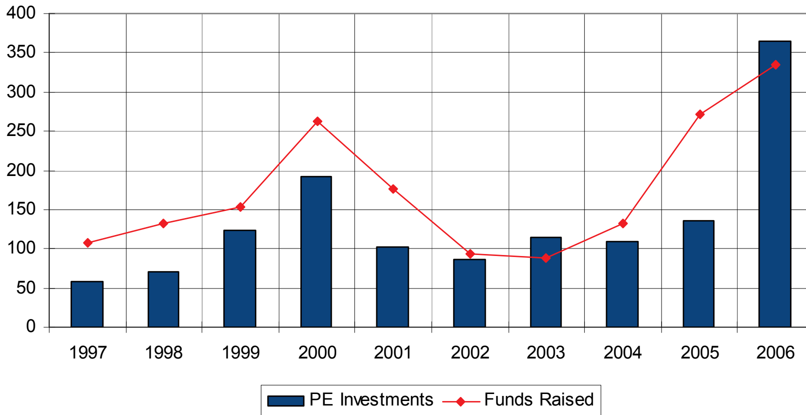
2.4 Private Equity

According to a McKinsey report[8] the global private equity assets under management (AuM) is estimated to be $1.1 trillion by year end 2006. The largest group of investments is leveraged buyout funds (LBO) followed by mezzanine and venture capital.

[7] In cooperation with S&P/Citigroup World Property Broad Market Index.
[8] "The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity are Shaping our Capital Markets", October 2007.



2000 and 2006 were the periods with the strongest capital inflows to private equity (see chart below). Funds raised means the money investors have committed to private equity funds in each year.



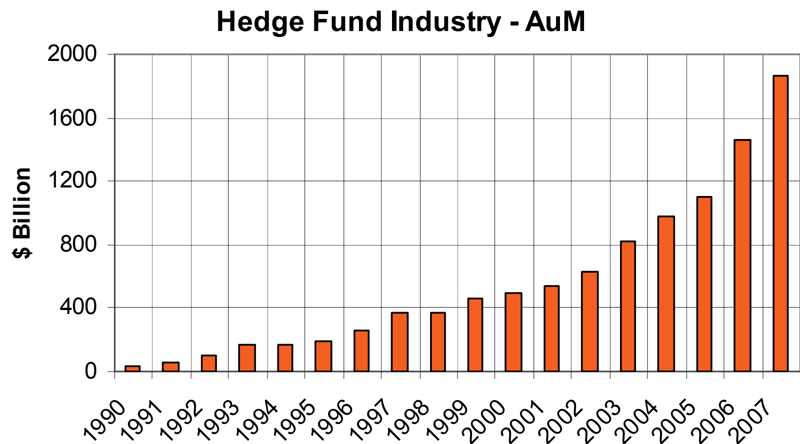
2.5 Hedge Funds

Hedge Fund Research (HFR) states the hedge fund market contained $1.9 trillion in December 2007. Net asset flows to hedge funds continue to grow. During 2007 investors allocated 194.5 billions to the industry and that is 50% more than 2006. Since 1990

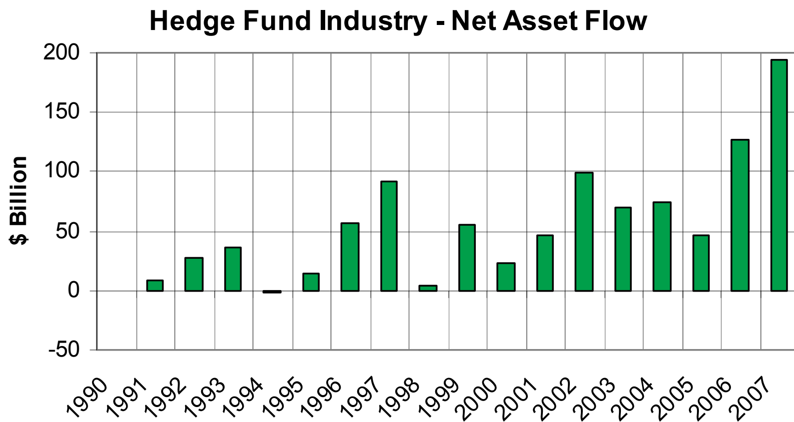
there has only been one year with negative net asset flows to hedge funds. That was in 1994 and ever since then hedge fund strategies have increased in popularity among the world's investors.

According to McKinsey[9], the number of registered hedge funds has increased steadily over the years. The growth is 1,400% when hedge funds have exploded from around 500 in 1990 to over 7,000 in 2007.

As noted earlier, for the purpose of this report we do not consider hedge funds an individual asset class but an alternative investment vehicle. Hedge funds are in this regard to be seen as investors in the other asset classes.



[9] "The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity are Shaping Capital Markets", October 2007



3 Pension Assets

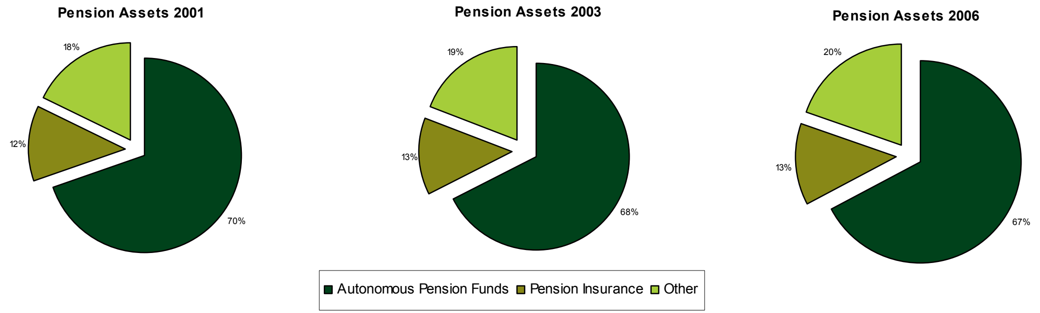
By the end of 2006 the total value of globally managed pension assets reached $26 trillion. In the past five years the pension assets have seen a steady growth which could be explained by an expansion in funding, pension reforms and a recovery in equity markets.[10]

According to IFSL Research the pension capital can be divided into three different categories:

- Autonomous Pension Funds – "public pensions"
- Pension Insurance – life and insurance companies
- Book reserves and other retirement products

The first category, the autonomous pension funds, constitutes two thirds of the total global pension volume and has done so over the past six years. Pension insurance stands for one fifth of the assets. The allocation has not changed much during the 21st century.

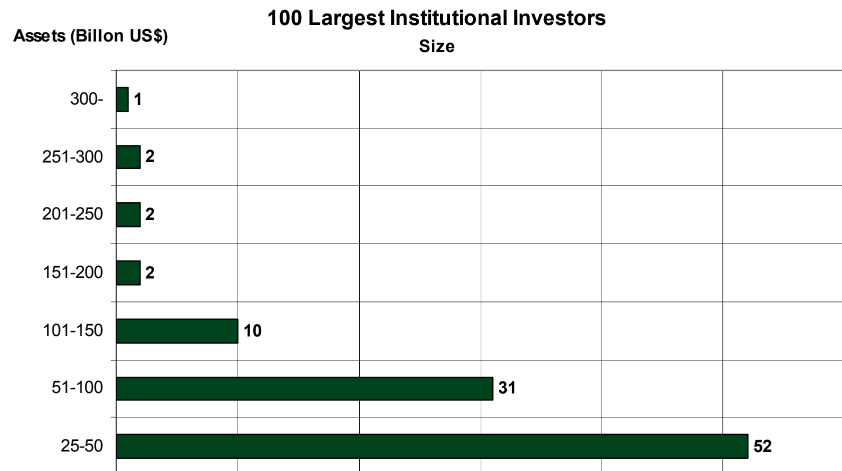
[10] IFSL Research, "Pension Markets 2008".



4 Size of Institutional Investors[11]

4.1 The Hundred Largest Institutional Investors

The chart below presents the distribution of size amongst the 100 largest institutional investors by the end of 2006.

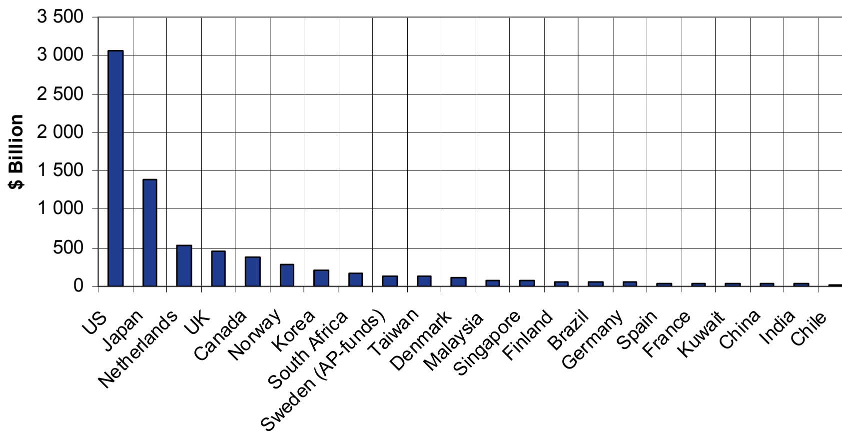


[11] If not mentioned otherwise, all statistics in this section comes from Watson Wyatt Worldwide, ”The world’s 300 largest pension funds – year end 2006”. The graphs and tables are reconstructions of information in that report.

AP-funds 1-4 qualify within the top 100 with assets around $30 billion each. In the table below you can see the exact placement of all the AP-funds.

Fund	Assets ($billion)	Rank
AP1	30.0	85
AP2	31.2	81
AP3	31.1	82
AP4	29.2	91
AP6	2.5	-
AP7	11.8	227
TOTAL	**135.7**	**11**

With aggregated assets the AP-funds would climb significantly in the ranking and place as the 11th largest institutional investor. Two other Swedish institutions are included in the Watson Wyatt report referred to earlier; Alecta (36) and AMF pension (59). These two are not included in the Sweden AuM in the chart below.

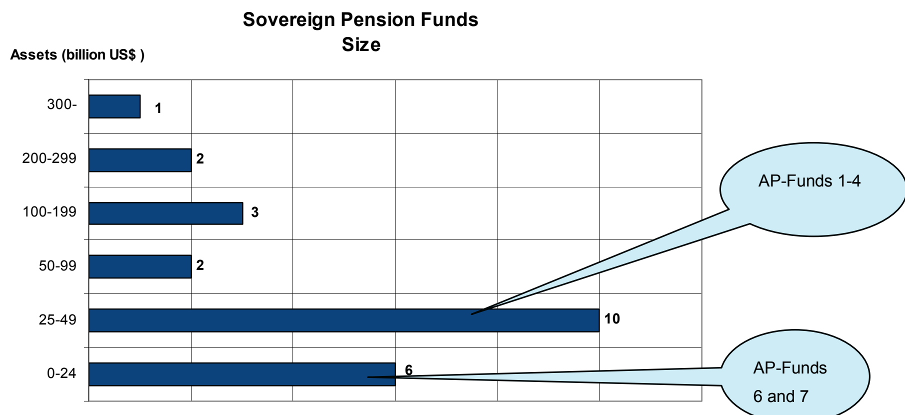


US investors have AuM which totals $3,070 billion. That makes the United States the largest institutional investor without competition. But if you put the assets in relation to the number of investors, the US is beaten by both Japan and the Netherlands.

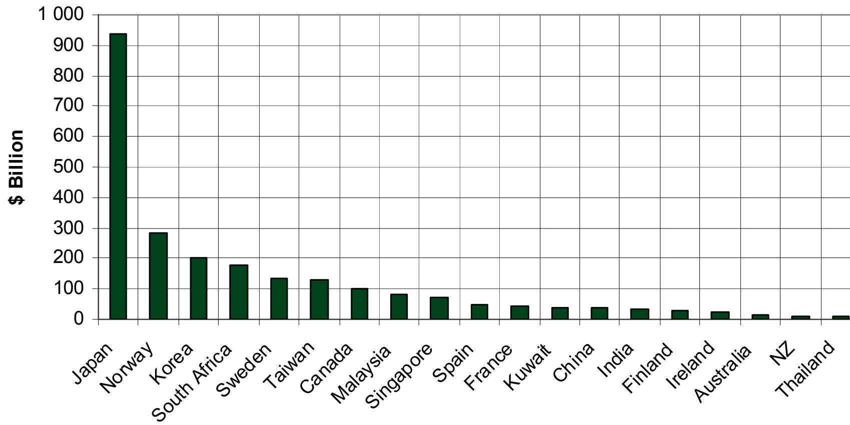
Country	No of Investors	Assets ($bn)/ investor
United States	46	67
United Kingdom	11	42
Japan	7	197
Canada	6	62
The Netherlands	6	88
Sweden	6	23
Denmark	2	55
Finland	2	32
Brazil, Chile, China, France, Germany, India, Korea, Kuwait, Malaysia, Norway, Singapore, South Africa, Spain, Taiwan	1	-

4.2 Sovereign Pension Funds

Watson Wyatt lists 23 sovereign pension funds (SPF). We have included AP 6 in the report as well. The bigger part of the funds has a volume between $25–49 billion. This is also the range where we find AP-funds 1–4.



