Board of Administration

Agenda Item 9d

June 16, 2021

Item Name: Senate Bill 457 (Portantino) – Segregated Investment Portfolio: Republic of Turkey

Program: Legislation

Item Type: Action

Recommendation

Adopt an **OPPOSE** position on Senate Bill (SB) 457 (Portantino), as introduced February 16, 2021, because it imposes a divestment mandate on the California Public Employees' Retirement System (CalPERS) Board of Administration (Board). In addition, this divestment would be implemented by CalPERS having to create a segregated trust fund for any school district or city that requests, which appears to infringe on the CalPERS Board's constitutional fiduciary duty and imposes unreasonable operational risk and expenses to establish a segregated trust fund.

Executive Summary

SB 457 requires CalPERS and the California State Teachers' Retirement System (CalSTRS) to provide a school district or a city the option to elect an investment portfolio that does not contain investment vehicles issued or owned by the government of the Republic of Turkey.

Strategic Plan

Divesting in response to external initiative is outside the scope of the 2017-22 CalPERS Strategic Plan.

Investment Beliefs

This agenda item supports CalPERS' Investment Belief 3 that investment decisions may reflect wider stakeholder views, provided that they are consistent with its fiduciary duties to its members and beneficiaries.

Background

Constitutional Authority and Fiduciary Responsibility

Article XVI, section 17 of the California Constitution gives the boards of public retirement systems in California plenary authority and fiduciary responsibility for investment of pension

assets and administration of the system. The Constitution expressly provides that the retirement boards of a public pension fund shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. It further requires board members of a public pension or retirement system to discharge their duties solely in the interest of, and for the exclusive purpose of providing benefits to, participant and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. The Constitution also requires the boards of public pension funds to diversify the investments of the system to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so. In accordance with California Constitution Article XVI, section 17, the Board's constitutional duties take precedence over any other considerations.

The Constitution also, however, provides that the Legislature may by statute continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board.

CalPERS Divestment Policy

Divestment as a catalyst for social change and an investment strategy has been a controversial topic within the public pension community for decades. As a California state agency, CalPERS is sensitive to public policy issues, but recognizes that our primary duty and obligation is to our members. Current CalPERS divestment policy, as described in Section VII of the Total Fund Investment Policy, acknowledges the following:

- CalPERS board members and staff have fiduciary duties of loyalty and prudence pursuant to the California Constitution and California Government Code section 20151.
- While CalPERS want companies in which it invests to meet high corporate governance, ethical, and social conduct standards, an investment in a company does not signify that CalPERS approves of the company's policies, products, or actions.
- Divestment almost invariably harms investment performance by compromising investment strategies and increasing transaction costs.
- There is considerable evidence that divesting is an ineffective strategy for achieving social and political goals. This is because the usual consequence is often a transfer of ownership of divested assets from one investor to another.
- Investors that divest lose their ability as shareowners to influence a company to act responsibly.

Armenian Genocide

According to the author,

> "Previous legislation attempted to divest California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) from the Government of Turkey due to its ongoing and aggressive denial of the Armenian Genocide. While this bill was approved by Governor Newsom, it does not go far enough.
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> "Continuing to invest in the republic of Turkey sends a dangerous signal and enables the government – through investments in its economy – to continue to deny justice to the victims of the Armenian Genocide. Divestment from Turkish bonds over the

government's denial of the Armenian Genocide would impose much needed economic consequences on a regime that continues to engage in policies that constitute crimes against humanity."

Republic of Turkey Divestment in Existing Law

AB 1320 (Chapter 459, Statutes of 2019), authored by Assembly Member Nazarian, was signed into law to address the same concerns raised by the author of SB 457. This law requires CalPERS and CalSTRS to divest from specified investments in the Republic of Turkey. However, the divestment mandate does not become effective unless a federal law, passed by the U.S. Congress and signed by the President, imposes sanctions on the Government of Turkey for failure to officially acknowledge its responsibility for the Armenian Genocide.

On April 24, 2021, President Biden issued a statement in remembrance of the Armenian Genocide committed by the Ottoman authorities beginning in 1915. This statement does not appear to meet the conditions in AB 1320 to mandate divestment.

Analysis

Bill Summary

As it pertains to CalPERS, SB 457 requires the CalPERS Board to provide a school district or a city the option to elect an investment portfolio that does not contain investment vehicles that are issued or owned by the government of the Republic of Turkey.

