

# Manager Expectations Pilot Update

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# Manager Expectations | Pilot Program Background

- Launched as a Pilot Program in May 2015 where each asset class trialed the guidelines with internal and external managers
- Established as a Strategic Priority in August 2016 as part of CalPERS' Environmental Social and Governance (ESG) strategy
- ESG Manager Expectation Project Goal:

FROM	TO
<p>Varied understanding, interpretation and integration of sustainable investment considerations with little clarity given to internal staff or external managers on how sustainability considerations will or should be factored into manager selection, contracting or monitoring.</p>	<p>Asset classes have clear and coherent processes, with the appropriate flexibility and recognition of differences amongst strategies and managers, for integrating sustainability considerations throughout the lifecycle of the relationship with internal and external managers.</p>

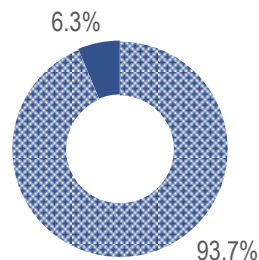
Source: May 2015 Investment Committee Agenda Item

# Manager Expectations | Asset Class Context

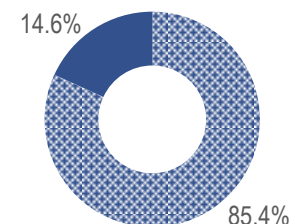
Each asset class faces a unique set of parameters with regard to:

- Internal vs. External Management
  - Control rights
    - Direct vs. Indirect ownership
    - Structure of investment vehicle (commingled/industry product vs custom product)
    - Position in the capital structure
- Passive vs. Active Management
- Security Level vs. Index Level
- Fundamental vs. Factor Approach
- Nature of Assets
- Legacy vs. Strategic Portfolios

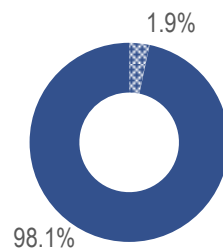
**Global Fixed Income**



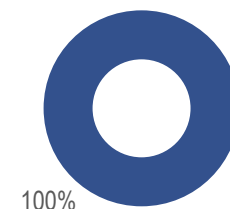
**Global Equity**



**Real Assets**



**Private Equity**



■ Externally Managed ■ Internally Managed

Source: May 2015 Investment Committee Agenda Item

# Managers Expectations | Next Steps

- Beginning in 2017, transition Manager Expectations Oversight to Investment Manager Engagement Program (IMEP) for central monitoring and external communication
- Sustainable Investment Practice Guidelines: ESG Manager Expectations
  - Lessons learned and next steps vary by asset class (attached)
  - Asset classes to establish and implement documented procedures
  - Explore including key excerpts of the guidelines into the Investment Portal for prospective managers

# Appendix: Asset Class Updates

# Global Fixed Income | Lessons Learned

- Most external managers report incorporating ESG factors into investment decisions when relevant, but level of implementation varies:
  - Formalized: Creation of Responsible Investment Team; Risk scoring & screens utilized in investment process
  - General integration: ESG risks and their potential impact on a credit's fundamental profile and valuation would be considered as part of bottom-up research
  - Currently evaluating ESG integration: Working group established to determine how best to implement for each investment platform
- Several external managers display increasing levels of ESG activity vs. a year ago. Examples include:
  - Becoming a signatory to the UNPRI
  - Establishing an ESG committee
  - Seeking to fill a dedicated ESG role
  - Evaluating and selecting data providers

# Global Fixed Income | Next Steps

## External Managers

- Managers have or will commit to have a firm wide ESG policy and/or an investment process which incorporates an assessment of relevant long-term Sustainable Investment or ESG factors
- At least annually, survey external managers on how ESG related risks and issues are incorporated into their investment process

## Internal Management

- Complete carbon footprint analysis of internal corporate fixed income portfolios
- Review relevant ESG research and findings from external managers to improve ESG implementation for internal portfolios

# Global Equity | Lessons Learned

- There is no one-size fits all approach
- Diversity of integration method is a strength
- Integration simpler in fundamental investment processes
- Most see ESG integration as a risk-control attribute rather than alpha source
- Partners are willing and able to contribute in a meaningful way



