DIVESTMENT RESEARCH REPORT–

HISTORICAL ANALYSIS OF

DIVESTMENT RELATED

POLICIES AND LEGISLATIVE FRAMEWORK

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I. Executive Summary of Findings

Over recent periods, there has been a marked increase in the intersection of public policy (legislative members and public interest groups) and the investment policy at public pension systems across the country. Public policy makers are increasingly concerned about broad issues, such as global warming, alternative energy, labor practices and civil liberties that have the potential to impact markets and investment performance. In many cases, these issues are being debated in the context of public pension plan investment policy. With nearly $3 trillion in assets under management, public pension fund investment decisions theoretically can have a meaningful impact on corporate behavior.

At the same time, investment policy makers are realizing that a wide range of issues, from corporate governance to pollution, can have an impact on the performance of a company and consequently the shareholder value of companies. Pension plan fiduciaries are debating how to make sound investments and simultaneously address public policy issues.

Just in the past year, legislative efforts have mandated that public pension funds take action to engage and possibly divest from companies involved in Sudan and Iran. The current oil price crisis has generated U.S. Senate debate over legislation to curb public pension funds' investments in oil and gas futures, under the belief that such investments are contributing to speculative price increases.

These debates are not new. Since public pension funds were granted broad investment authority, and trustees assumed fiduciary status, which requires them to invest plan assets to achieve the highest possible return at an acceptable level of risk, trustees have faced investment decision-making advocated for social or geopolitical reasons.

The policy debate over divestment strategies (disposing of existing investments, not making new investments, or both), as a means to influence geopolitical or social concerns, is ongoing and unresolved. Divestment remains one of the most controversial investment strategies of all socially responsible investment policies and programs.

Some believe that divestment strategies are inconsistent with plan fiduciary duties if they adversely affect investment performance.

Many institutional investors who practice socially responsible investing believe that shareowner engagement is a better tool for effecting change than divesting or refraining from investment. Other institutions, advocates, and policymakers contend that divestment is necessary in extreme instances such as South Africa or Sudan.

This study reviews CalPERS' historical divestment and investment legislation and policy history, the literature on the costs and benefits of divestments, and surveys the current state of divestment policies among institutional investors, particularly public pension funds.

Findings

- Because of the growing number of calls for divestment over different issues, public pension funds are beginning to evolve to broad divestment policies for dealing with divestment campaigns. A few plans have adopted "**No Divestment"** board resolutions or policies.

- Policymakers' and advocates' approach to these issues have evolved. Most recent legislative initiatives prioritize engagement, and include divestment as a last resort tactic to change a company's policy that has any complicity in substantial social injury policies, including human rights violations. In general, the campaigns today are also more targeted than the South Africa divestment campaign in the 1980s. Targeted campaigns are designed to allow pension funds to participate in a divestment campaign with less diversification risk.

- Generally speaking, the narrower the restricted list of companies, the lower the investment impact on the pension plan. The historically most prominent divestment campaigns of South Africa and tobacco differ significantly from the current Sudan campaign, which, in general, proposes a more nuanced approach, including a ranked list of highest targeted companies. The current Sudan campaign offers pension funds an alternative to divesting from a significant number of large multinational companies for which comparable replacements are difficult to find. In contrast, the South Africa campaigns often targeted 150 plus companies.

- There is limited evidence that divestment programs have had any impact on the social cause they are designed to promote (by either making financing more costly, for example for tobacco companies, or causing large multinational companies to cease doing buisiness in South Africa). There is no evidence showing that the divestment campaigns had a material impact on these South Africa results, and thus no direct comparison with an alternative corporate governance path that would be available to investors who refrained from divesting but engaged targeted companies as shareholders.

Conclusion

History suggests that divestment campaigns will continue to target large public pension funds such as CalPERS. In our opinion, divesting in response to such campaigns may constitute a breach of pension trustees' fiduciary duties.

II. Introduction to Divestment Issues

A central issue that faces public pension fund decision-makers today in divestment campaigns for social or geopolitical or ethical reasons is: Who controls the investments of the assets of the pension plan – the Board of Trustees, or the legislature or other governmental body?

CalPERS' existing policies directly address who controls CalPERS Investments.

As part of the CalPERS 2007-08 Federal Legislative and Regulatory Investment Policy Guidelines, the CalPERS Board adopted a CalPERS Overarching Principle regarding independent fiduciary authority and guidelines on Fiduciary Authority. These principles are as follows:

2007-08 Federal Legislative and Regulatory Investment Policy Guidelines

Overarching Principles

- To preserve and enhance the independent fiduciary authority of institutional investors, to act for the exclusive benefit of their plan participants and beneficiaries.

Fiduciary Authority

- Support efforts to preserve the investment authority of plan trustees and administrators, and to act as independent fiduciaries on behalf of plan participants and beneficiaries.

- Oppose policies that restrict or direct investment options and decision-making such as any federally mandated investment restrictions or requirements.

- To not oppose Federal investment restrictions, provided that any restrictions be imposed consistently among all U.S. investors, in the event that the Federal government determines that an investment is not in the national interest of the United States of America.

More specifically, in November 2007, CalPERS adopted the following Federal Investment Policy which outlines the objectives of pension fund investments:

- Support the independent investment authority of CalPERS trustees and administrators, and oppose federal restrictions on investments except those determined by the government to be against the U.S. national interest;

- Sustain policies for a healthy, accessible and transparent global marketplace; and oppose those that might limit its health, transparency, or sustainability;

- Back up actions and policies aligned with goals of the Sarbanes-Oxley Act, which addresses corporate accounting misdeeds; and policies enhancing greater communication and transparency between companies and investors;

- Support efforts to better align shareowners and corporate directors; give shareowners an effective way to nominate qualified directors; afford them input on executive compensation entailing enhanced transparency on design of compensation policies, stronger linkage of performance and compensation, and

the opportunity to review compensation policies; and policies that encourage implementation of majority vote election procedures for directors; and

- Endorse policies for improved transparency and timely disclosure of environmental risks; the development of a clear, predictable national climate change policy and more energy efficient economy; and energy and transportation policies that nurture competitiveness and innovation leading to meaningful greenhouse gas reductions.

III. CalPERS' Investment and Divestment Legislation and Policy History

The California State Public Employees' Retirement System (CalPERS) was founded in 1932, 77 years ago. CalPERS wasn't granted full range to invest in stocks until 53 years later – in 1984. In 1985, the year after the retirement fund was finally granted full rights to determine its investments within its fiduciary obligations, CalPERS faced its first divestment campaign to restrict investments in certain stocks: the 1985 South Africa Divestment Act.

During the 24 years since CalPERS was granted the ability to broadly invest without legislative restrictions, CalPERS has grown to become the largest pension plan in the nation, and emerged as a global leader that thoughtfully addresses environmental, social, and governance issues in a multitude of investment programs within the context of public pension fund fiduciary duties.

During this time, the size and complexity of the CalPERS investment portfolio had grown enormously. In 1984, CalPERS had $24.5 billion in assets under management. Its asset allocation target was 50% to domestic fixed income, 40% to domestic equity (benchmarks were for large cap stocks - the S&P 500 and the Dow Jones Industrial Average), and 10% to domestic real estate.

Today, with nearly $250 billion in assets under management, CalPERS invests in a wide range of asset classes globally, and has evolved sophisticated investment programs that address non-strictly financial issues that can affect the shareholder value. These include successful corporate governance investing programs domestically and internationally, active proxy voting policies, representation on corporate boards, global principles, director nominations policy, California targeted investment programs, real estate responsible contractor and hazardous materials policies, permissible equity market policies for emerging international markets, and private equity Clean Tech and Infrastructure Programs.

Since the South Africa divestment period, CalPERS established tobacco free benchmarks and portfolios, and now, as mandated by State law, is in the process of dealing with Sudan and Iran divestment legislation. Throughout the nearly quarter century since CalPERS was first granted full investment authority, divestment tactics for social reasons have remained among the most difficult of the social responsibility strategies to reconcile with a public pension fiduciary duties.

<u>The history</u>

When the State of California was founded in 1849 (after losing a battle to become an autonomous country), the California State Constitution stipulated that state governmental bodies were not allowed to invest in stocks. This constitutional status banning investments in stocks applied to CalPERS, founded in 1932, and CalSTRS, founded in 1937. This restriction was not modified until 1956, when the state retirement systems were allowed to invest in the stocks of water utility companies - deemed essential to the welfare of the State of California.

