



Investment Committee

Agenda Item 9a

March 15, 2021

Item Name: Five-Year Divestment Review

Program: Total Fund

Item Type: Action

Recommendation

For consideration and action by the Investment Committee (Committee), this item identifies several options related to the continuation of the current divestment mandates. Each option presented is supportive of the prudent stewardship of the System's assets consistent with the Investment Committee's (Committee) fiduciary obligations and is as follows:

1. Remove some or all Board-directed divestment restrictions; or
2. Affirm the continuation of divestments

Executive Summary

The CalPERS Total Fund Investment Policy addressing divestment (Divestment Policy) requires that at least every five years staff conduct an economic analysis of in-force mandates to understand the projected impact on the risk-return profile of the affected portfolios. These divestments comprise Board-directed mandates and mandates required by the California Legislature. These mandates are described in more detail within Attachment 1.

As the Divestment Policy acknowledges CalPERS' board members and staff have fiduciary duties of loyalty and prudence pursuant to the California Constitution and California Government Code Section 20151, the results of the analysis are presented to aid the Committee's determination whether continuation of the divestments is consistent with fiduciary duties.

A copy of the analysis is provided in Attachment 1. The Divestment Policy in its entirety is provided as Attachment 2.

Strategic Plan

A periodic review of existing CalPERS' divestments promotes the CalPERS Strategic Plan Goal to strengthen the long-term sustainability of the pension fund by supporting the Committee in evaluating whether existing mandates continue to support the System's investment objectives.

Investment Beliefs

This item supports the following Investment Beliefs:

- Investment Belief 2 – A long investment time horizon is a responsibility and an advantage.
- Investment Belief 4 – Long-term value creation requires effective management of three forms of capital: financial, physical and human.
- Investment Belief 7 – CalPERS will take risk only where we have a strong belief we will be rewarded for it.
- Investment Belief 9 – Risk is multi-faceted and not fully captured through measures such as volatility or tracking error.

Background

The Divestment Policy states “The Board and its Staff have fiduciary duties of loyalty and prudence, pursuant to the California Constitution, Article XVI, Section 17, and Government Code (GC) Section 20151, to invest “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an enterprise of a like character and with like aims.” (GC Section 20151(c).). The Board and Staff also have a fiduciary responsibility under the California Constitution to “diversify the investments of the system so as 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.” (Cal. Const., Art XVI, Sec. 17, subdiv. (d).)”

To ensure that prior divestment decisions remain supportive of the fiduciary duties of loyalty and prudence, the Divestment Policy requires:

1. The Board’s General Pension Consultant (Wilshire) to monitor and provide reports to the Committee on the estimated performance and risk impacts of all then in-force divestments; and
2. Staff to review all in-force divestments, to include an economic analysis, and present findings to the Committee for affirmative action at least every five years.

Wilshire currently provides the report to the Committee on an annual basis. The most recent review was for period ending June 30, 2020 and presented at the November 2020 Investment Committee.

In October 2018, the Committee Chair directed the five-year review and affirmation be scheduled for 2021. At the November 2020 Investment Committee meeting, staff were directed to bring the five-year divestment review to the March 2021 Investment Committee meeting.

Analysis

Staff from within the Investment Office’s Executive Office, Research & Strategy Group, Investment Controls & Operational Risk, Trust Level Portfolio Management & Implementation Group, and the Board Governance & Sustainability programs collaborated on the economic analysis presented in Attachment 1.

Staff observations and findings were reviewed with the CalPERS Legal Office, external fiduciary counsel, and the Board's consultants. The Opinion letter is included as Attachment 3.

Budget and Fiscal Impacts

If the Committee takes action to affirm divestments, there are no budgetary costs anticipated.

If the Committee takes action to reinvest, program costs would include investment transaction and administrative costs. Staff analysis of the estimated fiscal impact of transaction costs is listed in the Appendix of Attachment 1.

