NEPC, LLC

To: Seattle City Employees' Retirement System

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Date: February 25, 2016

Subject: Environmental, Social and Governance (ESG) Annual Review

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BACKGROUND

This memo is intended to meet the requirement in the Seattle City Employees' Retirement System's (SCERS) ESG Policy that the Investment Consultant provide an annual review of ESG matters. It is meant to complement the more detailed memo on fossil fuel divestment.

In February 2015, SCERS adopted a positive action strategy related to climate change that calls for corporate engagement, integrating climate change risk into SCERS's investment process and considering sustainability investments so long as they produce expected investment results consistent with SCERS's fiduciary duty to its members. SCERS has made considerable progress on this strategy as outlined in Staff's quarterly updates to the Board. NEPC considers SCERS's positive action strategy as a best practice for US public pension funds and an appropriate alternative to fossil fuel divestment.

Definitions

ESG is a very broad term as it relates to investing, so it is important to delineate between the various ways in which ESG can impact the investment process. In particular, we want to differentiate between impact investing and ESG integration. Impact investing seeks to accomplish a non-financial agenda or goal through the investment portfolio. For example, divestment strategies can be seen as a form of impact investing where a "negative screen" is applied to remove capital from a market segment that is inconsistent with the desired impact. "Positive screens" can also be applied to allocate capital to a market segment that is consistent with the desired impact. NEPC does not recommend impact investing, as defined in this manner, for its public pension fund clients as the goal of maximizing risk-adjusted return should not be subjugated for other goals. NEPC may support impact investing for its other investor segments, such as endowments and foundations.

ESG integration on the other hand is an understanding of the connection between seemingly non-financial factors and company performance, seeking to make the best investment without giving preference to non-financial goals. NEPC's research has shown that ESG factors have material impacts to a companies (and its securities) performance. These can be challenging to quantify but it is fairly easy to extrapolate a connection between these non-financial factors and company performance. For example, poor treatment of workers can result in strikes or turnover which can impact financial health, additionally it can impart reputational strain on a company which could affect how the market treats the company. NEPC views it to be prudent to incorporate ESG factor analysis as a complement to standard financial analysis, expanding beyond traditional financial analysis to incorporating positive and negative impacts from these “softer” elements. It is a tool that can be used for an added factor for investment analysis but does not substitute portfolio decisions. NEPC supports ESG integration for all of its investor segments, including public pension funds. ESG integration is already considered under SCERS’s positive actions strategy.

NEPC’s Efforts So Far

NEPC started getting involved in the ESG space in 2011. This process started with ad hoc client projects and later evolved into a focused effort for building our expertise and knowledgebase. Over the years, as ESG gained momentum across all types of investor segments, NEPC has sought to keep pace with few key initiatives such as:

1. Created a structured process: incepted an ‘Impact Investing Advisory Committee’ (tasked with all ESG activities) that meets bi-weekly to discuss various topics including – client policies and requests, new developments in the impact space as well as ongoing initiatives, impact investment products, and industry events, etc. This 17 member advisory committee includes members from across all practice areas in consulting as well as research.

2. Built out intellectual capital and knowledgebase:
   - Published white papers include:
     - Green bond white paper which was recently selected to be included in the Chartered Alternative Investment Analyst curriculum.
     - Completing the Analysis: ESG Integration
     - Socially Responsible Investing in Action: This profiles one of our client – The Unitarian Universalist Association focusing on their internal governance and performance results
   - Industry Events and Conferences: NEPC is considered an industry expert and speaks frequently on this topic. Over last 12 months, we have spoken on panels and helped organize sessions for more than 10 different institutional investor conferences.
   - Internal on-going education: NEPC is launching a “Lunch & Learn” series for employees, bringing in various practitioners from the field to discuss specific Impact topics.
   - Educational presentations and webinars: members of the impact advisory committee have created numerous educational presentations and conducted webinars on topical subjects and strategies (e.g. community based investing, fossil fuel divestment, Green Bonds, etc.). In addition, NEPC hosts an Annual Manager Webinar, where it provides the investment industry with our latest market outlook and important internal initiatives. NEPC spent a portion of this session on raising awareness regarding the trends we are seeing in impact investing and encouraging managers to reach out to us with products and ideas.
   - Client Conferences: NEPC integrated session on impact investing into its annual client conference which was extremely well received.

