

ESG (Environmental, Social, and Governance)

Definitions, Current Practice and a Path Forward

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ESG Part I: The Acronym

SRI – Where it all began.....

- ▶ Socially Responsible Investing (SRI) has been going on for hundreds of years and typically means overlaying a non-financial fact or opinion onto a financial decision for a non-financial reason (i.e. avoiding sin stocks)
- ▶ For decades, private citizens, plan sponsors and boards of trustees have struggled with the “exclusive benefit” rule and how that interacts with their personal or community views of certain activities
- ▶ Early on, these items typically manifested themselves as negative screening mechanisms that would exclude certain investments from a portfolio. There are many such screens but very common screens include investments in tobacco, gambling, alcohol, pharmaceuticals and defense contracting

Sustainable Development Goals (SDGs)

- SDGs are 17 global goals put forward by the United Nations in 2015 and approved by 193 countries that act as a blueprint for ESG investing to achieve a better and more sustainable future for all.
- SDGs have been highlighted by companies and investors as an opportunity to use a different lens to **filter future investment decisions** and **measure ESG impact**.



Some ESG Topics (no true consensus)

Environmental Issues	Climate Change and Carbon Emission	Air and Water Pollution	Biodiversity	Deforestation	Energy Efficiency	Traditional and Hazardous Waste Management
Social Issues	Human Rights	Gender and Diversity	Firearms or DOD Contracting	Socio-Economic Disparity	Police and Community Relations	Data Protection and Privacy
Governance Issues	Board Composition	Audit Committee Structure	Bribery and Corruption	Executive Compensation	Lobbying	Whistleblower programs

ESG Implementation Options and Statistics

ESG “action” can be accomplished through varied means:

- Enhanced risk monitoring
- Engagement
- Divestment
- Targeted investment
- Public/private partnerships

Environmental

- The Global sea level rose about 8 inches in the last century. The rate in the last two decades, however, is nearly double that. (NASA)
- The concentration of carbon dioxide (CO₂) in our atmosphere is the highest it has been in human history. (conservation.org)

Social

- Latinas on the job earn only 56% of what a white man earns. (AFL-CIO)
- Black unemployment has been twice as high or more than for whites in 46 of the past 53 yrs. (Source: American Bar, 2015)

Governance

- CEO pay multiple to the average employee in the S&P 500 was 30 in 1978, 122 in 1995 and 286 in 2015. (Source: American Bar, 2015)
- Only 19% and 13% of Russell 3000 Board seats are filled by women and minorities respectively. (Source: Harvard Law, 2019)

ESG Part II: Current TMRS Practice

U. S Department of Labor* – Fiduciary Duty

- ▶ “The primary responsibility of fiduciaries is to run the plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses. Fiduciaries must act prudently and must diversify the plan's investments in order to minimize the risk of large losses.” (<https://www.dol.gov/general/topic/retirement/fiduciaryresp>)

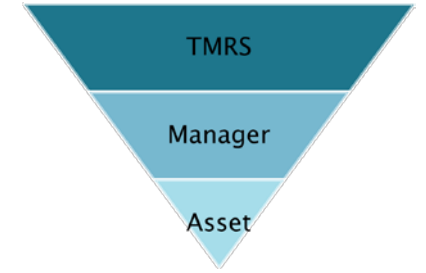
Current Department of Labor Status


Over the last 15 years, regulators have been back and forth on the acceptable use of ESG in decision making by plan fiduciaries.

“The department’s proposed rule reminds plan providers that it is unlawful to sacrifice returns, or accept additional risk, through investments intended to promote a social or political end.”

Eugene Scalia, Department of Labor Secretary
on proposed ERISA rule pertaining to
ESG Investing. June 23, 2020

What is TMRS Doing Today?





ESG Assessment

ADV Review Form

Manager / Diligence Process:

Relevant Manager Policies:

Relevant Manager Reporting:

Other Points of Diligence:

Further Notes:

Assessment of ESG Culture:

Reviewer:

Review Date:



As part of Due Diligence processes TMRS seeks out ESG information from Investment managers, be that in the form of Policies, DDQs, reporting, and other materials.

With the incorporation of Albourne Operational Due Diligence reports across TMRS' private market portfolios, TMRS has access to consultant reviews of the same.

