PCA PENSION CONSULTING ALLIANCE

November 29, 2016

Mr. Henry Jones, Chairman
Investment Committee
California Public Employees' Retirement System
Sacramento, California 95814

Re: Restrictions on Investments in Tobacco-producing Companies

Dear Mr. Jones,

Please find below PCA's comments on CalPERS' restriction on investments in companies producing tobacco products.

PCA finds that, generally, theoretical analyses hypothesize that divestment reduces the opportunity set available for investment, which, in turn increases potential risk. Actual return results can and do vary, given the specific divestment considered, the time period, the number and market capitalization of the restricted stocks, and, if any, the replacement portfolio.

Typically, the greater the total market capitalization (value) of the restricted stocks, the greater the potential risk to returns to the portfolio as compared to an underlying market capitalization weighted benchmark. For example, targeting four stocks in a Sudan divestment campaign had a de minimis impact on the total portfolio, as compared to restricting 37% of the NYSE market capitalization for a South Africa-free portfolio.

The time period studied can make the difference between outperformance and lagging returns as compared to an underlying benchmark. For example, fossil fuel free portfolios clearly outperform (underperform) benchmark portfolios during periods when pricing dynamics in oil and gas hurt (enhance) fossil fuel company's profitability. When oil prices were high in the early 2000's fossil free portfolios lagged the market. In contrast, in recent years when oil prices collapsed, fossil free portfolios outperformed their underlying benchmarks. In 2016 fossil free portfolios significantly underperformed as oil prices rose from the lows of 2015.

Most empirical analyses of divestment compare an underlying market capitalization weighted benchmark to a restricted portfolio in which a given set of securities are not allowed in the portfolio, and the remaining securities are reweighted proportionally to their market cap weight.

Wilshire's 2015 analysis of the CalPERS portfolio found that CalPERS' removal of 22 tobacco stocks historically generated reduced returns compared to the underlying benchmark that were not de minimis (measured from 12/31/2001 through 12/31/2014). Wilshire calculated that the 22 stocks comprise 0.66% of the benchmark ($1.0 billion of a $156.8 billion global equity portfolio. They calculated the present value impact of the Tobacco Exclusion as a loss of between $2.08 billion and $3.04 billion by the end of 2014, depending on the methodology used to calculate the present value. These past (negative) results are no guarantee of future negative results.

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Other studies have shown that tobacco stock divestments have generated negative results since the late 1990s when the issue became widespread in the United States. A November 2014 CalSTRS report, which divested from tobacco stocks in 2000, estimated that since the $178.7 billion retirement system fully divested from tobacco, and firearms in 2013, the pension fund has underperformed its custom benchmark by about $772 million compared with an index that included those stocks. 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 a 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.

More broadly, Hong et al, 2008, looked at the fluctuation over time of tobacco stocks and the variation in the social norms governing tobacco over time. Their key prediction was 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 essentially even the government acknowledged 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 et al conclude that "some investors, particularly institutions subject to public scrutiny and social norms, pay a financial price for not holding these stocks."

Expectations for the future of the tobacco industry range from long-term global decline, (driven by declining sales volumes, in developed markets and beginning in some emerging markets, rising global regulation, and the health impact externality of the proven health problems and costs associated with tobacco smoking), to an attractive investment prospect that is heavily consolidated, with manufacturers that exercise strong buying power for a product that has limited substitutes and is highly addictive, and strong brand loyalty and limits new entrants, with tobacco manufacturers posting 50-60% gross margins. Tobacco manufacturers have begun to invest in e-cigarettes, and monitor national legalization of marijuana legislation closely to determine if that may be a new potential business sector for them.

To date, there is no evidence that large institutional investor's divestments from the tobacco industry have impacted decision-making in these companies.

Generally, PCA believes that divestment is a relatively blunt instrument for seeking to impact societal goals that typically increases the potential investment risk without a commensurate increase in potential returns to a portfolio. Divestment also takes away institutional investors ability to vote proxies and actively engage on key corporate issues. From this perspective, PCA does not recommend the continued restriction on tobacco stocks in the CalPERS portfolio.

We look forward to participating in a lively and thoughtful discussion on this issue.

Respectfully,

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Allan Emkin