Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 12

MEETING DATE: **March 15, 2023**

SUBJECT: **Education: ESG and Values-Based Investing**

SUBMITTED FOR: __ **Consent** ___ **Deliberation and Action** _X_ **Receive and File**

RECOMMENDATION

Receive and file the presentation from general investment consultant Verus Advisory and Staff on ESG and Values-Based Investing.

PURPOSE

This item supports the 2023 Annual Investment Plan to provide investment education to Board members.

DISCUSSION

Verus and Staff are providing a discussion on ESG and Values-Based Investing based on Board direction. This is a topic which has garnered increasing attention within and outside of the investment community, including among public pension plans.

The objective of the presentation is to provide background and approaches that institutional investors take to ESG and values-based investing, and review SCERS' experience and approach on this topic.

ATTACHMENT

- Board Order
- ESG and Values-Based Investing presentation

Prepared by:	Reviewed by:
/S/	**/S/**
Steve Davis Chief Investment Officer	Eric Stern Chief Executive Officer

Retirement Board Order

Sacramento County Employees' Retirement System

Before the Board of Retirement
March 15, 2023

AGENDA ITEM:

Education: ESG and Values-Based Investing

THE BOARD OF RETIREMENT hereby approves Staff's recommendation to receive and file the educational presentation on ESG and Values-Based Investing, as presented by Staff and Verus Advisory.

I HEREBY CERTIFY that the above order was passed and adopted on March 15, 2023 by the following vote of the Board of Retirement, to wit:

AYES:

NOES:

ABSENT:

ABSTAIN:

ALTERNATES:
(Present but not voting)

Keith DeVore
Board President

Eric Stern
Chief Executive Officer and
Board Secretary

PERSPECTIVES THAT DRIVE ENTERPRISE SUCCESS

MARCH 2023

Education: ESG and Values-Based Investing

Sacramento County Employees' Retirement System

Purpose of Presentation

— Conversation – not recommendation
— What is "ESG"
— SCERS' experience
— Common peer public plan approaches
— Next Steps: Direction from the Board

Background on values-based investing

An abbreviated history

Events, people and interest have all contributed to the current environment

1700s
The origins are rooted with early religious investors who promoted screens avoiding gambling, tobacco gaming and other "sin stocks."

1968
Ford Foundation pioneered Program Related Investments. The IRS coined the term "program related investment" in the Tax code of 1969.

1971
Pax World Fund – considered the first socially responsible investment (SRI) mutual fund – avoids investments in weapons contractors. The fund offered an option to investors opposed to militarism & the Vietnam war.

1973
First 20th century shareholder resolution by religious organization filed by Episcopal Church through Interfaith Center of Corporate Responsibility.

1980s
Social investors supported the anti-apartheid movement by divesting from companies doing business in South Africa. As a practice based on values and moral principles, avoidance screening became one of the basic strategies of social investing.

1995
FB Heron Foundation championed Mission Related Investing.

2015
The Department of Labor issued new guidance confirming consistency with fiduciary duty of "economically targeted investments" by pension funds under ERISA.

TODAY
Many more strategies and approaches to ESG have evolved

Defining the terms

Investing with an intent that goes beyond generating financial returns

Socially Responsible Investing
SRI is investing with one's values, screening out or not investing in certain companies or industries (negative screens), or only investing in particular companies because they exhibit desirable traits (positive screens).