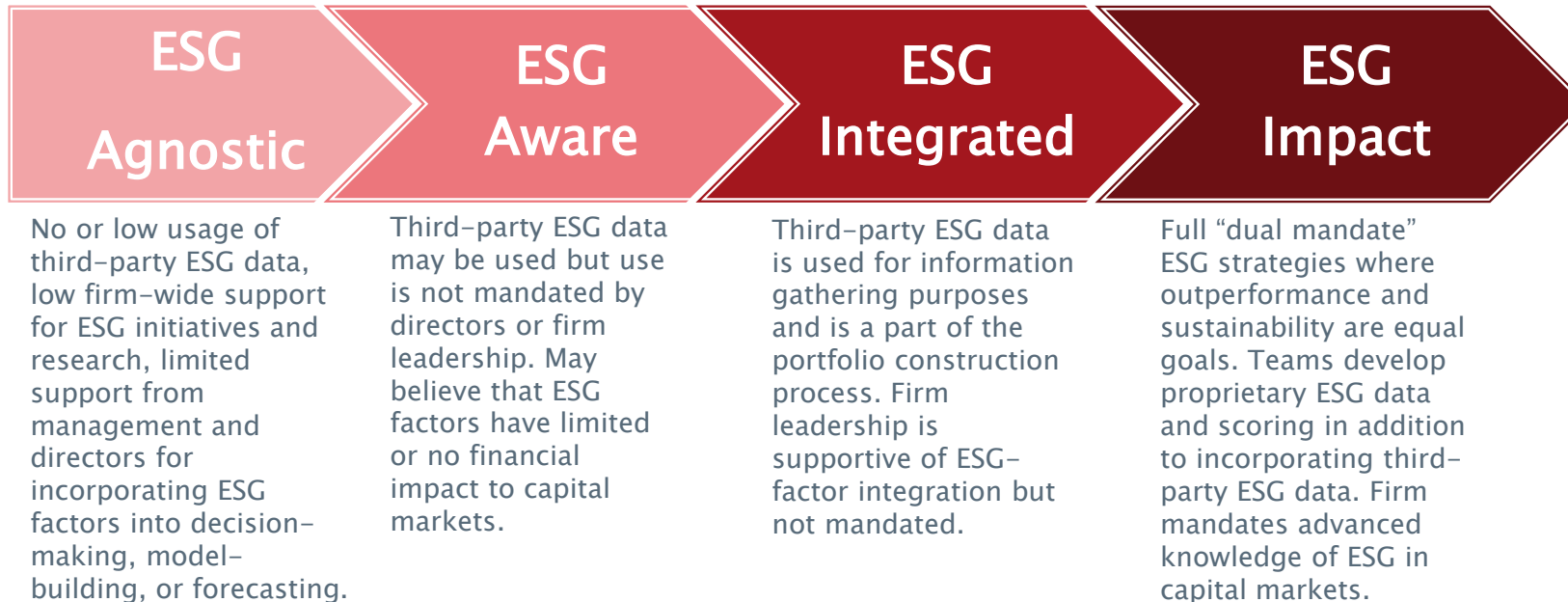
Additionally, while there has always been a market awareness of ESG issues and trends, TMRS has dedicated more research resources to the subject in the last several years.

We are actively evolving our research and monitoring processes.

RVK Research and Relationship-Led ESG Program

The ESG asset management industry has transformed from niche ESG products to wide-spread ESG factor adoption among institutional asset managers.

RVK's Investment Manager Research group takes a holistic approach that centers on interviews, conversations, and relationship-building with managers to understand their motivations, goals, and level of commitment to integrating ESG into their process and products.



Texas Statutory and Regulatory Requirements

- ▶ 2017 Legislative Session, HB 89, Chapter 2270. “PROHIBITION ON CONTRACTS WITH COMPANIES BOYCOTTING ISRAEL”.
 - Texas says it is "far from alone" in its move to "enact" a law against BDS, with 25 states passing similar legislation or issuing executive orders restricting boycotts of Israel and with only a handful of legislators voting against HB 89.
(CNN, 4-28-19)
 - TMRS is required to file a report with the Texas Comptroller and several senior members of the state legislature, when requested, on any investments identified by the Texas Comptroller as violating this statute.
- ▶ TMRS must also follow all federal prohibitions on investment such as investing in Iran, North Korea and with terrorist organizations.

Proxy Voting in the IPS

XIX. PROXY VOTING

Active voting of proxies is an important part of the Board's investment program.

Separately Managed Accounts. As per the Authority of Investment Managers in the Investment Manager Responsibilities section of this IPS, proxy voting for separately managed accounts is delegated to Investment Managers and will be authorized via the Manager's contract to represent TMRS on issues of corporate governance regarding the portfolio in a prudent manner. Records of proxy votes will be maintained by the Managers and submitted to investment staff and/or external service providers on request or at specified intervals.

Investment staff will monitor the proxy voting practices of the Managers. External service providers may be retained by the Board to assist staff in its monitoring efforts. This monitoring will be coordinated with each Manager to reasonably assure investment staff that Managers are fulfilling their fiduciary responsibilities with respect to proxy voting.

Investment staff will provide a proxy voting summary report for separately managed accounts to the IC on an annual basis and through the IC meeting minutes to the ED and Board as soon as practical after fiscal year-end. At a minimum, the summary report will contain, for each applicable Manager, the number of ballots cast, the number of issues voted upon, and percent of issues voted with management, against management and designated as abstaining.

