



Long Term Stewardship Research Project

September 21, 2016

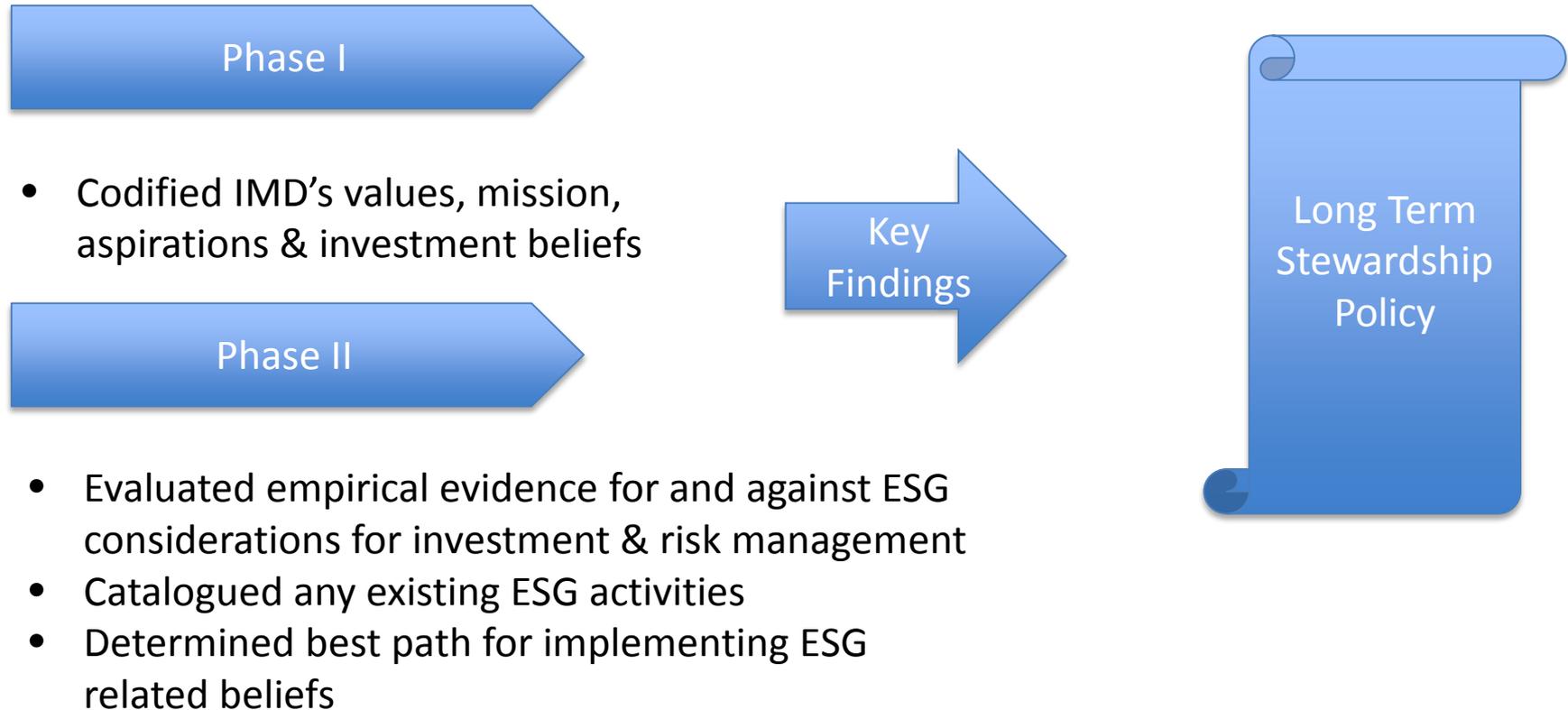


North Carolina Department of State Treasurer
Investment Management

Learn. Invest. Grow. Prosper.

Purpose

Two phase research project focused on critically analyzing role of Environmental, Social and Governance (“ ESG”) issues in the investment process; key findings used to develop Long Term Stewardship Policy.



Approach – collaborative & empirical

Collaborative

- Project sponsored by Treasurer, Chief of Staff & CIO
- Project team is cross-divisional
 - IMD staff
 - Corporate Governance staff

Empirical

- Phase II focused on answering these 5 key questions:
 - What, if any, ESG issues contribute to the financial performance of a company?
 - Which, if any, ESG issues matter by asset class?
 - How have ESG targeted investments performed?
 - How beneficial are ESG considerations in mitigating downside risk for a portfolio?
 - How are other institutional investors addressing ESG issues?



