OCTOBER 16, 2018

AGENDA ITEM 6
INFORMATION ITEM

CALIFORNIA SECURE CHOICE RETIREMENT SAVINGS INVESTMENT BOARD

ESG Investment Options

This item will be presented orally at the meeting.

Attachments

- ESG Option Discussion Report from Meketa

CalSavers

ESG Option Discussion

October 16, 2018

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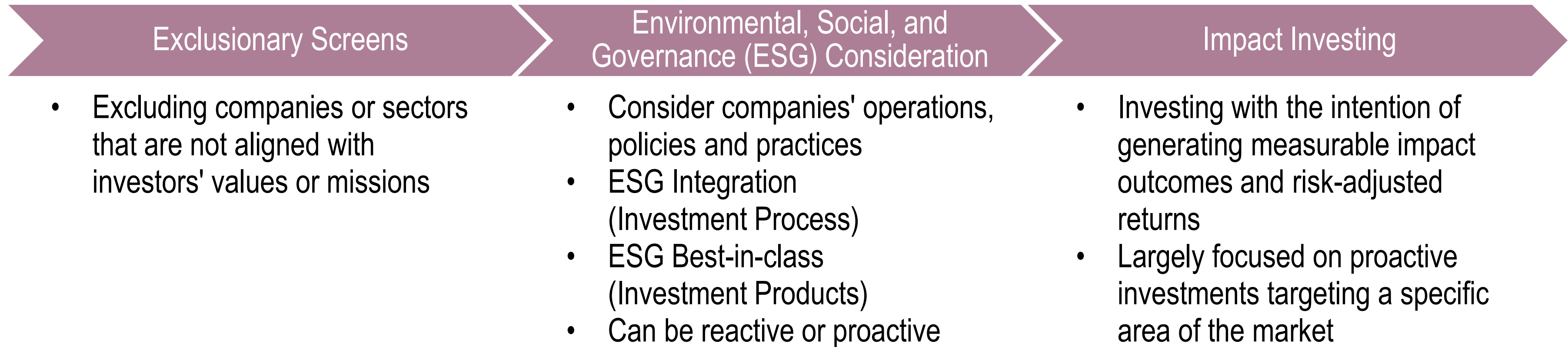
Background

Background

- California Secure Choice Retirement Savings Board did not identify an ESG option from the initial RFP.
- After further dialogue between Board, Staff and Consultants, the benefits of seeking to identify an ESG option prior to the start of the Program launch became clear for several reasons. Largely, postponing selection of the ESG option to a later date could potentially:
  - Increase administrative fees, placing undue burden on the Program.
  - Ignore and/or disappoint a set of Californian constituents who place a high value on environmental, social, and governance issues.
  - Create unintended inertia in Participants, as once elections are made the first time, it is less likely that they may make concerted efforts to move assets from one option to another later.
- On September 24, the Board requested an in-depth report and discussion at the October Board meeting on ESG including:
  - A full review of the ESG investment landscape, including types of strategies and associated fee ranges that might be expected from a search.
  - A discussion to elicit clear direction on the Board's view on social and responsible investing and what it means to them, so as to accurately target strategies that reflect their ESG beliefs and represent the most likely utilization by participants.

ESG Landscape and "Definitions"

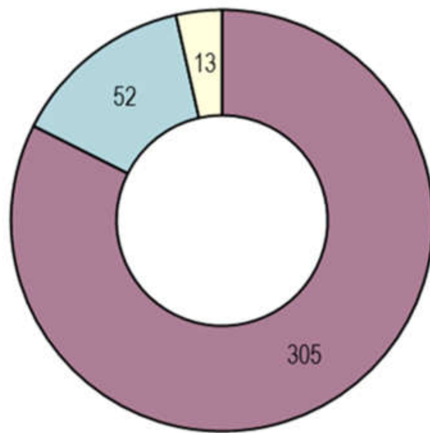
Socially Responsible Investing and Impact Investing

