MEMORANDUM

To: Seattle City Employees' Retirement System (SCERS)	Date: January 22, 2013
From: Pension Consulting Alliance, Inc. (PCA)	cc: Tony Smith Neil Rue – PCA Christy Fields – PCA Mike Moy – PCA David Sancewich – PCA Kay Ceserani – PCA

RE: Discussion of Potential Divestment Issues: Fossil Fuel Companies and Assault Weapons

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Summary

Over the last four-to-six weeks, SCERS (or "the System") has received requests to develop responses to two unrelated socio-political issues: (i) fossil fuels' threat to the global environment and (ii) recent incidents of mass killings in the U.S. by individuals using assault weapons. Staff has forwarded these requests to PCA in order to assist the Investment Committee in developing an appropriate policy response.

This memo presents brief backgrounds on both of the above issues from a plan sponsor investment perspective. To date, other public plan sponsors and their governing bodies have developed varying spectrums of policy responses to each issue. Through analysis and review of these activities and decisions of similar institutions, the Investment Committee may be able to formulate an appropriate policy model for further consideration. Importantly, an understanding of certain policy approaches may prove valuable as SCERS communicates its interests to its various stakeholder groups.

Any review of the issues presented herein must begin with recognition that it is the Investment Committee's fiduciary duty to act solely in the best interests of the System. These "best interests" pertain largely to ensuring that promised *economic* benefits flow to the pension plan's participants. These economic benefits are, in large part, influenced by the underlying investment results produced by the assets that support such benefits. Keeping these factors in mind, a critical issue with respect to integrating geopolitical issues with fiduciary responsibility is whether placing geopolitical constraints on an investment portfolio would or could impact the investment portfolio's long-term risk-adjusted returns. A broadly accepted conclusion is that the more constraints placed on an investment portfolio, the higher the likelihood that the investment portfolio will have a sub-optimal return-versus-risk structure. As a result, decision makers must weigh the tradeoffs associated with altering an investment portfolio to meet certain geopolitical objectives, which may or may not have a beneficial financial impact.

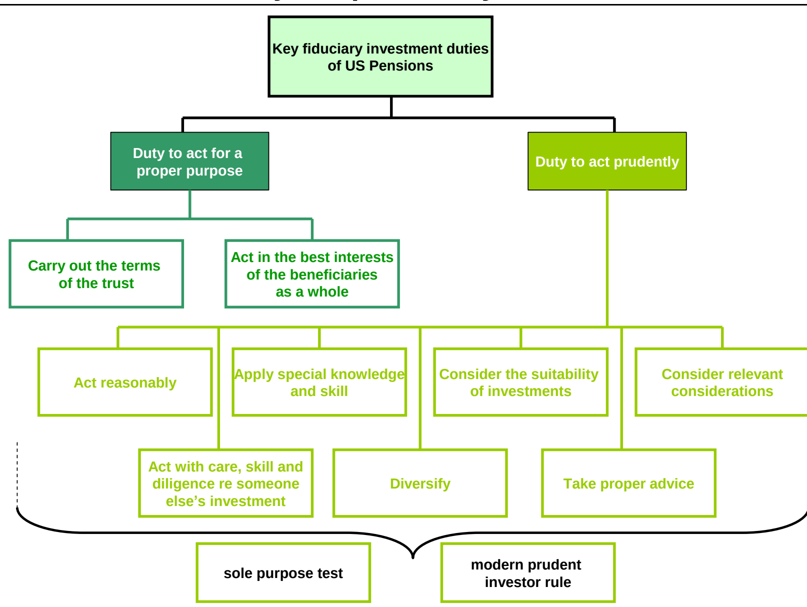
In addition, while the prudent person model of investing assets affords decision makers significant flexibility in designing investment portfolios, an important underlying feature of fiduciary responsibility is the delegation of key tasks to prudent experts. As an investment committee or board of trustees imposes more incremental constraints on an investment portfolio, the less they are relying on external prudent experts.

