Wilshire

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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 Ingram

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