REVIEW OF VPIC ENVIRONMENTAL, SOCIAL AND GOVERNANCE(ESG) ACTIVITIES (Update to 2024)

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Note: While utilizing public Treasury and VPIC materials, the views expressed are solely my views as a Vermont citizen and member of the retirement system and do not represent those of any organization.

Summary

- Divestment does not reduce fossil fuel emissions, but rather abdicates our voice in effecting positive change.

- Legislating investment can create fiduciary challenges
  - Slippery slope
  - Legislative changes vs. changing landscape
  - Liability issues

- VPIC studies in 2017 and now in 2023 state that there would be significant cons to the pension system if divestment was implemented.

- There are significant costs even to accomplish the reporting contemplated in S.42.

- Engagement with companies and their boards of directors has proven to be effective in changing corporate behavior. VPIC is a leader in the ESG Space.

- VPIC has also engaged its investment managers on ESG issues, including climate change, with positive results.

Fiduciary Responsibility and Prudence

- Procedural prudence is the process by which a fiduciary reaches a decision, and substantive prudence, is the outcome of the fiduciary's process.

- Procedural prudence refers to whether the fiduciaries followed an appropriate process to reach a decision.

- Fiduciary duties have both a substantive and a procedural component.

- A fiduciary who makes an adequate investigation, but then makes an investment decision that exposes beneficiaries to a risk that is excessively high relative to return, violates his or her substantive fiduciary duties.

Adapted from: "Tobacco Divestment and Fiduciary Responsibility, A Legal and Financial Analysis", by Carol V. Calhoun and "Expert Analysis: Using Simulation to Assist Courts in Assessing the Prudence of Retirement Plan Investment Decisions" and "Can a 401k Fiduciary Rely on Luck?" by Roger levy.

VPIC Exercise of Fiduciary Responsibility

- In 2017 VPIC engaged an Independent Pension Advisor, selected by members of the environmental community, to study divestment.
  - The conclusion :Divestment increases investment costs and lowers investment performance.
- VPIC exercised its fiduciary responsibilities by initiating this study.
- While divestment was not feasible, the consultant (Pension Consulting Alliance) did make recommendations on steps to address climate change.
- VPIC adopted an action plan and has made progress on each component.
- A new study was performed in 2023. With respect to divestment following concerns were noted:
  - "23 of the 149 VPIC public fossil fuel companies were also among the top 200 global renewable energy generation companies."
  - Low expected contribution to lowering real economy climate risks and expected low contribution to improving risk-adjusted return of investment portfolio over the next 10-20 years.
  - Reduces investment options in asset classes such as private credit and infrastructure.
  - Would constrain VPIC engagement efforts.

VPIC Comments on Divestment:

"For the reasons set out in Meketa's report, VPIC opposes this approach. As we have testified, a broad fossil fuel divestment mandate would lead to a phaseout of VPIC's private market investment program and a corresponding meaningful reduction in the assumed rate of return VPIC would utilize. Every 0.50% (50 basis point) reduction in the assumed rate of return drives the annual actuarial determined employer contribution higher by approximately $50 million, as estimated by the actuary, Segal Marco.

Further, selling off shares in the energy companies negates our ability to effect positive change through our proxy votes and to invest in the energy transition."

A few Studies... Engagement vs. Divestment

“This paper is an attempt to analyze the welfare implications of two traditional strategies aimed at shaping corporate outcomes: exit and voice. …we find that **in a competitive world exit is less effective than voice in pushing firms to act in a socially responsible manner**. Our conclusion is consistent with Kruger et al.’s (2020) survey of institutional investors, which finds that such investors consider engagement, rather than divestment, to be the better approach for addressing an externality such as climate risk.”

