BOARD OF INVESTMENT TRUSTEES

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MEMORANDUM

October 27, 2023

TO: Board of Investment Trustees and Board of Trustees

FROM: Eli Martinez, Executive Director
Kevin Killeavy, Chief Investment Officer

SUBJECT: Environmental, Social, Governance – Required Annual Update – 2023

As detailed in the Board's Governance Manual, the Boards are required to annually provide a comprehensive report describing the implementation and outcomes of the Boards' ESG policy, including recommendations for updates or revisions to this policy, as part of the year-end reporting process.

This report includes the following:

I. Industry Developments
II. Current Manager ESG Updates and Corporate Engagement
III. Consultant Initiatives
IV. Recent Board Actions
V. Staff Research

I. Industry Developments

- **NYC Pension Funds Sued Over Fossil Fuel Divestment –** Three New York City pension funds are being sued for allegedly breaching their fiduciary duty by selling billions in fossil fuel assets at depressed prices. The complaint is being made as the plans divested from roughly $4 billion in fossil fuel related securities in 2021, before energy rallied significantly. The complaint stated that "the defendants' actions in selling off high-performing securities, and prioritizing lower-yield investments, is especially troubling given the plans' chronic and severe underfunding".

- **Government Curbs U.S. Investments in Chinese Technology –** In August 2023, President Biden signed an Executive Order that will limit or ban private fund managers from investing in certain technologies like computer chips or semiconductors in China. The U.S. Department of Treasury will develop a list of investments that are prohibited as well as some that are allowable. The three main areas of concern for U.S. investment are semiconductors, micro-electronics, and artificial intelligence. As this restriction will not be retroactive, it will not apply to current holdings of investment managers but there will be limits on future investments.

- **Harvard Endowment CEO Cites Divestment Costs –** The CEO of Harvard University's endowment, Narv Narvekar, said that the University's commitment to climate goals has negatively impacted returns since the pandemic as the endowment was not able to take advantage of cheap valuations in the oil and gas sector like some of their peers. He noted that "a number of institutional investors leaned into the conventional energy sector, through either equities or commodity futures, adding materially to their total return."

- **Asset Managers Cite ESG Backlash in Filings –** Some large asset managers have warned that a backlash against ESG investing represents a material risk to their businesses. Examples of publicly listed asset managers that have cited this risk in their filings include Blackstone, BlackRock, KKR, and T. Rowe Price. For example, T. Rowe Price noted that pressures such as divergent views or competing demands on ESG investing could hurt their financial performance.

- **Republican-Led States Continue Push Back on ESG –** This trend, which began in 2021, has continued in earnest over the last year as states governed by Republican governors and legislatures continue to pass laws in opposition to ESG. The most notable was the state of Florida, which recently passed a law prohibiting the use of ESG factors in state and local investment decisions. Another example was the Indiana Public Retirement System awarding a contract to Strive Advisory, a firm focused on corporate governance and proxy voting in opposition to mainstream ESG positions.

- **PRI Signatory Growth –** The number of signatories to the Principles for Responsible Investment reached 5,384 by the end of June 2023. Over the last year, this group has grown by 4% with the current roster including 4,104 investment managers, 737 asset owners, and 543 service providers. Montgomery County became a signatory in October 2019.

II. Current Manager ESG Updates and Corporate Engagement

In 2021, Staff and our investment consultants began reporting to the Boards on impact/sustainable investments within the private market portfolio. The portfolio currently contains several funds with impact investment strategies. Some examples include strategies focused on renewable power development, sustainable forestry, water infrastructure, and real estate. The segment of our portfolio with the highest concentration of impact investments is private real assets, where 34% of the ERS portfolio is allocated to impact/sustainable investments.

- **Emerging Markets Manager** – In 2023, this manager avoided investing in a company that is exposed to water risk due to high flood vulnerability along the Yangtze River Basin. Limited evidence on the company's environmental and stakeholder engagement policies prevented the manager from fully assessing the company's risk management capabilities.

- **Global Equity Manager –** This quantitative manager chose to overweight a German semiconductor company due to the company scoring very highly on social and governance factors, which the manager viewed to be a risk reducer. While these weren't the only factors that led to the investment, they played a material role in improving the security's overall rating within their quantitative system.