# Global Equity | Next Steps

- Align ESG risk & opportunities with proxy voting and engagement activities
- ESG strategy research project
- Continue to refine and evolve ESG integration efforts

## Real Assets | Lessons Learned

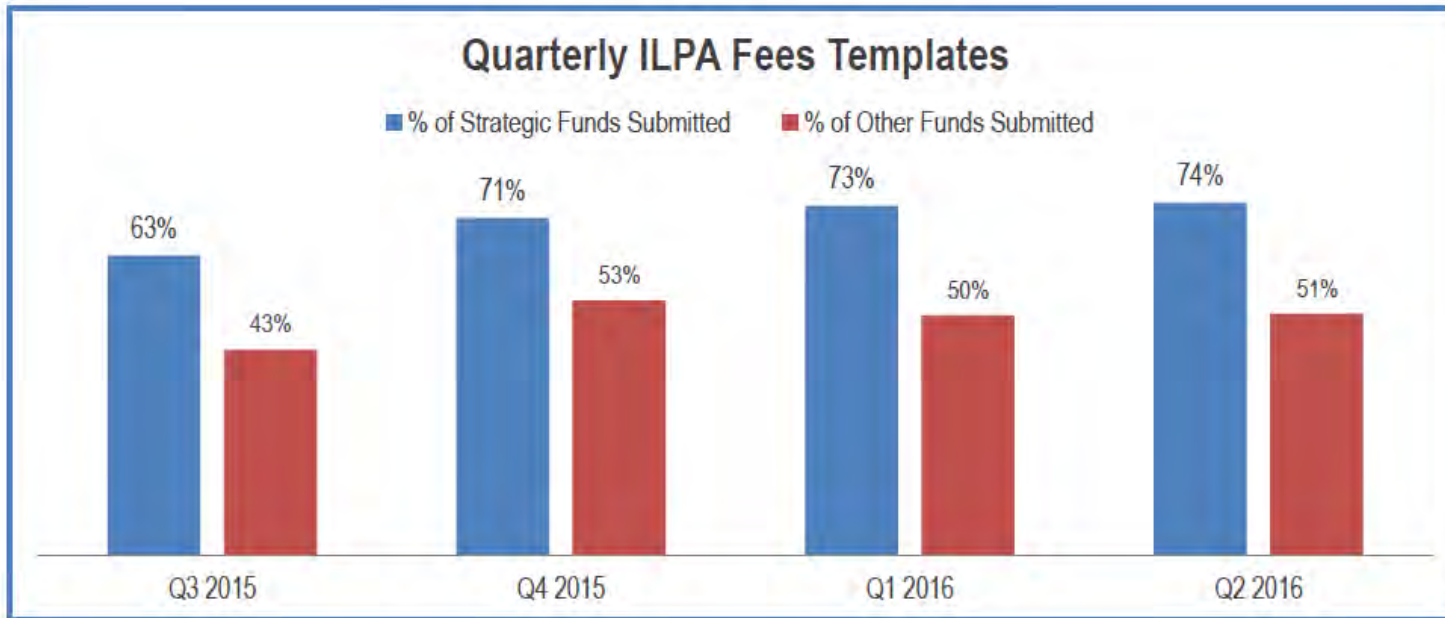
- With Real Assets Unit (RAU) Integration, identified the need for tools that work across Real Estate and Infrastructure, resulting in the following:
  - Incorporation of a combined Real Estate and Infrastructure Sustainable Investment Practice Guidelines into RAU procedures manual, in line with the Total Fund's ESG 5-year Strategic Plan
  - Review of GRESB (Global Real Estate Sustainability Benchmark) monitoring and benchmarking tool for Real Estate in addition to Infrastructure
  - Development of an ESG Consideration Matrix for Real Estate (in progress), similar to what has been implemented by Infrastructure
- Effort needed to learn and share best practices internally and amongst external managers

# Real Assets | Next Steps

- Broader utilization of GRESB (Global Real Estate Sustainability Benchmark) as a sustainability performance measurement platform for Real Estate and Infrastructure Programs
  - Majority of CalPERS' Infrastructure managers participated in Year 1 of the annual GRESB Infrastructure survey providing comprehensive ESG insights into infrastructure assets
  - Real Estate Managers to start reporting into GRESB in 2017
- Energy Optimization (EO) Initiative launched to research and explore ideas and approaches regarding improving energy use in Real Estate investment opportunities for economically and environmentally optimizing Real Estate energy use

