



BOARD OF INVESTMENT TRUSTEES

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MEMORANDUM

November 18, 2022

TO: Board of Investment Trustees and Board of Trustees

FROM: Kevin Killeavy, Acting Executive Director

SUBJECT: Environmental, Social, Governance – Required Annual Update – 2022

As detailed in the Board's Governance Manual, the Boards are required to annually provide a comprehensive report describing the implementation and outcomes of the Board's ESG policy, including recommendations for updates or revisions to this policy, as part of the year-end reporting process.

This report includes the following:

- I. Industry Developments
- II. Current Manager ESG Updates and Corporate Engagement
- III. Consultant Initiatives
- IV. Recent Board Actions
- V. Staff Research

I. Industry Developments

- **Endowments Continue to Announce Fossil Fuel Divestment Plans** – Over the last year, several university endowments across the country have announced fossil fuel divestment plans, including Boston University, the University of Minnesota, Harvard University, and Princeton University. The most notable divestment announcement was from Harvard University, the largest endowment in the U.S. These divestment pledges typically only pertain to directly held positions in companies with large fossil fuel reserves.
- **Impact Investing Market Exceeds \$1 trillion** – The global impact investing market now exceeds \$1 trillion in invested capital according to the Global Impact Investing Network. This sector seeks to make investments that generate a measurable, beneficial social or environmental impact alongside a competitive financial return. This market has grown significantly in recent years, essentially doubling since 2019. The market includes several dedicated impact firms in addition to large global asset managers like Apollo Global, KKR, and TPG Capital.

- **Harvard Endowment CEO Cites Divestment Costs** – The CEO of Harvard University’s endowment, Narv Narvekar, said that the university’s commitment to climate goals has negatively impacted returns since the pandemic as the endowment was not able to take advantage of cheap valuations in the oil and gas sector like some of their peers. He noted that “a number of institutional investors leaned into the conventional energy sector, through either equities or commodity futures, adding materially to their total return.”
- **BlackRock and Vanguard Refuse to Divest from Fossil Fuel** – The world’s two biggest asset managers, BlackRock and Vanguard, told a UK inquiry that they will continue to invest in fossil fuels. BlackRock noted that “BlackRock’s role in the transition is as a fiduciary to our clients – it is not to engineer a specific decarbonization outcome in the real economy.” Both asset managers noted that they intend to remain long-term investors in carbon-intensive companies because of their crucial role in the economy.
- **Republican-Led States Push Back on ESG** – During the last year, Republican-led states such as Florida, Texas, Louisiana, and Idaho have pushed back strongly against state pensions prioritizing ESG factors in their investments. Both Idaho and Florida passed bills prohibiting public entities from considering environmental, social, or governance factors in a way that could violate the prudent investor rule. Texas is threatening to divest from any company that divests from fossil fuels, an industry that is key to the state’s economy. Louisiana went a step further and divested nearly \$800 million worth of state funds from Blackrock due to their perception that the asset manager has “anti-fossil fuel policies.”
- **PRI Signatory Growth** – The number of signatories to the Principles for Responsible Investment reached 5,202 by the end of September 2022. Over the last year, this group has grown by 23% with the current roster including 3,964 investment managers, 713 asset owners, and 525 service providers. Montgomery County became a signatory in October 2019.

II. Current Manager ESG Updates and Corporate Engagement

In 2021, Staff and our investment consultants began reporting to the Boards on impact/sustainable investments within the private market portfolio. The portfolio currently contains several funds with impact investment strategies. Some examples include strategies focused on renewable power development, sustainable forestry, water infrastructure, and real estate. The segment of our portfolio with the highest concentration of impact investments is private real assets, where 31% of the ERS portfolio is allocated to impact/sustainable investments.

- **Private Equity Managers** – In 2022, the Trust Funds hired two private equity managers that have recently become recognized as minority-certified businesses. A minority and women-owned business enterprise, otherwise known as MWBE, is at least 51% owned and controlled by one or more minority persons or socially and economically disadvantaged individuals. Beyond ownership, these managers have diverse executive and senior management such as a female CFO, female Head of Business Development, and an Indian female Head of Operations.
- **Private Natural Resources Manager** – In 2022, the Trust Funds hired a private natural resources manager that targets investments in renewable energy assets and other sustainable infrastructure projects across the U.S. and Canada. The fund’s investments are expected to generate in excess of 233,300 MWh annually and have resulted in 165,400 tons of carbon abated. Additionally, the firm’s portfolio companies ensure that these renewable assets minimize their impact to the local

ecosystem. For instance, a portfolio company that is engaged in developing and rehabilitating local small hydro power plants has laid the groundwork this year to procure fish cannons to allow native species to bypass the dams as they swim upstream to spawn. The fish cannon is a new hardware technology that is imperative for the health of the ecosystem, and substantially more economic versus other solutions like fish ladders.

