



Investment Committee

Item Number 3b – Open Session

Subject: Net Zero First Year Progress and Planning Update

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Item Type: Information

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Attachment(s): None

PowerPoint(s): None

Item Purpose

The purpose of this item is to provide Investment Committee members with additional information on progress that has occurred since the [May 2022 Investment Committee](#) meeting to advance the CalSTRS pledge to achieve net zero portfolio emissions by 2050 or sooner. It complements the previous Action item.

Recommendation

None. Please refer to the complementary Action item which includes four recommendations relating to CalSTRS reducing portfolio emissions in Public Equity portfolios in alignment with the net zero pledge.

Executive Summary

As highlighted in the [May 2022 Investment Committee](#) meeting, staff has developed three core strategies for implementing the CalSTRS net zero portfolio emissions pledge: (1) reducing portfolio emissions, (2) increasing exposure to low-carbon investments, and (3) using our influence to accelerate the integration of net zero considerations across global financial markets. This item provides additional updates on staff activities in all three areas:

- (1) The Fixed Income and Investment Strategy & Risk (ISR) teams have been researching **additional methods to reduce emissions** in line with the Fund's risk-return goals and following the process that staff used in Public Equities.

- (2) The private asset classes have been developing an **internal classification system to help identify and expand low-carbon investments** as staff feels the private markets provide the best opportunity to source attractive low-carbon investment opportunities.
- (3) The Sustainable Investment & Stewardship Strategies (SISS) team is implementing **escalated engagement strategies** to drive accelerated adoption of economy-wide net zero commitments from companies, regulators and policy makers, entities whose actions we do not control but seek to influence to support our net zero pledge.

Background

1) Public Markets Portfolio Emissions Reduction Strategies

Fixed Income:

As reported during the [May 2022 Investment Committee](#) meeting, due to the lack of meaningful methodologies across all security types, Fixed Income is focused on measuring and reducing the carbon emissions of the portfolio's credit-related exposures of investment grade, high yield and emerging market corporate bonds. This exposure is approximately \$9.5 billion and represents 30% of total Fixed Income assets as of June 30, 2022. Staff will continue to monitor data and methodology advancements in other security types (e.g., sovereign bonds) to determine when and how emissions measurement could be expanded.

Fixed Income currently believes that integrating a low-carbon index is the most appropriate method of achieving portfolio emissions reductions over time. Similar to the process undertaken in Public Equity, Fixed Income is analyzing various low-carbon index options. Staff is working with BlackRock Aladdin, CalSTRS' risk management system, and the ISR team in modeling the impacts of an allocation on risk, return, emissions and the [CalSTRS Funding Plan](#). As with Public Equity, the intention would be to allocate and blend a recommended percentage of the selected low-carbon index with current Fixed Income credit indexes. The CalSTRS credit portfolio is actively managed on an index-aware basis that controls for active risk while generating a reasonable amount of excess return to its respective benchmarks. As such, the introduction of a low-carbon index is expected to result in CalSTRS credit bond portfolio reducing its carbon emissions as it is expected to closely follow the new blended low-carbon indexes over time.

Staff is currently favoring this strategy as it is expected to achieve the highest amount of carbon emissions reduction while minimizing the amount of measurable additional active risk versus the current portfolios and their benchmarks¹. In sum, it reduces emissions in a risk-controlled environment that staff believe is manageable and achievable over time.

¹ As discussed in the Public Equity emissions reduction strategy, this concept of **carbon emissions reduction per unit of active risk**, is one that staff will be looking to apply across CalSTRS portfolios.

Risk Mitigating Strategies (RMS):

The RMS unit continues to analyze and consider potential strategies to reduce portfolio emissions, including working with and learning from external managers. Due to the unique nature of RMS portfolio investments and the lack of reliable and relevant data available today to support emissions reduction strategies, staff is currently prioritizing activities within Public Equity and Fixed Income.

Next Steps: During the May 2023 Investment Committee meeting, staff will present the results of modeling an allocation to a low-carbon fixed income index and determine an appropriate recommendation.

2) Internal Classification for Low-Carbon Investments

As discussed in prior net zero progress updates, staff has found it challenging both to measure emissions exposures across a diverse set of private market assets and to determine a sufficiently nuanced, yet comprehensive way of identifying investments in all asset classes that either enable, or support, the transition to a net zero economy. While a few external classification methods exist, they are generally very complex and would be extremely difficult to apply in a practical manner to the CalSTRS Investment Portfolio. Staff’s focus on this topic is driven by the need to assess (1) current exposure across different asset classes and investment structures and (2) how best to increase exposure to low-carbon assets that meet our risk-return goals in alignment with our net zero pledge.

