AGENDA ITEM DETAILS

Subject: *Educational Presentation – Environment, Social and Governance (ESG)

Background:

The purpose of this agenda item on ESG (Environmental, Social and Governance) is educational. We seek to define ESG and communicate how it could impact investments at ERS. While there is no clear consensus about what constitutes ESG criteria, several examples are noted below.

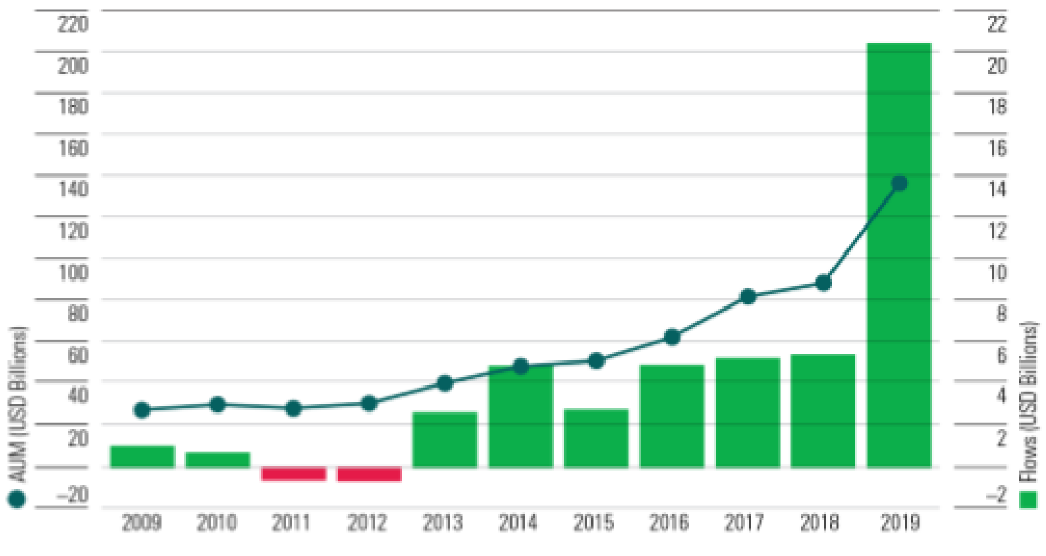
Environmental	Social	Governance
Carbon/Greenhouse Gas Emissions	Diversity	Transparency
Ecosystem Change	Consumer Protection	Reporting and Disclosure
Fossil Fuel Dependence	Fair Trade	Executive Compensation
Climate Change	Animal Testing	Shareholder Rights
Water Issues	Human Rights	Board Accountability and Makeup
Clean Tech	Health Care	Director Independence
Toxic Chemical Usage	Working Conditions	Accounting Practices and Policies
Renewable Energy	Child Labor	Voting Practices

ESG has been around for decades, but has been gaining momentum over the last 15 or so years, first in Europe, and more recently in the U.S. and elsewhere. There has been an increase in ESG mandates among asset owners and managers and increased focus on ESG metrics within companies. Modern ESG investing is related to the idea of Socially Responsible Investing (SRI) which was pioneered in Europe. SRI seeks to tie investing to a particular set of non-financial goals or beliefs. Alternatively, ESG integration seeks to use ESG data as a means to maximize risk adjusted returns. This is done by determining which ESG factors are financially material to a particular investment and integrating those factors—along with others—into a comprehensive analysis. As fiduciaries for the Trust, we cannot accept lower expected returns or take on greater risks in order to secure collateral benefits such as those espoused by ESG funds. The best interests of the plan and its members and annuitants always comes first.

ESG investing is most mature within public equities, where several third parties track reported ESG metrics and compile scoring systems. Fixed income, private equity, real estate, and real assets also have a growing universe of ESG managers and are in earlier stages of developing reporting standards. Hedge funds still have an overall low level of ESG integration, but there are a small and growing number of ESG strategies.