A decade later, in 1966, California public retirement systems were allowed to invest broadly in stocks for the first time subject to legal limits. Many other states had adopted or were then adopting similar rules.. In California, the legal limits included:

- No retirement system may invest more than 25% of its assets in common stock, or more than 5% of its total assets in preferred stock;
- No system may invest more than 2% of its total assets in the common stock of any one corporation, or own more than 5% of any company's outstanding common stock shares;
- The stock must be registered on a national securities exchange;
- The company must have total assets of at least $100 million; and
- The company must meet a specified common stock dividend history

In 1984, following federal law (ERISA), the California voters amended the public pension fund investments section of the State Constitution to remove investment restrictions on pension funds and to substitute provisions allowing the Legislature to authorize: any "investment of moneys" by such systems; declaring the assets of such systems to be trust funds held for the exclusive purposes of providing benefits to participants and their beneficiaries and defraying reasonable expenses, and imposing "fiduciary duties" on each system's board to act as a "prudent person." The amendment's expressed purpose was to maximize the return on the investment of the assets in question while minimizing risk, and also to prevent raids on those assets.

A year later, in 1985, the South Africa Divestment Act was attached to the State budget to direct State retirement systems to divest from companies doing business in South Africa. Adhering to the law, CalPERS began to divest from companies doing business in South Africa in 1986. This divestment program ended in 1994 after the South Africa Apartheid regime voluntarily ceded power. In 1993, de Klerk, the apartheid leader, and Nelson Mandela, the African National Congress leader, were jointly awarded the Nobel Peace Prize for their work for the peaceful termination of the apartheid regime.

The latest major revision to the state constitution regarding pension fund investments came in 1992. In response to "actions by the Governor and Legislature to balance the state budget by limiting or delaying the state's employer contributions to the Public Employees' Retirement System," the voters amended the Constitution to its present form. Section 17 of the State Constitution now gives the board of each public pension or retirement system "plenary authority" to administer the system's assets and "sole and exclusive power" over the actuarial function. Article XVI of the California Constitution, Section 17 (g), states, "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 pursuant to this section." In addition, Article XVI, Section 17 (b) provides, "The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty." Because the South Africa Divestment Act was on the books, it is unclear whether this provision merely permits that legislation to remain in effect or whether it authorizes future legilsation.

Since 1992, three prominent divestiture laws have been introduced in the state to support social issues – tobacco free, Sudan and Iran. CalPERS opposed or remained neutral on all three

divestment legislative mandates. In addition, legislative mandates have been enacted to report on investments in areas related to the Holocaust survivors and Northern Ireland (McBride Principles).

First, tobacco free legislation was introduced in the late 1990s. CalPERS opposed the legislated mandate. The California tobacco free legislation failed to pass. After financial reviews, in 2000, the CalPERS Board launched an investment program in which tobacco was removed from the benchmark that remains in place today.

California's next major divestment-related legislation involved Sudan in 2007, followed in the same year by Iran. CalPERS did not oppose or support the Sudan legislation, and worked actively with lawmakers to ensure that the legislation emphasized shareholder engagement first before considering any possible divestment. The CalPERS Board opposed the Iran legislative effort. Both bills passed. Neither law requires divestment to the extent that it would breach fiduciary duties. Calpers is now is now dealing with those laws.

Today, CalPERS' activities regarding divestment, refraining from investing, or monitoring of investments for social-geopolitical issues include the following.

Divestment and Social Issue Related Reporting Activities

1) Holocaust Era and Northern Ireland Report to Legislature (1999). Statutes of 1999 require CalPERS to monitor and annually report on investment holdings in companies and their affiliates that do business in California and that owe compensation to victims of slave or forced labor during World War II, and to require CalPERS to investigate and annually submit a report to the Legislature on the extent to which U.S. and international corporations operating in Northern Ireland, in which CalPERS assets are invested, are adhering to the principles of nondiscrimination in employment and freedom of workplace opportunity in compliance with the laws of Northern Ireland.

2) Tobacco free program (2000). Based on a full financial analysis, in 2000, and continuing through today, the CalPERS Board adopted tobacco-free indices and benchmarks for publicly held securities. Staff began to implement tobacco free benchmarks and tobacco company divestment in 2000.

3) Emerging Equity Markets Principles (Updated Policy-2007). The strategic objective is to delineate a principles-based approach to investing in emerging equity markets by CalPERS to control risk and enhance return, and to improve practices in emerging markets. External managers are responsible for country and stock selection in accordance with the Policy and their guidelines, and for reporting annually to CalPERS on the application of the Principles to the emerging markets portfolio managed for CalPERS. The Principles include:
    a. Political Stability
    b. Transparency
    c. Productive Labor Practices
    d. Corporate Social Responsibility and Long-term Sustainability
    e. Market Regulation and Liquidity
    f. Capital Market Openness
    g. Settlement Proficiency/Transaction Costs
    h. Appropriate Disclosure on environmental, social, and corporate governance issues.

IV. Costs and Benefits of Divestment and Benchmark Modification Programs

Over the years, numerous studies have sought to quantify the financial impact of divestment campaigns on the pension plans engaged in them. On the whole, the empirical studies support theoretical models that suggest that narrowing the universe of securities may have a negative impact on the portfolio in the near term, due to the direct costs of divestment including commission costs, market impact costs, and due to the opportunity cost of the portfolio being constrained and stocks being excluded from the universe of investment opportunities. Over the longer term, restricting a portfolio for non-financial reasons would therefore be expected to reduce the risk-adjusted return of the portfolio as compared to a non-restricted portfolio.

Our research suggests that divestment programs have, in general, had a negative risk-adjusted return on the plan. However, there have been instances when a plan has financially benefited from a given divestment, due to the timing of their particular divestment.

A second question addressed in the literature is whether divestment campaigns provide the non-financial benefit of furthering whatever social cause they were designed to support. Studies suggest that the measurable financial impact on the companies targeted for divestment has been largely minimal. There is some weak evidence that there was a financial improvement in the stock price of companies who subsequently exited the country in question, and some evidence that the tobacco-free portfolios of many large institutions has made financing more expensive for tobacco companies.

In this section, we review some of the literature produced over the decades. We begin with the South Africa divestment campaign.

<u>South Africa Divestment Studies</u>

The first widespread divestment campaign after public pension plan fiduciaries were granted broad investment discretion was aimed at companies that did business in South Africa. Many states directed their retirement systems to purge themselves of investments in such companies in the 1980s. The early research into portfolios constrained for social/ethical reasons related to portfolios constrained by South Africa exclusions.

Rudd (1979) looked at the avoidance of 177 United States S&P companies operating in South Africa (42% of the S&P market value). This list of stocks was then optimized to form a portfolio that matched the S&P 500 as closely as possible. Rudd found that the effect on portfolio risk of excluding the companies operating in South Africa was not particularly meaningful. He derived a formula which related the increase in ‘units of volatility’ (square of the annual standard deviation or tracking error) to expected loss. The general result was 0.0075% for every unit of volatility. He found that while there is some increase in risk, it should not be prohibitively significant unless a very large number of stocks are excluded. Rudd calculated that a loss of 0.03% a year might be expected based on an increased annual tracking error of 2-3%.

Loeb (1983) presents evidence that trading costs are significantly higher for midcap stocks than for large cap stocks for large block trades. Therefore, operating under conditions which restrict a significant number of large capitalization stocks, managers cannot maximize portfolio returns and must settle for some ‘optimized’ return within the given constraints.

A seminal article on the South Africa campaign by Wagner, Emkin and Dixon (1984) examined the effects of divesting from 152 companies in the S&P 500 with South African links. They

replaced each targeted company with the largest company available in the same industry. The returns for these companies were examined over the five-year period ending in the first quarter of 1984.

Wagner, Emkin and Dixon found a difference of over 7% in the annual rate of return of the 152 company South Africa free portfolio below the replacement 152 companies. The rates of return were higher for the non-South African linked companies than for the South African linked companies, a possible smaller company effect. They then looked at the increase in risk using the portfolio's beta and R-squared. The beta measures sensitivity to changes in the overall market or volatility. The R-squared measures the degree of diversification in comparison to the market benchmark. An actively managed portfolio with a bias towards favored stocks and sectors would be less diversified than the market and have an R-squared below the market. The market, as measured by the S&P 500, has a beta and R-squared of 1.0.