Benefits and Risks

Benefits:

- Each option presented is supportive of the prudent stewardship of the System's assets consistent with the Committee's fiduciary obligations

Risks:

Dependent upon the option selected:

- Potential increased reputational risk
- Potential financial impact
- Investors that divest lose their ability as shareowners to influence a company to act responsibly

Attachments

Attachment 1 – Five-Year Divestment Review

Attachment 2 – Divestment Policy Excerpt

Attachment 3 – Board Investment Consultant Opinion Letter – Wilshire Associates

Christine Gogan
Investment Director (Interim For)
Investment Controls & Operational Risk

Arnie Phillips
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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

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.”

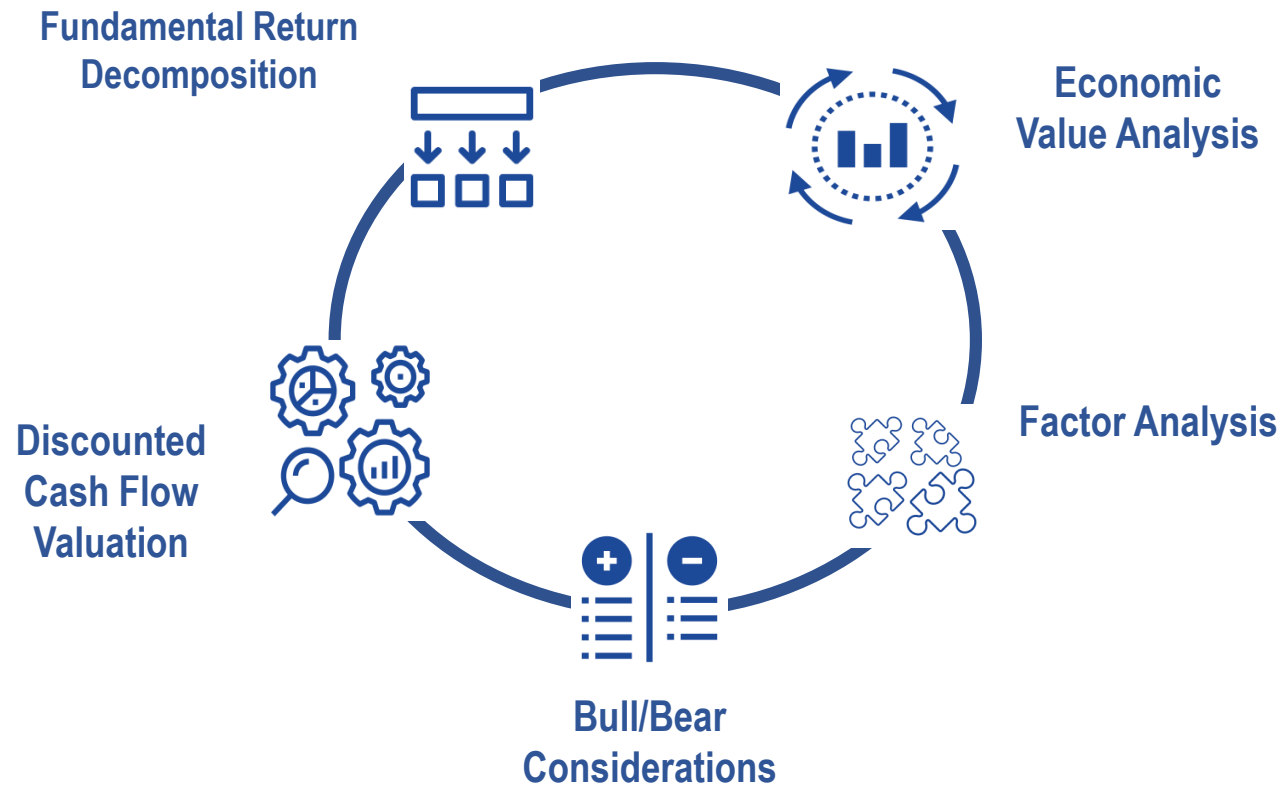
The analysis conducted does not establish that the legislative mandates result in a violation of these standards. For example, as to Iran divestment, CalPERS cannot demonstrate how “divestment disadvantages the fund and that any feasible investment alternatives would yield a lower rate of return with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

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

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)

