Board of Administration

Agenda Item 9f

April 19, 2022

Item Name: Senate Bill 1173 (Gonzalez) - Divestment from Fossil Fuel Companies

Program: Legislation

Item Type: Action

Recommendation

Adopt an **OPPOSE** position on Senate Bill (SB) 1173 (Gonzalez), as introduced February 17, 2022, because it imposes a divestment mandate on the California Public Employees' Retirement System (CalPERS) Board of Administration (Board).

Executive Summary

SB 1173 prohibits the CalPERS and the California State Teachers' Retirement System (CalSTRS) boards from making new investments in fossil fuel companies, as defined, and requires both systems to divest existing fossil fuel company investments on or before July 1, 2027, if consistent with its fiduciary duty. Beginning on February 1, 2024, and annually thereafter, requires each board to submit a report to the Governor and Legislature regarding any fossil fuel company holdings and divestments.

Strategic Plan

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

Investment Beliefs

This 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, participant 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

The call for divestment has become an increasingly popular tool for promoting a cause or belief. As laudable as the underlying motivations may be, divestment for the purpose of achieving certain goals, such as promoting social justice, focus on companies that do business in a specified country or are engaged in a specified industry that do not appear to be primarily investment-related (Divestment Initiatives) has unintended consequences for the CalPERS fund and its members. CalPERS wants companies in which it invests to meet high corporate governance, ethical, and social standards of conduct and CalPERS' investment in a company does not necessarily signify that it approves of all the company's policies, products, or actions.

However, fiduciary obligations generally preclude CalPERS from sacrificing investment performance for the purpose of achieving goals that do not directly relate to CalPERS' operations or benefits. Divesting appears to almost invariably harm investment performance, by, for example, causing transaction costs (e.g., the cost of selling assets and reinvesting the proceeds) and compromising investment strategies. In addition, there appears to be considerable evidence that divesting is an ineffective strategy for achieving social or political goals, since the usual consequence is often a mere transfer of ownership of divested assets from one investor to another. Investors that divest lose their ability as shareowners to influence the company to act responsibly.

Therefore, CalPERS' Investment policies generally prohibit divesting in response to Divestment Initiatives, but permit CalPERS to use constructive engagement, where consistent with fiduciary duties, to help Divestment Initiatives achieve their goals.

Fossil Fuel Divestment

According to the author,

"California has been a world leader in taking steps to combat the causes of climate change, and have set historic carbon reduction goals and taken meaningful actions to help prevent environmental destruction and protect communities who bear the overwhelming brunt of carbon emissions. Despite these forward-thinking actions, California's multi-billion dollar retirement pension funds are actively investing billions of dollars in the very fossil fuel companies that are causing climate change. CalPERS and CalSTRS, which invest the pension funds of state employees and teachers, have an investing power of $469 billion and $327 billion, respectively. A recent report estimates that out of these funds CalPERS invests $5.5 billion in fossil fuel companies and CalSTRS invests $3.4 billion.

…

"An estimated 1,500 institutions with over $39 trillion in assets have already committed to divestment, including the University of California, the California State University, the State and City of New York, the State of Maine, the Vatican, and the province of Quebec. The Legislature already began the work of divesting from dangerous carbon emitting companies through the passage of SB 185 (De Leon, Chapter 605, Statutes of 2015), which required CalPERS and CalSTRS to liquidate their investments in thermal coal companies. Further, Governor Newsom also recently issued an Executive Order on Climate Change (EO N-19-19) which called on CalPERS and CalSTRS to 'leverage the state's $700 billion investment portfolio to advance California's climate leadership.'

"SB 1173 seizes the momentum of the worldwide divestment movement and continues the bold and progressive actions that California must take to address climate change. SB 1173 ends the contradictory and incongruous policies that position the state as a leader in the fight against climate, while simultaneously investing billions in the fossil fuel companies that are causing climate change."

Analysis

Specifically, SB 1173:

- Prohibits the CalPERS and CalSTRS boards from making additional or new investments or renewing existing investments in a fossil fuel company, as defined.
- Defines "fossil fuel company" as one of the 200 largest publicly traded fossil fuel companies, as established by carbon content in the companies' proven oil, gas, and coal reserves.
- Requires the boards to liquidate existing fossil fuel company investments on or before July 1, 2027.
- Requires the boards to develop and send a report to the Legislature and Governor and post the report to the board's website beginning February 1, 2024, and annually thereafter, that includes the following information:
    - A list of fossil fuel companies that the board has liquidated its investments
    - A list of fossil fuel companies that the board has not liquidated its investments
    - A list of fossil fuel companies that the board has not liquidated its investments because the board has determined that the sale or transfer of investments is inconsistent with the board's fiduciary responsibilities and the board has adopted findings in support of that determination.

