INVESTMENT COMMITTEE

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

June 17, 2013

AGENDA ITEM 7b

PROGRAM REVIEW

Global Governance Program Update

The Global Governance Program Update was originally scheduled for the May 2013 Investment Committee meeting. However, due to time constraints at the meeting the item was not presented.

The materials originally submitted for the May 2013 meeting are attached. Staff will provide a verbal update at the June 2013 Investment Committee meeting.

Investment Committee

California Public Employees' Retirement System

Agenda Item 8b

May 13, 2013

ITEM NAME: Global Governance Program Update

PROGRAM: Global Governance

ITEM TYPE: Program Review – Information

EXECUTIVE SUMMARY

This item provides a quarterly update on the Global Governance Program (Program) in line with the core issues framework, which sets out a vision of sustainable investment focused on long-term value creation. The attached presentation (Attachment 1) provides an update on the following:

- **Program Overview** – Scope and Objectives, Mission and From-To Vision
- **Sustainable Value Creation Framework** – 3 Forms of Capital: Financial, Physical, and Human
- **Core Issues Evaluation Criteria** – Materiality, Principles, Capacity, Timeliness, Definition and Likelihood of Success
- **Core Issues** – Shareowner Rights, Board Quality & Diversity, Executive Compensation, Corporate Reporting and Regulatory Effectiveness
- **Core Issues Accomplishments and Progress**

We also have included an overview of CalPERS work on climate change given the growing public interest.

STRATEGIC PLAN

This agenda item supports the CalPERS Strategic Plan goal of improving long-term pension and health benefits sustainability. Regular program updates support the Investment Committee in its oversight capacity.

BACKGROUND

The Program's sustainable value creation framework is built upon effective management of the three forms of capital: financial, physical and human. The Program seeks good governance practices to ensure that CalPERS capital is deployed to produce sustainable long-term returns and meet pension obligations. The Program focuses on five core issues which support long-term value creation: shareowner rights, board quality and diversity, executive compensation, corporate reporting and regulatory effectiveness.

As a provider of capital, CalPERS has a deep interest in shareowner rights. These help us define the relationship between CalPERS and fiduciaries, such as corporate boards and external managers that are accountable for overseeing the use of our capital. In additon, we want to ensure the boards and leadership responsibile for oversight represent a diverse mix of characteristics, experience and competencies. Well-designed compensation programs should be in place to reward and align the users of our capital with CalPERS objective to achieve sustainable, long-term value creation. CalPERS expects fair, accurate, and timely reporting on how financial, human and physical capital are employed to generate sustainable economic returns. Finally, we look to regulation to protect CalPERS as an investor, maintain fair, orderly, and efficient markets, and facilitate capital formation.

CalPERS Work on Climate Change

As an example of our work on the three forms of capital, we identifed climate change as a theme that runs across our total fund. Environmental issues, and climate change in particular pose both risks and opportunities for CalPERS. The issues raised by climate change are complex and challenging. They require time, attention and coordinateion between investors, companies and policy makers.

We've set out a strategy for our work to address the unifying theme of climate change in the following areas: advocacy, engagement, targeted investments, research and operations – the details can be found in Attachment 1. Examples of work across the total fund include the following:

- **Advocacy**

  CalPERS was a founding member of the Investor Network on Climate Change – a leading network of 100 institutional investors representing more than $10 trillion in assets committed to addressing the risks and opportunities resulting from climate change.

  In connection with the United Nations Climate Change Conferences in Copenhagen (2009), Cancun (2010), Durban (2011), and Doha (2012), we have endorsed global investor statements and action plans on climate change calling for effective domestic and international policy frameworks to catalyze the development of clean energy and well-designed carbon markets.

  Our CEO, Anne Stausboll, Co-Chair's Ceres, who successfully advocated the US Securities and Exchange Commission (SEC) to issue guidance requiring disclosure of climate change risks in corporate filings.

CalPERS was recently appointed to the standards setting council of a newly established non-profit organization, the Sustainability Accounting Standards Board (SASB),engaged in the development and dissemination of industry-specific sustainability accounting standards. SASB will provide investors with something they vitally need to address climate change risks: standardized information on material sustainability factors alongside financial information.

- **Engagement**
  CalPERS firmly believes engagement is the first call of action with companies. Our Global Principles of Accountable Corporate Governance (Principles) set out our expectations on corporate governance, executive compensation, sustainability risks, diversity and market conduct. Specifically, we request companies to "provide accurate and timely disclosure of environmental risks and opportunities through adoption of policies or objectives, such as those associated with climate change."

  Our Principles also state our expectations on climate risk disclosure, calling for companies to use the Global Framework for Climate Risk Disclosure which recommends disclosure on greenhouse gas emissions, strategic analysis of climate risk and emissions management, assessment of physical climate risks, and an analysis of regulatory risks.

  Every year, we use our shareowner voting rights to ensure our interests and values are aligned with companies across the 47 markets that we invest in. All our votes are cast in line with CalPERS Global Principles of Accountable Corporate Governance. Over the last three years, on average, we voted 'for' sustainability-related shareowner proposals 93 percent of the time. These cover a wide variety of sustainability issues, including increased transparency of critical sustainability risks in the oil and gas sector and corporate sustainability reporting.

  Our Global Governance Program also engages with more than 100 companies on an annual basis to ensure the high standards of corporate governance that underpin effective climate change risk management. As part of our engagement work we lent our support to Ceres' campaign asking Russell 1000 companies to provide comments on the *21st Century Corporation: The Ceres Roadmap to Sustainability*[7] which calls for corporate reporting on sustainability factors, including climate change risks.

- **Targeted Investments**
  Global Equity: In 2010, we allocated $500 million to an internally managed public stocks environmental index fund. This strategy is modeled on the HSBC Global Climate Change Benchmark Index and invests in approximately 380 securities around the world that derive a material portion of their revenues from environmentally friendly sectors such as low-carbon energy production, energy efficiency management and carbon trading.

  Private Equity: We have approximately $1.2 billion of aggregate exposure to the alternative energy sector. Our investments are spread across hundreds of companies with particular emphasis on solar power and biofuels.

  Real Estate: In 2004, we established a goal of reducing energy consumption of the underlying assets in its Core Real Estate portfolio by 20 percent by 2009. At the end of this five-year program, the investment managers exceeded this target, reporting a total energy reduction of 22.8 percent. The Real Estate Unit continues to work with managers on ways to better track and reduce energy usage and measure the carbon footprint of our property investments.

  Forestland: CalPERS has a long-standing investment in forestlands that represents approximately $2.3 billion of the total fund. Timber is a renewable resource and with high growth rates, plantations can reduce CO2 emissions through carbon sequestration.

- **Research**
  We commissioned a study, *Climate Change Scenarios – Implications for Strategic Asset Allocation*, to examine the potential impacts of climate change factors on strategic asset allocation and we continue to assess the impact of climate risks across our total fund. Most recently, we have partnered with UC Davis to further research sustainability factors, including environmental innovation, and their impact on risk and return. This research will inform CalPERS Investment Committee's development of investment beliefs. We will hold an Investment Committee Board Workshop on June 17, 2013, to discuss the findings of this research.

- **CalPERS Operations**
  We have been reporting our greenhouse gas emissions since 2006, and we reduced them by almost 30 percent, from 9,099 metric tons in 2008 to 6,443 metric tons in 2010. Many of these savings result from our LEED certification program, which identified steps we could take to improve our performance. We also purchase 50 percent certified green renewable power through our local utility company, the Sacramento Municipal Utility District.

CalPERS also has a Green Club dedicated to learning about and discussing ways to save energy, reduce our carbon footprint, reduce waste and other green initiatives. This group includes volunteer representatives from divisions across the enterprise and is sponsored by the Sustainable Operations Program.

Addressing climate change is no small undertaking and we continue to partner with other like-minded investors to advocate for change on this important issue. CalPERS was also ranked 15th out of 1,000 global asset owners in the ranking of institutional investors on climate change disclosure by the Asset Owner Disclosure Project.

ANALYSIS

The last quarter resulted in a number of accomplishments for our five core issues. Details on the Program's progress are included in the attached presentation, Global Governance Program Quarterly Update (Attachment 1), with highlights on the following pages.

Core Issues Accomplishments and Progress

- **Shareowner Rights**

  Accomplishments: Apple's Management Proposal to Implement Majority Voting received 98% support of proxies prior to the meeting following CalPERS proxy solicitation. The vote was cancelled by the court following a lawsuit, which challenged the "bundling" of the different elements of the proposal, from Greenlight Capital – a hedge fund pressing for issuance of preferred stock without recourse to shareowners. Apple has promised to bring the proposal back to shareowners in the future.

  Through work with the CalPERS Legal Office, we submitted an amicus brief to the Commonwealth of Massachusetts Supreme Judicial Court on the issue of the interpretation of the phrase "annual basis", as applicable to the scheduling of shareholder meetings. We believe shareholder meetings should be held within a period of twelve months or in consecutive fiscal years.

  Progress: For the first quarter of 2013, CalPERS voted on 9,524 proposals, supporting 92% of management proposals and 77% of shareowner proposals. Staff is entering into the height of the 2013 Proxy Season and will vote an estimated 7,000 meetings. CalPERS has also filed a board declassification proposal at Hospitality Properties Trust to be presented at the Annual Meeting on May 15, 2013. We've also filed a Majority Vote proposal at Hatteras Financial, which will be presented at the upcoming May 21, 2013, Annual Meeting.

Proxy Access has been a longstanding priority for CalPERS. We continue to advocate for shareowners' right to access the company proxy and nominate candidates to company boards by supporting Proxy Access proposals. Previously, 14 shareowner resolutions were filed in 2012. Nabors Industries and Chesapeake Energy both received a majority of shareowner support – following CalPERS proxy solicitation.

The following management and shareholder Proxy Access proposals in Table 1 have been filed over this past quarter. CalPERS will be voting "FOR" each of these resolutions as they are consistent with our support of proxy access at the SEC proposed level of a 3% shareholder or group with a 3-year holding period or a threshold falling below that.

Table 1 – Proxy Access Proposals

Company	AGM Date
Walt Disney (DIS) – 36% support	March 6, 2013
Hewlett Packard (HPQ)* – 97% support	March 20, 2013
Verizon (VZ)	May 2, 2013
Bank of America (BAC)	May 8, 2013
Charles Schwab (SCHW)	May 16, 2013
Chesapeake Energy (CHK)*	June 8, 2013

*Management Proposals

- **Board Quality & Diversity**
  Accomplishment: At Hewlett Packard, governance reform continues with Board Chairman Raymond Lane stepping down and both John Hammergren and G. Kennedy Thompson leaving the board.

  Progress: As part of the Council of Institutional Investors' (CII) "Zombie" Directors Campaign, CalPERS is targeting Nominating/Governance Committee Chairs where directors received a majority of withhold votes and failed to step down.

  CalPERS in partnership with CalSTRS, sent a letter to the 41 S&P 500 companies we contacted back in June 2012, on board quality and diversity. A number of companies have made positive changes since our initial letter.

We are also including two attachments in our letter to the companies: the National Association of Corporate Directors' Blue Ribbon Commission Report, *The Diverse Board: Moving From Interest to Action* and the NACD Directorship Article that CalPERS co-authored with UnitedHealth Group, *How to Engage Shareholders When Selecting New Directors* (Attachment 3).

- **Executive Compensation**
  Accomplishment: We have engaged 200 companies as part of CalPERS Say on Pay letter writing campaign – 87 have reformed.

