

# Review of ESG Strategy Environmental Theme: Climate Change

Investment Committee, March 2016

# Objectives

- Seek Investment Committee's feedback on ESG Strategic Priorities
- Deep dive into climate change plan
- Initial discussion of potential key performance indicators (KPIs)

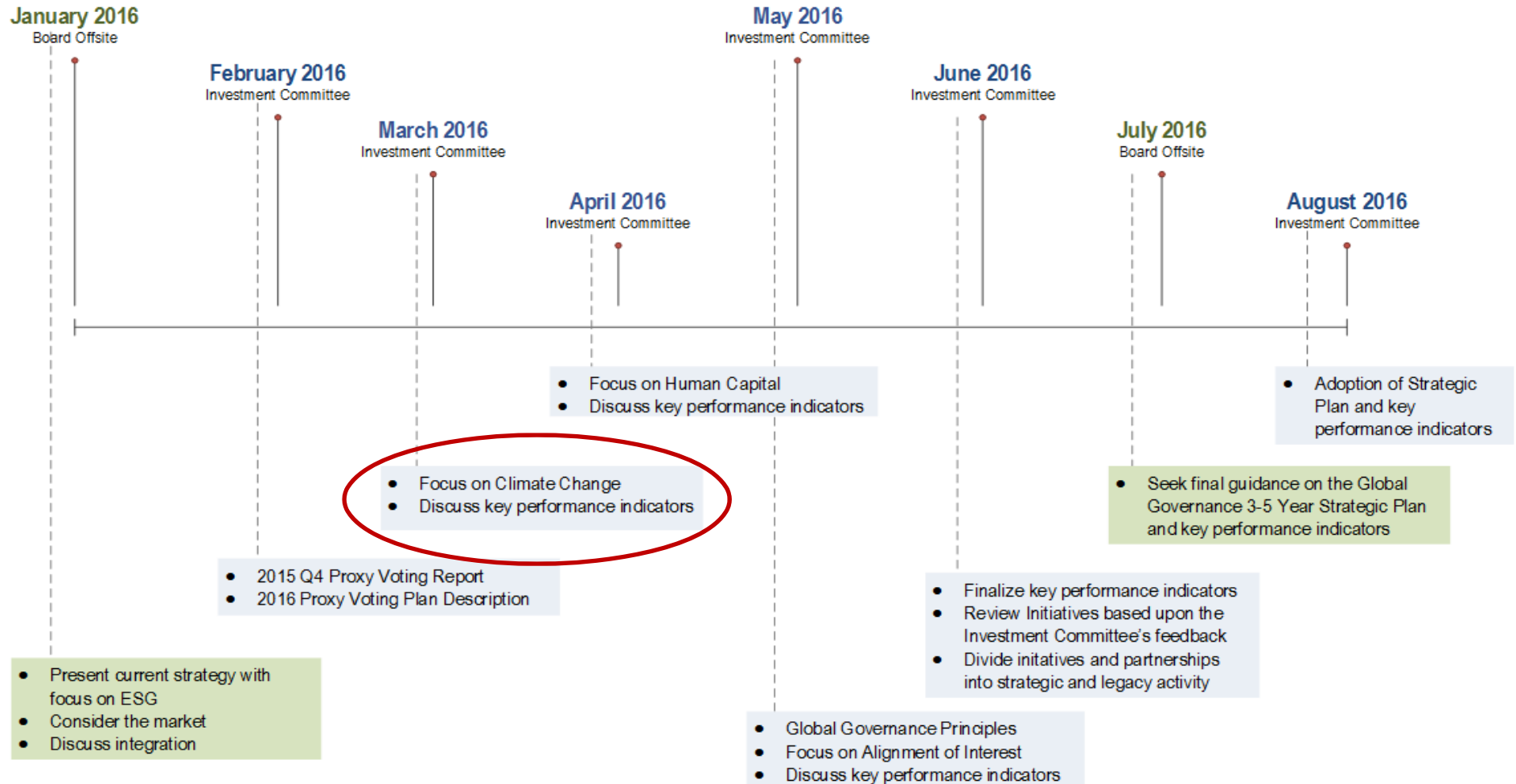
Review of ESG Strategy – Environment Theme: Climate Change

# Recommended Strategic Priorities: ESG

E	S	G
Climate Change	Human Capital	Alignment of Interest
<ul style="list-style-type: none"> <li>• Data and corporate reporting standards (includes water risk)</li> <li>• Engage 80 PRI Montreal Pledge Companies</li> <li>• Thermal Coal Companies: (SB185)</li> <li>• Manager Expectations Pilot (includes water risk)</li> <li>• Carbon Footprinting – Total Fund</li> </ul>	<ul style="list-style-type: none"> <li>• Diversity</li> <li>• Responsible Contracting Policy</li> <li>• Supply Chain Activities</li> </ul>	<ul style="list-style-type: none"> <li>• Principles and Proxy Voting (including proxy access and majority voting)</li> <li>• Focus List</li> <li>• Fee and performance transparency</li> <li>• Research                             <ul style="list-style-type: none"> <li>– Sustainable Investment Research Initiative (refresh to include research on income inequality)</li> <li>– Global Equities staff research (portfolio tilts)</li> </ul> </li> </ul>
<p style="text-align: center;">Work through Partnerships to leverage resources and impact</p>		

Review of ESG Strategy – Environment Theme: Climate Change

# Proposed Timeline for Developing a 3-5 Year Strategic Plan



# Investment Beliefs

CalPERS' Investment Beliefs frame our fiduciary approach to climate change:

## Investment Belief 3

CalPERS investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries.

- In considering whether to engage on issues raised by stakeholders, CalPERS will use the following prioritization framework:
  - Principles and Policy – to what extent is the issue supported by CalPERS Investment Beliefs, Principles of Accountable Corporate Governance or other Investment Policy?
  - Materiality – does the issue have the potential for an impact on portfolio risk or return?
  - Definition and Likelihood of Success – is success likely, in that CalPERS action will influence an outcome which can be measured? Can we partner with others to achieve success or would someone else be more suited to carry the issue?
  - Capacity – does CalPERS have the expertise, resources and standing to influence an outcome?

# Investment Beliefs

## Investment Belief 4

Long-term value creation requires effective management of three forms of capital: financial, physical and human.

- CalPERS may engage investee companies and external managers on their governance and sustainability issues, including governance practices, risk management practices, human capital practices, and environmental practices.