Keeping the above issues in mind, this report is organized as follows. First, we provide a brief review of fiduciary responsibility from an investment (versus legal) perspective and its connection to the inclusion of geopolitical factors in decision making.[1] Next, we provide a very brief summary of the fossil fuels issue and the assault weapons issue. Third, we highlight a small group of decision making models that institutions have used to apply to investment decisions with respect to these issues. Fourth, we review the market exposure to energy and assault weapons and present a list of firms that constitutes an approximate consensus of the lead corporate perpetrators in the assault weapons issue. Fifth, we highlight SCERS' exposure to these assault weapon companies and discuss SCERS exposure to hydrocarbon-based energy companies. Sixth, we develop a series of policy option recommendations for SCERS to consider.

Fiduciary Investment Responsibility and Geopolitical Issues[2]

Pension investment activities in the U.S. are governed by two far reaching laws: the Uniform Prudent Investor Act (UPIA) and the Employee Retirement Income Security Act (ERISA). ERISA covers pension funds sponsored by U.S. corporations, while 43 states and Washington D.C. have adopted the UPIA. There are two key aspects common to both laws: (i) that fiduciaries make investment decisions that meet the sole purpose test (with the sole purpose being the "best interests" of a plan's participants) and (ii) that fiduciaries apply modern prudent investor concepts to their decision making process (see chart below).

Fiduciary Responsibility Flowchart



1 Views expressed in this report do not express any form of legal review of fiduciary responsibility. PCA recommends that the Investment Committee's legal counsel review the legal aspects and risks of integrating geopolitical/social issues with overall plan fiduciary responsibility.

2 This section borrows heavily from "A legal framework for the integration of economic, social and governance issues into institutional investment," United Nations Economic Programme Finance Initiative, October 2005.

While the prudent investor concept allows investors significant flexibility in constructing diversified investment portfolios and delegating investment decisions, the sole purpose requirement requires that fiduciaries analyze investment decisions in the context of the fund's purpose.

In light of these requirements, several institutional investors have developed a generally acceptable framework for considering geopolitical policy decisions. This framework typically involves the following steps:

1. Determine a list of investments that reflect the geopolitical issue
2. Develop appropriate response strategies
    a. Adjust proxy voting standards
    b. Engage in dialogue with issuers of securities in (1)
    c. Disinvestment
    d. Divestment
3. Develop economic tradeoff analyses
    a. Assessment of changes in investment risk
    b. Assessment of potential differences in investment returns
    c. Assessment of costs associated with divestment
4. Establish sequence of response strategies
5. Implement response strategies

Importantly, advocates recognize the validity of taking a sequenced approach to incorporating geopolitical issues into an institutional portfolio.[3] For example, Stanford University's Statement on Investment Responsibility (considered a model for institutional investors) views divestment as a final course of action in its procedures to address social concerns through its endowment's investment portfolio.[4]

The most critical component in this process is arriving at appropriate definitions for security holdings that meet criteria relating to a specific geopolitical issue. We will discuss briefly processes for arriving at an appropriate listing of holdings in a later section. We do point out, however, that both the fossil fuels and assault weapons situations have revealed the polarity between well-researched focus lists of selected companies versus broad-based definitions of exposure that have the potential to result in significant impact upon investment return and risk to institutional investment portfolios. PCA believes that it will nearly always be the case that the former will prove more acceptable and reasonable than the latter.

Brief Background on the Fossil Fuels Issue

Institutional investors have been considering and integrating environmental issues into their portfolios for several years. Typically, such concerns are addressed under Environmental, Social & Governance (ESG) policy frameworks. Through such frameworks, institutional investors express investment beliefs about specific ESG issues that then form the foundation for specific environmental risk policies. One key feature of these specific policies is that

[3] See, for example, "Limited Sudan divestment bill," Letter to the Editor, Pensions & Investments, June 26, 2006.
[4] Paragraph 2.3, Stanford University Statement of Investment Responsibility Concerning Endowment Securities.

engagement with companies (versus rapid divestment) as long-term shareholders can impose significant change in corporate practices with respect to environmental sustainability practices. In this respect, institutional investors may address environmental issues through (i) direct contact with companies, (ii) shareholder representation, (iii) global forums on the environment, (iv) internally-developed forums on environmental topics, etc. Through these channels, institutional investors develop findings and response strategies for changing corporate behavior with respect to the environment.