It is worth noting that Sweden is the only country with more than one SPF. In the chart below all AP-fund's assets are added together to make a more fair comparison to the other countries.



Japan manages the largest SPF. Government Pension Investment's assets amounted to $937 billion by the end of 2006. The table below lists the ten largest SPF's.

Ten Largest Sovereign Pension Funds

Fund	Country	Assets ($ bn)
Government Pension Investment	Japan	935.6
Government Pension	Norway	285.6
National Pension	Korea	203.2
GEPF	South Africa	177.6
Postal Savings Fund	Taiwan	128.2
Canada Pension	Canada	100.7
Employees Provident Fund	Malaysia	82.3
Central Provident Fund	Singapore	70.5
Fondo de Reserva Seguridad	Spain	47.2
FRR	France	41.3

In the last few years we have seen the emergence of some very large sovereign wealth funds. When these funds have not been dedicated to manage pension assets they have been left out of this report. For many of the sovereign wealth funds it is difficult to get clear evidence of their assets under management.

5 Responsible Investments

5.1 Overview

An increase in total responsible investment (RI) assets under management (AUM) is evident in all the key markets including Europe, the US, Canada, Australia and New Zealand. In Europe, RI investing is estimated to represent 17.6%[12] of all funds under management with the two most active investor communities being those of the UK and the Netherlands. Institutional investors continue to lead the way on responsible investment.

One of the key themes emerging in the public conscience and among institutional investors is climate change. An increasing number of asset owners are examining how they might better address the risks and investment opportunities across their asset classes and investment horizon. Social criteria are also emerging as an area of concern and most investors globally remain focused on corporate governance issues, especially but not exclusively executive compensation.

Public equity investments remain the key focus for ESG integration however other asset classes – including alternatives – are increasingly considered valid subjects for ESG review, though using approaches and tools that are tailored to the asset class in question.

Much of the work on responsible investment continues to be coordinated globally through and encouraged by collaborative initiatives. For the most part, these initiatives are growing in terms of assets under management, number of signatories, and volume of interaction and joint actions.

[12] Eurosif (2008) "European SRI study 2008." Data as at 31/12/2007. http://www.eurosif.org/publications/sri_studies

5.2 Defining responsible investment (RI)

"Responsible investment" is a growing and changing field. Broadly defined, it incorporates an active consideration of environmental, social, and corporate governance (ESG) factors within investment decision making and ownership. This is driven by growing recognition among investors that responsible corporate behaviour with respect to ESG issues can have a positive influence on the financial performance of companies, particularly over the long term.

Unlike "ethical" or "socially responsible" investors, responsible investment describes investors who address ESG factors not on ethical grounds, but because they believe these factors can affect the performance of underlying investments. They therefore include these factors into the investment process as an element of prudent risk management.

5.3 Regional Trends

Throughout this section, we present data on the RI market in a common format. We distinguish between *core* and *broad* RI – the former includes ethical exclusions, positive screening and a combination of ethical exclusion and positive screening – while the latter includes simple screening, including norms-based screening, engagement and integration[13]. This typology is used by most national social investment industry groups.

5.3.1 Australia/New Zealand

Strong returns, new inflows into existing products, and the addition of pension funds integrating ESG analysis drove substantial growth in the RI market in 2007. A large part of the growth in the region is due to integration of ESG issues by mainstream institutional investors, most notably in 2007 a change in course for the AU$13.3 billion New Zealand Superannuation Fund.[14]

[13] For a more detailed explanation to these segments, please see Eurosif (2008) "European SRI study 2008." Data as at 31/12/2007. http://www.eurosif.org/publications/sri_studies
[14] Superannuation is a synonym for pension, used in the UK and Australia/New Zealand.

All three fund categories tracked by the Responsible Investment Association Australasia (RIAA) – Australian, Foreign, and Balanced Growth funds – outperformed passive benchmarks and the average mainstream fund over one, three, and five years (to June 2007).

Australia[15]		
Size of SRI market as at 30/06/07	Core SRI: AU**$19.4 billion**	Broad SRI: AU**$52.8 billion**
Key SRI investors	Core SRI: Managed portfolios, community finance, charitable trusts, environmentally themed investors	Broad SRI: Superannuation Funds, etc.
Main SRI practice	Corporate Engagement and ESG Integration (according to RIAA).	
RI Investments	Australian large cap equities are most often conducted with an RI element.	
Active Ownership	No specific shareholder resolutions that related to an issue of environmental or social responsibility in Australia in 2007.	
ESG Issues	Climate change is the over-riding issue.	
Legislative drivers & regulatory changes	Financial Services Reform Act 2001 – All investment funds (incl. Super Funds) are required by law to disclose to what extent ESG factors are taken into consideration in the selection, retention or realisation of an investment. Ethical funds are required to set out their criteria for what is and what is not an "ethical" investment.	
Actions of leading asset owners	AMP Capital Investors and BT Financial Group, provide a public report on their active ownership practices. VicSuper also leads the way in terms of RI implementation and disclosure. Three of the four largest fund managers in Australia and New Zealand have signed up to the UN PRI: BT Financial Group, AMP Capital Investors and Colonial First State Global Asset Management.	

[15] The information in this table is from the following reference unless otherwise noted: *Responsible Investment Association Australasia (RIAA) and Association for Sustainable & Responsible Investment in Asia (ASrIA)* http://www.eia.org.au/files/78RUBP9VVA/RIAA%20Benchmark%20Report%202007%20FINAL.pdf

5.3.2 Europe

Europe continues to be the leading region for RI strategies and, as Eurosif reports, some strategies will soon be considered accepted mainstream investment practice in several member nations. In recent years, the greatest growth has been in the area of engagement and integration strategies, compared to screening strategies. The key targets for engagement strategies remain climate change and carbon disclosure.

Screening is most prevalent in the Netherlands with €436 billion managed using ethical exclusions, best-in class and simple screening. Screens targeting the trade in armaments represent over half of all screening in Europe.

Adjusting for overall growth in European markets between 2005 and 2007, Eurosif reports an 85.5% real market growth rate for the total SRI market over the two year period. Composition of the European SRI market as at 31/12/07 was 94% institutional assets and 6% retail. This composition breakdown remained the same as 2005, although the 2007 figures take into account the Nordic SRI market (not including Iceland) which was not included in the previous Eurosif report.

Europe[16]		
Size of SRI market	Core SRI: **€512 billion**	Broad SRI: **€2.154 billion**
Key SRI investors	Institutional Investors, largely pension funds.	
Main SRI practice	Engagement and ESG integration.	
RI Investments	Emphasis remains on public equities (50% of total AUM). SRI bonds increased and now represent 39% of total SRI AUM.	
Active Ownership	• UK investors are ahead of their peers with regards to engagement activities. • Engagement is practiced almost equally at both domestic and international level. • Direct private engagement is the most common method adopted.	
ESG Issues	Climate change is the over-riding issue.	
Legislative drivers & regulatory changes	• National SRI regulations in place in the UK, France, Germany, Sweden, Belgium, Norway, Austria and Italy. • Soft legislation or ethical guidelines (the Netherlands and Switzerland). • European Parliament is currently in discussions regarding the possible introduction of mandatory transparency laws.	
Actions of leading asset owners	• The Environment Agency recently terminated two mandates, which is stated was partly due to the fact that the managers were not signatories to the PRI. • ABP has extended its commitment to microfinance investing by allocating an extra $75m (€50m) to Swiss asset manager BlueOrchard. • PGGM the Dutch pension fund, issued what is believed to be the first large emerging markets equity mandate to explicitly place environmental, social and corporate governance (ESG) factors at the heart of the investment process.	

[16] The information in this table is from the following reference unless otherwise noted: Eurosif (2008) "European SRI study 2008." Data as at 31/12/2007. http://www.eurosif.org/publications/sri_studies

5.3.3 Sweden

The SRI market in Sweden continues to be driven by large institutional investors, namely pension funds. This is partly due to a government directive from 2001 stating that pension funds must consider ethical and environmental aspects "without giving up their priority goal of a high return on investment". There has been an increasing number of smaller pension funds selecting investment funds with SRI characteristics.

The main SRI method adopted by Swedish companies is negative screening; with approximately 80% of SRI assets being managed using ethical exclusions or simple screens. The visibility of the Swedish Government within the SRI space is likely to continue influencing the integration of ESG factors by investors within Sweden.

Sweden[17]		
Size of SRI market	Core SRI: **€56.8 billion**	Broad SRI: **€134.3 billion**
Key SRI investors	Institutional Investors, mainly pension funds.	
Main SRI practice	Negative screening.	
RI Investments	Market is dominated by investments in equities, namely domestic equities.	
Active Ownership	Engagement is growing, primarily practiced amongst large organisations.	
ESG Issues	Climate change is the over-riding issue.	
Legislative drivers & regulatory changes	• National SRI regulations require pension funds to consider ethical and environmental aspects "without giving up their priority goal of a high return on investment". • Swedish Parliament appointed a committee to evaluate the implementation of ethical and environmental criteria in the investment process of the AP-funds.	

[17] The information in this table is from the following reference unless otherwise noted: Eurosif (2008) "European SRI study 2008." Data as at 31/12/2007. http://www.eurosif.org/publications/sri_studies

Actions of leading asset owners	• The AP national pension buffer funds (AP1, AP2, AP3 and AP4) have disinvested from nine companies that are involved in the sale of cluster bombs. • Svenska Kyrkans Pensionskassa, the Swedish Church Pension Fund, has allocated €26.3m in new global equities to Sustainable Asset Management (SAM) and increased its investments with Swedish ethical manager Ethos Sverige. • The Swedish AP7 fund recently announced that it will invest more than €300 million over the next 3 years via two or more clean tech private equity fund-of-funds[18].

5.3.4 Scandinavia

The Scandinavian region represents a large section of the SRI market within Europe. For the purpose of this report, Scandinavia as a region includes Finland, Denmark and Norway. The main driver in the region is demand from institutional investors who continue to be influenced by the Norwegian Government's adoption of SRI practices. In Norway, engagement is the most commonly applied method, with €151 billion SRI AUM using this approach.

SRI is steadily gaining momentum in the Danish and Finnish markets after initially making slow progress. Denmark's growth can be linked to the integration of ESG factors into fixed income asset classes, namely bonds, whilst Finland's lack of an institutional leader in the SRI space had hindered earlier uptake in the country. In Denmark and Finland SRI is mainly practiced through ethical exclusions and negative screening.

[18] Source: UK Social Investment Forum Responsible and Sustainable Investment Update, issue number 6, published spring 2008.
http://www.uksif.org/pension-funds/sustainable_pensions/newsletter/spring_2008

Scandinavia[19]		
Size of SRI market	Core SRI: **€229.6 billion**	Broad SRI: **€161.1 billion**
Key SRI investors	Institutional Investors, Norway also has a considerable SRI retail sector.	
Main SRI practice	Norms-based screening and ethical exclusions are most commonly applied in Denmark and Finland. The main approach in Norway is engagement (€150.8 billion).	
RI Investments	The majority of SRI investments are in equities and bonds..	
Active Ownership	• Engagement is the most widely applied strategy in Norway's broad SRI market. Engagement occurs at a much lesser extent in Denmark and Finland although this is growing. • Most common method is direct engagement.	
ESG Issues	Focus is on climate change.	
Legislative drivers & regulatory changes	• The Norwegian Government is currently reviewing its ethical guidelines for the government pension fund which were approved in 2004. The guidelines require the fund to carry out negative screening of companies producing certain categories of weapons (such as biological weapons and cluster bombs). • While there is a lack of strict regulations, public pressure plays an important role in influencing change in the Scandinavian region.	
Actions of leading asset owners	• Collaboration of largest Norwegian companies to form the Sustainable Value Creation, an initiative developed to influence Norwegian companies to incorporate long-term investment views. • Danica pension, the pension fund for Danske Bank, has adopted a new ethical investment policy which will be published in the third quarter.	

5.3.5 United States

Assets in all types of socially and environmentally screened funds – including mutual funds and exchange-traded funds (ETFs) – rose to $201.8 billion in 260 funds in 2007, a 13 percent increase over the $179.0 billion in the 201 tracked in 2005. Eight socially and environmentally screened exchange-traded funds (ETFs) with $2.25 billion in total net assets were available through the end of

[19] The information in this table is from the following reference unless otherwise noted: Eurosif (2008) "European SRI study 2008." Data as at 31/12/2007. http://www.eurosif.org/publications/sri_studies

2006 – the first time SRI-focused ETFs have been a factor in a Social Investment Forum Trends report.

At more than $1.9 trillion in assets, socially screened separate accounts managed for institutional investors and high net worth individual clients constituted the bulk of SRI assets tracked in 2007, up 28 percent from $1.5 trillion in 2005. Institutional investors have also used the stock they hold to increasingly participate in shareholder resolutions.