## Investment Belief 7

CalPERS will take risk only where we have a strong belief we will be rewarded for it. An expectation of a return premium is required to take risks; CalPERS aims to maximize return for the risk taken.

- Markets are not perfectly efficient, but inefficiencies are difficult to exploit after costs.

# Investment Beliefs

## Investment Belief 8

Costs matter and need to be effectively managed.

- CalPERS will balance risk, return and cost when choosing and evaluating investment managers and investment strategies.

## Investment Belief 9

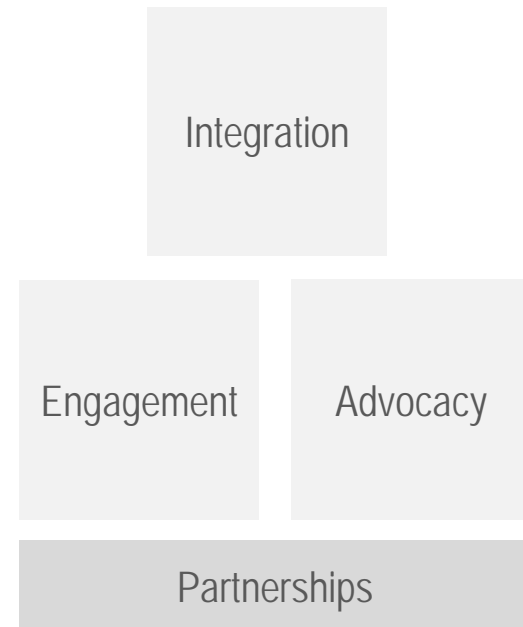
Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error.

- As a long-term investor, CalPERS must consider risk factors, for example climate change and natural resource availability that emerge slowly over long time periods, but could have a material impact on company or portfolio returns.

# Current Strategy on ESG

- Environmental  
Climate Risk
- Social  
Human Capital
- Governance  
Alignment of Interest

Our approach  
utilizes three  
channels  
supported by  
partnerships





# Climate Change Focus | Risks and Opportunities

## Climate change-related risks and opportunities: the Post – Paris COP21 Agenda

### 1. Physical impacts

- Sea level rise and related displacement
- Climate-driven changes in agriculture production and energy demand
- Impact of higher temperatures on labor productivity and public health

### 2. Liability

- Parties suffering from climate change-related loss seek compensation arising from regulation.
- Insurers or regulators failing to price in risk could suffer losses from physical risk claims.

### 3. Transition risk

- Financial risks from modifying economic activity in line with the Paris COP 21 targets, resulting in revaluing assets and opportunities.

The Financial Stability Board has been directed by the G20 to establish climate-related financial disclosure guidance. Its taskforce has defined three categories of disclosure needed from companies.

## Climate Change Focus | Reporting Standards

### “Why Investors Should Care about the Next Generation of Accounting Standards”

- “We take accounting standards for granted – whether it is the U.S.’s generally accepted accounting principles or the International Financial Reporting Standards. We shouldn’t.
- [T]here has been inadequate appreciation for how markets contribute to significant global problems such as climate change, excessive consumption of limited natural resources, pollution, waste and inequality.
- Part of the solution...is the development of accounting standards and reporting requirements for nonfinancial information: namely, a company’s performance on the material environmental, social and governance (ESG) issues”

<sup>1</sup> <http://www.institutionalinvestor.com/blogarticle/3533054/blog/why-investors-should-care-about-the-next-generation-of-accounting-standards.html#.VtYPFdJf3L8>

- Bob Eccles, Harvard University, *Institutional Investor*, Feb 2016<sup>1</sup>

# Advocacy Focus | Integrated Corporate Reporting

## Objective

- Focus on improving CalPERS' understanding and management of investment risk and opportunity by advocating that standard setters and regulators develop and mandate integrated corporate reporting.

## Initiative

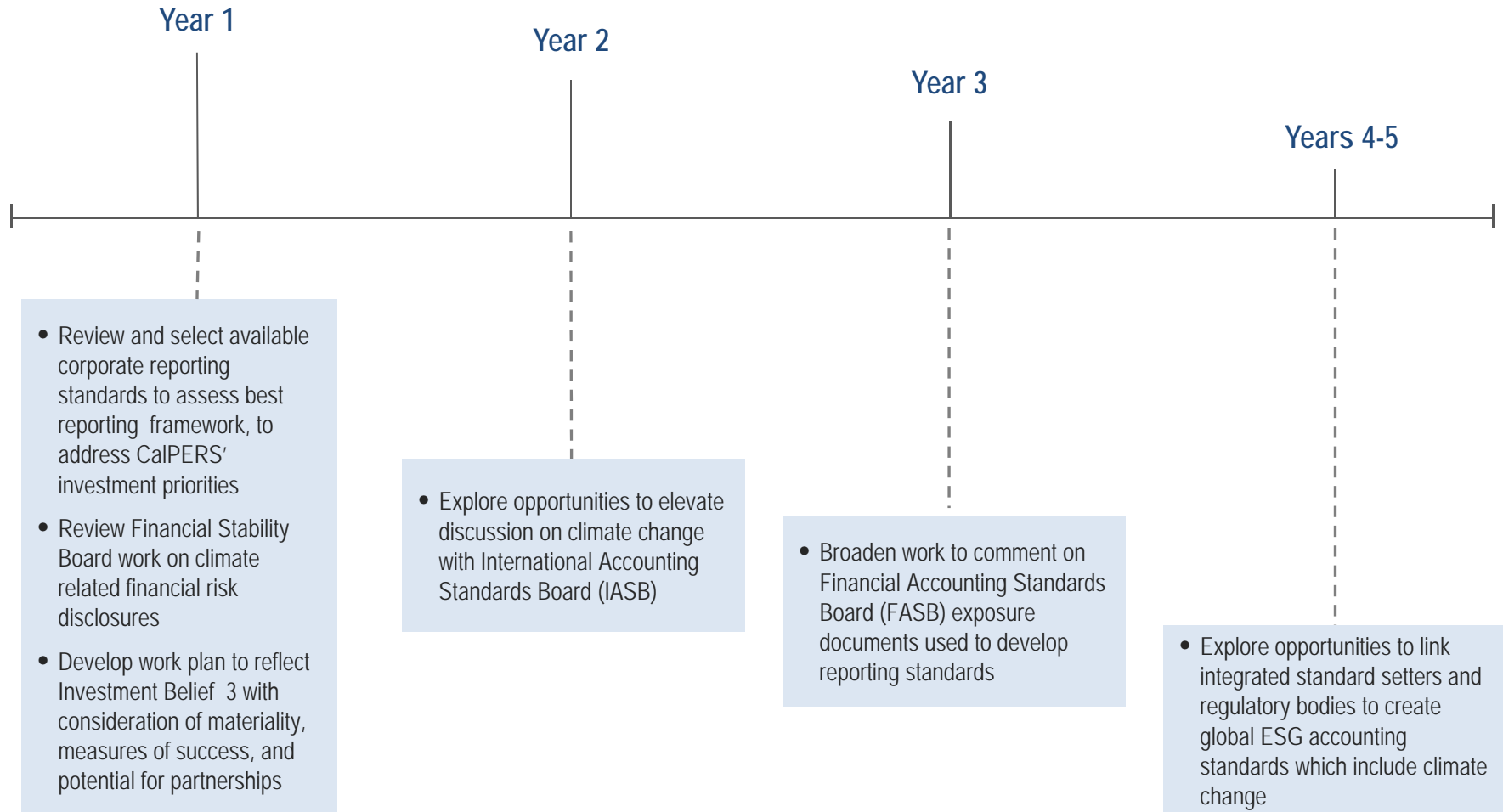
1. Review existing voluntary standards
2. Identify best practices
3. Engage with regulators and standard-setters to ensure best practices on integrated corporate reporting are implemented