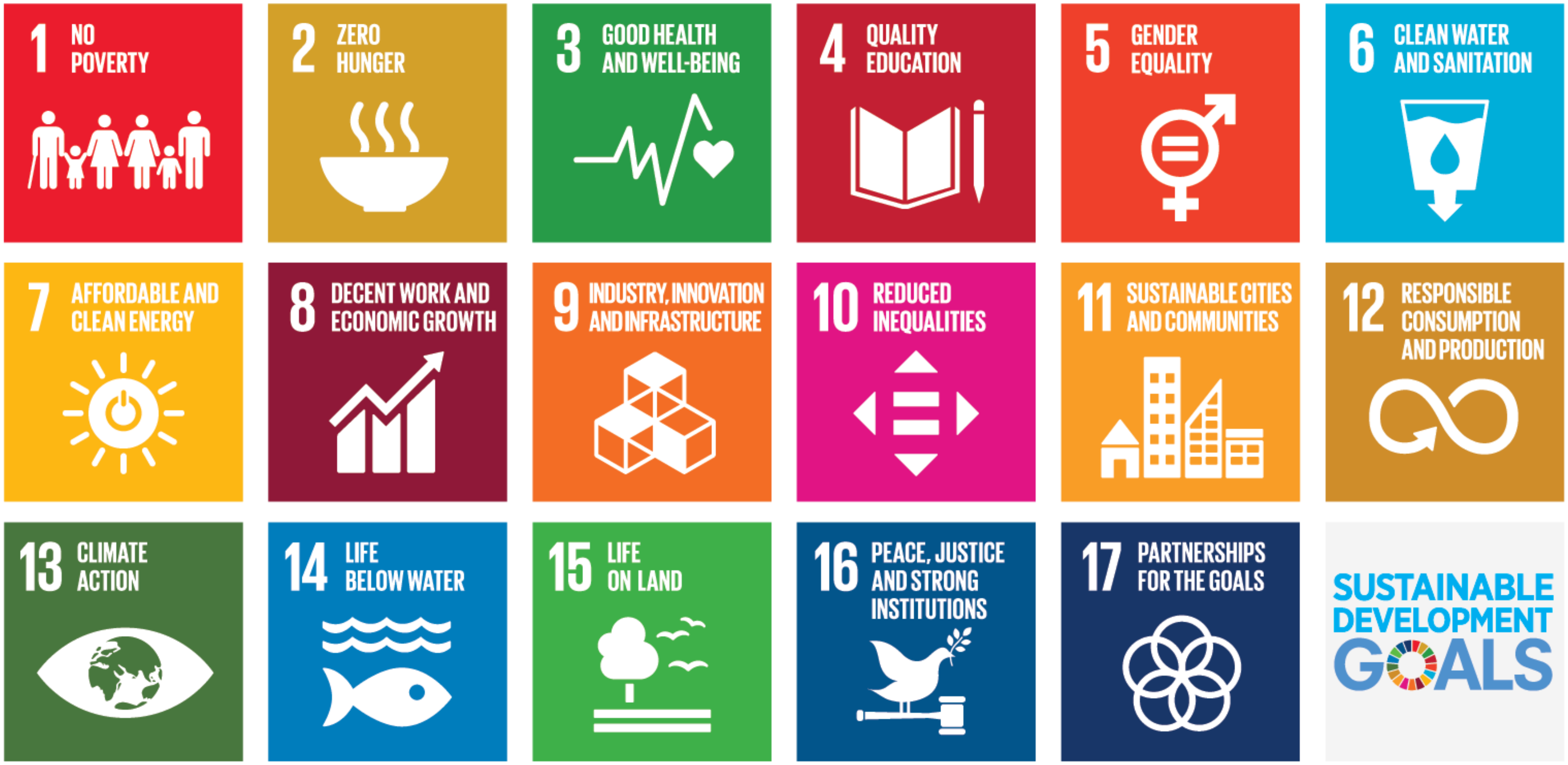
Environmental, Social and/or Governance (ESG)
ESG investments are made with the goal of positively impacting the environment, the social order and the company's own governance issues, such as executive compensation, board structures and actions that affect the interests of shareholders (e.g. proxy votes, shareholder activism).

Active Ownership
Investing with the purpose of encouraging companies to manage non-financial risks and run sustainable businesses in order to create long-term shareholder value. This can be exercised through shareholder advocacy or shareholder engagement, proxy voting and corporate resolutions.

Economically Targeted Investing
ETIs target a financial return to the fund as well as economic growth or some other ancillary benefit in areas related to beneficiaries.