  Progress: CalPERS filed a proposal at Nabors Industries to limit executive severance payouts without shareowner approval to be presented for vote at the Annual Meeting on June 4, 2013.

- **Corporate Reporting**
  Accomplishment: The Sustainable Investment Research Initiative (SIRI) call for papers sought empirical and theoretical papers from scholars and investment practitioners in the fields of finance, economics, accounting, law and business. We received 94 submissions, with seven selected by the selection committee, co-chaired by UC Davis and the Columbia Law School, for presentation at the upcoming technical Symposium.

  CalPERS was recently appointed to the standards setting council of a newly established non-profit organization, the Sustainability Accounting Standards Board (SASB),[4] engaged in the development and dissemination of industry-specific sustainability accounting standards. SASB will provide investors with something they vitally need to address climate change risks: standardized information on material sustainability factors that can be integrated with financial information.

  On April 16, 2013, CalPERS spoke on a panel at the Sustainability Accounting Standards Board (SASB) Delta Series Financial Sector conference in New York. The discussion focused on the newly developed draft financial industry standards – looking at the need for reporting of relevant sustainability factors in the Form 10-K (annual report). The Harvard Business Review's recent paper, *The Performance Frontier (*Attachment 4), examines the link between relevant sustainability factors and financial performance and highlights the work SASB is undertaking.

  Progress: The UC Davis Graduate School of Management is hosting the Sustainability & Finance Symposium, co-chaired by the Columbia Law School, on June 7, 2013, and will facilitate a technical academic inquiry into the definitions and relevance of sustainability factors and related policy issues for long-term capital providers. Findings from the Symposium will be presented at the Investment Committee Board Workshop on June 17, 2013.

- **Regulatory Effectiveness**
  Accomplishment: CalPERS met with Congressional staff and regulators on both the unfinished business of Dodd-Frank and financial benchmarks in the wake of the London Interbank Offered Rate (LIBOR) scandal.

  Anne Simpson, Senior Portfolio Manager and Director of Global Governance, was re-elected to the CII's Board and has also been re-appointed to the Public Company Accounting Oversight Board (PCAOB) Investor Advisory Group.

  Progress: CalPERS wrote to the new SEC Chair, Mary Jo White, to send our congratulations and looks forward to working with her on investor issues. Joseph Dear, Chief Investment Officer serves as Chairman of the SEC Investor Advisory Committee, which was established as a result of Section 911 of the Dodd-Frank Act.

ATTACHMENTS

Attachment 1 – Global Governance Quarterly Program Update
Attachment 2 – Q1 2013 Overview of Global Proxy Votes Cast
Attachment 3 – NACD Directorship Article, *How to Engage Shareholders When Selecting New Directors*
Attachment 4 – Harvard Business Review's paper, *The Performance Frontier*

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Director of Global Governance

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Global Governance Quarterly Program Update

May 13, 2013

CalPERS | Investment Office
Corporate Governance

Agenda

- Program Overview: Scope and Objectives, Mission and From-To Vision
- Sustainable Long Term Value Creation Framework
- Core Issues Evaluation Criteria
- Core Issues: Accomplishments and Progress

Program Overview: Scope and Objectives, Mission and From-To Vision

Program Scope and Objectives

- **We Aim to be a Principled and Effective Investor**: To deliver sustainable, risk-adjusted returns
- **Grounded in Economics**: Long-term value creation requires effective management of three forms of capital - financial capital, physical capital, human capital
- **Core Issue Driven**: Shareowner rights, board quality and diversity, corporate reporting, executive compensation, regulatory effectiveness
- **Work Streams**: Principles and Proxy Voting, Corporate Engagement, Capital Market Stability, Sustainable Investment, Institutional Relations
- **Thought Leadership and Coalition Building**: Investor Forum Leadership and the CalPERS Global Governance Website

Mission

Investment Office (INVO) Vision: We are known as an effective and principled investor, grounding everything we do with a commitment to serve our beneficiaries with excellence and be true to our fiduciary duty.

Global Governance Program Mission: Supports INVO's Vision by advocating sustainable risk adjusted returns via:

- Alignment of interest across corporations, markets, and external managers to address:
  - Shareowner Rights
  - Board Quality and Diversity
  - Incentive Structures – Executive Compensation
  - Corporate Reporting
  - Regulatory Effectiveness
- Transparent and stable capital markets
- Integration of relevant sustainability factors into long-term investment decision making

From – To Vision

FROM	TO
• Inconsistent and partial reporting on CalPERS sustainable investment initiatives	• Total Fund report, "Towards Sustainable Investment"
• Multiple guidelines on sustainability across asset classes and initiatives / programs	• Total Fund Principles on Sustainability and agreed list of priority initiatives
• Varied internal and external manager expectations on sustainable investment	• Total Fund sustainability expectations document for internal and external managers
• Lack of consensus on the evidence linking sustainability factors to performance	• Definition and analysis of sustainability factors and their impact on risk and return
• Financial market reform priorities focused on U.S. capital markets	• Advancing reform priorities in global capital markets based on investment exposure
• Unstructured process for managing CalPERS institutional relationships	• Leadership through partnerships with investors
• Domestic Focus List Program	• Monetized Focus List Program

Sustainable Value Creation Framework

Sustainable Value Creation Framework

Sustainable investment in its simplest form is the ability to continue, and for a long-term investor like CalPERS with long-term liabilities, it is critically important. Long-term value creation requires the effective management of three forms of capital: this is why we are concerned with environmental, social, and governance issues.

Physical Capital - Environment
Includes managing risk posed by climate change, and the use of natural resources and buildings

Financial Capital - Governance
To ensure alignment of interest over equity, debt, public and private investments

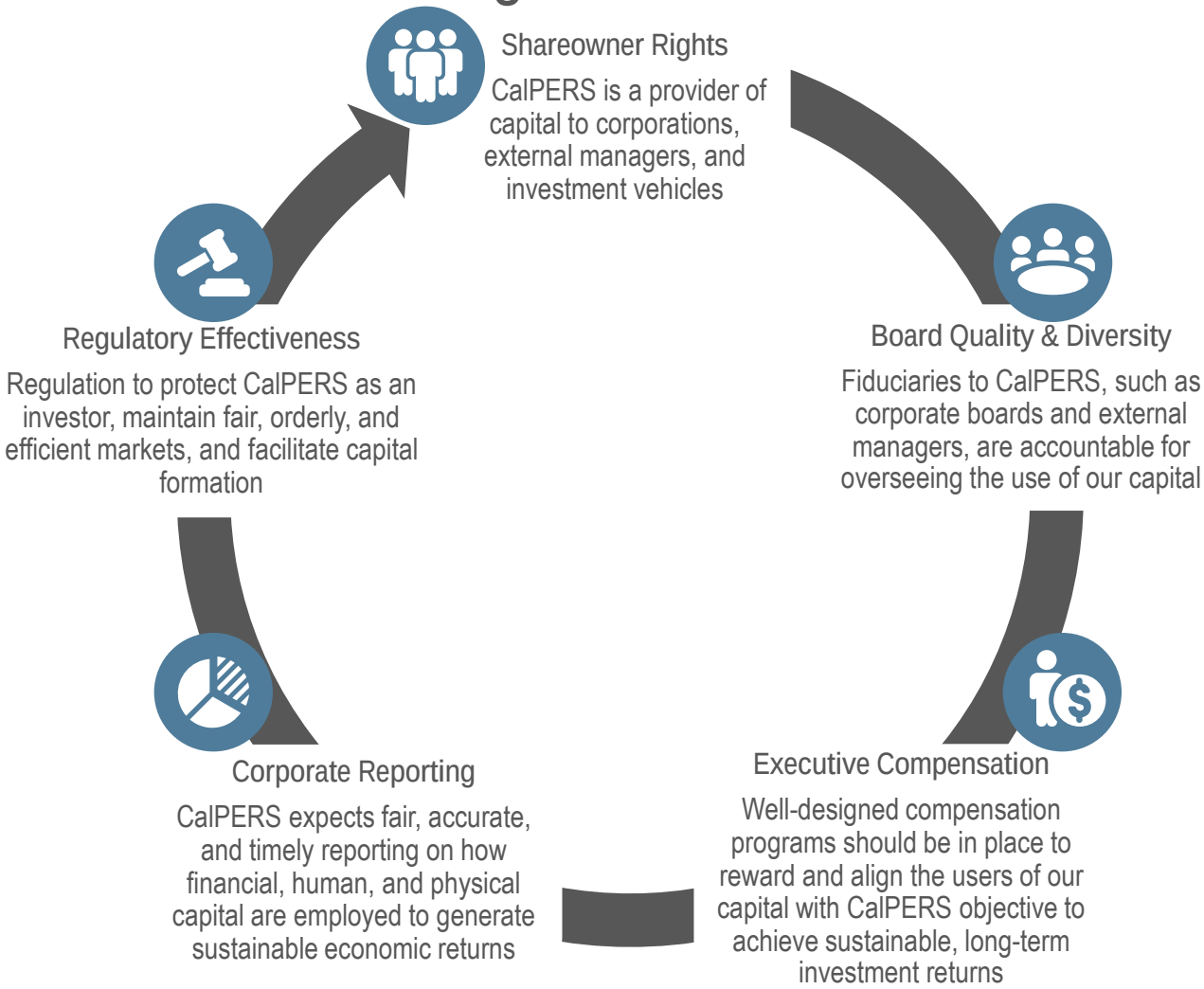
Human Capital - Social
Includes health, safety, and labor practices

Physical Capital Example – Climate Change

We've set out a strategy for our work to address the unifying theme of climate change in the following areas:

- Advocacy – with policy makers at home and globally
- Engagement – with our portfolio companies
- Targeted Investments – to deploy capital into opportunities
- Research – through our Sustainable Research Initiative (SIRI)
- Operations – we have also cut CalPERS impact on climate change from operations in significant ways

The Virtuous Circle of Long-term Value Creation



Core Issues Evaluation Criteria

Given the number of stakeholders and views, we need clear criteria for narrowing our focus on issues which can be clearly linked to furthering the Global Governance Program's mission and for deciding what type of role CalPERS should play.

Materiality	Does the issue have the potential for a meaningful impact on portfolio risk or return?
Principles	To what extent is the issue supported by CalPERS Principles of Accountable Corporate Governance?
Capacity	Do we have the expertise and resources to influence a meaningful outcome?
Timeliness	Is the issue time sensitive with a clearly defined deadline?
Definition and Likelihood of Success	Is there a likelihood of success in that CalPERS action will influence an outcome which can be measured? Can we partner with others to achieve success?

Core Issues:
Accomplishments and Progress

Core Issues: Where CalPERS Plays an Extensive Role

There are five priorities which staff believes have a material long term impact on risk and return, can effectively resource, and are considered to have a high likelihood of impacting the achievement of CalPERS goals.

