Seattle City Employees' Retirement System

Environmental, Social and Governance (ESG) Update
Third Quarter 2015

Purpose
This update is required by the following motion adopted by the Board at its meeting on February 12, 2015:

> *The Retirement Board of Administration directed that the Seattle City Employees' Retirement System (SCERS) pursue corporate engagement on climate change and other environmental issues, as presented by staff in their January 26, 2015 memorandum; and pursue, as appropriate, investments that are expected to produce investment results consistent with SCERS's fiduciary duty to its members and, if possible, also positively address climate change and other environmental issues. The Board recognizes that these types of investments (e.g. renewable energy, cleantech, and green bonds) are relatively new and limited in availability and will need to be considered prudently as SCERS pursues investments in its asset classes (e.g. real assets, private equity, fixed income).* ***SCERS's staff and advisers will provide quarterly updates regarding Environmental, Social and Governance (ESG) investment issues*** *and incorporate ESG into SCERS's work plan. The Board directs SCERS's staff to engage with trade associations such as Coalition for Environmentally Responsible Economics (Ceres) and other pensions to examine an approach to ESG investments, and also to consider engaging with an independent consultant to assist in this review.*

Staff has focused this update on the environmental issue of climate change since it was the catalyst for the motion. At the Board's direction, other ESG matters may be considered in future updates.

Industry Developments

Institutional Investors (with a focus on US Public Pensions)

- Vermont Pension Investment Committee declined to divest from fossil fuel companies in its pension plans. State Treasurer Beth Pearce wrote, in a memo to the committee, that "there would likely be significant, in the millions of dollars, one-time and ongoing annual losses as a result of implementing such a [divestment] strategy. Based on our analyses, and our statutory requirements and policies, I believe divestment from fossil fuels is not a strategy appropriate to the Vermont pension plans." [link]
- California's State Senate and Assembly passed SB 185 that requires CalPERS and CalSTRS to divest from investments in thermal coal companies unless their boards determine that it is inconsistent with their fiduciary responsibilities. It also indemnifies their boards from actions related to the bill. CalPERS and CalSTRS have officially taken "no position" in neither support nor opposition to SB 185. [link]

Topical Research

Mercer: Investing in a Time of Climate Change [link]
Mercer evaluates the investment impact of climate change through four potential scenarios, ranging from a 2°C increase with strong climate change mitigation activity to a 4°C increase with widespread economic damage. They introduce a framework based on four factors (technology, resource availability, impact, policy) in order to describe the multi-faceted nature of climate change. Mercer's analysis seeks to estimate asset class and equity sector performance for each of their scenarios. They find that developed market equities experience an annual return impact of -0.15% to -0.4% depending upon the scenario with higher losses associated with greater climate

change. Coal, oil and utilities perform poorly in terms of equity sectors, while renewables and nuclear perform well. *SCERS staff considers Mercer's analysis a useful first step to developing a framework that evaluates the impact of climate change on asset classes and equity sectors. While their findings are generally intuitive, staff notes that the analysis is based more on heuristics than empirical evidence and should be considered accordingly.*

The Economist: The Cost of Inaction [link]
Like Mercer, The Economist evaluates the investment impact of climate change. Their report differs from Mercer in two ways. Firstly, they only measure the impact of climate change on the aggregate value of investment assets rather than asset classes and equity sectors. Secondly, their methodology is based on simulations of future climate change paths rather than explicit scenarios. They estimate that climate change will have a present value cost, on average, of $4.2 trillion or 3% of aggregate investment assets with higher losses if climate change is greater than their base case expectations (that warming would be kept under 2°C). The Economist argues that climate change will decrease economic growth and, correspondingly, performance across portfolios. This systemic impact will make it difficult for investors to avoid climate risk. *SCERS staff finds merit in The Economist's findings. Given the relative lack of research and data on the investment impact of climate change, the more limited scope of their analysis is appropriate.*

BlackRock/Ceres: 21st Century Engagement [link]
This paper provides investors with strategies for incorporating ESG considerations into corporate interactions. It is a compilation of mostly public pension plan sponsors, money managers and a variety of advisors and other experts in ESG-related fields discussing ways to engage with company Boards on these issues. Each contributor explains the methods they have employed and how they have been successful. The topics range from informal meetings with the company's staff or Board members to drafting proxies and engaging on public policy. Some of the articles further explore the differences in engaging with international companies and how to tailor questions by sector. For SCERS, some of the articles are more or less relevant than others depending on the source and their objectives. Money managers, for example, who manage a socially responsible fund, will engage in a different way than a public pension plan. The contributions made by other public plans were instructive as to how our peers are approaching corporate engagement.

