MEKETA
INVESTMENT GROUP

San Jose Federated City Employees' Retirement System

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Environmental Social Governance Introduction

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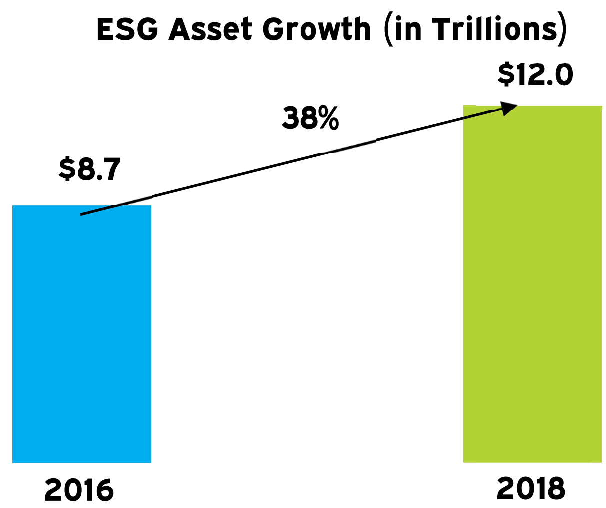
Introduction to ESG

- The San Jose Federated City Employees' Retirement System is among a growing number of US public investment entities taking steps to understand how Environmental, Social and Governance (ESG) issues may be integrated in to their investment decision-making process to support their fiduciary duties.
- Today we provide an introduction to ESG and an overview of institutional investor approaches to ESG.

ESG Investing

- ESG investing refers to the use of Environmental, Social, and Governance factors into investment decision making and management.
- ESG investing encompasses a wide range of approaches.
- Combined, all versions of ESG invested assets expanded by 38% from 2016 to 2018 in the United States.[1]



- Much of this growth was driven by asset managers, who now consider environmental, social or corporate governance (ESG) criteria across $11.6 trillion in assets, up 44 percent from $8.1 trillion in 2016.

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[1] US SIF 2018 Report.

ESG Investing

ESG investing encompasses shareholder proxy voting and engagement.

- Shareholder proxy resolutions related to ESG issues are gaining increasing traction.
- Institutional investor coordinated engagement on ESG issues continues to escalate.

ESG Potential Material Factors

- During the past decade, the institutional investor market has become increasingly attentive to the potential material impact of ESG factors on investment performance.

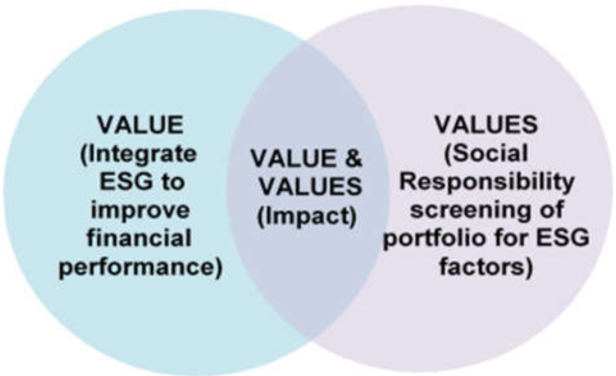
Common ESG Considerations

Environment	Social	Governance
Climate change	Consumer rights	Board structure
Energy transition	Health and safety	Board diversity
Sustainability best practice	Product safety	Independent directors
Environmental policy & mgmt.	Labor relations	Chairman / CEO split
Water supply	Community / stakeholder relations	Executive pay
Sustainable transport		Shareowner rights
Waste management		Accounting / audit

ESG Data

- ESG data availability, marketing presence and regulation have increased dramatically in the last few years.
- In 2011, only 20% of the companies in the S&P 500 Index reported ESG metrics; now over 80% report.
- ESG data and scores vary widely among vendors, which can result in different performance.

ESG Investing Encompasses Three General Approaches



VALUE (Integrate) – fits naturally with fiduciary role of US public pension plans

- Integrate material ESG factors into fundamental financial analysis to improve the financial value – the long-term risk-adjusted return of a portfolio; applies to market-wide and theme based strategies across all asset classes.

VALUE & VALUES (Impact)

- Identify specific ESG factors that impact an investment portfolio to both: meet or exceed market financial risk-adjusted returns and generate specific quantifiable ESG social responsibility impacts (typically private market).

VALUES (Social Responsibility)

- Identify specific ESG factors, typically through positive and/or negative screens, to generate or influence a specific ESG, ethical or social value, without explicit regard to the financial returns to the portfolio; negative screens often show under performance of risk-adjusted returns.