Wagner "et al" found that the non-South Africa linked universe was very well diversified with an R-squared of 0.968 but that it was riskier than the market, having a beta of 1.08. The overall conclusion of the study is that divestment restrictions may have a substantial impact on the investment management activities of large portfolios. Wagner "et al" conclude that "In general, the restrictions will increase investment risk, reduce investment and diversification opportunities, and increase the costs of research, trading and administration. And the larger the fund, the greater the impact will be."

Love (1985) estimated the one-time divestiture cost at 1.3% or $13 million per $1 billion portfolio. Ennis and Parkhil (1986) estimated a cost of $15 million per $1 billion for an unqualified divestment. Ongoing costs to monitor firms' actions toward South Africa are not captured in these studies, and would be in addition to those mentioned.

Teoh, Welch and Waazan (1999) examine the effect of the shareholder boycott of South Africa's apartheid regime. They find that for all the visibility associated with the boycott, there was little discernible effect either on the valuations of banks and corporations with South African operations or on the South African financial markets, because corporate involvement in South Africa was relatively small. They do find some weak evidence that institutional shareholdings in corporations with South African investments increased when those corporations divested from South Africa.

CalPERS divestment from companies doing business in South Africa began in January 1987 and ended in 1994. CalPERS estimates that there were $529 million in financial losses to the fund attributable to this divestment action, including commission costs, market impact and opportunity costs for the entire divestment period. In May, 2007, Wilshire estimated that if those $529 million in foregone funds would have earned the overall rate of return of the fund during all subsequent periods, the total impact of CalPERS' South Africa divestment as of December 31, 2006 would be $1.86 billion. This cost includes all applicable and appropriate costs (actual transaction costs, market impact and opportunity costs) since the original divestment in 1987.

Another example of a state retirement system South Africa divestment program is that of the State of New Jersey Division of Investment. New Jersey began divesting from companies doing business in South Africa as mandated by New Jersey State law in August 1985, and completed its divestment program in August 1988, having sold or otherwise disposed of $4.2 billion in targeted securities. The November 1988 report to the New Jersey State Legislature concludes that the program cost the fund, after initial transaction costs estimated at $44 million, opportunity costs considerably in excess of the original $25 million annual cost estimate. The report states that although market access has been improved in recent months by the withdrawal from South Africa of several large international companies, including IBM, Exxon,

Kodak and Merck, the aggregate equity market access of the South Africa-free universe available to the Division was $1.07 billion vs. $1.56 billion for the previously available universe. They conclude, “However, the effects to date are modest when viewed in the context of the size of the pension fund portfolios ($19.9 billion at market value on August 31, 1988).” The report is qualified with the statement: “the period covered is only three years, and the respective returns and markets for targeted and non-targeted securities will change over time”.

In sum, the literature on the largest country-specific divestment campaign ever conducted generally shows that in absolute terms it caused material costs and materially impaired investment performance.

The contribution of the broad divestment campaign to public pressure on the South African Apartheid government is not measurable. Proponents argue that such strong measures contributed greatly to the eventual demise of Apartheid, including encouraging large multinational companies to cease business operations with South Africa under the Apartheid regime. At the time, many plans concluded that although their South Africa divestment program imposed a financial cost to their pension plan, that cost was de minimis in relation to the total assets of the fund. Opponents contend that divestment took away large shareholders’ ability to influence the companies with operations in South Africa without having any meaningful impact on those companies’ financial situation.

Studies on Tobacco and other ‘Sin’ Stocks

A range of academic studies have been conducted on ‘sin stocks,’ which typically include companies involved in producing tobacco, alcohol and gaming products. In contrast to the South Africa campaign, which included many state legislative mandates to divest, campaigns to divest from tobacco holdings have often gone forward in the absence of legislative mandates.

A 1999 review by EIRIS on ethical investing summarizes prior studies on tobacco. Kahn ”et al” looked at the outperformance of tobacco stocks compared to the S&P 500. Over the 10-year period 1987-1996 the S&P Ex-tobacco index underperformed by 0.21% in terms of total return and the tracking error (standard deviation of the relative return) was 0.46. Kahn ”et al” looked at reducing this risk by replacing tobacco with some of the highly correlated industries, and found that it was possible to reduce tracking error to 0.42 from 0.46. Their general conclusions were that: tobacco divestiture doesn’t stand up as an investment decision and that it doesn’t reduce risk in the typical pension fund context.

A 1997 study by Guerard showed that the use of a) environmental, b) alcohol, tobacco & gambling, c) military and d) nuclear screens produces portfolios with higher excess returns than those from unscreened portfolios and tobacco-free portfolios for the period 1987-1996. Guerard found that the only social screen that consistently cost the investor returns is the military screen for the 1992-1997 period. Guerard concluded that there were no statistically significant differences between the average returns of a socially screened and an unscreened universe during the period 1987-1996.

A recent, and perhaps to date, most comprehensive study on tobacco and other “sin” stocks was conducted by Hong and Kacperczyk (Recent Draft-April 2008). Hong ”et al” hypothesize that there is a societal norm against funding operations that promote vice and that some investors, particularly institutions subject to norms, pay a financial cost in abstaining from these stocks. Consistent with this hypothesis, Hong and Kacperczyk find that sin stocks are less held by norm-constrained institutions, such as pension plans as compared to mutual or hedge funds that are natural arbitragers, and that sin stocks receive less coverage from analysts than stocks of otherwise comparable characteristics. Sin stocks also have higher expected returns than

otherwise comparable stocks, consistent with them being neglected by norm-constrained investors and facing greater litigation risk heightened by social norms.

Hong ”et al” find that about 28% of the shares of sin stock comparables on average are held by institutions, in contrast to about 23% for sin stocks, and 18% lower institutional shareholding.

They hypothesize that sin stock prices should be depressed relative to their fundamental values because of limited risk sharing and hence sin stocks should have higher expected returns than comparables. Second, because of neglect or limited risk sharing, the increased litigation risk associated with the products of sin companies, which is further heightened by social norms, should further increase the expected returns of sin stocks.

Using time-series regressions during the period of 1965-2006, they find that a portfolio that holds sin stocks and has short positions on their comparables has a return of 26 basis points per month. Second, using cross-sectional regressions controlling for firm characteristics (data from 1965-2006) they find that sin stocks outperform their comparables by 29 basis points a month- a statistically and economically significant and sizeable magnitude – even after accounting for well-known determinants of expected returns in cross-sectional regressions such as market size, past return, and market-to-book ratio.

They further validate their findings by looking at the fluctuation over time of tobacco stocks and the variation in the social norms governing tobacco over time. The key prediction is that tobacco stocks should under-perform over the period of the late 1940’s (when anecdotal evidence suggested the change in norms with previous reports about health in the late 1940s) until the mid-1960’s, when US government officially recognized that tobacco posed a health risk and imposed many restrictions. The study finds that tobacco under-performed the market by a significant 3% a year, or something on the order of 40% over the period 1947-1965. Post-1965, sin stocks, including tobacco outperformed. Hong conclude that "some investors, particularly institutions subject to public scrutiny and social norms, pay a financial price for not holding these stocks."

In 2000, the CalPERS Board voted to implement tobacco free benchmarks and indices and divest from passively-managed tobacco stocks and bonds. This decision was based on a portfolio risk-return analysis, including a review of the litigation, regulatory, and reputational risks that could affect the long term sustainability of the tobacco industry. In December 2000, CalPERS became the fifth state employee retirement system to divest from tobacco stocks. The divestment program was complete by February 2002. A total market value of $0.74 billion of tobacco securities were sold by CalPERS and external passive managers. These transactions incurred a total commission cost of $620,000 and a total market impact cost of $790 million. The opportunity cost through June 2006 is estimated at $650 million.

CalSTRS initiated an ex-tobacco modified benchmark in June 2000. Under the CalSTRS program, active investment managers are not prohibited from buying equity or debt of tobacco companies. However, since these securities are not in their performance benchmark, ownership of these companies may be a significant bet away from their “home base” benchmark. The CalSTRS semi-annual review of the Benchmark modification policy states that the “practical result of the Policy is that our external managers avoid these securities.” Since inception, through December 2006, the modified benchmarks for both the U.S. and non-U.S. equity markets have underperformed. The opportunity cost of not investing in stocks issued by tobacco companies has been approximately $640 million in the U.S. equity portfolio and $310 million in the non-U.S. equity asset class, and a minor cost of $0.5 million in Fixed Income over the past six and one half years. The CalSTRS total tobacco-free opportunity cost is now estimated at $1 billion.