- **Shareowner Rights:** structural mechanisms that define the formal relationship between CalPERS as the capital provider and those charged with protecting and growing CalPERS capital
- **Board Quality & Diversity:** diverse characteristics, experience, and competencies to ensure effective board leadership and oversight of CalPERS capital
- **Executive Compensation:** incentive structures designed to protect and grow CalPERS capital which are aligned with the long-term sustainable economic interests of CalPERS Total Fund
- **Corporate Reporting:** includes strong accounting and auditing standards, and sustainability reporting which leads to informed financial, physical, and human capital allocation decision making
- **Regulatory Effectiveness:** to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation

Shareowner Rights

Accomplishment

- **Apple Majority Vote:** In February 2013, Apple Inc. sponsored a management proposal to implement Majority Vote for Directors after two successful years of CalPERS shareowner resolutions. CalPERS collaborated with Apple Inc. management to solicit support for the Proposal No. 2, which received 98% support of proxies prior to the meeting . The passage of Proposal No. 2 would have amended Apple's charter to provide for majority voting for directors, established a par value for Apple stock and eliminate Apple's ability to issue preferred shares without shareholder approval. Greenlight Capital, a hedge fund pressing for issuance of preferred stock without recourse to shareowners, sought an injunction to block the vote. The court stopped the vote on the grounds that the three items were improperly bundled and should be voted on separately. Apple Inc. has promised to bring the vote back to shareowners at a later date.

- **Amicus Brief on the Timing of Annual Meetings**: Through work with the CalPERS Legal Office, we submitted an amicus brief to the Commonwealth of Massachusetts Supreme Judicial Court on the issue of the interpretation of the phrase "annual basis", as applicable to the scheduling of shareholder meetings. We believe shareholder meetings should be held within a period of twelve months or in consecutive fiscal years.

Shareowner Rights

Progress

- Majority Vote Campaign: Staff identified and began engaging 50 companies in the Fall of 2012. To date, 34 of the 50 companies have or will be adopting the CalPERS request to adopt Majority Voting. We will continue engagement efforts at the remaining 16 companies. CalPERS has filed a Majority Voting shareowner resolution at Hatteras Financial, which will go to the vote at their May 21, 2013, Annual General Meeting. Staff will be running a full proxy solicitation in connection with this resolution.

- Summary Proposal Votes: CalPERS voted on 9,524 proposals, supporting 92% of management proposals and 77% of shareowner proposals. CalPERS voted "FOR" or "AGAINST" proposals in the U.S. and overseas on a range of issues including board independence, voting thresholds, compensation, board oversight and disclosure of charitable and political donations, sustainability and takeovers. During this period, all proxy votes were successfully cast.

- Share Blocking: During the first quarter of 2013, staff did not cast our vote at Norwegian Energy's meeting due to share blocking as casting votes at these meetings would have prevented the rebalancing of portfolios. Share blocking is the "freezing" of shares for trading purposes at the custodian/ sub-custodian bank level in order to vote proxies. All other votes were successfully cast on behalf of CalPERS.

- Sustainability-Related Proposals: Over the past three years, on average, we voted "FOR" sustainability-related shareowner proposals 93% of the time. These cover a wide variety of sustainability issues, including increased transparency of critical sustainability risks in the oil and gas sector and corporate suitability reporting.

Shareowner Rights

Progress

- Proxy Access has been a longstanding priority for CalPERS. We continue to advocate for shareowners' right to access the company proxy and nominate candidates to company boards by supporting Proxy Access proposals. Previously, 14 shareowner resolutions were filed in 2012. Nabors Industries and Chesapeake Energy both received a majority of shareowner support where CalPERS ran a proxy solicitation. The following Proxy Access proposals have been filed over this past quarter. CalPERS will be voting "FOR" each of these resolutions as they are consistent with our support of proxy access at the SEC level of a 3% shareholder or group with a 3-year holding period or a threshold falling below that.

Company	AGM Date	Proposal Type
Hewlett Packard (HPQ) – 97% support	March 20, 2013	Management
Chesapeake Energy (CHK)	June 8, 2013	Management
Walt Disney (DIS) – 36% support	March 6, 2013	Shareholder
Verizon (VZ)	May 2, 2013	Shareholder
Bank of America (BAC)	May 8, 2013	Shareholder
Charles Schwab (SCHW)	May 16, 2013	Shareholder

Shareowner Rights

Progress

- Hospitality Properties Trust (HPT): CalPERS fifth consecutive proposal to declassify the board which will be put before shareowners at HPT's 2013 Annual Meeting on May 15, 2013. Last year, CalPERS proposal received support from 90% of the votes cast and 67% of the shares outstanding. To date, the company has not agreed to implement the proposal.

- Focus List (FL) :Continuing to engage 2012 FL companies and will be screening and selecting up to 10 Focus List companies that we will present and seek approval for at the September 2013 Investment Committee Meeting.

- Relationship Index: A draft of the total fund index cataloging staff participation in investor forums/networks has been completed. Next, staff will draft a framework for evaluating prioritization of CalPERS participation in sustainable investment related organizations.

Board Quality & Diversity

Accomplishment

- **Hewlett Packard (HP) Director Withhold Vote:** At the March 20, 2013, HP Annual General Meeting CalPERS withheld its vote from Board Chairman Raymond Lane, John Hammergren, and G. Kennedy Thompson due to failures at the company. After receiving a high opposition vote, Mr. Lane stepped down as chairman and both Mr. Hammergren and Mr. Thompson are leaving the board.

Progress

- **CII "Zombie" Directors Campaign – Directors who have lost the vote**: The Council of Institutional Investors (CII) started an initiative in 2012 to identify and engage companies where directors who fail to obtain at least a majority support in uncontested elections step down from their board and not be reappointed. In 2012, 62 directors failed to meet the 50.1% hurdle and CII has sent letters to these companies requesting boards remove these "zombie" directors. As of April 3, 2013, 53 of these directors remain on company boards. CalPERS will be targeting Nominating/Governance Committee Chairs at companies where directors received a majority of withhold votes and failed to step down.

Board Quality

Progress

- **S&P 500 Companies Board Diversity Engagement**: CalPERS and CalSTRS sent a joint letter to the 41 S&P 500 companies we contacted in June 2012 on board quality and diversity. The 41 companies were identified for having all male boards. Since the initial letters were sent, two companies nominated a woman to their board: AvalonBay Communities, Inc. and QEP Resources. A number of the companies have also made positive changes in the form of adoption of a board diversity policy. We are writing to follow-up and continue encouraging improved diversity on their boards as well as share the National Association of Corporate Directors' (NACD) recent Blue Ribbon Commission Report, *The Diverse Board: Moving from Interest to Action*.

- **UnitedHealth Group (UNH) Board Appointment**: CalPERS co-authored an article with Michele Hooper, Chair of the Nominating and Governance Committee at UNH, which was recently published in the NACD Directorship Magazine. The article, *How to Engage Shareholders when Selecting New Directors,* highlights CalPERS and UNH's collaborative work to appoint a new independent director to the UNH board and details the nomination process that was developed along the way.

- **NACD Panel on Board Quality**: CalPERS is coordinating with the National Association of Corporate Directors to develop a panel on Board Quality for their Chapter Meeting on June 20, 2013. CalPERS recently became a member of the NACD. Directors and executives from public, private and non-profit companies look to the NACD as a source of research, best practice, board development and director education.

Executive Compensation

Accomplishment

- Say on Pay Letter Writing Campaign: We have successfully communicated (via letter) CalPERS Say on Pay "AGAINST" votes to 231 U.S. companies. CalPERS engagement efforts highlight us voting "FOR" 87 companies where votes had previously been cast "AGAINST" – a demonstration of positive change with portfolio company compensation practices.

Progress

- Say-on-Pay Director Withhold Vote Campaign: As of the year-ending 2012 CalPERS voted "AGAINST" 52 portfolio company Say-on-Pay proposals for two consecutive years. Of these companies 15 failed to receive greater than 50 percent shareowner support in 2012. As we enter into the 2013 proxy season staff is recommending a withhold vote campaign for responsible directors at companies that have not adequately addressed shareowner concerns on executive compensation.

- Nabors Industries: CalPERS filed its second consecutive proposal to limit executive severance payouts without shareowner approval at the company's 2013 Annual Meeting on June 4, 2013. Last year the same proposal received support from 66% of votes cast and 52% of shares outstanding. Consistent with CalPERS Global Principles of Accountable Corporate Governance, the proposal asks the company to seek shareowner approval of future severance agreements with senior executives that provide total benefits exceeding 2.99 times that sum of the executive's base salary plus bonus.

Corporate Reporting

Accomplishments

- Review of Evidence: The Sustainable Investment Research Initiative (SIRI) call for papers yielded 94 academic papers; seven papers have been selected for presentation at the upcoming Sustainability & Finance Symposium, a technical academic discussion, hosted by the UC Davis Graduate School of Management, and co-chaired by the Columbia Law School.

- Sustainability Accounting Standards Board (SASB): As of January of this year, Jameela Pedicini of CalPERS was appointed to the standards setting council of Sustainability Accounting Standards Board. This newly formed organization is engaged in the development and dissemination of industry-specific sustainability accounting standards. SASB will provide investors with something they vitally need to address climate risks: standardized information on material sustainability factors alongside financial information. On April 16, 2013, CalPERS spoke on a panel at the SASB Delta Series Financial Sector conference in New York. The discussion focused on the newly developed draft financial industry standards – looking at the need for reporting of relevant sustainability factors in the Form 10-K (annual report). SASB will next develop standards for the Technology & Communications and the Non-Renewable Resources Sectors. The Harvard Business Review's recent paper, *The Performance Frontier*, examines the link between relevant sustainability factors and financial performance and highlights the work SASB is undertaking.

- Asset Owner Disclosure Project: CalPERS was ranked 15th out of 1,000 global asset owners.

Corporate Reporting

Progress

- **Climate Change Scenarios – Implications for Strategic Asset Allocation**: CalPERS commissioned a study to examine the potential impacts for climate change factors on strategic asset allocation and we continue to assess the impact of climate risks across our total fund.

- **The Sustainability & Finance Symposium**, hosted by the UC Davis Graduate School of Management, will convene leading academics and practitioners to foster a rigorous debate and discussion on sustainability, long-term value creation and capital market stability. The Symposium will be a technical academic inquiry into the definitions and relevance of sustainability factors and related policy issues for long-term capital providers. Research findings from the Symposium will be presented at the Investment Committee Board Workshop on June 17, 2013. It is expected that the results of the symposium will help inform the Investment Committee's discussion on investment beliefs.

- **Total Fund Principles on Sustainable Investment**: The next step in CalPERS work to integrate relevant sustainability factors across the portfolio is to develop Total Fund Principles on Sustainable Investment (Principles). We've commissioned Mercer Consulting to rationalize the existing list of the 111+ sustainability initiatives and policies by applying the criteria for evaluating core issues and ensuring alignment with the three forms of capital (financial, physical, human). The Global Governance Program will use the recommendations from Mercer's review to collaborate with the Sustainable Investment Cross-Asset Class Team and develop a total fund level Principles document that encompasses sustainability themes across all asset classes.

Corporate Reporting

Progress

- **Towards Sustainable Investment Report (2nd edition)**: The Governance Program will begin working with the Sustainable Investment Cross-Asset Class team to draft the next edition of the report in time for release at the PRI In Person Conference on October 1, 2013.

- **Auditing and Accounting Comment Letters**: In coordination with International Corporate Governance Network (ICGN), CalPERS responded to the Financial Accounting Standards Board's (FASB) request for comment on Financial Statement Disclosures and European Financial Reporting Advisory Group's (EFRAG) discussion paper on a Disclosure Framework for the Notes of the Financial Statements. Also, through this coordination we are in the process of drafting a letter to the International Accounting & Auditing Standards Board (IAASB) on a framework for audit quality as well as to the Financial Reporting Council (FRC) on revisions requiring the auditor's report to address risks of material misstatement, materiality and a summary of the audit scope.