## Potential Key Performance Indicator

- Metrics to track progress by standard setters include disclosure on climate change risk and opportunity in work plans.

Review of ESG Strategy – Environment Theme: Climate Change

# Proposed Timeline | Climate Change Advocacy



Review of ESG Strategy – Environment Theme: Climate Change

---

# Engagement Focus | Climate Change

## Objective

- Engage the 80 companies identified through the Carbon Footprint (PRI’s Montreal Pledge) that are responsible for 50% of “greenhouse gas” emissions for CalPERS’ Global Equity portfolio.

## Initiative

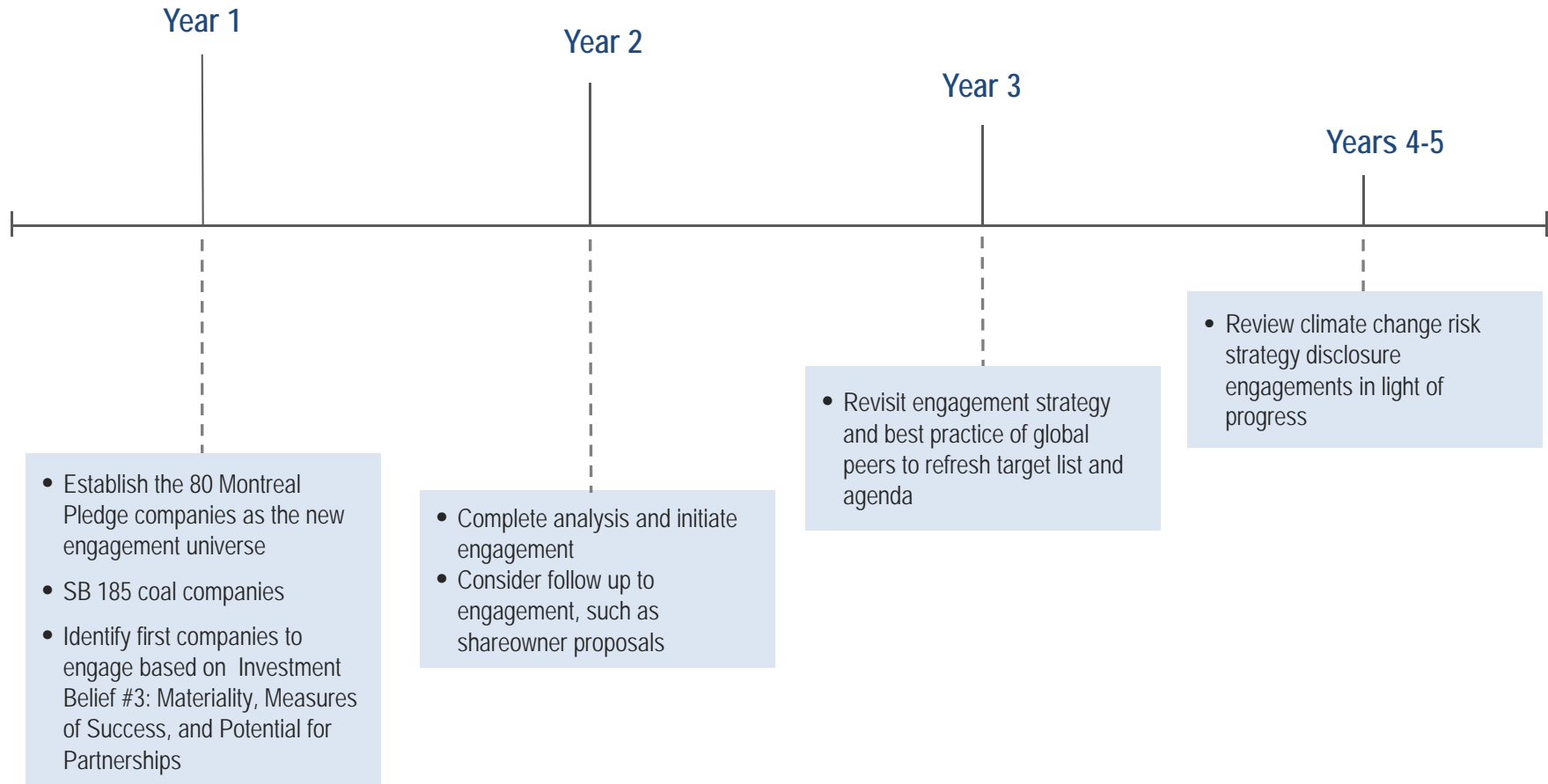
- Engage companies to ensure they:
  1. Develop a long-term strategy to address climate change, covering issues such as:
    - Capital allocation and R&D
    - Risk management
    - Asset portfolio resilience
    - Energy efficiency,
    - Natural resource scarcity
    - Board expertise and experience on climate change
    - Public policy strategy, including political contributions
    - Executive incentives / compensation
  2. Follow and disclose recommended standards of integrated corporate reporting inclusive of climate change risk and opportunity .

## Potential Key Performance Indicator

- Track metrics to show how engaged companies increase disclosure on strategy to manage climate change risk and opportunity. (For example, 6% carbon emission reduction is currently planned by Montreal Pledge 80 companies.)

