# Sustainable Investing:

## Integration of Environmental, Social, and Governance (ESG) Factors

CalPERS Investment Committee Workshop, 15 August 2011

CalPERS | Investment Office

# Workshop Objectives – Board Input

- Clarity
  - Map the range of current activity on sustainability factors: environmental, social, and governance
- Relevance
  - Establish those issues where CalPERS has capacity and there is potential impact on sustainable risk and return
- Priorities
  - Identify the areas of focus, sequence and co-ordination across the portfolio
- Implementation
  - Plan delivery of key components, with reporting and targets integrated into INVO strategy

# Overview

- Total Fund Process for Integrating ESG
  - INVO strategic initiative 2009: a process to integrate sustainability factors into the investment decision making across asset classes to improve risk management and investment returns
- IESG Cross-Asset Class Team
  - Asset classes and risk team, co-ordinated by Corporate Governance Unit
- Global Peer ESG Exchange
  - CalPERS benchmarked to 11 leading pension funds – $1.5 Trillion in AUM
- External Consultant
  - Mercer research report and menu of options: “Responsible Investment’s second decade: Summary report of the state of ESG integration, policy and reporting” (summary attached)

# Evidence of ESG Impact on Risk & Return

- **Assessing the Evidence:** Information usefulness varies by region, sector, & time horizon (see Appendix to Mercer report attached - Responsible Investment's next decade: Developing CalPERS Total Fund process for ESG integration)

- Pioneering Research
  - Mostly Conducted by Practitioners
  - Academic Interest is Growing

- State of Research - Attribution
  - Risk & Return
  - Environmental
  - Social
  - Governance

# Evidence of ESG Impact on Risk & Return

- Mercer Review of Research - Comments
  - Academic and broker studies considered
  - ESG themes are varied, more work completed on governance
  - A relatively new field, there are gaps in the literature
  - Focused on specific topics within asset class, much on exclusion

- High Level Findings
  - ESG results are primarily driven by manager skill and style
  - It is a misconception that responsible investment leads to financial underperformance
  - Balance of studies are positive to neutral, a minority are negative

# Evidence of ESG Impact on Risk & Return

- Mercer's Meta-Reports (36 studies total, through 2009)
  - 86% of the studies are either neutral or positive
  - More recent studies show positive relationship across asset classes

- 2010 – 2011: More Recent Evidence

# Trends in ESG - Two Decades

**FROM**

- Siloed
- Divestment
- Input Questions
- Scattered Initiatives

**TO**

- Integrated
- Engagement
- Measured Outcomes
- Focused Strategy

# Benchmark Analysis

- Global Peer Exchange: 11 Leading Pension Funds – $1.5 Trillion in AUM
  - APG Asset Management (Netherlands)
  - AustralianSuper (Australia)
  - BT Pension Scheme (United Kingdom)
  - Florida State Board of Administration (United States)
  - Government Employees Pension Fund (South Africa)
  - Norges Bank Investment Management (Norway)
  - Ontario Teachers' Retirement System (Canada)
  - PGGM (Netherlands)
  - Previ (Brazil)
  - TIAA-Cref (United States)
  - Universities Superannuation Scheme (United Kingdom)

# Benchmark Analysis – CalPERS vs. Peers

- Strengths
  - Broad asset class activity and innovation
  - Targeted investments
  - Engagement and market reform
  - Leadership on collaboration and standards

- Opportunities
  - Develop a total fund policy
  - Integrate ESG factors into investment strategy
  - Establish framework for monitoring
  - Publish a Sustainable Investment Report
  - Build out staff education

# CalPERS Sustainability Inventory

- 111 Separate Initiatives Catalogued
  - Including external and internal mandates, compliance with legislation, endorsement of guidelines, capital commitments, engagement and standards on ESG

- Sustainability: A Unifying Theme
  - Environmental: climate change – *carbon, energy efficiency, clean technology, renewable energy, water stress*
  - Social: human capital – *exploitative labor practices, health and safety, responsible contracting, diversity*
  - Governance: alignment of interest – *executive compensation, fund manager terms and conditions*

# Sustainability – What is it?

- Defining sustainable investment - understanding financial, governance, environmental, and social risks & opportunities that factor into long term continuity

- A wider consideration of risks and opportunities, which supports fiduciary responsibility

- Sustainability is based on the economics of capital: financial, physical, human, social