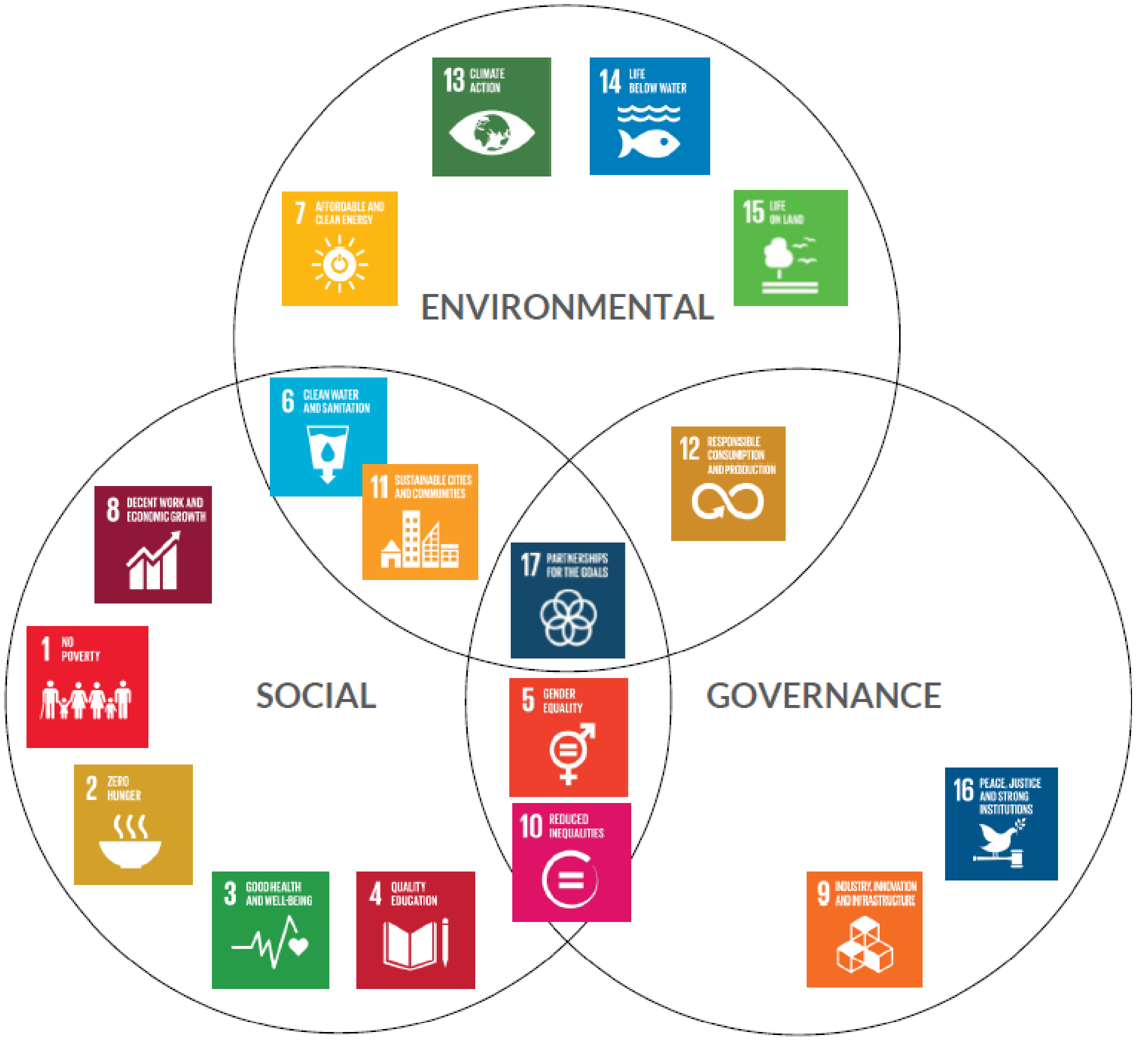
Impact Investing
Investing with the intent to create measurable social or environmental benefit in addition to financial return.

Many different focus areas



Source: UNPRI Sustainable Development Goals

Mapped within broader ESG categories



Source: UNPRI

So many questions with ESG-specific…

Since values and morals change from individual to individual, and organization to organization, ESG-specific and Socially Responsible Investing (SRI) are often viewed as cloudy and confusing areas.

Investment managers are not exempt from the confusion as they develop ESG-specific strategies.

The decision is based on which values to reflect.

"Low-fat, extra foam, double pump, ex-tobacco, light-fossil fuel delight"

"Extra hot, no whip, low foam, un-sweetened, diversity-friendly, alternative energy pour-over"

Comparison of different approaches

← Lower implementation cost/lower impact | Higher implementation cost/higher impact →

