BCG Private Capital ESG Conference

Event Notes

2021.03.09

Asset Owner Panel

Moderator

- VS – Vinay Shandal – Global Leader, Sustainable Finance and Investing @ BCG

Panelists

- MF – Marci Frost – CEO @ CalPERS
- MW – Mark Wiseman – Former CEO @ CPPIB; Former Chairman Global Investment Committee @ Blackrock

Discussion

- VS
    - Marcie let's start with you, as you know there's no shortage of bold climate and ESG commitments from asset owners, what's driving them?
    - MF
        - I think there's an increasing recognition that these factors will impact investment returns
        - We expect our portfolio at CalPERS to grow at 7% and we know this will have a material impact on the portfolio and the investments we're making today, so as with any other risk factor in the portfolio we're thinking about how to mitigate them now – the possibility for earlier rather than later mitigation exists
        - There's also a moral dimension to these issues, I just had my 5th grandchild, so how we steward society's collective resources gives added weight
        - When we think about the 2 million members who receive benefits from the CalPERS system these issues have become more paramount, when they're engaging with us these issues are front and center
        - The reason we've signed on to these groups is that CalPERS can't do this alone and we're stronger with other asset owners/managers
        - Today there are more bold pronouncements than actual actions – a dynamic I hope will be changing rapidly
- VS
    - What does it mean in practice to operationalize these net zero commitments
    - MW
        - Let me start by saying this is a tough topic and Bob (Eccles) was speaking earlier about how to create consistency around financial reporting – there's also no consistency in terms of measuring what net zero is

        - So we see lots of net zero targets stated, but what that means and how its measured is still a debate, a debate that exists even within the sustainability community
        - We own pieces of paper (or electronic pieces of paper) and the question is how is that net zero? What do those pieces of paper represent in a downstream sense in the actual corporatation?
        - I think for asset owners to make those commitments is hard and requires a lot of work, it's difficult for a corporation to know and measure what NZ (NZ = net zero) means so if you extrapolate that back it's even harder for the AO (AO = asset owner)
        - I also think there's a big difference between being net zero and contributing to the transition economy and we can talk about that further
- VS
    - We'll come to that, it's an important topic
    - Marcie, given the number of dollars CalPERS allocates to GPs and the scrutiny you place on ESG and making those decisions, any examples of GPs you find particularly advanced in the area of ESG? And related, what are the hallmarks of a GP that has it figured out in terms of ESG?
    - MF
        - We don't think any GP has really figured this out, anymore than a GP has figured out every nuance of investing, but we've seen improvements
        - The hallmarks we're looking for is
            - Defining what matters, as Mark touched on ESG can mean to anything to anyone, so starting with definitions that matter in terms of corporate purpose and investment beliefs matter
            - Having a consistent measurement tool will be extremely important
            - And once that's in place it will really be about the consistent application of the reporting of it
            - Data
                - The number of diverse board managers
                - How do they define and measure emissions consistently across portfolios and companies
                - Net employment growth over time – an important consideration to human capital, CalPERS believes that we have three forms of capital: human, physical, and financial. The three need to work together for long run growth
                - So there's a lot of talk not a sufficient amount of data, so this will be critical in terms of GP assessment
            - We look for GPs who track fewer things and then closely track those few items
            - Integration into the investment process – if a GP does not see value potential in improving ESG metrics we view their commitment as less likely to be durable

            - Private equity is an important asset class, Bob (Eccles) talked about having LPs be much more bold with GPs so this needs to be a collective action
- VS
    - Mark on the topic of the transition economy, we've heard the phrase "ESG is the ultimate convergence of value and values", you and I both agree there is value to be created in acquiring a company that is underperforming on ESG and improving ESG performance through real engagement with the management team. Is that what's happening on the ground? Are GPs doing enough to improve ESG performance in practice?
    - MW
        - It's starting, and that's a really good thing
        - The convergence of value and values as you said is good for the market, good for returns, and good for the planet/society at large
        - I'm an optimist in this regard, I think we're seeing an acceleration of understanding about that convergence
        - Management of good values around climate, all stakeholders, and employees in the long run (and PE has a big role to play because it's more long term than other forms of investing) makes that convergence more likely to take place – ie those companies will be more valuable
            - I think this is a huge source of alpha
            - What has PE been built on? It's been built on generating alpha in situations where there is asymmetry in information, where you have to roll up your sleeves and get involved and where you can undo the agency costs of a public company
            - The very hard and complicated transmission mechanism between the owner and the management of a public company is much shorter and more efficient in the private context – that is what's made PE so valuable to investor portfolios
            - In this regard PE is very well set up to generate alpha from the transition economy, all those things are true:
                - There's asymmetry
                - There's an ability to get involved and change how companies are operating and
                - Therefore create higher longer run value
        - One of the things that AOs are coming to grips with is this idea of transition and having an impact on the world
            - Buying another wind farm in Germany isn't going to make a difference, those assets today are priced at or near perfection – the returns are coming down
            - What's more interesting is buying an imperfect company in terms of GHG emissions and getting involved to transition that company and getting a bump in EBITDA because it does a better job on the back end