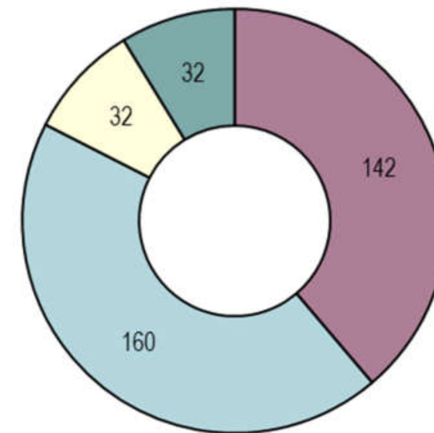


Typical ESG Considerations

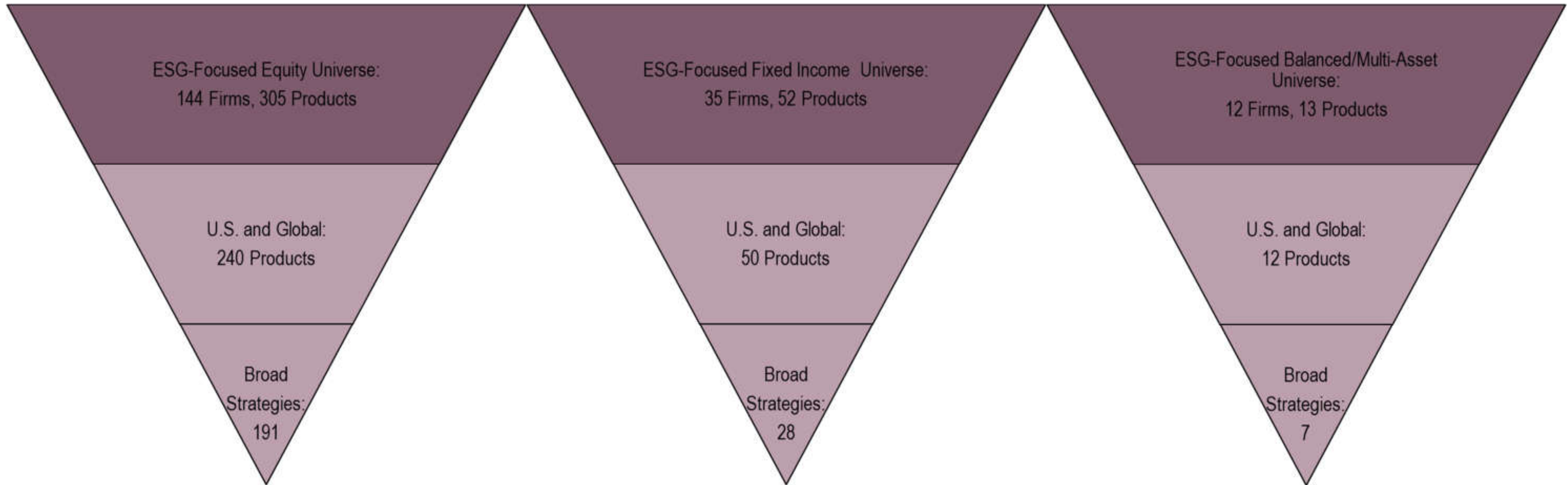
Environment	Social	
Climate change	Consumer rights	Board structure
Environmental policy	Health and safety	Board diversity
Sustainability best practice	Product safety	Independent directions
Environmental mgmt./Waste Mgmt	Labor relations	Chairman / CEO split
Water supply	Community / stakeholder relations	Executive pay/Shareholder rights

ESG Opportunity Set





- Based on eVestment database, a total of 370 products labeled as ESG were found.
- It should be noted that this opportunity set includes strategies across the globe and spectrum of “ESG”, and only represents one database’s information.
- Of this universe set, 305 products were equity strategies, accounting for 82% of the ESG investment landscape.
- From a geographic standpoint, there are 160 products focused on US versus 206 products being non-US focused.



- Breaking down the ESG landscape even further and eliminating very narrowly defined strategies, the availability of ESG products within the Fixed Income and Balanced products appears slim, with just 28 and 7 products respectively.