Florida SBA divested from tobacco in June 1997, at which time the state of Florida had lawsuits filed against the tobacco companies. The Florida Retirement Plan lifted its tobacco investment ban three years later when a new Administration and new set of Trustees determined that the litigation risk hanging over tobacco was largely over. The plan estimated its direct investment loss from deleting 16 stocks, including the transaction costs at $482 million.

The general conclusion from the literature and experience with the widest industry-related divestment campaign among public pension plans suggests that the tobacco free campaign has burdened plans that have divested with an opportunity cost that has become meaningful. The literature on the impact on the tobacco companies suggests that the broad institutional tobacco free campaign may have increased the financial costs to tobacco companies somewhat. In general, it is strongly debated whether divestment has generated the social benefit that it was intended to generate. The fund performance results have been on the whole negative, both for divestment plans, and for plans that introduced benchmark modification plans without explicitly dictating that their investment managers divest.

Sudan

The Sudan divestment campaign began in 2003 and is the largest country-specific divestment campaign since South Africa two decades ago. The campaign generally differs markedly from predecessor divestment campaigns in the accommodation to the fiduciary constraints on divestment of pension plans. As a result, the Sudan divestment model being generally deployed today is less expansive and intrusive for investors than were the South Africa divestment efforts. South Africa targeted a wide range of companies, including roughly 1/3 of the companies in the S&P 500 (with the S&P 500 representing a major portion of investor stock portfolios at the time). In contrast, the targeted Sudan divestment model entails less than thirty problematic companies, none of which are on the S&P 500 (or any other U.S. predominant index). U.S. law prohibits most U.S. multinational companies from engaging in trade and foreign investment with Sudan. (Exceptions are made for some firms in the agriculture and health care sectors that receive a license from the U.S. Department of the Treasury to do business in Sudan.) However, U.S. law does not prohibit companies, institutions, or individuals from investing in foreign multinationals that operate in or sell to Sudan. The Sudan divestment efforts focus solely on foreign multinational companies.

The targeted approach to Sudan divestment has not been universal. Adopting a broad inclusive target list was a major problem at the Teachers Retirement System of Illinois (TRSI), a $30 billion pension system. The Illinois legislature passed a Sudan divestment law that utilizes a very broad definition for companies doing business with Sudan. As a result, it was expected that TRSI would have to divest $3.3 billion to restructure its overall portfolio. In addition, Illinois law requirements may preclude TRSI from investing in numerous private equity vehicles. For example, the Texas Pacific Group, one of the world's leading private equity investors and a firm TRSI has done business with, indicated that it would no longer accept TRSI capital. At the other end of the spectrum, Stanford University approved a narrow divestment focus list of only four companies.

The SDTF 2008 Peer Performance Review finds that "evidence from states that have already adopted highly targeted Sudan divestment programs or policies suggests that only minimal percentages of an investment portfolio will be affected." None of the U.S. public pension plans that have adopted the targeted model held over 0.3% of their assets in problematic companies. Most have held less than 0.1%.The report also finds that "Recent data supports the hypothesis that targeted Sudan divestment may be a sound financial decision. The May 2008 report finds that on average the 'Highest Offenders:' in Sudan underperformed their peer group average by

45.97% over one year, 22.2% over three years, and 7.22% over five years. Forecasted return on equity for 'Highest Offenders' was on average 6.06% less than the peer group mean."

The median returns for "Highest Offenders" in Sudan underperformed their peer group median by 1.09% over 1 year, 16.07% over three years, and 3.3% over five years. The underperformance of the "Highest Offenders" in Sudan corresponds with the rise of the Sudan divestment movement, which began in 2005 and gained significant momentum at the start of 2007. It should be noted that these costs do not reflect transaction costs associated with divestment.

The Sudan divestment campaign is in its early years. For this brief time period, this campaign appears to have managed the fiduciary issues and financial impact in a much more targeted, and narrow manner than its major country targeted divestment campaign predecessor--South Africa. Because of the relatively narrow targeting, the financial impact on the plans that have divested has been de minimis to date. This does not include estimates based on a universe of all targeted plans including those that have not divested, which is most of the U.S. pension fund universe. The Sudan divestment campaign also contrasts with the most significant industry divestment campaign – tobacco. Like South Africa, the tobacco campaign targeted a wider segment of the large cap market, which, during various time periods, included relatively highly profitable stocks, thus resulting in a long-term loss to larger pension funds.

Costs and Benefits Summary Findings

In this review of the costs and benefits of divestment programs, we found that the divestment campaigns have generally incurred a financial burden to the fund, or been a zero benefit. However, the literature does have some evidence of a de minimus financial impact of divestment campaigns. The initial Sudan campaign efforts appear to show that the financial impact on plans that have divested has been de minimis, and divesting may have in the near term improved the returns relative to a non-Sudan-free portfolio. This is based both on SDTF reports and drawn from direct discussion with a small handful of funds that have divested. In each of the latter cases the pension funds, happened to only divest one to four stocks of "highest offenders" and only from separate accounts, leaving all stocks in comingled funds untouched. CalPERS own study showed 10s of millions of dollars in transaction costs alone for the CalPERS portfolio to divest and reinvest its Sudan-related stocks. Because the Sudan costs and benefits analysis is primarily based on SDTF reports (a divestment campaign advocate organization), in our opinion the broad conclusions on Sudan impact should only be taken as one indicator, rather than as a complete, independent analysis.

A key conclusion is that the narrower the restricted list of companies, the lower the financial impact on the pension plan. The historically most prominent divestment campaigns of South Africa and Tobacco differ significantly from the recent Sudan campaign which in general offered a more nuanced approach, including a ranked list of highest offenders that offers pension funds an alternative to divesting from a significant number of large multinational companies, for which comparable replacements are difficult to find. The campaign, and many state laws, including California's, emphasize constructive engagement as the most powerful tool investors can use to effect change at portfolio companies, and include divestment as a last resort. The South Africa campaign typically targeted 150 plus companies. Tobacco divestment programs have varied but typically target a broad segment of the tobacco industry. Differentiation has included, for example, specifying consumer tobacco companies as in CalPERS' program, but generally tobacco free programs are not currently aimed at ranking tobacco companies into a 'highest offenders' list similar to the Sudan approach.

Second, much of the literature and policy discussions raise concern that the 'slippery slope' that divesting for one non-financial cause opens the door to pension funds being urged to divest for

multiple social/geopolitical causes. We have not found case studies that attempt to aggregate the impact of different divestment or stock restriction campaigns that may be in place simultaneously at a single pension plan.

Third, some evidence suggests that the divestment programs have helped support the social cause they are designed to promote by either making financing more costly, for example, for tobacco companies, or by causing large multinational companies to stop doing business in South Africa. There is no direct evidence showing that the divestment campaigns were critical bringing an end to Apartheid, and thus no direct comparison with an alternative corporate governance path that would be available to investors who refrained from divesting from targeted companies.

V. Review of Institutional Investors' Approaches to Divestment

In this section, we present the results of our findings on the prevalence of various types of divestment policies in place today at U.S. public pension plans. As shown in the list below, among the 28 large U.S. public pension plans on which we have divestment policy information it is:

1. Very common to have a policy, or program/strategy to divest from Sudan and Iran, as a last resort after constructive engagement, and from typically only from companies deemed "highest offenders."

2. Less common to have a tobacco free policy/program to divest from, restrict, or manage tobacco-free benchmarks.

3. Uncommon to have an overarching policy that sets forth a process to address divestment issues whenever they arise. Most of these have been modeled after the CalSTRS policy and adopted in the 2007-2008 timeframe.

4. Rare that a plan has a general no-divestment policy or resolution.

However, it is important to note that these policies are usually not voluntarily implemented by the fund, but rather have been mandated.

