

Five-Year Divestment Review

Investment Committee

March 15, 2021

Total Fund Investment Policy | Divestment Review

Purpose

To ensure that prior divestment decisions remain supportive of the prudent stewardship of the System's assets consistent with the Committee's fiduciary obligations

Requirements*

- Board's General Pension Consultant to monitor and provide annual reports to the Committee on the estimated performance and risk impacts (November 2020)
- Staff-conducted review, **to include economic analysis of the projected impact on the risk-return profile** of affected portfolios, and presentation of analysis (At least every five years, due 2021)

*Detailed within Attachment 2

Divestment Review | Active Mandates

#	Board-Directed	Since Inception
1.	<u>Primary Tobacco Producers (Tobacco)</u> - CalPERS' public equity and debt portfolios are prohibited from having holdings in companies identified as "primary tobacco producers" – companies whose primary business involves the production and sale of cigarettes.	2001
2.	<u>Manufacturers of Assault-Style Weapons Illegal for Sale to Private Persons in California (Firearms)</u> CalPERS' public debt and equity portfolios are prohibited from having holdings in companies identified as manufacturing assault-style weapons illegal for sale in California.	2013

#	Legislative Mandates	Since
3.	<u>Sudan Act (Sudan)</u> - CalPERS must identify public equity/debt, and private equity holdings in companies with specified business operations in Sudan, conduct specified engagement activities, and divest if statutory requirements are met.	2010
4.	<u>California Public Divest from Iran Act (Iran)</u> - CalPERS must identify public equity/debt, and private equity holdings in companies with specified business operations in Iran, conduct specified engagement activities, and divest if statutory requirements are met.	2011
5.	<u>Public Divestiture of Thermal Coal Companies Act (Thermal Coal)</u> - CalPERS is prohibited from investing in public equity or debt securities of publicly-traded companies that generate 50% or more of their revenue from the mining of thermal coal.	2017



Note: Legislative mandates have specific standards that need to be met for the Board to discontinue carrying out the legislative mandates. Board directed mandates are effected under its plenary authority and fiduciary responsibility

Active Mandates | Economic Analysis Summary

Divestment	Dollar Exposure (Million USD)	GE Weight ¹	Wilshire's Return Impact ² (Million USD)		Predicted Tracking Error ³	Realized Tracking Error ⁴	Information Ratio ⁵
			Since Last Affirmation	Since Inception			5 Yr
Tobacco	1,125.3	0.524%	856	(3,692)	0.063%	0.165%	0.72
Firearms	8.5	0.004%	3	3	0.002%	0.007%	0.27
Sudan	133.7	0.058%	290	290	0.010%	0.024%	0.25
Iran	52.4	0.023%	183	183	0.007%	0.019%	0.28
Thermal Coal	30.5	0.013%	348	348	0.002%	0.017%	3.17 ⁶
ALL	1,350.4	0.622%	1,680	(2,863)	0.065%	0.165%	0.92

Please see appendix for additional information.

¹ As of 30 Nov 2020

² Return impact analysis completed by Wilshire, presented at the November 2020 Investment Committee meeting

³ Predicted Tracking Error based on cap-weighted benchmark completed by Wilshire Associates

⁴ Relative to divestment-unconstrained benchmark, annualized based on monthly performance for 10-year window as of 11/30/20

⁵ Calculated by dividing divested portfolio's annualized active return by its active risk, both calculated over a 5-year period as of 11/30/2020 using monthly observations

⁶ Less than a five-year period

Divestment Review | Emerging Markets Equity Principles

#	Board-Directed	Since
1.	The emerging equity markets component of CalPERS' public equity benchmark is screened to remove companies that have been linked to grievous human rights, environmental, or social welfare violations.	2008

- In 2015, the Investment Committee approved the consolidation of the Statement of Investment Policy for Emerging Equity Markets Principles into the Statement of Investment Policy for Global Governance to facilitate consistent consideration across all investment strategies, geographies, and engagements
- Staff will officially replace the Emerging Equity Markets Principles with an ESG Risk Screen during an upcoming benchmark modification
- Staff evaluated this ESG Risk Screen and determined that it is consistent with the action taken by the Investment Committee in 2015 and allows for the integration of the Emerging Equity Markets Principles into the CalPERS Total Fund Policy

Economic Analysis Summary | Conclusion

Board Mandates

Economic analysis indicates prudent stewardship of the System's assets consistent with the Committee's fiduciary obligations would be satisfied with either choice to:

- Remove some or all board-directed divestment restrictions; or
- Affirm continuation of divestments

Legislative Mandates

The related statutes for the California Legislature mandates have specific standards to discontinue.

Each legislative mandate references article XVI, section 17 of the California Constitution, which permits divestment only “where it is in the public interest to do so, and provided that the prohibitions satisfy the standards of fiduciary care and loyalty required of the retirement board pursuant to this section.”

