BOARD OF INVESTMENT TRUSTEES

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MEMORANDUM

September 28, 2018

TO: Board of Investment Trustees and Board of Trustees

FROM: Linda Herman, Executive Director

SUBJECT: Environmental, Social, Governance – Required Annual Update – 2018

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 Board's 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. Staff Research
V. Recent Board Actions

I. Industry Developments

- **San Francisco Employees Retirement System (SFERS)** rejected a fossil fuel divestment plan in January as they believe this approach will negatively impact risk-adjusted returns and lessen the plan's influence as a shareholder in fossil fuel companies. However, the plan recently committed to allocating $1 billion (4% of the plan) to a "carbon-restrained" investment strategy and hired a director of socially responsible investing.

- **New York City Employees Retirement System (NYCERS)** announced that they will conduct a carbon footprint analysis of their portfolios and determine how to best manage climate change risk. The funds have selected Mercer Investment Consulting to run the analysis. They also announced they will be conducting a comprehensive study to understand the economic feasibility of divesting from fossil fuel securities within the next five years.

- **California Public Employees Retirement System (CalPERS)** invested $1 billion in a new internally managed environmental, social, and governance (ESG) global equity portfolio, which represents 0.50% of the total equity allocation. While the portfolio will be internally managed, the

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investment methodology was developed by investment advisory firm QS Investors, who have entered into a five-year contract with the plan.

- **The University of Cambridge's endowment** Chief Investment Officer recently terminated his employment amidst growing pressure from the university's academic staff and students to divest from the endowments fossil fuel holdings. Cambridge's endowment, the largest endowment fund in the U.K. had delivered strong investment performance during CIO, Nick Cavalla's tenure. Two people familiar with Mr. Cavalla's move said, "he had become increasingly frustrated about the debate around divestment of fossil fuels, believing it left staff unable to get on with their jobs of trying to maximise the value of their endowment".

- **DOL guidance on ESG considerations.** In April 2018, the US Department of Labor (DOL) issued "Field Assistance Bulletin 2018-01". This bulletin provides guidance to regional enforcement offices about how to interpret prior DOL guidance related to an ERISA plan's exercise of shareholder rights and how fiduciaries can take ESG factors into account when making plan investments. The prior interpretation seemed to give more latitude to plan sponsor's considering such ESG factors. While not necessarily a repudiation of the prior guidance, FAB 2018-01 may be viewed as a narrow interpretation, inviting further deliberation by fiduciaries considering ESG factors in their investment process.

II. Current Manager ESG Updates and Corporate Engagement

- **Long Duration Fixed Income Manager –** Sold their holdings in an oil and natural gas company due to potential regulatory enforcement action and growing reputational risk. They determined that they didn't believe the company's board had supervised executives properly, and therefore, the risks could potentially be much larger than initial reports indicated. Additionally, the manager is researching and evaluating industry best practices related to ESG, including whether they will become a signatory to the UNPRI.

- **High Yield Fixed Income Manager –** Had invested in Turkey's medium-term debt but became concerned with the consolidation of power, ongoing deterioration of rule of law, freedom of speech and press, and civil liberties under President Erdogan. Given the team's deteriorating view of Turkey's political governance, they no longer felt they were being sufficiently compensated for the risks facing Turkey. As a result, they sold out of their position in October 2017.

- **High Yield Fixed Income Manager –** Passed on an investment in a pharmaceutical company due to concerns over their large exposure to drugs benefitting from large price increases and drugs that are more expensive than combinations of generic drugs. The manager actively engages companies on ESG issues as they believe that roughly 70-80% of their engagement actions have contributed to positive change in the companies in which they invest. They believe that most companies agree that sustainable ESG policies will help lead to long-run success, and accordingly are receptive to their engagement. An example of an engagement action over the past year is this manager's investment in an energy infrastructure company. The manager has pressed the company on the safety of their pipelines in the Rover and DAPL pipeline areas as well as their handling of Native American rights. They believe that problems in the construction phases of the respective pipelines have been addressed and that the risk of spills is minimal. Regarding Native American rights, the manager is aware that the company is continuing to engage with a variety of indigenous groups and stakeholders.

