MINUTES

MARIN COUNTY EMPLOYEES' RETIREMENT ASSOCIATION (MCERA) RETIREMENT BOARD STRATEGIC WORKSHOP

Embassy Suites
101 McInnis Parkway, San Rafael, California
Santa Rosa Room
October 29, 2015

8:00 a.m. – 9:00 a.m.
Continental Breakfast

9:00 a.m.
Call to Order

Chair Shore called the meeting to order at 9:04 a.m.

Roll Call

PRESENT: Bolger, Brenk, Given, Haim (alternate retired), Murphy, Piombo, Shaw (ex officio alternate), Shore, Stevens, Thomas, Webb

ABSENT: Cooper (alternate safety)

Open Time for Public Expression
Note: The public may also address the Board regarding any agenda item when the Board considers the item.

Stephen Silberstein encouraged the Board to consider how corporate proxy votes are cast on MCERA's behalf, in particular on corporate board diversity, disclosure of political spending, and Chief Executive Officer (CEO) compensation.

9:00 a.m. – 10:00 a.m.
Overview of MCERA's Fiduciary Responsibilities for Investing the Portfolio
Ashley K. Dunning, Partner
Nossaman LLP

Mr. Wickman welcomed those attending MCERA's Strategic Workshop focusing on environmental, social and governance (ESG) matters. The Administrator stated that Counsel Dunning begins with an overview of MCERA's fiduciary responsibilities for investing the portfolio that will include a discussion of recent U.S. Department of Labor proposals. Then investment consultant Callan Associates will present research, terminology and implementation avenues for ESG investment strategies. Finally, Divya Mankikar from the CalPERS Global Governance Team will discuss PERS' ESG Pilot Project and Sue Bonfeld from Wellington Management Company will discuss Wellington's use of ESG factors in their research.

Ashley Dunning, Board counsel for MCERA and Co-Chair of the Public Pensions and Investment Group at Nossaman LLP, presented the Overview of MCERA's Fiduciary Responsibilities for Investing the Portfolio. Ms. Dunning reported on recent developments regarding fiduciary duties in investing as applied in a 2015 United States Supreme Court case and a new Department of Labor Interpretive Bulletin that she will review in her presentation.

Ms. Dunning described the two basic duties for Plan fiduciaries as set forth in the California Constitution: the Duty of Care and the Duty of Loyalty. The Duty of Care consists of rules including the Prudent Expert Rule whereby trustees are not relieved of the obligation to get education and ask questions so as to act as a prudent expert. There is a duty to diversify system assets including an affirmative duty to minimize the risk of loss and maximize the rate of return, unless under the circumstances it is clearly not prudent to do so. With respect to social investing and ESG the legislature can and has prohibited certain types of investments; however, the fiduciary "savings clause" in the State Constitution requires an analysis before making such an investment decision to determine whether the investment alternative would be equal to or superior to the prohibited investment(s). In response to Chair Shore's inquiry Ms. Dunning stated with respect to the public there can be competing interests that may not be well defined. Furthermore, she explained that because the legislature has a fiduciary responsibility to the public there are different roles and responsibilities for legislators than there are for trustees of pension funds whose exclusive fiduciary responsibility is to the members and beneficiaries.

According to Ms. Dunning one aspect of the Duty of Care is the duty to monitor after making an investment. Specifically, there is a continuing obligation to monitor so long as you still have the investment and to take action if there is a need to do so. In addition, the Duty of Care requires consulting with experts such as legal, actuarial and investment consultants. Ms. Dunning explained that if trustees do not agree with the advice of their professional consultants, then it would be prudent to get the advice of other experts in the field. Finally, the Duty of Care provides that a fiduciary's responsibilities may be delegated under certain circumstances; however, the fiduciary's duties cannot ever be fully delegated. The Duty of Care equates to a Duty of Prudence as evidenced by asking questions, understanding the rationale for actions before taking them, analyzing the advice and recommendations of experts, and following applicable laws and governing documents.