ESG funds have grown rapidly in recent years. According to Morningstar, inflows were up about 400% in 2019 and are on track to double in 2020. Among U.S. institutional asset owners, more than 40% are estimated to have now integrated ESG into their process. The increased rate of growth and attention on ESG has been a result of at least six major influences: public policy, corporate initiatives, technological change, changing social norms around sustainability and the environment, and the emergence of ESG data sources. Growth has come from ESG-centric funds, as well as funds with traditional mandates increasingly applying the non-financial factors of environmental, social, and governance as part of their process to identify material risks and growth opportunities.

U.S. ESG Fund Flows*



Source: Morningstar Direct. Data as of 12/31/2019.

*Based on universe of 303 funds with ESG central to strategies and 564 funds that consider ESG factors

Data on the ESG fund performance is mixed and inconclusive at this point, with studies pointing to a slight-positive or neutral impact to investment performance. Some academic theories on why ESG could matter to a firm's value are as follows:

Firms with a higher ESG profile:

- Attract more or higher paying customers
- Have increased productivity due to higher employee morale
- Attract lower-cost capital
- Have managers who avoid short-term decision making
- Decreased firm risk

ESG is not without drawbacks. First and foremost is the risk that inclusion of ESG factors could require a tradeoff with funds' fiduciary goals. The Department of Labor (DOL) has recently finalized amendments to ERISA requiring plan fiduciaries to select investments and investment courses of action based solely on financial considerations relevant to the risk adjusted economic value of a particular investment or investment course of action. The proposal received 8,700 comment letters with 95% opposing the rule. Although the DOL has no jurisdiction over governmental plans because they are exempt from ERISA, ERS often complies with many of those requirements in the course of meeting its fiduciary duties to administer the Trust and manage its assets. The DOL rules for ERISA plans produce a legal restriction on investments that can be made by those plans. ESG investing can also rely on overly subjective opinions, and ESG ratings can vary widely between third party providers.

Current ESG Considerations at ERS:

ERS investment staff informally evaluates ESG factors when deemed material to various investments. Additionally, we comply with certain statutory exclusions related to Iran, Sudan, companies boycotting Israel, and terrorist organizations while also meeting ERS' fiduciary responsibility to act solely in the best interest of the Trust in connection with investment of plan assets. ERS also engages with investments via our proxy advisor, Institutional Shareholder Services, with a focus on governance that serves ERS' best interests in connection with its investments. We have also attended a handful of ESG seminars and begun a dialog with relevant industry groups.

<u>What Does ERS Plan To Do Going Forward?</u>

ERS continues to actively evolve our research and monitoring processes with annual updates to the Board and IAC:

- Continue to follow and comply with all Texas constitutional, statutory and regulatory requirements, which include current state and federal prohibitions on investment such as investing in Sudan, Iran, companies boycotting Israel and terrorist organizations in a manner that is consistent with ERS' fiduciary responsibilities.
- Define ESG at ERS on our terms that can be beneficial to competitive risk adjusted rates of return, but only if such investment is in ERS' best interest.
- Build key relationships and knowledge, including possible participation in working groups and standards bodies.
- Engage with external managers on ESG integration process for educational purposes.
- Identify and track exposure to Environmental, Social and Governance related risk factors.
- Evaluate use of growing pool pf ESG information in conjunction with ERS investment processes to help maximize long-term risk adjusted return.

This agenda item is presented for informational purposes only. No action is necessary.

**ERS is accredited by the State Pension Review Board (PRB) as a Minimum Educational Training (MET) sponsor for Texas public retirement systems. This accreditation does not constitute an endorsement by the PRB as to the quality of our MET program. This agenda item may be considered in-house training provided by ERS to board trustees and the system administrator for purposes of fulfilling the MET program requirements. ERS is an accredited sponsor of MET for its system administrator and trustees for continuing education.*

ATTACHMENTS:

1. Slides – Educational Presentation on Environment, Social and Governance