Attachment – 2
3/23/18

Montgomery County ERS and CRHBT

Fossil Fuel Divestment and ESG Update

Previous Reporting

- In July 2017, the Boards received comprehensive annual reports describing the implementation and outcomes of the their Environmental, Social, and Governance policy (ESG), including:
  - ESG developments within the public pension sector.
  - ESG policies for new investment managers added to the ERS and CRHBT portfolios.
  - Examples of our current managers engaging companies on ESG issues.
  - ESG initiatives undertaken by some of our investment consultants.
- On November 20, 2017, the Boards responded to several questions from Council members regarding the May 16, 2017 fossil fuel divestment resolution. The Boards also submitted their first report to the Council pursuant to the resolution, which included:
  - A review of the Boards' fiduciary duty and ESG policy guidelines employed by the Boards and their investment managers and consultants.
  - Research undertaken by the Boards since the adoption of the resolution.
  - Information about other pension funds and how they are addressing the divestment issue.
  - These documents are attached.
- On April 21, 2017, County Executive Leggett, in a memorandum to the Council, commended the Boards' approach to ESG factors, stressed the Boards' fiduciary duty under law, and called for strengthening the County's own climate initiatives. He opposed "actions that would have no practical effect and could harm the investment returns of our retirement funds."

Ongoing Actions

- Staff and the Boards are actively pursuing other avenues for our education and to develop industry knowledge. The ERS and CRHBT recently joined the CERES Investor Network on Climate Risk and Sustainability. By joining CERES, we hope to gain a better understanding of climate risk within our portfolio, explore the opportunities embedded in the clean energy economy, and develop a dialogue with other pension funds as to their analysis.
  - CERES comprises 146 institutional investors, collectively managing more than $23 trillion in assets, with a goal of advancing leading investment practices, corporate engagement strategies, and policy solutions to build an equitable, sustainable global economy and planet.
  - Notable CERES Investor Network members include MassPRIM, New York State Common, NYCERS, NY State Teachers, Washington State Investment Board, and Maryland State Retirement and Pension System.
- Staff has enhanced its practices with respect to assessing the ESG risks of new investments. Since the Boards' annual ESG reports in July, eight investment managers have been hired. Staff analyzed each firm's approach to incorporating ESG factors into their investment decision making framework.
  - Excerpts from Staff's analysis will be included in the 2018 annual ESG reports.
- Staff is currently working with the custodian bank to assist us in analyzing the ESG characteristics and exposure to renewable sources of energy within the ERS and CRHBT portfolios.
- Staff is also in discussions with other pension funds as to whether hiring a consultant specializing in ESG could provide additional assistance in this area.

Recent Events

- **New York State Common Fund:** Andrew Cuomo, the Governor of NY, said he will push for the state pension fund to divest from fossil fuel companies. However, State Comptroller Thomas DiNapoli, who is responsible for investment decisions, indicated that the fund has no plans to divest. Staff spoke with the plan's staff and confirmed that the plan has no intent to divest, as they view it to be a violation of their fiduciary duty.

- **NYCERS**: NYC Mayor Bill de Blasio announced that NYCERS is setting a formal goal to divest from fossil fuels within five years. However, divestment would need to be approved by the trustees for the city's five pension funds (Teachers, Fire, Police, Employees, and Board of Education). Before any actions are taken, NYCERS will hire a consultant to study the issue and its impact on risk and return.

- **San Francisco ERS:** In January 2018, the board of SFERS voted to shift a small portion of its holdings into an environmentally friendly portfolio, opting against a broader strategy of divesting from fossil fuels. The plan's investment consultant, NEPC, issued a report stating that divestment would negatively impact the fund's return, diversification, and inflation protection characteristics. The plan will hire a Director of ESG Responsible Investing.

Divestment Research - Consultants

- **NEPC Study for SFERS**: NEPC, the General Consultant for the San Francisco Employees' Retirement System, recently published a study that could be useful in our understanding of the costs of divestment, given that SFERS is also a multi-billion dollar pension fund that is diversified globally across multiple asset classes, both private and public.
  - NEPC estimated a one-time transaction cost of **0.5%** that would be incurred by selling the fossil fuel investments and replacing them with non-fossil fuel investments. This would result in a one-time cost of **$335,000** for the ERS and **$85,000** for the CRHBT, based on our current fossil fuel holdings of $67M and $17M, respectively.
  - NEPC estimated an annual performance impact of 0.03%-0.10% from divestment due to decreased diversification. This would result in annual costs of between **$1.2 million** and **$4.0 million** for the ERS and between **$274,000** and **$912,000** for the CRHBT.

- **Wilshire Study on CalPERS Previous Divestment Campaigns**: Wilshire Associates, the General Consultant for CalPERS, recently estimated that CalPERS has lost between **$3.8B** and **$8.3B** across five notable divestment campaigns (South Africa, Tobacco, Iran/Sudan, Firearms, and Impermissible Emerging Market Countries).
  - Every divestment campaign resulted in lost value for the pension, with Tobacco and South Africa representing material losses and Iran, Sudan, and Firearms representing marginal losses.