Next Ms. Dunning discussed guiding principles comprising the Duty of Loyalty, which she said are equal for all trustees. The Exclusive Benefit Rule requires trust fund assets to be ".... held for the exclusive purposes of providing benefits to participants in the ... retirement system and their beneficiaries and defraying reasonable expenses of administering the system." To this point, the Primary Duty Rule holds that trustees ".... shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system." The Primary Duty Rule comes up frequently because this duty takes precedence over any other rule, Ms. Dunning said.

In response to Trustee Brenk's inquiry, Ms. Dunning discussed considerations in prudently funding the Plan, including balancing the competing goals of minimizing volatility in employer contributions and maintaining a consistent funding model for the Plan.

Ms. Dunning stated in response to Trustee Stevens' inquiry that when it comes to addressing ESG questions there may be subtleties and room to consider collateral interests but the fiduciary must consider that there is equal weighting given to the consideration as described previously in the fiduciary savings clause. Prevailing rules on collateral interests, as evidenced in common case law and Department of Labor (DOL) Advisory Opinions, generally prohibit trustees from considering interests other than those of the beneficiaries of the Plan. For example, when considering investment alternatives the interests of trust beneficiaries may not be compromised by sacrificing investment returns. Furthermore, regarding socially responsible investing non-economic factors may not be considered unless the economic value would be equal to or superior to alternate investments. That said, Ms. Dunning pointed out that because DOL opinions under the Employee Retirement Income Security Act of 1974 (ERISA) use the concept "all else being equal" from a risk-return analysis standpoint, then it is not prohibited to consider ESG in making investment decisions. Furthermore, last week the DOL issued an "Interpretive Bulletin Relating to the Fiduciary Standard under ERISA in Considering Economically Targeted Investments" (ETIs). The DOL Bulletin states a fiduciary may invest so long as the asset is economically equivalent and the Bulletin withdraws other advice the DOL previously provided on ETIs that were understood to disfavor ETIs generally. As Trustee Bolger sees it, the DOL is backing away from the tiebreaker concept and moving to a holistic economic picture regarding consideration of ESG issues. In conclusion, Ms. Dunning advised that fiduciary compliance is demonstrated by the use of prudent processes, including talking about issues and asking questions of experts, which is then documented in the minutes.

Chair Shore recessed the meeting for a break at 9:55 a.m., reconvening at 10:10 a.m.

10:00 a.m. – 12:00 p.m.
Defining Environmental, Social and Governance (ESG) terms
Jim Callahan, Executive Vice President
Anne Heaphy, Vice President
Andy Iseri, Senior Vice President
Callan Associates

Jim Callahan, Callan Associates Executive Vice President, stated that today's presentations are based on the results of Callan Associates' third annual survey on the use of Environmental, Social and Governance (ESG) factors by public funds, including CalPERS and CalSTRS. Mr. Callahan stated that ESG investing evolved from social causes and became issues for public pensions in the 1970's and 1980's with the apartheid cause. As a result of events such as the Exxon Valdez oil spill, over the last 15 or 20 years the focus has shifted to the environment and corporate citizenship. In addition the Governance theme, with deep roots in how companies manage themselves and the degree to which the best interests of the shareholder are considered, has evolved in the institutional community. Rather than excluding investments that were deemed bad in some way as in the past, the ESG discussion is being recast to look at ESG factors such as Governance as possibly leading to better returns. In order to analyze the investment merit of positive ESG factors, he said, academic research and empirical evidence must be linked. For environmental factors the empirical evidence is still emerging, Mr. Callahan noted.

Mr. Callahan introduced Andy Iseri from the Global Manager Research group who leads global and international equity ESG research. Reinforcing Mr. Callahan's view, Mr. Iseri referred to DOL guidance discussed by Ms. Dunning as evidence that the ESG discussion is at a turning point.

Mr. Iseri reviewed the meaning of ESG terms like socially responsible investing and impact investing which he said consider non-financial interests. He also discussed methods of integrating ESG factors with traditional factors throughout the investment process. One avenue is encouraging diversity on corporate boards which he said is important from a communications standpoint. In addition ESG can be used as a form of risk mitigation that reduces the standard deviation of investment returns. An example is using "best in class" as a positive screen whereby the best oil company would be selected as opposed to no oil companies. This approach outperforms a negative screen strategy over time. Responding to Trustee Stevens' inquiry, Mr. Iseri gave examples of underperforming assets developed with negative screens.