Because all assets for active employers in the Public Employees' Retirement Fund are currently invested in a single-asset allocation, SB 457 would require the creation of a second asset allocation pool for pension investments. The creation of a second pool raises meaningful fiduciary concerns as to whether the alternate pool unduly burdens the existing pool/portfolio and the participating employers who do not move to the alternate asset allocation. Also, if a second allocation pool is not administratively feasible or carries greater risk than the current single-asset allocation, it is likely that the creation of a second pool would be inconsistent with the Board's fiduciary duties.

Impact on Investment Strategies

Divestment represents a form of active risk-taking that must be considered, first and foremost, within the context of the Board's fiduciary duty and the sustainable delivery of promised benefits. A divestment mandate represents a relatively static investment decision that unfolds comparatively slowly on a timetable of its own and within view of other investors, hampering the ability of investment staff to re-evaluate and reinvest as market conditions warrant.

Every dollar in investment returns that is forgone, or expended on transaction costs and fees, must be offset by employer and employee contributions. If CalPERS were to divest from Turkish investment vehicles and the companies performed well, employers and employees would bear the investment loss and transaction costs to maintain divestment through increased contribution rates.

Prior Research on Segregated Trust Funds

In February 2015, the CalPERS Board attended a workshop that provided an overview of funding risks that the System faced, how the risks were changing, and introduced several concepts that may address these risks. One of the concepts reviewed was the Multiple Asset Allocation Choice (MAAC) option which would consider an asset allocation choice for employers looking to lower their funding risk and whose circumstances could accommodate a lower discount rate. CalPERS determined that implementing the MAAC option would have substantial undesirable costs and increased complexity associated with its creation and maintenance.

A summary from 2015 identified some of high-level impacts related to increased costs, complexity and risk including:

1. Extensive programming changes required for major information technology systems. Several of the major information technology systems used for processing, calculating and storing information related to the creation and maintenance of system date would be affected by the implement of a MAAC. Among the functionalities required would be processing valuations and actuarial calculations for multiple discount rates and tracking member and employer data by different investment earnings.
2. Required actuarial restructuring for risk pooling and employer/member transactions.
3. The need to perform asset allocation analysis and establish asset class rebalancing parameters for each alternative. To support MAAC on an individual employer basis, asset allocation analysis would need to be performed for each asset class as well as rebalancing parameters developed for each alternative. This includes individual calculations of efficient frontier analysis, asset allocation alternatives, adjustment to benchmarks, change to asset portfolios and the identification of illiquid asset pricing and cross trading procedures.
4. Increased employer education and stakeholder outreach to implement the MAAC. A thorough communication plan would be required to ensure that all employers and stakeholders fully understand the options, risks and impacts on their potential decisions in participating in the MAAC. Costs associated with needed expertise and education for employers to implement would be in addition to the costs incurred by CalPERS.

In 2015, CalPERS had projected a 5 to 7-year period to perform analysis, planning, design and implementation functions of a MAAC program for employers. During this period significant resources would have been needed to be reallocated and dedicated to the project across the organization due to the expansive requirements necessary for staff to implement this complicated risk mitigation strategy.

Implementation Obstacles for Segregated Fund Under SB 457

There are key differences between the MAAC research and the segregated trust fund proposed by SB 457, including:

1. The MAAC was intended to provide a risk mitigation option for employers to minimize potential volatility and their contributions to the system. SB 457, on the other hand, creates a segregated trust fund solely for non-economic divestment reasons.

2. The MAAC investment allocation options would have been established by CalPERS within the scope of the Board's and investment team's constitutional and fiduciary obligations. Conversely, SB 457 mandates the creation of an alternate asset allocation pool that could easily be inconsistent with the Board's fiduciary duties and responsibilities by introducing new risk, costs, and administrative difficulties that place the current single-pool asset allocation in jeopardy.

In addition to the challenges identified above, SB 457 would likely present several administrative, legal, and implementation difficulties. In general, there are not clear solutions to resolve any of these issues.

1. Legal issues

Any decision to establish more than one asset allocation/investment pool for participating employers must be consistent with the Board's fiduciary duty and must be in the best interest of the System as a whole. This determination would include analyzing whether the benefits of offering an alternative asset allocation outweigh the costs and risks, and any such separate asset allocation must be operationally feasible.

