



Agenda Item 7b

October 19, 2015

ITEM NAME: Information on Public Market Investments in Coal Producers

PROGRAM: Total Fund

ITEM TYPE: Asset Allocation, Performance & Risk – Information

EXECUTIVE SUMMARY

Staff understands that Governor Jerry Brown has signed into law Senate Bill 185 (SB185, de León) – Public Divestiture of Thermal Coal Companies Act. This item provides an analysis of CalPERS public market investments in coal producers and the potential impact of implementing SB185, included as Attachment 1.

Absent direction from the Investment Committee (Committee) to the contrary, staff will begin to implement the provisions of SB185 as described below, including not making additional or new investments in applicable thermal coal companies. In addition, staff will begin to plan the engagement process with applicable companies.

STRATEGIC PLAN

This item responds to potential statutory requirements and does not directly support the CalPERS Strategic Plan.

INVESTMENT BELIEFS

This agenda item supports Investment Belief 3 that investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries. The subject matter of SB 185 is also consistent with Investment Belief 9 in that risk is multi-faceted and not fully captured through measures such as volatility or tracking error. As a long-term investor, CalPERS must consider unconventional risk factors, for example, climate change and natural resource availability, that emerge slowly over long time periods, but could have a material impact on company or portfolio returns.

BACKGROUND

SB185 requires CalPERS and CalSTRS to constructively engage publicly traded coal companies (Company) that generate 50 percent or more of their revenue from mining thermal coal. If following engagement a Company is not transitioning its business model to adapt to clean energy generation, SB185 directs CalPERS to sell or transfer any investments in that Company, and report to the Legislature and the Governor regarding these investments within specific timeframes. SB185 does not require divestment if the CalPERS Board of Administration (Board) determines, in good faith, the action would not be consistent with its fiduciary responsibilities.

CalPERS Divestment Policy (Section VII. of the Board's Total Fund Investment Policy) is included as Attachment 2.

On April 13, 2015, the Investment Committee (Committee) voted to take no position on SB185. Subsequently, on August 17, 2015, the Committee requested staff to provide an analysis on the potential impacts on the Total Fund in the event that SB185 is enacted. Table 1 outlines staff's implementation timeline if SB185 is enacted.

Table 1: SB185 Implementation Timeline

Timeline	CalPERS Action
Upon SB 185 Enactment	<ul style="list-style-type: none"> Initiate divestment determination process.
Portfolio Screening – by December 2015	<ul style="list-style-type: none"> Determine applicable list of thermal coal companies pursuant to defining parameters of SB185.
Company Engagement – by July 2016	<ul style="list-style-type: none"> Complete company engagement to establish whether Companies are transitioning their business models to adapt to clean energy generation.
Divestment Decision Making and Liquidation – by July 1, 2017	<ul style="list-style-type: none"> Estimate trading cost and price impact of divestment action. CalPERS Board approval to liquidate applicable securities pursuant to fiduciary responsibility. Liquidate investments in thermal coal companies.
Report to California Legislature – by January 1, 2018	<ul style="list-style-type: none"> Pursuant to reporting mandate as defined by SB185

ANALYSIS

The material below reflects the approximate public markets exposure contained within the Public Employees' Retirement Fund (PERF) to Companies meeting the definition specified in the legislation.