In conclusion, Mr. Iseri explained that the message is that engagement and inclusion are more effective in changing behavior than divestment. Environmental factors are part of a multi-factor investment model along with profitability and governance, he said.

Mr. Iseri responded to questions from the trustees. Trustee Stevens observed that considering ESG factors is not new and parameters include the potential liability of environmental factors. Ms. Stevens stated that in her experience ESG rankings involved both positive and negative screens. Chair Shore suggested letting the price of investments show the way, observing that there may be a premium for ESG investment vehicles as ESG gains popularity. Mr. Callahan believes the discussion needs to go beyond the initial price aspect. Pointing to the economic profitability of green investing in the real estate sector, he indicated stocks and bonds may respond in a similar way.

Research on the use of ESG in the investment process
Jim Callahan, Executive Vice President
Anne Heaphy, Vice President
Andy Iseri, Senior Vice President
Callan Associates

Mr. Iseri indicated that a longer time frame such as 15 to 20 years is needed for Callan Associates' to determine whether ESG factors can add value or reduce risk for investments as the current data is not definitive. He discussed the complex nature of analyzing results such as isolating ESG factors that requires diligent scrutiny. As an example, banks will not receive a high environmental score because it is not relevant to their industry. Other research considering six or seven ESG factors showed that the best scoring vehicles underperformed. Mr. Iseri stated that he has not seen any quantitative models based on ESG factors and therefore he remains skeptical on the value of ESG, advising caution in leaning on popular research. He added that the standards for assumptions when conducting viable academic research are high.

Trustee Given inquired as to the appropriate approach when the Board is presented with ESG agendas by members of the public. Mr. Callahan observed that there are few absolutes in investments and ESG is an evolving concept. It makes sense as an investor, he advised, to pay attention and incorporate these considerations into the analysis on what investments to make. Since the research is not robust historically, it is difficult to define a policy around it, he said. In response to Trustee Bolger's inquiry, Mr. Callahan stated it is rare to find a manager who completely excludes ESG factors.

Mr. Iseri discussed Callan Associates' initiatives around ESG investing that include a dedicated ESG research team. Considerations when analyzing ESG factors include taking care not to screen managers based on semantics alone. Mr. Iseri underscored the need to understand the methodology when being presented with statistics on ESG.

How are public plans using ESG
Jim Callahan, Executive Vice President
Anne Heaphy, Vice President
Andy Iseri, Senior Vice President
Callan Associates

Callan Associates conducted surveys in 2013, 2014 and 2015 on approaches to ESG by institutional funds in the United States. Respondents reporting they consider ESG in some way increased from 22% in 2013 to 29% in 2015. Mr. Iseri reported on the top four responses to "Why incorporate ESG?" Nearly 50% reported the Investment Policy Statement dictates considering ESG factors and 40% reported having other goals besides maximizing risk-adjusted returns. Finally 38% responded that ESG factors are part of the fiduciary responsibility and 35% reported expecting to improve the risk profile without sacrificing return. Top four responses to "Why NOT Incorporate ESG?" were an unclear value proposition, lack of performance research, a purely financial focus, and lack of time or resources. Callan's survey also included respondent's views on six general statements about ESG factors and investment decisions. The research shows a general trend led by endowments and foundations of growing interest in considering ESG factors for investments that should not be ignored. He emphasized the need for additional education on what is an unclear value proposition and the importance of selecting good managers.

Trustee Bolger asked if Mr. Callahan believes there should be ESG language in the Investment Policy Statement. Mr. Callahan said that is a reasonable place to start and have discussions with the managers on how they are looking at ESG while continuing with education and research on the topic. In order to manage this process Mr. Wickman recommended that the Board consider looking at developing something similar to the CalPERS Statement of Investment Beliefs.