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
Metals mining industry growth to benefit from growth in renewable energy technology deployment and infrastructure	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)
Industrial and precious metals as Inflation hedges	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
Oil E&P short-term cyclical upside due to of post-COVID supply/demand mismatch (production capacity shrunk during COVID)	
Increased visibility on Oil & Gas majors' renewables strategy to re-attract institutional investors, especially dividends are re-affirmed	
New technologies like carbon capture drive re-evaluation of oil reserves	

Thermal Coal | Bull/Bear Considerations



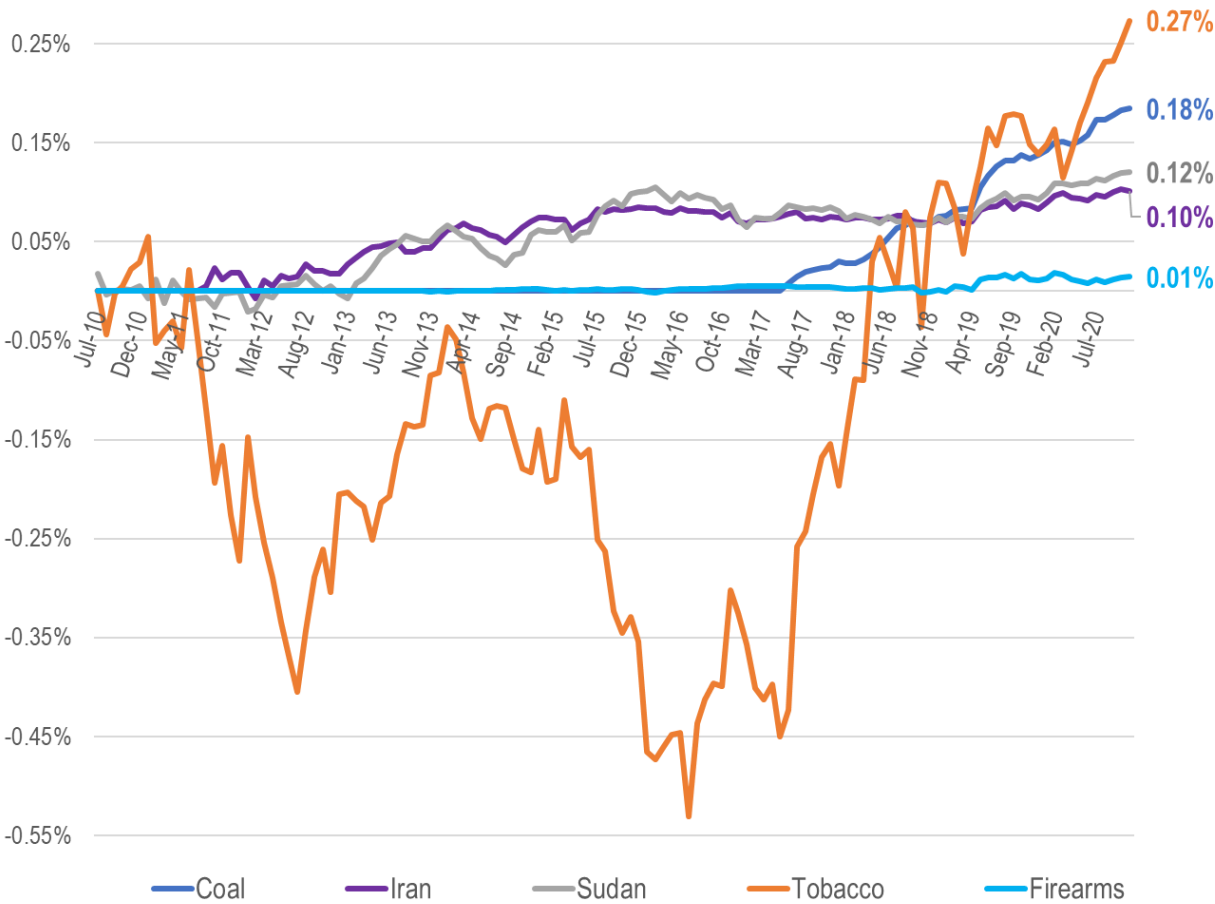
Bull	Bear
Thermal coal is a major source of energy for many Emerging Markets, especially in Asia (dominated by China and India)	Coal, as a source of power, is losing market share to lower cost and 'greener' alternatives like natural gas; Green subsidies decline worldwide as alternative green energy accelerates shift away from Coal
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	China recent commitments to economic decarbonization expected to impact thermal coal
Carbon Capture technology to neutralize CO2 emissions from extremely abundant energy source	Elevated CO2 emission intensity exposes industry to further fundamental deterioration in the case of a global rise in carbon prices
	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

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.”