Staff believes that the best way to tackle these challenges is to develop an internal classification framework for (1) investments that are ‘green’ or low-carbon, (2) investments that are transitioning to green (staff has applied the term ‘olive’ to these investments), and (3) investments that are high carbon and not likely to transition meaningfully, or where their transition trajectory is hard to evaluate (staff has applied the term ‘gray’ to these investments). Staff refers to this as our internal ‘Green-Olive-Gray (GOG) Framework.’

Recognizing that one set of metrics would be difficult to apply across different asset types, the Green-Olive-Gray (GOG) Framework allows each asset class, in conjunction with the SISS team, to identify and apply asset class-specific metrics to help judge whether an existing or potential investment is considered low-carbon (green), transitioning to low-carbon (olive) or high-carbon/unclear (gray). The intention is that these definitions can be applied not only to current investments but also to help identify new investments that meet CalSTRS risk-return profile, are innovative in nature and align with our net zero pledge. It is important to note that this framework is not intended to substitute for existing diligence processes but rather serve to supplement the extensive due diligence staff already conducts.

While the expectation is that the GOG framework could ultimately be used for both public and private market assets, staff intends to prioritize and trial it in private markets. This is where staff believes the best opportunities to capture low-carbon investments that meet our risk and return objectives exist. Brief updates from each private asset class follow:

Real Estate:

The CalSTRS Real Estate portfolio consists of two components: Control and Non-Control. Our Control portfolio is primarily comprised of properties that CalSTRS controls through Separate Accounts and Joint Ventures; it represents approximately 78% of our total assets. The remaining 22% of Non-Control assets are primarily closed-end fund investments and co-investments, for which there is more limited information transparency. Initial net zero emissions data collection efforts, for both greenhouse gas emissions and for applying the GOG framework, have been focused on operating assets within the Control portfolio, with the Non-Control portion to follow as phase II of the measurement and evaluation process.

Staff believes that approximately 381 Control investments could be classified using the Green-Olive-Gray framework, based on criteria such as EnergyStar Score, greenhouse gas emissions intensity, building designations such as LEED, as well as year of asset construction. The inclusion of building age in the evaluation framework is an important factor as discussions with peers and leading real estate experts support staff's assertion that there is often a high correlation between building age and the "greenness" of a real estate asset. These 381 Control investments have a total gross asset value to CalSTRS of \$39.6 billion and represent 99% of the operating assets in our directly-owned Control Portfolio.

In June 2022, the Real Estate team presented a concept of how it intends to classify its Control investments for a Green-Olive-Gray framework; this concept is still being tested as staff starts analyzing data on the assets. Initial indications are that it should provide a useful way to measure how much of the Real Estate our portfolio is invested in "green" assets. Over time, staff will continue to review the framework and adjust as needed, especially if data coverage and quality improves on factors like GHG intensity or EnergyStar scores.

Going forward, staff intends to utilize the asset rankings and the Green-Olive-Gray framework to measure changes in the portfolio, to help inform Hold/Sell decisions, and to provide a new metric for our managers to utilize while underwriting future investments. Staff anticipates that there will be some challenges to expanding this framework to incorporate our fund investments but will be reaching out to partners after solidifying our results on the directly-controlled operating assets.

Private Equity and Inflation Sensitive:

Private Equity and Inflation Sensitive plan initially to apply the GOG Framework to their co-investment exposure as there is more data available for these assets. For Private Equity, co-investments represent approximately 20% of total net asset value, while for Inflation Sensitive, co-investments represent approximately 13% of portfolio assets. Each unit is working to develop appropriate metrics that will help identify assets as either green, olive or gray. Assuming the application of the GOG framework to co-investments is successful and meaningful, staff intends to more broadly apply the framework to other portfolio assets.

Next Steps: At the May 2023 Investment Committee meeting, staff will provide an update on progress to integrate the GOG framework into private market assets and determine an appropriate recommendation for how it could inform increasing investments in Green and Olive assets.

3) Escalated Engagement Strategies

As has already been articulated, CalSTRS ability to achieve our net zero portfolio emissions pledge by 2050 or sooner, and any interim goals (should they be approved by the Investment Committee), will come from a combination of activities that we can control (active investment decisions) and activities that others control (companies, regulators, policy makers) that CalSTRS can seek to influence, but does not control.

Staff's net zero engagement strategies aim to leverage our influence on portfolio companies, partners, regulators and policy makers to coordinate and cooperate to accelerate the transition to a net zero global economy. This engagement is rooted in our belief that an accelerated but 'orderly' transition to net zero for the global economy is in the best interests of our plan participants. This is further supported by the analysis described in the accompanying Action item, which highlights the macro-economic challenges associated with 'disorderly' transition scenarios, which lack coordinated and phased approaches to emissions reductions by all economic actors.