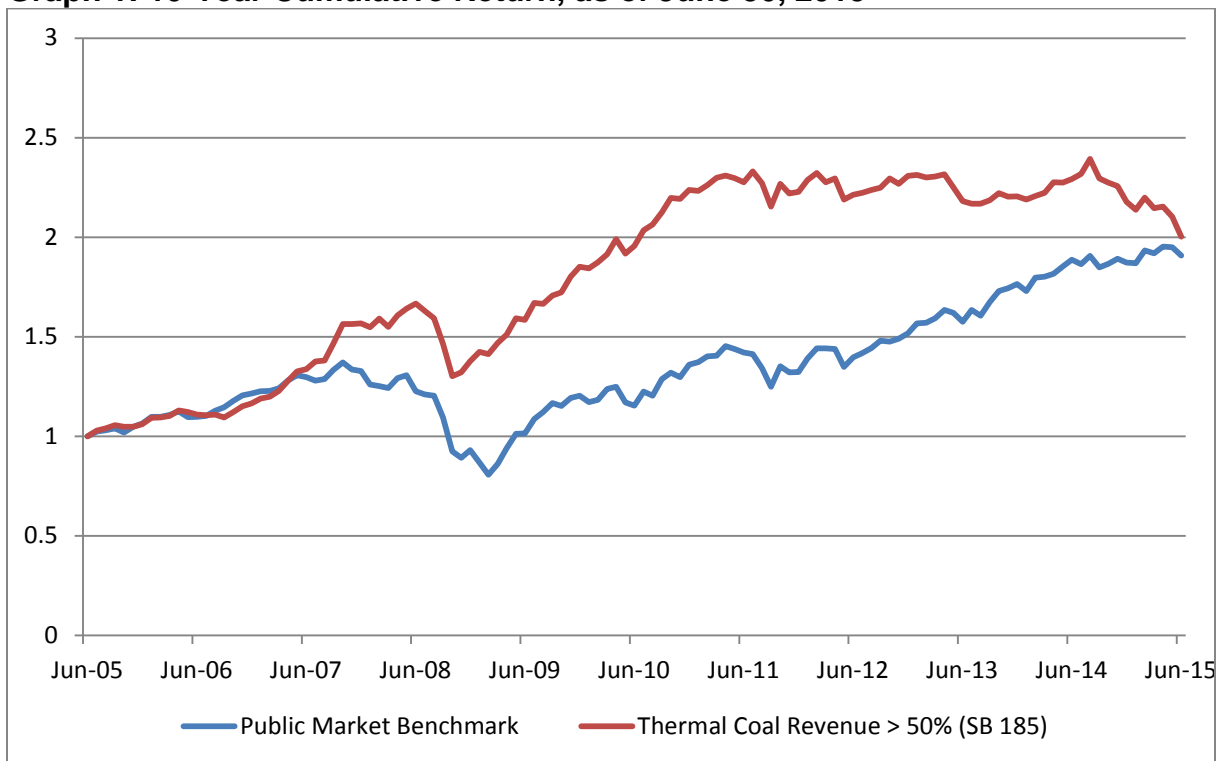
Current Estimated Exposure: As of June 30, 2015, CalPERS public equity and fixed income exposure to Companies, as defined by SB185, was approximately \$83 million, or 0.03% of the total fund as shown in Table 2.

Table 2 – Approx. CalPERS Exposure to SB185, as of June 30, 2015

	Weight in asset segment benchmark	Approximate Exposure (mm)
FTSE Developed Markets Index	0.01%	\$14
FTSE Emerging Markets Index	0.04%	\$63
Barclays Capital Long Liability Index	0.01%	\$6
Total	--	\$83

Historical Performance Impact: Thermal coal Companies have significantly underperformed the PERF public market benchmark¹ by -13.7% over the last year. However, as shown in Table 3, these Companies have outperformed the PERF public market benchmark by 0.5% over the last ten years.

Graph 1: 10-Year Cumulative Return, as of June 30, 2015¹



¹ Public market benchmark is composed of the PERF Global Equity and Global Fixed Income benchmarks weighted by their appropriate asset allocation targets in the PERF Policy Portfolio.

