Seattle City Employees' Retirement System

Environmental, Social and Governance (ESG) Update
Second Quarter 2015

Purpose

This update is required by the following motion adopted by the Board at its meeting on February 12, 2015:

> *The Retirement Board of Administration directed that the Seattle City Employees' Retirement System (SCERS) pursue corporate engagement on climate change and other environmental issues, as presented by staff in their January 26, 2015 memorandum; and pursue, as appropriate, investments that are expected to produce investment results consistent with SCERS's fiduciary duty to its members and, if possible, also positively address climate change and other environmental issues. The Board recognizes that these types of investments (e.g. renewable energy, cleantech, and green bonds) are relatively new and limited in availability and will need to be considered prudently as SCERS pursues investments in its asset class (e.g. real assets, private equity, fixed income).* ***SCERS's staff and advisers will provide quarterly updates regarding Environmental, Social and Governance (ESG) investment issues*** *and incorporate ESG into SCERS's work plan. The Board directs SCERS's staff to engage with trade associations such as Coalition for Environmentally Responsible Economics (Ceres) and other pensions to examine an approach to ESG investments, and also to consider engaging with an independent consultant to assist in this review.*

In this inaugural update, staff has focused on the environmental issue of climate change since it was the catalyst for the motion. At the Board's direction, other ESG matters may be considered in future updates.

Industry Developments

Institutional Investors (with a focus on US Public Pensions)

- California's State Senate passed SB 185 that requires CalPERS and CalSTRS to divest from investments in thermal coal companies unless their boards determine that it is inconsistent with their fiduciary responsibilities. It also indemnifies their boards from actions related to the bill. CalPERS and CalSTRS have officially taken "no position" in neither support nor opposition to SB 185. The bill will next be considered by the California State Assembly. [link]
- San Francisco Employees' Retirement System authorized staff to identify, perform due diligence and invest up to 0.5% ($100 million) in a passive equity strategy that excludes fossil fuel companies.
- CalPERS announced a one-year pilot program to integrate ESG into its manager selection process. [link]
- University of Washington recently decided to divest from companies whose principal business is the mining of coal for energy purposes. UW expects to lose $13 million from divesting from coal companies over the next 20 years. It would have expected to lose $250 million over the next 20 years if it had decided to divest from all fossil fuel companies. UW stated: "…we support divestment of coal companies whose principal business is the mining of coal for energy generation. However, further action by this board is neither recommended nor warranted with respect to its investments in other fossil fuel companies." [link]

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Investment Managers and Consultants

- BlackRock and State Street launched ETFs that track the MSCI ACWI Low Carbon Target Index, which was developed by MSCI to overweight companies with low carbon emissions and reserves and correspondingly underweight companies with high carbon emissions and reserves. The index also seeks to limit tracking error relative to the MSCI ACWI Index. It does not exclude all fossil fuel companies. The United Nations provided the initial seed capital for both ETFs.
- In an event attended by SCERS staff, Fossil Fuel Indexes announced that it is planning to launch a passive product that is benchmarked to its S&P 500 ex Fossil Fuels index.
- Mercer released a report that defines potential scenarios with respect to climate change and seeks to estimate their impact on asset class and industry performance over the next 35 years. [link]
- BlackRock and Ceres co-published a report that details investor strategies for ESG-related corporate engagement. [link]

Ceres/INCR Takeaways

Jason Malinowski attended the Ceres annual conference and INCR meeting in San Francisco from May 12-14 and identified these key takeaways:

- Renewable energy generation is growing rapidly as equipment costs (particularly solar) have substantially declined. Utilities may be challenged going forward as consumers unplug from the grid and instead rely upon their own solar power.
- Fossil fuels are not a uniform category. Depending upon the specific fossil fuel, there may be material differences in carbon intensity, production costs and importance to the global economy. For example, coal has the highest carbon intensity and declining economic importance. There was also recognition that most oil and gas production is essential in the medium term and, particularly for gas, can offer a lower carbon intensity substitute to coal.
- Mark Fulton, Ceres senior fellow, assessed the key risk factors of policy intervention, technological innovation and/or emerging markets economic growth that could lead to fossil fuel demand undershooting expectations. Such a scenario would make high cost/high carbon fossil fuels (e.g. tar sands, deep-water drilling) unneeded because there remains a large supply of oil with low production costs.
- Institutional investors have had recent successes with corporate engagement, particularly with disclosure by large oil & gas companies. For example, BP and Royal Dutch Shell both endorsed shareholder proposals requesting that the companies recognize climate change risks by improving transparency.
- With limited exceptions, US-based investment consultants are not engaged on ESG matters.
- Several sessions were focused on water risk.

SCERS Activity

Since February 2015, SCERS's staff has participated in 16 events, meetings and calls devoted to ESG with institutional investors, investment managers, consultants and/or membership organizations. The purpose of these interactions is to learn best practices and industry developments that may apply to the three areas of the positive action strategy that the Board has embraced:

Corporate Engagement

- SCERS joined the Investor Network on Climate Risk (INCR), a network organized by Ceres that includes 110 institutional investors representing more than $13 trillion in assets. INCR's mission is to mobilize investor leaders to address climate and other key sustainability risks, while building low-carbon investment opportunities. [link]
- SCERS joined institutional investors representing $1.9 trillion in assets in a letter to the SEC calling for greater regulatory prioritization on the disclosure of climate risks of energy companies. [link]
- SCERS engaged Institutional Shareholder Services (ISS) to report on the proxy voting records of its public equity managers as it compares to the ISS Standard and Sustainability policies. The first quarterly report is expected in mid-June. Staff also spoke with ISS, Rhumbline and Parametric to assess the feasibility of adopting the ISS Sustainability policy for SCERS's public equity separate accounts.

Integrating Climate Change into the Investment Process

- SCERS (through NEPC) included an ESG section in its RFP for infrastructure managers.

Sustainability Investments

Motion: "…The Board recognizes that these types of investments (e.g. renewable energy, cleantech, and green bonds) are relatively new and limited in availability and will need to be considered prudently as SCERS pursues investments in its asset class (e.g. real assets, private equity, fixed income)…"

- SCERS (through NEPC) issued an RFP for infrastructure managers. Staff believes that there are several managers with dedicated renewable energy strategies or diversified strategies with material allocations to renewable energy that will be responding to the RFP.

Appendix

Market Performance
Annualized as of May 31, 2015

	Performance					Std Deviation	
Index	1Y	3Y	5Y	10Y	Since 1/90	10Y	Since 1/90
S&P 500 Index	11.80%	19.67%	16.53%	8.12%	9.58%	14.71%	14.58%
S&P 500 Index ex Energy	14.98%	20.83%	17.21%	8.11%	9.57%	14.90%	14.97%
S&P 500 Index ex Fossil Fuels	13.68%	21.23%	17.30%	8.64%	NA	15.09%	NA

Source: Bloomberg, Fossil Free Indexes, SCERS calculation

SCERS Public Equity Exposure to the Carbon Underground 200
As of May 31, 2015

		Total CU200 Exposure		Coal CU200 Exposure	
Account Type	Mkt Value ($m)	$ million	%	$ million	%
Separate Accounts	632.7	29.6	4.7%	0.9	0.1%
Commingled Funds	590.8	48.4	8.2%	9.0	1.5%
Total	1223.5	78.0	6.4%	10.0	0.8%

Source: Bloomberg, Fossil Free Indexes, SCERS calculation; excludes overlay program, transition holdings
Note: Coal CU 200 exposure excludes a limited number of companies that are on both the coal and oil & gas lists