Divestment Related Policies of Sample Large U.S. Public Pension Plans

Public Plan	Overarching Procedural Policy for addressing divestment issues	Generic No divestment Resolution/ Policy	Plan has a Tobacco Divestment Strategy and/or Policy in Place	Plan has a Sudan and/or Iran Divestment Strategy and/or Policy in Place
Arkansas Teacher Retirement System				Yes
Arizona				Yes
CalSTRS	X		Benchmark Modification	Yes
CalPERS			Benchmark Modification and Divest	Yes
Public Employees' Retirement Association of Colorado				Yes
Colorado Fire and Police Pension Association				Yes
Connecticut				Yes
Delaware Public Employees' Retirement System		X		--
Denver Employees Retirement Plan				Yes
Florida Retirement System			Yes (3yrs)	Yes
Employees' Retirement System of the State of Hawaii				Yes
Indiana				Yes
Illinois State Board of Investment				Yes
Iowa Public Employees' Retirement System		X		Yes
Los Angeles City Employees' Retirement Plan	X			Yes
Los Angeles County Employees' Retirement Association			Non-Tobacco Preference Policy	Non-Sudan Preference Policy
Los Angeles Dept. of Water and Power	X			Yes
Maine				Yes
Los Angeles Fire and Police Pension Plan	X			Yes
State Retirement and Pension System of Maryland				Yes
Massachusetts Public Retirement Investment Mgt Trust			Yes	Yes
Minnesota State Board of Investment			Yes	Yes
Missouri				Yes
New Jersey				Yes
New Mexico				Yes
New York City Employees Retirement System			Froze Indexed	Yes
New York State Common Fund			Froze Actively mgd Holdings	Yes
New York State Teachers' Retirement			Underweighted	Yes
North Carolina				Yes
School Employees Retirement System of Ohio				Yes
Ohio Public Employees Retirement System				Yes
Oregon				Yes
Rhode Island				Yes
South Carolina				Yes
TIAA-CREF		X		--
Texas				Yes
Washington State Investment Board				Yes
State of Wisconsin Investment Board				Yes
Vermont Pension Investment Committee			Yes	Yes

Sudan-Related Divestment Policies or Programs

To date, 25 states have adopted divestment policies from Sudan. A central origination in the Sudan campaign is the Sudan Divestment Task Force (SDTF). Seventeen of these states have passed the SDTF Force model of targeted Sudan divestment: Arizona, California, Colorado, Florida, Hawaii, Indiana, Iowa, Kansas, Massachusetts, Minnesota, New Mexico, New York, North Carolina, Rhode Island, South Carolina, Texas, and Vermont. Eight of these states have developed state specific methods of Sudan divestment: Arkansas, Connecticut, Illinois, Maine, Maryland, Missouri, New Jersey and Oregon. Additionally, LACERA adopted a non-Sudan Preference Policy that does not mandate divestment.

The SDTF's Divestment Resource Guide (March 2008) summarizes key aspects that distinguish the Sudan campaign for fiduciaries as set forth below. The following aspects of the targeted Sudan divestment model may lessen its adverse impact on investments (although it is important to note that there are still outstanding fiduciary issues from CalPERS' perspective):

1) Limited scale of divestment: The SDTF list of "Highest Offenders" in Sudan represents a minute fraction of total holdings (under one-third of one percent of total assets) to every state implementing the targeted Sudan divestment model. No state or investor implementing targeted Sudan divestment has reported that divestment has affected portfolio performance adversely.
2) Minimal implementation costs: All resources and pertinent information needed to carry out the research, engagement, and reporting provisions of the targeted Sudan divestment model are available free of charge from SDTF or for a reasonable price from third-party research firms, thereby minimizing administrative burdens.
3) Potential to change company behavior through engagement first: The targeted Sudan divestment model requires that fiduciaries try to change company behavior through a brief engagement process before divesting. This creates the potential to avoid divestment altogether if the company is responsive. Several companies previously classified as "Highest Offenders" in Sudan have already been removed from divestment consideration because shareholder engagement led to a change in company behavior.
4) Special treatment for certain: hard-to-divest asset classes: The targeted Sudan divestment model precludes from immediate divestment certain types of investments that are difficult to divest from, such as mutual funds and private equity funds. Fiduciaries are required only to ask asset managers to provide Sudan-free versions of such funds and to move into them once they become available, provided that such a transition is deemed to be financially prudent.
5) Long sell-off period to allow strategic planning: The model provides fiduciaries with a 15 month period to complete the sell-off of problematic companies unresponsive to engagement, thereby allowing fiduciaries to be strategic about the sale, as well as the purchase of replacement investments.
6) Opportunity costs involved in investing in "Highest Offenders" in Sudan: The SDTF Sudan Peer Performance Analysis (May 2008) found that, on average, "Highest Offenders" in Sudan underperformed their peer group by 45.97% over one year, and 7.22% over five years. Forecasted return on equity for "Highest Offenders" in Sudan (based on analyst consensus) was on average 6.06% less than the peer group mean.
7) Recent federal legislation affirming targeted Sudan divestment falls within ERISA standards: Section five of the Sudan Accountability and Divestment Act affirm the right of ERISA plans to divest from Sudan without violating ERISA as long as investment policy change is executed in accordance with ERISA and Department of Labor guidelines. This provides helpful guidance to vast majority of public pension plans, which are bound by similar principles, because it prohibits divestment if it is expected to adversely effect investment performance in any way, taking transaction costs into account.

The SDTF reports that some plans have adopted targeted Sudan divestment without a legislative mandate; having made the determination that targeted Sudan divestment is consistent with fiduciary duty. These plans include the Arkansas Teachers Retirement System, Colorado Public Employees' Retirement Association, New Mexico Educational Retirement Fund, New Mexico State Investment Council, New York State Common Retirement Fund, Pennsylvania State Treasury and the Vermont Public Investment Committee."

In general most Sudan-related policies do not require divestment if no comparable alternative can be found. Most Sudan-related policies exclude commingled funds and private equity from divestment. We have included a number of samples in Appendix I below.

Tobacco-free policy and programs

Ten plans among those included in this review have adopted tobacco-free programs at some point in time. These programs vary in approach and include:

1) non-tobacco preference policy, that does not dictate divestment
2) benchmark modification that does not dictate divestment
3) freeze investment (refrain from new investment) in passively managed accounts
4) freeze investment (refrain from new investment) in actively managed accounts
5) underweight tobacco stocks
6) divestment along with benchmark modification
7) divestment without benchmark modification

General No-Divestment Resolution or Policy

We identified two public pension plans, and the Teachers Insurance and Annuity Associate-College Retirement Equities Funds (TIAA-CREF) that have established no-divestment policies.

Delaware, which has not divested in any of the campaigns from South Africa, through Tobacco, to Sudan and Iran, and has not been mandated to do so by Delaware state law, recently adopted a Board Resolution stating the trustees' position on whether divestment would breach the trustees' fiduciary duty: "Therefore, be it resolved, for the above reasons, the Board opposes any mandated divestment effort that would either implicitly or explicitly, attempt to direct or influence the Board or engage in investment activities that violate and breach the Trustees' fiduciary responsibility."

Iowa, which is mandated by state law to divest from Sudan, has adopted a general divestment policy statement that states: "As fiduciaries, the IPERS Investment Board, Staff and investment managers must perform their duties for the exclusive benefit and in the best economic interest of the System's members and beneficiaries. The System and Board will not support investment policies or strategies which seek to promote specific social issues or agendas through investment or divestment of IPERS' assets. To act otherwise could be construed as a violation of fiduciary duty and could endanger the System's tax-exempt status."

TIAA-CREF's recently adopted divestment policy emphasizes the positive aspects of engagement: "TIAA-CREF is committed to engagement with companies rather than divestment of their securities. This policy is a matter of principle that is based on several considerations (i) divestment would eliminate our standing and rights as a shareholder and foreclose further engagement; (ii) divestment would be likely to have negligible impact on portfolio companies or the market; (iii) divestment could result in increased costs and short-term losses; and (iv) divestment could compromise our investment strategies and negatively affect our performance. In addition, divestment is not an option in segments of our portfolio that track market indices, as we are required to invest in all companies included in an index. For these reasons, we believe

that divestment does not offer TIAA-CREF an optimal strategy for changing the policies and practices of portfolio companies, nor is it the best means to produce long-term value for our participants.

As a matter of general policy, TIAA-CREF's trustees and its Asset Management Group may consider divesting or underweighting a company's stock from actively managed accounts in cases where they conclude that the financial or reputation risks from a company's policies or activities are so great that continued ownership of its stock is no longer prudent.