Review of ESG Strategy – Environment Theme: Climate Change

# Proposed Timeline | Climate Change Engagements



## Integration Focus | Climate Change

### Objective

- Focus on improving CalPERS' understanding and management of climate change risk and opportunity in investment decisions across the portfolio.

### Initiative

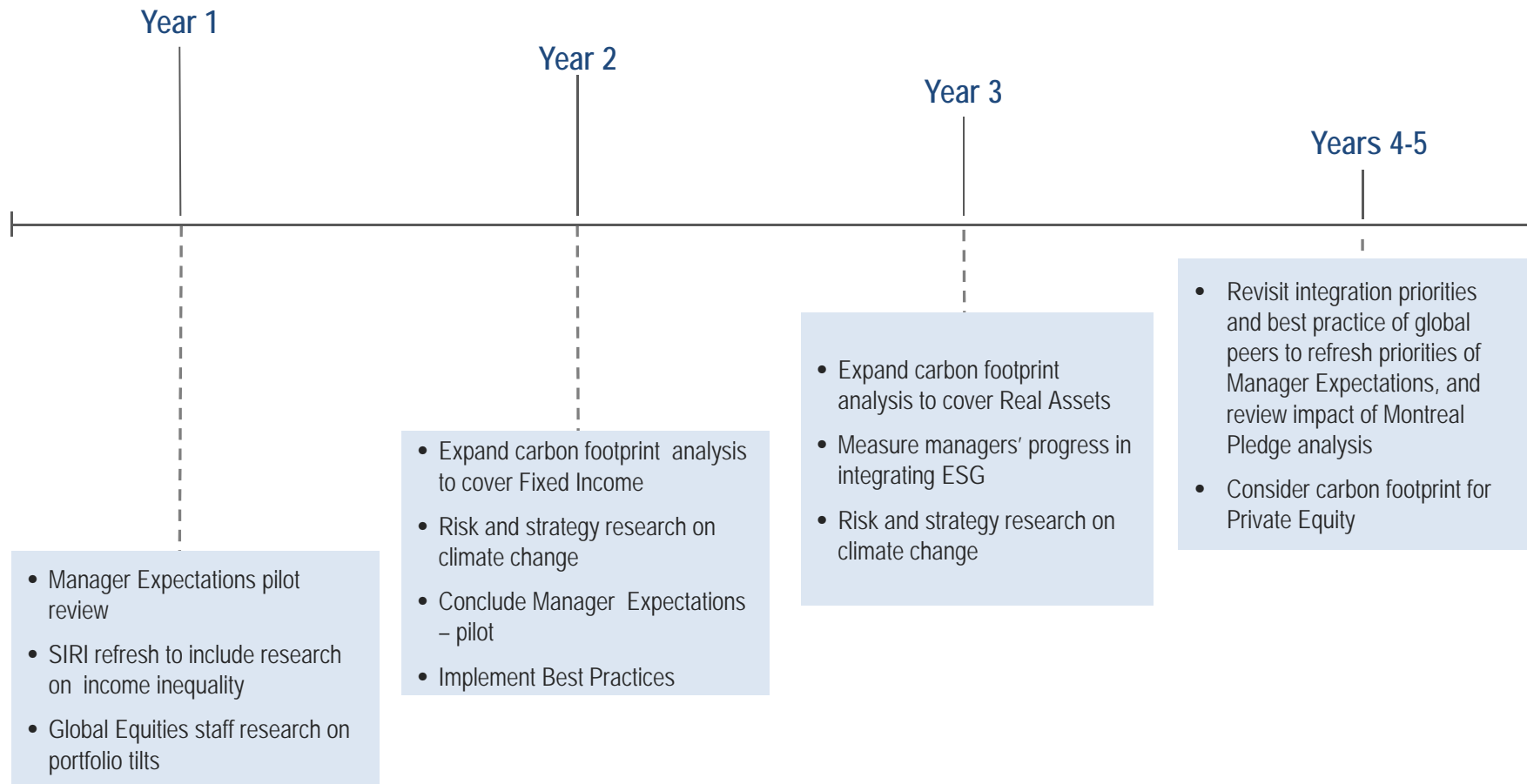
- Manager Expectations – pilot (including water risk)
- PRI's Montreal Pledge – carbon footprint for each asset class
- Sustainable Investment Research Initiative (SIRI) refresh
- Global Equity research on portfolio tilt

### Potential Key Performance Indicator

- Metrics to track progress on integration of climate change risk and opportunity into investment decision-making via Manager Expectations, Montreal Pledge completion across asset classes, and SIRI refresh.

