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