Investment strategies evolving from Socially Responsible to Integrate and Impact

		Investor Expected Outcomes		
Investment Approach to ESG Factors	**Description**	**ESG outcome at companies**	**Investor ESG Exposure**	**Competitive Performance**
Value - Integrate ESG	Integrate material ESG risks to improve financial risk adjusted return	Not Always Required	Not Always Required	Required
Value and Values - Impact Investing	Incorporate a quantifiable social outcome and seek to make a market return	Required	Required	Not Always Required
Values – Socially Responsible Negative Screen	Exclude companies based on non-financial concerns, such as tobacco, firearms, fossil fuels	Not Required	Required	Not Always Required
Values - Socially Responsible Positive Screen	Select a portfolio of companies with desirable characteristics to form an investment universe, such as clean energy, women on boards	Not Always Required	Required	Not Always Required

- There is no one 'right' approach to ESG.
- ESG implementation can be costly, time consuming, and require additional staff and external resources.

Commonly Used Terms in ESG Investing

Investment Approach to ESG Factors	Description	Most Relevant Terms		
Value - Integrate ESG	Integrate material ESG factors to improve financial value (risk-adjusted return)	ESG	Integrate	Value & Values Material
Value and Values – Impact	Incorporate a quantifiable social outcome and seek to make a market return	ESG Impact	Sustainable SRI	Value & Values Material
Values – Socially Responsible Investing	Develop a portfolio of companies with desirable socially responsible characteristics to form an investment universe	ESG Negative Screen	SRI CSR	Values Positive Screen

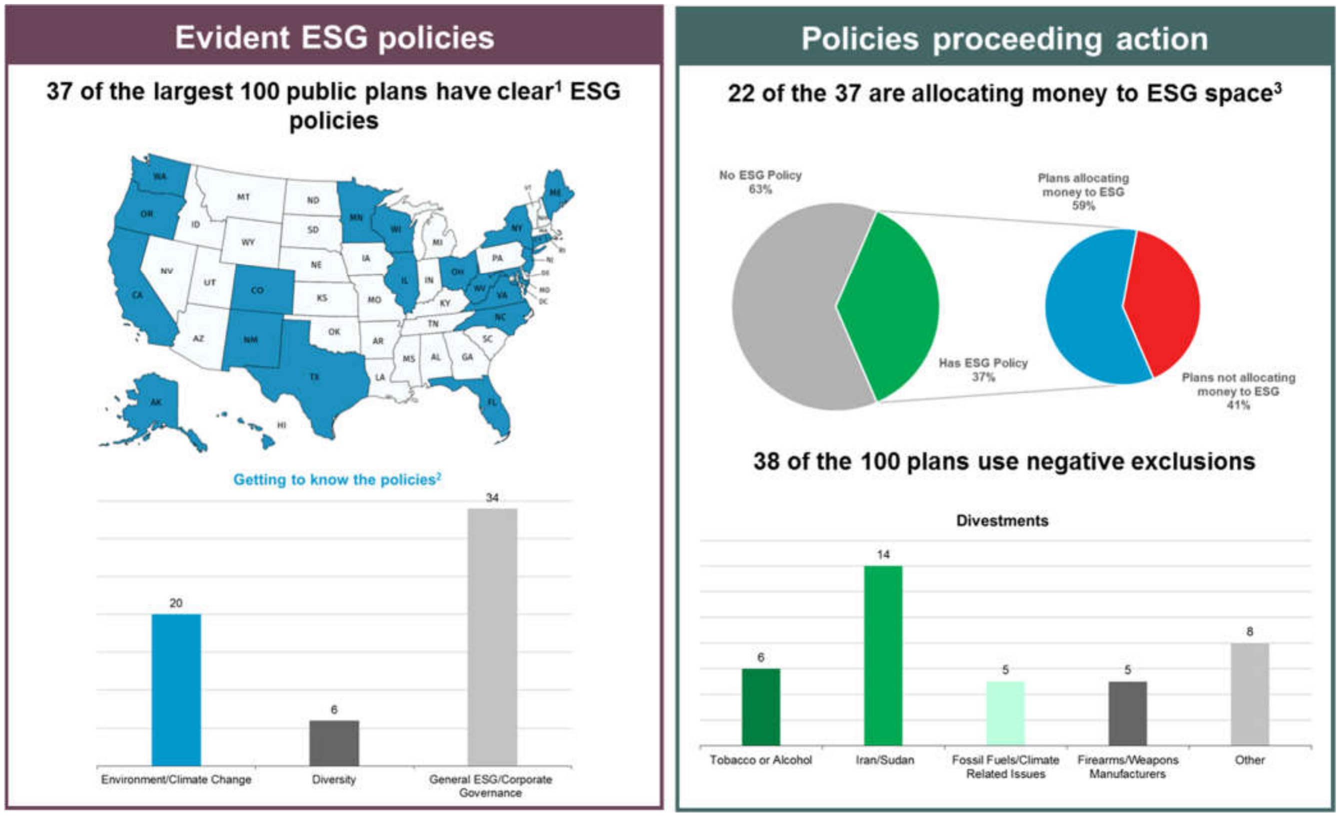
- ESG measures environmental, social and governance activities to arrive at an assessment of a company's actions and impact on its employees, consumers, the environment and wider community.
- MATERIAL ESG factors have a potentially material impact on an investment's financial value.
- IMPACT investing refers to investments made into companies, organizations, and funds with the intention to generate a measurable, beneficial social or environmental impact alongside a competitive financial return that meets or exceeds market returns.
- SUSTAINABLE investing considers environmental, social and corporate governance criteria to generate long-term competitive financial returns and positive societal impact.