3. Modified our Due Diligence process: NEPC integrated ESG into our due diligence process across all asset classes by working with eVestment Alliance to enhance and expand their reporting of ESG Integration. We have notified all of the managers in our database about this enhancement, and have encouraged all managers to complete this section as

they report in to eVestment. In addition NEPC has also partnered with MSCI to develop ESG reporting for clients.

4. Got actively involved: NEPC became a signatory of the UN Principles of Responsible Investing (PRI), and an affiliate member of Mission Investors Exchange. PRI began in 2006 as a network of investors working together to integrate the 'six principles' into common practice in an effort to create a more sustainable financial system. The 'six principles' that signatories pledge to implement:
   - We will incorporate ESG issues into investment analysis and decision-making processes
   - We will be active owners and incorporate ESG issues into our ownership policies and practices
   - We will seek appropriate disclosure on ESG issues by the entities in which we invest
   - We will promote acceptance and implementation of the Principles within the investment industry
   - We will work together to enhance our effectiveness in implementing the Principles
   - We will each report on our activities and progress towards implementing the Principles

A significant effort and focus is maintained on understanding the different impact related movements and ultimately how it affects our client's policy and portfolios. During 2016, NEPC plans to spend a considerable amount of time researching and performing due diligence on the investment options across various spectrum of ESG.

In 2015, NEPC published a white paper titled 'Completing the Analysis: ESG Integration.' This research paper examines the evolution and benefits of incorporating ESG factors into the fundamental analysis process. Not only can ESG criteria have a material impact on a company's performance, they can also provide investors with the ability to make more holistic and informed investment decisions. The paper concludes with the following thoughts: "*It is clear that ESG factors represent non-financial components that can have a material impact on a company's performance. Incorporating ESG analysis into the investment process is an effort to assess these factors, ideally resulting in improved decision-making capabilities and enhanced expectations for risk-adjusted performance. While ESG analysis is often grouped with screening approaches, significant progress has been made to increase awareness and understanding around this concept. As a result, the universe of investment managers integrating ESG analysis into their decision-making process has rapidly expanded. In addition, the capital invested in these strategies has served to drive product innovation and creation. We expect to see continued growth around ESG analysis. Over time, we expect to evolve from speaking of ESG analysis as an independent element or an impact-based approach. Instead, ESG analysis will become a standard element of the investment process, providing investors with the ability to make more holistic and informed investment decisions*".

SUSTAINABILITY INVESTMENTS

SCERS's positive action strategy includes consideration of investments that address climate change and other sustainability issues, but importantly do not reduce the portfolio's risk-adjusted performance. SCERS rightly recognizes that these investments represent a very small component of the investable universe and are therefore unlikely to represent a material portfolio allocation in the near future. Given SCERS's broad adoption of passive strategies in public equities, sustainability investments are more appropriate for private market asset classes (e.g. infrastructure). These investments are also more likely to be accessed through diversified strategies where a manager has a broad opportunity set and finds sustainability investments attractive from a financial perspective.

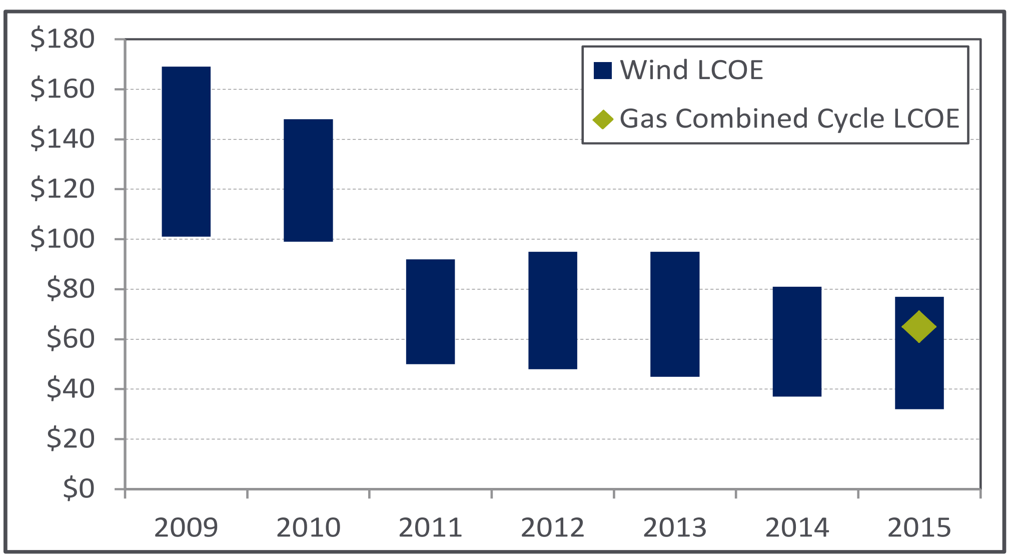
As part of its market research, NEPC has evaluated two sustainability investment areas.