Review of ESG Strategy – Environment Theme: Climate Change

# Proposed Timeline | Climate Change Integration



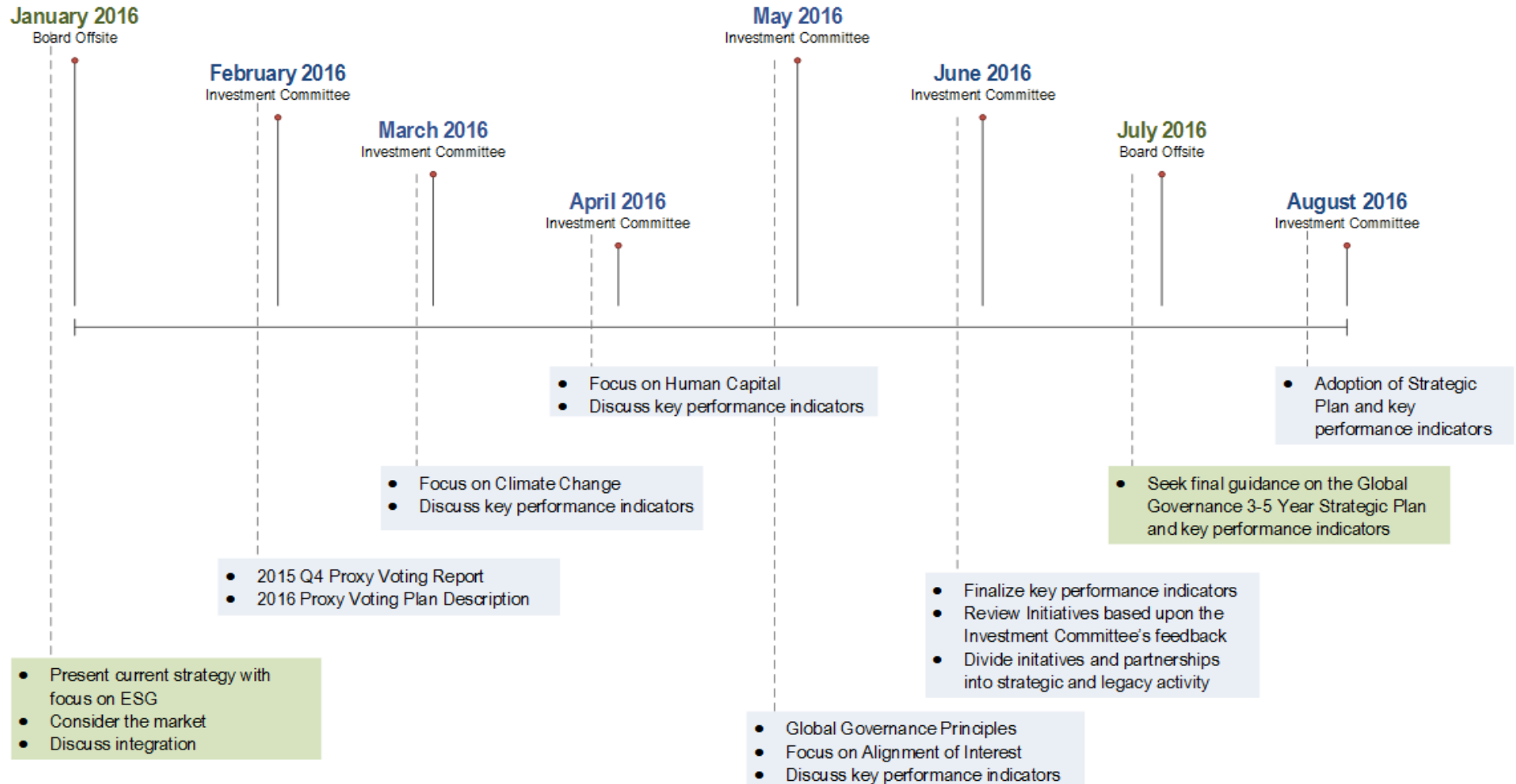


# Climate Change Focus | Overview

Advocacy	Engagement	Integration
<ul style="list-style-type: none"> <li>Data and corporate reporting standards (includes water risk)</li> </ul>	<ul style="list-style-type: none"> <li>Engage 80 PRI Montreal Pledge Companies</li> <li>Thermal Coal Companies (SB 185)</li> </ul>	<ul style="list-style-type: none"> <li>Manager Expectations – Pilot (includes water risk)</li> <li>Carbon Footprint – total fund</li> <li>Research                             <ul style="list-style-type: none"> <li>– SIRI refresh</li> <li>– Global Equities staff research on portfolio tilts</li> </ul> </li> </ul>

Review of ESG Strategy – Environment Theme: Climate Change

# Next Steps



## Appendix:

1. Current work: climate change initiatives
2. Climate change engagement strategy details
3. Advocacy: standards setting on climate change reporting
4. Environmental theme: water risk as an element of climate change

Review of ESG Strategy – Environment Theme: Climate Change

# 1. Current Work: Climate Change Initiatives

## Engagement work

Completed	Evolving	Core
<ul style="list-style-type: none"> <li>• Proxy Access Campaign – 33 energy companies out of 75 target firms.</li> <li>• Aiming for A resolutions – BP, Shell, Statoil backed shareholder proposal to disclose climate risks</li> <li>• Carbon Asset Review – Established list of target companies for engagement</li> </ul> <hr/> <ul style="list-style-type: none"> <li>• Advisory Vote on Executive Compensation                             <ul style="list-style-type: none"> <li>– CalPERS letter writing campaign to communicate company “against” votes (488)</li> </ul> </li> <li>• Human Capital Management Initiative- engagements with (6) companies on supply chain activities</li> </ul>	<ul style="list-style-type: none"> <li>• Legislative Mandates                             <ul style="list-style-type: none"> <li>• Investment Compliance and Operational Risk: responsible for identifying companies effected by legislative mandates and reporting to CalPERS Board</li> <li>• Global Governance continues engagement                                     <ul style="list-style-type: none"> <li>– Thermal Coal Companies (24)</li> <li>– Iran/Sudan (12), Northern Ireland and Holocaust (33)</li> </ul> </li> </ul> </li> <li>• Strategy for engaging Montreal Pledge-identified companies and aligning with:                             <ul style="list-style-type: none"> <li>• CERES Carbon Asset Risk</li> <li>• Climate Risk Reporting (Aiming for A)</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Shareholder Proposals (125 Environmental or Climate Proposals in 2015)                             <ul style="list-style-type: none"> <li>– Proxy Solicitations</li> <li>– Exempt SEC Filings – Shareowner Letters</li> </ul> </li> <li>• Proxy Access Campaign (Energy companies continue )</li> </ul> <hr/> <ul style="list-style-type: none"> <li>• Advisory Vote on Executive Compensation                             <ul style="list-style-type: none"> <li>– CalPERS letter writing campaign to communicate company “against” votes (488)</li> </ul> </li> <li>• Board Quality and Diversity</li> <li>• Diverse Director Data Source (3D)</li> <li>• Enhanced Focus List – Japan (8)</li> <li>• Human Capital Management Initiative- engagements with (6) companies on supply chain activities</li> <li>• Majority Voting for Director Elections Campaign (45)</li> <li>• Proxy Voting – Vote at 11,000 company meetings and 105,000 resolutions annually</li> <li>• Proxy Voting Engagements                             <ul style="list-style-type: none"> <li>– Over 1000 company engagements (via conference call, email, letter, and in-person meetings) on corporate governance related matters and proxy voting</li> </ul> </li> <li>• The Conference Board Diversity Events</li> </ul>