With the prior comments as context, in late 2012, a leading climate change advocacy group, 350.org (founded by Harvard University alumni), instituted a 21-city promotional campaign entitled “Do the Math – Fossil Free: Divest From Fossil Fuels!”. This campaign began in Seattle in November 2012 and was attended by Seattle’s mayor, Mike McGinn. Subsequent to 350.org’s Seattle event, Mayor McGinn called on SCERS to:

> “refrain from investing in fossil fuel companies in the future, and begin exploring options for moving existing investments from fossil fuel companies.”[5]

With this statement Mayor McGinn has requested that SCERS and its managers no longer purchase fossil fuel energy-related investments and to, over time, exit such investments that currently reside in the SCERS portfolio. To PCA’s knowledge, no other public pension fund has taken such action to eliminate such companies from their respective investment portfolios.

One challenge with such a substantial request is that the global/U.S. energy sector (90% of which consists of hydrocarbon-related activities) is a dominant segment of the global/domestic economy, comprising of approximately 8%-10% of economic output/consumption.[6] In contrast, the global healthcare segment comprises approximately 9%-10% of global spending,[7] while in the U.S., healthcare spending is estimated to capture 15% - 18% of domestic GDP.[8] Clearly, the energy segment of the economy is significant, both in terms of economic activity and in respective investment markets. Therefore, any policy matter with respect to a segment of such scale requires significant deliberation and analysis.

Brief Background on the Assault Weapons Issue

Within less than six months, culminating with the horrendous incident in Newtown, Connecticut, the U.S. has experienced at least three highly-reported examples of civilians murdering and injuring dozens of other civilians in public settings through the use of assault weapons. In July 2012, twelve people died and nearly 50 injured in a movie theater in Aurora, Colorado. In mid-December, two people died and dozens injured while Christmas shopping in a mall in Clackamas, Oregon. And, less than one week later, assault weapons were again used to kill 20 children and eight adults (mostly teachers) in an elementary school in Newtown. These incidents follow an extended track record of assault weapon use on innocent civilians, not only in the U.S., but elsewhere around the globe.

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[5] “An update on fossil fuel divestment,” http://mayormcginn.seattle.gov/an-update-on-fossil-fuel-divestment/

[6] “A Primer on Energy and the Economy: Energy’s Large Share of the Economy Requires Caution in Determining Policies that Affect It;” www.instituteforenergyresearch.org; February 16, 2010.

[7] Sources: World Health Organization, World Bank, Credit Suisse.

[8] Ibid.

In the U.S., gun ownership and usage by civilians is a complex issue dating back to the founding of our country and protected under the Second Amendment of the Constitution. While U.S. citizens have specific rights to own and operate guns, gun laws vary dramatically across the fifty States. For example, the gun laws within the State of Washington are relatively lenient while gun laws in California and New York are more restrictive. Within the State of Washington, there is no assault weapon ban and open carry of firearms is allowed. In contrast, both California and New York have specific assault weapon bans and do not allow open carry of firearms.[9] Importantly, it is these specific state laws that form the basis for the recent institutional responses to the terrible events cited above.

Response Models Used to Address the Potential ESG Issues

Large scale plan sponsors have developed a range of approaches for addressing major social issues such as Sudan genocide, South Africa apartheid, and tobacco litigation, to name a few leading issues from recent history. From a governance perspective, these issues are often raised outside of the plan sponsor community and then plan sponsors are faced with developing strategies to react to such issues. These issues can be raised by parties characterized as "top-down" (e.g., by a jurisdiction's lawmakers that put in place legislation that might bind a plan to a specific policy response) or "bottom-up" (e.g., student groups at several of the country's leading universities have brought the fossil fuel issue to the attention of their respective university regents, or equivalent, decision makers).

Regardless of who raises a specific issue, fiduciary models responding to the fossil fuel and assault weapons crises follow one, or a combination, of five approaches:

1. Ad hoc
2. Standing committee review
3. Matrix analysis
4. Replication (i.e., using other institutions' policies as templates)
5. Mandated

Each of these approaches is described in more detail below:

Ad hoc approach Plan sponsors utilizing an ad hoc response approach respond to major social issues on a case-by-case basis. Initial communication of the issue usually takes place through senior level decision makers at the plan level, or above. For example, at Harvard, the fossil fuel issue has been raised before their Board of Regents. The Board of Regents then forwarded the issue to the respective committees overseeing investments. These committees (who are responsible for recommending investment policy) research the issue and develop a policy recommendation to the Board of Regents.