# Strategy on Sustainability - Issues to Address

- Priorities
  - CalPERS activity covers a wide array of issues
  - Select for capacity to deliver and potential impact on risk & return
  - Co-ordinate internally and externally
- Performance
  - Identify quality data and key performance indicators linked to long term investment objectives on both risk and return
- Procurement
  - Develop a framework for external management and services to allow monitoring and reporting across asset classes

# Global Equity – Potential Focus

- Priorities
  - Engagement strategy: globalize and monetize the Focus List Program with ESG integrated into financial objectives
- Performance
  - Quantitative and qualitative ESG analysis: commission research to evaluate weighting techniques to provide capital “tilt” to capture risk and return opportunities
- Procurement
  - Develop framework to identify relevant ESG quantitative and qualitative factors

# Fixed Income – Potential Focus

- Priorities
  - Articulate how ESG factors are considered in fixed income's investment decision making process
- Performance
  - Commission a study to quantify ESG factors and their contribution to risk adjusted return
- Procurement
  - Develop an asset-class specific expectations documents for external managers

# AIM – Potential Focus

- Priorities
  - Monitor the performance of existing clean tech & emerging manager exposures and evaluate manager alignments of interest
- Performance
  - Evaluate the on-going performance of AIM's exposures to Clean Technology (Approximately $1.2 billion) & Emerging Managers (Approximately $7.5 billion) relative to the total portfolio
- Procurement
  - Implement new manager due diligence process that includes ESG factors

# Real Assets – Potential Focus

- Priorities
  - Real Estate: Initiate CalPERS and investment manager membership in Greenprint Foundation
  - Infrastructure & Forestland: Research and identify appropriate reporting standards
  - Infrastructure & Forestland: Research and identify appropriate alignment of interest standards
- Performance
  - Infrastructure & Forestland: Utilize investment and manager reporting to track and report ESG progress
- Procurement
  - Real Estate, Infrastructure & Forestland: Research and identify methods to incorporate ESG factors into due diligence for investments and manager selection process
  - Infrastructure & Forestland: Research and identify methods to incorporate ESG factors into due diligence for investments

# Asset Allocation – Potential Focus

- Priorities
  - Evaluate findings of co-commissioned Mercer study, "Climate Change Scenarios Analysis - Implications for Strategic Asset Allocation" (study attached)
- Performance
  - Assess potential impact of fund exposure
- Procurement
  - Support risk management scenario planning and long term asset allocation review

# Total Fund – Potential Focus

- Priorities
  - Replace ESG labels with “Sustainable Investing”
  - Develop a Sustainable Investing Policy for the Total Fund
  - Develop and publish CalPERS Sustainable Investment Report for 2012
- Performance
  - Review results of asset class commissioned research on sustainability data
  - Develop implementation plan with key performance indicators
  - Evolve cross asset class team and staff education
- Procurement
  - Develop uniform process to collect relevant disclosure on sustainability factors by external investment managers for each asset class

## Investment Beliefs

| | Strongly Agree | Agree | Neutral | Disagree | Strongly Disagree |
|---|---|---|---|---|---|
| 1. Strategic asset allocation is the dominant determinant of return and risk | 45% | 45% | - | - | 9% |
| 2. A return premium is required to take on risk | 45% | 45 % | - | - | 9% |
| 3. Premium is required for illiquidity | 27% | 55% | 18% | - | - |
| 4. Long term investment horizon is an advantage | 75% | 18% | 9% | - | - |
| 5. Risk is not fully measurable | 27% | 27% | - | 45% | - |
| 6. Costs matter because they reduce returns | 64% | 27% | - | 9% | - |
| 7. Asset valuations are mean reverting | 9% | 64% | 27% | - | - |
| **ESG factors impact risk and return over the long term** | **36%** | **9%** | **27%** | **18%** | **9%** |
| **Additional Investment Beliefs** | | | | | |
| 1. Inefficiencies in the market create investment opportunities | 55% | 45% | - | - | - |
| 2. Make it as simple as possible; simple solution is often the best | 18% | 45% | 18% | 18% | - |
| 3. Be unconventional – Do not follow the herd | 55% | 36% | 9% | - | - |

# Next Steps

- Finalize recommendations – based on Board workshop discussion
  - Develop timetable expectation: One, Three, and Five Year Plan

- Investment Committee Action Item, Fall 2011, to propose implementation plan