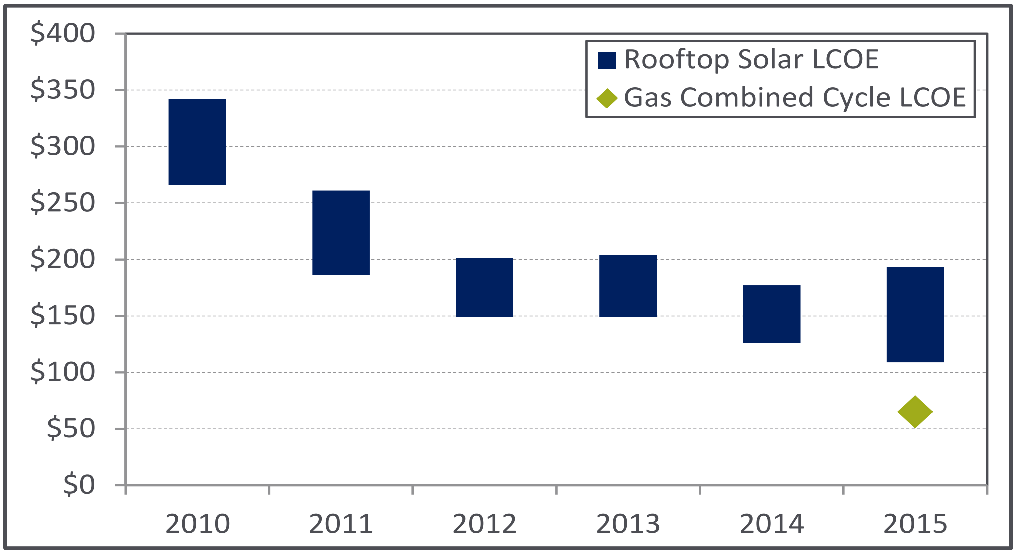
RENEWABLE ENERGY INFRASTRUCTURE

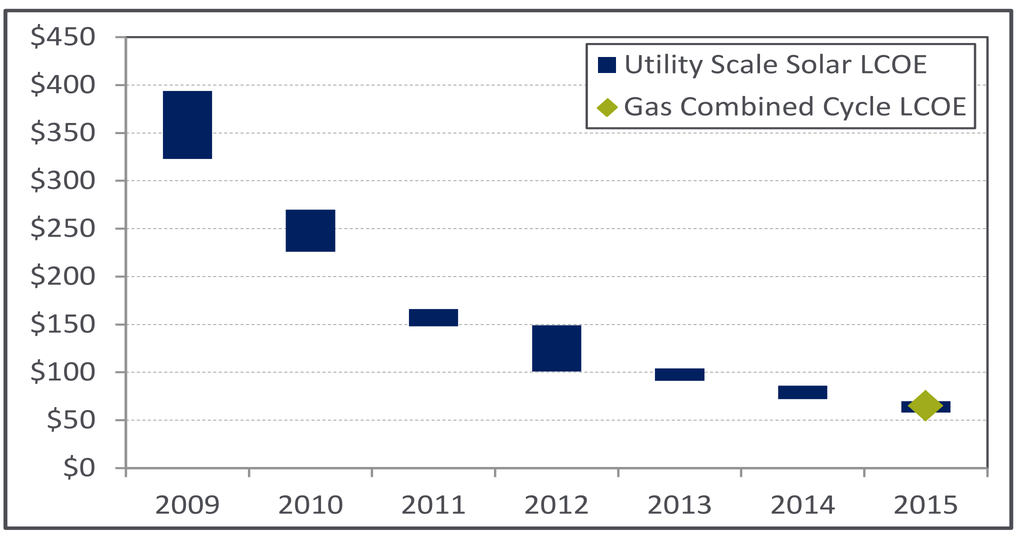
There is no question that on average renewable energy sources are becoming more cost competitive and are likely to continue to see rapid growth. The direct investment opportunity set for institutional investors is still somewhat limited as the main players have been governments, utilities, and fossil fuel companies.