United States[20]	
Size of SRI market	**$2.71 trillion**[21]
Key SRI investors	High net worth individuals and other retail investors, defined contribution retirement plans, public and faith-based pension funds.
Main SRI practice	Screening, advocacy, community investing.
RI Investments	Primarily domestic large-cap equity but expanding into other asset classes; real estate, hedge funds, etc.
Active Ownership	Shareholder resolutions more popular than in others regions. The average level of shareholder support for resolutions on social and environmental issues increased 57 percent from 9.8 percent in 2005 to 15.4 percent in 2007, a record high.
ESG Issues	Climate change is the over-riding public issue. However, executive compensation controversies continue to generate more shareholder actions.
Legislative drivers & regulatory changes	US government passed the *Sarbanes- Oxley Act* (2002), including new requirements that should serve to significantly enhance corporate governance. 2003 requirement by the SEC that mutual funds disclose their proxy voting policies and actions.[22] Some state laws on renewable energy standards or other environmental regulations, and forthcoming carbon legislation.

[20] The information in this table is from the following reference unless otherwise noted: Social Investment Forum. 2007 Report on Socially Responsible Investing Trends in the United States. March 5, 2008,
http://www.socialinvest.org/pdf/SRI_Trends_ExecSummary_2007.pdf
[21] The US SIF does not give a breakdown between core and broad SRI categories.
[22] As of 31 August 2004, mutual funds and registered investment advisors must disclose both their proxy voting policies and how votes are cast.

Actions of leading asset owners	California Teacher's and Los Angeles made allocations to governance/activist funds which seek to improve financial performance through active engagement strategies.[23] Leading US & European institutional investors, with over $1.75 trillion AUM, have signed a climate change action plan to increase pressure for environmental disclosures by companies as well as greater direct investment in energy efficiency and cleantech.[24]

5.4 Collaborative industry initiatives

Principles for Responsible Investment (PRI)[25]

The PRI is an investor-led initiative which was launched in partnership with UNEP Finance Initiative and the UN Global Compact. As of June 2008, the signatories included 135 asset owners, 168 investment managers, and 75 service providers with over US$13 trillion in assets under management.

Carbon Disclosure Project (CDP)[26]

The CDP is an independent not-for-profit organisation aiming to create a lasting relationship between shareholders and corporations regarding the implications for shareholder value and commercial operations presented by climate change. As of June 2008, there were 385 CDP signatories with AUM of $57 trillion.

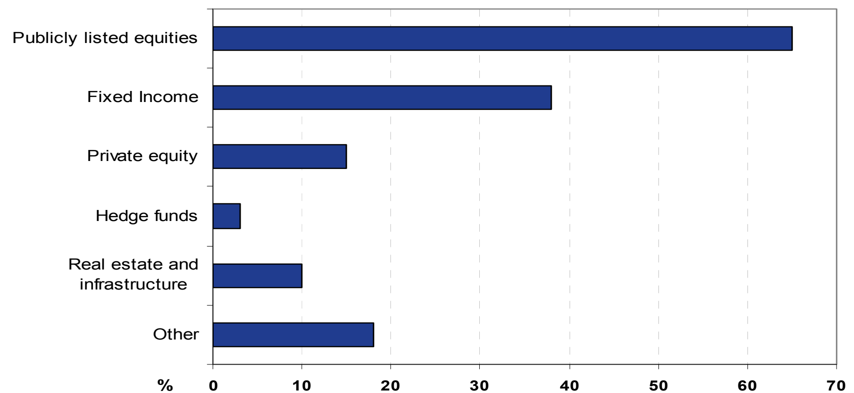
5.5 Asset classes

Public equities have traditionally been the focus for the SRI community and 2007 saw the continuing growth of new products targeting this asset class. The Responsible Investor 2007 survey[27] of 84 institutional asset owners, managing over $1.5 trillion in assets,

[23] Global Proxy Watch, February 1, 2008.
[24] Website: www.ceres.org
[25] Website: www.unpri.org
[26] Website: www.cdproject.net
[27] Responsible Investor (2008) *RI Landscape 2008: Asset Owners.* Retrieved from http://www.responsible-investor.com/reports/reports_page/ri_landscape_2008_asset_owners/

found that public equities continue to be the most important asset class for RI investments.

Figure 1 Percentage of AUM invested using responsible investment criteria allocated to different asset classes[28]



However, as more investors become interested in and committed to ESG integration, more attention is being paid to other asset classes. We see the development of responsible investment strategies for other asset classes, including alternatives, as an important trend for 2008 and beyond.

A number of introductory studies examining the application of RI to diverse asset class have been published. Of particular note, the *Handbook on Responsible Investment across Asset Classes*, published by the Institute for Responsible Investment in 2007, is an excellent resource regarding the broader application of responsible investment.[29]

Fixed Income: Systematic consideration of ESG issues with regards to risk and opportunity within fixed income portfolios is still relatively uncommon though there are a number of products available. Fixed income investment vehicles that employ a traditional SRI screening approach are more common, but still

[28] Responsible Investor (2008) *RI Landscape 2008: Asset Owners.* Retrieved from http://www.responsible-investor.com/reports/reports_page/ri_landscape_2008_asset_owners/
[29] Institute for Responsible Investment. (2007). *Handbook on Responsible Investment across Asset Classes.* Retrieved from http://www.bcccc.net/index.cfm?fuseaction=page.viewPage&PageID=1869

form a very small part of the fixed income market. In February 2007, JPMorgan and Innovest Strategic Value Advisors launched the JPMorgan Environmental Index – Carbon Beta. The high grade US corporate bond index is based on the JPMorgan US Liquid Index and is tilted in favour of companies that have relatively lower risk due to climate change.

Public Equities: Public equities are expected to remain the most important asset class in the RI space in the foreseeable future. The last years has seen an increasing interest in emerging market equities. For example, Mercer has worked with the large Dutch pension fund, PGGM, in this area. Focusing on emerging markets, we developed a framework to combine our assessment of manager integration of ESG with Mercer's traditional manager research process. The ESG assessment was conducted after the short-list of managers was determined.[30]

Private Equity: The Cleantech Group tracks private cleantech investments around the world. For 2007, they counted US$5.18 billion in North America and Europe, up from $3.6 billion in 2006 and $2.5 billion in 2005.[31] The top five categories by financing activity in 2007 were energy generation, energy storage, transportation, energy efficiency, and recycling and waste. Nicholas Parker, the Chairman and co-founder of the Cleantech Group is based in Toronto.

Real Estate/Property: Energy conservation strategies have become an accepted focus for most if not all property developers, tied in no small part to projected and actual increases in energy prices. There are, however, other ESG-related considerations that are gaining a higher profile. Examples include concerns about labour standards, environmental remediation, and the fit between development projects and broad urban planning trends.

Hedge Funds: 2007 saw the launch of some environmentally themed funds, but the consideration of ESG factors by most hedge fund managers is likely limited. Notable exceptions included Perrella Weinberg's Oasis Fund, launched in June. The Oasis Fund focuses on water and clean technology with long/short strategies

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[30] Mercer. (2007). *Mercer conducts search for world's first major ESG-driven emerging markets mandate.* Retrieved from
http://www.mercer.com/pressrelease/details.jhtml/dynamic/idContent/1285435

[31] Cleantech Group. (2008). *Cleantech investments reach new apex.* Retrieved from
http://cleantechnetwork.com/documents/CleantechGroup_PressRelease_20080117.pdf

and private equity placements. Similarly, Kenmar Securities, Inc. has launched their Global Eco Fund of Funds targeting commodities, energy and water.

Infrastructure: Because infrastructure investments are often so large and involve multi-year if not multi-generational contracts, the potential for public scrutiny can be a material consideration. An interesting example from 2007 was the purchase of Texas power company TXU Corp. by Kohlberg Kravis Roberts & Co. and TPG Capital. Facing concerns about regulatory approval and openly expressed opposition from environmental groups, the consortium agreed to reduce the number of coal-fired plants it would build and to invest instead in energy efficiency and renewable energy.

5.6 Responsible Investment and Performance

Academic research on responsible investment, socially-responsible investment, and ethical investing continues apace. Mercer monitors academic literature, focusing where possible on highly-cited peer-reviewed publications.

In conjunction with the Asset Management Working Group of the United Nations Environment Program Finance Initiative (UNEP FI), Mercer researched and wrote a report, *Demystifying Responsible Investment,* released in October 2007.[32] The report examined 20 academic studies and ten broker studies that studied responsible investment using various research methods and concentrating on diverse regions and approaches.

[32] The report can be found online at www.mercer.com/ri under "Publications" or form the UNEP FI website: www.unepfi.org

The overall findings from the majority of the research include:

- It is a *misconception* to assume that responsible investment *leads to financial underperformance*
- Various factors such as manager skill, investment style and time period are integral
- Evidence suggests that there appears to be *no performance penalty* from taking ESG factors into account in the investment management process (10 studies are positive, 7 neutral and 3 negative)
- As a financial discipline, responsible investment can be *successfully implemented in virtually any investment style*
- Genuine ESG analysis needs to be distinguished from simple automatic exclusions
- Systematic translation of ESG factors into quantitative inputs and financial ratios still needs to be developed in broker research

Other articles of interest from 2007 and early 2008 include the following research on corporate governance issues:

- Pornsit Jiraporn and Kimberly Gleason demonstrate a link between shareholder rights and capital structure. Firms covered by the study showed higher levels of leverage where rights were more restricted than other firms.[33]
- Jiraporn and Yixin Liu study the impact of staggered board elections on leverage. Again, firms with a staggered board show lower levels of leverage than firms in which all directors are elected at the same meeting. The same results were found in regulated as well as industrial firms. The difference between the two board structures, with regards to leverage, seems to disappear after the passage of Sarbanes-Oxley. The authors posit this relationship exists, at least in part, because staggered boards tend to protect inefficient management.[34]

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[33] "Capital structure, shareholder rights, and corporate governance," *Journal of Financial Research,* Volume 30, Number 1.

[34] "Capital structure, staggered boards, and firm value," *Financial Analysts Journal,* Vol. 64, No. 1.

- Denise Dickens and Robert Houmes find that higher executive compensation levels, vis-à-vis the firm's peers, does not lead to better performance than the rest of the peer group.[35]
- The Association of British Insurers recently completed a study, *Governance and Performance in Corporate Britain* (February 2008), which found that companies with the best corporate governance records have produced returns 18% higher than those with poor governance records. This was based on a survey of 654 UK FTSE-listed companies from 2003 to 2007. Causality was also tested and the Association reports that governance drives performance, rather than the reverse.[36]

Other articles of interest, addressing social, environmental, and related issues, include:

- Holden Partners, based in the UK, published a report on SRI and ethical funds that argues that these funds have little positive impact on the struggle to confront climate change. In fact, many of them have significant positions in corporations that are considered, by many environmentalists, to be obstacles to climate change reforms. By contrast, there are an increasing number of targeted funds that invest in nothing but clean technologies.[37]
- Alex Edmans argues that there is positive relationship between employee satisfaction and long-run stock performance. Using backtesting, Edmans created a portfolio based solely on *Fortune* magazine's, "Best Companies to Work for in America". The portfolio was rebalanced annually. The results from 1998 to 2005 showed a return double that of the market and outperformance against industry- and characteristic-matched benchmarks.[38]
- In a major nod to industry trends, the *Economist* published a long survey of corporate CSR practices in its January 19th 2008 edition. The survey presented a positive view of the relationship

[35] "Executive compensation: Much ado about nothing?" *Financial Analysts Journal,* Vol. 63, No. 3.
[36] Available online at http://www.abi.org.uk/BookShop/ResearchReports/Research_Feb_08.pdf
[37] From firm website: http://www.holden-partners.co.uk
[38] "Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices" by Alex Edmans of Wharton, 2007 Moskowitz Prize Winner, see: http://www.socialinvest.org/resources/research/documents/Moskowitz2007Paper.pdf

between CSR and corporate results – although recognizing many of the problems involved in assessing and implementing CSR. The magazine also noted and rejected its earlier editorial criticism of CSR noting, in addition to financial results, peer pressure is such that few corporations can afford to ignore how they are perceived by social critics.[39]

- A survey article by Iain Davies on the development of the "fair-trade" industry focuses on how the industry has changed over time and the role of mass-marketing in this transition. The phases identified respond to changing approaches to consumer demand and include the solidarity era, niche-market era, and mass market era, followed by the institutionalisation era. This typography provides an interesting parallel with responsible investment as it has evolved to meet customer (i.e. Investor) needs starting with a values-driven era, moving through niche products towards value-added and finally incorporation into institutional risk management processes.[40]

5.7 Looking ahead

In recent years, we have seen increased interest in responsible investment and growing integration of ESG-analysis into the investment process of many asset owners and investment managers. More importantly, however, there is increasing evidence that responsible investment strategies are being integrated into mainstream dialogue within the financial services industry. We have come to a point where few asset owners and investment managers deny the role an enhanced risk-return framework should play in modern investment management.

However, despite an overall growth in RI, ESG integration remains quite rare. Looking at the full spectrum of approaches to RI amongst global pension funds, very few position themselves as 'leaders' in this area.

We define the 'leaders' as those funds that fully integrate ESG factors in decision making processes from a risk and return perspective. Examples include Dutch Pension Fund for Health, Mental and Social Interests (PGGM), the UK Environment

[39] *Economist,* January 19, 2008.
[40] "The eras and participants of fair trade: an industry structure/stakeholder perspective on the growth of the fair trade industry," *Corporate Governance,* Volume 7, Number 4, 2007.

