



Investment Committee

Agenda Item 7b

March 18, 2019

Item Name: Assembly Bill 33 (Bonta) Private Prison Divestment

Program: Legislation

Item Type: Action

Recommendation

Adopt an **OPPOSE** position on Assembly Bill (AB) 33 (Bonta) because it imposes a divestment mandate on the California Public Employees' Retirement System (CalPERS) Board of Administration (Board).

Executive Summary

This bill requires CalPERS and the California State Teachers' Retirement System (CalSTRS) to cease making any new or additional investments in publicly issued stock, corporate bonds, or other debt instruments in any private prison company, defined as a "company that generates the majority of its revenue from operating, managing, or contracting as a prison or detention center." AB 33 would further require that CalPERS and CalSTRS constructively engage with each private prison company "to establish if the company is transitioning its business model to another industry," and for those companies that do not transition, CalPERS and CalSTRS would be required to liquidate existing investments on or before July 1, 2020, subject to the fiduciary duty of the boards.

Strategic Plan

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

Investment Beliefs

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

Background

Constitutional Authority and Fiduciary Responsibility

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

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

CalPERS Divestment Policy

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

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

Private Prisons

Private prisons are generally third-party entities with whom government agencies may contract to provide staff and facilities to house inmates. Services provided to governments by private prison companies also include the building and leasing of modernized prison real estate and rehabilitation services for in-custody and post-release services. The decision by the State of California to outsource some of its prison operations to the private sector followed a three-judge panel ruling, later upheld by the United States Supreme Court, ordering the state to reduce its prison population to 137.5 percent of design capacity to address prison overcrowding and to provide adequate healthcare to inmates. The state currently has one out-of-state and four in-state private prisons under contract. The author has also introduced AB 32, which, if enacted, would prohibit the Department of Corrections and Rehabilitation from contracting with a private prison to house inmates in or out of the state. Note that the operations of the two portfolio companies identified are not confined to California – Geo Group in fact is a global company – and that neither bill can be expected to have an impact on their out-of-state operations.

Analysis

Proposed Changes

AB 33 prohibits the CalPERS and CalSTRS boards from making additional or new investments or renewing any existing investments in a private prison company, as defined. Specifically, this bill:

- Requires CalPERS and CalSTRS to liquidate existing private prison company investments on or before July 1, 2020,
- Requires CalPERS and CalSTRS to engage with private prison companies to determine whether or not the company is transitioning its existing business model to another industry as part of its decision to liquidate investments,
- Defines “private prison company” as a company that generates the majority of its revenue from operating, managing, or contracting as a prison or detention center,
- Specifies that its provisions do not require either board to take action if it determines in good faith that the action would violate its fiduciary responsibilities described in Article XVI, section 17 of the California Constitution.

Reason for the Bill

According to the findings and declarations, this bill is in response to the immigration policies introduced by President Trump’s Administration that separate children from their families, and have detained thousands of adults and children in two for-profit, private facilities operating outside of San Antonio, Texas. In addition, the bill states that private prison companies have incentives to maximize their profits and to minimize their costs, including the important costs of investments in programs, services, and rehabilitation efforts for inmates. This bill is part of California’s efforts to redirect the criminal justice system to “value and prioritize effective prison rehabilitation programs.”

Potential Scope and Workload

Currently, CalPERS has identified two companies that meet AB 33's definition of a private prison company – Geo Group and CoreCivic. As of December 31, 2018, a preliminary estimate indicates that the Public Employees' Retirement Fund (PERF) has approximately \$10 million in publicly traded equity holdings with Geo Group and CoreCivic. Publicly traded equity securities are typically bought and sold on the secondary market. A purchase of securities on the open market does not provide any direct benefit to the issuing company, and similarly, a sale has no direct financial impact. More often than not, the issuing company will not even be aware that CalPERS has decided to sell or hold.

Private prison divestment would require CalPERS to analyze the impact of potential divestment, including both the initial cost to divest and the long-term impact of continued divestment from private prisons. This analysis would also take into account the impact to the PERF's risk and return profile, including volatility and tracking error. CalPERS would have to identify transaction costs, operational changes (such as benchmark modification), a transition plan, trades to be executed, and implement an ongoing screening process to support compliance. These findings would be presented to the Board to make a fiduciary determination regarding these holdings.

Impact on Investment Strategies

CalPERS' public equity holdings are typically not the result of any active decision to invest in a particular company or industry. In this case, CoreCivic and Geo Group are both in our benchmarks. These so-called "passively managed" stock portfolios are designed to track their benchmarks with as little deviation as possible (referred to as low "tracking error"). The benchmarks we track are established by the Board on a 4-year cycle, consistent with our long-term investment view. Sound investing strategy requires the discipline not to make continual course corrections. Divestment represents an active deviation from our benchmarks that, in CalPERS' experience has harmed investment performance over time in most cases.

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

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

Budget and Fiscal Impacts

CalPERS estimates \$175,000 in potential trade costs, which reflect brokerage fees and the market impact of divesting from these companies as well as reinvesting the proceeds into different securities, which would have to be identified at a later date. CalPERS would also incur costs for investment transactions and analytic service provider expenses for yearly portfolio screening and reporting by an external vendor to exclude private prison company investments. The annual cost for similar investment transactions and analytic service provider expenses are

over \$50,000. These costs do not include the opportunity cost of continued investment into these two companies.

Benefits and Risks

Benefits:

- May reduce stakeholder perception that CalPERS' investments contribute to private prison companies' detention policies.

Risks:

- Compromises CalPERS' investment strategies by eliminating alternatives from the investment opportunity set and reducing diversification, which may have a detrimental effect on investment returns over the long term.
- Imposes financial risks on CalPERS members and employers.
- Increases risk to the system.
- Reduces alignment of current Investment Office practices with CalPERS' Investment Beliefs and Investment Policies.
- Increases future likelihood of external parties directing portfolio activities.

Attachments

Attachment 1 – Legislative History

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