Unsubsidized Levelized Cost of Energy (LCOE)

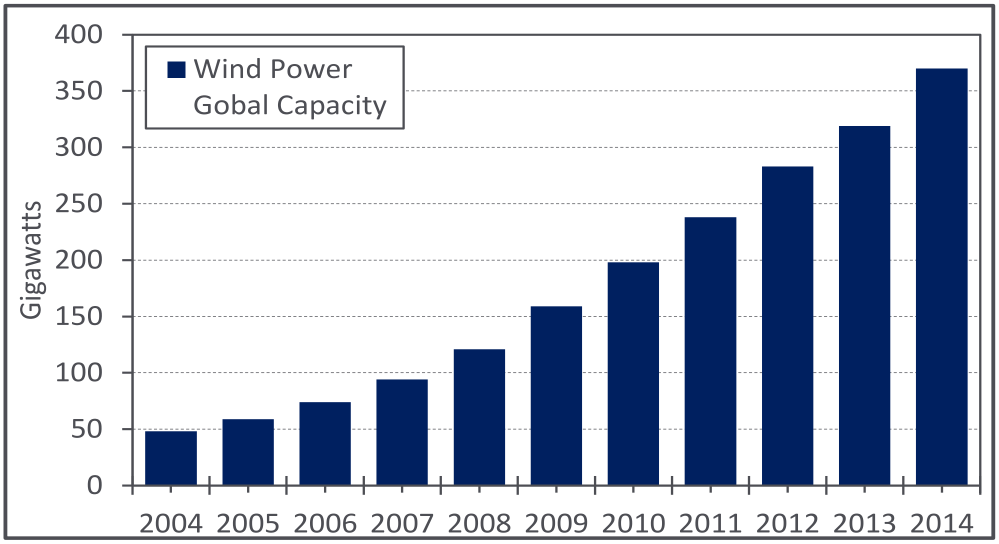
Wind and solar are becoming more cost-competitive with conventional technologies. Wind LCOE is down 61% in the past six years and solar LCOE is down 82%. Bloomberg New Energy Finance (BNEF) predicts that solar project costs will come down by 48% and wind by 32% by 2040.



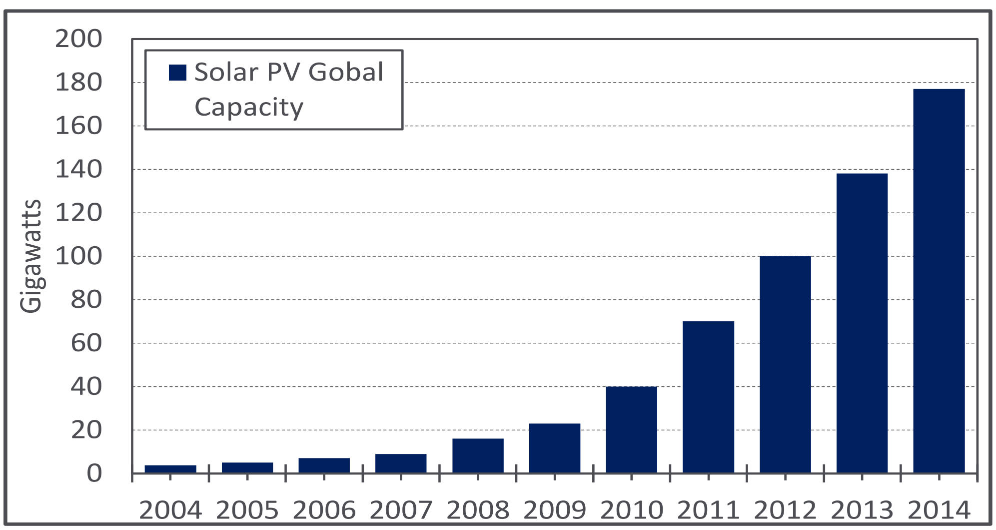




New Investment in renewable energy is growing rapidly. Renewable energy represented 59% of net addtions to global power capacity in 2014. The estimated investment has grown from $45 billion in 2004 to $270 billion in 2014.