- **CII Audit Policy**: Revisions to the CII Corporation Governance Policies went to a vote at the April 19, 2013, CII General Members' Meeting. A portion of the revisions address the role of the audit committee in oversight of the independent auditor and further calls upon audit committees to proactively carry out their responsibilities and facilitate auditor independence, audit quality and auditor rotation.

Corporate Reporting

Progress

- Corporate Reporting White Paper: In partnership with the CalPERS Legal Office, we've begun drafting a corporate reporting white paper, which sets out the corporate reporting issues, proposed best practices and our long-term vision.

- Investor Network on Climate Risk (INCR): CalPERS was a founding member of INCR and continues to actively participate in regular calls, events, and webinars on topics such as Sustainable Stock Exchanges. INCR is a leading network of 100 institutional investors representing more than $10 trillion in assets committed to addressing the risks and opportunities resulting from climate change.

Corporate Reporting

Progress

- Company Engagement on Disclosure: CalPERS firmly believes engagement is the first call of action with companies. Our Global Principles of Accountable Corporate Governance (Principles) set out our expectations on corporate governance, executive compensation, sustainability risks, diversity and market conduct. Specifically, we request companies to "provide accurate and timely disclosure of environmental risks and opportunities through adoption of policies or objectives, such as those associated with climate change." Our Principles also state our expectations on climate risk disclosure, calling for companies to use the *Global Framework on Climate Risk Disclosure* which recommends disclosure on greenhouse gas emissions, strategic analysis of climate risk and emissions management, assessment of physical climate risks, and an analysis of regulatory risks.

- Ceres Campaign: Our Global Governance Program also engages with more than 100 companies on an annual basis to ensure the high standards of corporate governance that underpin effective climate change risk management. As part of our engagement work we lent our support to Cere's Campaign asking Russell 1000 companies to provide comments on the *21st Century Corporate: The Ceres Roadmap to Sustainability* which calls for corporate reporting on sustainability factors, including climate change risks.

Regulatory Effectiveness

Accomplishments

- **Congressional Meetings:** We've met with Congressional staff and regulators on both the unfinished business of Dodd-Frank and financial benchmarks in the wake of the London Interbank Offered Rate (LIBOR) scandal. (The meetings are in alignment with the CalPERS 2012-14 Enterprise Business Plan initiatives to impact regulatory oversight by engaging legislative, regulatory, securities exchange, or other policy makers to address CalPERS capital market stability priorities.)

- **Re-election to the Council of Institutional Investors' (CII) Board** : Anne Simpson, Senior Portfolio Manager and Director of Global Governance, was re-elected to the CII's Board as one of the nine public fund directors. Serving on the Board this past year, Anne contributed to the vitally important work of promoting good governance, shareowner rights and sustainable financial markets. She has been active on the governance and activism committees, championed CII campaigns by engaging companies that did not implement shareowner proposals, and elevated the issues of "zombie" directors and rogue pay arrangements.

- **Public Company Accounting Oversight Board (PCAOB) Investor Advisory Group**: Anne Simpson was re-appointed to the PCAOB Advisory Group (IAG). The IAG consists of 20 members who will serve three-year terms ending October 2015. This group was established as a forum for the investor community to provide views and advice on matters affecting investors and the work of the PCAOB.

Regulatory Effectiveness

Progress

- New SEC Chair : CalPERS wrote to the new SEC Chair, Mary Jo White, to send our congratulations and looks forward to working with her on investor issues.

- SEC Investor Advisory Committee: Joseph Dear, Chief Investment Officer, continues to serve on the SEC Investor Advisory Committee as Chairman. The most recent meeting was held on April 11, 2013. Section 911 of the Dodd-Frank Act established the Committee, which meets to advise the Commission on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectives of disclosure, and on initiatives to protect investor interests and promote investor confidence and the integrity of the securities marketplace.

- SEC Climate Change Risk Disclosure: Our CEO, Anne Stausboll, Co-Chair's Ceres, who successfully advocated the US Securities and Exchange Commission (SEC) to issue guidance requiring disclosure of climate change risks in corporate filings.

- Global Investor Statements: In connection with the United Nations Climate Change Conferences in Copenhagen (2009), Cancun (2010), Durban (2011), and Doha (2012), we have endorsed global investor statements and action plans on climate change calling for effective domestic and international policy frameworks to catalyze the development of clean energy and well-designed carbon markets.

Global Governance website:

www.calpers-governance.org/

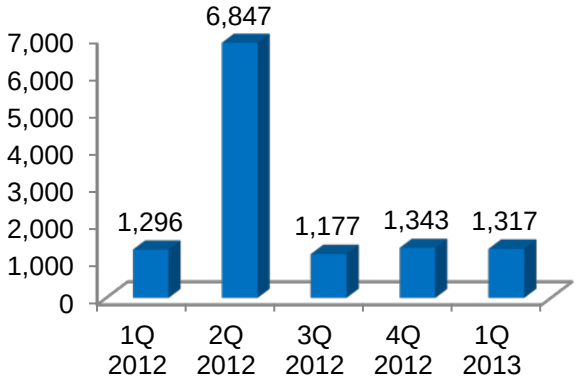
View and download Full Sustainable Investment Report at:

http://ow.ly/aoHfm or scan the QR code

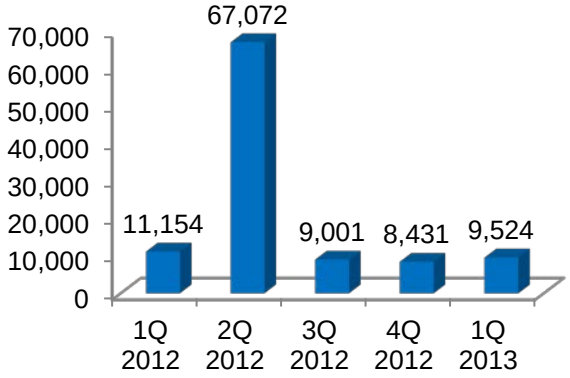
CalPERS

2013 Q1 Overview of Global Proxy Votes Cast

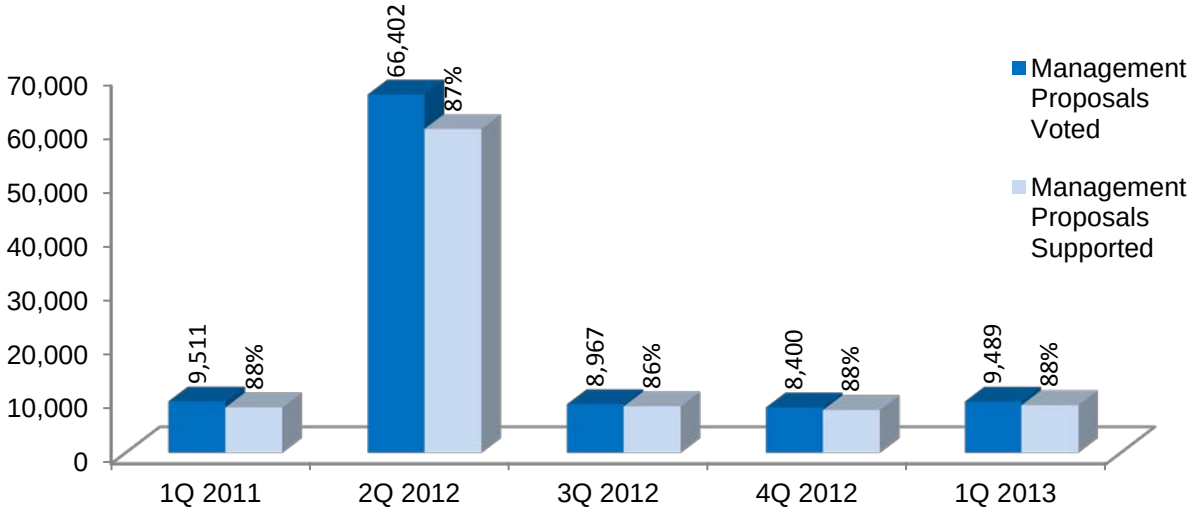
Number of Meetings Voted



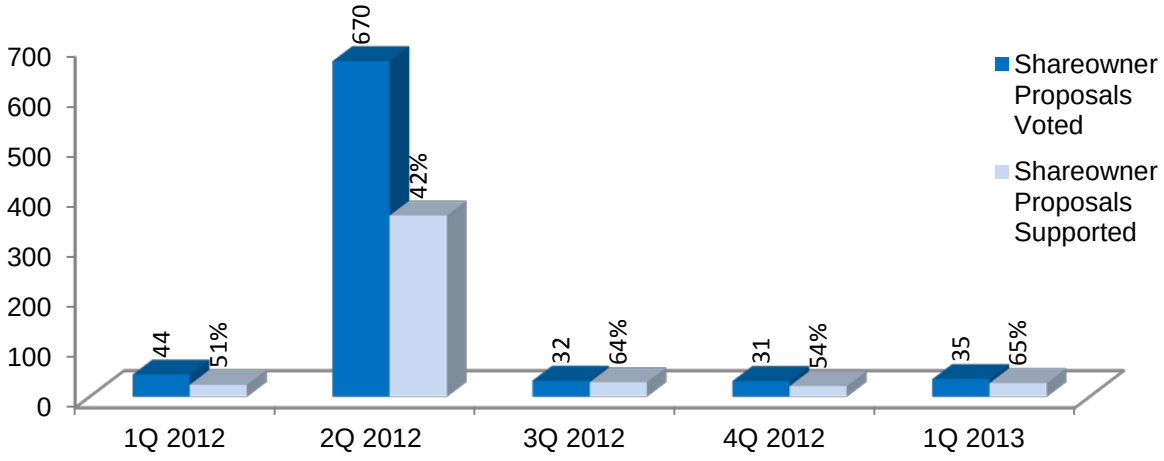
Resolutions Voted



Management Proposals



Shareowner Proposals



Source: Glass Lewis (Viewpoint)

Domestic Management Proposals
Examples of CalPERS FOR Votes

Apple Inc.

- **Issue**: Amend the Articles of Incorporation allowing for Majority Voting and the elimination of blank check preferred stock
- **Reason**: The proposal strenghens shareowner rights in-line with CalPERS principles.
- **Vote Result:** 98% FOR; however, the proposal was removed from the ballot due to legal action. Apple Inc. management has committed to bring the proposal back to shareowners for vote later in 2013.

Hewlett Packard Co.

- **Issue**: Amend the Bylaws to allow for Proxy Access
- **Reason**: Shareowners should have access to the director nomination process.
- **Vote Result:** 98% FOR

Joy Global Inc.

- **Issue**: Adopt Majority Vote for Director Elections
- **Reason**: CalPERS believes directors should be elected by a majority of the proxy votes cast.
- **Vote Result:** 96% FOR

Domestic Management Proposals
Examples of CalPERS AGAINST Votes

Northfield Bancorp Inc.

- **Issue:** Provision requiring a Supermajority Vote
- **Reason:** CalPERS believes shareowners should not be subject to Supermajority Voting thresholds.
- **Vote Result:** 24% AGAINST

Hovnanian Enterprises Inc.

- **Issue:** Authorization of Dual Class Stock
- **Reason:** CalPERS is a firm supporter of the concept of one share one vote.
- **Vote Result:** 15% AGAINST

Hewlett Packard Co.

- **Issue:** Elect Directors
- **Reason:** Withhold from directors R. Lane, J. Hammergren, and K. Thompson and others due to oversight failures at the company.
- **Vote Result:** After high vote opposition R. Lane (41% Against) will step down from his chairmanship. Both J. Hammergren (46% Against) and K. Thompson (45% Against) also announced they will leave the board.

