Wilshire

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Mr. Henry Jones
Chair of the Investment Committee
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Consultant Review of ESG Integration at CalPERS

Dear Mr. Jones:

As outlined in its Investment Beliefs (IB) on long-time horizon (IB #2) and on long-term value creation (IB #4), CalPERS has a long-standing and proud commitment to sustainable investment. In addition to providing the Investment Committee with an annual update on ESG integration practices in CalPERS' public equity and global fixed income programs, going forward Wilshire will also provide an annual opinion of CalPERS' sustainable investment practices and behaviors across different areas of the organization [including, for example, policy and strategy design, reporting and Trustee governance of sustainable investing].

Following discussion with members of CalPERS' Investment Committee and Investment Staff, it was agreed that Wilshire's first strategic review of sustainable investment should be well-defined, narrow in scope and focus on CalPERS' ESG integration, resources, and processes. This letter reviews CalPERS' positioning on ESG integration compared to its peers and offers some thoughts on how CalPERS can continue taking steps toward sustaining a culture which encourages Investment Staff to lead innovation in this field.

In Wilshire Consulting's February 2018 white paper, *Where's the "F" (for Financial) in ESG?* we describe how asset owners may adopt more than one approach to sustainable investing. This review focuses on just one aspect of CalPERS approach to sustainable investment: ESG integration. It does not provide commentary on: CalPERS' broader sustainable investing choices; the efficacy of its divestment programs; or investment performance of its ESG- related investment strategies.

Review Scope and Process

In the context of the 2016 sustainable strategic investment plan, this review provides an assessment of CalPERS':

- Resources and responsibilities for ESG integration compared to similar sized peers;
- Approach to integrating ESG considerations through committee structures and the asset class teams; and
- Leadership position compared to similar sized peers.

Wilshire's review included a combination of onsite meetings and phone discussions with almost 20 investment staff, dedicated ESG staff and other stakeholders. We reviewed materials and papers provided by Staff and conducted additional research, drawing on the PRI database comparing CalPERS' practices to a North American peer group of asset owners each with over $100bn of assets.

A global leader in sustainable investing

CalPERS is recognized as a global leader in sustainable investing according to a range of different best practice surveys and league tables, including the PRI annual assessment and the Bretton Woods II Responsible Asset Allocator Initiative.

- **CalPERS has established an award-winning strategic plan.**
  As a result of more than a year's worth of review by Staff and the Investment Committee, in 2016 CalPERS adopted its 5-Year Strategic Plan. The Plan serves as a framework to engage public companies and work with internal and external investment managers to ensure their practices align with relevant Investment Beliefs. The Plan identified six strategic initiatives each with specific objectives, key performance indicators, and a timeline. Staff reports to the Investment Committee on the status of the key performance indicators on a quarterly basis.

  In 2017 CalPERS was selected from a wide pool of nominees as the winner of Responsible Investor's inaugural award for innovation and industry leadership for its 5-year ESG strategic plan by an independent judging panel of 80+ distinguished experts. They ranked global asset owner nominees according to different categories, focusing on innovation, leadership, relevance to institutional investment, change-making potential (i.e. collaboration, ability to bring about transformation, longevity), and clarity.

- **CalPERS has adopted best in class ESG integration practices.**
  The PRI carries out the annual assessment based on how a signatory has progressed year-on-year and relative to peers. The investment categories are evaluated using 6 performance bands (A+, A, B, C, D, and E), where A+ distinguishes the top scoring signatories, representing a score of 95% or above. CalPERS is a top-decile asset owner achieving an average A score or above for each reporting segment three years running, reflecting its consistent leadership in the field.

  Another survey, the Bretton Woods II Responsible Asset Allocator Initiative, established ten core principles and criteria for sustainable investing that are specific to the asset allocator community, easy to understand and practical to adopt. The ten principles are: Disclosure; Intention; Clarity; Integration; Implementation; Commitment; Accountability; Partnership; Standards; and Development. Sovereign wealth funds and government pension funds are measured against these Principles based on analysis of annual reports, websites and other materials in the public domain. CalPERS ranks as a top-quintile performer alongside others in its peer group such as CalSTRS and New York State Common Retirement Fund.

Examples of ESG integration at CalPERS
In our aforementioned white paper we highlight four main steps asset owners may take toward integrating ESG considerations into their investment decisions including:

1. Analyzing financial information alongside ESG data in selecting assets and constructing portfolios
2. Adjusting valuations and portfolios to reflect the potential financial impact of material ESG issues
3. Sourcing investment managers with best in class ESG integration processes
4. Acting as a long-term steward of portfolio companies and assets

CalPERS' is entering a more mature phase of its ESG integration efforts whereby policies, processes and people are now in place. Wilshire's review found several best practice areas of ESG integration at CalPERS, two examples of which we highlight below with clear and demonstrable links to financial risk and return.

Real Estate Energy Optimization (EO) Initiative
Issue: Buildings account for approximately a third of the world's energy consumption and global greenhouse gas (GHG) emissions.