Wind Power
Gobal Capacity
Gigawatts
0
50
100
150
200
250
300
350
400
2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014



Solar PV Gobal
Capacity
Gigawatts
0
20
40
60
80
100
120
140
160
180
200
2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014

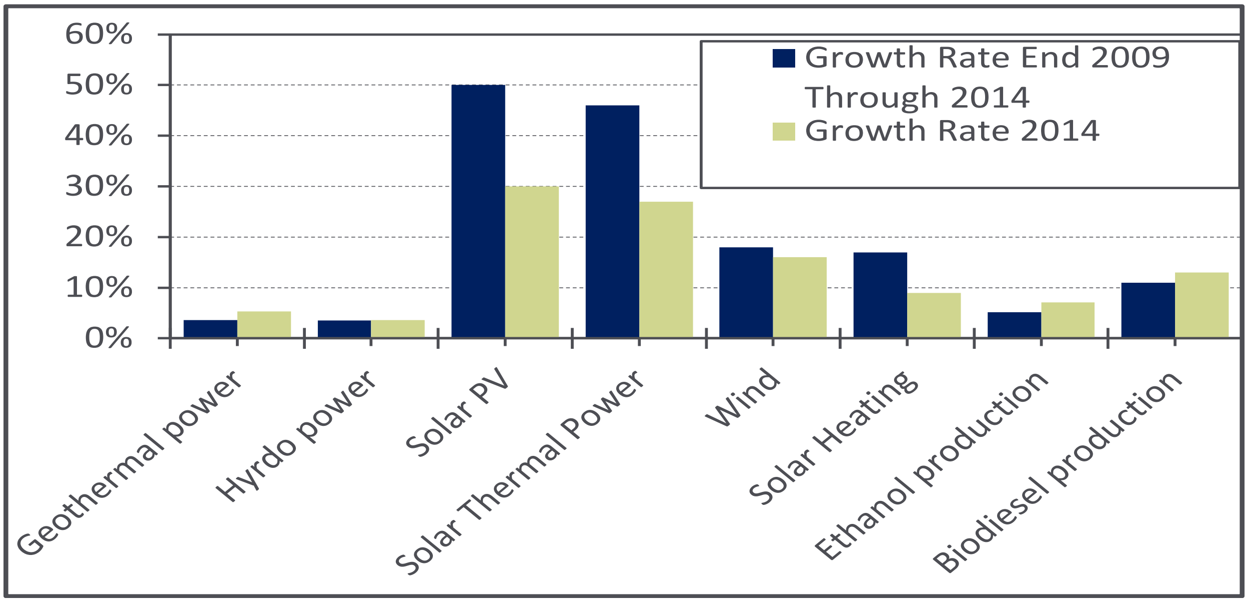
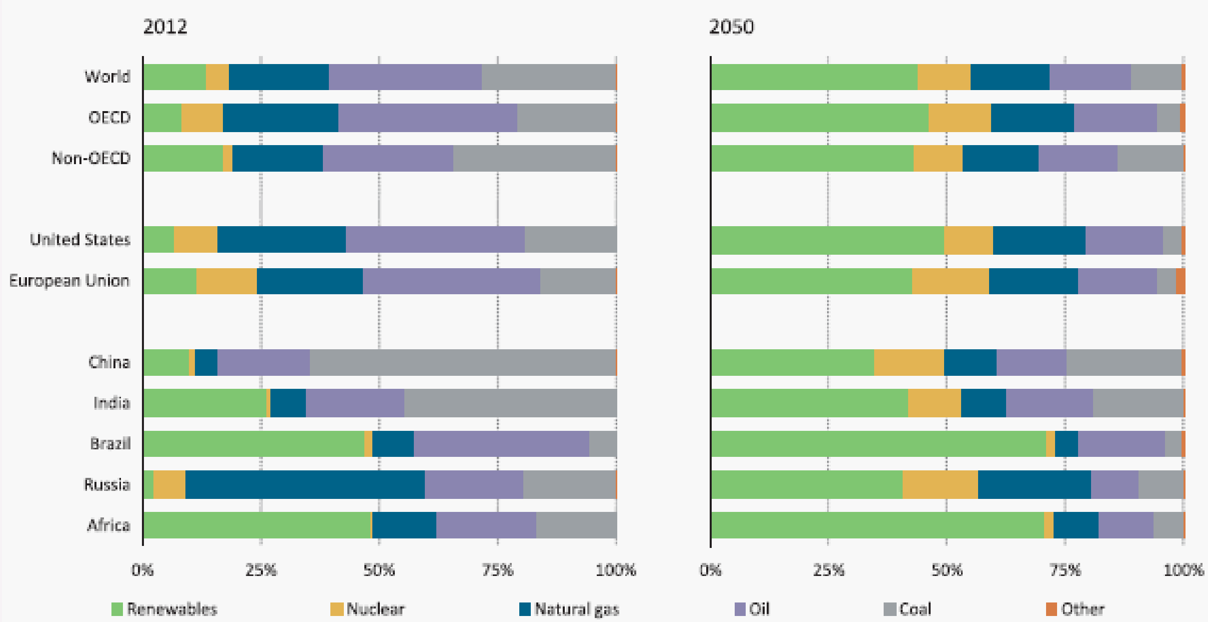