Active vs. Passive Decision for Search

Active vs. Passive Decision

- The first decision the Board can make, in order to ensure the RFP issued focuses on the appropriate pool of investment product options, is whether to focus on passive products, active products, or to allow either type of product for a manager to respond.
- The Program focus on keeping fees reasonable will eliminate many active options from consideration, unless the Board chooses to utilize the "white label approach" to combine multiple strategies (e.g., an equity index and a blended active strategy) to keep fees low.
- Passive strategies are often exclusionary in nature, and will focus on eliminating "undesirable" components of either the stock or bond market. However, there are some passive strategies that may strategically target "green" or socially responsible companies, rather than eliminating less focused companies.
- Active strategies run the gamut in terms of focus, but can also be either proactive or exclusionary in nature. Fees are generally higher for active strategies, as one might expect.
- **Meketa recommends leaving the search open in terms of active vs. passive, focusing instead on a total maximum fee load.**

Equity vs. Fixed Income Decision for Search

Equity vs. Fixed Income Decision

- The next major decision point for the Board is whether to offer participants, at launch, an equity focused option (stocks), a fixed income focused option (bonds), or a blended product (both stocks and bonds, often called “balanced”).
  - This approach could be accomplished through hiring one investment manager, or multiple investment managers (e.g., an equity index fund focused on ESG principles, and a bond index fund focused on ESG principles to accomplish a “blended” approach).
- There are many more options available that are focused on stocks, primarily because this has historically been where demand is. This is also where the most passive investment options exist.
- Bond options do exist however, in both active and passive form.
- Blended products are typically “active” in nature, given that a manager needs to determine the split of stocks and bonds and the criteria used to select them.
- It is also possible to offer both a stock and a bond option, each as a standalone investment. However, given the Board’s stated objective of keeping the lineup “simple”, adding two options in an area that will likely garner a small minority of total assets, may inadvertently create complexity, even while it offers participants a strong choice for how to invest their assets. Again, if the two strategies were combined into a “white label” of ESG, and the blend was monitored by Meketa and Ascensus and CalSavers, combining two strategies could be considered.
- **Meketa recommends offering a blended or “balanced” option to participants**. Meketa believes allocating to equity and fixed income in a single Option will lower portfolio risk relative to a standalone Equity ESG Option. This balanced approach is especially important for those participants who may decide to direct all of their dollars to the ESG option. **We are open to utilizing a single manager, or multiple managers to create this blended approach.**

E vs. S vs. G Decision for Search Recommendations

E vs S vs G Decision

- Lastly, the Board must consider integration of the E (environmental), S (social), and G (governance) principles for the Option offering.
- There are a myriad of socially responsible fund offerings that target all three components into what is considered a “core” ESG fund. For example, this would be a portfolio of investments where an environmentally friendly company and a company ranked high for its employee diversity would sit alongside each other, and have I representation within the Fund. Companies who score, or rank lower on these metrics would either be excluded, or weighted at a reduced level in many portfolios.
- Likewise, if the Board has stronger views on one ESG component in particular, such as a focus on environmental responsibility, there are sector-focused options that can be considered. A Clean Energy Fund, Solar Fund or a Water Fund are some examples.
- Governance gets integrated into many ESG strategies, as well as many “traditional” investment offerings, with active managers, or even passive strategies, focusing on strong corporate governance, equity and representation on Boards, and CEO pay, for example.
- Environmental, social and governance (ESG) investing provides criteria that allow investors to select investments that align with their values in addition to their financial goals. The Board must consider their collective values, to ascertain that the Option ultimately selected for the CalSavers Program reflects both their views, as well as a broad representation of participant views.
- **Because it is difficult to know what all 7 million potential participants may desire from an ESG option, Meketa recommends offering an ESG option that spans a full set of values as this would seek to satisfy a larger base of Participants’ socially responsible needs and beliefs**. Additionally, the Board, through white labeling, may want to consider offering one or more strategies rolled into the CalSavers ESG Option that would reflect the core values considered most important.

