

Sustainable Investment Case for ESG Integration

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CalPERS – Why Sustainable Investment?

- **We Aim to be a Principled and Effective Investor:** To deliver sustainable, risk-adjusted returns for more than 1.6 million members and their families.
- **Our Fiduciary Duty:** To at all times work in the best interest of our 1.6 million members and their families – for every dollar paid in CalPERS pensions, 66 cents comes from investment earnings, so it is vital that we achieve successful returns from our investment strategy.
- **Grounded in Economics:** Long-term value creation requires effective management of three forms of capital - financial, physical and human
- **Total Fund Approach:** Our total investment portfolio is valued at approximately \$284 billion and is diversified across stocks, bonds, real estate, infrastructure, private equity, cash and other investments.

Sustainable Value Creation Framework

Sustainable investment in its simplest form is the ability to continue, and for a long-term investor like CalPERS with long-term liabilities, it is critically important. Long-term value creation requires the effective management of three forms of capital: this is why we are concerned with environmental, social, and governance issues.

Physical Capital - Environment

Includes managing risk posed by climate change, and the use of natural resources and buildings

Human Capital - Social

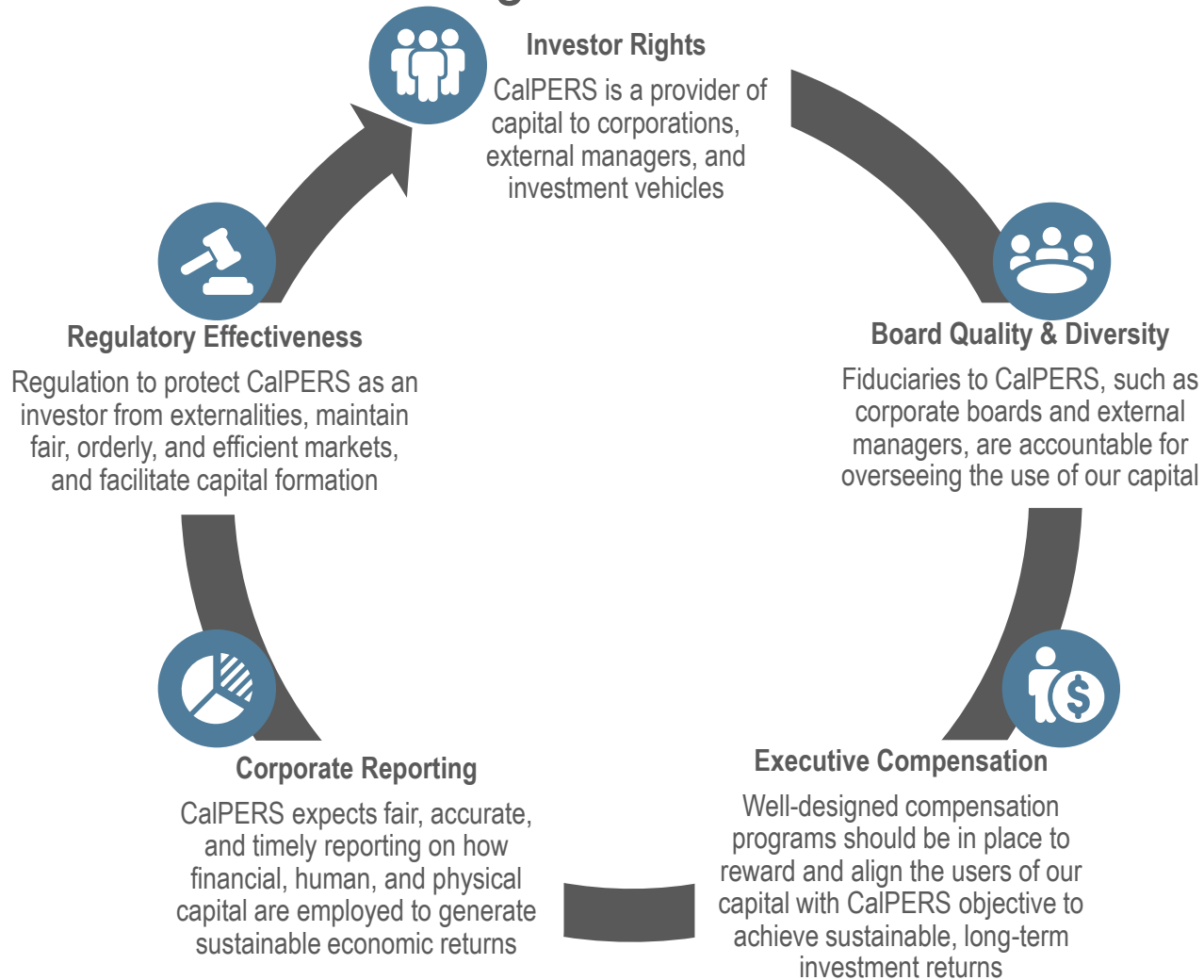
Includes health, safety, and labor practices



Financial Capital - Governance

To ensure alignment of interest over equity, debt, public and private investments

The Virtuous Circle of Long-term Value Creation



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

Investment Belief 2 (continued)

A long time investment horizon is a responsibility and an advantage.

Long time horizon enables CalPERS to:

- Invest in illiquid assets, provided an appropriate premium is earned for illiquidity risk
- Invest in opportunistic strategies, providing liquidity when the market is short of it
- Take advantage of factors that materialize slowly such as demographic trends
- Tolerate some volatility in asset values and returns, as long as sufficient liquidity is available

Investment Belief 4

Long-term value creation requires effective management of three forms of capital: financial, physical and human.