CalPERS Total Fund Policy, Divestment-related Excerpts

VII. Divestment

Purpose

This section sets forth CalPERS' policy for responding to external or internal initiatives to cause CalPERS to sell investments or refrain from making additional investments (Divesting) for the purpose of achieving certain goals that do not appear to be primarily investment-related, such as promoting social justice (Divestment Initiatives). Typically, Divestment Initiatives focus on companies that do business in a specified country, are engaged in a specified industry, or in specific practices deemed undesirable by federal and state law (e.g., human rights violations) (Targeted Companies).

CalPERS' investment in a company does not necessarily signify that it approves of the company's policies, products, or actions. CalPERS, nevertheless, wants companies in which it invests to meet high corporate governance, ethical, and social standards of conduct. The Committee believes that this generally will promote superior long-term investment performance.

The Board and its Staff have fiduciary duties of loyalty and prudence, pursuant to the California Constitution, Article XVI, Section 17, and Government Code (GC) Section 20151, to invest "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an enterprise of a like character and with like aims." (GC Section 20151(c)). The Board and Staff also have a fiduciary responsibility under the California Constitution to "diversify the investments of the system so as 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." (Cal. Const., Art XVI, Sec. 17, subdiv. (d)).

These 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, such as by 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.

This Policy, therefore, generally prohibits Divesting in response to Divestment Initiatives, but permits CalPERS to use constructive engagement, where consistent with fiduciary duties, to help Divestment Initiatives achieve their goals.

CalPERS Total Fund Policy, Divestment-related Excerpts

Approaches & Parameters

A. CalPERS' Preferred Approach is Engagement

As reflected by CalPERS Investment Belief 3, CalPERS uses the following prioritization framework in considering whether to engage on issues raised by stakeholders:

- Principles and Policy – to what extent is the issue supported by CalPERS' Investment Beliefs, Governance and Sustainability Principles, or other Investment Policy?
- Materiality – does the issue have the potential for an impact on portfolio risk or return?
- Definition and Likelihood of Success – is success likely, in that CalPERS' action will influence an outcome that can be measured? Can we partner with others to achieve success or would someone else be more suited to carry the issue?
- Capacity – does CalPERS have the expertise, resources, and standing to influence an outcome?

Consistent with the foregoing, CalPERS will undertake constructive engagement in support of Divestment Initiatives to the extent the Committee determines to be appropriate or as required by law, but CalPERS will not sell investments in Targeted Companies or refrain from investing in them in response to Divestment Initiatives except as follows:

1. CalPERS will sell Targeted Company investments or refrain from making them to the extent investment in the Targeted Company is imprudent and inconsistent with fiduciary duties. CalPERS recognizes that the prudence of an investment may depend on its purpose.
2. To the extent required by law and consistent with fiduciary duties, CalPERS will comply with federal and constitutional California state laws that require Divesting.

B. Divestment Review

The following processes will be used to ensure that prior divestment decisions remain supportive of the prudent stewardship of the System's assets consistent with the Committee's fiduciary obligations:

1. The Board's General Pension Consultant will monitor and provide reports to the Committee on the estimated performance and risk impacts of all then in-force divestments for the affected portfolios. (See Appendix 1.)
2. For so long as any divestments remain in effect for any of the portfolios, staff shall conduct a review of all such in-force divestments at least every five years, to include an economic analysis of the projected impact on the risk-return profile of the affected portfolios, and present such analysis to the

CalPERS Total Fund Policy, Divestment-related Excerpts

Committee for a determination whether continuation of the divestments is consistent with fiduciary duties.

C. Notice and Voting Protocol

For each divestment included in a regularly scheduled review as described above, continuation of the divestment will require an affirmative roll-call vote of the Committee.