9 Wikipedia, "Gun laws in the United States by state."

Standing committee review The most noteworthy example of this approach is Stanford University.[10] Under this approach, there is a standing committee (in Stanford's case, the Special Committee for Investment Responsibility, or SCIR) comprised of endowment trustees. This standing committee is advised by another committee comprised of students, academics, and endowment staff. This latter advisory committee is required to meet at least two times during an academic year. The advisory committee is also required to take on any issue that originates from (i) endowment trustees or key endowment staff or (ii) two or more members of the advisory committee itself.

An important function of both the standing and advisory committees is to research, screen, and vet social issues before they impact investment policy. At Stanford, a key component of this vetting process is the term "substantial social injury," which has a very precise definition. The degree to which the standing and advisory committees agree that an issue meets the substantial social injury criteria dictates whether the endowment's trustees will consider the issue from an investment policy perspective.

Matrix analysis Under this approach, specific criteria are established that determine whether a security, or subset of securities, qualifies for further review. Examples of a subset of securities might be a country market, an industry, or economic sector. One example of the use of matrix analysis is the approach CalSTRS utilizes to assess risk across both industries and countries. CalSTRS utilizes 21 risk factors focusing on criteria not only for accounting practices and monetary payment systems, but also relating to human rights and civil liberties standards. Ongoing monitoring of all investments and/or security subsets is one important aspect of the matrix analysis approach. As a result, matrix analysis is typically very resource intensive and costly to maintain. In addition, the matrix approach may not identify unique issues that fall outside of the pre-specified criteria.

Replication Given that numerous plan sponsors typically analyze and assess such issues for at least twelve months and oftentimes longer, one approach is to review the various institutional responses on a case-by-case basis and adopt an approach that is most consistent with SCERS' approach for incorporating social issues into the investment portfolio. Given that endowments typically are the "first movers" in this area, monitoring a small group of large university endowments may provide appropriate guidance for developing a policy response.

Mandated The above four approaches assume that the plan sponsor has discretion and flexibility to determine its own policy response. In contrast to these approaches, several government-based plan sponsors (mostly state pension systems) have been forced to implement state laws that are crafted specifically to address a geopolitical issue. Such politically-based mandates can produce highly detrimental consequences, putting the plan sponsor's fiduciary roles at risk.

[10] Op cit, Stanford University Statement of Investment Responsibility Concerning Endowment Securities.

Final Remarks on Response Models

For plan sponsors with limited resources and a desire to address an important social issue, the standing committee response model and replication response model appear to be the best solutions.

One advantage of the standing committee model is that the highest-level decision making board delegates research and analysis of a specific geopolitical/social issue to a committee that would likely utilize pre-established criteria to determine (i) whether the issue warrants further consideration and, if so, (ii) how to identify portfolio investments that are directly related to the issue. In addition, the committee can be charged with developing recommended policy language to address the issue. Under this construct, senior investment policy decision makers (with the exception of trustees that might be standing committee members) are not involved in the process until its later stages, freeing up time to focus on other key portfolio investment areas.

A main advantage of the replication model is that significant learning can occur by monitoring others' policy activities. For example, a spectrum of responses to the assault weapons issue is beginning to develop that there is potential that some investment policy responses could require revision. Observing policy formation and then adopting the "best practices" from a spectrum of responses might be viable. Two key downsides of replication are (i) another party's policy response is very likely to not be directly applicable to SCERS and (ii) significant time may elapse before a decision to replicate takes place making the policy response moot, at best. Still, under the standing committee model, replication can be looked upon as a viable input into developing a committee's policy recommendations.

Finally, as alluded to earlier in this paper, regardless of the response model used by the plan sponsor, the consensus view has been to develop a sequential approach to implementing a policy involving a specific social/geopolitical issue. Again, the general sequence of this implementation is:

a. Adjust proxy voting standards
b. Engage in dialogue with issuers of securities
c. Disinvestment (not purchasing additional security positions)
d. Divestment

Importantly, this sequence of activities forms a process record that the plan sponsor can rely upon as its upholding fiduciary responsibility.