- **Private Natural Resources Manager** – In 2022, the Trust Funds hired a private natural resources manager that targets control investments in middle-market infrastructure assets that are difficult to replicate and are essential to their customer base. The fund targets smaller-scale assets that are highly fragmented with a special focus on utilities. The manager also seeks to make direct social impacts in the local communities that they serve. For example, towns generally welcome their water utility portfolio companies as they are able to professionalize and stabilize water operations. Legacy owners of these assets are generally family businesses, real estate developers, or local entrepreneurs that lack the knowledge and sophistication to properly operate the assets. As a result, customer bills are usually higher due to suboptimal infrastructure such as old or damaged pipes. As new owners of the utilities, the manager will put in new pumps, build storage facilities, and fix leaks. The manager uses their scale to operate the waterworks at a lower cost basis while incorporating regional rate cases to minimize the impact of customer bill increases.
- **Emerging Market Equities Manager** – This firm has recently made several advancements in their investment process to incorporate ESG themes. In 2022, the firm added the Gender Balance signal to their Alpha Model. The signal measures changes in the composition of the male/female gender ratios in the senior management, executive management, and board members of a company. The firm believes that gender diversity & equality fits “resource theory” in that a more diverse workplace represents a valuable set of resources that may help achieve better economic outcomes due to the different points of view and experiences it offers. Furthermore, there is an underreaction by investors to adequately price in the value of a company moving towards a more gender balanced composition due to limited access to the information. Additionally, in 2022, the firm implemented a Climate Analytics dashboard that allows them to evaluate companies and portfolios on a variety of climate-related metrics. The dashboard calculates and shows the carbon emissions measures of companies and portfolios, both historical and future predicted emissions, pathway alignment analysis with several different climate scenarios, and decomposition of changes in carbon exposures over time. Finally, in late 2021, the firm added a country stability and governance signal to the Global Country Model. The firm’s Global Country Model uses a set of county governance factors aimed at capturing the socio-economic development of countries they invest in. Country governance extends the notion of ESG to the macro level as it applies to countries' progress toward building robust and prosperous societies. Countries are seeking to do this by improving their physical infrastructure and institutions, developing human capital, and managing the impact of their economic activities on the world around them. The signal uses survey-based data to assess country-level exposures to the Sustainability Development Goals (SDGs). The signal integrates SDGs into country-level risk assessments. Examples include scoring countries on health and well-being (SDG3), education (SDG4), equality (SDG5, SDG10), water sanitation (SDG 6), innovation and infrastructure (SDG9, 10), and political risk (SDG 16).
- **Domestic Fixed Income Manager** – This index-based manager engages and collaborates with peers on matters related to index design and on the incorporation of ESG principles. While the manager is required to track the index and cannot tilt the portfolio based on ESG metrics, they are increasingly engaging directly with companies. For instance, the manager engaged with Ford in Q2 2022 to discuss how the company will achieve carbon neutrality, as well as their plans for EV investments and supporting infrastructure, and efforts to reduce water consumption. The manager

will monitor the company's progress toward its goal of producing only zero-emission vehicles by 2035. The manager will follow up annually to monitor the progress and update their ESG score of the company based on this engagement.

- **Emerging Markets Debt Manager** – This manager regularly has face-to-face visits with officials from countries' central banks, treasuries, and/or debt management offices. On average, the manager meets with between 25-30 sovereign or quasi-sovereign issuers per year, with most of the engagements involving some ESG elements. For instance, in March of 2022, the firm met with the Government of Suriname where they recognized Suriname's status as a negative net carbon emitter. They also proposed a governance structure for a value recovery mechanism linked to oil production that would reduce the opportunity for corruption and improper governance, maximizing financial resources for social welfare and development objectives.

Additionally, this manager has made multiple ESG improvements within the past year:

- Developed a proprietary ESG scoring model
 - Published their first responsible investing and sustainability report
 - Hired a Head of ESG and Sustainability who is responsible for overseeing all their ESG and sustainability-related initiatives
 - Signed up for the Net Zero Asset Manager's initiative and the CDP's nondisclosure campaign
- **Emerging Markets Equities Manager** – This manager has been continuously expanding their sources of ESG third-party research and data. One of their current focus areas is sharpening their materiality assessments of ESG factors in the investment process. To that end, in February 2022, they joined the Sustainability Accounting Standards Board (SASB) Alliance. The SASB materiality framework is used as an information source by the investment team to help identify financially material ESG issues.