In addition, SB 457 provides no criteria/parameters for which an employer may make such an election into or out of the alternative asset allocation. Even if the board determines that offering another asset allocation is consistent with its fiduciary duty, significant legislative changes would still be needed before it could be implemented.

2. School districts contracting issues

In most cases school districts participate in the Schools Pool under the contract of its County Office of Education. In order for a school district to exercise the divestment option proposed in SB 457, the district would need to separate from the pool and contract independently with CalPERS as a contracting agency. While the Public Employees' Retirement Law (PERL) has provisions that allow for a school district to contract directly with CalPERS, they conflict with the Public Employees' Pension Reform Act making them unworkable. Without conforming changes to the PERL, school districts would not be able to exercise the investment option proposed in SB 457.

Even if the statutory issues are resolved, there are other operational and administrative issues that would also need to be addressed to execute separation from the Schools Pool and ensure that separation accurately reflects the school district's assets and liabilities.

3. Economy of Scale and Portfolio Diversity issue

The administrative costs for the retirement system are paid by all the employers through total trust fund dollars. The administrative costs to each employer to the trust fund that is over $450 billion are nominal.

SB 457 would require CalPERS to administer a segregated trust fund that would need to be funded by the participants in that smaller fund. However, there are basic costs required to administer any trust fund, regardless of size, including technology hardware, software, office space, and staffing.

In addition, a segregated trust fund may not be large enough to include the level of investment diversity of the current total fund. A smaller trust fund may not be financially able to participate in opportunities available to larger trust funds. Therefore, if a larger percentage of the smaller

segregated trust fund is dedicated to administrative costs and is unable to participate in higher yield investment opportunities, as larger funds can, then the discount rate and expected investment return for the segregated trust fund may be significantly lower than for the main CalPERS trust fund. As a result, the segregated trust fund may require higher contributions for employers and employees due to economic inefficiency.

4. Slippery Slope issue

The divestment required by SB 457 reflects a relatively small investment exposure, but requires the creation of a completely new segregated trust fund. If the Legislature began requiring segregated trust funds in order to implement divestment mandates in the future, the economic inefficiencies of multiple segregated funds may compound and damage the ability of the overall system to meet its obligations to its members.

Budget and Fiscal Impacts

Administrative Impacts – Segregated Trust Fund

CalPERS estimates $2.3 million annually in administrative operating costs to develop, implement, and manage a segregated trust fund. If the fund were externally managed, CalPERS estimates a range of 55 to 95 basis points. Therefore, for every $1.0 billion invested, there could be between $5.5 million and $9.5 million in external management fee expenses annually. External management fees are based on assets under management.

Among the administrative tasks required for a segregated trust fund option are establishing a sound annual investment return target, an appropriate asset allocation mix, segregated accounting processes, actuarial system changes, new annual contributions rates for employers, a contracting process for employers requesting to participate in the segregated trust fund option, and an additional layer of investment compliance monitoring. These activities among others will add costs, complexity, and risk to the work performed in the actuarial office, investment office, legal office, financial office, and the information and technology branch.

Divestment Impacts

If CalPERS is required to divest, the program costs would include investment transaction and administrative costs to identify and divest from investment vehicles that would meet the criteria stated in SB 457 at the time of divestment. Administrative costs include the cost of hiring an external investment research firm to determine which CalPERS holdings meet the criteria specified in the bill that would be subject to divestment. Potential trade costs could extend into the millions.

A preliminary analysis conducted by CalPERS indicates that the potential exposure to Turkish investment vehicles is up to $152 million as of 12/31/2020. The preliminary analysis does not indicate which of those investment vehicles would meet the criteria specified in SB 457; that analysis would be performed by the external investment research firm. The costs above also do not include the opportunity cost of continued investment into investment vehicles that meet the criteria specified in SB 457.

Benefits and Risks

Benefits:

- None

Risks:

- Compromises CalPERS' investment strategies by eliminating alternatives from the investment opportunity set and reducing diversification, which may have a detrimental effect on investment returns over the long term.
- Imposes financial risks on CalPERS members and employers.
- School districts must remove themselves from the Schools Pool to participate in the proposed segregated trust fund, which would increase risk to those districts and members.
- Increases fiduciary duty risks by mandating the creation of a new investment pool that potentially harms existing employers in the current single-asset investment pool.

Attachments

Attachment 1 – Legislative History

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