Emerging Manager Tracking

- ▶ TMRS has no formal Emerging Manager program like ERS or TRS (Emerging Managers are typically defined as a firm with under \$2B in AUM, a firm on Fund I–III, or diverse owned or run)
- ▶ TMRS uses a differentiated due diligence process whereby small or new asset managers are not screened out arbitrarily by a minimum size or track record length screen which is common at many pension funds
- ▶ TMRS Investment Staff participates in +/– 1400 manager meetings per year (a combination of current and potential managers)
- ▶ Gives us a broad view of what is available in the market and at what cost
- ▶ Over 10% of TMRS assets are managed by firms that meet one or more of these “emerging manager” definitions

ESG Part III: The Path Forward

Texas Constitution and the TMRS Act

Trustees have an investment duty under Article XVI, Sec. 67 of the Texas Constitution and the TMRS Act to invest “prudently.” Specifically, the Constitution says:

3) Each statewide benefit system must have a board of trustees to administer the system and to invest the funds of the system in such securities as the board may consider prudent investments. In making investments, a board shall exercise the judgment and care under the circumstances then prevailing that persons of ordinary prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income therefrom as well as the probable safety of their capital. The legislature by law may further restrict the investment discretion of a board.

Additional Fiduciary Commentary

The Board should be aware of the following legal points:

- The best interests of the plan and its members always comes first
- State courts have not defined the parameters of ESG in public retirement plans. There is only one (40 year old) reported state law case in the country
- The Department of Labor has no jurisdiction over a state plan but their rules for ERISA plans can inform TMRS decision making
- The legislature has already prescribed certain divestment limitations and those political decisions are best made by the political branch of the government
- The board should not engage in investment decision making for political reasons
- The Board has always considered “governance” in investment recommendations from the CIO
- If all other things are equal, social considerations are acceptable

Investment Policy and Governance Survey Statements

Sustainability - Environmental, Social and Governance (ESG) Factors

Survey Question 12: Environmental, social and governance factors can impact investment performance and should be considered as important in TMRS' investment strategy.

Board Response: 17% strongly agree, 50% agree, 33% disagree
Limited Similarity of Views

Staff Response: 50% agree, 25% unsure, 12.5% disagree, 12.5% strongly disagree

Survey Question 13: Integrating corporate governance and corporate responsibility in TMRS' core investment process is important and adds value.

Board Response: 33% strongly agree, 33% agree, 34% unsure
Some Similar Views

Staff Response: 25% strongly agree, 25% agree, 25% unsure, 25% disagree

ESG Model Examples



Staff believes TMRS falls somewhere between the fully Compliant and Integration models as indicated by our logo placement.

ESG Model Challenges

Aware

By educated but take no explicit or proactive steps.

It is difficult as a public institution to be completely agnostic to headlines or as an investor to not think increasingly about ESG as its economic impacts apparently increase.

Compliant

Comply with all laws, receive reports on ESG and Proxy Voting

Being minimally compliant can be a lightning rod for interest groups that want a more proactive stance from the Trustees of large pools of capital.

Integration

Incorporate ESG principles into due diligence, and institutional processes where possible.

Processes are unlikely to completely avoid negative ESG headlines. Process implementation will need to continually evolve in the wake of accumulated information.

Exclusion

Specifically do not invest in identified companies, sectors, etc.

More easily implemented the more directly an institution invests. In private markets the common format of investing is blind commingled pools meaning there is limited influence over what line items the manager invests in.

Impact

Pursue specific goal with regard to a Environmental Social or Governance Topic

Institutions must identify what positive economic goods are and must determine whether or not those goods can be pursued within the confines of existing economic goals of the institution.



Proposed Investment Belief Statements for consideration or modification

1. Fiduciaries must demonstrate compliance with applicable law, including those related to environmental, social, and governance issues.

OR

2. As prudent stewards of the System's assets, we integrate environmental, social, and governance research into our rigorous investment process, where consistent with our fiduciary duty.

OR

3. The System actively manages environmental, social and governance factors as they can have an impact on long term investment performance.

OR

4. The System will seek to make an impact on environmental, social or governance issues through its investment practices.

DISCLOSURES

TMRS periodically discloses public information that is not excepted from disclosure under Section 552.0225(b) of the Texas Public Information Act. Information provided by a manager, a Managing General Partner (GP), any of its Associates or other data provider to TMRS or a TMRS service provider, and contained in these materials (i) may have been independently produced or modified by TMRS or the TMRS service provider; (ii) has not been reviewed or approved by the manager, Managing GP or any of its Associates; and (iii) may not reflect the historical performance or asset value reflected in the manager's, Managing GP's or any of its Associates' records and, therefore, should not be used for comparative purposes.