This manager has also made multiple DEI enhancements in the past year. For example, during Q3 2022, they partnered with WorkplaceDiversity.com to expand the reach of their job postings across twelve diversity-based job boards. Their Diversity and Inclusion Council launched a DEI Survey to illustrate the importance of diversity and inclusion to the Firm and to engage employees in illustrating what they would like to see as prioritized efforts in DEI. Lastly, during Q2 2022, they completed an annual review of its Diversity and Inclusion Policy. Human Resources undertook a project to collect diversity data across their global offices and revised DEI statistics to provide historical data and a broader picture (hiring and departures, for example) of DEI at the firm. Finally, Human Resources also initiated a company-wide monthly newsletter. In the newsletter, there is a section dedicated to reporting or sharing on diversity topics within the Firm.

- **Emerging Markets Debt Manager** – This manager has made multiple advancements in their ESG and DEI practices this year. On the ESG front, in Q3 2022, they hired an ESG coordinator that sits within their Risk Management group and is a member of the ESG Committee. The professional will oversee and support ESG data integration and reporting efforts across their investment teams, collaborate with Investor Relations on client materials, and keep the ESG Committee up to date on integration progress and larger ESG trends. In time, the ESG coordinator could partner with business units to design and develop ESG-focused products to meet client needs. They are also in the process of onboarding the services of an ESG risk ratings provider and they continue to strive to develop strong data partnerships and systems so that they can better analyze ESG-related risks relevant for each asset class. Depending on the nature of the underlying investment, different tools and data are utilized to best support their ESG efforts.

On the DEI front, in Q3 2021, they became a sponsor to the Association of Asian American Investment Managers (AAAIM) and 100 Women in Finance, offering firmwide involvement with associated events and panels. Additionally, they are engaged with a leading firm to bring valuable career development programs in-house for their Women's Network. They partner with organizations to increase their recruiting and hiring pool of diverse candidates, including Sponsors for Educational Opportunity. Finally, they have a mentorship program which aims to retain and promote the professional development of their existing talent. Within the program, senior employees are matched with less experienced team members to further improve performance, build a stronger culture, and enhance retention.

- **Fixed Income Manager** – In Q1 and Q2 2022, this manager rolled out the Mursion training platform. The Mursion training platform is an inclusive leadership and soft skills training platform to help managers facilitate courageous conversation on race and other challenging DEI topics with their staff. The Mursion training platform leverages virtual reality, artificial intelligence, and trained actors who use avatars, to provide immersive online training scenarios that managers participate in to practice in a safe manner and gain critical skills. The Mursion training platform will also help managers facilitate effective career and coaching conversations with staff. Mursion was vetted by their DEI Committee and piloted with their Management Committee in 2021.

Additionally, this manager has had multiple other DEI highlights within the past year:

- **Hired a new Chief Diversity Equity and Inclusion Officer (CDEI Officer):** This individual is collaborating and engaging with employees from across the firm to advance four DEI 2021 priorities focused on 1) governance and alignment, 2) representation, retention, and recruitment, 3) communications and culture, and 4) career conversations.
 - **Conducted a DEI Listening Tour:** The CDEI Officer conducted a listening tour and uncovered two critical observations prompting the need to 1) continue and enhance firm-wide courageous conversations on race, trauma, and hate crimes in the community, and 2) work to ensure the consistency of career coaching and development resources for all staff.
 - **Led a Culture Workgroup:** The Culture Workgroup was charged with identifying culture initiatives and culture characteristics that will help all their staff positively reaffirm and reimagine the firm's culture. The firm's CEO announced the Culture Characteristics IDEALS (which stands for Inclusion & Diversity, Dedication to Team, Excellence, Accountability, Leadership and Solutions Oriented) at a December 16, 2021, firm-wide town hall event.
- **Global Real Estate Investment Trust Manager** – This manager has made multiple enhancements to their firm's ESG practices recently. Highlights include:
 - The creation of a systematic template analysts to assess a company's fundamentals and quality. A quality score is now produced for every company.
 - The addition of MSCI ESG research and scoring data to enhance their analysis of ESG factors.
 - The enhancement of their proprietary Net Entity Value (NEV) models.
 - The switch to a new risk factor technology provider, switching from SunGard's APT to Barra's Risk Factor Analysis.