Review of ESG Strategy – Environment Theme: Climate Change

# 1. Current Work: Climate Change Initiatives

## Advocacy work

Completed	Evolving	Core
<ul style="list-style-type: none"> <li>• <b>Climate Change Policy Advocacy</b> <ul style="list-style-type: none"> <li>– Global Investor Statement on Climate Change</li> <li>– “Pocantico Statement” on Climate Resilient Infrastructure</li> <li>– Paris Pledge for Action</li> <li>– Participation in United Nations climate events including: COP 21 (Paris), UN Climate Summits (New York) - 2014–16</li> </ul> </li> <li>• Securities and Exchange Commission                             <ul style="list-style-type: none"> <li>• <b>Petition for Interpretive Guidance on Climate Risk Disclosure</b></li> </ul> </li> <li>• United Nations Environmental Programme Finance Initiative                             <ul style="list-style-type: none"> <li>– Inquiry into the Design of a Sustainable Financial System</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Work with Public Affairs and Federal Representative to continue Climate Change Policy Advocacy                             <ul style="list-style-type: none"> <li>– <b>Environmental Protection Agency Clean Power Plan review</b></li> <li>– Carbon Pricing</li> </ul> </li> <li>• <b>Carbon Pricing Leadership Council (World Bank – IMF)</b></li> </ul>	<ul style="list-style-type: none"> <li>• Legislative and Regulatory Guidelines                             <ul style="list-style-type: none"> <li>– Investor Independence; Corporate Accountability; Financial Markets; Diversity; <b>Sustainability</b></li> </ul> </li> <li>• <b>Financial Accounting Standards Board</b> <ul style="list-style-type: none"> <li>– <b>Materiality on climate change</b></li> </ul> </li> <li>• <b>International Accounting Standards Board</b> <ul style="list-style-type: none"> <li>– <b>Conceptual Framework; Agenda</b></li> </ul> </li> <li>• Securities and Exchange Commission                             <ul style="list-style-type: none"> <li>– Proxy Access; Universal Proxy Ballots; Shareholder Proposal Rights; Executive Compensation; Derivatives; Political Spending; SEC Funding; Petition on diversity; <b>Climate Change – more robust enforcement around climate risk reporting</b></li> </ul> </li> </ul> <hr/> <ul style="list-style-type: none"> <li>• Commodities and Futures Trading Commission                             <ul style="list-style-type: none"> <li>– Derivatives; CFTC Funding</li> </ul> </li> <li>• International Listing Standards (Hong Kong)</li> <li>• Litigation</li> <li>• Public Company Accounting Oversight Board                             <ul style="list-style-type: none"> <li>– Auditing Standards; Audit Partner Disclosure</li> </ul> </li> <li>• Targeted Investments Program – California Legislative Policy</li> </ul>

Review of ESG Strategy – Environment Theme: Climate Change

# 1. Current Work: Climate Change Initiatives

## Integration work

Completed	Evolving	Core
<ul style="list-style-type: none"> <li>• Global Equity Portfolio – HSBC</li> <li>• Private Equity – Clean Energy and Technology Fund</li> <li>• Asset Owner Disclosure Project</li> </ul>	<ul style="list-style-type: none"> <li>• Publish Principles for Responsible Investment Reporting Assessment</li> <li>• ESG Data and Tools</li> <li>• Clean Power Research</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Manager Expectations</b> – continue integration of ESG considerations throughout the lifecycle of the relationship with internal and external managers, including climate change as a risk and opportunity factor</li> <li>• <b>Montreal Pledge – cross asset classes</b></li> <li>• <b>Global Governance Principles</b> – Principle development: – Investor Rights; Compensation; Capital Allocation: <b>Environmental and Climate</b>; Total Fund; Human Capital Management; Alignment of Interest</li> <li>• <b>Greenprint</b></li> <li>• <b>GRESB Infrastructure</b></li> </ul> <hr/> <ul style="list-style-type: none"> <li>• Affordable Housing Policy</li> <li>• CA Investments</li> <li>• Responsible Contractor Policy</li> <li>• Steering Committee                             <ul style="list-style-type: none"> <li>– Corporate Boards; External Investment Managers; INVO Talent Management</li> </ul> </li> <li>• Targeted Investment Program (TIP) – Five Year Emerging, Transition, and Diverse Manager Programs; Diversity and Inclusion</li> </ul>

## 2. Climate change engagement strategy details

### Montreal Pledge – Carbon Footprint | Quartile Estimates for Top 80 Companies

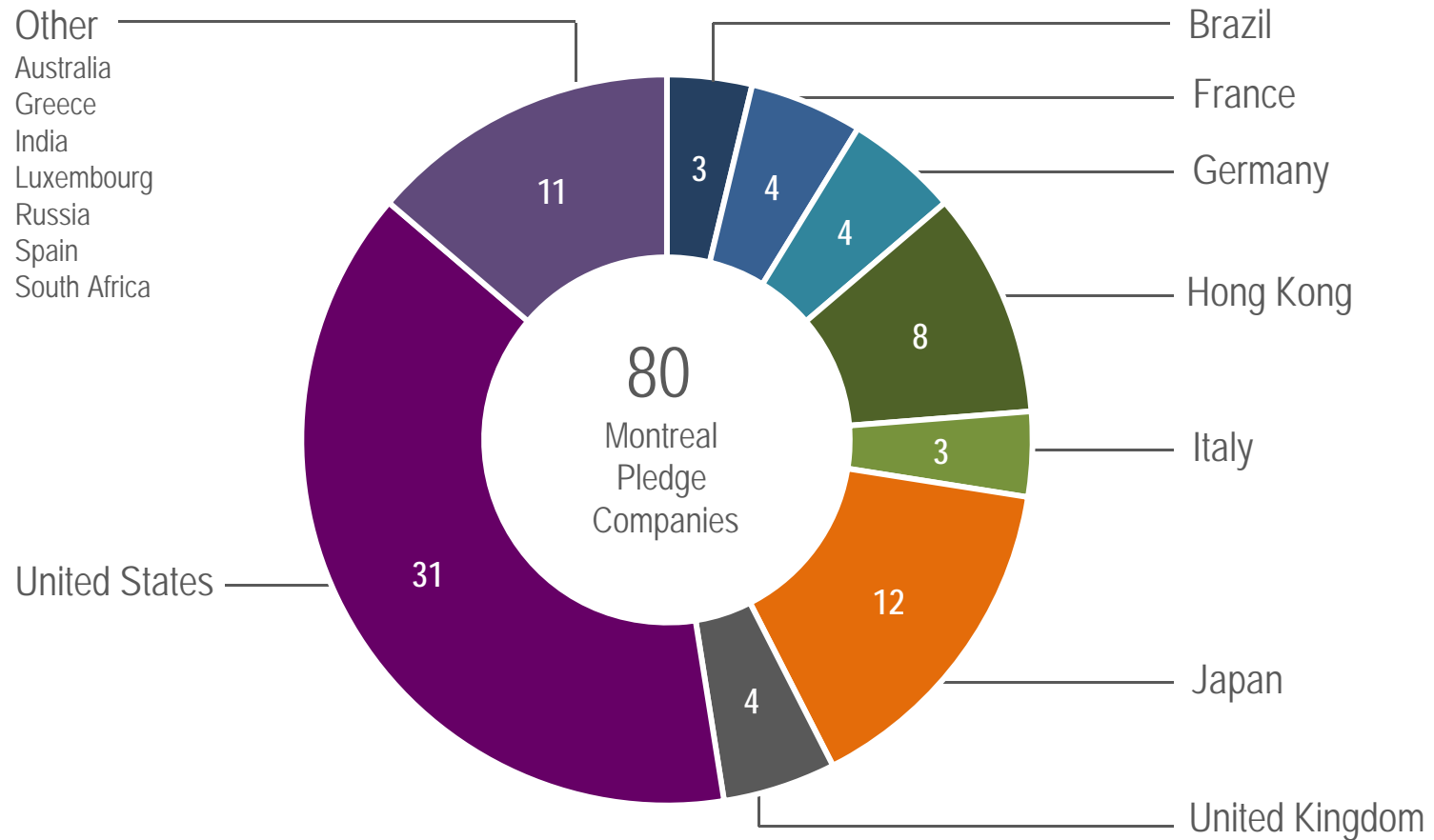
Quartile	Apportioned emissions (CO2e/tonne)	Large Cap (>\$10 bil)	Mid Cap (\$2-10 bil)	Small Cap (<\$2 bil)	Controlled Companies	Median Investment Position (\$mil)
1	30%	13	5	2	6	\$63
2	13%	11	5	4	2	\$37
3	8%	12	6	2	1	\$37
4	6%	9	8	3	5	\$24