Sub-beliefs:

- Governance is the primary tool to align interests between CalPERS and managers of its capital, including investee companies and external managers
- Strong governance, along with effective management of environmental and human capital factors, increases the likelihood that companies will perform over the long-term and manage risk effectively

Investment Belief 4 (continued)

Long-term value creation requires effective management of three forms of capital: financial, physical and human.

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

Investment Belief 9

Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error.

Sub-beliefs:

- CalPERS shall develop a broad set of investment and actuarial risk measures and clear processes for managing risk
- The path of returns matters, because highly volatile returns can have unexpected impacts on contribution rates and funding status
- 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

What is the Evidence?

Evidence of how sustainability can affect performance does exist; but we don't have the data across the ESG spectrum due to the lack of consistent reporting.

CalPERS commissioned a comprehensive review in 2013 of the academic literature (700 papers) in this field through the Sustainable Investment Research Initiative (SIRI) led by UC Davis and Columbia.

- **Good Evidence** – “G” has an impact on risk and return
- **Early Days of Corporate Reporting** – Impact of “E” and “S” is inconsistent
- **Example** – Academic at the London Business School, Elroy Dimson reviewed 10 years data provided by a global fund manager concludes that investor engagement on environmental and social issues leads to improved performance.

(Dimson, Karakas and Li, “Active Ownership” available on the CalPERS governance website www.calpers-governance.org)

Factors CalPERS is Looking For on Sustainability

A growing number of companies are providing investors and stakeholders with information on sustainability factors.

Today, information is not integrated with financial reporting, and we lack standards; therefore, CalPERS has made corporate reporting one of our five core issues in our strategy for governance reform.

- **Sustainability Accounting Standards Board (SASB):** CalPERS actively supports SASB, a new initiative which is developing reporting standards, sector by sector, through working groups that comprise both investors and companies.
- **Objective:** Reporting standards on sustainability which are material, relevant, timely and ultimately subject to assurance (in parallel with auditing of the financial information).

Integrating ESG – From Belief to Action

CalPERS Focus List Program is a strategy employed to generate alpha through the engagement of portfolio companies on ESG factors.

We identify companies in our U.S. portfolio that we believe are significantly underperforming on both stock returns and ESG factors.

- **Strategy** – Improving financial performance on an investment over and against the market
- **Process** – Screening, researching, engaging, catalyzing, and partnering
- **Results** – Evidence of improved financial performance after being engaged on governance has become known as the “CalPERS Effect”
- **Monetization** – Beginning in 2012, and as a result of the evidence, CalPERS initiated the monetization of its Focus List strategy

What is the Business Case for Integrating ESG?

The business case is simple and compelling.

Global megatrends driving the economy require company leaders to address sustainability – resource scarcity, extreme weather events, social dislocation through global supply chains, labor disruptions, or the impact of drought and food shortages – these are business issues.

- **Old fashioned economics:** long term value creation requires effective management of three forms of capital – financial, physical and human. Companies ignore these issues at their peril.
- **Our message is “prosper or perish”:** companies that capture the potential of these global trends, and address the risks, are those which will thrive in the long term.

Corporate Engagement – Carbon Asset Risk Initiative

Example: Assessing the risk of portfolio company exposure to carbon assets

Topic	Sample Questions
Board Oversight	<ul style="list-style-type: none"> How does the board exercise oversight over carbon asset risk throughout the organization?
Forecasting GHG Emissions	<ul style="list-style-type: none"> What are the potential GHG emissions associated with the production of all unproduced reserves categorized by resource type?
Capital Expenditure	<ul style="list-style-type: none"> What are the capital expenditure plans for finding and developing new reserves, including consideration of rates of return and payback periods and alternative uses of capital?
Impact of Climate Policy	<ul style="list-style-type: none"> What are the risks to unproduced reserves, due to factors such as carbon pricing, pollution and efficiency standards, removal of subsidies and/or reduced demand?
Physical Impact	<ul style="list-style-type: none"> What are the risks to assets, particularly oil and gas infrastructure, posed by the physical impacts of climate change, including extreme weather, water stress, and sea level rise?
Human Capital	<ul style="list-style-type: none"> What are the impacts of risks associated with climate policies and the physical impacts of climate change on the Company's current and projected workforce?

Corporate Engagement – Human Capital Management Initiative

Example: Addressing financial, legal and reputational risk at portfolio companies.

Topic	Sample Questions
Board Oversight	<ul style="list-style-type: none"> How does the board exercise oversight over human capital management (HCM) throughout the organization?
Operational Integration	<ul style="list-style-type: none"> What resources are committed to managing human capital best practices not only throughout the company's domestic and international operations, but also throughout the company's supply chain?
Data Collection, Risk Management, Accountability	<ul style="list-style-type: none"> What are the major challenges or risks for human capital management that the company has identified; and, how does the company mitigate these risks?
Employee Engagement	<ul style="list-style-type: none"> What information is collected through employee outreach and engagement, and how is this information used to monitor or improve human capital management?
Incentives and Compensation Structure	<ul style="list-style-type: none"> How is human capital management aligned with incentive pay structures or other compensation practices?
Investor Engagement and Disclosure	<ul style="list-style-type: none"> What data (and how), if any, is disclosed to investors pertaining to the company's risk assessment and management of human capital?

CalPERS website:
www.calpers.ca.gov

View and download the full Investment Beliefs at:
<http://www.calpers.ca.gov/eip-docs/about/press/news/invest-corp/board-offsite.pdf>

View and download Full Sustainable Investment Report at:
<http://www.calpers.ca.gov/eip-docs/about/pubs/esg-report-2012.pdf>
or scan the QR code