Divestment Process Policies

CalSTRS Investment Policy Regarding Geopolitical and Social Risks sets forth a process for engagement and possible divestment in the event that a given company violates the CalSTRS Geopolitical and Social Risks and/or is identified by the federal government as a country in which there is Government supported genocide. In light of the recent Sudan and Iran divestment campaigns, more plans are beginning to adopt overarching divestment policies. These include LACERS, LAFPP and LA WPERP which are modeled generally on the CalSTRS policy. The Stanford University Endowment is another example of an institutional investor that has developed a divestment process policy.

Policy Review Summary

In this study, we found most public pension plans currently have no general policy statement governing non-financial related divestment programs. Many plans have grappled with each divestment campaign issue on a program level as it has arisen. In some cases, plans have policy statements related to a specific divestment campaign, such as Sudan. Many of these are geared toward implementation of a state-mandated law requiring some level of divestment or restriction on investments.

We also find that with the rise of recent divestment campaigns concerning Sudan and Iran, public pension plans are beginning to adopt broader, process-oriented policies to address divestment campaigns on any issue when they should arise.

Related to divestment policies, CalPERS and other large public pension funds have evolved policies such as the CalPERS Emerging Equity Markets Policy that does not specifically address divestment, but provides a framework for CalPERS' emerging market investment managers to consider a wide range of social, political, environmental and event risks when making investment decisions on behalf of CalPERS. Similarly, CalPERS activism on corporate governance issues, such as executive pay practices, director accountability, and shareowner rights have been found to add significant economic valuce to CalPERS, in addition to providing a positive market impact by influencing publicly traded companies to adopt good governance principles.

VI. Conclusions

The legal framework governing pension funds has evolved to grant full fiduciary responsibility for investments to pension trustees over the last few decades. Meanwhile, divestment campaigns, and the related policies and state laws mandating divestment have become more sophisticated such that they more often than not prioritize engagement and include divestment as a last resort tactic in changing a company's policy. In general, the campaigns today are also more targeted than the South Africa divestment campaign, which allows pension funds to participate with significantly lower diversification risk.

The central challenge for fiduciaries nevertheless remains the same: will divestment legislation or policy, based at least in part on social considerations violate fiduciary duties? Because it is clear that constraining nivesgtments for non-financial reasons generally reduces risk-adjusted returns, the critical divestment issue is how much of an adverse financial impact, if any, do fiduciary principles permit plan fiduciaries to incur to promote social goals.

Today, most institutional investors address divestment issues individually outside of any broad explicit policy on divestment. Given the expectation that large institutions will continue to face calls for divestment for social issues, institutional divestment policies are just beginning to evolve to broad umbrella type policies to set forth a process for review of any such divestment campaigns brought to a pension fund.

History suggests that divestment campaigns will continue to target large public pension funds such as CalPERS. In our opinion, divesting in response to such campaigns may constitute a breach of pension trustees fiduciary duties. We believe there is a legitimate policy debate over whether divestment strategies are appropriate tools for public pension fund policy makers. At this juncture in time, PCA believes that it is appropriate to consider adopting an overarching investment policy framework on divestment.

APPENDIX 1. DIVESTMENT POLICIES OF PUBLIC PENSION FUNDS

Appendix 1 provides examples of institutional investor polices, particularly public pension funds regarding divestment. We begin with the rare overarching policies and resolutions on divestment. These are followed by a number of examples of divestment-campaign specific policies from public pension plans around the nation.

Delaware Public Employees' Retirement System

Delaware PERS has never divested in any campaign, from South Africa, Tobacco, or other. The State did not pass legislation forcing divestment from Sudan or Iran. In this context, the DPERS Board passed the following resolution. "Therefore, be it resolved, for the above reasons, the Board opposes any mandated divestment effort that would either implicitly or explicitly, attempt to direct or influence the Board or engage in investment activities that violate and breach the Trustees' fiduciary responsibility."

Iowa Public Employees' Retirement System (IPERS)

General Policy Statement: As fiduciaries, the IPERS Investment Board, Staff and investment managers must perform their duties for the exclusive benefit and in the best economic interest of the System's members and beneficiaries. The System and Board will not support investment policies or strategies which seek to promote specific social issues or agendas through investment or divestment of IPERS' assets. To act otherwise could be construed as a violation of fiduciary duty and could endanger the System's tax-exempt status.

TIAA-CREF

TIAA-CREF, the Teachers Insurance and Annuity Associate-College Retirement Equities Funds, has developed an overarching corporate governance policy which is currently in its fifth iteration. The policy statement includes four segments in its corporate governance program:

A. Engagement Policies and Practices
B. Proxy Voting
C. Influencing Public Policy and Regulation, and
D. Divestment.

The TIAA-CREF policy statement on Divestment is as follows:

TIAA-CREF is committed to engagement with companies rather than divestment of their securities. This policy is a matter of principle that is based on several considerations (i) divestment would eliminate our standing and rights as a shareholder and foreclose further engagement; (ii) divestment would be likely to have negligible impact on portfolio companies or the market; (iii) divestment could result in increased costs and short-term losses; and (iv) divestment could compromise our investment strategies and negatively affect our performance. In addition, divestment is not an option in segments of our portfolio that track market indices, as we are required to invest in all companies included in an index. For these reasons, we believe that divestment does not offer TIAA-CREF an optimal strategy for changes in the policies and practices of portfolio companies, nor is it the best means to produce long-term value for our participants.

As a matter of general policy, TIAA-CREF's trustees and its Asset Management Group may consider divesting or underweighting a company's stock from actively managed accounts in cases where they conclude that the financial or reputation risks from a company's policies or activities are so great that continued ownership of its stock is no longer prudent.

California State Teachers' Retirement System (CalSTRS)

CALSTRS Investment Policy for Mitigating Environmental, Social, and Geopolitial Risks (ESG)

PRINCIPLES

The fiduciary responsibility of the Board, as described in detail within the overall Investment Policy and Management Plan, is to discharge its responsibility in the sole and exclusive interest of the participants and beneficiaries in a manner that will assure the prompt delivery of benefits and related services.

CalSTRS invests a multi-billion dollar fund in a unique and complex social-economic milieu and recognizes it can neither operate nor invest in a vacuum. The System's investment activities impact other facets of the economy and the globe. As a significant investor with a very long-term investment horizon and expected life, the success of CalSTRS is linked to global economic growth and prosperity. Actions and activities that detract from the likelihood and potential of global growth are not in the long-term interests of the Fund. Therefore, consideration of environmental, social, and governance issues (ESG), as outlined by the CalSTRS 20 Risk Factors, are consistent with the Board fiduciary duties.

Consistent with its fiduciary responsibilities to our members, the Board has a social and ethical obligation to require that the corporations and entities in which securities are held meet a high standard of conduct and strive for sustainability in their operations. As an active owner, CalSTRS incorporates ESG into its ownership policies and practices.

Since CalSTRS is a long-term investor and may hold an investment in a corporation or entity for decade after decade, short-term gains at the expense of long-term gains are not in the best interest of the Fund. Sustainable returns over long periods are in the economic interest of the Fund. Conversely, unsustainable practices that hurt long-term profits are risks to the System's investment.

Since CalSTRS must invest huge sums of moneys for long periods of time to pay for future benefits promised to California Teachers, our actions to invest in securities of a corporation predominately reflects a judgment that the ownership will produce a sustainable rate of return which will make it an attractive investment and help CalSTRS meet its long-term obligations. It is important to note that CalSTRS ownership of a security in a company does not signify that CalSTRS approves of all of the company's practices or its products or that CalSTRS believes a particular company is an attractive investment since the security may be owned due to its membership in a particular index or for risk mitigation purposes.

Since 1978, CalSTRS has used a written policy, the Statement of Investment Responsibility (SIR), to navigate the complex landscape of ESG issues. The long history of this document is testimony to the national leadership of CalSTRS among pension funds in addressing ESG matters through a written policy. The SIR will continue its longevity as guidance on proxy voting; however this Policy now replaces the SIR as CalSTRS's preeminent policy on ESG matters.

POLICY

Geopolitical Risks and Social Risks: To help manage the risk of investing a global portfolio in a complex geopolitical environment, CalSTRS has developed a series of procedures to follow when faced with any major geopolitical and social issue as identified by the 20 risk factors. It is important to note that fiduciary standards do not allow CalSTRS to select or reject investments based solely on social criteria.

