

**June 13, 2016****Item Name:** Global Governance Strategic Review: Key Performance Indicators**Program:** Global Governance**Item Type:** Information**Executive Summary**

This agenda item proposes CalPERS' approach to defining key performance indicators (KPIs) for environmental, social, and governance (ESG) themes within its sustainable investment strategy. The new ESG strategy is being developed through an interactive process with the Investment Committee, intended to seek feedback on the proposed approach to KPIs for engagement, advocacy and integration activities in the new strategy.

**Strategic Plan**

This agenda item supports the CalPERS Strategic Plan goals of improving long-term pension benefits sustainability and actively managing business risks with an enterprise-wide view.

**Investment Beliefs**

This agenda item supports the CalPERS Investment Beliefs:

1. Investment Belief 2: A long time investment horizon is a responsibility and an advantage
  - Long time horizon requires that CalPERS:
    - Consider the impact of its actions on future generations of members and taxpayers
    - Encourage investee companies and external managers to consider the long-term impact of their actions
    - Favor investment strategies that create long-term, sustainable value and recognize the critical importance of a strong and durable economy in the attainment of funding objectives
    - Advocate for public policies that promote fair, orderly and effectively regulated capital markets
2. 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?
3. Investment Belief 4: Long-term value creation requires effective management of three forms of capital: financial, physical and human
- Strong Governance, along with the effective management of environmental and human capital factors, increases the likelihood that companies will perform over the long-term and manage risk effectively
  - CalPERS may engage investee companies and external managers on their governance and sustainability issues, including:
    - Governance practices, including but not limited to alignment of interests
    - Risk management practices
    - Human capital practices, including but not limited to fair labor practices, health and safety, responsible contracting and diversity
    - Environmental practices, including but not limited to climate change and natural resource availability
4. Investment Belief 5: CalPERS must articulate its investment goals and performance measures and ensure clear accountability for their execution
- A Key success measure for the CalPERS investment program is delivery of the long-term target return for the fund
  - The long time horizon of the fund poses challenges in aligning interests of the fund with staff and external managers
  - Staff can be measured on returns relative to an appropriate benchmark, but staff performance plans should include additional objectives or key performance indicators to align staff with the fund's long-term goals
  - Each asset class should have explicit alignment of interest principles for its external managers
5. 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
6. 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
7. Investment Belief 9: Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error
- CalPERS shall develop a broad set of investment and actuarial risk measures and clear processes for managing risk

- 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
8. Investment Belief 10: Strong processes and teamwork and deep resources are needed to achieve CalPERS goals and objectives
- Diversity of talent (including a broad range of education, experience, perspectives and skills at all levels (Board, staff, external managers, corporate boards) is important

### **Background**

In January 2016, the Investment Committee embarked on a six-month process to develop CalPERS' new 3-5 year ESG strategy aligned with our core investment objectives of risk and return. Development of key performance indicators related to our ESG related investment activities is critical to evaluating the success of CalPERS' efforts in the area and is consistent with Investment Belief 5.

### **Budget and Fiscal Impacts**

Not Applicable.

### **Benefits and Risks**

- Benefits – Continuing our focus on understanding and improving alignment of interest factors is consistent with our Investment Beliefs.
- Risks – Poor disclosure creates uncertainty around implementation of Investment Beliefs.

### **Attachments**

Attachment 1 – Review of ESG Strategy: Defining Key Performance Indicators

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