Agency, British Telecom Pension Scheme (BTPS) and Dutch Stichting Pensioenfonds ABP. These funds integrate RI considerations into requests for proposals, investment mandates and investment manager agreements, and have developed a proactive approach to active ownership. Furthermore, the 'leaders' assess the ESG capacity of current or prospective investment managers and tend to analyse existing portfolios for exposure to ESG risks. To various degrees, these funds have also conducted RI manager search and selection for alternative strategies.

At the other end of this spectrum are the "ethical" or "socially responsible" investors, who address ESG factors on ethical grounds, and are not necessarily concerned about any affect that these factors may have on the performance of underlying investments. These funds are considered 'laggards' according to this definition as their ethical considerations are taken independently from the investment management function. Also asset owners who have reverted to simplistic exclusions and /or superficial engagement policies would fall in this category.

In the mid-category on this spectrum, we find 'developing' funds that have started to move towards integration. They have generally developed an RI action plan in the context of their overall plan philosophy and beliefs. This often includes a component of peer benchmarking. To various degrees, they have also started to move away from simplistic exclusions and to integrate RI considerations into their own portfolio construction, requests for proposals, investment mandates and investment manager agreements.

6 Next steps for the AP funds

The Swedish AP funds vary considerably in their integration and can be found in both the developing and lagging category. Few have communicated clear rationales for their adopted positions on RI, and are not among the global pension funds that actively consider risks and opportunities that arising from ESG issues in their investment processes. Looking forward, the AP funds can further enhance their aptitude in the RI space by moving towards full integration of ESG issues in investment decisions.

The asset owners that are leading in the RI field have often addressed a number action items that are described below. Many of the following have relevance for the AP funds as well.

Possible Action Areas	Example of Actions Taken
Beliefs and Policy Development	
Review beliefs and attitudes towards RI RI policy review	Review of RI policy, strategy and philosophy Integration of RI into Investment Policy and Guidelines Peer comparison and positioning Stakeholder surveys
Review of Mandates and Managers	
Ensure ESG integration of all relevant policies, mandates, and activities Review all existing managers and consultants for ESG suitability Report on the carbon footprint of the company's entire portfolio	Investment Manager Agreement, Mandate and RFP review Manager RI/ESG review ESG portfolio monitoring
Manager Search and Selection	
Incorporate ESG as an essential factor in manager and other supplier selection processes	Manager search and selection Review of ESG integration and research providers
Active Ownership	
Review of active ownership policy Develop criteria for engagement Develop internal engagement capacity or appoint external engagement overlay manager	Review of active ownership policy Collaborative shareholder engagement program development Proxy voting and engagement services review Search and selection process for a engagement overlay manager
Leadership and Collaborative Initiatives	
Become a leader in incorporating responsible investing Participate in collaborative initiatives	Seek advice and recommendations on collaborative initiatives Seek advice on PRI implementation
External Communication	
Inclusion of fund performance against RI targets in Annual Report Educate and inform clients and the public on RI Communicate new developments to beneficiaries and the wider public regularly Encourage research and demand standardised reporting	Determination of strategy for communicating policies, practices, outcomes with respect to RI/ESG integration among beneficiaries and the wider public

Doing Well While Doing Good? A survey of the socially responsible investments literature[1]

Kees Koedijk[2] and Jenke Ter Horst[3]

[1] This survey is written by order of the Commission on ESG-issues for the Swedish Public Pension Funds.

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1 Introduction

During the last decade, one of the impressive new developments in the financial community has been the rise of social and ethical investments. Although the origins of ethical investing date back many hundreds of years, the modern roots of social investing can be traced to the political climate of the late 1950s and early 1960s. Issues such as the environment, civil rights, and nuclear energy increased the social awareness of investors. Accordingly, mutual funds were set up that specifically met the demand for incorporating ethical criteria into the investment process. This development led to a dramatic increase in ethically managed mutual fund assets, an industry that now represents several hundred billion dollars in the United States. If all U.S. private and ethically screened portfolios are included, now, at the end of 2008 this number tops the three trillion dollar mark. At the moment, approximately 10% of all money under professional management in the United States is part of a socially responsible portfolio.

Because of the size and importance of this movement, both academics and practitioners have investigated the financial consequences of ethically or socially responsible investing (SRI). The fact that MISTRA, the foundation for strategic environmental research, is funding a Sustainable Investment research program, is an excellent example of the relevancy of this topic. In this survey we will discuss a number of projects from the Sustainable Investment research program amongst others. One of their questions is, does it cost to be socially responsible? There are many authors who have investigated the financial consequences of these investments and evaluated how SRI factors such as environmental, social, and governance factors (the ESG factors) affect the portfolios' financial outcomes. For the U.S. and the UK, there is little evidence that the financial performance of the SRI industry is different from that of the conventional investment industry (see, e.g., Statman, 2000; and Bauer, Koedijk, and Otten, 2005). However, for Continental Europe and the Asia-Pacific region, there is evidence of underperformance (see, e.g., Renneboog, Ter Horst, and Zhang, 2008a).

In the SRI industry it is common for investment professionals to pursue both financial goals and non-financial objectives. SRI funds usually employ all kinds of SRI screens that restrict their investment opportunity set. Excluding companies based on screens

that reflect social, environmental, or corporate governance issues reduces the diversification opportunities, and therefore may negatively affect the financial performance of those funds compared to the performance of conventional mutual funds. Moreover, the exclusion of companies may negatively affect the stock prices of those companies, and raise the expected returns. This exclusion effect probably explains why the so-called 'sin' stocks in the U.S. have significantly outperformed the stock market in the last decade (Hong and Kacperczyk, 2008). However, one can also argue that the screens are used as filters to identify companies that can expect superior future performance. The identification effect would imply that the screening process generates value-relevant information that would otherwise not be apparent to investors. This implies that screening would later result in superior fund performance.

Both the outperformance and the underperformance hypotheses can both be motivated by theoretical arguments. For example, if financial markets underestimate costs that may emerge during corporate social crises or environmental disasters, then portfolios that use screens based on these criteria may show outperformance. For example, Derwall, Gunster, Bauer, and Koedijk (2005a) show that a portfolio of firms with high environmental scores outperforms a portfolio of firms with low scores. One of the key assumptions in this part of the SRI literature is that stock markets misprice information on ESG in the short run. In this survey, we examine the most important and recent papers that provide the theoretical arguments and empirical findings related to financial under- or outperformance.

It has to be stated that the empirical literature on SRI fund performance mainly focuses on mutual funds. Pension funds that invest with SRI constraints hardly got attention, probably due to data availability. Besides data availability, it is also difficult to compare social responsible pension funds with usually much smaller social responsible mutual funds. Nevertheless, the question whether and how pension funds should incorporate ESG issues in their investment decisions is a topic that receives considerable attention (see, 'De gearriveerde toekomst, 2007). Recent studies by Eurosif (2006) and Social Investment Forum (2006) show that engagement and integration strategies are becoming mainstream for pension funds nowadays. The potential power of pension funds in terms of voting practices or in the form of direct dialogues between the funds and the companies are instruments to encourage

companies to incorporate ESG issues in business practices. Furthermore, the integration of values-based investing in the traditional asset allocation and risk management process is a trend that becomes truly visible.

The historical development of the SRI industry also shows some interesting patterns. The first-generation SRI funds used mostly negative or exclusion screens. This negative screening implies that the funds excluded certain parts of the initial asset pool. In contrast, the second-generation SRI funds primarily used positive or selection screens. Doing so enabled them to select companies with a 'best in class' approach. The more recent third and fourth generation of SRI funds combines the selection and exclusion screens together with shareholder activism. In a sequence of papers, Renneboog, Ter Horst, and Zhang (2006, 2008a, 2008b), using a sample of SRI funds from throughout the world, discuss the effects of the use of different investment screens on the performance of SRI funds, the money flows into and out of SRI funds, and the flow volatility of the SRI funds. In this survey, we discuss their findings and relate them to the issue of whether there are systematic differences between SRI investors who work on an 'engagement' basis and those who use a 'divestment' strategy.

For pension funds that already incorporate ESG issues in their investment policy an interesting question is whether they should restructure investment strategies from negative screening towards positive screening. Positive screening will probably narrow down the investment opportunity set of the pension fund much stronger than negative screening does. Furthermore, it has to be noted that the use of engagement power of pension funds can only be effective when the funds have an ownership stake in a company. Therefore, switching from negative towards positive screening may have undesirable ESG implications for society in general. Alternatively, empirical evidence shows that positive screening can generate value. Over the period 1992-2007, a best-in-class approach would have outperformed a conventional portfolio strategy for the U.S. market.

A recent SRI literature stream focuses on what socially responsible investors want, and what distinguishes them from conventional investors. The integration of personal values in the traditional risk-return trade off framework of portfolio optimization is an important cornerstone of this part of the SRI literature. As stated by Statman (2007), 'Like conventional investors, socially respons-

ible investors want high returns and low risk, but socially responsible investors also want their portfolios to conform to their values, whether promotion of worker rights, opposition to war, or protection of the environment'. Renneboog, Ter Horst and Zhang (2006) find that socially responsible investors care about social or ethical issues in their investment decision. Money flows into and out of SRI funds that mainly employ sin/ethical SRI screens are much less sensitive for past fund returns than conventional fund flows.

Alternative investments such as private equity and hedge funds are important asset classes. Thus, it is interesting and relevant for us to examine whether and to what extent these asset classes incorporate social responsibility into their investment decision process. Although, as far as we know, there are hardly any academic papers on the subject, we nevertheless observe that sustainable or socially responsible private equity is gaining momentum. For example, a recent study by Cumming and Johan (2008) shows that Dutch institutional investors invest in sustainable private equity. However, it appears that both the organizational structure and the global diversification opportunities affect the size of the sustainable investment program.

Today, the SRI industry represents a significant part of all investment funds. Therefore, we wish to examine whether ESG affects corporate behavior. In this survey we present a number of different papers that investigate this issue. For example, Barnea, Heinkel, and Krause (2005) examine the effects of negative pollution screening on the investment decisions of polluting firms. The main finding in this study is that negative screening reduces polluting firms' incentives to invest, which would lower the firms' total investment in the economy.

The remainder of this paper is organized as follows. In Section 2 we review theoretical arguments and the empirical findings related to financial under- or outperformance of SRI funds. Section 3 discuss differences in behavior between socially responsible investors and conventional investors. In Section 4 we discuss financial performance and SRI Factors. In Section 5 we review the studies on systematic differences between SRI investors who work on an 'engagement' basis and those who use a 'divestment' strategy. In Section 6 we review the few papers on alternative assets such as private equity, hedge funds, and real estate in relation to social responsible investment. In Section 7 we discuss the literature

related to the question of whether ESG affects corporate behavior. In Section 8 we conclude. We briefly indicate the scholarly frontier and topics for future research in the development of SRI.

2 The Performance of Socially Responsible Investment Funds

The performance of SRI mutual funds compared to conventional funds is the most extensively studied topic in the SRI literature. From a theoretical point of view, imposing SRI constraints in the investment process reduces the diversification opportunities. According to Markowitz's portfolio theory, these constraints move the mean-variance frontier to the right, and result in less attractive risk-return tradeoffs relative to those in conventional mutual funds. Alternatively, SRI screening may generate value-relevant information. Socially responsible portfolio selection based on environmental, social, or governance criteria may lead to outperformance.

For the period 1981–1990, Hamilton, Joe, and Statman (1993) examine the performance of 32 SRI funds and 320 non-SRI funds in the U.S. They find that SRI funds established before 1985 outperform, on a risk-adjusted basis, their conventional counterparts by almost 1% per year. The more recently initiated SRI funds underperform their counterparts by almost 2.5% per year. Although economically significant, the differences in performance are not statistically different from zero. Statman (2000) finds a similar result. Statman examines the performance of 31 SRI funds and 62 non-SRI funds over the period 1990–1998 and reports a risk-adjusted outperformance of about 2.5% on an annual basis. For both studies, it holds that both SRI and non-SRI funds underperform the benchmark.