SRI (Socially responsible investing), or social investment, also known as socially conscious, green or ethical investing, is any investment strategy which seeks to consider social/environmental good to bring about social change regarded as positive by proponents.

- CSR (Corporate Social Responsibility) represents a company's efforts to have a positive impact on its employees, consumers, the environment and wider community. It's a form of self-regulation that most large companies report on annually.
- NEGATIVE SCREEN excludes securities from an investment portfolio based on specific socially responsible criteria.
- POSITIVE SCREEN creates a portfolio of securities based on specific socially responsible criteria.

What ESG Looks Like For Institutional Investors Today

Preliminary assessment of ESG among the largest US public plans



[1] LGIMA reviewed public fund websites for straight-forward disclosure of ESG policies and practices. It is possible that plans use or follow ESG policies that were not captured in this analysis. Understanding the current state of disclosure was one of the objectives of the research.
[2] Some plan policies incorporate more than one component so values will not sum to total.
[3] There are three additional plans in the top 100 without policies that are allocating (not reflected in the numbers above)
Source: Legal & General Investment Management America, Inc.

- General ESG corporate governance polices are most prominent today.

ESG at US Public Pension Plans

- ESG approaches may be incorporated into any or all of the following aspects of a plan's investment strategy and governance.
  - Investment beliefs
  - Investment policy
  - Asset allocation
  - Investment manager selection
  - Monitor investment managers
  - Monitor investment portfolio
    - Select ESG factors
    - Climate change reporting
  - Engagement
    - Investment Managers
    - Regulators/Government
    - Companies

ESG at US Public Pension Plans

- Plans vote their proxies in accordance with their ESG policies, with a service provider's or custom guidelines.
- Plans of widely different sizes may also conduct ESG engagement that can be heavily resource intensive.
- Some plans are beginning to monitor their investment manager's approach to material ESG factors.
- Some plans allocate assets using ESG criteria, with an increasing trend toward ESG integration, and impact.
- A handful of plans are beginning to monitor their overall investment portfolio.
  - Accelerating this year - climate change risk (some legally required)
    - Carbon footprint
    - Carbon footprint, green revenue share, physical climate risk
    - Climate risk report, including forward-looking climate scenario analyses and assessments of company strategies to address climate risks, in line with TCFD (Task Force on Climate Related Financial Disclosures) guidelines
    - Climate change Value at Risk (incubator)
  - Emerging – overall portfolio monitoring on key E, S, and G metrics (some specific asset class already).
    - Challenges
      - Overview ESG scores among data providers range widely
        - Moody's and Fitch bond ratings correlation is over 99% - clear market signals
        - ESG data ratings correlations range between 44% and 77% (no standards)
      - ESG data metrics can capture key points but do not provide integrated overview

ESG at US Public Pension Plans

Below provides just a sample of the activities of a few plans:

- CalPERS ($380 billion) – Co-founder of a number of global organizations, from the UN PRI to Climate Action 100+, to 2019 Net Zero Asset Owners Alliance; sustainability allocations; exclusions for tobacco, and mandated Sudan, Iran, thermal coal.
- CalSTRS ($242 billion) – Leads engagements (civilian firearms); lead investor in ESG passive index strategies such as Women on Boards and Low Carbon; active private equity green/clean tech investor; exclusions for tobacco, and mandated Sudan, Iran, thermal coal.
- New York CRF ($207 billion) – new policy to monitor managers and consultants for alignment with climate policy, and put service providers on watch for non-compliance.
- UC Regents ($120 billion) – active responsible investment; 2019 announced long-term fossil fuel divestment.
- San Francisco ERS ($25 billion) – first US public pension plan to monitor individual company fossil fuel company using climate and financial risk; watch & exclude criteria.
- Hawaii ERS ($17 billion) – PRI member; adjusting investment portfolio to state legislation aligned with the Paris agreement on environmental and renewable energy goals -reducing ERS fossil fuel company exposure.
- Vermont Pension Investment Committee ($4.5 billion) – co-filer on multiple climate shareholder proposals.
- Seattle City ERS ($3 billion) – developed their first climate scenario portfolio analysis in 2019.