Phase II Steps

Following steps taken to answer questions:



- Benchmarking peer groups on ESG activity
 - 61 U.S. Public Pensions
 - 19 Endowments & Foundations
 - 11 Sovereign Wealth Funds
- Determining which ESG issues matter for investment performance & risk management
 - Understanding ESG data and standards issues
 - Reviewing academic literature
 - Evaluating performance of ESG investing
- Developing and implementing EDGE, a 13-part educational ESG educational series for staff
- Determining current best practices for ESG integration



Findings - Benchmarking

Table I – ESG Activity by Investor Type

Investor Group	Active	WIP	Inactive	Sample Size
US Public Pensions	15%	26%	59%	61
Endowments	53%	0%	47%	14
Foundations	80%	0%	20%	5
Sovereign Wealth Funds	15%	26%	59%	11

Source: IMD Staff



- Highest degree of ESG activity is observed for Foundations
- Lowest degree of ESG activity is observed for US Pension Plans and Sovereign Wealth Funds



Findings – Benchmarking

Motivations for ESG Activity Vary By Investor Type – US Public Plans

Table II – Impetus for ESG Activity for US Public Plans

Public Pension	Impetus	Comment
Pacific A	Board, CEO & CIO	Early mover, before 2005
Pacific B	Treasurer	Early mover, before 2005
Northeast A	Legislature	Statutory requirements allow consideration of ESG factors in investment decisions
Southeast	Senior management	Well established corporate governance program
Northeast B	Senior management, divestment push	Shift to alternative investments and response to activist fossil fuel divestment push targeting legislature
Northeast C	Senior leadership	Focus on climate change & shareholder activism
Northeast D	Senior management	Shift to private investments, complemented by legislative and activist interest.
Pacific C	Board & senior management	Views climate change as risk to portfolio
Midwest	Board, CIO	Well established corporate governance program

Source: IMD & CG Staff



Findings – Benchmarking

Motivations for ESG Activity Vary By Investor Type - EnF

Table III – Impetus for ESG Activity for Endowments & Foundations

EnF	Impetus	Comment
Endowment 1	Compliance	Certain ESG issues part of operational due diligence
Endowment 2	Divestment & risk management	Response to student & faculty concerns on fossil fuels & mitigating climate change risk
Endowment 3	Risk management	Material ESG factors part of manager due diligence
Endowment 4	Divestment	Response to student & faculty concerns on fossil fuel
Endowment 5	Divestment	Response to student & faculty concerns on fossil fuel
Endowment 6	Alumni gift	Donation earmarked for ESG themed investments
Foundation 1	Alignment with philanthropic goals	Negative screening done by external managers
Foundation 2	Alignment with philanthropic goals	ESG targeted investments
Foundation 3	Alignment with philanthropic goals	ESG targeted investments
Foundation 4	Divestment	Negative screening & low carbon index

Source: IMD



Findings – Benchmarking

Motivations for ESG Activity Vary By Investor Type - SWF

Table IV – Impetus for ESG Activity for Sovereign Wealth Funds

Sovereign Wealth Fund	Impetus	Comment
SWF1	Mission driven	Seeking social justice Limit negative physical & financial impact of climate change
SWF2	Performance driven	Seeking better risk-adjusted returns through integration of material governance factors into Private Equity transactions
SWF3	Risk management	Limit negative impact of climate change & poor company management on Private Equity and Real Estate investments
SWF4	Performance & Mission driven	Seeking better risk-adjusted returns through ESG integration Promote economic stability and growth of middle class in South East Asia & other emerging markets
SWF5	Mission driven & risk management	Seeking to be a responsible corporate citizen and to mitigate select risks

Source: IMD



Findings – Materiality

Data & Standards Issues

- Lack of regulatory standards
 - Self-reporting
 - Staleness
- “Signal-to-noise” issue for investors and financial analysts