Figure I.3 Regional primary energy demand profiles in the 2DS



Key point *Different national circumstances, including availability of resources, will require tailor-made solutions and pathways for deep decarbonisation by 2050 that initially leverage available solutions before developing home-grown solutions.*

Green Bonds

In 2015, NEPC also published an informational white paper on green bonds titled 'Green Bonds: An Overview'. This paper discusses the surge in issuance of green bonds and provides an overview of these environmentally focused fixed income securities, while examining important considerations for investors. Bonds labeled 'green' signify that proceeds raised from the issuance will be tagged for projects intended to benefit the environment, for instance, the funds could be used for renewable energy or energy efficient endeavors with the issuer agreeing to report on the use of proceeds. This is the main factor distinguishing green bonds from the rest of the fixed income market; they are otherwise identical to their non-green brethren. One hurdle in the market is that currently, the process of labelling a bond as green is largely unregulated. Issuers have the discretion to self-label and there is no formal approval or vetting process. Issuers claiming green bond status must include a brief declaration statement within their offering documents indicating that the proceeds raised will be allocated to green projects. However, there is no requirement to provide standardized reporting and therefore actual reporting may vary greatly from issuer to issuer. While green bonds are subject to the same oversight from the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) as their non-green counterparts, there is no regulatory body ensuring that the funds raised through the issuance of green bonds are actually benefiting green initiatives. Regulations prohibiting companies with otherwise poor environmental practices from issuing green bonds are also non-existent. For these reasons, 'greenwashing' a term used to describe the act of a bond issuer self-labelling an issue as green for marketing purposes without having a true commitment to the environment or intention to use the proceeds as indicated is a buzzword among investors in the space. NEPC opines that despite this special focus for the use of bond proceeds, investors should prefer that there be a significant focus on the fundamental analysis of the issuer and relative value analysis to evaluate these securities.

NEPC views that green bonds, which form a small subset of the fixed income market, present issuers with the opportunity to widen their investor base as they also appeal to ESG investors. As green bonds become more diversified across credit quality, geography and instrument type, they will likely integrate more readily with mainstream investment products. However, it currently makes up less than 1% of the global fixed-income market and widespread acceptance of the Principles and the Statement of Investor Expectations will be essential to facilitate standardization and credibility within the market in the absence of an official regulatory body and/ or independent scrutiny from third-party organizations. We will continue to monitor this growing market and vet investment opportunities for clients as they arise.

Disclaimers and Disclosures

- Past performance is no guarantee of future results.
- All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.
- The information in this report has been obtained from sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.
- The opinions presented herein represent the good faith views of NEPC as of the date of this report and are subject to change at any time.
- This report contains summary information regarding the investment management approaches described herein but is not a complete description of the investment objectives, portfolio management and research that supports these approaches. This analysis does not constitute a recommendation to implement any of the aforementioned approaches.