International Proposals
Examples of CalPERS AGAINST Votes

Randstad Holding

- **Country**: Netherlands
- **Issue**: Share issuance with unequal voting rights
- **Reason**: CalPERS is a firm supporter of the concept of one-share-one vote.
- **Vote Result:** 93% FOR

Thomas Cook Group

- **Country**: Switzerland
- **Issue**: Remuneration Report
- **Reason**: CalPERS has concerns the company has not adequately linked pay and financial performance.
- **Vote Result:** 70% FOR

Chemring Group Plc

- **Country**: United Kingdom
- **Issue**: Authority to set General Meeting Notice at 14 days
- **Reason**: CalPERS believes this reduced timeframe may not allow shareowners sufficient time to review voting matters.
- **Vote Result:** 93% FOR

Canon Electronics Inc.

- **Country**: Japan
- **Issue**: Elections of Statutory Auditors
- **Reason**: Withhold vote from director nominee Tatsuya Kawana. CalPERS believes a majority of the statutory auditors should be independent.
- **Vote Result:** Pending

Yamaha Motor Co. Ltd

- **Country**: Japan
- **Issue**: Takeover Defense Plan
- **Reason**: CalPERS believes the authority to issue warrants as a takeover defense plan is not in shareowners best interests.
- **Vote Result:** Pending

Shareowner Proposals
Examples of CalPERS FOR Votes

Walt Disney Co.

- **Issue**: Request to adopt Proxy Access
- **Reason:** CalPERS believes shareowners should have effective access to the director nomination process.
- **Vote Result:** 35% FOR

Johnson Controls Inc.

- **Issue**: Request for an Independent Board Chairman
- **Reason**: CalPERS believes if the Board Chair was independent the Board may be able to exercise stronger oversight of management.
- **Vote Result:** 30% FOR

Toll Brothers Inc.

- **Issue:** Request to Adopt Majority Vote for Director Elections
- **Reason:** CalPERS believes a majority of the proxies cast should be required to elect a director.
- **Vote Result:** 44% FOR

Rock-Tenn Co.

- **Issue**: Declassify the Board of Directors
- **Reason**: CalPERS is a firm supporter of annual director elections.
- **Vote Result:** 86% FOR

Hewlett Packard Co.

- **Issue**: Stock Retention Requirements
- **Reason**: CalPERS is a firm supporter of holding and stock retention requirements.
- **Vote Result:** 28% FOR

Shareowner Proposals
Examples of CalPERS AGAINST Votes

Apple Inc.

- **Issue**: Regarding Formation of a special Human Rights Committee
- **Reason**: CalPERS is a firm supporter in the protection of human rights. However, the company's current policy and board level oversight address the request.
- **Vote Result:** 5% FOR

Whole Foods Market Inc.

- **Issue**: Regarding Adoption of Extended Producer Responsibility
- **Reason**: CalPERS believes the proponent's request on the topic is unneccessary due to the company's existing policies.
- **Vote Result:** 12% FOR

Starbucks Corp.

- **Issue**: Eliminate Electioneering Expenditures
- **Reason**: CalPERS believes board oversight and disclosure of political contributions and activities benefit shareowners. However, we feel the proponent's request to eliminate the practice is unessesary.
- **Vote Result**: 3% FOR

Executive Compensation Proposals
Examples of CalPERS FOR Votes

Qualcomm Inc.

- **Issue**: Amend Long-Term Stock Incentive Plan
- **Reason**: Proposal is in line with CalPERS Global Principles of Accountable Corporate Governance. The plan is performance based and awards vest over a three year period.
- **Vote Result**: 84% FOR

Deere & Co.

- **Issue**: Say on Pay
- **Reason**: Proposal is in line with CalPERS Global Principles of Accountable Corporate Governance. The company has structured a compensation program with a pay-for-performance discipline.
- **Vote Result**: 96% FOR

Intuit Inc.

- **Issue**: 2011 Cash-Based Incentive Plan
- **Reason**: Proposal is in line with CalPERS Global Principles of Accountable Corporate Governance related to annual incentive awards.
- **Vote Result**: 97% FOR

Executive Compensation Proposals
Examples of CalPERS AGAINST Votes

Keynote Systems Inc.

- **Proposal**: Say-on-Pay
- **Reason**: The company has failed to link pay with performance.
- **Vote Result**: 86% FOR

Alico Inc.

- **Issue**: Long-term Incentive Plan
- **Reason**: The company allows for re-load stock options.
- **Vote Result**: 98% FOR

Spartech Corp.

- **Issue:** Advisory Vote on Golden Parachutes
- **Reason**: The presence of a single trigger related to a change in control.
- **Vote Result**: 60% FOR

Mergers & Acquisitions Votes Cast

Alliance Financial Corp.

- **Aquirer**: NBT Bancorp Inc.
- **Reasons**: Strategic board rationale, positive market reaction and premium offered. CalPERS had a position in both securities.
  Vote Result: 98% FOR

Warnaco Company Inc.

- **Aquirer**: PVH Corp.
- **Reasons**: Strategic board rationale, positive market reaction, and premium offered. CalPERS had a position in both securities
- **Vote Result**: 92% FOR

TNS Inc.

- **Aquirer**: Trident Private Holdings LLC
- **Reasons**: Positive market reaction and premium offered. Going private transaction.
- **Vote Result**: 99% FOR

How to Engage Shareholders When Selecting New Directors

Clarity, respect and communication—the hallmarks when CalPERS and UnitedHealth collaborated to add a director to the company's board.

By Michele Hooper and Anne Simpson

Michele Hooper is an independent director for UnitedHealth Group and chairs the nominating and corporate governance committee. Hooper also serves on the board of NACD. Anne Simpson is senior portfolio manager of investments and director of corporate governance at CalPERS.

One of the most important responsibilities assigned by a board of directors to its nominating and corporate governance committee is the job of finding, vetting and nominating candidates to become new directors. The competency, appropriate skills, experience and compatibility of directors is of critical importance to the successful oversight of every public company. The election of directors to the board is also viewed as a fundamental right of shareholders, meant to help ensure the board's accountability. It is no surprise then that greater shareholder participation in the selection of director candidates and the nominating process is a high-visibility corporate governance issue, one that can often be a source of contention between boards and shareholders.

As part of the settlement of certain litigation, UnitedHealth Group and CalPERS reached an agreement: UnitedHealth would further open to shareholders the process to select a new member to its board of directors. UnitedHealth and CalPERS worked together to develop a protocol that respected the responsibilities and role of the board's nominating and corporate governance committee in identifying, vetting and nominating a director candidate, while allowing for significant and meaningful participation by shareholders. CalPERS was engaged by the company as an active participant in the board's process with the responsibility of voting its consent to the director candidate chosen through this process once the board's deliberations were complete.

Our purpose here is to describe our shared experience and the foundation of best practices that enabled us to work well together. We particularly want to highlight those approaches that allowed us to keep the process moving forward successfully in an atmosphere of collaboration and cooperation, rather than confrontation.

The Process Matters

First and foremost, it is necessary to establish clear steps supported by consensus and move forward at a deliberate pace. This will result in a more positive outcome for all of a company's constituents. It is better to let such a process run its natural course rather than rushing to meet artificial deadlines.

Communication should adhere to a regular, frequent schedule and not be left to happenstance or initiated only when there is pressing need for information. It is also important to have the right people actively engaged and leading the process. (Each of our meetings involved both of the authors.) This free flow of information and the frequent exchange between CalPERS and UnitedHealth built a framework of trust that was critical to our joint success. Regular updates also allowed us to identify and correct misunderstandings quickly before they could inadvertently undermine the trust and cooperative spirit that was being built.

Respect, Communicate

UnitedHealth embraces regular communication with shareholders' and believes in the positive effects of soliciting their perspectives. In 2006, prior to the agreement with CalPERS, UnitedHealth's board established a nominating advisory committee comprised of four individuals associated with shareholders and one member of the medical community. The nominating advisory committee provides a forum through which shareholders can participate in the search for director candidates by the board, as well as a means to broaden the

pool of potential director candidates. This committee (1) provides input on the director skills matrix developed by the nominating and corporate governance committee, (2) suggests potential candidates for consideration by the nominating and corporate governance committee and (3) reviews and provides feedback on qualifications of candidates under consideration by the nominating and corporate governance committee. The nominating advisory committee has met with UnitedHealth's chairman of the board, the chair of the nominating and corporate governance committee and the CEO of the company once or twice a year since late 2006.

The Skills Matrix

In devising a process with CalPERS, the natural starting point for the director search was a thorough review of the skills matrix that had been previously created by the nominating and governance committee. The purpose of UnitedHealth's skills matrix is to assist the corporate governance and nominating committee in considering the appropriate balance of experience, skills and attributes required of a director and to be represented on the board as a whole. It was developed after considering the company's near and long-term strategies and identifies skills and attributes that assist the board in exercising its oversight function.

A well-designed skills matrix can only occur if the company's overall business strategy is well understood and the necessary skills for board members who, of course, must oversee the attainment of those business goals are included in the skills matrix. We found that a robust discussion with shareholders about the board-level skills necessary to help the company achieve its long-term strategies and consideration of shareholders' feedback from those discussions provides valuable input to the corporate governance and nominating committee. At a minimum, a clearer understanding among shareholders of where the company is going and how it intends to get there leads to broader consensus on the skills to be sought in candidates for the board.

The skills matrix must be considered a living document that is regularly reviewed, updated and compared to the skills of the current board members. Markets evolve, business needs change and a company—including its board of directors—must remain nimble enough to respond quickly and efficiently to new demands and shifting market priorities. UnitedHealth's skills matrix has two sections—a list of core criteria that every member of the board should meet and a list of skills and attributes desired to be represented on the board as a whole, with a goal of having members of the board possess one or more of the collective skills and attributes listed. The skills matrix is periodically reviewed and updated by the corporate governance and nominating committee as necessary.

Before the skills matrix was finalized, it was reviewed with the members of the nominating advisory committee and CalPERS along with a few other key shareholders for their views on whether the skills reflected on the matrix adequately captured the skills necessary for oversight of our business on both a near- and long-term basis.

Next, current directors were plotted on the matrix, providing a useful picture of the board's overall strengths and those areas of expertise where the company could use the talents and experience of new directors. These focus areas and skill sets were discussed with the shareholder nominating advisory committee and CalPERS.

In fact, the committee and CalPERS, in separate consideration of the skills needed for successful oversight, not only largely agreed on the overall core criteria for directors, but also came to the same conclusions when considering the skills to be sought in the newest member of the board.

Identifying the Best Candidates

Development of the skills matrix assured that the qualifications—not the identity—of the candidate became the driving consideration for selection in our process. The nominating and governance committee and CalPERS agreed that neither side was determined to place "their guy" on the board, but rather to find the best person

Ongoing Work Between CalPERS, UnitedHealth Group

The engagement between CalPERS and UnitedHealth Group and the exchange of ideas and approaches on director selection were highly productive for both organizations. Among the best practices learned and put to the test are:

- Establish a straightforward process with clear, incremental steps, agreed to by consensus;
- Don't rush things, but move steadily forward;
- Focus on selecting the best candidate and don't set artificial deadlines;
- Maintain communication, regularly and frequently;
- Make sure shareholders have a comprehensive understanding of the company's near and long-term business goals and its strategy for reaching those goals;
- Establish a skills matrix that accurately reflects the board's requirements for effective oversight;
- Carefully consider shareholders' perspectives and insight on choosing director candidates; and
- Conduct a thorough search through traditional channels while remaining open to a broad range of qualified candidates who can bring fresh perspectives to the board.