When faced with a corporate decision that potentially violates CalSTRS Policies; the Investment Staff, CIO and Investment Committee will undertake the following actions:

A. The CIO will assess the gravity of the situation both as an ESG risk and as to the System. The extent of the responsibility of the System to devote resources to address these issues will be determined by: 1) the number of shares held in the corporation, and 2) the gravity of the violation of CalSTRS Policies.

B. At the CIO's direction, the Investment Staff will directly engage corporate management to seek information and understanding of the corporate decision and its ramifications on ESG issues.

C. The CIO and investment staff will provide a report to the Investment Committee of the findings and recommend any further action of engagement or need to commit further System resources. The Investment Committee can marshal further resources given the gravity of the situation.

To assist CalSTRS Staff and external investment managers in their investment analysis and decision-making, CalSTRS has developed a list of 20 risk factors that should be included within the financial analysis of any investment decision. This list is not exhaustive and does not attempt to identify all forms of risk that are appropriate to consider in a given investment transaction; however they do provide a framework of other factors that might be overlooked. These risk factors should be reviewed for an investment in any asset class whether within the U.S. or across the globe.

CalSTRS expects all investment managers, both internal and external to assess the risk of each of the following factors when making an investment. The manager needs to balance the rate of return with all the risks including consideration of the specific investments exposure to each factor in each country in which that investment or company operates.

CALSTRS 20 RISK FACTORS
Monetary Transparency The long-term profitability by whether or not a country or company has free and open monetary and financial data, and its observance of applicable laws.
Data Dissemination The long-term profitability by whether or not a country is a member of the IMF (or similar organization) and satisfies the conditions for access, integrity, and quality for most data categories.
Accounting The long-term profitability by whether or not the accounting standards are formulated in accordance with International Accounting Standards or the U.S. Generally Accepted Accounting Principles.
Payment System: Central Bank The long-term profitability by whether the activities of a country's central bank encompass

implementing and ensuring compliance with principles and standards which are established to promote safe, sound, and efficient payment and settlement systems.
Securities Regulation The long-term profitability by exposure to operations in countries that have not complied with IOSCO objectives, which provide investor protection against manipulation and fraudulent practices.
Auditing The investment's long-term profitability by whether or not the country uses International Standards on Auditing in setting national standards.
Fiscal Transparency The investment's long-term profitability by its exposure or business operations in countries that do not have not some level of fiscal transparency such as publication of financial statistics, sound standards for budgeting, accounting, and reporting.

Corporate Governance The investment's long-term profitability by whether or not the government recognizes and supports good corporate governance practices and whether it generally adheres to OECD principles.
Banking Supervision The investment's long-term profitability from its exposure to countries that have not endorsed/complied with the Basel Core Principles. An endorsement includes an agreement to review supervisory arrangements against the principles and bring legislation in line with the principles where necessary.
Payment System: Principles The investment's long-term profitability by whether a country complies with the 10 Core Principles for Systemically Important Payment Systems, which includes operational reliability, efficiency, real time settlement, final settlement in central bank money; and whether rules and procedures are clear and permit participants to understand the financial risks resulting from participation in the system.
Insolvency Framework The investment's long-term profitability from its business operations and activities in specific countries with regard to bankruptcy reform or insolvency legislation.
Money Laundering The investment's long-term profitability from exposure and whether or not a country has implemented an anti-money laundering regime in line with international standards; consideration should be given to compliance with the 40 recommendations in the Financial Action Task Force (FATF) on Money Laundering; and whether it is a member of FATF.
Insurance Supervision Whether or not a country has a regulatory framework in line with International Association of Insurance Supervisors (IAIS) Principles.
Respect for Human Rights The investment's long-term profitability from its business operations and activities in countries that lack or have a weak judicial System. Assess the risk to an investment's long-term profitability from its business operations and activities in a country that engages in or facilitates the following: arbitrary or unlawful deprivation of life, disappearance, torture and other cruel, inhuman, or degrading treatment or punishment, arbitrary arrest, detention, or exile, arbitrary interference with privacy, family, home, or correspondence, use of excessive force and violations of humanitarian law in internal conflicts. Consideration should be given to governmental attitude regarding international and non-governmental investigation of alleged violations of human rights.
Respect for Civil Liberties The investment's long-term profitability from operations, activities, and business practices in countries or regions that do not allow freedom of speech and press, freedom of peaceful assembly and association, freedom of religion, freedom of movement within the country, allowance for

foreign travel, emigration, and repatriation.

Respect for Political Rights The investment's long-term profitability from business practices and activities in countries that do not allow their citizens the right to advocate for change to their government.
Discrimination Based on Race, Sex, Disability, Language, or Social Status The investment's long-term profitability from business practices and activities on discrimination, such as discrimination against women, children, and persons with disabilities, national/racial/ethnic minorities, or indigenous people.
Worker Rights The investment's long-term profitability from management and practices globally in the area of worker's rights; specifically the right of association, the right to organize and bargain collectively, prohibition of forced or bonded labor, status of child labor practices and minimum age for employment, acceptable work conditions, or human trafficking.
Environmental The investment's long-term profitability from activities and exposure to environmental matters such as; depleting or reducing air quality, water quality, land protection and usage, without regard for remediation. Consideration should be given to how a company is dealing with the impact of climate change, including whether the government is taking steps to reduce its impact, exacerbating the problem, or oblivious to the risk.
War/Conflicts/Acts of Terrorism The investment's long-term profitability from business exposure to a country or region that has an internal or external conflict, war, acts of terrorism or involvement in acts of terrorism, and whether the country is a party to international conventions and protocols.

Arkansas Teacher Retirement System (ATRS)

Sudan – State Statute. The Board immediately communicates with all of its investment managers, that within appropriate prudent and fiduciary guidelines said managers prospectively refrain from investing in companies identified by best available information as doing business with the Government of Sudan. Additionally, where such holdings currently exist, managers are requested to, within the bounds of prudent portfolio management, and always acting in the best interest of protecting the value of Trust assets, strongly consider the elimination of those Sudan related holdings at the earliest appropriate time. Nothing in this provision is to be interpreted to diminish or remove the on-going fiduciary responsibility that each investment manager owes to the Trust assets of the Arkansas Teachers Retirement System.

Colorado PERA Public Employees' Retirement Association of Colorado

PERA will initiate a phased strategy to address PERA's direct public investments in foreign companies doing business the Islamic Republic of Iran. The strategy will address and will include a number of actions, up to and including possible divestment. PERA recognizes the federal government has sole responsibility for the conduct of American foreign policy. PERA is acting out of a fiduciary concern for the welfare of its member's assets which requires a broad horizon and sensitivity to the potential risks posed by investment in Iran.

The United States prohibits loans from U.S. financial institutions and direct investment in the Iranian energy and defense sectors. The U.S. government can also impose economic sanctions on foreign companies investing in Iran's petroleum and natural gas sector. It is widely reported that Iran supports terrorism, supplies explosively formed penetrates for use against our troops in Iraq, continues to develop the infrastructure to support advanced nuclear technology, and that its president publicly calls for the destruction of the State of Israel.

PERA must be managed for the benefit of the members, retirees and beneficiaries, and this policy is developed to address the potential for risk presented by pension fund investments in companies doing business in Iran.

Accordingly, the PERA Board of Trustees adopts a policy consisting of the following phases:

Phase I: Commencing immediately, staff shall undertake research to identify a list of public companies doing business in Iran which meet the following criteria: (This list will be developed through staff research of publicly available information that may include the retention of external third party research and/or other information provided by other public funds, pension systems and investor organizations).

Phase II: Upon a company being included on the list that meets the criteria set forth under Phase I in which PERA holds a direct public investment, staff shall within 30 days after identifying such a company engage such company to find out on their actions to mitigate their involvement.

Phase III: the Board enacts a moratorium on direct public investments in companies in which PERA currently holds interest. The moratorium shall apply upon the date that staff determines such a company meets the criteria. The Board shall give 90-days advance notice before the effective date of any amendment or repeal of this moratorium to the public, the General Assembly and the Governor.

Phase IV: Within 90 days after engaging such a company, staff shall evaluate the companies' responses and determine if they have taken sufficient steps to minimize risk to PERA and/or whether additional time is required to effectively engage such company. If not, staff shall analyze available strategies for addressing the risk, the materiality of the operations, and the availability of alternative direct public investments providing similar diversity and return expectations.