They have also started several social initiatives including:

- Established a scholarship program for students who are members of a minority group, are veterans, have a disability, or have financial need. The scholarship offers up to \$7,500 per student per year, renewable for up to four years.
- Established an internal employee resource group called Women In Real Estate (WIRE). The mission of WIRE is to create development and networking opportunities that attract, develop, advance, and retain women; promote an inclusive and diverse organizational culture; and cultivate leadership in the global real estate investment management industry.
- Supported the Iowa chapter of Commercial Real Estate Women (CREW) and paid the membership dues for all employee's involved in the organization.

III. Consultant Initiatives and Approach to ESG

- **NEPC (General Consultant)** – During the last year, NEPC became a founding member of the U.S. Investment Consultants Sustainability Working Group. The group consists of leading institutional investment consultants across the globe and will collaborate to better empower asset owners to advance sustainable investment practices across the industry. NEPC has also further integrated diverse manager research into their broader research process. This allows NEPC to leverage the expertise and experience of their research specialists in evaluating these firms. Full integration into their broader research process has led to strong representation of diverse managers across their client's investment programs. NEPC is also taking steps to target diverse managers more proactively for their Focused Placement Lists across all asset classes. While it is yet to be completed, NEPC is also in the final stages of developing a proprietary DEI scoring system to evaluate investment managers' commitment to DEI practices as well as their progress.
- **Franklin Park Associates (Private Equity & Debt Consultant)** – During the last year, Franklin Park continued to refine their ESG Policy Statement and their ESG due diligence process, while also revamping their DEI reporting efforts and joining the ILPA Data Convergence Initiative. This initiative is an open partnership of private equity stakeholders committed to streamlining the private investment industry's historically fragmented approach to collecting and reporting ESG data. When conducting ESG diligence on prospective fund managers, Franklin Park evaluates whether the manager has an ESG Policy, whether the manager is a signatory to the UNPRI or similar body, and which team members are involved in ESG and their time, dedication, and experience on these topics. For funds purporting to have an impact or sustainable mandate, Franklin Park requests the manager complete their ESG Questionnaire. Further, Franklin Park is very active in providing feedback to the private manager community around potential improvements to their ESG policies and practices.
- **Albourne (Private Real Assets Consultant)** – Over the last year, Albourne established a new Sustainable Investing Team (SI), which sets out to create new fund offerings, adapt existing ones, and build internal capabilities to deliver these to clients, while developing and airing narratives to help client make sense of this evolving area. To coordinate these activities, Albourne has created a Sustainable Investing Taskforce comprised of senior employees from across the firm. They also recently finalized their Diversity, Equity, and Inclusion Questionnaire, which has been completed by 536 investment managers to date.

IV. Recent Board Actions

- **PRI Annual Asset Owners Summit** – In October 2022, Staff attended the virtual Annual Asset Owners Summit for the second consecutive year. This annual meeting was a forum where global asset owners (i.e., institutional investors like MCERP) gathered to discuss strategies and challenges for integrating ESG considerations into the investment process. Staff also developed several relationships with other investment organizations that we will engage with in the coming year.
- **CERES Conference at 2022 United Nations Climate Change Conference** – In November 2022, Staff will attend the United Nations Climate Change Conference (COP 27) via video conference. The two meetings that Staff plans to attend at this conference are the Sustainable Innovation Forum and the Net Zero discussion.
- **CERES** – The Boards joined the CERES Investor Network in 2018 to gain a better understanding of climate risk within the portfolios, explore opportunities embedded in the clean energy economy, and develop a dialogue with other institutional investors on ESG-related matters. Since joining, Staff has been an active participant in the Disclosure Working Group, which seeks to push companies to disclose all relevant sustainability information using the Global Reporting Initiative (GRI) guidelines as well as additional sector-relevant indicators. The goal of this working group is for more companies to disclose material sustainability risks and opportunities within their financial filings.
- **CFA Institute ESG Expert Network** – Investment Staff continues to actively participate in the CFA ESG Expert Network, a diverse working group to share knowledge and resources focused on integrating ESG best practices. The CFA Institute is a leading global association for investment professionals.