- **International Equity Manager** – Staff recently hired an international small cap manager that utilizes a proprietary scoring methodology within their ESG framework. Specifically, they have an internal template of key ESG company data used to calculate an ESG score for an individual company. The investment team contributes to the template by collecting raw ESG company data on activities and products through company websites, reports, and meetings with management teams. This template is systematically integrated into various aspects of the investment analysis, including industry analysis, analysis of a company's strategy, quality of management, and valuation.

- **Emerging Markets Debt Manager** – During the last year, this manager met with the finance minister and other representatives from the Colombian Finance Ministry to hear about their views on ESG, fossil fuel reserve risk, and their plans for future decarbonization.. On the governance side, the manager has also encouraged the country to prioritize tax reforms, as well as changes to their healthcare and pension systems. Engagement from large investment managers can help to drive government policy, particularly in emerging markets.

- **Emerging Markets Equity Manager** – In late 2022, the manager avoided a fast-growing coffee chain based in Asia, in part due to ESG concerns. One of the manager's analysts took a deep dive into the company and found multiple governance red flags with its shareholding structure that seemed to disproportionately favor a tight group of insiders centered around the founder and his family members. Despite this stock being very popular with much of the investment community, the manager passed on the investment due to these concerns.

- **International Equity Manager** – During the year, this small cap manager was considering a Swiss machinery producer as a contrarian recovery opportunity. However, they passed on the investment due to concerns over corporate governance, particularly the firm's poor capital allocation decisions around acquisitions. Additionally, the company paid out a special dividend immediately prior to Russia's invasion of Ukraine in response to concerns from one of the company's largest shareholder's, a Russian, about his ability to recover his investment after the invasion.

- **Fixed Income Manager –** This manager passed on a pharmaceutical investment as the company is involved in several ongoing litigations related to its involvement in the opioid epidemic and conspiring with other drug manufacturers to fix prices. While the security is very underpriced, these social and governance issues are too material for the manager to make an investment in the debt of the company. The potential for large litigation losses calls into question the ability for the debtor to be repaid by the company.

- **International Equity Manager –** During the year, the manager made an investment in a company specializing in multichannel distribution for the energy sector and connecting organizations with electrical products and solutions. The purchase was made, in part, due to the likelihood that the company will be heavily involved in the energy transition. The company has benefitted from recent electrification trends, helped by both an increasing global focus on sustainability and higher energy prices. In addition, excess demand in the market for electrical products is likely to continue as digitalization and ESG considerations accelerate.

- **Public Real Assets Manager** – During the year, this manager engaged with one of their railroad holdings to reduce their emissions targets, ensure line of sight to a net-zero approach in the coming decades, and to invest heavily in hydrogen-based propulsion technology. The firm also began to develop a new Climate Strategy Assessment Framework that provides additional insight into client approaches to climate.

- **Emerging Markets Equity Manager** – This manager held a position in a UK mining company and the manager heavily engaged with the company to improve carbon reporting transparency, coal reduction plans, and future capital expenditure plans. However, during the hold period, the security increased to the manager's measure of fair value, so the position was sold.

- **Domestic Equity Manager** – During the year, this manager sold their position in a U.S. software company due to governance concerns as the company's board of directors amended the management incentive plan to be more focused on growth at the expense of return on invested capital, which the manager thinks will distort the economic incentives of the management team.

- **Domestic Equity Manager-** In 2023, the manager purchased a pure-play, fully integrated producer of performance lithium compounds. Long-term, the global lithium market remains tight, and this company plays a critical role in the battery value chain and remains uniquely positioned for the continued adoption of electric vehicles.

III. Consultant Initiatives and Approach to ESG

- **NEPC (General Consultant) –** During the last year, NEPC met regularly with impact-oriented investment managers across asset classes as they continue to source preferred strategies and options for their clients. They have also sourced several preferred strategies that target attractive risk-adjusted returns and align with the respective missions and values of their client base. In the last year, NEPC participated in national conversations about the evolution of ESG investing, such as the Department of Labor and the White House Office of Social Innovation's stakeholder roundtable.