- Eleonora Broccardo, Oliver Hart and Luigi Zingales, “Exit vs. Voice”, December 2020

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According to our survey about climate risk perceptions, institutional investors believe climate risks have financial implications for their portfolio firms and that these risks, particularly regulatory risks, already have begun to materialize. **Many of the investors, especially the long-term, larger, and ESG-oriented ones, consider risk management and engagement, rather than divestment, to be the better approach for addressing climate risks…”**

- Philipp Krueger, Zacharias Sautner, and Laura T. Starks, “The Importance of Climate Risks for Institutional Investors”, ECGI Working Paper Series in Finance, November 2019

A few Studies… Engagement vs. Divestment

We evaluate the quantitative impact of ESG divestitures. For divestitures to have impact they must change the cost of capital of affected firms. We derive a simple expression for the change in the cost of capital as a function of three inputs: (1) the fraction of socially conscious capital, (2) the fraction of targeted firms in the economy and (3) the correlation between the targeted rms and the rest of the stock market. Given the current state of ESG investment we find that the impact on the cost of capital is too small to meaningfully affect real investment decisions. We empirically corroborate these small estimates by studying firm changes in ESG status. When rms are either included or excluded from the leading socially conscious US index (FTSE USA 4Good) we find no detectable effect on the cost of capital. We conclude that current ESG divesture strategies have had little impact and will likely have little impact in the future. **Our results suggest that to have impact, instead of divesting, socially conscious investors should invest and exercise their rights of control to change corporate policy**.

- Jonathan B. Berk Stanford University and NBER, Jules H. van Binsbergen, University of Pennsylvania and NBER, **National Bureau of Economic Research,** October 25, 2021

There are certainly a number of studies with differing perspectives. I recommend that the Committee be provided with some discussion of these, again from representative groups.

ESG is All About Engagement, Action and Investment Decision-Making

- Examples of environmental factors include climate change, pollution, and deforestation.
- Examples of social factors include human rights, working conditions, and employee relations.
- Examples of governance factors include bribery and corruption, executive pay, lobbying, and board diversity.
- ESG is all about investment decision-making.
- Responsible investment is an approach to managing assets that sees investors include environmental, social and governance (ESG) factors in their decisions about:
    - what to invest in;
    - it aims to combine better risk management with improved portfolio returns, and to reflect investor and beneficiary values in an investment strategy;
    - it is essential to traditional financial analyses and portfolio construction techniques

VPIC Five Point Plan after 2017 Report

(In Addition to Proxy Policy and Shareholder Engagement)

- The VPIC ESG policy should be revised to include: “When conducting an investment manager search, the investment consultant shall require each prospective investment manager to disclose, in addition to its proposed investment guidelines and practices for investment selection, its ESG polices, processes and systems for identifying ESG related value drivers and managing material ESG-related risks, to the extent the same may be applicable.”
- PCA recommends exploring the possibility of creating a new passive investment vehicle that could be seeded by VPIC and would be consistent with our ESG policy.
- Related to recommendation 2 above, the Treasurer’s Office recommends working with investment consultant to explore ways to identify renewable energy opportunities as incorporated in asset classes or as a subset of asset classes.
- Consistent with the PCA recommendation, the Treasurer’s Office recommends working with our third-party vendors to review the feasibility of developing reporting tools on ESG factors to further our monitoring efforts.
- VPIC should continue its dialogue with investment managers on climate change and ESG issues and prepare periodic updates.

VPIC Engagement Makes A Difference

STEWARDSHIP

Segal Marco is assisting Staff to execute the VPIC's 2024 engagement plan as approved at the September 26, 2023, meeting. The following was accomplished since Staff last reported to the VPIC:

- Staff has submitted resolutions to 6 companies for the 2024 proxy season, on topics ranging from DEI, methane emissions, GHG reductions, and flaring reductions. In addition, we have continued engaging 3 companies on topics of methane emissions, just transition, and independent chair. To date we have withdrawn 5 of the 6 after reaching agreements to meet the spirit of the resolution's ask. Please see some highlights from these engagements on the next page. Maureen O'Brien of Segal Marco is also with us today to provide an overview of the proxy season to date. We will keep the Commission apprised of progression of these engagements.
- Devon Energy Corporation informed VPIC that the reporting they agreed to provide for a withdrawal during the 2023 proxy season on their alignment of lobbying activities with the Company's climate-related targets, has been published in their "Political Activity and Lobbying Report". We are pleased with the outcome of this engagement with the Company.

