Sustainable Investment Research Initiative: Review of Evidence

Topic Overview – June 17, 2013

Topic Summary

This topic includes an in-depth discussion of CalPERS Sustainable Investment Research Initiative (SIRI) review of evidence of sustainability research to inform CalPERS development of Investment Beliefs and Total Fund Sustainability Strategy.

Topic Background Information

CalPERS launched SIRI to drive innovative thought leadership to inform and advance our understanding of sustainability factors and the impact they may have on companies, markets, and investment intermediaries from the perspective of a large, global, long-term, and multi-class institutional asset owner.

Sustainability issues range from climate change, labor practices and human rights, to executive compensation. CalPERS has framed this agenda through our sustainable value creation framework built upon the effective management of the three forms of capital: financial, physical and human. This is why we are concerned with environmental, social and governance issues.

Board and staff discussions in relation to the Investment Beliefs development process have highlighted the need for a review of evidence to provide clarity on the definition of sustainability and its potential impact on investment risk and return across the portfolio.

As an investor, we believe that environmental, social, and corporate governance issues can affect the performance of investment portfolios to varying degrees across companies, sectors, regions, and asset classes through time. But what we have lacked is an independent appraisal of the existing body of academic research and an identification of potential gaps for further inquiry.

As part of this important initiative, we partnered with the UC Davis Graduate School of Management (UC Davis) to conduct a comprehensive review of evidence comprising of a bibliography of over 500 academic studies on sustainability factors and seven selected papers, from over 90 submissions, for a rigorous academic debate at the inaugural *Sustainability & Finance Symposium*, co-chaired by Columbia Law School, on June 7, 2013.

Analysis

The Symposium Program Committee, co-chaired by UC Davis and Columbia Law School, comprising of leading scholars, issued a call for papers seeking empirical and theoretical research from academics and investment practitioners in the fields of finance, economics, accounting, law and business that would contribute to a rigorous debate and discussion on sustainable long-term value creation and capital market stability.

The Committee received over 90 submissions and selected seven papers to be presented and debated at the Symposium on June 7, 2013.

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Analysis *Continued*

Program Committee Co-Chairs:

Brad M. Barber
Gallagher Professor of Finance
Graduate School of Management
University of California, Davis

Robert J. Jackson Jr.
Assoc. Professor of Law, Milton Handler Fellow Co-Director, Ira M. Millstein Center for Global Markets and Corporate Ownership Columbia Law School

Program Committee Members:

Rob Bauer Professor of Institutional Investors	Maastricht University
Alon Brav Professor of Finance	Duke University
James Bushnell Associate Professor of Economics	UC Davis Department of Economics
John Core Nanyang Technological University Professor of Accounting	Massachusetts Institute of Technology (MIT) Sloan School of Management
Martijn Cremers Professor of Finance	University of Notre Dame
Roger Edelen Associate Professor of Management	UC Davis Graduate School of Management
Jeff Gordon Richard Paul Richman Professor of Law	Columbia Law School
Yaniv Grinstein Associate Professor of Finance	Cornell University
Nadja Guenster Assistant Professor of Finance	Maastricht University
Harrison Hong Professor of Economics & Finance	Princeton University
Wei Jiang Professor, Finance & Economics Division	Columbia University
Steve Kaplan Professor of Entrepreneurship & Finance	University of Chicago Booth School of Business
Jonathan Karpoff Professor of Finance	University of Washington
Robert Marquez Professor of Finance	UC Davis Graduate School of Management
Andrew Metrick Professor of Finance	Yale University

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Analysis *Continued*

Program Committee Members *Continued*:

Anna Scherbina Associate Professor of Management	UC Davis Graduate School of Management
Laura Starks Chair, Finance Department	University of Texas at Austin
Ayako Yasuda Associate Professor of Management	UC Davis Graduate School of Management

The Symposium convened leading academics and practitioners, including CalPERS senior investment staff. The purpose of this event was to engage in a rigorous technical debate on the findings of the seven presented papers in order to further our understanding of the definitions and relevance of sustainability factors and the impact they may have on long-term value creation from the perspective of a large, global, long-term, and multi-class institutional asset owner.

The Symposium program schedule and research findings are summarized below.

Sustainability & Finance Symposium Program Schedule:

Welcome Steve Currall, Dean, UC Davis Graduate School of Management Anne Stausboll, Chief Executive Officer, CalPERS	
Review of Evidence – Research Papers	
Stakeholder Relations and Stock Returns: On Errors in Expectations and Learning Presenter: Jeroen Derwall Assistant Professor of Finance Maastricht University Discussant: Joey Engelberg Assistant Professor of Finance University of California, San Diego	The authors investigate whether stakeholder information predicted risk-adjusted returns due to errors in investors' expectations and ultimately ceased to do so as attention for such information increased. The stakeholder-relations index was positively associated with long-term risk-adjusted returns, earnings announcement returns, and errors in analysts' earnings forecasts over the period 1992-2004.