- **Franklin Park Associates (Private Equity & Debt Consultant) –** During the last year, Franklin Park continued to refine their ESG Policy Statement and their ESG due diligence process. Over the last year, they also refined their Corporate Citizenship Statement, continued to refine their DEI reporting efforts, and conducted corporate citizenship training for all employees. Additionally, Franklin Park completed their annual reporting that is required for their membership as a PRI signatory.

- **Albourne (Private Real Assets Consultant) –** Over the last year, Albourne has created the Albourne Sustainability Integration Score (SiQ Score), which is a survey-based evaluation of the extent to which environmental, social, and governance considerations are incorporated into a fund's risk management and investment decision making process. Funds are scored between 1-100. This year, Albourne has engaged with more than 1,000 funds via this survey and has provided commentary on sustainability factors in over 700 investment due diligence (IDD) reports. Additionally, they have also engaged with more than 700 investment managers on DEI via their DEI Questionnaire.

IV. Recent Board Actions

- **CERES Conference at the 2023 United Nations Climate Change Conference** – In November 2023, Staff will attend the United Nations Climate Change Conference (COP 28) via video conference.

- **CERES** – The Boards joined the CERES Investor Network in 2018 to gain a better understanding of climate risk within the portfolios, explore opportunities embedded in the clean energy economy, and develop a dialogue with other institutional investors on ESG-related matters. Since joining, Staff has been an active participant in the Disclosure Working Group, which seeks to push companies to disclose all relevant sustainability information using the Global Reporting Initiative (GRI) guidelines as well as additional sector-relevant indicators. The goal of this working group is for more companies to disclose material sustainability risks and opportunities within their financial filings.

- **CFA Institute ESG Expert Network** – Investment Staff continues to actively participate in the CFA ESG Expert Network, a diverse working group to share knowledge and resources focused on integrating ESG best practices. The CFA Institute is a leading global association for investment professionals.

V. Staff Research

- **Portfolio DEI Analysis** – Staff completed a second annual diversity and inclusion analysis of the underlying funds within the portfolio to understand the level of diverse ownership across the portfolio and within various asset classes. This analysis revealed that the portfolio has roughly 24% invested in women- or minority-owned investment organizations with exposure across public markets, private equity, private debt, and private real assets, a slight increase from last year. Staff will continue to track this metric on an annual basis and will explore ways to further enhance our approach to DEI. Albourne, NEPC, and Curcio Webb have significant levels of diverse ownership and management. For example, Curcio Webb, our defined contribution plan consultant, is a women-owned business.

  Staff has also been collecting DEI data across multiple levels (board, executive, and mid-level investment staff) in the organizations of the public funds we invest in. Staff collects this data to gain more granular insights and to analyze managers at a level that more accurately reflects diversity across their organizations. By collecting this data across multiple years, Staff can also better monitor and report on the impact that our managers' diversity initiatives are having. After analyzing data collected through the questionnaire for all managers that provided statistics for 2021, 2022, and 2023, we found that:

  - The largest improvements were in our equity managers, which had year-over-year increases in every category. Ethnic diversity across board-, executive-, and mid-levels saw the most significant increases.
  - On average, increases in gender diversity were observed in every category except mid-level, while ethnic diversity at the board-level saw the largest percentage increase.
  - Over the past two years, gender diversity at the board-level and ethnic diversity at the board- and executive-levels have seen the largest increases, with all three categories increasing by 4% or more.

- **Portfolio PRI Signatory Portfolio Analysis** – Both Boards became signatories of the Principles for Responsible Investment (PRI) in October 2019. The Boards believe this is the premier organization for asset owners and investment managers in terms of ESG integration. While it is not required that investment managers be signatories, it is highly encouraged. Staff recently conducted an analysis to see the proportion of investment managers within the portfolio that are signatories. As of June 30th, 2023, 52% of the managers within the portfolio are signatories, while 74% of the portfolio by market value is invested with signatories. Whereas most of the public market managers within our portfolio are signatories, the adoption level on the private market side remains somewhat low. Additionally, all three of the Boards' core investment consultants – Franklin Park, NEPC, and Albourne are signatories.