- **Domestic Equity Manager -** Engaged with a technology company about the potential to work on an extension to their current platform to improve diversity in governance. The manager identified a void in sourcing qualified and diverse perspectives for board membership. The manager has been in discussions with this company about creating a new product to give small and mid-sized companies the opportunity to see diverse qualified candidates for their boards. The manager will continue to engage the management of this issuer and monitor its developments with the hope that engagement will lead to an extension of the company's commitment to the Sustainable Development Goals (SDGs.)

- **Domestic Equity Manager** – Engaged a small bank to implement change among its board of directors after it was discovered that corruption/misuse of capital by its CEO (and family) and other members of the board. This behavior was destroying shareholder value and the manager felt it was prudent to engage and enact management change. The board now has new directors who are more aligned with shareholders and are focused on the strategic direction of the company.

- **Listed Infrastructure Manager** – Has historically avoided traditional power generation companies due to stranded asset risk (i.e. policy pushing production away from less environmentally-friendly sources). Changes in environmental policy has also caused them to alter their treatment of energy infrastructure assets from perpetual assets to finite-life assets. This, in turn, has led to a reduction in the overall energy weighting. The manager engages company management teams on environmental concerns. This is particularly relevant with energy infrastructure companies regarding environmental impact studies, as well as with various utility operations. For example, the manager had a discussion with a particular utility company this past year where they shared with the manager their sustainability efforts and also emphasized how they wanted to be a leader amongst their peer group when it comes to environmental issues.

- **Public Real Estate Manager** – Purchased a U.S. Data Center company in their portfolio. One of the factors in their analysis was the company's initiative to draw power from renewable sources. In 2016, 40% of their electricity use came from wind, solar, and hydro power plans. The U.S. EPA has listed the company as one of the 12 largest buyers of renewable energy. The manager also recently purchased a Japanese real estate developer that emphasizes fostering a quality workplace that they believe empowers their employees and encourages long-term retention. Some of the initiatives include a flat management structure, gender diversification at the management level and an in-house day care facility at their headquarters. The company's progressive view towards the social characteristics of its company extends from a broader progressive strategy towards business strategy in general, which the manager values highly in their selection for their portfolio.

- **International Equity Manager** – Purchased a Dutch consumer products company. One of the aspects of this company that bolstered their decision was strong sourcing and procurement practices, high employee satisfaction and retention, and impressive governance. They recently sold a Swiss-based food company due to labor-related issues and increased concerns over governance. This manager also recently engaged the management team of a current holding in a Dutch financial services company. This company has a strong ESG profile as it has a heavy environmental focus as well as diversity and inclusion initiatives. However, recently press reports regarding settlement with Dutch prosecutors on IT oversight raised some governance questions. The manager promptly engaged with the company's management and received a prompt response that suggests that the matter should not be a material concern.

III. Consultant Initiatives and Approach to ESG

- **Wilshire Associates (General Consultant) –** Over the last 12 months, Wilshire has been providing ESG advice to the Boards as well as its other clients on: drafting ESG/climate change risk policies, conducting ESG research notes on managers, searching for low carbon tilted indexes, providing portfolio ESG scores, and analyzing portfolio carbon footprints relative to benchmarks.

  As part of its ESG integration activity, Wilshire has produced and circulated several ESG resources to its clients, including the following:

  - Wilshire's first ESG Asset Owner Survey. Wilshire intends to conduct the survey again in future years to build a better picture of themes and trends in this space.
  - A white paper analyzing the potential financial impacts of ESG risks.
  - A research report that summarizes the recent DOL guidance related to ERISA plan's considerations of ESG factors.