        - I think PE, infrastructure, and private credit are all well positioned to do this AND generate alpha, I think GPs are starting to understand that
            - The GPs need to build the expertise, show that they're able to integrate these factors into the investment process, build different types of value creation models
            - If they can, they'll be rewarded with multiple expansions
            - This involves not starting with a NZ portfolio on day 1, but improving towards a NZ portfolio
            - I see this is a huge opportunity for private asset classes
            - And remember from an AO perspective, it's much harder to get that done in public companies – you've got to vote in proxy statement, changes boards, put pressure in different ways – that transmission mechanism is more efficient in privates
- VS
    - I couldn't agree more about the opportunity and private capital being the perfect arena and a real source of alpha. The same was true for digital – digital laggards didn't fetch the same premium as exists where the company was excelling in digital
    - But the exception of EQT who have made it part of their playbook, or OTPP with the launch of the incubator for new business and services, we haven't seen that type of uptake to equip management teams to accelerate that journey. Do you think it will be different for sustainability? Will GPs actually make the investment to accelerate the journey or is there a risk it goes the same way digital did?
    - MW
        - I'm a little less critical of the digital revolution, I think a lot of GPs pushed their portfolio companies to digitize and move into that strategy, maybe they didn't build the expertise they needed
        - But I'd give a higher mark to PE than your question implies, but I do think we'll do a better job on sustainability because the pressure is coming from AOs
        - I think those who are in sustainability have figured out that the transmission mechanism is through AOs, that impetus never existed in digital
        - My friend Larry Fink has been at the forefront of this messaging and I love Larry and think he believes in what he says, but it's also great business for Larry because he knows his clients, asset owners, are demanding this and he understands that a sea change is taking place which is a business opportunity for Blackrock
        - I think that alternative asset managers are hearing the exact same thing, that this is were value is going to be created particularly as long term investors
        - Here's where I think AOs have a huge role to play, they're long term by nature
- VS
    - Marcie before we go the topic of non financial disclosure, I saw you nodding when Mark disagreed with me so anything you'd like to add on the topic of engagement and helping companies generate returns
    - MF

        - I think Mark has it exactly right, the expectations of how capital is invested is where this starts
        - Obviously recipients want to see their benefits which requires growth in the portfolio, and that growth is quickly becoming a debate between social issues/ESG
        - CalPERS, who operates in a public setting where every decision is talked about in the media, sees more pressure coming and it's on the list of shareholder activism, people are calling into board meetings to have a say in how capital is invested
        - 60 cents out of every dollar is done through investment earnings, not contributions, so the investment portfolio is extremely important and we have to balance this stakeholder/shareholder engagement in a way everybody understands the stewardship of these funds over time
        - We're approaching that 7% through 3 prongs:
            - Policy (placing the capital appropriately)
            - Advocacy
            - Engagement (the integration side is still weak)
- VS
    - Our view is that ESG activism will be what really drives making capital the catalyst for ESG improvement in companies, this is a great segue into the disclosure issue.
    - The reason for that issue in public markets is that there is no alignment on what ESG is good/bad given the massive fragmentation of scoring, reporting, and frameworks
    - The focus today is private markets, so Marcie what do you expect from GPs when it comes to ESG disclosures and what do see as the future for ESG reporting in private markets?
    - MF
        - The sector really needs data driven metrics on ESG, that is the future and the key piece missing today
        - In the push to understand ESG issues on a granular level there's a lack of visibility into what's happening today across GPs on key ESG factors, having a broad database as Bob Eccles mentioned where we can compares and contrast this industry is key (private and public)
        - The ability to measure performance across managers is key, and the allure of tracking everything has lead to the ability to collectively track nothing
        - What we face now is a collective action problem, not a measurement problem
- VS
    - Bob did say AOs are potentially not doing enough to hold GPs to account, these are long term relationships we have to be mindful of so there's a lot at play
    - MW
        - Can I jump in to say that the measurement metric isn't hard but the act of measuring shouldn't be hard for GPs – they're used to this, there's the old adage of what gets measured gets done

