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Office of the Chief Investment Officer

**TO MEMBERS OF THE COMMITTEE ON INVESTMENTS / INVESTMENT
ADVISORY GROUP:**

DISCUSSION ITEM

For Meeting of September 12, 2014

FINDINGS OF THE TASK FORCE ON SUSTAINABLE INVESTING

EXECUTIVE SUMMARY

The President of the University and Chairman Varner convened the Task Force on Sustainable Investing (Task Force) to explore issues related to the University's investments in fossil fuels. In this item, the Chief Investment Officer reports the findings and recommendations of the Task Force, which are being presented to the Task Force for their final approval on September 10 and, if approved, will be presented to the Committee on Investments on September 12.

BACKGROUND

About the Task Force on Sustainable Investment

President Napolitano, in consultation with Chairman Varner, established the Task Force on Sustainable Investing (Task Force) on June 16, 2014 in response to a growing interest in and concern over issues involving the relationship between the University's investments in fossil fuels and its commitment to sustainability. The Task Force consisted of three Regents, the Chief Investment Officer, the Academic Council Vice-Chair, two members of the Investment Advisory Group, and two student representatives from the Fossil Free UC campaign.

Task Force Findings

The Task Force strongly agrees that climate change is a serious issue and that addressing and accounting for this issue in a holistic way is necessary to produce the best possible returns in the long-term and align the University's investment practices with its demonstrated commitment to sustainability. Given the many factors that contribute to climate change and the potential for both energy producers and consumers to eventually bear the costs of carbon use externalities, climate risk should be approached holistically and become fully integrated into the investment analysis process. Accordingly, after careful consideration, the majority of members of the Task Force recommends the development of a framework for the management of environmental, social, and governance (ESG) considerations for investment decisions made by the Office of the Chief Investment Officer (OCIO). The Task Force recommends that the OCIO should:

1. Establish and implement a framework for sustainable investment with the goal of completion by the end of the current fiscal year.
2. Integrate Environmental, Social, and Governance (ESG)SG factors as a core component of portfolio optimization and risk management. Evaluate all strategies for achieving ESG goals as soon as practical, including whether to use divestment.
3. Allocate \$1 billion over a period of five years to solutions-oriented investments such as renewable power and fuels, energy efficiency, and/or sustainable food and agriculture.

~~The majority of the Task Force concluded that divestment in and of itself would not meaningfully impact climate change. In addition, the majority of Task Force members believe that the cumulative benefit from the University's divestment from fossil fuels would not outweigh the total costs incurred from the divestment of fossil fuels from the University's \$91 billion investment portfolio.~~

The Task Force believes that its recommendation for a multi-faceted, strategic approach to sustainability offers benefits and flexibility ~~versus the inflexibility and permanence of divestment.~~ If the recommendations of the Task Force are approved, the OCIO should implement the approach as agreed and provide updates to the Regents Committee on Investments on progress.

What is an Environmental, Social, and Governance Framework?

The Task Force recognizes the immediate, public threat of climate change and its potential long-term impact on investment results. Given the many factors that contribute to climate change and the potential for both energy producers and consumers to eventually bear the costs of carbon use externalities, the Investment Office should address climate risk holistically and fully integrate climate risk into its process of investment analysis. The Task Force and the OCIO also recognize a risk in focusing attention on the single issue of climate change. While climate change is of pressing concern, there is evidence that other ESG issues can also impact portfolio returns. The Task Force advocates a strategic approach to sustainability issues across all aspects of the University's investment programs that will seek to accomplish the following goals:

1. Ensure that the University's portfolio is positioned for a changing world where resource scarcity, demographics, and climate change are likely to impact risk and return.
2. Respond to the concerns of the University's stakeholders, including students, faculty, donors, and alumni in a way that aligns with the University's values while upholding and solidifying the OCIO's fiduciary role to maximize long-term investment results, on behalf of current and future students, faculty, and retirees, among others.
3. Enhance the OCIO's due diligence and monitoring processes to better account for long-term costs of climate change and to more broadly assess sustainability, providing a more holistic view of assets and markets.