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for the position based on the company's needs as illustrated by the skills matrix. In our search, we agreed on the importance of several skills, including experience in consumer marketing and with technology.

The rising importance of consumerism in health care and the need to interact and engage with individuals, as both consumers and patients—when, where and how they wish to engage—is opening new markets and new channels for the company's UnitedHealthcare benefit offerings. UnitedHealth's business strategy in expanding ira Optum health services platform is based on a balanced combination of internal innovation and development and acquisition of established businesses. Oversight of these activities requires strong director competencies in consumer marketing and technology. Given the complexity of our business, both UnitedHealth and CalPERS agreed that it was important to consider a diverse slate of candidates and that only those candidates with the most impeccable records of service and highly desirable industry backgrounds would be considered. While prior board experience was not a prerequisite, familiarity with highly complex business organizations was.

Selecting Finalists

The board committee considered shareholder suggestions and conducted a thorough search through more traditional channels as well. While the nominating and corporate governance committee was developing a slate of potential candidates, UnitedHealth and CalPERS had regular meetings to discuss the characteristics and skills of the potential candidates under consideration. The nominating and corporate governance committee then subjected all candidates to a vigorous screening process that included:

- Review of qualifications against the skills matrix
- Assessment of interest and the availability of potential qualified candidates
- Personal interviews with qualified candidates by relevant board members

Once UnitedHealth's nominating and corporate governance committee identified finalists for the position, they were discussed with the advisory committee and other shareholders (privacy and other considerations precluded sharing the exact identity of candidates). The nominating and corporate governance committee considered feedback from all of these channels in identifying a finalist candidate. After CalPERS signed a confidentiality agreement, executives from the fund interviewed the candidate identified as the finalist, whose business experience provided expertise in technology and consumer marketing and an institutional investor perspective. In order to accommodate various schedules, the authors flew to New York to meet with the candidate at UnitedHealth's offices; Peter Mixon, CalPERS general counsel, participated by video conference. Following that interview, CalPERS notified UnitedHealth of its support for the candidate. With shareholders' opinions and information in hand, the nominating and governance committee then fulfilled its fiduciary duty to shareholders and the company by making the final decision on the nomination.

Positive Proof

Perhaps the best proof of the efficacy of this process is in the final results. In the last four years, UnitedHealth has added five new directors to its board, and each new director appointment has been overwhelmingly approved by annual shareholder votes. The company is delivering a high level of performance for shareholders growing strongly in the face of difficult challenges to the U.S. and world economies, and growth is expected to continue over the next decade.

The Big Idea

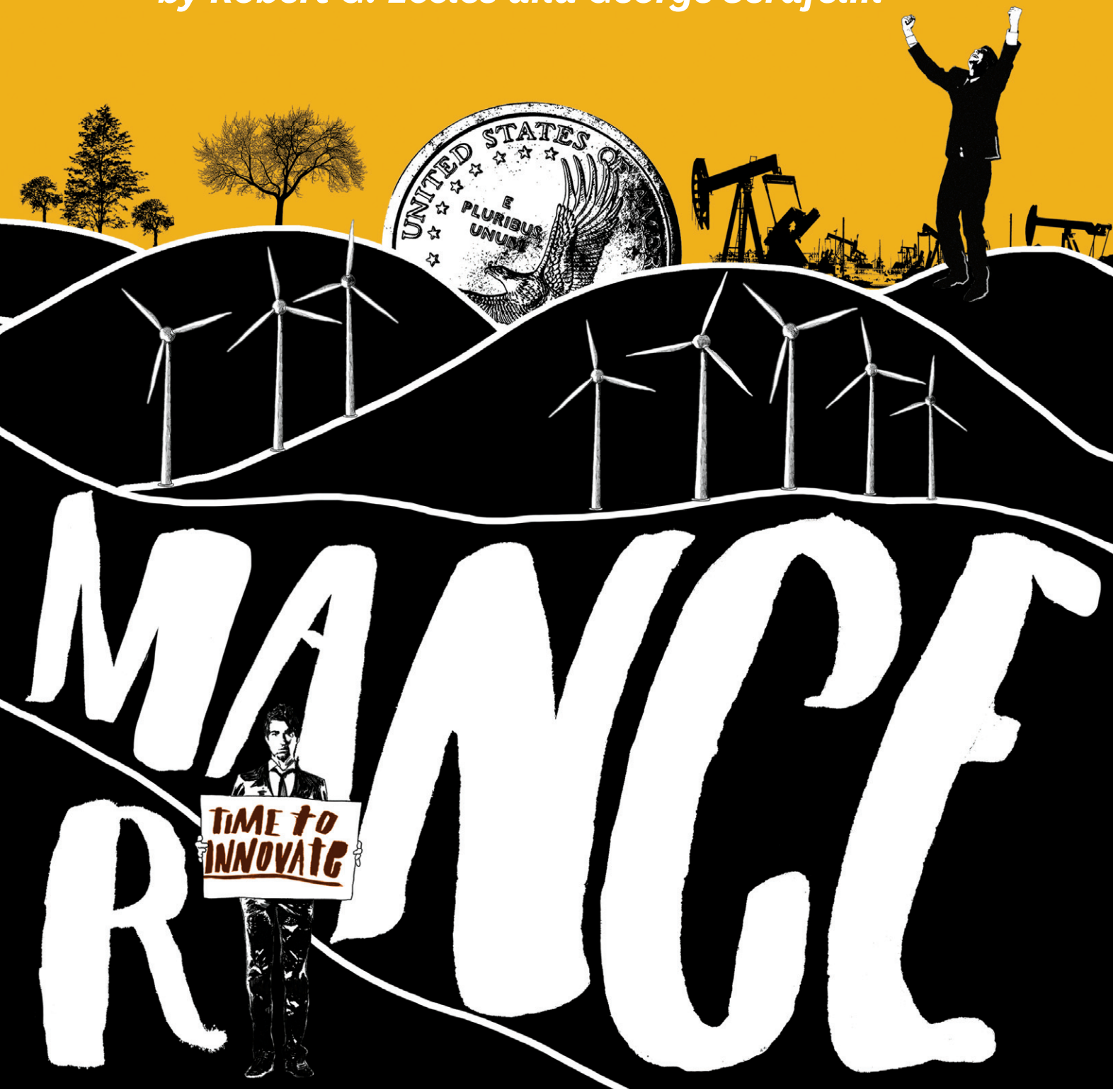
Robert G. Eccles is a professor of management practice at Harvard Business School and the chairman of the Sustainability Accounting Standards Board.

George Serafeim is an assistant professor of business administration at Harvard Business School and a member of the SASB Standards Council.

THE PERFORMANCE FRONTIER

Innovating for a sustainable strategy

by Robert G. Eccles and George Serafeim



By now most companies have sustainability programs. They're cutting carbon emissions, reducing waste, and otherwise enhancing operational efficiency. But a mishmash of sustainability tactics does not add up to a *sustainable strategy*. To endure, a strategy must address the interests of all stakeholders: investors, employees, customers, governments, NGOs, and society at large.

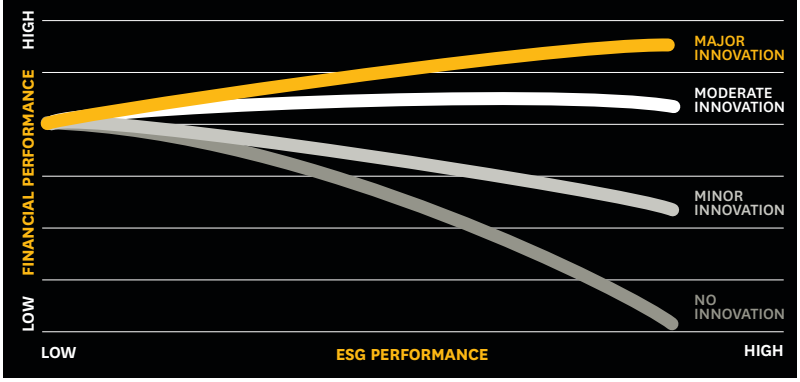
To do that, it has to increase shareholder value while at the same time improving the firm's performance on environmental, social, and governance (ESG) dimensions.

Companies understand this, but too often they launch programs with the hope that they'll be financially rewarded for "doing good," even when the issues they address aren't relevant to their strategy and operations. Largely missing from these efforts is a clear understanding of the very real trade-offs that exist between financial and ESG performance. Improving one typically comes at a cost to the other. While using expensive solar energy is good for the environment, it's often bad for the bottom line; paying workers above-market wages benefits the community but eats into profits. The capital markets know this only too well. As a result they don't reward firms for ESG programs that fail to enhance financial performance, and they punish those whose programs—relevant or not—depress financial results.

In this article we examine the trade-offs and provide a framework for creating sustainable strategies that—by definition—simultaneously boost both financial and ESG performance. It requires companies to do two things: focus strategically on the most "material" ESG issues—the ones that have the greatest impact on the firm's ability to create shareholder value; and produce major innovations in products, processes, and business models that prioritize those concerns.

THE PERFORMANCE FRONTIER

In the absence of substantial innovation, the financial performance of firms declines as their environmental, social, and governance (ESG) performance improves. To simultaneously improve both kinds of performance, they need to invent new products, processes, and business models.



SOURCE AUTHORS' ECONOMETRIC ANALYSIS OF MORE THAN 3,000 ORGANIZATIONS

Innovation and Performance

The penalties for ignoring ESG issues can be harsh. Foxconn, Apple's manufacturer in China, was reminded of this in 2010, when revelations about the deplorable working conditions in its factories unleashed a firestorm of bad press and ultimately halved its market cap. BP is still mopping up after the catastrophe on its *Deepwater Horizon* oil rig in the Gulf of Mexico—as much a managerial as an engineering disaster. And the banking giant UBS learned—after an estimated $200 billion outflow of private client assets, fines of $780 million, and pressure from national governments to disclose clients' names—that in the age of transparency, hiding behind Swiss secrecy laws is not a good strategy.

In each case the company prioritized financial over ESG performance, putting controls in place to prevent similar debacles only after the fact. Misguided decisions like these are made because the costs of negative externalities (external consequences of the company's activities), such as pollution or abusive labor practices, are often borne by society, to the benefit of shareholders. Conversely, activities that help society, such as voluntarily reducing emissions or investing in youth education initiatives, often create costs for the firm.

ILLUSTRATION: PETER STRAIN

Idea in Brief

Investments in sustainability programs often require trade-offs in companies' financial performance, but this doesn't have to be. By strategically focusing on the environmental, social, and governance (ESG) issues that are the most relevant—or "material"—to shareholder value, firms can simultaneously boost both financial and ESG performance. Firms must do four things to achieve this:

- Identify which ESG issues are most critical in their particular business. Materiality Maps that the Sustainability Accounting Standards Board is creating for 88 industries can aid this process.
- Quantify the financial impact that improvements on those issues would have.
- Undertake major innovation in products, processes, and business models to achieve the improvements.
- Communicate with stakeholders about those innovations. Integrated reporting, which combines financial and ESG performance information in one document, is an effective way to do this.

To facilitate the process, companies must break down barriers to change—namely, incentive systems and investor pressure that emphasize short-term performance; a shortage of required expertise; and capital-budgeting limitations that fail to account for projects' environmental and social value.