Phase V: Staff shall report to the Board its findings, actions and recommendations concerning individual companies on the list at every regularly schedule board meeting. This report shall be made available to the public and forwarded to the General Assembly and the Governor; provided, however, the first public report shall be made no later than March 21, 2008. Should adequate mitigation of risk not be possible, the PERA Board of Trustees, consistent with its fiduciary obligations and responsibilities, will thereafter direct staff to: withhold additional or new direct public investments in non-complying companies and/or divest current direct public investments in the companies.

Florida Retirement System (FRS)

The Florida Retirement System (FRS) Pension Plan is the fourth largest public retirement plan in the U.S, with approximately $135 billion under management. Florida has divested from various companies for socio-geopolitical reasons primarily when mandated by Florida State Statute. This includes the System's divestment, and/or divestment related monitoring and reporting related to Cuba, Northern Ireland (The McBride Principles), and more recently under the Protecting Florida's Investments Act, which addresses Sudan and Iran. In addition, by Board Resolution, the FRS divested from companies doing business in South Africa during the anti-Apartheid campaign, and divested from Tobacco companies during 1998 and 2001, at which time the State was pursuing litigation against tobacco companies. The tobacco divestment program was reversed in 2001 with a new Board in place and the threat of litigation risk was determined to be largely behind the tobacco companies, and with a desire to not restrict the

investment management universe for social reasons for fear of compromising the risk adjusted returns of the System.

"Florida has no broad policy statement on divestment in place, and regards Statutes that mandate divestment, or reporting/consideration of divestment on a given issue as the effective policy statement that they must abide by. At the operational level, the only mention of divestment issues in the FRS Investment Policy can be found in the System's Corporate Governance Policy Statement and is as follows:

Additionally, Florida Law sometimes prohibits investment in companies or mandates reporting on certain investments due to geopolitical, ethnic, religious, or other factors. Compliance with these laws and any related reporting requirements has similarities to corporate governance issues and will be consolidated organizationally."
Florida – SUDAN/IRAN

Illinois State Board of Investment

Iran Divestment Policy-State Mandate. A new section of the Illinois Pension Code limits the investment of retirement system assets in certain companies with ties to the Government of Iran and its oil-related and mineral-extraction business sectors. With respect to actions taken in compliance with the Act, including good faith determinations regarding companies are prescribed by the Act, the Board is exempt from any conflicting statutory or common law obligations, including any fiduciary duties under Article I and any obligations with respect to choice of asset managers, investment funds, or investments for the Board's securities portfolios. In accordance with the Act, the following actions shall be taken:

1. The Board shall use best efforts to identify all scrutinized companies in which it has direct or indirect holdings.
2. The Board shall assemble and adopt an official list of scrutinized companies, and Staff shall supplement the list regularly.
3. The Board shall engage scrutinized companies (series of processes delineated).
4. If the company continues to have active scrutinized business operations following the 90-day period, the Board shall sell, redeem, divest or withdraw all publicly traded securities of the company within 12 months after the company's most recent appearance on the scrutinized company's list.
5. Subsequent to the Board's adoption of the scrutinized company's list, the Board shall not acquire securities of companies on the last with active business operations. This requirement does not apply to indirect holdings in a private market fund.
6. The Board shall request the private equity funds set up funds devoid of scrutinized companies with active holdings.
7. The Board shall file an annual report.
8. The Board may cease divesting from scrutinized companies or reinvest in scrutinized companies if clear and convincing evidence shows that the value of the investments in such companies with active scrutinized business operations becomes equal to or less than 0.5% of the market value of all assets under management by the Board.

Iowa Public Employees' Retirement System (IPERS)

General Policy Statement: As fiduciaries, the IPERS Investment Board, Staff and investment managers must perform their duties for the exclusive benefit and in the best economic interest of the System's members and beneficiaries. The System and Board will not support investment policies or strategies which seek to promote specific social issues or agendas through

investment or divestment of IPERS' assets. To act otherwise could be construed as a violation of fiduciary duty and could endanger the System's tax-exempt status.

Sudan-State Law. To comply with State legislation requiring IPERS to develop a list of scrutinized companies with operations in Sudan, and to restrict its purchase of, and under certain circumstances, to divest of holdings of publicly traded securities in any company determined to have active business operations in Sudan, IPERS will do the following:

1. Staff will develop a list of scrutinized companies
2. Staff will post the list of scrutinized companies on its web site within 30 days of creation/update.
3. Staff will be responsible for sending all required written notices to companies on the list and maintaining files and tracking correspondence.
4. Staff will contact those investment managers that invest in direct holdings of securities on behalf of IPERS, and notify them of the investment restriction/divestment matter.
5. Staff and consultant will develop custom performance benchmarks for each investment manager to reflect the limitations, if any, that have been placed on managers.
6. Staff and consultant will track and include in its annual reports the costs, including any opportunity costs, associated with the Sudan legislation.
7. Staff will contact investment management firms that currently manage IPERS' assets in commingled funds and request, as required by law, that they consider developing Sudan-free commingled funds for the System's possible investment. After staff review, the Board shall determine if replacement with a Sudan-free commingled fund is consistent with prudent investing standards.

LACERA

Tobacco Policy
Manager should refrain from purchasing tobacco securities when the same investment goals concerning risk return and diversification can be achieved through the purchase of other securities.

Sudan Policy
Manager should refrain from purchasing securities where the company has been identified as doing business in Sudan or with the government of Sudan, when the same investment goals concerning risk, return and diversification can be achieved through the purchase of another security.

Maryland SRA (State Retirement and Pension System of Maryland)

Sudan Divestment Policy – State Law After July 1, 2007, the State law's effective date, and the following policies will be utilized in Agency staff's ongoing administration of the Sudan investment law.

1. Interaction with Managers informing of restricted companies, or companies recommended for divestment.
2. Engagement with Companies to encourage avoiding actions that may support human rights violations
3. Reporting to the Board of Trustees of divestment recommendations if and when engagement efforts have been completed
4. Reporting to the Legislature quarterly.
5. Other – Federal law/policy changes.

Minnesota State Board of Investment (SBI).

Tobacco- Board Resolution: At its September 1998 meeting, the Minnesota SBI adopted a resolution that required each active and semi-passive equity manager to divest by September 2001 shares of any company which obtained more than 15 percent of its revenues from the manufacture of consumer tobacco products. At the close of fiscal year2001, the SBI had divested from its active portfolios all shares of companies covered by its tobacco divestment resolution.

Sudan – State Law: Laws of Minnesota 2007, Chapter 117 concerns the Sib's investment in companies with operations in Sudan. The legislation calls for the SBI to make its best efforts to identify all "scrutinized companies" in which the SBI has direct or indirect holdings or could possible have holdings in the future. At its June 2007 meeting, the SBI tentatively adopted the same list of companies from the Sudan Divestment Task Force as was recommended by the Proxy Committee for the Board's resolution. Further steps in implementing the 2007 law will be taken by the SBI in the future.

West Virginia Investment Management Board

The West Virginia Investment Management Board has the following language imbedded in its Investment Policy Statement:

Consistent with its fiduciary responsibility and the concepts of Modern Portfolio Theory, the Board does not and will not systemically exclude or include any investments in companies, industries, countries or geographic areas

APPENDIX 2. Bibliography

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Appendix 3. Glossary

Beta: Describes how the expected return of a stock or portfolio is correlated to the return of the financial market as a whole.

Divestment: Disposing of an existing investment or refraining from making an investment.

Market-to-Book Ratio (also known as Price-to-Book Ratio): A ratio used to compare a stock's market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share.

Passively Managed: A financial strategy in which a fund manager makes as few portfolio decisions as possible, in order to minimize transaction costs, including the incidence of capital gains taxes. One popular method is to mimic the performance of an externally specified index—called “index funds.”

Portfolio Risk: The unexpected variability or volatility of returns and thus includes both potential worse-than-expected as well as better-than-expected returns.

Risk-adjusted Return: Used to characterize how well the return of an asset compensates the investor for the risk taken.

R-Squared: A statistical measure that represents the percentage of a fund or security's movements that can be explained by movements in a benchmark index.

Volatility: Refers to the degree of (typically short-term) unpredictable change over time of a certain variable. It may be measured via the standard deviation of a sample.