For example, across many large-scale European funds, proactive investment strategies have been developed to compel companies to promote, foster, and develop environmentally sustainable business practices and products. In the U.S., both CalPERS and CalSTRS are well known for developing and implementing leading-edge ESG policies. For example, CalSTRS has worked closely with such companies as Sysco Corporation and ConocoPhillips to refine corporate practices with respect to water management and drilling practices, respectively.[11] In this respect, the engagement phase (particularly in concert with other institutional investors) may prove to be a viable change strategy.

[11] "CalSTRS Marks Success in Sustainability Efforts," Sept. 2011 press release.

A Brief Review of Market Exposure to Energy & Assault Weapons

Establishing appropriate lists of investments relevant to the specific ESG issue is critical from a fiduciary standpoint for two reasons: (i) the broader the list, the higher the likelihood that marginal companies have only minor impact and (ii) the larger the aggregate value of companies on a list, the larger the impact a disinvestment or divestment decision will have on the overall risk-adjusted returns of the investment portfolio.

Having a list that is too inclusive can cause havoc for an investment portfolio. If the definition is too broad, an institutional investor can be held accountable for significant deviations in portfolio structuring and/or investment performance. For example, in 2000 the National Foreign Trade Council (NFTC) sued the State of Massachusetts, claiming that (i) individual states' unilateral foreign divestment policy actions were unconstitutional and undermined federal foreign policy actions and (ii) divestment activities are typically harmful to pension plan participants.[12] The U.S. Supreme Court ruled unanimously in NFTC's favor.[13] Such anecdotal evidence indicates that broadly defined divestment mandates that limit jurisdictional authority and discretion may result in significant negative consequences. At the other end of the spectrum, Stanford University approved a focus/divestment list of only four companies related to Sudan divestment after receiving and reviewing significant research from its student advocacy group STAND.[14]

An important finding is that divestment advocates have made significant strides in researching and identifying corporate perpetrators. In fact, a consensus view has developed that it is better to adopt a more "focused" rather than "blanketed" response strategy. This focused approach has been effective in establishing successful Sudan divestment policies:

> "…AB 2941 follows a model of 'targeted' divestment first adopted by the University of California board of regents.
>
> This model is limited only to those companies that provide significant revenue to the government of Sudan, impart minimal benefit to those outside of government circles, and have expressed no significant corporate governance policy regarding the situation in Sudan. Additionally, the bill limits the type of investments targeted and gives fiduciaries the option of avoiding divestment from particular companies (or types of investments) if it rigorously can be demonstrated that no financially equivalent alternative is available. Finally, the bill requires that potentially offending companies be engaged before divestment is mandated…"[15]

Interestingly, this divestment advocate believes that two key factors should be considered in developing a response strategy and improving the likelihood of change: (i) to have a narrow scope and (ii) to engage prior to divestment.

Given these findings, PCA believes the use of narrower, rather than wider, focus lists is an appropriate initial approach to defining a list of corporate perpetrators with respect to geopolitical/social issues.

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12 "Seven States Consider Sanctions Legislation as NFTC Moves Against Illinois Law on Sudan," nftc.org, August 17, 2006.

13 *Ibid.*

14 "Request for review by the Administrative Panel on Investment Responsibility of Stanford University of PetroChina, ABB Ltd., Sinopec, and Tatneft," Students Taking Action Now: Darfur, April 4, 2005.

15 Miller, Jason, national policy director, Sudan Divestment Task Force, "Limited Sudan divestment bill," Letters to the Editor, Pensions & Investment, June 26, 2000.

Assault Weapons Issue

Since the Newtown crisis, a handful of actions have been taken to encourage divestment. There are several important trends that are unfolding:

- The Treasurer for the State of California submitted a motion to the CalSTRS Investment Committee to divest "from all firms that manufacture for sale to private citizens firearms which are banned for purchase or possession by private citizens of California."[16]

- The Comptroller of the State of New York froze further New York Common Fund investments in firearm manufacturers, stating that "The New York State Common Retirement Fund will not buy stocks in companies whose primary business is manufacturing firearms for commercial sale." Freezing further investments is not the same as divestment. Freezing future investment allows current investments to remain in the portfolio while divestment seeks elimination of specified investments.

- The Mayor of Los Angeles asked the three City-wide pension systems "to end investments in companies that produce the assault weapons and ammunition so devastating to our communities."