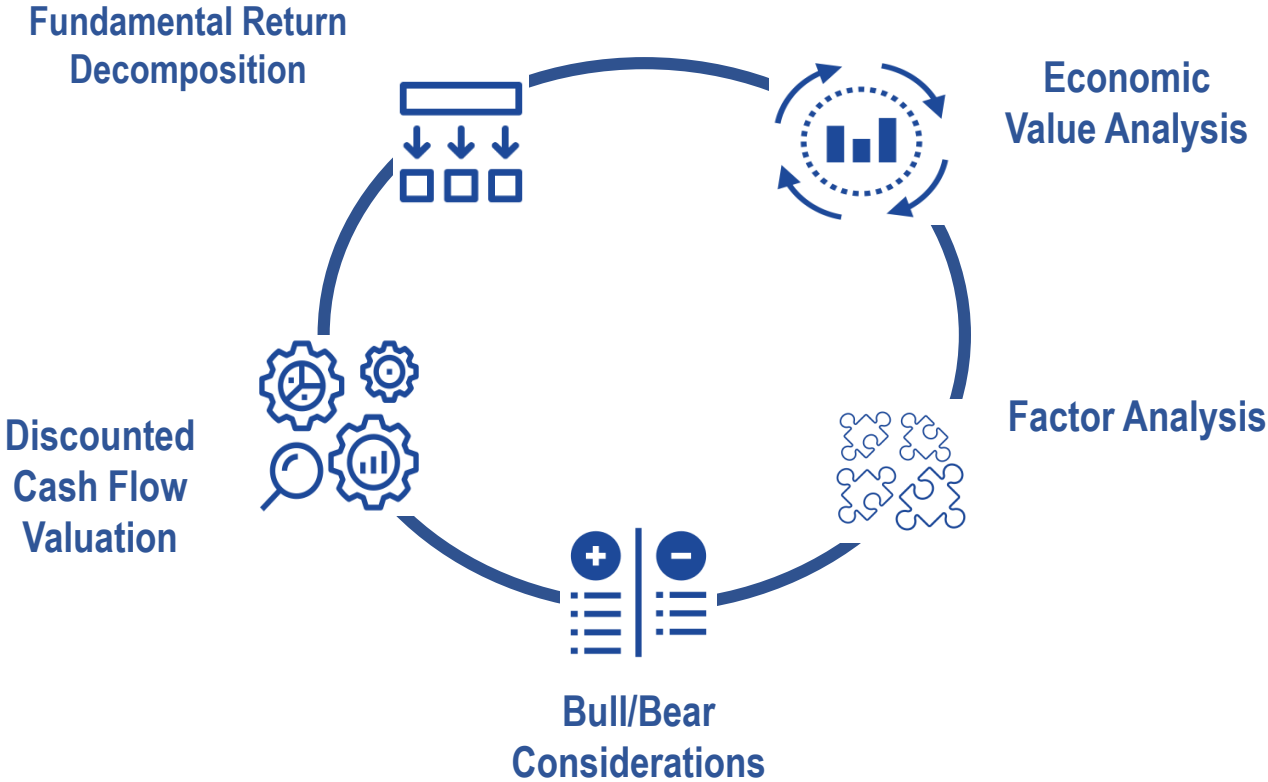
The analysis conducted does not establish that the legislative mandates result in a violation of these standards. For example, as to Iran divestment, CalPERS cannot demonstrate how “divestment disadvantages the fund and that any feasible investment alternatives would yield a lower rate of return with commensurate degrees of risk, or create a higher degree of risk with commensurate rates of return.”

Note: Legislative mandates include Sudan (G.C. §7513.6), Iran (G.C. §7513.7), and Thermal Coal (G.C. §7513.75). For additional details, see page 16 in the Appendix.

Appendix

Analysis Framework

Using a multi-lens approach, the research and analysis conducted focused on



Forward Looking Analysis | Summary

Divestment	Forward Looking Performance				
	Factor Analysis	Total Return Decomposition	EVA Analysis	Scenario Based DCF	Bull/Bear Arguments
Tobacco	+	++	++	+	neutral
Firearms	-	+	+	++	neutral
Sudan	++	-	-	-	neutral
Iran	++	-	-	-	neutral
Coal	++	++	-	neutral	neutral

Taking the companies not owned by CalPERS as their own baskets of securities, the forward-looking analysis found:

- Tobacco: support for attractive fundamentals and return potential however this has not yet translated into growth and outside shocks (US and ex-US) could be impediments.
- Firearms: upside potential comes with the disclaimer that there are only two names in this basket and outside shocks (greater regulation in the US) could be impediments.
- Sudan & Iran: have excess return potential but the baskets are not creating value and face risk from the low carbon transition
- Coal: potential for excess return from mean reversion, but the basket is not creating value and faces risk from the low carbon transition (displacement by natural gas and potentially high carbon price)