Recommendations

Conclusions and Recommendations

- ESG availability in the marketplace is strong and growing as the eVestment database shows, particularly in the equity space.
- However, while the availability of ESG products is robust, suitability of these as it relates to the CalSavers participants' needs must be considered, which will further narrow the ESG universe. Additionally, fee constraints will further refine the number of strategies available to the Program.
- Our work in this space shows that participants who want to express their ESG principles often want to do so with "all" of their investments, which makes offering ONLY an equity option or ONLY a fixed income option challenging. Likewise, offering participants multiple ESG funds can create confusion and inertia.
- We believe structuring a well-crafted RFP based on this discussion and the Board's ultimate direction will elicit qualified responses from the industry and allow the Board the option of including an ESG fund into the CalSavers investment lineup.
- Meketa recommends focusing the RFP on a broad set of ESG principles, rather than just one subset (such as environmentally focused funds), and allowing both active and passive responses, but with the RFP clearly stating that the only way an active fund with fees over 20 basis points could be considered is by being combined with an index option, which would ultimately lower the cost of a blended "white label option" to less than 20 bps. Meketa will then work with Staff to evaluate the proposals, including whether a single blended investment option, or the utilization of multiple providers, makes the most sense, in order to provide participants a "balanced" investment option, with both equity and fixed income exposure. Finalist options and a recommendation will be brought to the Board for selection.

Disclaimer, Glossary, and Notes

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Credit Risk: Refers to the risk that the issuer of a fixed income security may default (i.e., the issuer will be unable to make timely principal and/or interest payments on the security.)

Duration: Measure of the sensitivity of the price of a bond to a change in its yield to maturity. Duration summarizes, in a single number, the characteristics that cause bond prices to change in response to a change in interest rates. For example, the price of a bond with a duration of three years will rise by approximately 3% for each 1% decrease in its yield to maturity. Conversely, the price will decrease 3% for each 1% increase in the bond's yield. Price changes for two different bonds can be compared using duration. A bond with a duration of six years will exhibit twice the percentage price change of a bond with a three-year duration. The actual calculation of a bond's duration is somewhat complicated, but the idea behind the calculation is straightforward. The first step is to measure the time interval until receipt for each cash flow (coupon and principal payments) from a bond. The second step is to compute a weighted average of these time intervals. Each time interval is measured by the present value of that cash flow. This weighted average is the duration of the bond measured in years.

Information Ratio: This statistic is a measure of the consistency of a portfolio's performance relative to a benchmark. It is calculated by subtracting the benchmark return from the portfolio return (excess return), and dividing the resulting excess return by the standard deviation (volatility) of this excess return. A positive information ratio indicates outperformance versus the benchmark, and the higher the information ratio, the more consistent the outperformance.

Jensen's Alpha: A measure of the average return of a portfolio or investment in excess of what is predicted by its beta or "market" risk. Portfolio Return- [Risk Free Rate+Beta*(market return-Risk Free Rate)].

Market Capitalization: For a firm, market capitalization is the total market value of outstanding common stock. For a portfolio, market capitalization is the sum of the capitalization of each company weighted by the ratio of holdings in that company to total portfolio holdings; thus it is a weighted-average capitalization. Meketa Investment Group considers the largest 65% of the broad domestic equity market as large capitalization, the next 25% of the market as medium capitalization, and the smallest 10% of stocks as small capitalization.

Market Weighted: Stocks in many indices are weighted based on the total market capitalization of the issue. Thus, the individual returns of higher market-capitalization issues will more heavily influence an index's return than the returns of the smaller market-capitalization issues in the index.

Maturity: The date on which a loan, bond, mortgage, or other debt/security becomes due and is to be paid off.

Prepayment Risk: The risk that prepayments will increase (homeowners will prepay all or part of their mortgage) when mortgage interest rates decline; hence, investors' monies will be returned to them in a lower interest rate environment. Also, the risk that prepayments will slow down when mortgage interest rates rise; hence, investors will not have as much money as previously anticipated in a higher interest rate environment. A prepayment is any payment in excess of the scheduled mortgage payment.