# Private Equity | Lessons Learned

Slow but steady adoption of the ILPA Fee & Profit Sharing Template



- Four consecutive quarters of collecting the ILPA Fee Reporting Template
- Strategic funds are generally more responsive than legacy
- ILPA Fee Reporting template is not consistently requested by other LPs (according to GPs)

## Private Equity | Lessons Learned (cont.): GP Level of Engagement on ESG

- 83% of commitments made in past 16 months include an ESG section in Side Letter or Limited Partnership Agreement.
- Larger PE firms are leading the way with designated sustainability staff and annual sustainability reports. Several smaller PE firms are working towards creating an ESG policy.
- Based on the recent experience, CalPERS is typically one of the few LPs that actively brings up an ESG topic at annual meetings and LPAC meetings.

*Data based on PE commitments made from 06/30/2015 through 10/31/2016*

## Private Equity | Next Steps

- Continue to ask ESG-related questions and engage managers during the pre-investment phase
- During post-investment (monitoring) phase continue to:
  - Review manager's ESG reports and UNPRI reporting on an annual basis
  - Document any ESG-related issues staff becomes aware of in periodic meeting notes
  - For the top 10 managers in the PE portfolio by value, inquire at the annual LPAC meetings regarding the Firm's ESG-related issues
- Continue to focus on adoption and dissemination of the ILPA Fee and Profit Sharing Template.
- Evaluate whether there are recurring Environmental and/or Social themes across the private equity portfolio.

# Private Equity | Fee & Profit Sharing Transparency

## Objective

- Industry adoption of the Institutional Limited Partners Association (ILPA) framework for transparency of fees and profit sharing

## Key Performance Indicators

- Ensure 100% of CalPERS' strategic private equity partnerships complete the ILPA fee reporting template and provide profit sharing information
- Target 100% of CalPERS private equity partnerships complete the ILPA fee reporting template and provide profit sharing information
- Track and report industry ILPA adoption
  - Partnerships completing the ILPA fee reporting template and providing profit sharing information
  - Limited partners requiring such information from their general partners

## Timeline

- 90% of all partnerships: 5 years
- 100% of all partnerships: 10 years

# Governance & Sustainability Subcommittee Membership

**Co-Chairs:**

- Dan Bienvenue, Managing Investment Director, Global Equity
- Anne Simpson, Investment Director, Sustainable Investment

<b>Global Equity</b>	<ul style="list-style-type: none"> <li>• Simiso Nzima, Investment Manager</li> <li>• Stuart Hall, Investment Officer II</li> </ul>	<b>Real Assets</b>	<ul style="list-style-type: none"> <li>• Beth Richtman, Investment Manager</li> <li>• Rina Lessing, Investment Manager</li> </ul>
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<b>Global Fixed Income</b>	<ul style="list-style-type: none"> <li>• Lou Zahorak, Investment Director</li> <li>• Paul Kramer, Investment Manager</li> </ul>	<b>Private Equity</b>	<ul style="list-style-type: none"> <li>• Christine Gogan, Investment Director</li> <li>• Liliya Kamalova Investment Officer II</li> </ul>
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<b>Asset Allocation/ Risk</b>	<ul style="list-style-type: none"> <li>• Dianne Sandoval, Investment Manager</li> <li>• Alison Li, Investment Manager</li> </ul>	<b>Investment Compliance &amp; Operational Risk</b>	<ul style="list-style-type: none"> <li>• Kit Crocker, Investment Director</li> <li>• Anna Morrison, Investment Officer I</li> </ul>
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<b>Sustainable Investment</b>	<ul style="list-style-type: none"> <li>• Divya Mankikar, Investment Officer III</li> <li>• Tiffany Pokk, Investment Officer II</li> </ul>	<b>Execution Services and Strategy (ESS)</b>	<ul style="list-style-type: none"> <li>• Don Pontes, Investment Director</li> <li>• James Andrus, Investment Manager</li> </ul>
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