Key:

- “+/++” = implied positive contribution based on analysis parameters
- “-” = implied negative contribution based on analysis parameters
- “neutral” = positive contribution is offset by negative contribution OR results are not meaningfully different from analysis parameters

Tobacco | Bull/Bear Considerations



Bull	Bear
Undervalued relative to fundamentals (profitability, cash flows)	Increase in excise taxation (next generation products largely untaxed); recent increase in Indonesia
High, stable and well-covered dividend yield appealing to income-seeking investors in context of low interest rates	Increase in litigation activity (Canada)
Greater consumer acceptance of “reduced risk products” (RRP) (heated tobacco, vaping)	Deeper secular decline in combustible tobacco products as resulting from increased regulatory action (bans, health warnings, packaging constraints)
Improved public health care stance on new generation products (heated tobacco approved by FDA in the US in 2020)	Price pressures from increased competition within the industry
Sustained sales growth in Emerging Markets: exposure to increasing incomes in less regulated environments	Stronger US Dollar
Secular weaker dollar helps industry whose main players are US-based	Longer than expected social distancing
Tobacco is second source of excised tax in the world: governments across the world to “nurture” source of income	Increased ESG focus hurting equity ownership

Iran-Sudan | Bull/Bear Considerations



Bull	Bear
<p>Metals mining industry growth to benefit from growth in renewable energy technology deployment and infrastructure</p>	<p>Oil and gas industries' carbon intensity face significant earnings risk from a low carbon transition (price on carbon, higher cost of capital, new tech expenses)</p>
<p>Industrial and precious metals as Inflation hedges</p>	<p>Increased pressure on dividends (main driver for investors to hold low profitability industry assets) due to secular decrease in oil consumption (peak oil) and deleveraging associated with write-offs of stranded assets</p>
<p>Oil E&P short-term cyclical upside due to of post-COVID supply/demand mismatch (production capacity shrunk during COVID)</p>	
<p>Increased visibility on Oil & Gas majors' renewables strategy to re-attract institutional investors, especially dividends are re-affirmed</p>	
<p>New technologies like carbon capture drive re-evaluation of oil reserves</p>	

Thermal Coal | Bull/Bear Considerations



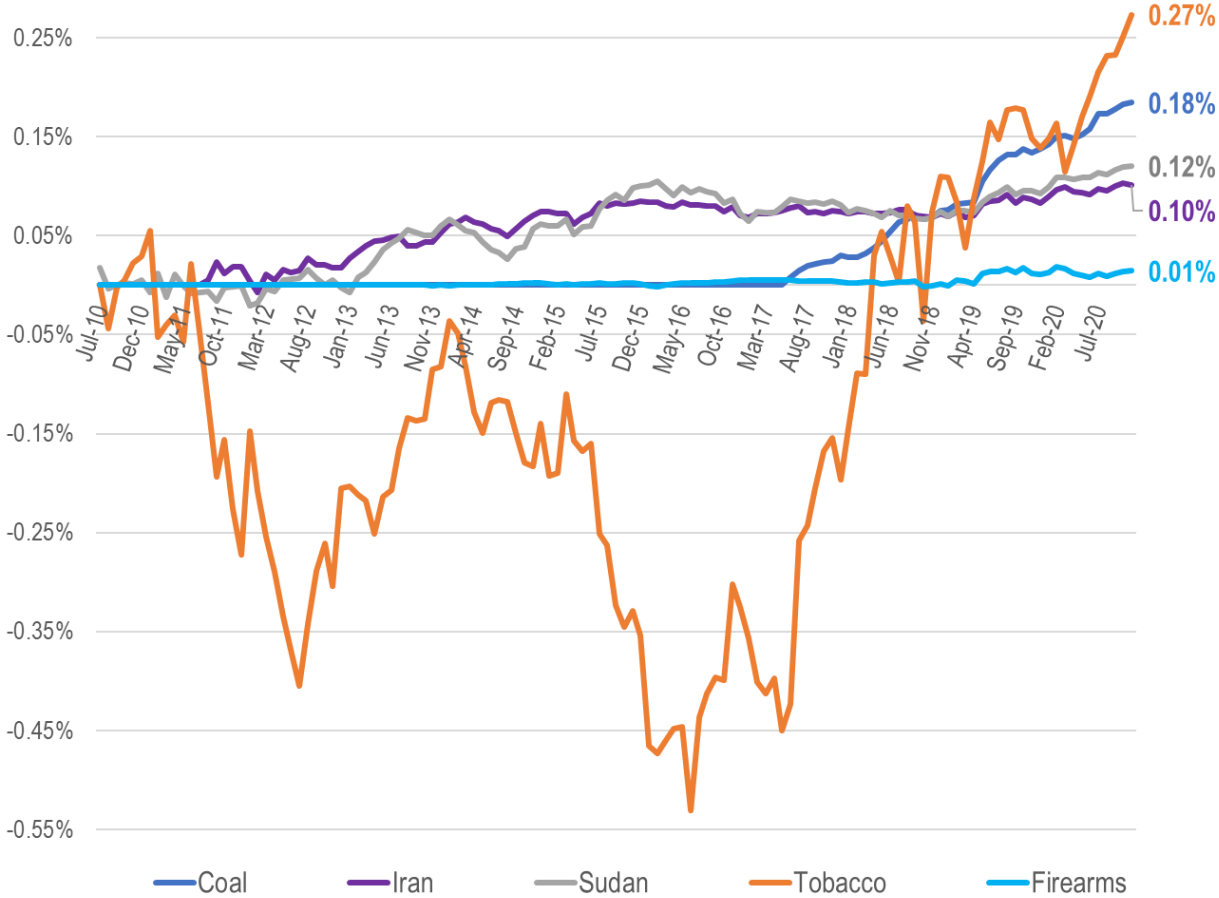
Bull	Bear
<p>Thermal coal is a major source of energy for many Emerging Markets, especially in Asia (dominated by China and India)</p>	<p>Coal, as a source of power, is losing market share to lower cost and 'greener' alternatives like natural gas; Green subsidies decline worldwide as alternative green energy accelerates shift away from Coal</p>
<p>Asset valuations assume excessively rapid phasing out of coal as source of energy; foreseeable mismatch between energy demand and clean energy supply to support traditional energy sources, including coal</p>	<p>China recent commitments to economic decarbonization expected to impact thermal coal</p>
<p>Carbon Capture technology to neutralize CO2 emissions from extremely abundant energy source</p>	<p>Elevated CO2 emission intensity exposes industry to further fundamental deterioration in the case of a global rise in carbon prices</p>
	<p>Increased cost of funding resulting from banks reluctance to fund the industry (ESG profile, credit risk) further pressures economic value add generation, already negative on average across the industry</p>