        - One of the strengths of PE is the high degree of accountability in the system, so at the very least GPs should be setting strong targets for their portfolio companies on metrics
        - Over time the industry can come together much faster because there's no regulator on those metrics – employee engagement scores, supply chain resiliency, and whatever else is determined to be important can be reported on as appropriate – that's just doing your job as a good PE investor
            - You measure on a monthly basis what your EBITDA margins are, you just need to expand your thinking in terms of what goes to value
- VS
    - There's a question on how AOs in your view Mark will be an additional driver of engagement on ESG performance and improvements, do we need AOs to do more?
    - I agree that it's intuitive and logical and if you understand ESG you understand that is just part of 21st century value creation and therefore measuring drivers of value means measuring ESG. But there's a view among AOs that they're not getting enough disclosures from GPs, so the question is are AOs doing enough?
    - MW
        - AOs do need to do more, I would encourage the ILPA to do more in this as the best industry association (I'm biased having been the chair of it)
        - This should be an easy topic for GPs and LPs because you're aligned in interest as long as you believe these factors go to value creation – it's not about managing fees or fee offsets or how carry waterfalls should be calculated
        - Here, there is complete alignment of interest so they should be able to work much more easily together than in other areas to figure this out
- VS
    - Marcie we heard today from Q about some of the commitments his fund has made in the area of diversity, at the same time BCG has gone on the record publicly for calling the PE industry out for being behind the public markets when it comes to DEI. Do you agree and what do you hope to see from GPs in this area?
    - MF
        - I think the expectations we'd have of a company where we're placing our capital would be the same as the expectations we'd have of our own organization: that we'll see improvements over time
        - I don't think public companies are doing so great in this area either – both private and public have a lot of work to do
        - I come back to data and information
            - There is sufficient data out there for boards and c-suits to understand that diversity matters, improves performance, and that balance of decision making will the company more sustainable over time
            - We firmly believe that, our 13 member board is quite diverse, so the expectations of companies we're investing in are the same as for our own org
    - MW
        - Couldn't say it better than Marcie, agree with her 100%

        - If you haven't read it yet read what the Yale Endowment and David Swensen has said on this topic – diversity leads to better outcomes
        - At the level of the GP you start with your own practices, and as per Q's commitment at Carlyle you drive that down into your own portfolio companies
        - So I think GPs need to get their own house in order in terms of best practices and then demand the same of their portfolio companies
- VS
    - We got a question in the chat – what is one innovation that Blackrock or CPP brought in ESG that others can learn from? And same question for Marcie for CalPERS?
    - MW
        - Marcie talked earlier about integration, and I think about both Blackrock and CPPIB we had some success in making sure that integration is owned by the investment teams – it's got to sit as part of the investment process
            - It can't sit in CSR, or in the general counsels office or in public relations
            - It must be imbedded in the investment organization
        - If you think that sustainability and ESG and diversity is owned by HR or corporate communications you've missed the entire point, the function should be owned within the investment organization
            - Both Blackrock and CPPIB made strides in that
    - MF
        - I don't think we've been as innovative as we'd like to be in term of ESG in PE, it is an area we're going to make some significant strides in coming years
        - Where we have been a leader is more on the public markets side, we talked about Climate Action 100, we have the ability and responsibility to make an impact across all asset classes
        - On the PE side specifically we do a lot of engagement with the GPs to fully understand what they're doing on ESG and DEI items and those conversations are going well
            - The GPs and entity heads are thinking about this
            - Jim Coulter at TPG has been a thought leader on these items, and KKR is doing some good work as well, but there's a lack of transparency
            - For CalPERS, through ILPA we're going to really focus on this for the next 24 months
- VS
    - And the last question from the audience – we have plenty of young people in from the investment industry asking how to make sustainability a bigger part of their professional focus
    - MF
        - Because we're in the early stages of integration patience and persistence are going to be extremely important
        - Individuals who are attracted to this journey in their career will have to be resilient and understand that these things are not going to move at the pace that expectations are set for, so there's a combination of patience, resilience, goal orientation, and finding solutions to problems that will be important

- If you're comfortable with a slower pace – at CalPERS for example we have a scaling issue where we think there are great ESG managers out there but they're not at the scale for us to engagement and invest directly with – and this is something you're passionate about be persistent, flexible and solutions oriented

- MW
    - I think this is a burgeoning area and all AMs and AOs need expertise in this area, so if you want to be in this area it used to be you earned your CFA and learned about financial modelling
    - Today that's still important but largely commoditized, if you can add to that expertise in understanding the factors that drive value through ESG factors you can set yourself apart
        - With Hillhouse capital where I'm a senior advisor I know desperate we are to find investors who have that skillset
    - Increase your skills as an investor and develop a good return track record