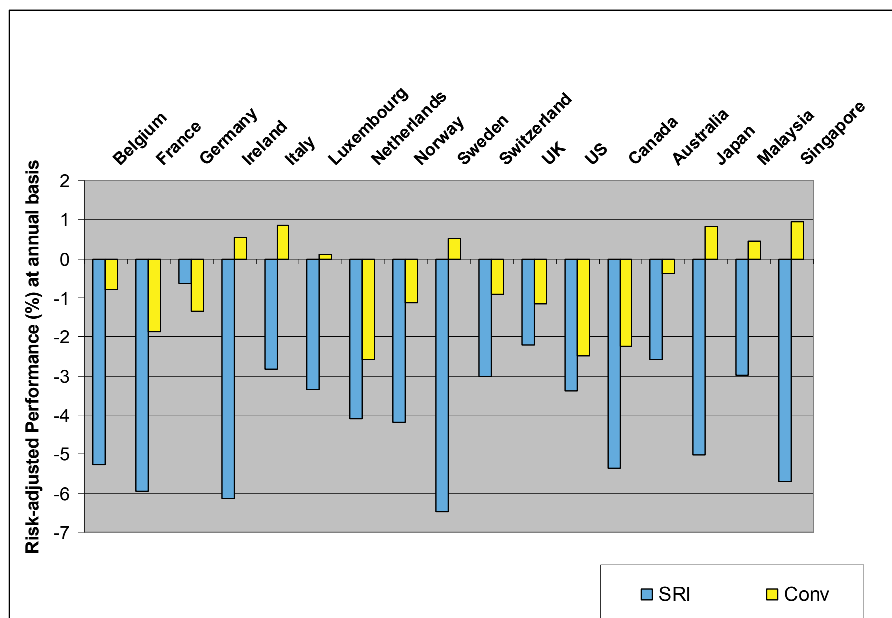
One of the first international SRI fund performance studies is by Bauer, Koedijk, and Otten (2005). These authors use the Fama-French Carhart (FFC) model to measure the performance of SRI funds in Germany, the UK, and the U.S. over the period 1990-2001. For the UK, they find that domestic and internationally investing SRI funds significantly outperform their conventional counterparts. Domestic ethical SRI funds in the U.S. significantly underperform, but the difference for internationally investing funds is not significant. For Germany, they find nonsignificant

differences between ethical and conventional funds. Bauer, Koedijk, and Otten (2005) report that German and U.S. ethical funds experienced a learning phase. Initially, the funds under-performed, but during the period 1998–2001 the funds matched the performance of conventional funds.

Geczy, Stambaugh, and Levin (2005) use a different approach. Using a Bayesian framework, these authors examine whether investors in socially responsible equity mutual funds pay a price, via their investments, for their willingness to do well. Imposing SRI constraints reduces the diversification benefits to less favourable risk-return tradeoffs. The difference between the certainty equivalent returns on a portfolio with and without SRI constraints clearly reveals the costs of trying to do well via investments. It appears that investors who have a strong belief in the traditional CAPM and a disbelief in managerial ability bear very little cost in terms of certainty equivalent loss. However, as soon as the investor beliefs shift in the direction of multifactor models such as the FFC model, then the costs of imposing SRI constraints rises significantly to about 30 basis points per month.

A recent study by Renneboog, Ter Horst, and Zhang (2008a) compares socially responsible and conventional equity funds in 17 countries. They determine FFC 4-factor alphas (annualized) for equally weighted portfolios of SRI funds and conventional funds. The returns of the benchmark portfolios are in local currency and are evaluated from a local investor's perspective, i.e., with local benchmark factors and local risk-free rates. Figure 1 shows the 4-factor alphas for the SRI funds as well as their conventional counterparts.

Figure 1 **SRI and Conventional risk-adjusted performance around the world**



Source: Renneboog, Ter Horst ,and Zhang (2008a).

It appears that in all 17 countries under consideration, the SRI mutual funds underperform their benchmark. For seven countries (France, Ireland, Netherlands, Sweden, the UK, Canada, and Japan), the authors find a significantly negative risk-adjusted performance. However, they report a significantly negative difference in performance between SRI funds and conventional funds only for Sweden and Japan. This result implies that although SRI funds economically underperform conventional funds in all countries, the underperformance is only statistically significant for two out of the 17 countries.

The empirical evidence on the nonsignificant difference between SRI and conventional responsible funds focuses mainly on equity funds. In a recent study, Derwall and Koedijk (2008) evaluate the performance of SRI bond funds and the SRI funds that hold both debt and equity (balanced funds). Over the period 1987–2003, these authors find that socially responsible fixed-income funds show a risk-adjusted performance similar to that of their conven-

tional counterparts. SRI balanced funds even outperform conventional balanced funds by about 1.3% per year. Derwall and Koedijk's results are robust for various performance evaluation techniques and imply that SRI constraints do not negatively affect fixed-income fund performance.

To summarize, most empirical studies provide evidence that the risk-adjusted performance difference between SRI funds and their conventional counterparts is not statistically different from zero. In the U.S. and UK, the average performance of SRI funds and conventional funds is comparable. Sweden and Japan are the only two countries for which researchers find a significant underperformance. Nevertheless, socially responsible investing has experienced a strong growth.

3 The Appeal of Socially Responsible Investing

An important observation in the recent SRI literature is that socially responsible investors care about other issues than performance only. Note that this does not imply that performance of pension or mutual funds is not relevant. Like conventional investors, socially responsible investors also have to save/invest for their own personal financial planning such as retirement. Socially responsible investors care about the integration of personal and societal values in the traditional investment decision process. In a sequence of papers, Statman (2007a, 2007b, 2007c) portraits socially responsible investors. Who are those people and what drives them? Bollen (2007) and Renneboog, Ter Horst and Zhang (2006) relate this part of the SRI literature with a more quantitative approach to disentangle the difference in behavior between conventional investors and socially responsible investors.

In the previous section we have seen that a lot of research regarding socially responsible investing focuses on the question whether there is a performance difference between SRI funds and their conventional counterparts. However, many investors may derive utility from owning companies or mutual funds that care about their personal expressive characteristics as well. Bollen (2007) introduces a multi-attribute utility function that incorporates personal or societal values into the traditional investment decision problem. Even in the case that social responsible screening negatively affects fund performance, investors can nevertheless

derive nonfinancial utility by investing in SRI funds consistent with their environmental, social, and ideological issues. To examine whether SRI investors care more about these nonfinancial issues than about fund performance, Renneboog, Ter Horst, and Zhang (2006) extend the framework of Bollen (2007) and examine the flow-performance relation of SRI and conventional funds. For conventional mutual funds and hedge funds, researchers know well that financial attributes, such as risk-adjusted and raw past returns, significantly affect the money flows into the funds (see, e.g., Sirri and Tufano, 1998; and Agarwal, Daniel, and Naik, 2004). Top-performing funds attract most of the inflow, while poor performing funds are hardly affected by outflows.

Renneboog, Ter Horst, and Zhang (2006) report that SRI investors around the world care less about past performance than do conventional fund investors. In comparison to conventional funds, the authors find a somewhat weaker reaction to positive performance in the previous year, but more interestingly, that the flows of SRI funds are significantly less sensitive to past negative returns. Furthermore, they report that the types and the intensity of the screening significantly affect the money flows. SRI funds that are characterised by primarily negative screens, or by mainly sin and ethical screens, receive larger money inflows and have a weaker sensitivity to negative returns. The reduced sensitivity to past negative returns corresponds to Bollen's (2007) study on U.S. funds. However, Bollen (2007) reports a stronger flow sensitivity to past positive returns. According to Renneboog, Ter Horst, and Zhang (2006) this result can be explained by the fact that U.S. SRI funds mostly use ethical and sin screens. Finally, Renneboog, Ter Horst, and Zhang (2006) report that stock-picking based on in-house SRI research increases the money flows by about 0.8% per month. This result indicates that investors in SRI funds care more about nonfinancial attributes and pay less attention to financial performance.

The findings of Bollen (2007) and Renneboog, Ter Horst and Zhang (2006) correspond with the way Statman portraits socially responsible investors. A clear picture of a social responsible investor does not exist. Social responsibility has different interpretations for different investors as well as their aims. Some investors care about the environment, and prefer a portfolio where polluting companies are excluded, while alcohol, gambling and tobacco companies are not considered as social responsibility

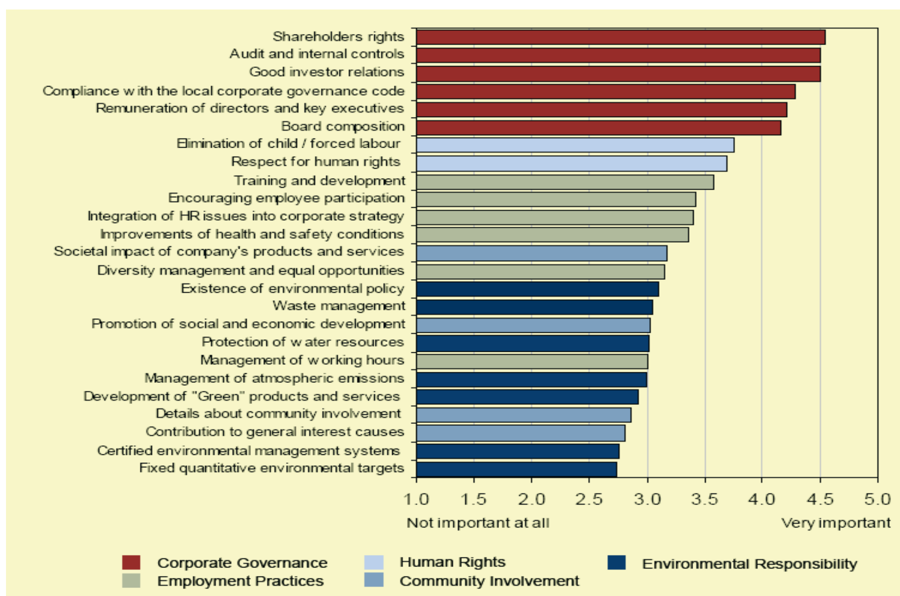
issues. But what socially responsible investors share is consistency between their values and investments. They care about performance, but some of them are even willing to sacrifice returns in order to have peace of mind.

4 Are SRI Factors Priced by the Market?

One of the most controversial issues in the SRI literature is whether the introduction of nonfinancial criteria in the investment decision process affects financial performance. But beforehand, it is difficult to claim that criteria such as environmental, social, and corporate governance targets will positively or negatively affect performance. At the heart of the discussion is the question of whether these nonfinancial targets are priced by the market. In the recent SRI literature we can distinguish three alternative hypotheses. The ‘neglect’ or ‘doing good but not well’ hypothesis states that the expected returns of social responsible stocks are lower than are those of the stocks of conventional, or even controversial, companies. Alternatively, the ‘errors in expectations’ or ‘doing well while doing good’ hypothesis states that expected returns from social responsible firms are higher than are those of conventional firms. Finally, in the ‘no effect’ or ‘irrelevance’ hypothesis, the social responsibility feature is not priced in the market, and expected returns of SRI companies will be equal to those of conventional companies.

Jaworski (2007) conducted a survey among research analysts and investors to examine how and the ways in which they incorporate ESG issues into their analysis. Jaworski's results show a growing interest in SRI. Table 1 shows which ESG factors matter the most for the investment community. It appears that corporate governance indicators are the most important factors, and that environmental responsibility and community involvement receives relative less attention. Furthermore, most participants think that ESG factors have an impact on market value and financial performance, in particular over the long term, and that the information on ESG issues is not fully reflected in the stock prices.

Table 1 **Relative Importance of ESG issues to investors' investment decisions and recommendations**



Source: Jaworski (2007), www.corporate-engagement.com

Nilsson, Cunningham and Hassel (2008) examine whether environmental information is actually used by financial analysts in their equity valuation reports on two industries: the chemical and the oil and gas industry. Although companies increasingly report environmental information, the authors find that only 35% of the financial analysts' equity valuation reports actually contain environmental information. Surprisingly, environmental information is used more often by American analysts than by European, and it is used more often for North American than for European companies. Apparently, the higher litigation risk faced by American companies makes analysts focus more on environmental factors when valuing American companies.

From a theoretical point of view, we could argue that incorporating ESG targets reduces potential costs of conflicts between society and corporations, and therefore may lead to a higher shareholder value. However, according to traditional finance thinking, the focus in companies should be only on shareholder value maximization. As soon as the interest of other stakeholders, such

as, for example, employees or the environment in general, is taken into account, the economic efficiency and managerial incentives can be negatively affected. Thus, the implementation of the so-called stakeholder theory could be a prescription for destroying firm value and reducing social welfare (Jensen, 2001). As stated by Tirole (2001) "management can almost always rationalize any action by invoking its impact on the welfare of some stakeholder".

Although some well-known economists express a negative view on incorporating nonfinancial goals in the investment decision process, corporate social responsibility is becoming increasingly popular. Part of this popularity can be explained by pressure from society in general. Media attention or the growing social and environmental awareness of people may lead to a 'boycott' of those firms that do not take these issues into account in their business policy. Thus, the effects of social norms on markets is one of the key interests in recent SRI literature. The fact that a growing group of investors, among which are institutional investors such as pension funds, ignore a set of stocks could negatively affect the stock prices of those companies. The limited risk-sharing opportunities and the increased litigation risk of the products of those companies has the potential to increase the expected returns of the companies involved.

Hong and Kacperczyk (2008) test the so-called 'neglect' hypothesis for a sample of sin stocks over the period 1965–2006. These authors define a sin stock as a publicly traded company involved in the production of alcohol, tobacco, or gaming. In the U.S. SRI industry, sin screening is the most popular screening structure, i.e., 92% of the SRI mutual funds use some kind of sin screen, which implies that such funds exclude companies involved in the manufacturing of tobacco products, alcoholic beverages, and casinos and suppliers of gambling equipment from the investment opportunity set. Hong and Kacperczyk (2008) find that sin stocks outperform comparable stocks by about 3.6% at an annual basis. An explanation for their result is that the sin stocks have less institutional ownership due to social norms pressure compared with the otherwise comparable stocks. Moreover, the sin stocks have less analyst coverage. Although hedge funds, mutual funds, and individual investors will also feel the social pressure, it can nevertheless be expected that some of them buy these often neglected and cheaply priced sin stocks.