The exhibit on the previous page presents a conceptual model of this relationship. We developed this model through interviews, surveys, and several years of field research involving hundreds of companies across numerous sectors. Financial performance, as gauged by revenues, profit margins, stock price, and other metrics, is plotted on the Y axis; ESG performance, represented by lower carbon emissions and waste, fair labor practices, effective risk management, and other metrics, is captured on the X axis. The slope of a line (what's shown represents a composite picture of more than 3,000 companies from 2002 to 2011) reveals the relationship between financial and ESG performance. The steeper the line's downward slope, the greater the negative impact a firm's ESG improvements have on financial performance; the steeper the upward slope, the greater the positive impact such improvements have. We call this line "the performance frontier."

Because of limitations on the measurement of ESG performance and the presence of myriad confounding variables such as leadership style and company culture, it is not yet possible to plot a precise graph for any single company. But our econometric analyses of 3,000-plus organizations confirm that if companies innovate, they can simultaneously improve ESG and financial performance and move the trajectory of the frontier line upward.

Pushing the Frontier

While minor innovations, such as efficiency improvements, can nudge a downward-sloping performance frontier up a bit, only major innovations in products, processes, or business models can shift the slope from descending to ascending. Such innovations are high risk, involving large-scale investments and long payback periods (often of five years or more). Typically, they concern a bundle of related ESG issues and tackle significant, unsolved challenges in a sector.

Four broad initiatives are required to develop the kind of innovation programs that create a sustainable strategy.

1 IDENTIFY MATERIAL ESG ISSUES

The list of ESG concerns that could have a large impact on financial performance is long and broad. It ranges from emissions, water and energy use, and waste management to labor practices, community development, employee safety, and executive compensation. Whether an issue significantly affects a company's ability to create long-term shareholder value depends on both the sector the firm operates in (carbon emissions are more material for a coal-fired utility than for a bank) and its particular strategy (human rights are more material for a company using low-cost labor in developing countries than for a firm using skilled workers in developed countries).

The Sustainability Accounting Standards Board (SASB), where one of us (Bob) is chairman and the other (George) is a member of the Standards Council, is currently devising a framework to help companies determine their material ESG issues. The nonprofit is developing standards for use by public corporations in disclosing performance on dozens of ESG measures. Central to the project is the creation of Materiality Maps for 88 industries in 10 sectors. Each map prioritizes 43 ESG issues, ranking their materiality for a given industry on a scale from 0.5 to 5, with 5 being most material. The higher the score for an issue, the greater its probable impact on a firm's financial performance. At press time, SASB had completed maps for two sectors and 13 industries; new sector maps are expected to become available approximately every three months.

Materiality is assessed through a rigorous process that examines "evidence of interest" by search-

ing thousands of source documents, from 10-Ks to media reports, for ESG keywords; and "evidence of economic impact" by evaluating whether management (or mismanagement) of the issue will affect valuation parameters such as revenue growth and return on capital. (See the sidebar "How to Determine 'Materiality.'")

The "Which Issues Matter Most?" exhibit contains a map for the health care sector and ranks ESG dimensions for six industries. The most material ESG issues are shaded in a darker color. You can see that in the biotechnology industry, for instance, product quality and safety are paramount, whereas regulatory issues, access to services, and customer satisfaction are among the most important issues for managed care providers. Conversely, fuel management is hardly material at all in the biotech industry (although it is quite material in health care distribution), while supply chain standards are less material for health care distribution (although they are quite material in biotech).

If a Materiality Map isn't available for an industry, a company can join the SASB Industry Working Group for its sector to see the analysis under way and engage with shareholders and other stakeholders to develop a general sense of the relevance of various issues.

2 QUANTIFY THE RELATIONSHIP BETWEEN FINANCIAL AND ESG PERFORMANCE

Once you understand your firm's material ESG issues, assess the impact that improvements in each would have on financial performance. Such performance has many dimensions, of course. Depending on the company's strategy and the issue being considered, the most important dimension could be cost reduction, revenue growth, or gross margin defense.

In its "Plan A" sustainability program, the British retailer Marks & Spencer evaluated 180 ESG initiatives ranging from becoming carbon neutral to improving employee health, looking at how they'd affect sales, costs, the brand, employee motivation, and the resilience of the business. With some the impact was easy to measure; with others it wasn't. In some cases the trade-offs between financial and ESG performance were clear. Because many initiatives required investments, Marks & Spencer conducted return-on-investment analyses to determine which projects to devote more resources to.

A host of factors complicate evaluations of the relationship between ESG and financial performance. Not the least of them are limitations on the ability to precisely measure ESG performance—a challenge that SASB and others are working to address. Nevertheless, companies can make an informed estimate of the slope of the performance-frontier curve for any pair of ESG and financial variables by determining whether each incremental improvement in ESG performance causes a corresponding positive or negative change in financial results—or has no impact.

3 INNOVATE PRODUCTS, PROCESSES, AND BUSINESS MODELS

The analyses you've done will provide the foundation for your innovation strategy. Once you know which ESG issues to focus on, you should determine how the firm compares with its peers on them. Trade associations and the trade press can be useful resources for this. If your firm's performance in an area—say, energy use or labor practices—falls short of industry benchmarks, getting it up above par is a first priority. At the very least it will mitigate your risks, since stakeholders tend to focus on industry laggards in campaigns aimed at increasing corporate ESG performance. Many improvements, such as reducing manufacturing waste, involve minor or moderate innovations that can enhance efficiency and, therefore, financial performance. Those sorts of innovations are increasingly necessary (but not sufficient) to ensure competitiveness.

Addressing the most significant trade-offs between financial and ESG performance—challenges that are often unsolved in a sector—requires major, organization-wide innovation: entirely new products, processes, and business models that improve performance in "bundles" of material issues. Developing a single product or process innovation to address a specific issue may be part of the solution but in and of itself won't shift the performance frontier for the company as a whole.

Consider the cases of three very different companies that have instituted the kind of broad initiatives we're talking about:

Natura. The Brazilian cosmetics and fragrances company has implemented a major process innovation that supports its pioneering management culture and business model. For fiscal year 2002, Natura issued its first integrated annual report, which captured financial as well as environmental and so-

How to Determine "Materiality"

The Sustainability Accounting Standards Board (SASB) has identified five broad categories of environmental, social, and governance (ESG) issues that can affect a firm's financial performance and therefore be highly material to investors. The materiality of any issue varies from one industry to the next, however.

To gauge it within an industry, SASB evaluates evidence of interest by different types of stakeholders and evidence of economic impact. Companies can use a similar approach to find out which ESG issues are most material to their investors if SASB assessments for their industry are not yet available.

EVIDENCE OF INTEREST is determined by searching tens of thousands of source documents using keywords. The results reveal the intensity with which issues arise in each industry. The documents examined include Form 10-Ks, legal news, CSR reports, shareholder resolutions, media reports, and innovation journals.

EVIDENCE OF ECONOMIC IMPACT is determined by evaluating both anecdotal reports and quantitative studies to gauge whether management (or mismanagement) of the issue will affect traditional corporate valuation parameters: revenue growth, return on capital, risk management, and management quality.

A FORWARD-LOOKING ADJUSTMENT acknowledges an emerging issue that is not yet reflected in these evidence-based tests. In a small number of cases, SASB may make an adjustment to raise the importance of an issue if the management (or mismanagement) of it might create positive or negative effects that other stakeholders, industries, or generations will have to deal with, or if there is the potential for systemic disruption. In any case, the effects must be reasonably likely to occur and of significant magnitude to be deemed material.

cial performance. Natura was among the first companies in the world to make this shift, long before the practice had gained currency through the work of organizations like the International Integrated Reporting Council (the IIRC, where Bob is a council member). The company saw integrated reporting as the best way to signal its management's focus on environmental and social stewardship and to ensure leadership's commitment to those goals.

In addition, the company has tied managers' performance ratings and bonuses to environmental and social goals as well as financial results, so that decision making will be guided by all three types of measures. The company also pays close attention to stakeholders, formally seeking input from investors, customers, and employees on decisions that affect their interests. Indeed, Natura's business model is predicated on a particular form of engagement: Its sales force of 1.4 million "consultants" share in the firm's profits and serve as emissaries for the brand and conduits for customer and community feedback.

Natura's performance showcases the impact of its management culture, business model, and innovativeness in both products and processes. (In 2011, *Forbes* ranked Natura among the top 10 most innovative companies.) In Brazil, Natura—which launched 435 new products from 2009 to 2011—has a leading market share of 23.2% (greater than Unilever's or Avon's), a 62% household penetration rate, and nearly 100% brand recognition. From 2002 to 2011 the firm's revenues grew by 463% and its net income by 3,722%, and the company had an average gross margin of 68%, compared with the industry average of 40%. In 2010, the company's return on assets (24.7%) and return on equity (62.1%) also far surpassed industry averages. Financial analysis shows that the company's high profitability was driven by exceptional operating performance and not by financial leverage. Since 2002, Natura has significantly reduced its greenhouse gas emissions and water consumption, developed more environmentally friendly packaging, and provided training and education opportunities to about 560,000 consultants.

Dow Chemical Company. Dow has suffered ferocious public criticism of its environmental record, including outcries over its manufacture of the defoliant Agent Orange and the dioxin contamination near its Midland, Michigan, facilities. To understand and respond to stakeholder concerns, in 1992 the company recruited a group of leading scientists and policy experts to form an advisory body charged with challenging the firm on its environmental goals and processes. Among other things, the experts recommended that the company shift its focus from how to get rid of waste to eliminating waste altogether.

Dow ultimately embraced aggressive waste-reduction targets and to that end launched two decades' worth of massive innovation in new products, such as solar-cell shingles, and processes, including new health and safety procedures that drastically re-

duced the number of leaks, breaks, and spills. As Dow improved its sustainability performance, its strategy evolved to include helping its customers address their own environmental challenges—a $350 billion market opportunity. In every year since 2009, EBITDA that is directly attributable to new-product innovation has exceeded $400 million at Dow. It hit $1 billion in 2012 and is projected to reach $2 billion by 2015. The company has also grown the net present value of its R&D pipeline from $5 billion in 1997 to $33 billion in 2011. Innovative new products, many of which offer improved sustainability performance, account for 90% of that pipeline's value.

CLP Group. Electric utilities are in a bind when it comes to optimizing both carbon emissions and financial performance. On one hand, pressure to limit emissions is growing—though inexpensive and dirty coal remains the chief technology for electricity generation. On the other, consumers expect low prices and investors want decent and predictable returns. Complicating matters, the regulatory environment governing carbon emissions is murky at best and varies from country to country.

How can a company meet these conflicting expectations in an uncertain environment? Hong Kong–based CLP Group has found the answer through a business model innovation that gives it unusual agility in balancing renewable and nonrenewable sources of energy generation across regions as regulatory conditions and technologies change. First, it has developed analytic capabilities that allow it to optimize when and how it makes use of low-carbon energy sources, including solar, wind, and hydroelectric power. Second, it has become skilled at responding strategically to the regulatory regimes in its diverse markets. And finally, CLP has learned to monitor new technology developments and figure out how they can make alternative energy sources more viable.