	Integration	Exclusion/Divestment	Shareholder Engagement	Impact Investing
Cost considerations	Least resource-intensive in terms of staff and; may result in increased costs Proxy voting can be tool	Requires more staff time and resources. Proxy voting can be tool Necessity for custom benchmarks may increase custody or analytic service fees May increase fees for typically lower cost mandates (i.e., passive indexes)	Higher resource (e.g., dedicated ESG staff) requirements to actively follow, engage with and monitor companies Proxy voting can be tool Likely higher legal and administrative related fees	Highest cost in terms of resources, oversight and due diligence Often requires utilizing specialist partner(s) to proactively seek ESG opportunities
Implementation considerations	*Mutual funds, commingled funds and separate accounts*: onus is on investment manager(s) to integrate ESG in investment decision making	*Mutual funds, commingled funds and separate accounts*: onus is on investment manager(s) to implement funds' exclusion rules and provide reporting	*Mutual funds, commingled funds and separate accounts*: onus is on investment manager(s) to exercise active ownership on behalf of investors	Most time and labor intensive to implement relative to other approaches. Dedicated ESG staff optimal for success
	Direct investments: onus is on asset owner to incorporate ESG into mandate guidelines and conduct due diligence and monitoring	*Direct investments*: onus is on asset owner to develop exclusion mandate guidelines and conduct due diligence and monitoring to ensure adherence	*Direct investments*: asset owner directly engages with investee companies	Can only be implemented via direct investment separate account mandates
	Managers and/or consultants can provide ESG reporting in fulfillment of Fund oversight requirements	Custodian bank and/or consultant can provide reporting and support for oversight	Asset owners conduct monitoring and evaluation of engagement activities	Opportunities tend to be limited; scalability can be issue for larger Funds. Asset owners conduct monitoring and evaluation activities

Comparison of different approaches

INTEGRATION/VALUE/RISK-BASED	THEME BASED/VALUES/ESG-SPECIFIC
Incorporates ESG value-oriented evaluation into the investment process.	Incorporates ESG values-oriented exclusions/screening and evaluation into the investment and portfolio construction process.
— ESG factors are used to identify financial or headline risk	— Reducing carbon emissions
— ESG factors are used to identify financial opportunities	— Lessening, or solving, water stress
— ESG factors are considered when determining the appropriate valuation for a security	— Investing inline with religious beliefs
— May hold "ESG-ugly" securities if the manager believes the valuation reflects the risks	— Support increasing diversity
— May focus on engagement, rather than exclusion	— Support for affordable housing
	— Investing inline with environmental beliefs
	— Excluding firearms

SCERS' Experience

— No formal policy or process – closest to 'Integration/risk-based' approach

- Informally part of the asset allocation and investment manager due diligence process
- Evaluate mosaic of factors and risks to maximize total portfolio returns

— Most investment managers self-report "ESG" policies, processes

- Consultants review and rate the process, but do not validate value criteria or compliance

SCERS’ Experience

ENVIRONMENTAL

- Investment Policy includes fossil fuels and renewables as part of investable universe
- Benchmark-centric exposure to fossil fuels within public markets and modest exposure within private markets; growing exposure to renewables and energy transition

SOCIAL

- Due diligence includes diversity within manager organizations and investment teams
- Can also include company ethics, reputation, and employee turnover

GOVERNANCE

- Mostly via public market proxy voting
- ISS ‘Benchmark’ policy – maximize shareholder value

Peer Investor Approaches

— Varying approaches

- Informal integration/value/risk-based approach
- Formal ESG policy – can include scoring of managers
  - Can also include policies against ESG
- Exclusion of certain investments (i.e., fossil fuels)
- ESG specific target allocations into the strategic asset allocation (i.e., renewables/energy transition mandates)

— Political dynamics have an impact

- Legislative mandates around divestment and exclusion (California)
- Legislative initiatives that prohibit allocating to investment managers that focus on ESG at the organizational level (Texas/Florida)
- Public pension plan ambiguity between adhering to fiduciary duties versus potentially adhering to legislative mandates
  - Creates challenges for investment managers and consultants also

Key takeaways from Board ERT Survey on ESG in 2021

In the 2021 Enterprise Risk Tolerance Survey, Verus included three questions related to ESG:

1. What is your perspective on ESG policies/initiatives which are implemented and governed at the Plan level versus ESG considerations/implementation at the investment/manager/fiduciary level?
2. How do you feel about maximizing portfolio returns at the expense of ESG risks /considerations?
3. Energy – fossil fuels vs. renewables? Exclusionary screening?

— The consensus opinion, at that time, was that ESG was important and perhaps something we should be thinking about, but any implementation should NOT come at the expense of potential returns or the overall SCERS Plan Objectives.

— All of the Trustees were against the idea of screening out investments that violate a set of common ESG standards (i.e., fossil fuels).

Next Steps

- Options for SCERS
  - Continue with current approach
  - Any changes to current approach require more Board discussion and direction

Roles:

- Board/Staff: Identify value
- Investment Consultant: Education
- Board: Approve investment policy statement (IPS) with specific criteria

Identify Values › **Board Education** › **Board Consensus** › **Investment Policy Statement** › **Implement Values**