Seattle City Employees' Retirement System

**Environmental, Social and Governance (ESG) Update**
Second Quarter 2016

## Purpose

This update is required by the following motion adopted by the Board 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 class (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 on the environmental issue of climate change. At the Board's direction, other ESG matters may be considered in future updates.

## Industry Developments

- **CalPERS** reviewed the performance impact of their past divestment actions within the global equity portfolio as reported by Wilshire Associates (CalPERS's investment consultant) in October 2015. Wilshire Associates estimated that these divestment actions had reduced investment earnings by $3.8 to $8.3 billion with the largest impact resulting from tobacco and South Africa divestment actions. In April 2016, the Investment Committee directed staff to revise its Investment Policy to require that the performance impact of any future divestment efforts be monitored. CalPERS also began considering whether to reinvest in tobacco companies as a result of these losses.[1]
- On June 6, 2016, DC Divest announced that the **District of Columbia Retirement Board** (DCRB) has divested of its directly held stock in fossil fuel companies on the Carbon Underground 200 list. It appears that this action is limited to the approximately 10% of DCRB's total portfolio that is in actively-managed public equity separate accounts. No further information is available as of the time of this update.
- **Wilshire Associates**, an investment consulting firm, released a program and accompanying paper in May 2016 to help their clients understand and potentially respond to climate change risk. Related to divestment, Wilshire stated that "the systemic nature of climate risk may make

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divestment an ineffective investment strategy for bringing about change and could actually introduce new risks and costs into an asset owner's portfolio." Wilshire did state the divestment could be prudent if ownership of certain assets is incongruent with an asset owner's beliefs and mission, such as in the case of foundations and endowments.

**Membership Organization Activity**

- Jill Johnson attended the **Council of Institutional Investors (CII)** spring conference from March 21-23, 2016. CII sponsors a semi-annual conference on topical areas regarding corporate governance. The conference speakers and panelists spoke on ESG issues, including considering environmental factors as a risk, carbon asset risk after the Paris COP21 agreements, CEO pay, board tenure and diversity and other topics. Some key takeaways include how long tenures for board members may prevent boards from becoming more diverse; boards' difficulties in balancing short term advocacy issues with longer term strategic planning; efforts to compel private equity firms to be more transparent; ESG as a mainstream risk consideration; how to reign in CEO pay.
- Jill Johnson participated in **Ceres**' monthly conference calls and frequent list serve activity for their *INCR Carbon Asset Risk Working Group*, the *INCR Policy Working Group* and the *Shareholder Initiative on Climate and Sustainability*.
- Ken Nakatsu attended an event sponsored by the Washington State Insurance Commissioner and University of Washington Climate Impacts Group on the subject of climate risk and the insurance industry. The event included presentations by insurance company representatives and insurance regulators who shared their experiences in addressing climate change through their underwriting and monitoring activities.

**SCERS Activity**

Since February 2015, SCERS's staff has participated in 51 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**

- Jill Johnson participated in a call with **BlackRock**'s Head of Corporate Governance that was organized by Zevin Asset Management, a socially responsible investment company, and also included Walden Asset Management, State of Connecticut, CalSTRS, Mercy Investment Services, Ceres, Florida SBA, Mercer and Cornerstone Capital. The purpose of the call was to ask BlackRock about the inconsistency of its stated "social, ethical and environmental" beliefs and its actual proxy voting track record. Blackrock described that they prefer to take an active approach to engagement versus being oppositional to company management in proxy voting.
- SCERS joined with other asset owners to sign a declaration of support for climate asset risk shareholder resolutions at the Annual General Meetings of nine fossil fuel companies, including Chevron and Exxon. SCERS supported these resolutions through its recent adoption of the ISS Public Funds policy for its proxy voting activities. While the Chevron and Exxon resolutions narrowly lost with 41% and 38% support, respectively, this proxy season witnessed continued momentum in the effort to require fossil fuel companies to perform climate change stress tests.[2]
- SCERS joined Green Century Funds and other investment managers, institutional investors and businesses in a letter to the Department of Justice requesting an investigation of Exxon for its alleged efforts to intentionally misinform the public about climate change.[3]

**Integrating Climate Change into the Investment Process**

- SCERS engaged Mercer to produce an ESG-focused research report on Global Infrastructure Partners III. Mercer's ESG report rated GIP III highly. Both the Investment Committee and the Board approved SCERS's investment in GIP III.
- Friends of the Earth had contacted SCERS staff and made public comment at its March Board meeting with concerns that **Dimensional Fund Advisors** (DFA) was not in compliance with the United Nations-supported Principles for Responsible Investment (UN PRI) of which DFA is a signatory. SCERS expressed this concern to DFA, which replied that it was indeed compliant with the UN PRI. SCERS reviewed the UN PRI guidelines and confirmed compliance.