- **Pension Consulting Alliance Analysis for the State of Vermont:** PCA, the general consultant for the Vermont State Employees' Retirement System, recently released an extensive study on divestment. They recommended against divestment for the plan due to increased costs, reduced diversification, the inability to have an impact on climate change or the financial situation of the company, and the likelihood that divestment could lead to a slippery slope where further restrictions are placed on Vermont's investment opportunity set.

Divestment Research - Consultants (Continued)

- **NEPC Survey of Institutional Consultants**: NEPC, a large institutional consulting firm, surveyed the 10 largest public pension consulting firms to see if they have recommended divestment to any of their clients. All 10 consultants responded that they have not made a divestment recommendation to any clients and will not do so. Some of the reasons cited are the following:

  - Conflict with fiduciary responsibilities.
  - Transaction costs associated with selling the fossil fuel securities and buying replacements.
  - Increased cost of monitoring portfolio against divestment guidelines.
  - Reduction of the investment opportunity set for active managers.
  - Reduction in performance during periods of high inflation.
  - Historical cost of divestment campaigns (South Africa, Tobacco, Sudan, Iran, etc).
  - Historical ineffectiveness of divestment campaigns to affect change.

Divestment Research - Staff

- **Analysis of the MSCI KLD 400 Index.** Staff analyzed the holdings of the MSCI KLD 400 Social Index, which is the industry standard index for U.S. companies that have positive ESG characteristics. This index includes 15 companies that appear on the Carbon Underground 200 list, comprising 2.4% of the index. This highlights the difficulty of broad divestment based on one group’s view (Carbon Underground 200) of what constitutes a “bad” company.

- **Other Plans’ Divestment Actions**. Staff’s research indicates that as of December 2017, none of the top 100 U.S. endowments or top 100 U.S. public pension funds have divested from broad fossil fuel investments.

- **Inflation Protection.** One of the key goals of the ERS and CRHBT is to generate adequate performance even in periods of high inflation. Pension benefit payments are linked to inflation in the ERS, and keeping up with health care cost inflation is crucial for the CRHBT. While inflation has generally been muted since the early 1980’s, several respected investment firms (e.g,. Bridgewater Associates) are warning that inflation is on the horizon. Significantly reducing our energy exposure would have an impact on the performance of the trusts during inflationary periods.

- **Interest Rate Increases.** Another benefit to energy exposure is that these securities have generally performed well when interest rates are rising, which can be a time when the broader equity and bond markets experience losses. Staff examined the last six periods of large interest rate increases, and energy equities outperformed the S&P 500 in 4 out of 6 of these periods, by an average amount of 5% per year.

Future Initiatives and Engagement

- **Climate 50/50.** Staff met with the Climate 50/50 group, which is an organization with a mission of uniting investors in engaging public companies with the largest carbon footprints to create effective long-term climate change strategies. This group provides resources for institutional investors to respond to the challenges and opportunities presented by climate change and to increase their climate competency. Staff is evaluating joining this group in the future.

- **Current Consultant**. Staff met with Wilshire Associates Vice President of Responsible Investment Research & Consulting, Daniel Ingram. He will be assisting Staff in analyzing the ESG characteristics of our current portfolio as well as examining our current approach to ESG.

- **Other Consulting Firms:** Staff will seek to engage with other consulting firms to understand what ESG-related services they are providing to other institutional clients. Staff plans to speak with NEPC, PCA, as well as some smaller consulting firms with a specialty for ESG.

- **Other Institutions.** Staff will be engaging with several institutional investors to understand their approaches to ESG and divestment. Plans we expect to speak with are Georgetown University, Florida State Board of Administration, and Fairfax County.

Firearms

- **State of Florida:** Following the shooting in Parkland, there have been proposals to have the pension fund divest from firearms manufacturers. The spokesman for the Florida State Board of Administration stated that divesting would conflict with their fiduciary duty. Florida's investments in firearms stocks only total $500,000 of a $154B portfolio.
- **State of Connecticut:** Following the Sandy Hook shooting in 2012, the Connecticut State Employees Retirement System considered divesting from their small investment in firearms manufacturers. While no action has yet been taken, there have been renewed calls for divestment following the Parkland shooting. Connecticut has $16.5M invested in firearms stocks, which represents 0.05% of the portfolio.
- **CalSTRS**: Following the Sandy Hook shooting in 2012, CalSTRS sold its stake in publicly traded gun manufacturers Sturm Ruger and American Outdoor Brands (formerly Smith & Wesson). CalSTRS had $3M out of their $232B pension invested in these stocks, representing .001% of the total portfolio.
- **BlackRock:** Blackrock, the firm that owns the largest stake in American Outdoor Brands and Sturm Ruger through their passively managed index track funds, said it reached out to these companies following the Parkland shooting to see how they plan to address gun violence. There has been no divestment to date as BlackRock is seeking to replicate the performance of a market benchmark.

Note: Neither MCERS or CRHBT has any exposure to firearms manufacturers as of December 31, 2017.