

## Public Agenda Item #31

### *\*Educational Presentation – Environment, Social and Governance*

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# Introduction to ESG

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# Agenda



- What is ESG?
- Why is ESG potentially important to ERS?
- Steps taken by ERS and plan moving forward

# What is ESG?

## Environmental, Social, Governance



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

# What is ESG?

*Application of ESG factors to investing varies widely*



Exclusion-based ESG	Impact/Socially responsible Investing (SRI)	Integrated ESG
<i>Comply with ESG mandate by <b>avoiding certain investments</b></i>	<i>Seek to promote ESG agenda with <b>targeted deployment of capital</b></i>	<i>Combine ESG data with traditional fundamental analysis to <b>improve returns and/or reduce risk</b></i>
Exclude sectors	Example: Renewable energy investments	Focus on financial materiality
Exclude regions	Popularized in Europe	Aligned with fiduciary responsibility

# What is ESG?

## *Integration within asset classes*



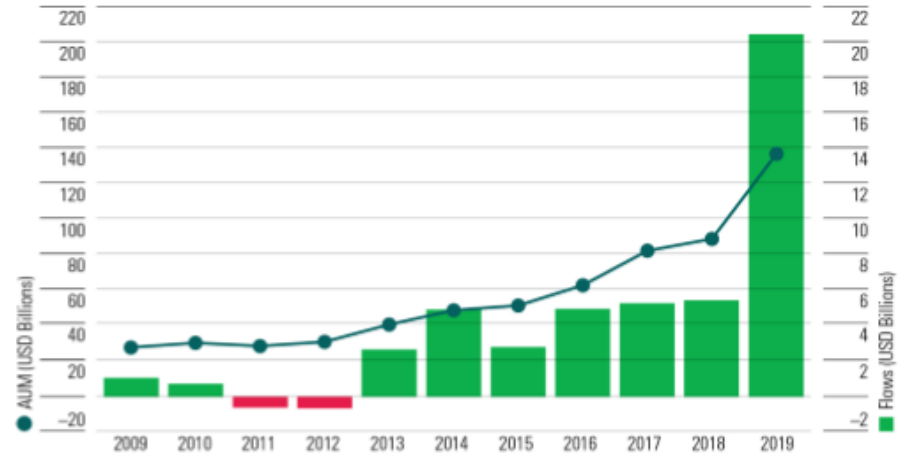
Strategy Type	Level of ESG Integration	Notes
Public Equity	High	Highest level of adoption; European market generally ahead of US
Fixed Income	Moderate	ESG ratings more applicable for corporate debt; sovereign debt and structured credit generally less compatible; growing adoption
Private Equity	Moderate	Funds are often smaller in size, have shorter track records and are newer entities; ESG issues can present an opportunity to unlock value
Real Estate	Moderate	Value-add and opportunistic strategies are often more focused on ESG given their emphasis on property repositioning
Real Assets	Moderate	Sustainable real assets present a wide range of options from renewables to agriculture
Hedge Funds	Low	Limited but growing adoption of ESG amongst hedge funds; will be strategy dependent

# Why is ESG Potentially Important to ERS?



*Fund flows demonstrate mainstream adoption in U.S.*

- ESG flows up 4x in 2019, on track to double in 2020\*
- 40% of U.S. asset managers have adopted some form of ESG integration
- Policy, demographics, corporate behavior, technology, social trends & data availability are driving adoption
- Many ERS external managers integrate ESG already



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

# Why is ESG Potentially Important to ERS?



## *Impact on investment performance*

- Academic research suggests firms with higher ESG scores:
  - 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
- Investment performance inconclusive
  - ESG funds have outperformed recently
  - Longer-term studies show neutral to slight-positive impact
  - Nascent nature of ESG data makes integrated approach hard to study



# Why is ESG Potentially Important to ERS?



## *Pension considerations*

- Department of Labor (DOL) recently implemented restrictive guidelines\*
- Requires ERISA plans to select investments solely on financial considerations
- Could prevent ESG-centric strategies from inclusion in plan assets
- No jurisdiction over state plan, but could guide oversight decisions
- Reinforces need for fiduciary alignment with ESG strategy

\* Although the DOL has no jurisdiction over governmental plans because they are exempt from ERISA, ERS complies with many of those requirements in the course of meeting its fiduciary duties to administer the Trust and manage the assets of the Trust.

# Why is ESG Potentially Important to ERS?



## *Timing considerations*

- Adoption within broad investment landscape appears at a tipping point based on adoption rates, asset flows, & corporate behavior
- Reporting standards and best practices evolving quickly
- External managers already integrating ESG

# Steps Taken by ERS and Plan Moving Forward

- Current approach
  - Administering scrutinized investment decisions in compliance with Texas state law such as prohibitions on investments in Sudan, Iran, companies boycotting Israel, and terrorist organizations, all consistent with our fiduciary responsibility
  - ERS does not change its due diligence or prudent processes for the sole purpose of ESG investments
  - Active voting of proxies via Institutional Shareholders Services our proxy advisor with a strong emphasis on corporate governance
- Plan moving forward
  - Continue to actively evolve our research and monitoring processes with annual updates to the Board and IAC
  - Define ESG @ ERS on our terms that can be beneficial to competitive risk adjusted rates of return
  - 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
  - Evaluate use of growing pool of ESG information in conjunction with ERS investment processes to help maximize long-term risk adjusted returns

Questions?