Firearms | Bull/Bear Considerations



Bull	Bear
Anticipation of stricter gun control stimulates ammo/firearm demand (stockpiling purchases ahead of restrictions)	Stricter federal gun control regulation
Fears of social unrest fueled by political divide/polarization and increased frequency of natural disasters causes structural shift in demand for firearms	Jurisprudence shift to assign financial liability to firearms industry for homicides involving handguns
US Supreme Court 'conservative' composition to support firearms business	

Divestment Policies 10yr Active Performance *



Re-Investment | Transaction Costs Estimates

- Transaction costs estimates parameters:
 - Are for aggregated public equity segments based on holdings as of 11/30/20
 - Estimated using liquidity forecasts for 10/01/20 (“normal day of liquidity”)
 - Expressed in basis points of the divestment basket dollar value
 - Do not include transaction cost associated with funding trade (selling assets), considered negligible in all cases except for Tobacco
 - Funding cost for Tobacco range (millions USD): 0 to 3.11

Mandate	T-Cost Estimate (millions USD)	
	Low	High
Tobacco	3.97	15.24
Sudan	-	1.63
Iran	-	1.08
Coal	-	0.48
Firearms	-	0.21

Legislative Mandate Details

- Sudan - Gov. Code section 7513.6(k)
 - (k) “Nothing in this section shall require the board to take action as described in this section unless the board determines, in good faith, that the action described in this section is consistent with the fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution.”
- Iran – Gov. Code section 7513.7(k)
 - (k) “Nothing in this section shall require the board to take action as described in this section if the board determines, and adopts findings, in good faith and based on credible information available to the public, that the action described in this section would fail to satisfy the fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution. Any adopted findings shall demonstrate how divestment disadvantages the fund and that any feasible investment alternatives would yield a lower rate of return with commensurate degrees of risk, or create a higher degree of risk with commensurate rates of return. Notwithstanding any other law, any determination that an action would fail to satisfy the fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution shall require a recorded rollcall vote of the full board, following a presentation and discussion of findings in open session, during a properly noticed public hearing of the full board. All proposed findings of the board shall be made public 72 hours before they are considered by the board, and the board shall maintain a list of interested parties who shall be notified of proposed findings 72 hours before board consideration. The findings and any public comments regarding the adopted findings and determinations made pursuant to this subdivision shall be included in the report to the Legislature required by subdivision (i).”
- Thermal Coal Gov. Code section 7513.75(f)
 - (f) “Nothing in this section shall require a board to take action as described in this section unless the board determines in good faith that the action described in this section is consistent with the fiduciary responsibilities of the board described in Section 17 of Article XVI of the California Constitution.”