Ms. Dunning reviewed MCERA's proxy voting process outlined in the Investment Policy Statement in response to Trustee Stevens' inquiry. Trustee Gladstern referenced the Council of Institutional Investors (CII) as a resource on how to engage with managers and Mr. Iseri noted smaller plans may pool resources for CII services.

Chair Shore recessed the meeting at 11:40 a.m. for lunch, reconvening at 1:15 p.m.

12:00 p.m. – 1:30 p.m.
Lunch (on site)

Mr. Wickman presented Trustee Webb with a SACRS 10 year pin.

1:30 p.m. – 2:30 p.m.
CalPERS ESG Pilot Project Overview
Divya Mankikar, CalPERS Global Governance Team

Mr. Wickman welcomed Divya Mankikar from the CalPERS Global Governance Team who is leading the integration of ESG factors into the CalPERS investment process. Ms. Mankikar stated we are in the midst of shifts within the industry due to climate change and the question is how to approach ESG integration in a smart way. Within CalPERS Ms. Mankikar's role is to integrate ESG across asset classes managed by a relatively large investment team of both external and internal managers. As part of this process she will assist in defining ESG strategies for each asset class. Ms. Mankikar's background is in private asset management in sustainable investments, specifically to reduce the carbon footprint, and her focus is on climate change, diversity, and proxy access.

Ms. Mankikar reviewed CalPERS investment beliefs that support the ESG integration process. Fundamentally the idea is to think about risk over the long term. Assuming climate change is real, the goal is to shift the market to preserve the Fund's integrity over the long term. Second, risk is not fully captured in traditional financial measures since the data is backwards looking and climate change is going to change business as usual. Trustee Shore asked why the future would be any more predictable. In response Ms. Mankikar said climate change is changing resource availability.

The overall CalPERS strategy on climate change is engagement, advocacy and integration. Ms. Mankikar stated that engagement includes working with companies individually and through CERES and Investment.org. Companies with the biggest carbon footprint are asked to disclose how they consider climate change over the long term and to define the risks. As a result of these efforts one of the largest coal mining companies in the world responded in a thoughtful way by accepting the concepts presented, considering how they would change their business model, and bringing a climate scientist to sit on their Board. This is a story of positive engagement, she said.

In response to Trustee Bolger's inquiry, Ms. Mankikar indicated the engagement process is a prioritized effort with the goal of measuring progress with key companies. Resource-intensive internal analysis is conducted on recommendations from external groups that are supported if they make sense for CalPERS.

Advocacy includes working with the Carbon Pricing Leadership Coalition on carbon pricing. In response to Trustee Haim's inquiry, she described carbon pricing groups and explained that developing countries have implemented a carbon tax. The goal is to come up with a shared understanding supporting carbon pricing and bring carbon emissions into the decision-making process. Companies with voluntary carbon reduction programs are supported as forward-thinking companies pursuing carbon pricing in a rational way.

CalPERS' projects to integrate ESG include calculating the carbon footprint of holdings. Assessing which companies pose the greatest carbon risk sets up a broader question on how managers view sustainable investing, she said. The CalPERS Pilot Project focuses on manager expectations, she said. In July of 2015 the manager expectations project was launched which is an internal process where guidelines are developed around each asset class that are nested within PRI principles and global governance issues. The guidelines include how ESG metrics are translated into financial metrics and material ESG factors for each industry. The analysis is an extension of risk management in defining the key questions that should be asked when selecting managers. In addition contract language and the monitoring process, including an ESG scorecard to measure the correlation to financial performance, are considered. It is left to each asset manager to determine how to deal with the question raised on the carbon footprint, according to Ms. Mankikar. One result has been that managers have generally refocused on the power of engagement versus divestment.

Referencing Draft Sustainable Investment Guidelines including CalPERS Investment Beliefs and UN Principles for Responsible Investment, Trustee Haim inquired as to whether and how economic return is taken into account. In response Ms. Mankikar stated her role is to bridge the gap between what we want to do and what we can do. The process is asset-class specific in terms of maneuverability and what is most actionable, she stated, adding that the link to financial performance is not always obvious. Trustee Bolger inquired about manager reporting. Ms. Mankikar responded that there is a standard questionnaire about the integration of ESG into the investment decision making process, including risk analysis, contracting and monitoring. There is a wide divergence in the degree to which managers are attuned to ESG, according to Ms. Mankikar.