Source – Trucost, MSCI

Review of ESG Strategy – Environment Theme: Climate Change

## 2. Climate change engagement strategy details

Country of Primary Listing: 80 Companies



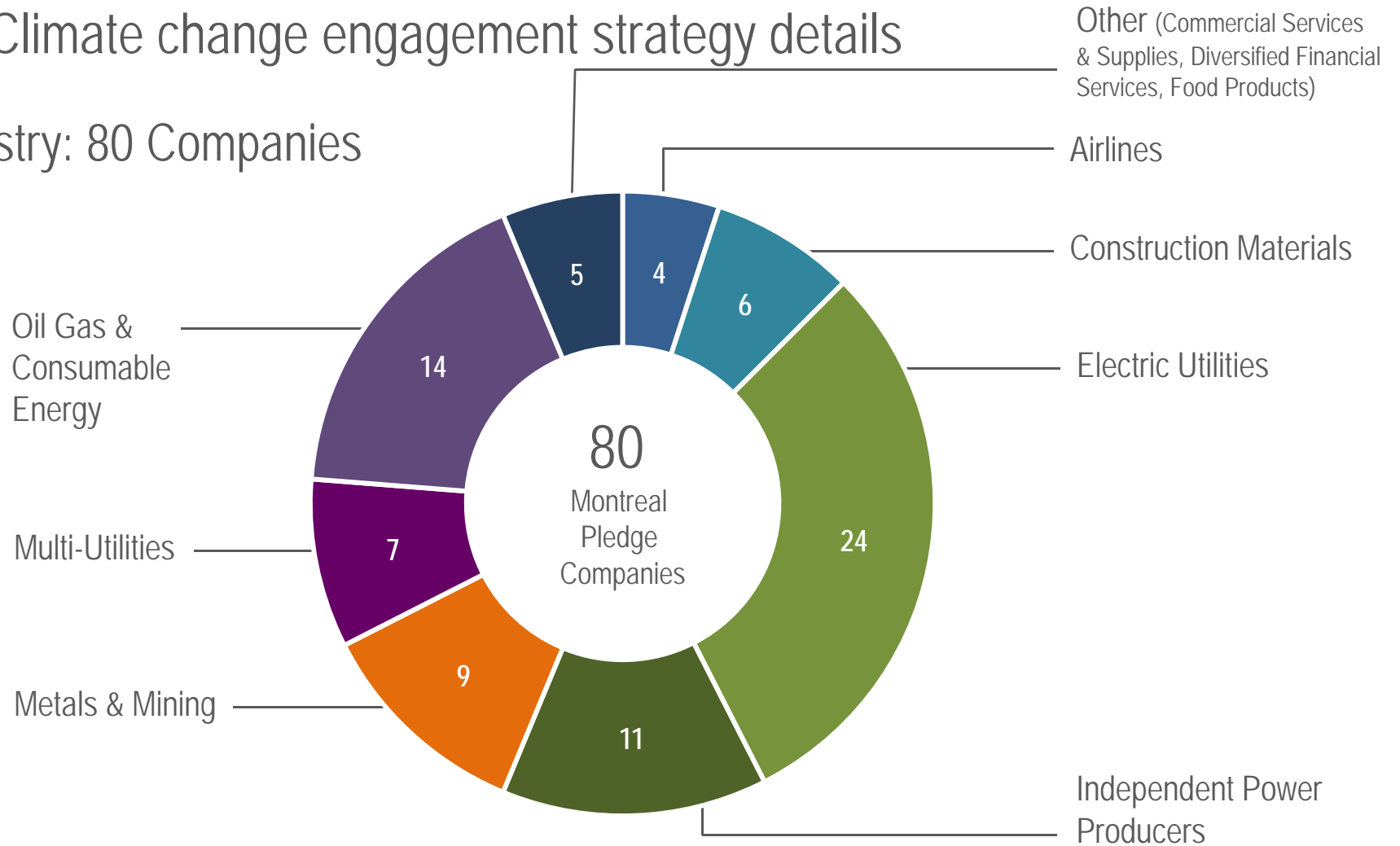
Source – Factset



Review of ESG Strategy – Environment Theme: Climate Change

## 2. Climate change engagement strategy details

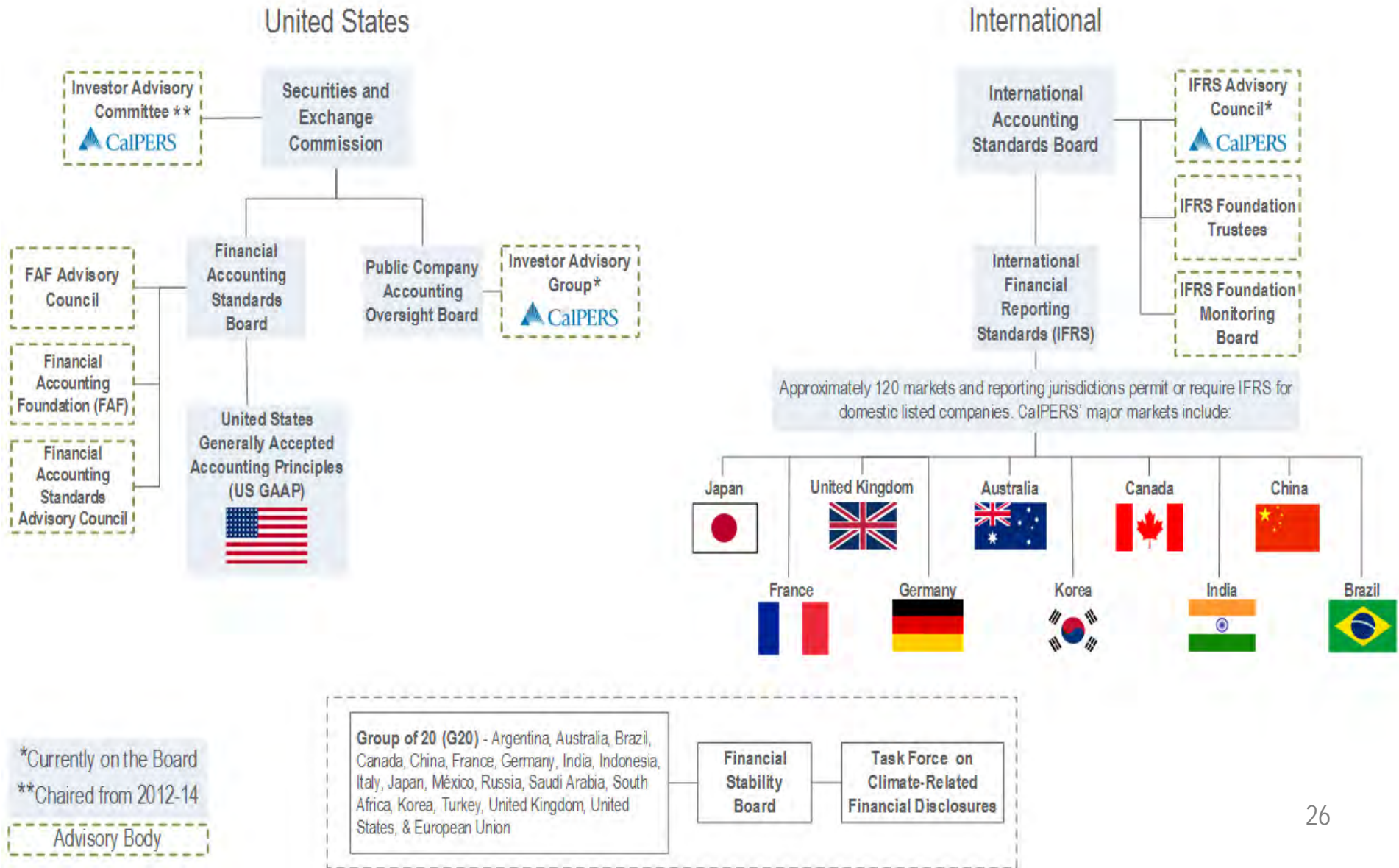
Industry: 80 Companies



Source – Factset

Review of ESG Strategy – Environment Theme: Climate Change

# 3. Advocacy | Standard Setting on Corporate Reporting



## 3. Advocacy | Standard Setting on Climate Change Reporting

### Financial Stability Board (FSB)

The Task Force on Climate-related Financial Disclosures (TCFD) is an entity under the FSB. Mandated by the G20 it will develop climate-related financial risk disclosures for use by companies in providing information to investors, regulators and other stakeholders. The Task Force will consider the physical, liability and transition risks of climate change.

- The TCFD launched in December 2015, announcing the advisory council members in January 2016.
- We plan to review and comment on the disclosure standards, and potentially support efforts for corporate adoption.

### International Accounting Standards Board (IASB)

IASB develops corporate reporting standards that are intended to bring transparency, accountability and efficiency to financial markets around the world. The US SEC allows companies to report under this framework but they have not been adopted.

- The International Financial Reporting Standards (IFRS) Advisory Council has featured a presentation from the FSB on developing climate disclosure standards. CalPERS represents the Council of Institutional Investors on the IFRS Advisory Council.

## 3. Advocacy | Standard Setting on Corporate Reporting

### Financial Accounting Standards Board (FASB)

The Financial Accounting Standards Board (FASB) is the designated organization in the United States for establishing standards of financial accounting known as US GAAP (Generally Accepted Accounting Principles), that govern the preparation of financial reports by companies.