Price-Book Value (P/B) Ratio: The current market price of a stock divided by its book value per share. Meketa Investment Group calculates P/B as the current price divided by Compustat's quarterly common equity. Common equity includes common stock, capital surplus, retained earnings, and treasury stock adjusted for both common and nonredeemable preferred stock. Similar to high P/E stocks, stocks with high P/B's tend to be riskier investments.

Price-Earnings (P/E) Ratio: A stock's market price divided by its current or estimated future earnings. Lower P/E ratios often characterize stocks in low growth or mature industries, stocks in groups that have fallen out of favor, or stocks of established blue chip companies with long records of stable earnings and regular dividends. Sometimes a company that has good fundamentals may be viewed unfavorably by the market if it is an industry that is temporarily out of favor. Or a business may have experienced financial problems causing investors to be skeptical about is future. Either of these situations would result in lower relative P/E ratios. Some stocks exhibit above-average sales and earnings growth or expectations for above average growth. Consequently, investors are willing to pay more for these companies' earnings, which results in elevated P/E ratios. In other words, investors will pay more for shares of companies whose profits, in their opinion, are expected to increase faster than average. Because future events are in no way assured, high P/E stocks tend to be riskier and more volatile investments. Meketa Investment Group calculates P/E as the current price divided by the I/B/E/S consensus of twelve-month forecast earnings per share.

Quality Rating: The rank assigned a security by such rating services as Fitch, Moody's, and Standard & Poor's. The rating may be determined by such factors as (1) the likelihood of fulfillment of dividend, income, and principal payment of obligations; (2) the nature and provisions of the issue; and (3) the security's relative position in the event of liquidation of the company. Bonds assigned the top four grades (AAA, AA, A, BBB) are considered investment grade because they are eligible bank investments as determined by the controller of the currency.

Sharpe Ratio: A commonly used measure of risk-adjusted return. It is calculated by subtracting the risk free return (usually three-month Treasury bill) from the portfolio return and dividing the resulting excess return by the portfolio's total risk level (standard deviation). The result is a measure of return per unit of total risk taken. The higher the Sharpe ratio, the better the fund's historical risk adjusted performance.

Standard Deviation: A measure of the total risk of an asset or a portfolio. Standard deviation measures the dispersion of a set of numbers around a central point (e.g., the average return). If the standard deviation is small, the distribution is concentrated within a narrow range of values. For a normal distribution, about two thirds of the observations will fall within one standard deviation of the mean, and 95% of the observations will fall within two standard deviations of the mean.

STIF Account: Short-term investment fund at a custodian bank that invests in cash-equivalent instruments. It is generally used to safely invest the excess cash held by portfolio managers.

Style: The description of the type of approach and strategy utilized by an investment manager to manage funds. For example, the style for equities is determined by portfolio characteristics such as price-to-book value, price-to-earnings ratio, and dividend yield. Equity styles include growth, value, and core.

Yield to Maturity: The yield, or return, provided by a bond to its maturity date; determined by a mathematical process, usually requiring the use of a "basis book." For example, a 5% bond pays $5 a year interest on each $100 par value. To figure its current yield, divide $5 by $95—the market price of the bond—and you get 5.26%. Assume that the same bond is due to mature in five years. On the maturity date, the issuer is pledged to pay $100 for the bond that can be bought now for $95. In other words, the bond is selling at a discount of 5% below par value. To figure yield to maturity, a simple and approximate method is to divide 5% by the five years to maturity, which equals 1% pro rata yearly. Add that 1% to the 5.26% current yield, and the yield to maturity is roughly 6.26%.

$$\frac{\text{5\% (discount)}}{\text{5 (yrs. to maturity)}} = \text{1\% pro rata, plus 5.26\% (current yield)} = \text{6.26\% (yield to maturity)}$$

Sources: Investment Terminology, International Foundation of Employee Benefit Plans, 1999.
The Handbook of Fixed Income Securities, Fabozzi, Frank J., 1991.

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Throughout this report, numbers may not sum due to rounding.

Returns for periods greater than one year are annualized throughout this report.

Values shown are in millions of dollars, unless noted otherwise.