- **Franklin Park Associates (Private Equity Consultant) –** Given the increased institutional investor interest in ESG/Impact investing, Franklin Park updated their ESG/Impact fund manager list and compiled a synopsis of fund manager profiles in this space. Some key takeaways from this study were:
  - There were only 15 fund managers pre-2005, most of whom focused on renewable energy technology.
  - Post-2005, the manager universe ballooned during the clean technology bubble to 150.
  - More than 40% of the managers that Franklin Park has tracked since 2003 are no longer active or are not of institutional quality.
  - Today, Franklin Park estimates that there are less than 50 managers that they deem to be institutional quality. Most of these managers are in the growth equity and venture capital space.

- **Aberdeen (Private Real Assets Consultant) –** In the last year, the Aberdeen Private Real Assets team has implemented a communication line with their Europe-based ESG group through a regularly scheduled quarterly call so that they can remain current on specific trends that affect the investment environment and the needs of their investors. Additionally, Aberdeen continues to include ESG as an integral component of their Operational Due Diligence practices.

IV. Staff Research

- **Discussions with Other Plans –** Staff engaged in dialogue with the following pension plans to discuss their approach to ESG and fossil fuel divestment

  - **New York State Common Fund –** Andrew Cuomo, the Governor of NY, said he will push for the state pension fund to divest from fossil fuel companies. However, State Comptroller Thoma DiNapoli, who is responsible for investment decisions, indicated that the fund has no plans to divest. Staff spoke with the plan's staff and confirmed that the plan has no intent to divest, as they view it to be a violation of their fiduciary duty.
  - **NYCERS –** NYC Mayor Bill de Blasio announced that NYCERS is setting a formal goal to divest from fossil fuels within five years. However, divestment would need to be approved by the trustees for the city's five pension boards (Teachers, Fire, Police, Employees, and Board of Education). One of the boards (Police) has explicitly rejected any divestment actions. Before any actions are taken, NYCERS will hire a consultant to study

the issue and its impact on risk and return. Additionally, Mayor de Blasio and Comptroller Stringer recently announced that NYCERS will target an investment of $4 billion, or 2% of the city's pension, in renewable energy, energy efficiency, and other climate change solutions. This would represent a 100% increase relative to the current target for environmentally targeted investments.

- **San Francisco ERS –** In January 2018, the board of SFERS voted against divesting from fossil fuels after the plan's investment consultant, NEPC, issued a report stating that divestment would negatively impact the fund's return, diversification, and inflation protection characteristics. Additionally, SFERS recently announced they will be committing $1 billion to a "carbon-restrained" investment strategy. This strategy passively tracks a carbon-restrained Russell 1000 Index that targets 50% of the carbon emissions of the broader Russell 1000 Index.
- **Vermont ERS –** Following a push from the Governor of Vermont to divest from fossil fuels, the fund's staff conducted significant internal analysis and commissioned Pension Consulting Alliance (PCA), a national pension consulting firm, to study the impact that fossil fuel divestment would have on the plan. PCA's research reaffirmed the research that Vermont's staff had performed, which indicated that divestment would not be an appropriate strategy as a fiduciary.
- **MainePERS –** The Board of Trustees for MainePERS opted to not divest from fossil fuels as their state constitution mandates that "investment decisions will only be made to fund benefit payments and for no other purposes"

- **Natural Resources Strategy -** Staff evaluated adding a dedicated natural resources strategy within the public real asset portfolio to help hedge against inflation risk. However, after further analysis Staff concluded that the potential risks outweigh the merits, specifically because of the significantly higher volatility relative to a diversified real asset strategy. In addition, there is a tail risk associated with investing in natural resource companies related to climate risk and the continued demand for fossil fuels. A diversified public real assets active manager who invests across multiple strategies (i.e. commodities, TIPS, REITs, listed infrastructure, emerging markets debt) can monitor and evaluate this tail risk and appropriately adjust the portfolio depending on the relative risk adjusted return opportunities offered by natural resource companies compared to other potential investments within their mandate. However, a dedicated public markets natural resources manager does not have this flexibility and must remain fully invested in natural resource companies, which could result in high volatility and significant underperformance during periods of time when natural resource equities suffer. For example, the S&P North America Natural Resources Index lost over 30% of its value from 2011-2015 as oil prices plummeted.