Solution: Having spotted energy efficiency as a "low-hanging" opportunity for the portfolio, in 2016 the real estate team held an Energy Optimization (EO) Roundtable with industry experts and investment partners to research, develop and assess the wide range of energy efficiency strategies being adopted by industry. CalPERS' partners were asked to submit project proposals which focused on gathering information about how different EO considerations have been factored into the renovation's design and the expected results in terms of energy savings per year ($ and kwh), Internal Rate of Return (%) and payback period (number of years).

Expected Result: A total of twenty EO projects were added to real estate's 2017/18 Annual Investment Program at an expected total cost of $8.5million with expected annual savings of 9.8 M kWh/ year or $1.6million with a combined NPV of $14.8million.

Focused engagement with carbon-intensive portfolio companies
Issue: As we note in Wilshire's 2016 paper on *Climate Change: Evolving Risks and Opportunities for Asset Owners* (attached), the systemic nature of climate risk may make divestment an ineffective investment strategy for bringing about change and could actually introduce new risks and costs into an asset owner's portfolio (p.17). For asset owners seeking to build a better understanding of the potential magnitude and scale of climate risk for their portfolios, an initial first step may involve measuring exposure to carbon emissions and identifying any concentrations of portfolio risk, for example in particular asset classes or securities.

Solution: In fulfilling its commitment to the "Montreal Pledge", the CalPERS Sustainable Investment team, which has specific skills in carbon footprinting, worked with both the Global Equity and Global Fixed income teams to measure the carbon footprint of the portfolios. CalPERS is the first US public pension plan to disclose a fixed income carbon footprint. Both footprint exercises identified a small number of companies are responsible for the majority of carbon emissions. Recognizing other asset owners had similar risk concentrations, CalPERS initiated an innovative collaborative corporate engagement program called Climate Action 100+ to ask portfolio companies to: implement a governance framework which clearly articulates the company board's accountability and oversight of climate change risk; take action to reduce greenhouse gas emissions across their value chain, consistent with the Paris Agreement and provide enhanced corporate disclosure in line with the final recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

Initial result: In February 2018, ExxonMobil produced its 2018 Energy and Carbon Summary as a result of CalPERS and 62 per cent of shareholders supporting a 2017 proxy ballot resolution requiring the company to report on environmental risks associated with climate change. In the report Exxon acknowledges that in a low carbon transition, low supply costs will be critical and also recognizes for the first time that demand for some of its future resources may be reduced if stronger there are stronger regulations on high carbon assets. Such disclosures demonstrates the benefit of conducting forward-looking scenario analysis to consider which investments would remain attractive in a low carbon transition period.

Areas for further consideration

To sustain its leading position CalPERS should consider what steps it can take to improve upon its existing processes and become more efficient with its on-going utilization of resources. We have identified a number of key areas for further consideration:

1. **Linking strategic objectives to resources and implementation**
    - What lessons can CalPERS learn from designing its award-winning 5-year strategy?
    - How can CalPERS best consider and explore new themes and initiatives, including those which arise during the five-year period, such as the Sustainable Development Goals, and prioritize emerging themes against previously identified objectives?
    - In setting its strategy and ambitions in this space should CalPERS provide an assessment of the resources and skills required to implement the plan?
    - Are the resources committed to ESG integration sufficient and deployed in the right areas given its objectives now and in the future?

    Recommendation: CalPERS should consider how to link its strategic planning process to implementation. This may include, for example, setting-up an ad-hoc working group to review the 5 year plan, prioritize emerging ESG issues, consider resource implications and “translate” ESG issues into investment terms. Each ESG issue should be appraised according to a pre-determined set of criteria, including potential impact on risk /return and level of staff resource commitment, so that once an objective is articulated in the plan it is ready to be deployed to Staff for efficient implementation.

2. Clarifying leadership roles and responsibilities

- With the balance of ESG integration resource and efforts focused at the asset class level, how can CalPERS investment Staff best coordinate and collaborate across teams on different ESG integration initiatives?
- How visible are Staff and Trustees expected to be in engaging with external partners and contributing to collaborative initiatives?
- Do ESG objectives flow down from the 5 year plan into Staff's annual performance objectives?

Recommendation: With senior investment Staff now much more visible to their teams and the Investment Committee for their role in ESG integration, the IC would benefit from further clarity over which senior investment Staff and their direct reports are responsible for delivering specific ESG integration objectives including those outlined in the 5 year plan.

3. Creating an investment culture of innovation on ESG integration

- Are investment Staff throughout the organization sufficiently empowered and incentivized to step outside of their primary areas of responsibility to reflect on, and contribute to, internal discussion about what ESG integration means for their specific asset class investment decisions?
- Is there process for including ESG questions in the hiring of new investment Staff?

Recommendation: Set clear expectations on the level of formal and informal training required for ESG Staff to further their investment knowledge and similarly for investment Staff to broaden their ESG skillset. Signal the importance of ESG integration practices in Staff's future career development and reward implementation of innovative ESG integration practices.

Conclusion

Wilshire believes that CalPERS' best in class ESG integration practices continue to evolve to best serve the needs of its members. Consistent with its peers at similar stages of development, we believe further discussion is warranted about how CalPERS might take steps toward supporting cultural change on ESG integration within the organization. Wilshire would be happy to assist in supporting CalPERS' efforts by providing further details on any of the specific areas we highlight for consideration.

Best regards,

Daniel Ingram

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