

MEMORANDUM

TO: Investment Committee, CalSTRS
FROM: Stephen McCourt, Allan Emkin, Mika Malone, Eric White, Stephanie Sorg,
Meketa Investment Group
CC: Christopher Ailman
DATE: May 4, 2023
RE: Opinion Memo – Fixed Income Emissions Reduction Strategy

Summary & Recommendation

In March 2023, Staff asked that Meketa review a proposal that would incorporate an initial 15% carbon reduction to the credit exposure of the fixed income indices used by Staff to execute Net Zero investment strategy within the fixed income asset class. The proposal would enable Fixed Income to begin realizing emissions reductions in alignment of CalSTRS net zero pledge to lower carbon emissions by 50% in 2030 and net zero by 2050 or sooner. ***After independently evaluating Staff's proposed changes, Meketa supports Staff's recommendation to optimize the Bloomberg Fixed Income indices for a 15% carbon reduction as an initial step in aligning the portfolio to CalSTRS' Net Zero goals.***

Discussion

At the September 2021 Investment Committee, CalSTRS adopted a pledge to achieve a net zero investment portfolio by 2050 or sooner. Subsequently, at the August 2022 Investment Committee, an action item was approved to set an interim reduction goal of 50% less emissions by 2030 for the Total CalSTRS Fund. In response, the Fixed Income team evaluated multiple carbon reduction strategies in support of the goals. Three distinct strategies for reducing portfolio carbon emissions were identified and researched:

- 1.) Utilize Bloomberg index low-carbon optimization
- 2.) Active discretionary approach to reducing portfolio emissions
- 3.) Replace current Bloomberg indices with MSCI low-carbon indices

Of these options, Staff has identified option 1 above, Bloomberg index optimization, as the appropriate strategy to achieve CalSTRS goals. Based on Staff's analysis, the approach reduces carbon emissions efficiently, as it produces the highest carbon emissions reduction per unit of active risk. This decision-making framework is similar to the one Staff used to identify carbon-reducing strategies for the global equity portfolio. Staff believes the strategy would allow them to continue their enhanced indexing asset management approach with a relatively low level of additional active risk compared to the other strategies considered.

Recently, Bloomberg introduced an index feature that utilizes an index optimizer function to generate indices that are designed to reduce carbon emission exposure while largely preserving current index metrics such as yield, duration, industry sectors, issuers, and the number of securities.



In addition, while Staff notes any allocation to the optimized indexes has the potential to skew Fixed Income's portfolio characteristics, an initial 15% carbon reduction index optimization would be manageable and provide reasonable expectations that Fixed Income portfolio profile and returns could be maintained. In addition, Staff believes the Fixed Income portfolio can be managed within the current annualized forecast active risk range of 10 basis points to 60 basis points.

In summary, Meketa reviewed Staff's proposal and respective justifications for the changes, conferred with our internal team, and ***we support Staff's recommendation to optimize the Bloomberg Fixed Income indices for a 15% carbon reduction as an initial step in aligning the portfolio to CalSTRS' Net Zero goals.***

If you have any questions, please feel free to contact us at (760) 795-3450.

SBS/SPM/EDW/nca