V. Staff Research

- **Portfolio DEI Analysis** – Staff completed a second annual diversity and inclusion analysis of the underlying funds within the portfolio to understand the level of diverse ownership across the portfolio and within various asset classes. This analysis revealed that the portfolio has roughly 24% invested in women or minority owned investment organizations with exposure across public markets, private equity, private debt, and private real assets, an increase of 3% relative to last year's 21% invested. Staff will continue to track this metric on an annual basis and will explore ways to further enhance our approach to DEI. Albourne, NEPC, and Curcio Webb have significant level of diverse ownership and management. For example, Curcio Webb, our defined contribution plan consultant, is a women-owned business.
- **Portfolio PRI Signatory Portfolio Analysis** – Both Boards became signatories of the Principles for Responsible Investment (PRI) in October 2019. The Boards believe this is the premier organization for asset owners and investment managers in terms of ESG integration. While it is not required that investment managers are signatories it is highly encouraged. Staff recently conducted an analysis to see the proportion of investment managers within the portfolio that are signatories. As of September 30th, 2022, 44% of the managers within the portfolio are signatories while 78% of the portfolio by market value is invested with signatories. While most of the public market managers within our portfolio are signatories, the adoption level is still somewhat low on the private market side. However, the level of adoption across the portfolio, both public and private, has been increasing recently with the signatory rate across our portfolio improving from 29% to 44% since

2020. Additionally, all three of the Boards’ core investment consultants – Franklin Park, NEPC, and Albourne are signatories.

- **Fossil Fuel Securities Continue to Provide Diversification During Inflation** – During the decade prior to the pandemic, which was characterized by increased energy supply, steady energy demand, low inflation, and low interests, fossil fuel securities were a drag on portfolio performance for most investors. This underperformance led some institutions to heed the call for fossil fuel divestment. However, the recent two years following the onset of the pandemic have demonstrated the value of these holdings given the economic regime change to one of high inflation, supply constraints, rising interest rates, and significant geopolitical tensions. As inflation has surged, fossil fuel securities have been the top performing segment of the market for two consecutive years, proving particularly valuable in a period when a traditional stock/bond portfolio has delivered incredibly weak performance. Over the last year, commodity-oriented securities have significantly outperformed the market, across both stocks and bonds, and provided an element of inflation protection to those investors who remained invested. Some performance data from this highly inflationary period (October 2021 through September 2022) is shown below:

 - The S&P 500 Fossil-Free Index significantly underperformed the S&P 500 with a return of -16.9% vs. -15.5%.
 - The Russell 2000 energy sector significantly outperformed the broader Russell 2000 (domestic small cap equity index) with a return of 20.3% vs. -23.5%
 - The BAML US High Yield Index Excluding Energy, Metals, and Mining significantly underperformed the BAML US High Yield Index with a return of -14.98% vs. -14.06%.

- **ESG and DEI Questionnaire** – Over the last year, Staff developed an ESG and Diversity questionnaire for our investment managers and consultants. By using this questionnaire, Staff will be able to better analyze ESG integration and progress across our portfolio in a more streamlined fashion. The questionnaires are shown below:

ESG Questionnaire

Question	Response
1. What are some examples of how ESG factors may have influenced an investment decision (buy, sell, or avoid)	
2. What are some examples of where you engaged company management on ESG issues	
3. Has there been any recent enhancements to your firm’s ESG practices?	
4. Has there been any recent enhancements to your firm’s DEI practices?	

DEI Questionnaire

Job Categories	Gender			Ethnicity	
	Male (%)	Female (%)	Other (%)	Caucasian (%)	Non-Caucasian (%)
Firm & Investment Board Members					
Executives, Senior Level Investment Managers					
Junior/Mid Level Investment Professionals					
Back Office Staff, and Other Non-Investment Related Employees					

By collecting the data shown above, Staff can analyze our investment managers and consultants at a granular level. This granularity allows Staff to analyze our managers at a level that more accurately reflects diversity across their organizations. By collecting this data across multiple years, Staff can also better monitor and report on the impact that our manager’s diversity initiatives are having. After analyzing data collected through the questionnaire for all managers that provided statistics for 2021 and 2022, we found that:

- The largest improvements were in our equity managers, specifically female executive-level and non-Caucasian mid-level representation, both of which improved by 4% on average from the prior year.
- The largest improvements across all asset classes and consultants were in female board-level and non-Caucasian mid-level representation, which improved by 2% and 3%, respectively, on average from the prior year.
- On average and relative to last year, the smallest improvements across all asset classes and consultants were in non-Caucasian board-level and executive-level representation.
- All categories in every asset class improved or were flat from the prior year.

With these diversity statistics, it is important to note that any year-to-year fluctuations, whether positive or negative, shouldn’t be overemphasized. Staff believes that simply monitoring and reporting on diversity statistics across multiple levels in our manager’s organizations will sufficiently incentivize them to make progress in their diverse representation over time and that the general trend, rather than year-over-year changes, is a more significant measure of progress or the lack thereof.