The alternative hypothesis that receives a lot of attention in the empirical literature is whether stocks of social responsible companies have higher expected returns than do those of conventional stocks. This 'doing well while doing good' or 'errors in expectations' hypothesis can only hold true when stock markets misprice information on ESG in the short run. Selecting firms with above-average scores on these ESG targets can then lead to a better financial performance in the long run.

Derwall, Gunster, Bauer, and Koedijk (2005a) use monthly eco-efficiency ratings obtained from Innovest Strategic Value Advisors, and find a positive relation between the rating and firm value as measured by Tobin's q. Eco-efficiency is defined as the creation of more value with fewer environmental resources, resulting in less environmental impact. For the period 1995-2003, an investment strategy based on the eco-efficiency scores shows that a portfolio that contains stocks with the highest scores outperforms a portfolio that contains stocks with the lowest scores by almost 6% per annum (Derwall, Gunster, Bauer, and Koedijk (2005b). This result supports the claim that the stock market undervalues the publicly available environmental information, which is at odds with market efficiency. Alternatively, the eco-efficiency premium may also reflect a premium for missing risk factors in asset pricing models.

Previous research on the relation between environmental and financial performance has been extended by Semenova and Hassel (2008). While Derwall et al. (2005a) only use eco-efficiency as an environmental measure, Semenova and Hassel (2008) extend the analysis to a multi-variate three factor environmental model. The environmental measures are obtained from GES Investment Services. GES assigns stocks an environmental risk rating that includes the industry risk level and company specific risk level. The authors make a distinction between inherent environmental industry risk, preparedness and performance. Environmental preparedness reflects reputational benefits from a company's environmental policy, management systems and regular reporting. This distinction allows the authors to distinguish between industry effects and company specific environmental effects. The authors find a positive relation between environmental preparedness and firm value, while preparedness has a negative impact on operating performance. For low risk industries, environmental preparedness and performance have a positive impact on market value, but no

effect on operating performance. Apparently, as stated by the authors, companies attempting to be environmentally responsible, show low profitability but a high market value.

Olsson (2007) uses the GES environmental risk ratings in an investment strategy setting. Using the FFC model, the author finds that a more responsible low environmental risk portfolio has a similar risk-adjusted performance as a high risk portfolio over the period 2004-2006. This indicates that responsible investing does not necessarily lead to poor performance.

Using event study methodology, Lundgren and Olsson (2008) examine whether environmental incidents affect firm value. The authors observe 142 environmental incidents during the period 2003-2006. The incidents appear to have a negative significant effect for European firms, while the effect is nonsignificant for U.S. firms. Apparently, U.S. firms are less sensitive for environmental incidents than European firms.

Corporate scandals such as Ahold in the Netherlands, and Enron and Worldcom in the U.S., have led to increased attention on corporate governance. Corporate governance is usually defined as the relationship between all the stakeholders in a company. This relationship includes the shareholders, directors, and the management of a company, as defined by the corporate charter, by laws, formal policy, and the rule of law. Such designs induce or force management to internalize the welfare of stakeholders (Tirole, 2001). Gompers, Ishii, and Metrick (2003) analyze the relation between corporate governance and long-term equity returns for the U.S. market. They report that an investment strategy based on selecting well-governed companies outperforms a strategy based on selecting poorly governed companies by about 8.5% per year. Combined with a positive relation between good corporate governance and firm value, this result clearly indicates that good corporate governance increases financial performance for U.S. companies, and that the information is not incorporated in the stock price.

Bauer, Gunster, and Otten (2004) examine the impact of corporate governance on firm value by using a sample of European corporate governance ratings of Deminor. They find that on average, there is a positive relation between corporate governance rating and firm value. However, the relation appears to be much stronger for EMU countries than for the UK. Moreover, an investment strategy that is long in a ‘good corporate governance

portfolio' and short in a 'poor corporate governance portfolio' leads to an average annual return of 2.1% for EMU countries, while it is more than 7% for the UK. This result implies that in EMU countries, the corporate governance standards are already incorporated in stock prices, but in the UK, the adjustment is still taking place.

In traditional finance, employees were considered as a cost that had to be minimized. Moreover, opponents of the stakeholder theory claimed that taking into account the interests of other stakeholders, such as employees, destroys value. Nowadays, management philosophies are more likely to recognize employees as important organizational assets (see, Zingales, 2000). Edmans (2008) examines whether employee satisfaction is related to equity prices. It appears that a portfolio of firms from the '100 Best Companies to Work For in America' generates a risk-adjusted return of about 4% on an annual basis over the period 1984–2005. (Since 1998, *Fortune* has published this list of companies in its magazine; before 1998 it was only published in book form.) The positive relation between employee satisfaction and shareholder return indicates that the stock market does not incorporate this publicly available information in the stock price, at least not in the short run. Apparently, environmental, social, and corporate governance factors are not always priced in the market.

Now the question is, can social responsible investors do both well and good? The studies by Edmans (2008), Gompers, Ishii, and Metrick (2003), and Derwall, Gunster, Bauer, and Koedijk (2005b) show that selecting firms with above-average scores on environmental, social, or corporate governance targets can lead to a better financial performance. These studies strongly support the 'doing well while doing good' or 'errors in expectations' hypotheses. In contrast, Hong and Kacperczyk (2008) show evidence for the 'doing good but not well' or 'neglect' hypotheses. In their study, sin stocks outperform comparable stocks by about 3.6% annually. However, a recent study by Statman and Glushkov (2008) arrives at the opposite conclusions. Statman and Glushkov show that the return advantage of selecting stocks of U.S. companies with high social responsibility scores is almost canceled out by the return disadvantage of neglecting stocks of so called 'shunned' U.S. companies. Shunned stocks include sin stocks as well as stocks of companies involved in firearms, military and nuclear industries. Nevertheless, over the period 1992–2007, a portfolio strategy with

a tilt towards stocks of companies with high social responsibility scores outperformed a conventional portfolio. Although economically significant, the outperformance is statistically significant only in case of the Fama-French factor model. Nevertheless, by following a best-in-class approach in the construction of portfolios, socially responsible investors can do both well and good.

5 Optimal SRI Strategies: the Divestment versus the Engagement Strategy

Another extensively studied question concerns optimal SRI strategies for portfolio management: should a SRI strategy lead to a divestment policy or an engagement strategy?

In a recent study, Renneboog, Ter Horst, and Zhang (2008b) describe the development of the SRI industry across the world. Although the first signs of ethical investing can be found in the bible, the Pioneer Fund (1928) was the first modern mutual fund to screen its investment portfolio based on religious traditions. Sinful companies, such as the companies involved in the production of alcohol, were excluded from the investment portfolio. In 1971, the Pax World Fund was the first fund to use screens that were not based on religious traditions. However, it did avoid investments in the weapon industry.

Although the first generation of SRI funds primarily used negative screening structures, the second generation mainly applies positive screening structures. This structure implies that SRI funds select companies for their investment portfolios when such companies meet superior environmental, social, or corporate governance standards. Often, SRI funds follow a best-in-class approach, selecting firms within an industry when the firms pass a minimum threshold. The third generation of SRI funds combines the negative and positive screens into what is referred to as "sustainable investing." The fourth and newest, most modern generation of funds combines sustainable investing with shareholder activism. The fourth-generation portfolio managers try to be actively involved in the company's policy through direct dialogue or via the annual meetings with the shareholders. For a more extensive overview of the historic development of the SRI industry, we refer to Sparkes (2002).

In SRI we can distinguish three main investor strategies. First of all, SRI investors can screen their investment portfolios or mutual funds on social, ethical, environmental, or sin criteria. Second, socially aware investors may exhibit shareholder advocacy. Finally, SRI investors may be involved in community investing, in which capital is directly provided to communities underserved by traditional financial services. SIF (2005) reports that in the U.S., 68% of the total assets under management (AUM) in the SRI industry is socially screened only, and 26% of the total AUM exhibits shareholder advocacy only, while 1% of the total AUM is involved in community investing. Renneboog, Ter Horst, and Zhang (2008a) develop a list of SRI screens used by SRI funds around the world. They identify 21 different screening criteria, which are classified into four main categories: sin, ethical, governance and social, and environmental. Table 2 summarizes the most interesting characteristics of SRI funds around the world.

Table 2 Summary statistics of SRI funds around the world

Percentage of funds with	Continental Europe	UK	USA	Asia-Pacific
Negative screens	56%	85%	97%	72%
Positive screens	92%	87%	69%	58%
Sin screens	54%	85%	92%	67%
Ethial screens	38%	85%	57%	52%
Governance & Social screens	78%	85%	68%	47%
Environmental screens	88%	94%	72%	60%
Islamic screens	3%	2%	3%	36%
Activism policy	18%	31%	47%	6%
In-house SRI research	22%	27%	55%	11%

Source: Renneboog, Ter Horst, and Zhang (2008b).

It appears that 97% of the U.S. SRI funds apply negative screening, while in Continental Europe 92% of the funds apply one or more positive screens. Sin screens are the most popular in the U.S., but in Continental Europe, we more often find governance, social, and environmental screens. In the UK, all screens are more or less equally popular. We are interested to note that the role as active shareholder is much more common in the U.S. SRI industry than in Continental Europe or the Asia-Pacific region. Finally, Renneboog, Ter Horst, and Zhang (2008a) report that 55% of the

U.S. SRI funds base their SRI screening activities on in-house research.

Furthermore, Renneboog, Ter Horst, and Zhang (2008a) examine whether the screening structure affects the risk-adjusted performance of the SRI funds, an issue that has not previously been explored. They find that on average, SRI funds underperform a sample of matched conventional funds by about 60 basis points per month. However, screening activities have a significant impact on the risk-adjusted performance. Funds that focus on community involvement can expect an additional return of 30 basis points per month, while an in-house research team can increase risk-adjusted performance by ten basis points per month. Apparently, the screening process can generate value-relevant information. Screening intensity, as measured by the number of screens applied, increases the underperformance. Finally, following an activism policy does not significantly affect performance.

Johnson and Gjolberg (2008) study the potential ethical implications of screening of the Norwegian Government Pension Fund-Global (GPFG). The study shows some interesting conclusions that do not necessarily hold for the usually much smaller SRI funds. In the recent public debate, it has been proposed that the GPFG should restructure its investment strategy from negative screening towards positive screening. However, as stated by the authors, for a large pension fund such as GPFG, this restructuring can significantly narrow the investment opportunity set of the fund. In the extreme case, positive selection can imply that the fund only holds 'clean' companies in the portfolio. But that implies that you cannot directly use your engagement power to change ESG standards in the right direction in companies that failed to be included in the portfolio. Furthermore, according to GPFG's mandate, the fund is not allowed to hold an ownership stake that exceeds 10%. This constraint implies that the fund's investment universe is already restricted to larger companies. Positive selection strategies in combination with the size of pension funds and the often existing maximum ownership stake, will reduce diversification possibilities. This reduction will lead to higher risk exposure of the fund itself, and may have undesirable ESG implications for society in general due to less influence of the fund in companies.

Major institutional investors increasingly recognize that social, environmental, and ethical issues may have an impact on

shareholder value. According to Sparkes and Cowton (2004), the maturation of the SRI concept has important implications for the relation with corporate social responsibility. SRI has shifted from margin to mainstream, and these days, due to shareholder pressure by institutional investors, companies are more or less obliged to address CSR issues. The direct engagement strategy and shareholder advocacy can both involve writing letters to the management, filing shareholder resolutions, engaging upper-level executives in a direct dialogue, or initiating lawsuits. According to SIF (2005), the number of shareholders' resolutions in the U.S. on ESG issues increased by 16%, from 299 proposals in 2003 to 348 in 2005. It is interesting to note that companies seem to respond in a cooperative way rather than fighting shareholder resolutions. Shareholders increasingly withdraw their proposals after the management agrees to address the shareholders' concerns.

In Europe, the Broad SRI market, i.e., Core SRI plus engagement and integration, has grown by about 106% to more than €1 trillion assets under management as of December 2005 (Eurosif, 2006). The engagement strategy, dominated by the UK, has gained a lot of momentum, and has grown by 157%. Eurosif observes an increase in shareholder involvement at general meetings, in particular at those involving corporate governance issues.

But the question is whether institutional activism creates value for shareholders. Barber (2006) evaluates the activism of the largest pension fund in the world, CalPERS (California Public Employees' Retirement System). Barber (2006) distinguishes two types of activism: shareholder activism and social activism. Shareholder activism relates to the conflict of interest between corporate managers and shareholders. Increased monitoring by institutions may reduce the agency costs involved and raise the value of stocks for all investors. Social activism covers the conflict of interest between portfolio managers and investors. Managers may abuse their voting power to benefit their own objectives, rather than those of their investors. Although social activism may lead to important social benefits, such as reduction of pollution, it may damage potential returns to shareholders. However, investors in SRI mutual funds may care more about ESG issues in their investment decisions and pay less attention to fund performance.

CalPERS is considered a leader in institutional activism, taking on issues such as greenhouse gas emissions, labor negotiations, and investments in tobacco firms. Barber (2006) reports that during the

period 1992–2005, CalPERS activism led to a small positive market reaction of about 23 basis points the moment that CalPERS publicly announced its focus-list firms. This result indicates that activism creates shareholder value at the short run. Over the long term, the performance of the focus-list firms is even more impressive. The average focus-list firm appears to outperform the market by almost 32% annually. A portfolio strategy of investing in the focus-list firms as soon as the firm is placed on the list leads to an economically but statistically nonsignificant abnormal performance of about 4.1% annually over a holding period of five years.

