



Investment Committee

Item Number 4 – Open Session

Subject: Net Zero Annual Strategy – Fixed Income Emissions Reduction Recommendation

Presenter(s): Glenn Hosokawa and David Gold

Item Type: Action

Date & Time: May 4, 2023 – 40 minutes

Attachment(s): Attachment 1 – CalSTRS Fixed Income Emissions Reduction Analysis

Attachment 2 – Meketa Memo

PowerPoint(s): Fixed Income Emissions Reduction Recommendation

Item Purpose

The purpose of this item is to present Fixed Income's (staff) plan to lower carbon emissions within the Fixed Income credit portfolio in support of CalSTRS pledge to reach net zero portfolio emissions by 2050 or sooner.

Recommendation

Staff recommends that the Investment Committee approve an initial 15% low carbon credit-related index optimization strategy which reduces Fixed Income's credit emissions by 12%. This emissions reduction plan will be achieved by incorporating an initial 15% low carbon optimization to current credit-related indices. This allows Fixed Income to begin realizing emissions reductions in alignment with CalSTRS Net Zero Pledge to achieve net zero portfolio emissions by 2050 or sooner. Meketa Investment Group, the Board consultant, agrees with the changes recommended by staff.

Executive Summary

Staff's rationale for its recommendation is summarized below and explained in more detail in Attachment 1.

- The emissions reductions recommendation applies to the Fixed Income credit-related portfolios which represent approximately 35% of the total Fixed Income portfolio. Emissions data and analytical tools are currently measurable in this market segment, so staff believes it prudent to initially focus efforts on this market segment.
- Staff researched multiple strategies designed to reduce carbon emissions and minimize impact to Fixed Income's total active risk. The strategy staff recommends provides the highest emissions reduction per unit of active risk, in alignment with the approach taken in Public Equity.
- The strategy recommended utilizes an optimization of existing Bloomberg Fixed Income indices for emissions reductions. With an index optimization, the index effectively remains the same, but the composition of active risk changes. As such, this could alter staff's active investment decisions relative to the index and could have an impact on excess returns. However, staff believes it will be able to manage this change in risk composition.
- Staff views an initial 15% low carbon optimization of current credit-related indices, which will reduce Fixed Income credit portfolio emissions by 12%, as manageable and provides reasonable expectations that Fixed Income portfolio profile and returns can be preserved.
- An initial 15% low carbon optimization of current credit-related indices will allow CalSTRS Fixed Income assets to continue to be actively managed using an enhanced indexing strategy and benchmarked to their related Bloomberg Fixed Income indices.
- With the recommended 15% low carbon optimization of current credit-related indices, the long-term assets of the Fixed Income portfolio can continue to be managed within an annualized forecast active risk range of 10 basis points (bps) to 60 bps.
- The index optimization strategy was reviewed by CalSTRS risk and actuarial teams. Their modeling results found negligible effects on CalSTRS funding plan variables.

In summary, staff recommends this approach since it reduces emissions most effectively by producing the highest emissions reduction per unit of active risk and maintains the existing Fixed Income strategy. Meketa Investment Group supports this recommendation.

Background

In September 2021, the Investment Committee (IC) approved CalSTRS' pledge to achieve net zero portfolio emissions by 2050 or sooner. In May 2022 the IC approved a plan to reduce emissions in CalSTRS Public Equity Portfolio by adopting a target allocation of 20% of its passive exposure to a low-carbon index. Concurrently, Fixed Income staff has been analyzing methods to reduce emissions in our portfolio in-line with the Fund's risk-return goals and utilizing a similar process to that deployed by Public Equities.

Strategic Plan Linkage: Goal 1 - Trusted Stewards: Ensure a well-governed, financially sound trust fund

Board Policy Linkage: [Fixed Income Investment Policy](#)

Optional Reference Material:

[September 1, 2021, Investment Committee - Pledge to a Net Zero GHG Portfolio by 2050](#)

[May 5, 2022, Investment Committee - Net Zero Strategy Progress and Planning Update](#)

[August 31, 2022, Investment Committee - Net Zero First Year Progress and Planning Update](#)