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Testimony for House Bill 740
State Retirement and Pension System - Investment Climate Risk - Fiduciary Duties
House Appropriations Committee

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1:00 P.M.

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The Board of Trustees for the State Retirement and Pension System (System) wishes to provide the Appropriations Committee with informational testimony regarding House Bill 740, State Retirement and Pension System - Investment Climate Risk - Fiduciary Duties. This Joint Committee on Pensions legislation requires a fiduciary of the System to consider the potential systemic risks of the impact of climate change on the assets of the System.

The System has a long history of addressing climate risk. The Board sets overall investment policy and has provided leadership through its focus on proxy voting and engagement. For almost 20 years, the Board has embraced the importance of proxy voting to provide a voice regarding how companies are managed and who manages them. Additionally, for more than 17 years, the Board has had proxy policies focused on global warming, environmental impacts and in support of Coalition for Environmentally Responsible Economies (CERES) principles. These policies are reviewed and updated annually by the Board with the assistance of the Investment Division staff and its proxy advisor Independent Shareholder Services (ISS). The policies broadly support disclosure of risks and development of plans to address climate change and greenhouse gas emissions. In 2008, the Board expanded its focus on corporate governance by becoming one of the first U.S. pension systems to become a signatory to United Nations Principles of Responsible Investing (UNPRI). As of 2020, the System remains one of seven state plan signatories.

The proxy voting policies, alone, have been effective tools for shaping climate risk policy in our public stock investments. Yet, when paired with direct engagement through the Board's industry partners such as CERES and Climate Action 100+, proxy voting has promoted changes in corporate behavior that many believed impossible. A prime example is the 2020 director election for Exxon, one of the largest oil and gas producers in the world, and a company that had not developed a plan to reduce the carbon impact of its activities. The Board voted for a new slate of directors who were opposed by management. In January 2022, this new slate of directors led Exxon to adopt a 2050 Net Zero pledge.

The Board's proxy voting policy is most effective for U.S. public stocks, which represent only 16% of the System's assets. Proxy voting and engagement can have meaningful impact on corporate policy, but do not include private investments and debt investments with significant risk from climate change. Also, these practices do not address the investment opportunities from the transition to a low carbon world.

The Board and Investment Division staff firmly believe that climate change and other ESG risks have potential to impact nearly all the System's assets. The Investment Division, under the direction of the Chief Investment Officer, has embraced corporate responsibility across the System's asset classes and has become increasingly effective through the years. UNPRI provides evidence of the improved effectiveness of the Investment Division's efforts. Through an annual survey, UNPRI rates its members on the effectiveness of their programs. The System's grade for strategy and governance has improved to "A" in 2019 from "C" in 2016. Similarly, the System's score for manager selection and monitoring improved from "D" to "B" over the same period. These scores reflect the System's ranking globally. Domestically, the System ranks the same or better than other similar public plans. The System's score in the direct and active ownership category is still at a "C" ranking, as it does not have a direct engagement program or actively manage assets internally.

The manager selection and oversight processes are primary tools for incorporating climate risk within the portfolio. As the System is primarily engaged with external managers to manage assets, the selection and oversight process is key to ensuring appropriate management of climate risks and proactive identification of investment opportunities. Every existing and potential manager is subject to an ESG evaluation by the Investment Division that identifies the major risks the product or strategy could face, and assesses the effectiveness of the strategies in place to manage those risks. These evaluation processes are developed and promoted by the Investment Division's internal ESG Committee. This group, comprised of senior portfolio managers across the asset class mix, includes the Division's Compliance Manager and Chief Investment Officer. The Committee reviews the changing practices of managers, academic research and data providers to help guide and educate the investment team and Board. This group publishes a bi-annual report on ESG, including climate change that documents the System's progress. In addition to the ESG report, the risk team within the Investment Division also produces an annual risk assessment including the risk of climate change that builds on the work of the ESG committee.

One of the concerns in the investment industry is that managers advertise that they are incorporating climate risk into their investment process as an advertising and promotion tactic with no change in the investment process. This practice is known in the industry as "Greenwashing". To evaluate that possibility, the Investment Division examined the practice of our public equity and bond managers with respect to the main carbon emitters in the energy sector as defined by Carbon Action 100+. The analysis showed that the System's exposure to energy companies has been declining for several years on an absolute and relative basis. In fact, the stock managers held approximately half the exposure to equity issuers relative to the equity index and the bond investors held 76% fewer bonds than the index.

Carbon Action 100+ ranked the energy companies based on their preparedness for the transition to a low carbon world. Looking further into System's energy holdings revealed that its managers held close to market weight in the companies that had a transition plan and had an underweight to those without a viable plan. The System's managers are not engaged in "Greenwashing" but have implemented investment strategies that effectively incorporate climate risk into individual security selection.

The Investment Division is also interested in the extent that managers are focused on assets supporting the transition to a low carbon world. Within the equity portfolio an obvious example was a high concentration in Tesla, the electric car company. Across the asset classes, staff identified new asset types in which managers have begun to invest to support the transition. From financing solar power fields, to building electric charging stations, to improving the operations of existing businesses such as changing the formulation of foam insulation to reduce the green house gas emissions of the product, the transition has become an investment theme across the System's investment portfolio.

Most of the literature analyzing climate risk focuses on the risks to individual securities. As most investors understand, the biggest determinant of long-term return is the mix of asset classes employed. The System's CIO worked with Meketa Investment Group, the System's investment consultant, over a three-year period to develop the ability to include the risk of climate change in the System's asset allocation process. In September 2019, the System became one of the first public plans to incorporate the risk of climate change into the asset allocation study.

The study itself developed a model that analyzed the risk of climate change as well as the risk of mitigating climate change. In the model, forecasted returns were reduced regardless of the path that was followed but some asset classes performed better than others in individual scenarios. A key outcome of the exercise was an expectation of higher inflation. During the same study it was apparent that the liabilities showed higher sensitivity to inflation than the assets, so there was an additional reason to focus on inflation in evaluating asset allocation options. The Board evaluated different asset mixes that would perform similarly and chose an asset mix that was aligned with the most climate change protection. Without the analysis of climate risk, the proposed outcome would have invested more dollars in natural resources industries including the production and transportation of oil and natural gas.

In 2021, the CIO and Board took the next step by creating a dedicated governance position to provide day-to-day leadership in managing climate and other ESG risks and expanding the effectiveness of the System's engagement with companies in the best position to have a significant impact. The Board of Trustees and Investment Division are dedicated to continuously improving the implementation of the investment portfolio, and managing the risk of climate change is an important element of that improvement. Further, climate change risk impacts the whole portfolio, and requires a holistic mitigation approach. Similar to the fable of the tortoise and the hare, mitigating climate risk in a meaningful, impactful manner, cannot be achieved through quick fixes; it is an endeavor that must be addressed methodically and with purpose.

We would like to conclude by thanking the Joint Committee on Pensions for their commitment to this issue and working with the State Retirement Agency to have a better understanding of the efforts the Board and the Investment Division are making to mitigate climate risk in the System's portfolio. We also appreciate being given the opportunity to share this information with the Committee and stand ready to provide any further information or services the Committee might request.