- Permits 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.
- Indemnifies 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 fossil fuel companies.

Impact of Divestment Initiatives on CalPERS' Investment Strategies

CalPERS uses a mix of investment strategies to diversify sources of risk and alpha while minimizing costs. These strategies include market-based, systematic, and fundamental strategies to enhance risk-adjusted returns to construct a portfolio that is aligned with its 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 CalPERS investment staff to reevaluate and reinvest as market conditions warrant.

Impact on CalPERS Path to Net Zero

CalPERS recognizes that climate change poses a material risk to society, the global economy, and CalPERS' investments, and CalPERS has a strong commitment to the reduction of fossil fuel emissions. However, as a global investor with a fiduciary duty to its members and employer partners, CalPERS does not believe that divestment is an effective solution to this problem.

CalPERS has a long record of enacting positive corporate change as a result of engaging the companies it owns, both directly and as a part of coalitions of like-minded investors. While divesting often only transfers its shares to other investors - investors that might not share CalPERS' commitment to tackling climate risk – engagement has produced tangible results.

For example, CalPERS' seat at the table as an owner of Exxon recently allowed CalPERS to lead a shareowner campaign to elect climate-conscious board members to the Exxon board of directors. As a result, Exxon now has three directors working towards meaningful climate solutions at the company. CalPERS was also part of the coalition that moved Royal Dutch Shell to support a shareowner proposal on climate risk reporting.

Divestment has little impact on a company's operations or bottom line and does nothing to reduce real economy emissions. But it does mean that investors like CalPERS, who are committed to reducing emissions, lose their influence over these companies. If CalPERS divests, it loses its voice and CalPERS potentially loses money.

Slippery Slope issue

According to a February 9, 2021, letter from the investment firm Wilshire as part of its review of CalPERS' divestment programs, "Since inception, the active divestment programs have reduced the potential market value of the CalPERS Total Fund by an estimated $2.18 billion in present value terms." In recent years, the California Legislature has introduced bills that have or would have required CalPERS to divest from the Governments of Turkey, Azerbaijan, Russia and Belarus, private prison companies, thermal coal, fossil fuel companies, firearms, and the Dakota Access Pipeline.

Each individual divestment proposal may impose a small or theoretically manageable impact on the CalPERS trust fund. Regardless of the relative impact on the fund's investment portfolio, each divestment would reduce fund diversification. As such, each divestment proposal signed into law weakens CalPERS' ability to be a responsible fiduciary of the System by limiting investment opportunities, decreasing diversification, limiting returns, and increasing risk in its investment portfolio.

Advocates for each individual divestment proposal argue that CalPERS can implement each individual proposal without fundamentally damaging the trust fund, and often cite other alternative investment sectors that would be better suited for CalPERS' investment. However, these suggestions ignore the cumulative impact of divestment mandates, as noted above, and ignore the realities of shifting public attitudes. Today divestment advocates are focused on fossil fuels and U.S. foreign policy, but tomorrow it may be social media platforms, vehicle manufacturers, or the meat industry. The ultimate effect of such divestment mandates may create increasing economic inefficiencies that may compound or damage the ability of the overall System to meet its obligations to its members.

Budget and Fiscal Impacts

As of December 31, 2021, the estimate of publicly traded securities held by CalPERS that meet the criteria of a "fossil fuel company" as defined in SB 1173 is $7.4 billion. Should the CalPERS Board direct investment staff to divest these securities, the estimate of transaction costs (including commissions and market impact and excluding opportunity costs) to divest and reinvest the proceeds in other securities is between $75-$100 million.

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 fossil fuel companies and the companies performed well, employers and employees would bear the investment loss and transaction costs to maintain divestment through increased contribution rates.

Benefits and Risks

Benefits:

- None identified. The divestment mandates do not appear likely to alter the activities of any coal, oil, or gas company, and do not appear likely to have effect on climate change.

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.

Danny Brown, Chief
Legislative Affairs Division

Brad W. Pacheco
Deputy Executive Officer
Communication and Stakeholder Relations

Marcie Frost
Chief Executive Officer