The stock market has recognized the potential of this new and more flexible business model. From 2005 to 2012 CLP's shares outperformed the S&P index of electric utilities by 20 percentage points (48% versus 28%). CLP's price/earnings ratio rose from 17 in 2005 to 24 in 2012—a 41% increase. In contrast, the P/E ratio for the index of electric utilities declined by 10%, from 19 to 17, within the same time period. Because the P/E ratio reflects the expected growth in the firm's earnings and the cost of capital investors need as compensation for their risk, these numbers suggest that investors require a lower cost of capital

WHICH ISSUES MATTER MOST?

SASB's Materiality Maps, like this one for the health care sector, rate how relevant 43 environmental, social, and governance issues in five categories are to shareholders, on a scale from 0.5 to 5.0. The higher the number, the greater the probable impact on a firm's financial performance.

	ESG ISSUES IN HEALTH CARE	BIOTECH	PHARMACEUTICALS	MEDICAL EQUIPMENT & SUPPLIES	HEALTH CARE DELIVERY	HEALTH CARE DISTRIBUTION	MANAGED CARE
ENVIRONMENT	Climate change risk	3.75	3.75	1.25	0.75	0.75	1.00
	Environmental accidents and remediation	0.75	1.25	1.50	1.00	1.00	0.75
	Water use and management	1.00	1.25	1.25	1.00	1.00	1.00
	Energy management	2.25	2.50	2.25	3.75	1.00	1.75
	Fuel management and transportation	0.50	0.75	0.75	0.50	2.25	0.50
	GHG emissions and air pollution	1.00	1.00	1.75	1.00	1.00	1.00
	Waste management and effluents	3.00	3.00	2.50	2.25	1.25	0.75
	Biodiversity impacts	1.00	0.75	1.00	1.25	1.00	1.00
SOCIAL CAPITAL	Communications and engagement	1.00	1.00	0.75	1.00	0.50	1.25
	Community development	0.50	0.75	0.75	1.75	1.25	0.50
	Impact from facilities	0.50	1.00	1.00	4.00	1.25	1.00
	Customer satisfaction	0.75	0.75	1.00	2.25	1.00	3.00
	Customer health and safety	5.00	5.00	3.00	3.00	1.50	2.50
	Disclosure and labeling	3.00	3.00	2.50	0.75	2.75	0.75
	Marketing and ethical advertising	2.50	2.50	2.50	1.75	2.00	1.75
	Access to services	4.25	4.50	2.50	3.00	3.00	3.00
	Customer privacy	0.75	0.75	1.00	2.25	1.75	2.75
	New markets	3.50	3.75	1.00	0.75	0.75	0.75
HUMAN CAPITAL	Diversity and equal opportunity	1.25	1.25	1.00	1.25	1.25	1.25
	Training and development	3.00	2.75	2.00	2.50	1.50	2.00
	Recruitment and retention	2.25	2.50	1.50	3.00	1.75	1.50
	Compensation and benefits	1.75	1.75	1.50	1.25	1.25	1.00
	Labor relations and union practices	1.75	1.75	1.75	1.25	1.75	1.25
	Employee health, safety, and wellness	2.00	2.00	2.00	2.00	2.50	1.50
	Child and forced labor	0.50	0.75	0.75	0.50	0.50	0.50
BUSINESS MODEL & INNOVATION	Long-term viability of core business	0.75	0.75	0.75	0.50	0.75	3.50
	Accounting for externalities	0.50	0.50	0.50	0.50	0.50	3.00
	Research, development, and innovation	5.00	5.00	4.75	1.00	0.75	0.75
	Product societal value	2.75	3.00	3.00	3.00	0.50	2.50
	Product life-cycle use impact	3.75	3.75	4.50	0.75	2.25	0.75
	Packaging	1.00	1.00	1.00	0.50	0.75	0.50
	Product pricing	2.50	2.50	2.50	2.50	2.50	2.50
	Product quality and safety	5.00	5.00	3.00	5.00	3.00	2.25
LEADERSHIP & GOVERNANCE	Regulatory and legal challenges	3.00	3.00	3.00	3.00	3.00	3.00
	Policies, standards, and codes of conduct	2.50	2.50	2.25	1.00	1.75	1.00
	Shareholder engagement	0.75	0.75	0.75	0.75	0.75	3.00
	Business ethics and competitive behavior	2.50	2.50	2.50	2.50	3.00	2.00
	Board structure and independence	1.25	1.50	1.25	1.50	1.50	1.25
	Executive compensation	1.00	1.00	1.00	0.75	1.00	0.75
	Lobbying and political contributions	0.50	0.75	0.75	1.25	1.00	0.75
	Raw material demand	0.75	0.75	0.75	0.50	0.75	0.50
	Supply chain standards and selection	2.50	2.25	2.25	0.75	0.75	1.00
	Supply chain engagement and transparency	0.75	1.00	0.75	1.00	0.50	0.50

LOWER MATERIALITY HIGHER MATERIALITY

from CLP, since it is doing a better job of walking the tightrope between carbon emissions and economic performance.

4 COMMUNICATE THE COMPANY'S INNOVATIONS TO STAKEHOLDERS

A company cannot assume that shareholders and other stakeholders will understand how its innovations have improved ESG and financial performance—and how the two interrelate—if it fails to communicate effectively. This is more than a matter of public relations; major innovations often require substantial investments whose benefits will not be seen for years to come. If a company expects shareholders to commit for the long term in order to receive those benefits, it needs to provide them with information that justifies their investments. Combining ESG and financial performance information in a single document, as Natura did, is an effective way to do this.

While such integrated reporting remains the exception, it's gaining momentum largely as a voluntary practice around the world—though it is now required of all companies listed on the Johannesburg Stock Exchange. To help promote it, the IIRC published a draft framework for integrated reports in the spring of 2013; it expects to release the final "version 1.0" in December.

As a communications tool, integrated reporting involves more than posting a PDF on a company website. The most effective reporting is as much about listening as talking, and it serves as a key platform for stakeholder engagement. It's a way to establish a conversation that considers a company's performance in a holistic way, identifies the tough trade-offs, and builds a case for innovation and the benefits it can generate. This engagement is also central to eliciting feedback on how well the company is meeting expectations, the quality of its communications, and what it can do to improve them.

Natura, for example, developed a virtual social network called Natura Conecta that invited the public to participate in discussions about corporate responsibility, sustainability, and people's expectations of the company. In the first year more than 8,000 people registered and contributed to the company's integrated reporting process. Participants in the network were invited to create a WikiReport for inclusion in the final integrated annual report.

Finally, integrated reporting enhances discipline. It forces management and employees to think about both the financial and the ESG implications of their decisions and helps spur innovation as they seek to improve both kinds of performance.

Organizational Barriers to Change

Though the imperative for developing a sustainable strategy is clear, the process often isn't. In interviews with more than 200 executives and in-depth research on 30 companies engaged in the process, we've identified four barriers to change that must be overcome:

Short-term incentives. Many employees, including senior managers, are rewarded for short-term performance. Because addressing most sustainability issues requires a long-term outlook, firms' incentive structures often undermine their ability to improve on ESG measures. Moreover, employees are frequently given incentives to boost the performance of their division or unit, but not corporate-wide performance. This also works against ESG improvement as it discourages the cross-division collaboration that's essential to innovation.

As a firm that produces major commodities such as aluminum, copper, iron, coal, oil, and gas, BHP Billiton understands the business risks environmental mismanagement poses, and so has structured corporatewide executive compensation to protect its license to operate. In 2011 the company adopted a balanced scorecard approach for its ESG metrics, which include fatalities, environmental incidents, HSE (health, safety, and environment) risk management, human rights impact assessment, and environmental and occupational health. Fifteen percent of executives' short-term incentives are now based on delivering on goals in those areas. (Though short-term, the incentives are designed to improve long-term ESG performance.) According to the company, linking remuneration to ESG performance has had a significant impact. For example, the amount of greenhouse gas the firm emitted per unit of energy consumed fell by 16% from 2006 to 2012, and in 2012 Billiton recorded its lowest injury rate in more than a decade.

Shortage of expertise. New strategies that address environmental and social challenges often require new skill sets. When CLP realized it had to diversify its energy sources away from fossil fuels to include more hydroelectric, wind, and solar power, it had to recruit dozens of engineers with capabilities in those technologies. The new talent helped CLP increase the percentage of electricity from renewable sources that it delivers to customers from less than 1% in 2004 to 18% in 2011.

What Is a License to Operate?

In discussions about corporate sustainability, the concept of a firm's "license to operate" frequently arises, as does the potential for that license to be diminished or even lost.

The State is the ultimate source of a corporation's charter, which is where the license to operate begins. More broadly, the license is granted by society and represents a continuum of permission to do business. Customers have to be willing to buy the firm's products, suppliers to provide the materials the company needs to make them, and people to go to work there. Changing social expectations, such as those about firms' responsibility for the environment and for their communities, can threaten the company's license. These expectations are typically represented by nongovernmental organizations, which may put pressure on a company in a variety of ways (boycotts, social media campaigns, and lawsuits, for example). If the company refuses to change its behavior, and NGO activity induces customers, suppliers, and employees to stop engaging with the company or the State takes action (such as levying fines), the firm's ability to compete erodes. The license, though not literally revoked, is diminished—a situation no firm wants to find itself in.

Capital-budgeting limitations. The long-term investments that most sustainability improvements require make them unattractive to corporations that apply high discount rates in calculating projects' net present values. Companies need to consider an expanded definition of value that takes into account the environmental and social worth of a project and what that means for a company's brand, ability to attract employees, and license to operate.

At Natura, senior vice president of finance Roberto Pedote and his team are working to develop a valuation model that more explicitly incorporates ESG factors. In one instance the company assessed a policy that would encourage managers to hire a significant number of people with handicaps at a new distribution center. While the financial costs of this policy were relatively easy to determine, the value to society, the value from increased employee morale and long-term productivity, and the positive impact on Natura's reputation and brand were harder to quantify. Ultimately, Natura determined that the policy was a good investment. According to João Paulo Ferreira, vice president for operations and logistics, equipment at the center is undergoing adjustments to accommodate employees with physical and cognitive disabilities. The first group of employees hired under the new policy have been trained and are now working at the facility.

Organizations that develop the tools to accurately incorporate nonfinancial metrics into their valuation methods and capital-budgeting processes will better understand the relationship between ESG and financial performance. Without such tools, firms will find it difficult to shift the slope of the performance frontier.

Investor pressure. A company developing a sustainable strategy needs to attract farsighted investors that support this goal. Unilever, under CEO Paul Polman, achieved this by ceasing quarterly earnings guidance in 2009. The move sent a strong signal that the company wanted investors who were interested in the firm's long-range prospects and would not put its strategy at risk by demanding maximum short-term profitability.

Our research shows that through focused communications and integrated reporting, a company can actually increase its proportion of long-term investors. By analyzing the language that executives use during conference calls with sell-side analysts, for example, George has been able to document that companies with more long-term-oriented communications tend to attract more investors who are in it for the long haul.

TODAY CORPORATIONS are larger than ever: Just 1,000 businesses now account for half of the total market value of the world's 60,000 public companies. As they grow, firms will be under increasing pressure to devise sustainable strategies, creating economic value in ways that are consistent with the interests of customers, employees, and society at large. The organizational and management tools for accomplishing this, such as Materiality Mapping and integrated reporting, are still evolving and will be refined through experimentation and experience.

This vast concentration of economic power gives companies the ability and the responsibility to assume roles that were previously the province of nations. By building sustainable strategies, the world's most influential and innovative firms—perhaps more effectively than nations themselves—can pave the way to a sustainable society, one that meets the needs of the current generation without sacrificing those of generations to come.

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