- **Consultant Studies –** Staff conducted research on the work performed by some of the largest pension consulting firms in the country to understand their analysis of the risks associated with fossil fuel divestment. Noted below are comments related to their studies:

  - **NEPC Study for SFERS –** NEPC, a national pension consulting firm, and the General Consultant for the San Francisco Employees' Retirement System, published a study in January 2018 that is useful in understanding the costs associated with divestment. SFERS is a multi-billion-dollar pension fund that is diversified globally across multiple asset classes, both private and public. The main results of the study are:
    - NEPC estimated a one-time transaction cost of 0.5% that would be incurred by selling the fossil fuel investments and replacing them with non-fossil fuel investments. This would result in a one-time cost of $335,000 for the ERS and $85,000 for the CRHBT, based on the Trust Funds' current fossil fuel holdings of $67M and $17M, respectively.

        - NEPC estimated an annual performance impact of 0.03%-0.10% from divestment due to decreased diversification. This would result in annual costs of between $1.2 million and $4.0 million for the ERS and between $274,000 and $912,000 for the CRHBT.
    - **Wilshire Study on CalPERS Previous Divestment Campaigns –** Wilshire Associates, the General Consultant for CalPERS, recently estimated that CalPERS has lost between $3.8 billion and $8.3 billion across five notable divestment campaigns (South Africa, Tobacco, Iran/Sudan, Firearms, and Impermissible Emerging Market Countries).
        - Every divestment campaign resulted in lost value for the pension, with Tobacco and South Africa representing material losses and Iran, Sudan, and Firearms representing marginal losses.
    - **Pension Consulting Alliance Analysis for the State of Vermont –** The Vermont State Employees' Retirement System hired PCA to conduct an extensive study on divestment. Their recommendation was against divestment for the plan due to increased costs, reduced diversification, the inability to have an impact on climate change or the financial situation of the company, and the likelihood that divestment could lead to a slippery slope where further restrictions are placed on Vermont's investment opportunity set.

V. Recent Board Actions

- **CERES –** The ERS and CRHBT recently joined the CERES Investor Network on Climate Risk and Sustainability. By joining CERES, the Boards hope 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 pension funds as to their analysis.

    - CERES comprises 146 institutional investors, collectively managing more than $23 trillion in assets, with a goal of advancing leading investment practices, corporate engagement strategies, and policy solutions to build and equitable, sustainable global economy and planet.
    - Notable CERES Investor Network members include CalPERS, MassPRIM, New York State Common, NYCERS, NY State Teachers, Washington State Investment Board, and Maryland State Retirement and Pension System.

- **ESG Monitoring and Evaluation –** Northern Trust, the custodian bank for the ERS and CRHBT, recently ran two analyses on our public equity portfolios. The first analysis looks at the carbon footprint of our equity holdings. The result of this analysis shows that 14 out of 15 of our public equity managers have a smaller carbon footprint than their benchmark index. Additionally, Northern Trust analyzed our exposure to various Sustainable Development Goals (SDGs) and initiatives as defined by the United Nations. The five SDGs that were analyzed were Alternative Energy, Energy Efficiency, Green Building, Pollution Prevention, and Sustainable Water. The amounts of the CRHBT's equity portfolio invested in companies engaged in these five areas of environmental sustainability are noted below:

    - Alternative Energy: 1.7%
    - Energy Efficiency: 11.5%
    - Green Building: 0.4%
    - Pollution Prevention: 1.8%
    - Sustainable Water: 1.1%