Investment Committee

Agenda Item 9a

April 18, 2016

Item Name: Divestment Review – Proposed Timetable

Program: Total Fund

Item Type: Action

Recommendations

At the Investment Committee's (Committee's) request, Staff is presenting options for reviewing CalPERS' various existing divestment initiatives (Divestment Initiatives).

Executive Summary

Divestment as a catalyst for social change and an investment strategy has been a difficult topic of discussion in the public pension industry for decades. For CalPERS and many public pension funds, divestment has presented a challenging internal conflict that pits social responsibility against our fiduciary duty as outlined in the California Constitution. CalPERS' primary duty and obligation is to its members. The Constitution states that the CalPERS Board shall act "…solely in the interest of … providing benefits to participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system." It further states that the Board "…shall diversify the investments … so as to minimize the risk of loss and to maximize the rate of return…."

As a California state agency, CalPERS is sensitive to public policy issues. We strive to reconcile our legal and constitutional obligations with the greater good. However, whether or not to invest in tobacco or other sectors that may be the focus of a public policy debate has become a difficult and complex issue.

Where we have been an effective change agent is through engagement of companies as a shareowner. We believe that engagement is the first call to action and the most constructive form of communicating concerns with companies. We have been progressive in fighting for corporate board diversity, climate risk reporting, and shareowner rights. We are guided by a clear set of well-defined corporate governance principles that set expectations for Corporate America and ensure that our interests are aligned with value creation.

This agenda item aims to establish a path forward for reviewing CalPERS' existing divestments.

An updated version of the Total Fund Investment Policy (Policy) was presented to the Investment Committee for a second reading on March 14, 2016. The Committee Chair directed staff to return with options for reviewing CalPERS' divestments in a manner consistent with the Committee's fiduciary duties. This memo outlines those options.

Strategic Plan
This agenda item supports the CalPERS Strategic Plan goal of improving long-term pension and health benefit sustainability. Reviewing the Divestment Initiatives strengthens CalPERS' ability to achieve the System's investment objectives and promotes the responsible and efficient stewardship of the System to deliver promised retirement benefits.

Investment Beliefs
This agenda item supports CalPERS Investment Belief 3 – CalPERS investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries – and Belief 7 – CalPERS will take risk only when we have a strong belief we will be rewarded for it.

Background
CalPERS' investment policies represent the Committee's primary direction to staff with respect to the management of the CalPERS investment portfolios. As part of Staff's effort to update the Total Fund Investment Policy commencing earlier this year, the divestment section was revised and presented to the Committee for first and second readings, along with the other proposed updates to the Policy, on February 16, 2016, and March 14, 2016, respectively. The Committee is considering a re-examination of past divestment decisions following a report from Wilshire Associates (in October 2015) indicating that the majority of CalPERS' divestment initiatives have reduced investment returns for the portfolio. At its March 14 meeting, the Committee discussed divestment in the context of fiduciary duty, including the possible use of a loss threshold to prompt the consideration of reinvestment for one or more Divestment Initiatives. The Committee directed staff to return with options for reviewing those Initiatives.

Analysis
One possible approach to reviewing the Divestment Initiatives is to separate the tobacco divestment from the other divestments. The rationale for such a separation is that the tobacco divestment dwarfs the others in size. All the non-tobacco divestments, either separately or taken together, could be considered *de minimis*.

Once the tobacco divestment has been separated from the other Divestment Initiatives, the Committee could review the tobacco divestment within the next 12 to 24 months. The reason for such a delay would be the desire to undertake more extensive stakeholder education on the issue and to obtain stakeholder input. (An additional benefit of such delay would be the ability to review the divestment free of the tobacco-related controversies that now exist in the legislative environment.)

If the Committee does not wish to separate the tobacco divestment from the other Divestment Initiatives, it could include the tobacco divestment in the approaches suggested below.

Regarding the non-tobacco divestments, the potential options include:

- Option 1: The Committee could review these *seriatim* over the next several months.

- Option 2: The Committee could direct Staff to bring the divestments to the Committee for review when Staff determines that either individually or taken together, the divestments are no longer *de minimis*. (If the Committee chooses to include the tobacco divestment in this approach, Staff would bring it to the Committee for review within the next several months.)

- Option 3: The Committee could adopt a loss threshold policy like the one Staff brought forward previously. Whatever thresholds the Committee adopts would not trigger automatic reinvestment, but would provide objective standards for determining when to review existing divestments. If the Committee chooses this option, Staff would return at a future Committee meeting with a specific proposal for the Committee to consider.

Under all three of these options, all potential Committee decisions would be publicly noticed and considered, and would require a roll call vote before the initiation of any reinvestment.

Budget and Fiscal Impacts
Not Applicable.

Benefits and Risks
Staff's proposed options are consistent with the Target Operating Model's objectives to design, develop, and implement a robust operating model that minimizes complexity, improves transparency, and strengthens processes, systems, governance, and controls. The benefit of adopting one of the proposed options would be the establishment of a clear process for reviewing existing divestments. Such a process would enhance both the Committee's and Staff's ability to make decisions that are consistent with their fiduciary duties.

____

Wylie Tollette
Chief Operating Investment Officer

____

Theodore Eliopoulos
Chief Investment Officer