A Proactive Approach to Developing a Sustainable Investing Strategy

The first step towards developing a long-term sustainable investing strategy is to develop a forward-looking, holistic framework on sustainable investment. The second step will be to bring this framework to life via enhanced processes and a culture shift within the OCIO. Elements of a framework on sustainable investment are expected to include:

1. **Environmental Social Governance:** Commitment to environmental, social, and governance factors, a focus on long-term value creation, and the potential for investor stewardship to promote well-functioning companies and capital markets. The OCIO should establish an internal sustainability committee to develop, implement, and ensure that a sustainability framework becomes fully integrated into the investment process. The sustainability framework would be applied to both existing and future investments made by the OCIO.
2. **Institutional Leadership Around Sustainability:** Working with the industry and participating in key initiatives that can help the OCIO achieve successful implementation of a framework on sustainable investment.
3. **Becoming a Signatory to the United Nations Principles for Responsible Investment (PRI):** Established in 2006, the PRI is the leading global network for investors to publicly demonstrate their commitment to sustainable investment, to collaborate with peers across a range of issues from ESG research to engagement, and report on progress annually. The six key principles of the PRI are:
 - “We will incorporate ESG issues into investment analysis and decision-making processes.
 - We will be active owners and incorporate ESG issues into our ownership policies and practices.
 - We will seek appropriate disclosure on ESG issues by the entities in which we invest.
 - We will promote acceptance and implementation of the Principles within the investment industry.
 - We will work together to enhance our effectiveness in implementing the Principles.
 - We will each report on our activities and progress towards implementing the Principles.”

The PRI now represents ~1200 signatories and \$45 trillion in assets. Upon becoming a signatory, the University would be both the largest university overall and the first university in California to join the PRI.

4. **Stewardship and Engagement:** Review the OCIO’s approach to proxy voting and shareholder engagement across a range of ESG issues. This may involve identifying priorities or thematic focus areas to guide the engagement process. This could include issues such as climate risk, water scarcity, human rights, and/or discrimination.

5. **Holistic Integration of Environmental Social Governance:** A holistic integration of ESG will enable the OCIO to more fully consider and account for ESG risks and opportunities, including the potential risks associated with stranded assets and other implications of policy and physical impacts of climate change. A holistic integration of ESG factors may also include reviewing portfolio holdings using a third-party ESG data provider, and could lead the OCIO to underweight certain assets as a risk hedging mechanism. The OCIO should make these decisions in a financial context once an enhanced approach to risk management is developed.
6. **Invest In Solutions:** The Chief Investment Officer and Task Force believe that there is an opportunity to generate attractive returns in fields that contribute to sustainability. The OCIO should be open to partnering with peer institutions and provide leadership in attracting more investment dollars to support the development of sustainable industries. The OCIO should commit to allocate up to \$1 billion over a five year period to solutions-oriented investments. These investments could be made from any of the OCIO's existing asset classes and could include opportunities such as renewable power and fuels, energy efficiency, green real estate, sustainable food and agriculture, smart water solutions, and/or recycling, re-use, and resource sharing. The Task Force believes that this will be the largest and most significant commitment to solutions-oriented investment by a university to date.
7. **Integrated Reporting:** The OCIO should provide updates to the Regents on the status and results of the implementation of a framework on sustainable investment. In addition, the OCIO should contribute an update on its ESG implementation progress to the Office of the President's annual sustainability report. This will ensure full transparency for all members of the University community on the implementation of the framework and the OCIO's progress on applying this framework to its practices.

Implementation of the Environmental, Social, and Governance Framework

The OCIO should begin to implement the framework for sustainable investment this fiscal year. Steps to take include:

1. Developing priorities and clear objectives for implementation.
2. Hiring a Sustainability Officer to lead the implementation of the OCIO's sustainable investment approach.
3. Formalizing the OCIO's expectations for external managers about how they include ESG considerations in the investment services and investment management mandates they undertake on the OCIO's behalf.
4. Developing the culture towards a heightened awareness of, and focus on, ESG considerations.

5. Committing to staff training and organizing presentations by outside experts to help educate staff about best practices for implementing ESG and sustainability into investment decision making.

Once these steps are achieved, environmental, social, and governance considerations, and sustainability will become an integral part of the OCIO's culture and will help OCIO Staff adopt an investment lens that naturally focuses on sustainability. This will allow the OCIO to be proactive rather than reactive, whereby it will not be responding to a particular divestment request, but rather proactively leading its own path based on a robust and thoughtful platform, and communicating with stakeholders regularly on its progress and plans.

During the meetings of the Task Force, a number of good ideas were raised, such as the use of carbon pricing. The Task Force encourages the continued discussion of these ideas at the President's Global Climate Leadership Council.

While the Task Force's work concludes with these recommendations to the Regents on issues related to sustainable investing, the Regents always remain open to receiving data or other research that students wish to present related to the efficacy of other measures to align the University's investments with its commitment to sustainability.