Ceres/INCR Takeaways
Staff reviewed Ceres's 2015 report: "Carbon Asset Risk: A Review of Progress and Opportunities." It reflects results from the Carbon Asset Risk Initiative, launched jointly in 2013 by Ceres and the Carbon Tracker Initiative. Key results/conclusions include [link]:

- As a result of increasing investor concern and activism, some fossil fuel and utility companies have begun to disclose information on their risks including whether they have internal prices on carbon emissions, how they might be affected by low carbon scenarios, and the extent to which they are examining renewable energy sources.
- The fossil fuel industry has a fractured response to engagement. Some oil and gas companies (Shell, BP, Statoil, and other European firms) support shareholder resolutions on the need to address climate change and establish global prices on carbon pollution, in contrast to American firms (Exxon and Chevron) that oppose doing so. Some companies also extoll the climate benefit of natural gas over coal.
- There are increasing technological breakthroughs and correspondingly increasing investment in clean energy.

Ken Nakatsu and Jason Malinowski attended (via conference call) a strategy meeting for INCR's Shareholder Initiative on Climate and Sustainability. Discussion topics included proxy advisory services and strategies for impacting corporate responsiveness, such as promoting climate risk aware directors. Several attendees mentioned they had written to the EPA and White House strongly encouraging them to curb methane, just before the EPA's announcement that they intended to do so.

SCERS Activity
Since February 2015, SCERS's staff has participated in 30 events, meetings and calls devoted to ESG with institutional investors, investment managers, consultants and/or membership organizations. The purpose of these interactions is to learn best practices and industry developments that may apply to the three areas of the positive action strategy that the Board has embraced:

Corporate Engagement

- SCERS joined institutional investors representing $37 billion in assets in a letter to Institutional Shareholder Services (ISS) expressing concern for their conflicting recommendations with regard to resolutions calling on companies to establish greenhouse gas reduction goals. SCERS and Vermont were the only two public plans who signed on to the letter. [link]
- SCERS Staff is recommending adoption of the ISS Public Fund Proxy Voting policy.

Integrating Climate Change into the Investment Process

- Staff has begun to evaluate Mercer's ESG ratings and research for potential incorporation into the infrastructure RFP process.

Sustainability Investments

- At the invitation of NEPC, Ken Nakatsu attended the White House Clean Energy Summit on June 16, 2015, in Washington, DC. Speakers included Vice President Biden, senior White House officials, entrepreneurs and investors. The summit content tended to be oriented toward foundations, endowments and venture capitalists, with discussions focused on such innovative technologies as small cap nuclear reactors. The White House announced that $4 billion had been committed by investors in 2015 for clean energy. [link]
- Several respondents to the infrastructure RFP put forth either dedicated renewable energy strategies or diversified strategies with material allocations to renewable energy. Staff and NEPC are evaluating the investment merits of all respondents with the goal of making a recommendation(s) in the fourth quarter.

Appendix

Market Performance
Annualized as of August 31, 2015

	Performance					Std Deviation	
Index	1Y	3Y	5Y	10Y	Since 1/90	10Y	Since 1/90
S&P 500 Index	0.47%	14.30%	15.86%	7.15%	9.22%	14.86%	14.58%
S&P 500 Index ex Energy	4.05%	15.92%	16.74%	7.37%	9.24%	15.05%	14.98%
S&P 500 Index ex Fossil Fuels	3.13%	16.37%	16.78%	7.78%	NA	15.23%	NA

Source: Bloomberg, Fossil Free Indexes, SCERS calculation

SCERS Public Equity Exposure to the Carbon Underground 200
As of August 26, 2015

		Total CU200 Exposure		Coal CU200 Exposure	
Account Type	Mkt Value ($m)	$ million	%	$ million	%
Separate Accounts	514.6	18.8	3.6%	0.7	0.1%
Commingled Funds	683.3	44.0	6.4%	6.7	1.0%
Total	1197.9	62.7	5.2%	7.4	0.6%

Source: Bloomberg, Fossil Free Indexes, SCERS calculation; excludes overlay program
Note: Coal CU 200 exposure excludes a limited number of companies that are on both the coal and oil & gas lists