- The FASB is overseen by the SEC, whose Investor Advisory Committee was chaired by CalPERS' CIO from 2012-14.

### Public Company Accounting Oversight Board (PCAOB)

Public Company Accounting Oversight Board (PCAOB) is a regulator established by Congress under Sarbanes-Oxley to oversee the audits of U.S. public companies in order to protect investors.

- CalPERS is represented on the PCAOB's Investor Advisory Group.

## 4. Environmental Theme | Water Risk an Element of Climate Change Work

### What we are already doing on water risk:

- CalPERS' Manager Expectations – Pilot: All Asset Class Sustainable Investment Practice Guidelines identify Water Scarcity, Water Stress and Climate Change Vulnerability as potentially relevant factors for Managers to consider.
- CERES' AquaGauge tool to measure corporate water risk is part of sustainability engagements.
- CDP Water Disclosure: Voluntary corporate reporting on use of water and exposure to changing patterns of water availability - CalPERS is a signatory. As of 2015, 1,000 companies disclosed water use to CDP.
- Greenprint: CalPERS' Core Real Estate managers are members. Greenprint provides an environmental management platform for members to track, report, benchmark, and analyze energy, emissions, water, and waste performance for properties, funds, and portfolios.
- GRESB Infrastructure's monitoring and due diligence platform (launching in April 2016) will request that funds and assets report on water policies, water usage and sourcing, and water risk and opportunity management. CalPERS is a co-founder of GRESB Infrastructure.
- Education: As part of the Cross-Asset Class Sustainable Investment Team's work, speakers from the Coca-Cola Company, Vidler Water, California American Water Service, Water Asset Management and the office of Assembly member Anthony Rendon participated in a panel discussion on Water Risk.
- SASB: Disclosure metrics for material corporate reporting include water risk and management. CalPERS sits on the Standards Committee