CalSTRS net zero-related engagement strategies include:

- [Proxy voting](#)
- Corporate engagement
- Policy maker/regulator engagement

Proxy Voting: broad-based engagement aiming to raise baseline market standards

CalSTRS expects all companies - and especially the largest global companies and the highest emitting companies - to have climate change-related strategies in place. At a minimum, companies should be demonstrating their climate risk management strategies by reporting Scope 1 and 2 emissions (not least as CalSTRS requires these disclosures for managing our own portfolio emissions) and by issuing a report aligned with the [Task Force on Climate Related Financial Disclosures](#) (TCFD). TCFD-aligned reporting details a company's strategy to operate successfully in a low-carbon economy.

- This year, staff integrated these net zero-related expectations into [our proxy votes](#) at 1,900 of the largest global companies, in addition to the 167 highest global emitters. Staff escalated our votes by voting against all incumbent directors at these two groups of companies who did not demonstrate appropriate oversight of this full-board responsibility. Staff also supported shareholder proposals asking for robust net zero commitments, targets and reports.
- For next year's proxy season (2023), staff intends to expand the universe beyond the 1,900 largest companies to hold more directors and companies accountable for critical climate strategic planning and disclosures.

Corporate Engagement: focused engagement with high-emitting companies

[Climate Action 100+](#)

CalSTRS has been a leading participant in Climate Action 100+, the largest ever investor engagement initiative on climate change, since 2018. Through this collaboration, investors have accelerated the corporate transition to a net-zero economy by engaging 167 focus companies accounting for up to 80 percent of global corporate industrial greenhouse gas emissions. As a result of these engagement efforts, 110 companies have made a net zero commitment and now produce TCFD-aligned reports.

- Over the next year, Climate Action 100+ investors, including CalSTRS, will push companies to show measurable action in support of their emissions reduction commitments. Companies will be asked to provide science-based assurances that validate transition plan alignment with a 1.5C scenario, and demonstrate collaboration with policymakers, peers and investors. This includes the development of capital expenditure plans and decarbonization strategies that explain a company’s technological path and its intent to meet long and medium-term GHG reduction targets throughout its value chains.
- Climate Action 100+ investors will also be adding elements supporting a Just Transition into corporate engagements. Companies will be asked to demonstrate how their policies and practices provide an equitable foundation that allows all employees to attain quality jobs, supportive benefits, and safe working conditions. This engagement will also call on companies to prioritize respect for human rights, positive community impacts, and the remediation of harms to society.

Policy Maker/Regulator Engagement: setting expectations and incentives for net zero

As a broad market investor or ‘universal owner’, CalSTRS leverages our influence with securities regulators, standard-setters, legislators, environmental and energy agencies, and policy makers to set expectations for corporate behavior regarding net zero and to mandate investor-grade climate reporting. Staff regularly speaks with the U.S. Securities and Exchange Commission (SEC) to encourage decision-useful corporate disclosure rules that support CalSTRS net zero pledge, particularly our carbon emissions measurement work. Staff also takes the opportunity to [provide comment](#) on proposed rulemakings.

- In June, staff wrote a detailed set of [recommendations to the SEC](#) encouraging it to mandate climate reporting and specifically that all companies be required to disclose Scope 1, 2 and 3 emissions. Requiring corporate disclosure of emissions aligns with our major priority of leveraging our proxy votes to accelerate increased corporate disclosure around climate emissions exposure and corporate emissions reduction plans. Staff expects the SEC to release a final rule on climate disclosure in late 2022 or early 2023 and will provide comment on the final draft, should there be a comment period. There is considerable risk

that the SEC’s rulemaking will be challenged extensively², so staff believe it essential to make our support for enhanced climate disclosures a very significant engagement priority in the year ahead.

Next Steps: At the January 2023 Investment Committee meeting, staff traditionally present CalSTRS [Stewardship Priorities](#). Staff will use this opportunity to provide an update on the progress of our net zero-related engagement activities and our supporting tactics to escalate engagement where necessary.

Strategic Plan Linkage:

One of the five objectives of the current CalSTRS Strategic Plan is to operationalize sustainable investment beliefs to create long-term value. A three-year progress indicator is that CalSTRS defines appropriate portfolio carbon measurements and sets interim emission reduction targets that meet the Fund’s risk-return profile.

Board Policy Linkage:

The development of the Investment Committee Work Plan and setting annual objectives/projects is covered by the [Board Governance and Administration Policy](#), Teachers’ Retirement Board Policy Manual, Section 500, page 17. The CalSTRS net zero emissions pledge by 2050 or sooner, and the accompanying timeline and activities are part of the Investment Committee Work Plan.

This item is also covered as part of the CalSTRS Low-Carbon Investment Belief:

Investment risks associated with climate change and the related economic transition—physical, policy and technology driven— materially impact the value of CalSTRS’ investment portfolio.

² [Companies Skewer SEC’s Climate-Disclosures Plan in Comment Letters - WSJ](#); [Companies weigh in on proposed SEC climate disclosure rule | AP News](#)