- Other plan sponsors (such as Connecticut's state pension system) did not alter their investment policies, but did examine their holdings closely for exposure to assault weapon/guns manufacturers.

- Other jurisdictions requested that pension plans consider divesting of producers, distributors, retailers, and marketers of firearms. These requests produce a very lengthy list of potential divestment candidates.

Here the clear consensus, from a practical perspective, is to focus on public companies that manufacture firearms and/or equipment used for assault weapons. Importantly, in the case of New York and California, where policy decisions have been made, the actions by their respective retirement systems reflect State law relating to firearms. Both California and New York ban assault weapons.

These decisions have resulted in a focus list of approximately six companies: (i) Smith & Wesson Holding Corp., (ii) Olin Corp., (iii) Sturm Ruger & Co., Inc., (iv) Alliant Techsystems, Inc., (v) Forjas Taurus SA-PREF (Brazil) and Howa Machinery (Japan). In aggregate, these manufacturers make up less than 0.05% of the total equity market. Because of their relative size, choosing to engage and/or divest of these companies would have virtually no impact on the economic results of a large-scale institutional portfolio.

Fossil Fuel Issue

PCA is not aware of any public retirement system that has divested from energy (i.e., hydrocarbon-related) investments. At the time this memo is being written, Harvard

[16] December 28, 2012 letter from Treasurer Lockyer to Investment Committee Chair Harry Keiley.

University was continuing their divestment review process to determine an appropriate course of action. Harvard alumni are the driving force behind the current fossil fuel divestment idea. Harvard's review process is very similar to that of Stanford University's (described earlier) in that they have a standing committee in place to handle such issues. Given the current lack of any significant divestment actions across the country at this point, PCA believes continued monitoring of peer institutions along these lines would prove most prudent.

As highlighted earlier, ESG best practices involve engaging companies first on the relevant issues with explicit divestment as a subsequent decision point. Through this process, well-organized investors may be able (and have been able) to effect significant change in corporate behavior. For example, CalSTRS has been able to influence climate change impact reporting at a handful of public companies.[17] With respect to climate change-related advocacy, the Investor Network on Climate Risk (INCR) of the non-profit Ceres is one example of sophisticated institutional investors organizing to effect climate change policy.

On a market value basis, hydrocarbon-based energy companies constitute one of the largest segments on the global equity markets and also represent a small proportion of the fixed income investment universe. In aggregate, energy companies constitute approximately 10% of the global public equity market, making the energy sector the fifth largest sector out of ten - being smaller than financials, technology, consumer discretionary, and industrials, but larger than healthcare, consumer staples, materials, telecommunications, and utilities. Based on the policy market benchmarks utilized by SCERS, there are over 500 companies representing the energy sector of the global equity market. Within the fixed income universe, energy companies comprise approximately 2% of the policy benchmark's market value.[18]

SCERS Exposure to Assault Weapon Manufacturers and Hydrocarbon-based Companies

The discussion below summarizes SCERS' exposure to both assault weapon manufacturers and fossil fuel companies. With respect to the latter, we use as a proxy SCERS' allocation to the equity and fixed income energy sectors, since these sectors consists of >90% hydrocarbon-related companies. While the allocation to assault weapons manufacturers is virtually insignificant, the allocation to energy companies is significant and material.

Exposure to Weapon Manufacturers

As of November 30, 2012 (the most recent date available), SCERS had a negligible allocation of assets to only two of the five weapons manufacturers cited earlier. That positions are a $39,000 holding of Alliant Techsystems, Inc. (Alliant) spread across two passive domestic equity accounts (Rhumbline separate account and Blackrock commingled account) and a $7,000 position in Howa Machinery, Ltd. Through the DFA International Small Fund. Alliant is a manufacturer of weapons equipment for law enforcement agencies. Ironically, this is the sole position held by the State of

[17] "CalSTRS Marks Success in Sustainability Proposals," CalSTRS press release, September 22, 2011.

[18] Source: BNY/Mellon, Russell, Barclays Capital. As of 11/30/2012.

Connecticut's pension fund. The Treasurer of Connecticut continues to monitor its Alliant holding, but has not divested. Howa Machinery manufactures a bolt-action military/sniper rifle used by the Japanese military. The rifles also utilize magazines that can contain up to five bullet casings.