In the late 1990s, CalPERS became the leader in the divestment of tobacco industry stocks. Barber (2006) reports 'according to press accounts of this decision, the CalPERS board did not consider political nor moral values of CalPERS investors when arriving at their decision.' We note that Hong and Kacperczyk (2008) report that sin stocks, such as tobacco stocks, outperform comparable stocks by about 3.6% at an annual basis. This result indicates that CalPERS' decision to divest stocks from this industry did not benefit CalPERS investors. However, although social activism probably does not maximize shareholder value, it can nevertheless be in accordance with the preferences of the investors.

A Dutch report on sustainable investing for pension funds shows that pension funds increasingly pay attention to environmental, social or corporate governance issues in their investment decisions during the period 2003–2007 (De gearriveerde toekomst; 2007). Interestingly, only 20% of the Dutch pension funds consider financial performance as a reason to incorporate ESG issues, indicating that pension funds take the personal or societal values of their participants into account in the investment decision process. For the pension funds the question remains on how to incorporate ESG in their investment policy? Corresponding to the figures of Eurosif (2006), besides engagement the integration of values in the traditional risk-return trade off framework seems to be preferred above pure negative or positive screening. The reason is that e.g. in a pure best-in-class approach, companies will be compared on ESG issues only, while financial performance is not taken into account. In the integrated values process both issues play a role.

To summarize, the answer to the question whether institutional activism creates value for shareholders is still an open issue. As shown by Statman and Glushkov (2008) divesting from so-called

shun stocks did result in a return disadvantage. However, this return disadvantage can be compensated by investing in companies with high ESG scores, indicating that activism related to ESG issues can potentially lead to shareholder value.

6 SRI and alternative asset classes.

Alternative investments such as private equity, real estate, and hedge funds are important asset classes nowadays. Given the increase in the size of the investments in these alternative asset classes, it is relevant to examine whether they also incorporate social responsibility in the investment decision process.

The aim of a hedge fund is to generate a positive return independent of the market movement. While managers of traditional mutual funds charge a management fee, hedge fund managers impose both a management fee and an incentive fee. The incentive fee encourages managers to achieve high returns, while high-watermark levels try to avoid excessive risk taking by the managers. A high-water mark implies that previous losses must be recovered before the manager receives an incentive fee. Moreover, hedge funds are very flexible in the type of securities they hold and the positions they take. Investors in hedge funds are often confronted with lock-up periods of sometimes more than three years. These restrictions on withdrawals allow fund managers to set up long-term or illiquid positions. The nonstandard features and the low correlation of hedge funds with traditional asset classes make them an interesting investment alternative that reduces risk exposure by diversification. This is one of the main reasons why institutional investors such as pension funds allocate capital to hedge funds.

According to SRI-advisor.com, there are only a very few socially responsible (green) equity hedge funds in the market. As far as we know, there is no academic research on the performance of those green hedge funds. The magazine *Investment Advisor* reports that in October 2006, AIG global investment group was managing about $300 million in assets that had been invested under SRI constraints. The head of the hedge fund strategies of AIG states that 'the returns on the restricted accounts are very similar to those of the non-restricted funds', indicating that SRI constraints do not necessarily have a negative effect on the aim of hedge funds to generate positive returns independent of market movements.

Some other green hedge funds in the market are the Winslow Hedge Fund, which has about $20 million under management and which focuses on environmental factors; and Green Cay Asset Management, which has four market-neutral funds and about $200 million under management. These funds are managed using environmental and social factors as criteria. Furthermore, there is a small number of hedge funds that are based on religious grounds, such as the Shariah funds that invest according to Islamic law. So, we can state that hedge funds with an SRI agenda are only a recent phenomenon, and it is hard to predict how such funds will develop in near future.

Another important asset class is real estate. Researchers report that buildings account for approximately 40% of the consumption of raw materials and energy. In addition 55% of the wood that is not used for fuel production is consumed in construction. Overall, buildings and the associated materials produced for construction account for at least 30% of world greenhouse gas emissions. Once a building is constructed, the energy consumption associated with it continues. Recent estimates indicate that energy represents 30% of operating expenses. These magnitudes suggest that real estate can play an important role in making societies more energy efficient and sustainable.

Typically, awareness of this possibility is growing. A recent example is the increasing emphasis on green ratings for both new and existing construction. In general, these ratings assess the energy footprint of buildings and provide the owners and occupants with a yardstick of the energy efficiency and sustainability of properties. However, the use of these ratings has been limited. Moreover, both real estate developers and institutional investors are generally uncertain about how far they should go in implementing environmental investments. Thus, sustainable real estate investment vehicles is still in its infancy. But research in the area is picking up. In a recent paper Kok, Quigley, and Eichholtz (2008) investigate the impact of sustainable building practices and analyse a large sample of U.S. office buildings. For some 8,000 subject and office buildings, the authors relate market rents and asset values to a set of objective hedonic characteristics of buildings, holding constant the location characters of properties. In addition to determining the average rental premium, their method also makes it possible for them to estimate the rental increment for each green

building relative to the control buildings in its immediate geographic neighbourhood.

Another asset class with attractive diversification opportunities for institutional investors is private equity. Most private equity funds are organized as limited partnerships, with institutional investors acting as capital providers and limited partners. The limited partners usually make a commitment to provide funds when needed for new investments. A typical fund has a lifetime of about ten years. The general partners make investment in companies during the first five years, and exit from the companies during the second half of the company's lifetime. The funds usually charge an annual management fee on committed capital during the lifetime of the fund (see, Metrick and Yasuda, 2007).

Sustainable or socially responsible private equity is gaining momentum in the private equity industry. According to a case study by Robeco (2007), there are about 200 dedicated sustainable private equity funds, and more than 50 of them can be considered as being of institutional quality, given the amount of money raised. The funds focus on new forms of energy, agriculture, and new ways of utilising resources such as, water. Since it is expected that the demand for water will increase in near future, the potential for sustainable private equity investments is very large.

A recent study by Cumming and Johan (2008) examines the intersection between socially responsible investing and private equity. Using survey data from Dutch institutional investors, the authors report that the internal organizational structure of the institution and global diversification opportunities significantly affect an institution's decision to invest in sustainable private equity. Institutions in which the investment decisions are centralized through a Chief Investment Officer are more likely to have socially responsible investment policies than are institutions with less centralized decision structures. Furthermore, it is more likely that the funds invest in socially responsible private equity programs in Europe and the U.S. than that invest in domestic or Asian programs. This result may indicate that there are relatively few sustainable investment opportunities in Asian countries. Finally, Cumming and Johan (2008) report that larger institutional investors are more likely to be involved in socially responsible private equity.

So, although academic research in the direction of alternative investments is still in its infancy, we nevertheless observe that

socially responsible private equity and sustainable real estate starts to incorporate social responsibility in their investment process. Academic research will probably catch up in near future.

7 The Effects of SRI on Corporate Behavior

In both Europe and the U.S., 10% of the total assets under professional management is invested according to SRI policies. Given the huge growth of the SRI fund industry over the past decade, it is interesting to examine whether the increased attention to environmental, social, and corporate governance issues affects corporate behavior. One of the important trends that researchers observe is the growth in activities related to corporate social responsibility. Corporate social responsibility can be defined as actions taken by firms with respect to stakeholders and environment that go beyond what is legally required. As stated by Porter and Kramer (2006): "CSR has emerged as an inescapable priority for business leaders in very country." Today, most major companies devote a large section of their annual report to CSR. One of the reasons companies may take ESG or CSR issues into account in their business policies may be due to increased pressure of society in general. Nongovernmental organizations, such as human rights organizations, community groups and anti-apartheid activists, have strong networks and force public pension funds to divest companies that do not take CSR issues into account (Guay, Doh, and Sinclair, 2004). Due to reduced risk-sharing opportunities, divesting those firms that do not adhere to ESG standards can lead to an increased cost of capital for these firms. Later, it can be more difficult for those firms to find investment projects that increase the total value of the firm. Alternatively, reporting that your company takes ESG issues into account may also be used as an information signal to financial or labor markets regarding the firm's quality or reputation.

Lundgren (2007) develops a micro-economic model of firm CSR behavior in order to explain the often observed over-compliance of companies with respect to social and environmental responsibilities. In the model, investing in CSR is considered as investing in goodwill capital. The model shows that when consumers reward CSR the costs of CSR may be offset by the benefits in terms of higher profitability. Hassel and Semenova (2008)

provide empirical evidence in this direction. Firms are motivated to invest in CSR to obtain a higher ESG ranking, and are rewarded with relatively higher stock prices.

Heinkel, Kraus, and Zechner (2001) examine the effect of exclusionary ethical investing on corporate behaviour. Basically, these authors examine whether the presence of green investors influences or persuades the company to change from using a polluting technology to a clean one. The theoretical model assumes that there are two types of risk-averse investors, green and neutral. The latter ignore ethical considerations in their investment decisions, while green investors refuse to invest in firms that do not meet their ethical criteria. Furthermore, the model assumes that each company can choose between a polluting and a clean technology, and that the green investors will not invest in the firms that use the polluting technology. From the model, it follows that negative screening criteria by investors leads to fewer polluting firms in investment portfolios. This result implies that the stock price of those companies will fall and that the cost of capital will increase due to lower risk-sharing opportunities. A result implying a higher cost of capital that is empirically confirmed by Hong and Kacperczyk (2008), who report that sin stocks outperform the stock market Heinkel, Kraus, and Zechner (2001) show that the proportion of green investors in the economy eventually decides whether a company will convert from a polluting technology to a clean one. Thus, as soon as the increased cost of capital of the polluting firms exceeds the cost of capital of firms that use a clean technology, the polluting firms will decide to turn to the more environmentally friendly technology. A calibration of their model with empirically reasonable parameters indicates that a proportion of about 25% green investors in the economy is necessary to persuade a company to change to a clean production technology. This result implies that the previously mentioned 10% of the total assets under professional management that is invested according to SRI guidelines is not sufficient to encourage firms to use a clean technology in their model. Nevertheless, it increases the cost of capital of those firms.

Barnea, Heinkel, and Kraus (2005) extend the previous model by explicitly modelling investments by firms. They report that negative screening reduces the incentives for polluting firms to invest for various levels of reforming costs. This result implies that the total level of investment in the economy as a whole decreases.

In both models that predict an increase of the cost of capital for companies that do not take ESG issues into account, a necessary condition is that there are not sufficient arbitrageurs in the market who are buying the shares of the polluting firms if they are underpriced.

Barnea and Rubin (2006) examine the drivers behind firms' increase in CSR expenditures. They argue that when CSR expenditures are low, that fact contributes positively to firm value due to, e.g., lower pollution related costs. However, since there is no limit in the amount that firms can transfer to its stakeholders, Barnea and Rubin (2006) state that at some point, CSR expenditure must decrease shareholder wealth. This reduction of firm value is in line with the theoretical objections against the stakeholder model, as shown by Jensen (2001) and Tirole (2001). Using a data set in which they classify firms as either social responsible or irresponsible, these authors find that insider ownership is significantly and negatively related to CSR ratings. Insiders are usually defined as all officers and directors of the company, and beneficial owners as those who own more than 5% of the company's stock. These insiders may gain private benefits, such as reputation effects, from having a high CSR rating. However, the costs of obtaining a high rating may reduce total firm value due to overinvesting in CSR. Therefore, when insiders bear little of the cost of overinvesting in CSR, CSR expenditures may create a conflict between different shareholders in a company. Barnea and Rubin's (2006) findings show that apparently, insider interests are more aligned with firm value maximization rather than with bearing the costs of being involved in CSR. Furthermore, Barnea and Rubin (2006) report that on average, leverage is negatively related to CSR ratings, indicating that high debt levels make overinvesting in CSR more difficult because creditors take a more active monitoring role in the firm. Finally, the authors find that institutional ownership appears to be positively correlated with CSR ratings. Apparently, possibly driven by pressure from society, public institutions care more about social issues than about financial performance.

8 Concluding Remarks

In this survey we present an overview of the literature on the financial consequences of socially responsible investing. The performance of socially responsible investment (SRI) funds is the topic that is most extensively studied in the empirical SRI literature. In this literature, the question of interest is whether imposing SRI constraints affects the performance of SRI mutual funds compared to conventional funds. We can conclude that the majority of studies show that the risk-adjusted performance difference is not statistically different from zero between socially responsible investment mutual funds and their conventional counterparts.

A more recent SRI literature stream considers the performance of SRI funds as granted, and explicitly examines the behavior of socially responsible investors. From this part of the literature it becomes clear that socially responsible investors care about other issues than financial performance only. Personal and societal values also play an important role in their investment decision process. For pension funds active engagement and the integration of values into the investment decision process becomes mainstream. Apparently, the values of their participants are taken into account.