**Sustainability Investments**

Motion: "…*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 class (e.g. real assets, private equity, fixed income)…*"

- No updates

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[1] www.calpers.ca.gov/docs/board-agendas/201510/invest/item07a-01.pdf
[2] www.ceres.org/issues/carbon-asset-risk/investor-support-of-portfolio-resilience-resolutions
[3] www.greencentury.com/investors-call-on-the-doj-to-investigate-exxon

# Appendix A

**SCERS Public Equity Exposure to the Carbon Underground 200**

*As of May 31, 2016*

| | | Market Value | Total CU200 Exposure | | Coal CU200 Exposure | |
|---|---|---|---|---|---|---|
| Ownership | Account Type | $ million | $ million | % | $ million | % |
| Direct | Separate Account | 589.6 | 30.3 | 5.1% | 1.6 | 0.3% |
| Indirect | Commingled Fund | 632.9 | 42.1 | 6.7% | 7.7 | 1.2% |
| Total | | 1,222.5 | 72.4 | 5.9% | 9.3 | 0.8% |

Source: Bloomberg, Fossil Free Indexes, SCERS calculation; excludes overlay program, transition holdings

Note: Coal CU 200 exposure excludes a limited number of companies that are on both the coal and oil & gas lists; CU200 constituents as of January 2015

## Appendix B

**SCERS Activity since the Positive Action Strategy began in February 2015**

### Corporate Engagement

- 2Q15: SCERS joined the Investor Network on Climate Risk (INCR), a network organized by Ceres that includes 110 institutional investors representing more than $13 trillion in assets. INCR's mission is to mobilize investor leaders to address climate and other key sustainability risks, while building low-carbon investment opportunities.
- 2Q15: SCERS joined institutional investors representing $1.9 trillion in assets in a letter to the SEC calling for greater regulatory prioritization on the disclosure of climate risks of energy companies.
- 2Q15: SCERS engaged Institutional Shareholder Services (ISS) to report on the proxy voting records of its public equity managers as it compares to the ISS Standard and Sustainability policies. The first quarterly report is expected in mid-June. Staff also spoke with ISS, Rhumbline and Parametric to assess the feasibility of adopting the ISS Sustainability policy for SCERS's public equity separate accounts.
- 3Q15: 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.
- 3Q15: SCERS Staff recommended adoption of the ISS Public Fund Proxy Voting policy.
- 4Q15: SCERS rejoined the Council of Institutional Investors (CII). CII describes itself as: “the Voice of Corporate Governance. The Council of Institutional Investors (CII) is a nonprofit, nonpartisan association of corporate, public and union employee benefit funds and endowments with a focused policy mission: to be the leading voice for effective corporate governance practices for U.S. companies and strong shareowner rights and protections. CII has more than 120 General Members with combined assets that exceed $3 trillion.”
- 4Q15: SCERS began instructing its public equity separate account managers to vote the proxies of its shares according to the Institutional Shareholders Services (ISS) Public Funds policy, when practicable. Previously, SCERS had delegated proxy voting to its investment managers. ISS's Public Funds policy is more in line with SCERS's goals for corporate governance and stronger ESG accountability.
- 4Q15: SCERS joined 400 other investors in signing the Global Investor Statement on Climate Change that calls on governments to reach a robust global agreement to combat climate change.

### Integrating Climate Change into the Investment Proces

- 2Q15: SCERS (through NEPC) included an ESG section in its RFP for infrastructure managers.
- 3Q15: Staff began to evaluate Mercer's ESG ratings and research for potential incorporation into the infrastructure RFP process.
- 3Q15: Mercer presented to the Board on its paper, “Investing in a Time of Climate Change.”
- 4Q15: SCERS hired Mercer to produce ESG-focused research reports on the infrastructure finalist candidates so that the Board and Staff could consider their approaches to ESG risks in making selections.

- 1Q16: SCERS engaged Mercer to produce an ESG-focused research report on Brookfield Infrastructure Fund III, which was approved by the Board in March 2016.

**Sustainability Investments**

- 2Q15: SCERS (through NEPC) issued an RFP for infrastructure managers. Staff believed that there are several managers with dedicated renewable energy strategies or diversified strategies with material allocations to renewable energy that would respond to the RFP.
- 3Q15: 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 evaluated the investment merits of all respondents.
- 1Q16: Staff and NEPC recommended a commitment of up to $15 million to Brookfield Infrastructure Fund III due to its expected investment return and risk properties. Additionally, the strategy is expected to have a 35% allocation to renewable power investments, primarily in hydroelectric facilities and wind farms.