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<u>Sustainability & Finance Symposium Program Schedule *Continued:*</u>

<table>
<tr><td>Corporate Social Responsibility and Asset Pricing in Industry Equilibrium

Presenter:
Artem Durnev
Assistant Professor of Finance
University of Iowa

Discussant:
Laura Starks
Chair, Finance Department
University of Texas at Austin</td><td>This paper presents an industry equilibrium model of corporate social responsibility (CSR) and its asset pricing effects. The authors model CSR activities as an investment in higher customer loyalty. The paper tests the model predictions empirically and finds evidence consistent with the following: CSR firms exhibit lower systematic risk and expected returns, systematic risk of CSR firms have increased over time, the ratio of CSR profits to non-CSR profits is countercyclical, and, increased industry CSR adoption lowers systematic risk for non-adopters.</td></tr>
<tr><td>Do Managers Do Good with Other Peoples' Money?

<u>Presenter</u>
Ing-Haw Cheng
Assistant Professor of Finance
University of Michigan

<u>Discussant</u>
Nadja Guenster
Assistant Professor of Finance
Maastricht University</td><td>The authors test the hypothesis that corporate social responsibility is due to managerial agency problems using two identification strategies. They use the 2003 Dividend Tax Cut, which increased the after-tax effective firm ownership for managers. Consistent with the agency view, they find that the tax cut led to a decline in corporate goodness. Second, the authors provide evidence in which shareholder-initiated governance proposals which narrowly passed experienced significantly slower growth in corporate goodness relative to firms in which the proposals narrowly failed.</td></tr>
<tr><td>Active Ownership

<u>Presenter</u>
Elroy Dimson
Emeritus Professor of Finance
London Business School

<u>Discussant</u>
Wei Jiang
Professor, Finance & Economic Division
Columbia University</td><td>This study analyzes the impact of environmental, social, and governance engagements between asset managers and companies. On average, successful CSR engagements give rise to a positive one-year abnormal return of 4.4%, whereas there is no market reaction to unsuccessful CSR engagements. Positive abnormal returns are most pronounced for engagements on the themes of corporate governance and climate change.</td></tr>
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Sustainability & Finance Symposium Program Schedule *Continued:*

Signaling through Corporate Accountability Reporting Presenter James Naughton Assistant Professor of Accounting Information & Management Northwestern University Discussant Todd Henderson Professor of Law University of Chicago	The authors find that CSR expenditures are not charity nor do they improve future financial performance. Rather, firms undertake CSR expenditures in the current period when they anticipate stronger future financial performance.
Corporate Governance and the Environment: Evidence from Clean Innovations Presenter Mario Amore Assistant Professor, Department of Management and Technology Bacconi University Discussant Jonathan Karpoff Professor of Finance University of Washington	This paper presents causal evidence on the importance of corporate governance for the environmental performance of firms. The authors show that worse governed firms patent fewer clean innovations relative to their total innovation effort. They also find that worse governed firms patent more non-green innovations, suggesting that the governance shock affects the composition of innovative activities by inducing a substitution from green to dirty projects.
Do Private Equity Fund Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance Presenter Berk Sensoy Assistant Professor of Finance Ohio State University Discussant Jonathan Berk Professor of Finance Stanford University	This paper studies the relationship between compensation practices, incentives, and performance in private equity using new data that connect ownership structures, management contracts, and quarterly cash flows. The authors find no evidence that higher compensation or lower managerial ownership are associated with worse net-of-fee performance, in stark contrast to other asset management settings. Instead, compensation is largely unrelated to net-of-fee cash flow performance. In addition, the behavior of distributions around contractual triggers for fees and carried interest is consistent with an underlying agency conflict between investors and general partners.

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Sustainability & Finance Symposium Program Schedule *Continued:*

Closing Remarks Joe Dear, Chief Investment Officer, CalPERS Anne Simpson, Senior Portfolio Manager, Director of Global Governance, CalPERS

Benefits & Risks

Benefits:

This inquiry will help staff to define relevant sustainability factors and the impact they may have on companies, markets, and investment intermediaries supporting CalPERS aim to be a principled and effective investor delivering sustainable, risk-adjusted returns.

Risks:

The inability to identify relevant sustainability factors may undermine CalPERS aim to be a principled and effective investor and ultimately CalPERS ability to deliver sustainable, risk-adjusted returns.

Additional Information

Additional information on this topic can be found in the following attachment provided as part of this agenda item:

- Attachment 6 – SIRI: Review of Evidence – Research Findings and Areas for Further Inquiry