Trustees Bolger and Stevens asked how the carbon footprint is measured and why it is a factor. Ms. Mankikar indicated the need to assess the carbon footprint is the first step in addition to assessing expected rises in sea levels. There is data available on carbon and so it is useful to focus attention on what sectors are creating risk and whether you being compensated for that risk, she said. Doing so drives questions and forces entities to find partners to help assess carbon risk. In particular, Ms. Mankikar said there are data providers that track carbon footprints and CalPERS has its own model for estimating the amount of carbon produced each year for non-disclosing companies. Much of the impact comes from supply chains, she noted, and she discussed the problem of double counting.

Responding to Trustee Gladstern's inquiry on how multiple ESG factors are assessed, Ms. Mankikar stated that some factors are qualitative and hard to measure. CalPERS relies on data providers and then rolls scores into separate overall scores for a company on governance, social and environmental matters.

Chair Shore recessed the meeting for a break at 2:30 p.m., reconvening at 2:43 p.m.

2:30 p.m. – 3:30 p.m.
Wellington Management Company ESG Research
Sue Bonfeld, Managing Director and Relationship Manager

Ms. Bonfeld stated that ESG is fundamental to equity and credit analysis. The unifying concept for Wellington is that considering ESG factors is a risk management and transparency exercise. The questions are whether risks are being properly evaluated and what the market is not pricing in. Integrating ESG factors is not mandated but is at the discretion of each portfolio manager. The majority of engagement is in the governance area; how best to do that is a question as some companies welcome engagement and some do not.

There are complexities to ESG analysis, Ms. Bonfeld said, noting that often companies generate alpha from inefficiencies that do not consider ESG and so there is a balance. For example, firms such as Google and Facebook use a tremendous amount of electricity. Furthermore, she distinguished environmental factors as fundamentally different from social or governance because they are externally generated, likening them to surprises versus known quantities. Ms.

Bonfeld further stated that the integration of ESG will increase the need for specialists to perform the related analysis.

Auditing for compliance to ESG standards is moving to third parties, according to Ms. Bonfeld. Trustee Brenk asked if insurance is a factor when rating companies and she responded that where data is their business, the answer is yes. The firm's thesis on executive compensation, which is the most frequent ESG topic at Wellington, is that pay plans should match up with long term shareholder objectives and they look for inconsistencies in this regard.

In response to Trustee Bolger's inquiry Ms. Bonfeld stated that Wellington analysts are encouraged to think more holistically where the broader risk is, for example pricing climate risk in an insurance portfolio. She noted the ESG integration process is not straightforward and there are no universal answers. As a process Wellington uses ESG ratings on 300 stocks and assigns ratings to outliers within sectors. The data is overlaid on the portfolios by the global industry analyst group which managers use in accordance with their beliefs or those of their clients for customized portfolios.

3:30 p.m. – 4:30 p.m.
Closing and Follow-up Items from Today's Agenda

Chair Shore indicated he was pleased with the workshop presentations. Mr. Wickman believes the first step for MCERA is to follow CalPERS' lead by developing a statement of investment beliefs as a framework for ESG integration. A focus on ESG engagement would be good and timely for the Board, Trustee Bolger said. Trustee Given indicated a review by counsel of our existing policies may be sufficient.

Trustee Haim made a motion to develop a list of ESG factors to ask managers to consider and there was no second to the motion.

Responding to Chair Shore's inquiry, Mr. Callahan supported formulating a statement of investment beliefs around ESG as the starting point that will help define the process and integrating ESG engagement into the annual manager reporting process. Based on discussions the Governance Committee will consider developing a Statement of Investment Beliefs.

Trustee Piombo agreed having a straightforward process through a statement that defines our structure would be responsive to the Board's fiduciary duties.

There being no further business, Chair Shore adjourned the meeting at 4:20 p.m.

D N Shore
Dave Shore, Chair

Attest: Jeff Wickman
Retirement Administrator