

California green

A new investment approach by two of California's largest pension funds could have more environmental impact than if the US were to join the Kyoto Protocol, say

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Amid the environmental exuberance that has welcomed the cascade of green programmes announced by the state of California over the past year, the implementation of one particular initiative has been relatively inconspicuous – although it is potentially groundbreaking.

California's Green Wave Initiative (GWI) is beginning to channel the vast wealth of America's first and third largest pension funds – the California Public Employees Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS), respectively – towards environmentally-responsible investing, with the aim of achieving both environmental and financial returns.

Unveiled in 2004, California's GWI envisages the placement of \$1.5 billion by CalPERS and CalSTRS in environmental instruments. While that size investment is clearly a placeholder for two massive funds with a combined asset base of well over \$250 billion, the GWI may nonetheless have far-reaching effects on institutional asset allocation and capital markets.

The GWI impacts investors and markets in four ways, via: private equity investment in environmental technologies; environmentally-responsible public equity investing; real estate asset management; and environmental disclosure and corporate governance activity.

The private equity component is focused on venture capital for environmental technology or 'clean-tech' companies. The public equity part involves the allocation of funds to managers that integrate environmental sustainability factors into their asset management process. The real estate focus is on maximising energy efficiency – and reducing greenhouse gas emissions – at properties the funds already own. The disclosure and corporate governance component extends CalPERS' and CalSTRS' long history of social and corporate governance activism to environmental issues; it is intended to improve the availability and quality of information on environmental practices and liabilities available to asset managers.

This approach recognises the opportunities that CalPERS and CalSTRS can find in every asset class – none are immune to climate change. The GWI balances the relatively higher risk of investing in new technology venture investments with the traditionally lower risks of blue-chip equity and real estate.

Citing a Light Green Advisors report (*The Profitable Correlation*) as well as several additional reports, the California GWI is the first major public fund initiative in the US to allocate capital to the positive return promise of the next generation of environmentally responsible investing.

While public funds have managed social issues on a reactive basis for several decades using negative or 'blacklist' screens, the GWI is based on a watershed concept: the notion that companies which are more eco-efficient (with a lower environmental footprint per

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unit of revenue) than their competitors are also more profitable. CalPERS and CalSTRS, in fact, require that their environmental sustainability investment managers show a proven track record of results-oriented environmental investing.

The GWI reflects the California funds' expectation that financial opportunities coinciding with environmental objectives are growing; which is a distinction from the traditional 'social' investing formulation in which financial goals are subservient to social restrictions. The global flow of funds into the clean-tech sector illustrates the acceptance of this positive opportunity viewpoint in the venture capital community.

The distinction is also due to certain features of environmental investing – namely that corporate environmental performance trends can be more precisely analysed and quantified than corporate social performance. Leading companies recognised years ago that environmental leadership can be a source of substantial cost savings. As a result, superior environmental management seems to be a more reliable proxy for superior business management than other social issues.

By virtue of their leadership, CalPERS and CalSTRS are in a better position than most to get in front of these environmentally-responsible investing trends. As both private and public investors go green, these funds seem well placed to benefit from associated changes.

The looming question, however, is whether at some point investors may have an affirmative duty, rather than simply a choice, to incorporate environmental considerations into their investment practices. The fiduciary duty of prudence that governs the actions of US institutional investors is generally understood to require consideration of environmental liability as an investment risk. Climate change legislation, certainly in California, presents investment risk that cannot be ignored. Consideration of investment returns, particularly those derived from environmentally-responsible portfolios that meet diversification standards, may eventually be viewed as a component of a fund's fiduciary duty, particularly for long-term investors.

This emerging discussion of fiduciary duty is likely to play out over the issue of climate change. As a result of legislation, carbon markets and changes in the business climate, the environmental liabilities and opportunities of public companies can now be more accurately analysed and investment portfolios can be more effectively calibrated. As substantial investors place increased emphasis on environmental opportunities and risks – in part as a matter of fiduciary responsibility – the US capital markets could begin to penalise and reward climate change losers and winners.

The playing-out of this scenario is likely to depend in part on the success of the GWI as a model for other investors in both the public and private sectors. With institutional investors controlling approximately 50% of the US equity market, the initiative's impact may ultimately be more important to climate change than whether the US joins the Kyoto Protocol or not.

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