In addition, any determination by the Committee that a divestment activity required pursuant to state legislative mandate would be, or, in the case of an in-force divestment, has become, inconsistent with the Committee's fiduciary duties, such that divestment is precluded or reinvestment is required, will include:

1. A presentation and discussion of relevant findings in open session at a properly noticed meeting of the Committee.
2. A roll-call vote of the Committee.

CalPERS Total Fund Policy, Divestment-related Excerpts

Appendix 1 – Reporting to the Investment Committee

Reporting to the Investment Committee - Investment Office Staff Responsibilities

Ref #	Program	Responsible Party	Report Content	Frequency
17.	Divestment	Investment Compliance and Operational Risk	Staff shall report to the Committee on (a) compliance activities undertaken pursuant to statutory divestment mandates from the state legislature, as applicable, and (b) any corresponding divestment decisions that may be required.	No less than annually
18.	Divestment	Investment Compliance and Operational Risk	Staff shall prepare and submit to the Committee any divestment activity reports required by statute to be submitted to the California Legislature (e.g., Iran, Sudan etc.).	No less than annually

Reporting to the Investment Committee - General Pension Consultant Responsibilities

Ref #	Program	Report Content	Frequency
4.	Divestment	Consultant shall present to the Committee a comprehensive review and analysis of divestment activities to date.	No less than annually

CalPERS Total Fund Policy, Divestment-related Excerpts

Appendix 2 – Investment Program Related Responsibilities

Investment Program Related Responsibilities - Investment Committee

Ref #	Program	Responsibility
5.	Divestment	If necessary, engage an independent consultant to provide an analysis of the economic impact on the portfolio of any contemplated divestment activity, to include one-time transaction costs, predicted tracking error, and risk-return trade-offs, in order to aid the Committee in determining whether divestment is both appropriate and consistent with the Board's fiduciary duties. Staff can help facilitate this process as requested.

Investment Program Related Responsibilities - Investment Office Staff

Ref #	Program	Responsible Party	Responsibility
21.	Divestment	Trust Level Portfolio Management and/or Asset Class/ Program Areas	Provide the Committee with an analysis of the economic impact on the portfolio of any contemplated divestment activity, or of any in-force divestments subject to review pursuant to the Divestment Section, to include one-time transaction costs, predicted tracking error, and risk-return trade-offs, in order to aid the Committee in determining whether divestment is both appropriate and consistent with the Board's fiduciary duties.
22.	Divestment	Trust Level Portfolio Management and/or Asset Class/ Program Areas	Implement any required divestments or prohibitions on future investments.
23.	Divestment	Investment Controls & Operational Risk	Staff shall present to the Committee a comprehensive review and recommendation, consistent with the Divestment Section, on all in-force divestments for the Committee's consideration and action at a minimum every five years.
24.	Divestment	Investment Controls & Operational Risk	Maintain the lists of companies subject to potential divestment.
25.	Divestment	Investment Controls & Operational Risk	Monitor the implementation, or required reconsideration, of any divestments or prohibitions on future investments as required by the Policy.

CalPERS Total Fund Policy, Divestment-related Excerpts

Ref #	Program	Responsible Party	Responsibility
26.	Divestment	Investment Controls & Operational Risk	As applicable in connection with a given divestment mandate, and with any proposed reinvestment in previously divested securities, implement an appropriate plan of engagement with the targeted portfolio companies.

Wilshire

DANIEL E. INGRAM
SENIOR VICE PRESIDENT, WILSHIRE

February 9, 2021

Ms. Theresa Taylor
Chair of the Investment Committee
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Review of Divestment Programs

Dear Ms. Taylor,

You requested Wilshire's opinion with respect to CalPERS' divestment programs. While Staff has provided investment analysis for the Investment Committee to consider, it is up to the Investment Committee to weigh the relative pros and cons for remaining divested or for reinvesting. Wilshire feels that the Investment Committee should focus on adopting a reasonable process to weigh the known costs, unknown risks and potential return impact associated with divestment.