Academic Studies

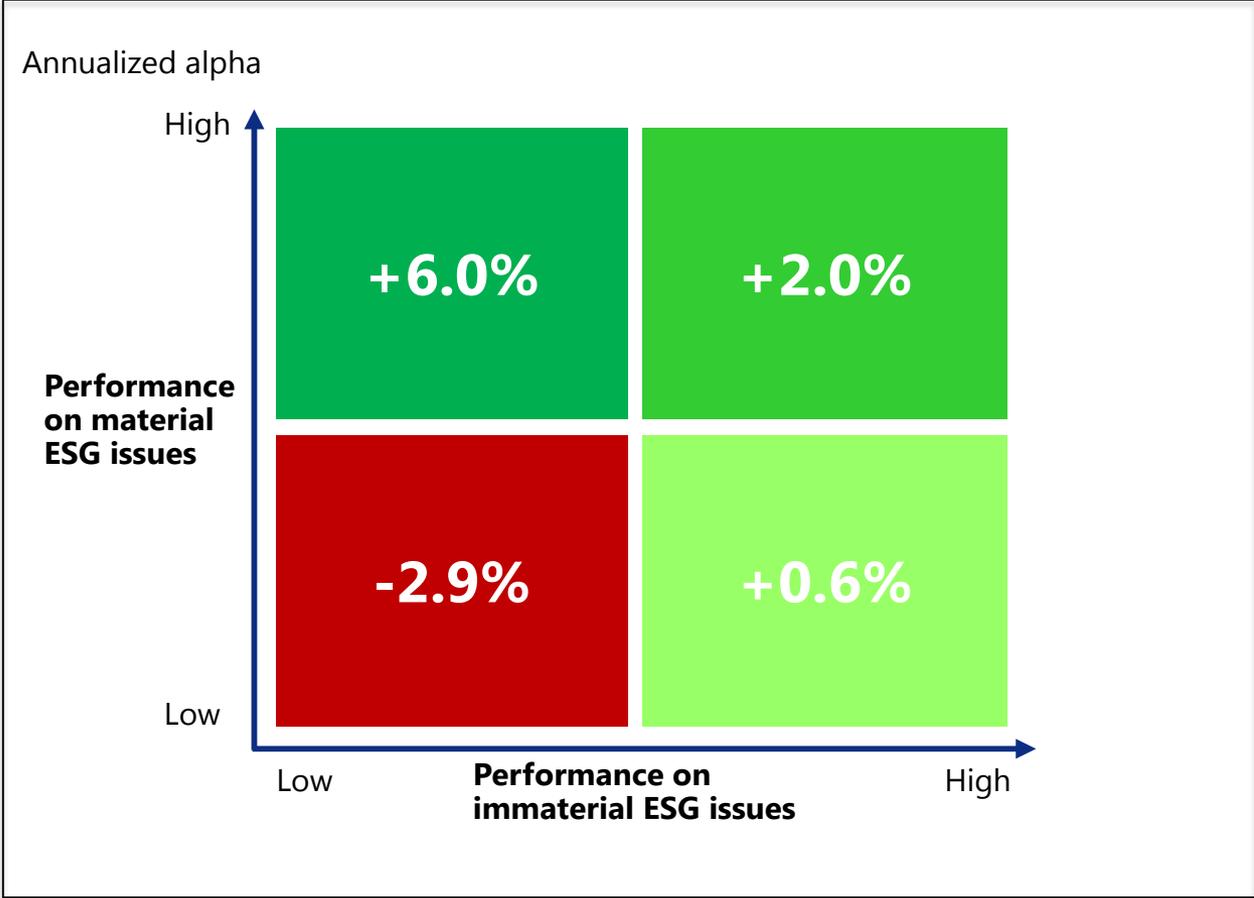
- Large number of studies (> 1000 papers), asking different questions on relationship between financial performance and ESG issues.
- Until 2015, mixed evidence in literature about relationship between ESG issues and performance.
- Serafeim* et al. were first researchers to develop a unique data set for measuring which ESG issues are material for financial performance of public companies.

* “Corporate Sustainability: First Evidence of Materiality.” Mozzar Khan, George Serafeim and Aaron Yoon. Harvard Business School Working Paper, March 9 2015. Forthcoming in *Accounting Review*.



Findings – Materiality & Performance

Table V – Impact of Material vs. Immaterial ESG Issues on Company Financial Performance



- Companies with strong ratings on material ESG issues outperform companies with poor ratings on these issues.
- Companies with strong ratings on immaterial ESG issues do not outperform companies with poor ratings on these issues.

Source: McKinsey presentation at EDGE Series, March 2016



Findings – Performance

Project observations

- Self-reported performance for ESG targeted investments by US pension plans in benchmarking study has largely been disappointing, particularly for early clean tech investments.

Academic observations

- Mixed evidence in literature, largely stemming from lack of distinction made between material and immaterial ESG issues in studies until 2015.
- Cautionary lessons from recent studies
 - National Bureau of Economic Research
 - Wharton Social Impact Initiative



Key Findings & Long Term Stewardship Practices

Key Findings

Engagement
over
Divestment

Bottoms up
approach to
material risk
factors

Integration
over Allocation

Long Term Stewardship Practices

- **Governance**
 - Adopting and advocating well-recognized governance and regulatory principles/policy
- **Global Risks Management**
 - Managing assets with awareness of material long-term economic, environmental, geopolitical, societal and technological risks
- **Integration**
 - Systematically integrating governance risk considerations across portfolio management and corporate governance processes



Thank you

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EDGE Team

- Sondra Vitols
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Thank You!

Together we can build and maintain a fiscally strong and prosperous North Carolina.

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