San Jose Federated City Employees' Retirement System Options

San Jose Federated – Possible Future Considerations

- Depending on Board interest, could amend San Jose Federated Investment Policy to include an ESG investment policy statement.
- Include in Investment Beliefs if desired.
- Review on an annual basis San Jose Federated ESG due diligence questions for manager monitoring and selection.
- Consider expanding ESG engagement *(costs and staff time can vary widely)*.
  - Investment managers

    (Cost - can be least costly type of engagement– an extension of annual monitoring)
  - Regulatory/governments – in coordination with other institutional investors

    (Cost - may require minimal staff, Board discussion, and consultant time, depending on number of issues and approach (e.g. letter writing to support an organized institutional investor advocacy)
  - Company engagements – in coordination with other institutional investors

    (Cost - staff/Board time and costs to determine key focus, avenues, plus range of costs that increase significantly from low (e.g. co-filer on an existing proxy proposal) to high (lead investor on a long-term engagement)
- Discrete, periodic, portfolio monitoring – such as climate risk, and/or other key ESG metrics.

  (Cost - likely to vary from modest to significant, depending on approach)

Currently, ESG Due Diligence Questions are Incorporated in Manager Selection and Monitoring for Searches.

- Public equity manager sample questions:
  - Is your firm a member of PRI and/or other institutional investor ESG related organizations? Please list.
  - How do you integrate ESG factors into your investment approach?
  - Have ESG factors affected your investing? If so, please provide example(s).
  - What impact have ESG factors had on the fund's risk, return and diversification performance?
  - What reporting on ESG do your firm provide for clients?
  - How is your organization staffed regarding ESG analysis and investments?
  - Do you have ESG Investment Policy and Guidelines? If so, please provide.
- Portfolio-wide considerations
  - ESG questions designed for each asset class.

Investment Manager Engagement

- Typically, large pension funds or others consider this option.
- Can be an extension of investment manager monitoring.
- Because investment managers, particularly very large investment managers, may control the shareholder votes on a material amount of assets, they can yield influence on investee companies through their proxy voting and through engagement.
- Investment managers increasingly are organizing and disclosing their engagement on key ESG issues:
  - Designing questionnaires on key ESG issues to their plan.
  - Require all managers to respond.
  - Actively follow up with managers on key issues that the plan thinks need additional attention.

Company Engagement

- Mostly large pension funds or endowments or religious organizations pursue this option.
- Can be very labor intensive.
  - Leading coordinated engagements can take significant staff and/or consultant resources.
  - Less resource-intensive options:
    - Seek to co-lead with a large institutional investor from the Climate Action 100+.
    - Consider an outsourced engagement service – new services emerging from institutional investment service providers including managers, proxy service providers and consultants.

Regulatory/Governments Engagement

- Some public funds expand participation in institutional investor efforts to shift ESG regulatory frameworks.
- Coordination assisted by institutional investor organizations such as:
  - Investor Stewardship Group
  - Principles for Responsible Investment
  - Council of Institutional Investors
  - CERES, Investor Network on Climate Change
  - Climate Action 100+
  - Sustainable Accounting Standards Board
  - Net Zero Asset Owner Alliance
- Become signatories to coordinated institutional investor letters such as:
  - Global Investor Statement to Governments on Climate Change.
  - Formally endorse the Taskforce on Climate-related Financial Disclosure ("TCFD") recommendations that seek enhanced quality data disclosure on climate related risks; No cost; Plans are listed on TCFD website.
  - Review ESG related issues as they arise for possible signature or plan letter, domestic, such as the Securities and Exchange Commission, and global entities.

Summary

Summary

- ESG institutional investor investment standards continue to evolve.
- Approaches to ESG vary widely among US public pension plans.
- Some low-cost ESG-related steps public plans consider:
  - Continue education on ESG and its increasing role in public fund management.
  - Amend the Investment Policy Statement to incorporate ESG.
  - Consider Investment Beliefs to incorporate ESG.
  - Annually review routine manager monitoring on ESG issues, including how public equity managers vote proxies and engage with underlying companies (indicator of how manager actions are in concert RHCTF).
  - Consider potential manager and/or regulatory ESG engagements.
- Likely require greater time and cost.
  - Climate Risk portfolio assessment; Company engagement strategy and implementation.