Source: VPIC public documents

Manager Assessment and ESG Actions

- VPIC, in conjunction with the Investment Consultant, evaluates each manager's ability to integrate ESG factors into their investment process alongside financial factors through the procurement process.
- Once the investment is made, the Commission conducts ongoing evaluations of each manager on a quarterly basis through the Investment Performance reporting process.
- VPIC conducts an annual survey of its managers to evaluate their ESG policies, integration of ESG into their investment policies, investments consistent with their policies and progress on metrics to evaluate their carbon footprint.

https://outside.vermont.gov/dept/VPIC/Shared%20Documents/VPIC%20Website/ESG%20Reports/Annual%20Investment%20Manager%20ESG%20Surveys

Source: VPIC Web Site

VPIC Has Taken It to the Next Level

- Vermont Pension Investment Committee Environmental, Social And Governance Initiatives
  - Revised And Restated June 27, 2017
- VPIC Carbon Reduction and Mitigation Policy
  - Adopted April 26, 2022
- Domestic Proxy Policy
  - Effective May 28, 2013 Amended and re-adopted: March 26, 2024
- International Proxy Policy
  - Effective November 19, 2019
- Annual Recommended ESG Initiatives for 2024 Proxy Season
- Annual Investment Manager ESG Survey
- VPIC Sustainability Report

Participant Participation in Low Carbon Option is Low

- At the recommendation of the Treasurer and approval by the Retirement Boards, a fossil fuel free (now listed as low carbon) investment option was added in 2014 to its deferred compensation and other optional retirement investment programs.
- The addition of this fund offering provides employees the opportunity to invest in companies that support a sustainable future, while supplementing their retirement savings.
- Despite efforts to publicize, pick-up by state, teacher and municipal members has been limited.

Utilization of Low Carbon Investment Fund in Optional Retirement Programs

Retirement Plan	Total Assets	Assets in Low Carbon Fund	Percentage	Total Participants 2023	Number of Participants	Number Using this Fund as Sole Option
Deferred Compensation Plan	$668,845,648	$3,481,467	0.5%	8,711	552	3
Teacher 403(b) Plan	$177,038,295	$514,836	0.3%	3,471	79	1
State Defined Contribution Plan	$81,252,622	$225,502	0.3%	536	7	0
Muni. Defined Contribution Plan	$28,763,075	$10,593	0.0%	422	3	0

Recommendation: Any Discussion of S.42 by The House Should Include…

- Testimony by the Chairs of the three Boards of Trustees
  - State, Teacher’s and Municipal Systems

- Testimony from employee groups who represent employees and retirees who participate in the pension system (VSEA, VT-NEA, Firefighters, others).
- Additional expert groups with a various viewpoints

A Possible Starting Point

“If we are to solve this problem, we need the best thinking from everyone. People need to start focusing more on areas where they can agree than on those where they disagree.”*

- VPIC’s ESG Committee could conduct six-month in-depth forums bringing parties together for discussion and action:
  - VPIC Carbon Policy
  - Investment Manager Survey
  - Meketa Approach 3: Portfolio-wide Net Zero Goal and Approach 4: Portfolio-Wide Real Economy Net Zero Approach
  - Expanded engagement activities identifying priority companies to target.
  - Collaboration with pension oversight joint committee, pension boards, legislature, environmental groups, and interested parties.

*Source: Robert Eccles, “Is ExxonMobil’s Acquisition Of Pioneer Good News Or Bad News For Climate Change?”, January 20,2024 Note: While I am not in agreement with all of the author’s position, I believe the message is on target.