Wilshire advises its clients on a broad spectrum of ESG approaches including: integrating ESG information into investment analysis and manager selection; allocating to thematic or impact investments; and values-based investing which may involve divestment. For example, a healthcare plan may choose to divest from tobacco securities due to a misalignment of interests with their core mission. Divestment may also be appropriate where the client has a strong investment view that better long-term risk adjusted returns may be improved by avoiding some securities or smaller markets.

One important consideration regarding divestment from entire sectors, whether for investment or values-based reasons, is that it precludes asset owners from influencing companies. CalPERS' Investment Belief 4: states that "Long-term value creation requires effective management of three forms of capital: financial, physical, and human." CalPERS has a long history of corporate engagement to drive positive business change although there are legitimate questions about the limits of effecting change at companies where substituting or disposing core products or services could destroy long-term value. To summarize, in discussions regarding divestment, investors should consider their view on one or both of these questions:

- Is the investment under consideration antithetical to the mission of the organization?
- Is there a reasonable investment rationale (i.e. higher returns and/or lower risk) underpinning divestment?

We focus our comments below on assisting the Investment Committee in thinking through questions related to an investment rationale for divestment.

Current State

As we noted in our annual divestment impact analysis at the November 2020 Investment Committee, since their last affirmation, for the period up to June 30, 2020, all CalPERS' divestment programs have delivered positive performance, with tobacco delivering a gain of \$856m since its last affirmation in Q1 2017. Since inception, the active divestment programs have reduced the potential market value of the CalPERS Total Fund by an estimated \$2.18bn in present value terms. **CalPERS' current state is an important factor for the Investment Committee to consider.**

Expected Return

The material provided by Staff sets out to frame the investment view. Though Wilshire forecasts returns for 10 and 30-year periods for a variety of asset classes,

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we do not forecast returns for individual industries, as we do not believe that we have unique insight into the expected relative returns of any one industry versus other industries (i.e. the broader market). While CalPERS has experienced material opportunity costs over the period in which the divestment programs have been in place, there is no guarantee that future returns will emulate the past.

While we fully expect that the performance of divested securities will differ from the broad benchmark in the future, Wilshire can provide no visibility into whether the divestment programs will outperform or underperform the broad market.

Expected Risk

As reflected in Staff's agenda material, Wilshire's 2021 analysis projects an expected tracking error of 0.065%. With reference to Investment Belief 7 (CalPERS will only take risk where we have a strong belief we will be rewarded for it), the divestment program could outperform or underperform the broad market in the future. Tracking error simply implies that a difference exists between the restricted portfolio and the broad market portfolio. It does not pass judgement on which will perform better on a relative basis.

With reference to CalPERS' Investment Belief 9 (Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error), it is worth noting that qualitatively, there are other meaningful risks associated with the divestment programs that are not captured by traditional risk management systems. For example, the tobacco and coal industries are facing significant secular decline, in some cases supported by meaningful regulation. Risk factors such as this should be incorporated when forming potential investment views.

Costs

Unlike expected return or risk, costs can be estimated with greater certainty. With reference to CalPERS Investment Belief 8 (Costs matter and need to be effectively managed), Staff estimates that, across the divestment program, the reinvestment transaction cost, at the high end of their estimates, would range from \$0.21m for Firearms to \$15.24m for Tobacco. Depending on the timing of the trades, these costs could be higher or lower than these estimates. **However, whatever their size, it is known with certainty that there will be explicit costs associated with trading activity.** While these estimated average trading costs may not be significant relative to the total size of the PERF and could be dwarfed by any performance differences between the restricted portfolio and the broad market portfolio (as they have in the past), both are meaningful numbers. The Investment Committee should weigh these known costs against the expected investment impact of reinvesting into one or more divestment programs.

Conclusion

The decision to remain divested or reinvest will certainly affect the return and the risk of the portfolio – but those effects are difficult to project in advance. The realization of a cost in moving from the current structure is certain, although the amount may vary modestly from the estimate and is likely to be relatively small versus the realized contributions from return impacts.

Wilshire looks forward to discussing this topic with the Investment Committee. Should you require anything further or have any questions, please do not hesitate to contact us.

Kind regards,



Daniel E. Ingram