CalPERS

Investment Committee

# Agenda Item 7a

**April 15, 2019**

**Item Name**: Assembly Bill 1320 (Nazarian) Divestment from Turkish Investment Vehicles

**Program**: Legislation

**Item Type**: Action

## Recommendation

Adopt an **OPPOSE** position on Assembly Bill (AB) 1320 (Nazarian) 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 any investment vehicle in Turkey that is issued, owned, controlled, or managed by the government of Turkey, upon the passage of a federal law imposing sanctions on the government of Turkey for failure to officially acknowledge its responsibility for the Armenian Genocide. If such action is taken by the federal government, CalPERS and CalSTRS would also each be required to liquidate its Turkish investments as described above within 18 months. Finally, the requirements of this bill will automatically sunset on January 1, 2025, or sooner if a federal entity, as specified, determines that the government of Turkey has officially acknowledged its responsibility for the Armenian Genocide

## 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.

Armenian Genocide

According to the author,

> "The genocide of the Armenians is the first recorded instance of genocide in the 20th Century. Beginning in 1915, ethnic Armenians living in the Turkish Ottoman Empire were

rounded up, deported and executed by orders of the government. The combination of massacres, forced deportation marches, and deaths due to disease in concentration camps are estimated to have killed more than 1.5 million ethnic Armenians, between 1915 and 1923…To this day, Turkey has not acknowledged their role in the Armenian genocide, and has made numerous attempts to refute that one ever occurred. California has clear policy on the Genocide, as demonstrated by decades of legislative resolutions and gubernatorial proclamations."

## Analysis

Proposed Changes

Upon passage of a federal law imposing sanctions on the government of Turkey for failure to officially acknowledge its responsibility for the Armenian Genocide, AB 1320 would:

- Prohibit CalPERS and CalSTRS from making additional or new investments in any investment vehicle that is issued, owned, controlled, or managed by the government of Turkey;
- Require that CalPERS and CalSTRS liquidate any investment vehicle described above within 18 months of the passage of such federal law;
- Require CalPERS and CalSTRS to report the following to the Legislature and the Governor within one year of the passage of such federal law:
    - A list of investment vehicles in the government of Turkey that have been liquidated, and
    - A list of investment vehicles in the government of Turkey that were not liquidated as a result of a determination that a sale or transfer of the investments is inconsistent with the Board's fiduciary duty under the California Constitution, as well as its findings adopted in support of that determination;
- Permit the Board to refrain from any such actions if it determines in good faith that such action would be inconsistent with the Board's fiduciary responsibilities as described in Section 17 of Article XVI of the California Constitution;
- Sunset on the earlier of the following dates:
    - Upon a determination by the U.S. Congress, U.S. Department of State, or other appropriate federal agency that the government of Turkey has officially acknowledged its responsibility for the Armenian Genocide, or
    - January 1, 2025;
- Require CalPERS and CalSTRS to submit a report to the Legislature on or before January 1, 2024 on the merit of continuing to divest from investment vehicles issued, owned, controlled, or managed by the government of Turkey, including the financial effect of that divestment on the fiduciary responsibilities of the board, before the provisions of this bill can be extended beyond the sunset dates described above; and
- Indemnify present, future, and former board members of CalPERS and CalSTRS, jointly and individually, along with state officers, employees, and investment managers, for any decision to restrict, reduce, or eliminate investments in investment vehicles issued, owned, managed, or controlled by the government of Turkey.

Impact on Investment Strategies

CalPERS uses a mix of investment strategies to diversify sources of risk and alpha while minimizing costs. These strategies include market based strategies and systematic and fundamental strategies to enhance risk-adjusted returns to construct a portfolio that is aligned with our targeted risk and return profile.

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 Turkish investment vehicles 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

The fiscal impact of this bill is contingent upon the federal government taking the necessary actions, as described in the bill, to trigger a divestment action. If CalPERS is required to divest, the program costs would include investment transaction and administrative costs to identify and divest from investment vehicles that meet the stated criteria, and comply with the subsequent reporting requirements. Total costs will depend on the number of CalPERS holdings that meet the criteria for divestment pursuant to AB 1320 at the time of divestment. Based on our preliminary analysis, we estimate exposure to Turkish investment vehicles ranging between $77 million up to $350 million as of December 31, 2018.

Administrative costs will include the cost of hiring an external investment research firm to determine which holdings meet the criteria specified in the bill that would be potentially subject to divestment. Potential trade costs could extend into the millions.

These costs do not include the opportunity cost of continued investment into investment vehicles that meet the stated criteria.

## Benefits and Risks

Benefits:

- May reduce perception that California and the state retirement systems are contributing to the continued denial of the Armenian Genocide by the government of Turkey.

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 parities directing portfolio activities.

## Attachments

Attachment 1 – Legislative History

Attachment 2 – Support and Opposition

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