Closely related is the question of whether the introduction of environmental, social, and corporate governance targets affects financial performance. Major institutional investors, such as pension funds, increasingly recognize that ESG issues may have an impact on shareholder value. Direct engagement or shareholder advocacy has gained a lot of momentum. Although the answer depends critically on whether these non-financial targets are priced by the market, it appears that social responsible investors can do well and do good. Over the period 1992-2007, for U.S. companies, a portfolio strategy that followed a best-in-class approach would have outperformed a conventional portfolio strategy. Furthermore, a case study by Barber (2006) shows that activism by CalPERS creates shareholder value in both the short and long run.

Today, alternative investments such as private equity, real estate, and hedge funds are important asset classes. Although academic research on this subject is still in its infancy, we nevertheless observe that sustainable or socially responsible private equity is gaining momentum. We find similar patterns for sustainable real

estate investment vehicles and hedge funds. Apparently, research in this area is picking up.

Finally, the increased attention to environmental, social, and corporate governance issues affect corporate behavior. Media attention and the growing social and environmental awareness of people may lead to a boycott of firms that do not take these issues into account in their business policies. These days, most major companies devote a section in their annual report to corporate social responsibility. Divesting stocks in firms that do not adhere to ESG standards can lead to increased cost of capital for those firms. Therefore, we can conclude that the maturation of the SRI industry and the shift from the movement from margin to mainstream has led to important financial consequences that will certainly develop further in the near future.

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The Influence of the AP Funds on the Ethical and Environmental Activities of Portfolio Companies

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Background

This study provides background information for use by the committee appointed by the Ministry of Finance to investigate the ethical and environmental activities of the AP funds (Fi 2007:13).

The purpose of the study is to gauge what impact the AP funds have had on Swedish portfolio companies' work with environmental and social responsibility issues (CSR) since the introduction in 2001 of the guidelines for this type of activity (see Directive 2007:160).

The study is based on interviews with representatives of ten Swedish publicly listed companies. These were selected by first asking the AP funds which companies they had met with over the years and then identifying the ones with whom the AP funds have had the most contact. The following companies were interviewed: AtlasCopco, Clas Ohlson, Ericsson, Hennes & Mauritz, Hemtex, Lundin Petroleum, Sandvik, SCA, Securitas, and TeliaSonera. In all cases, the interview was held with the person with whom the AP funds typically meet to discuss ethical and environmental issues. This was usually someone with special responsibility for CSR but sometimes involved somebody from the Investor Relations (IR) department.

When the companies in this study refer to the AP funds, they mean AP1, AP2, AP3 and/or AP4, also known as the First-Fourth AP Funds. AP7, the Seventh AP Fund, has little contact with Swedish companies, focusing instead on foreign investment.

The portfolio companies' views of their interaction with the AP funds

The AP funds initiate meetings with selected companies about once a year. Only a few of the companies in this study have been contacted by all four AP funds, while the remainder meet with two or three of them. While some of the companies have had only a few meetings with the funds over the years, several have met with AP funds repeatedly. The meetings are typically convened at the AP fund's initiative and take the form of face-to-face meetings on the company's premises. Email and telephone communication sometimes occurs between meetings. One of the companies has also arranged stakeholder dialogues in which some of the AP funds take part. In a few cases, AP funds have also visited companies' production sites (e.g. in China) – an apparently new phenomenon for both AP funds and other ethically and environmentally oriented investors. However, face-to-face meetings at the portfolio companies' premises continue to be the primary forum for discussions.

In general, it is the company's CSR manager (who may belong to different departments in different companies, such as human resources or communications) or possibly its investor relations officer who is approached by the AP funds. In most cases, the companies' CSR and IR functions appear to have a well established relationship, and either one or the other participates in meetings, sometimes along with the CEO and other individuals of relevance to the issues on the agenda. If the issue to be dealt with is more a matter of corporate governance, however, it is the IR department that is contacted. CSR and corporate governance are essentially treated as separate issues by both investors and companies. From the AP funds' side, the companies are contacted by a specially designated ethical and environmental analyst rather than by a conventional analyst or fund manager.

Besides the AP funds, the companies are also contacted by SRI funds (such as Banco, Folksam and Swedbank Robur) and by third-party ethical analysts. Some companies only cite Swedish contacts, whereas others say they are also contacted by foreign actors.

The reason why the AP funds contact companies about ethical and environmental investment (in the opinion of the companies themselves) is that the funds want to determine how the companies approach these issues and to verify and supplement the

information in their sustainability reports. Issues raised by the AP funds at these meetings include the companies' risk analyses and risk management systems, how their codes of behaviour are implemented and followed up, their goals regarding various environmental and social issues, and what they are doing to achieve those goals. Sometimes the AP funds also contact companies to follow up on an issue that has appeared in the media, such as criticism of inadequate employment conditions in a specific country etc.

The influence of the AP funds

In most cases, the AP funds do not forward specific demands on the companies, except in a few cases when the funds express clear preferences with regard to reporting. Nor can most of the companies give examples of the AP funds having influenced their ethical and environmental activities, except in a few cases when, again, those activities affected how the companies presented their information.

One company, however, stated that the contacts not only reflected a desire on the part of the AP funds to update their information about its work or request additional reporting, but also that "over the past few years many SRI funds have expressed views about our requirements and follow-up mechanisms for labour conditions at our suppliers". The company also said that one AP fund offered concrete advice and suggestions as to how it thought the company should proceed. At the same time, the company felt that its work on these issues could not be directly attributed to input from the AP funds. Rather, the funds' views could be seen as part of a general focus on the company prompted by public criticism of supplier conditions (initiated by a Swed-Watch report), and that this could conceivably have helped speed up efforts already under way. In other cases, too, where companies were the object of public criticism over CSR-related issues, it was felt that AP funds and other investors did not play a decisive role, if any, in how they themselves dealt with the issue.

The portfolio companies stated that their discussions with the AP funds are useful primarily for the purpose of confirming that they are doing the right thing: that they are on the right track and fully comprehend both the expectations placed on them and which

issues are important. The effect of these discussions on their actual operations was more limited. Some said they receive valuable input from the AP funds, particularly regarding reporting requirements. Most of the companies appreciate the meetings. One respondent, however, said that an AP fund had (hitherto) mainly reacted to media events without basing its discussions on its own analysis, adding that the company did not find its contacts with the fund rewarding.

Most of the companies replied either that the AP funds cannot be viewed as the catalyst in their environmental and social responsibility activities, or that they may have made an impact to some extent but only indirectly – since to show interest may also be a way to exert pressure – or that they understand that shareholders do have certain demands even though the companies are already doing more than the minimum in this sphere. One company replied that "we began working with CSR without the AP funds but our contacts with them have made clear that this is an important issue, and I relay feedback from them to our CEO, the number one decision maker."

Several companies felt that some shareholders have more of an influence than the AP funds. One said foreign investors are more forceful than their Swedish counterparts, but it would appear that some Swedish SRI fund, too, are more progressive than the AP funds.

Even though the AP funds do not play a prominent role for the companies' CSR activities, investors as a group were deemed an important stakeholder. One company pointed out that, unlike other groups, investors are interested in the entire operation, which makes them relatively important stakeholders. Another company felt that of its various stakeholders, SRI funds and some NGOs are the most influential because they work in symbiosis with the media and therefore have a powerful effect on public opinion. (The AP funds, however, do not use the media; the reference here was mainly to other funds.) A few companies said that their customers and employees are at least as important stakeholders as investors, with regards to CSR.

As regards for the AP funds as a discussion partner, most respondents appreciate the contacts and feel that the funds have done their homework. The dialogue is worthwhile and the discussions are not conflict-ridden. However, one respondent felt that despite the good contacts and the funds' close understanding of the

company's operations, the meetings lacked verve – they seemed a little too "nice". The AP funds could challenge and question the companies to a larger extent.

In response to the question of whether investors add extra legitimacy to CSR issues within the company, all respondents felt this to be the case. One respondent, for example, said: "I really believe it helps us get the rest of the company to understand the importance and necessity of working with these issues." Another commented: "Of course it makes things easier when heavyweight actors want to discuss these issues."

When asked whether the companies listen to different shareholders to varying degrees, most replied that they value all shareholders equally and try to listen to all in equal measure. Some pointed out that the more knowledgeable a shareholder is, the more interesting the dialogue can be, and that some shareholders choose to play a more proactive role. One company, while acknowledging that all shareholders are of equal importance, replied that because the SRI funds know a lot about these issues the company engages in CSR discussions to a larger extent with them.

While the AP funds are knowledgeable in CSR and have opinions about it, the companies did not think the funds play a role as consultants. Some companies said that they are seeking a dialogue that will enable them to learn from the AP funds as well, and a few companies have submitted a report or other documents to solicit feedback from the funds. At the same time, none of them felt that the AP funds engage with them in a consultative capacity.

Opportunities for improvement

Most respondents stated that they do not find their contacts with the AP funds to be problematic in any way, with two exceptions. One felt that the AP funds do not always understand that a company may be too small to be able to devote the same resources to preparing sustainability reports etc as the large corporate groups in the same industry. The funds' expectations concerning how much paperwork the company can deal with are, in other words, too high. Another respondent felt that recently its contacts with the AP funds seem to have been replaced by contact with a consultancy company (GES) and that it (the respondent) would prefer to revert to the previous type of communication. This is

presumably due to the fact that several AP funds use GES to undertake an initial screening on which they base their own subsequent efforts. However, it would seem that this was not clearly communicated to the portfolio companies, which in at least one case believed that GES had replaced the funds' contacts with them.

When the companies were asked if they had any suggestions as to how their dialogues with the AP funds could be more constructive, several offered their views. One company would like more comparative information to be provided, as a type of best practice – for example, an AP fund could say "company ABC does things this way, and we think that's good." One company wanted the AP funds to express their expectations on the company more clearly. Another company pointed out that it would be helpful to have the fund managers involved as well, so as to link up with their activities. This is reminiscent of a comment from another company, which felt it would be problematic if CSR and the financial perspective were treated as separate issues. One company was unsure where its point of contact is – if for instance the AP funds speak for each otherso that it is enough to communicate with one of them. A couple of companies also called for documentation and feedback. Several companies said they do not receive feedback after meetings; however, the extent to which this is considered a problem varied.

All interviewed companies seemed to think national-level CSR cooperation between the AP funds is a good idea. One respondent said this would likely make the AP funds more effective. Another felt that the more you share the better you become, and that the CSR issue is not shielded from competition in the corporate sphere (where, for instance, round-table discussions and other joint forums are common), so this should not be the case for financial actors either.

Conclusions

The study shows that the AP funds have a marginal direct influence on the portfolio companies' ethical and environmental activities. None of the companies could give an example of the AP funds having persuaded them to deal with the issues differently or more extensively. On the other hand, some companies felt that the AP funds have a favourable effect on corporations' dissemination of

information – they may for instance express goals for various aspects of their CSR work more clearly and be more transparent in their sustainability report. The significance of this should not be underestimated, since follow-up and transparency are an essential stage in constructive sustainability work. At the same time, it is noteworthy that so few of the comments seem to refer to the more practical CSR work. This is perhaps a matter of maturity, as many companies are still building up adequate reporting practices. When these eventually become established, investors' attention can be focused more on the work itself.

At the same time, the study shows that even though the direct impact of the AP funds on the portfolio companies' ethical and environmental work is marginal, the funds may have a significant indirect impact, not least by strengthening external pressure on companies to focus actively on their ethical and environmental activities. Probably the most important aspect is that the AP funds, together with other investors, add weight to these issues within companies. As a result, CSR may play a more central and strategic role in these companies than it would otherwise have done.

Recommendations to the AP funds and to the Committee

Recommendations to the AP funds:

- If the AP funds want to have a greater direct impact on the ethical and environmental activities of the portfolio companies, they need to focus on other issues besides transparency. They need to challenge the companies to set higher goals for their operations and/or address new issues (such as water issues, if not previously on the agenda, for example). Moreover, they need to see their role not only as information gatherers and analysts but also as active agents in stimulating companies' activities.
- If the AP funds want to influence the ethical and environmental activities of the portfolio companies more, they should seek to meet more companies and should allocate the necessary resources for this purpose. The funds meet only a handful of companies per year despite the fact that their portfolios are often considerably larger. The funds should also consider meeting with small companies and less experienced ones –

insofar as these are part of the portfolio – as such organisations probably have most to gain from learning the AP funds' views, and the funds would reap more benefits from involvement at this level.

- If the AP funds want to influence the ethical and environmental activities of the portfolio companies more, they should try to ensure that their fund managers discuss CSR issues to a greater extent in their meetings with the companies. This would add more weight to the issues and place CSR more firmly in a strategic, commercial context.
- If the AP funds want to influence the ethical and environmental activities of the portfolio companies more, they should provide more feedback to the companies than at present.

Recommendations to the Committee:

- If one of the purposes of the requirement, whereby the AP funds are to take into account ethical and environmental considerations in their investment activities, is to ensure that the funds help promote companies' efforts in this sphere, then the requirement should continue to apply, since the AP funds evidently have an influence on the portfolio companies' operations, albeit usually in an indirect or general manner.
- To ensure greater effectiveness and to exert a stronger influence on the portfolio companies' environmental and ethical work, the AP funds should be empowered to cooperate on CSR issues at national level in the same way as cooperation is undertaken via the Ethics Council in the case of foreign investment.