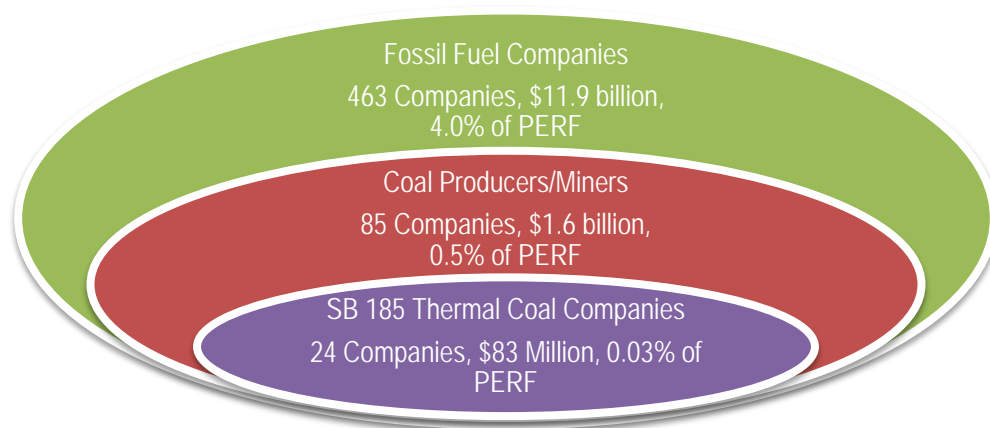
Table 3 reflects the relative annualized investment performance of Companies over 1, 5, and 10 year periods.

Table 3: Relative Annualized Performance, as of June 30, 2015

Total Return	1 Year	5 Year	10 Year	1 Year Over/Under Performance	5 Year Over/Under Performance	10 Year Over/Under Performance
Public Market Benchmark ¹	1.2%	10.6%	6.7%	--	--	--
SB 185 Companies	-12.6%	0.5%	7.2%	-13.7%	-10.1%	0.5%

Fossil Fuel Exposure: Graph 2 reflects the approximate exposure that SB 185 Coal Companies and overall coal mining contribute to the nearly \$12 billion of PERF exposure to fossil fuel producers. SB 185 Coal Companies represent less than 1% of the total fossil fuel exposure, while firms with any revenue from coal reserves make up more than 13% of the fossil fuel exposure.

Graph 2: Approx. Fossil Fuel Exposures, as of June 30, 2015



Equity Investment Metrics: Current valuation metrics of thermal coal Companies are reflected in Table 4 along with measures for the CalPERS Global Equity benchmark. The recent pricing weakness for coal and other fossil fuels is partly reflected in more recent numbers such as the 3 year earnings growth measure.

Table 4: Valuation Metrics, as of June 30, 2015

Description	Dividend Yield	Price / Earnings	Return on Asset	Return on Equity	Operating Margin	3 Yr. Earnings Growth	10 Yr. Earnings Growth
CalPERS Global Equity Benchmark	2.3%	17.5	6.8	15.5	18.1	9.9%	7.5%
Companies with Thermal Coal Revenue > 50%	4.7%	14.5	8.7	21.5	14.8	-10.7%	9.3%

Forecasted Volatility Impact: The volatility implications from the potential removal of Companies from the CalPERS overall and asset class benchmarks are minimal and shown in Table 5. In each instance, the change in expected tracking error is less than one basis point.

Table 5: Volatility Metrics, as of June 30, 2015

Benchmark	Benchmark Forecast Total Volatility (%)	Forecast Total Volatility (%)	Forecast Tracking Error
		Excluding SB185 Companies	
PERF	8.8%	8.8%	< 1 basis point
Global Equity	12.8%	12.8%	< 1 basis point
Global Fixed Income	6.3%	6.3%	< 1 basis point

BUDGET AND FISCAL IMPACTS

The costs associated with SB185 will primarily be related to Company engagement prior to the Board's divestment decision making. A Board decision to divest of SB185 Companies is anticipated to be step 4 of the timeline reflected in Table 1. A decision to divest would incur some additional cost associated with the sale and reinvestment of applicable securities. These costs will be estimated when information is brought to the Board for decision making.

BENEFITS/RISKS

The benefits and risks will be dependent on the CalPERS holdings in companies that meet the criteria for divestment pursuant to SB 185. This is scheduled to be determined by July, 2016 as shown in the timeline on page 2.

ATTACHMENTS

Attachment 1 – Senate Bill 185, as amended June 2, 2015

Attachment 2 – CalPERS Total Fund Investment Policy, Section VII. Divestment

ERIC BAGGESEN
Managing Investment Director
Asset Allocation and Risk Management

TED ELIOPOULOS
Chief Investment Officer