Based on November 30, 2012 market values, the above positions amounted to less than 2/1,000th of 1% of SCERS' total assets. Some or all of the above five companies are included in lists utilized by other plan sponsors. To PCA's understanding, there have been no policy decisions involving divestment lists beyond these specific companies. As a result of these findings, PCA believes that divesting of these specific companies would likely have no impact on risk-adjusted performance.

Exposure to Hydrocarbon-related Companies

As of November 30, 2012, SCERS had a significant allocation of assets to the energy/hydrocarbon sector. Based on November 30, 2012 market values, total energy exposure amounted to more than $102 million of total portfolio assets, representing more than 5% of SCERS' total portfolio. Within the public equity class, energy-related holdings amounted to approximately $89 million of equity assets, representing approximately 8% of total public equity. In aggregate, SCERS held at least 550 individual energy-related companies across both its equity and fixed income portfolios.

Divesting of this many companies and this proportion of the portfolio would likely have material impact on risk-adjusted performance for two reasons. First, as mentioned earlier, the energy segment represents one of the largest segments of both the economy and the global investment markets; divesting of this large segment if others do not will clearly distinguish SCERS' investment portfolio from those of their peers in a significant way – for better or for worse. Second, there are frictional costs associated with making material adjustments to an institutional investment portfolio, particularly at this scale. A reasonable preliminary estimate of transition costs associated with moving out of energy into other segments would amount to approximately 50 basis points (0.5%) on both the buy and sell sides of the adjustment process. In total, that approximates to close to $1 million in transition costs alone.

Suggested SCERS Initial Policy Actions

PCA takes no position on how SCERS should respond to the assault weapons crisis and the push for fossil fuel divestment. However, we have presented significant background and information in this report to indicate targeted policy actions at least with respect to the assault weapons issue may prove a reasonable course of action. As highlighted earlier, a handful of SCERS' institutional peers have already made such decisions.

Addressing the fossil fuel/hydrocarbon divestment issue is a completely different matter. Hydrocarbon-related companies represent a significant proportion of SCERS portfolio. PCA believes direct divestment would both be costly and cause investment performance to deviate materially from a portfolio that otherwise had exposure to this segment of the market/economy. Reflecting these considerations, as highlighted earlier, PCA is not aware of any public pension fund that has divested of hydrocarbon-related companies. Therefore, before SCERS takes any action with respect to fossil fuels, SCERS should conduct further research into the matter. Areas requiring exploration include (i) developing a better quantification of the potential economic impact of the decision to extract the energy segment out of the total portfolio and (ii) determining whether any divestment strategy should focus on a particular subset or focus list of companies (e.g., a "selected perpetrators" list, if you will). In addition, extending the research window will also allow SCERS to monitor the activities of other significant institutional investors along these same lines. From a prudence perspective, PCA believes SCERS should not necessarily be the first to develop a divestment model of this magnitude.

Assuming SCERS has the discretion and desire to take action on these issues, PCA suggests SCERS consider the following steps:

1. Examine SCERS' ESG policy statement to determine whether or not the fossil fuel issue warrants consideration. If the policy statement is not explicit enough, then SCERS should deliberate on the sufficiency of its policy language.

2. Refine SCERS' existing policy statement to better describe a phased engagement/divestment approach (see pages 7-8 of this memo) to address specific environmental/societal/governance issues within the investment portfolio. Before determining a response strategy with respect to a specific issue such as fossil fuel usage and investment, SCERS should have a policy framework in place to help articulate such a response.

3. Develop and adopt a position statement with respect to both the assault weapons and fossil fuels issues. These position statements could include specific target lists of companies that qualify for further (i) engagement/monitoring, (ii) disinvestment (i.e., freezing investment), or (iii) divestment. Keep in mind that constraints (ii) and (iii) are non-market constraints placed upon SCERS' investment managers. As such, further analysis, discussion, and research would have to be undertaken to factor in such exclusions when analyzing and assessing SCERS' investment managers' performance.

4. Engage SCERS investment managers to eliminate/ban specific holdings. With respect to the assault weapons issue, this becomes, in effect, a disinvestment strategy because SCERS positions in assault weapons manufacturers is not material. With respect to fossil fuels, if a more narrow focus list can be developed after further research, then SCERS could potentially develop a more meaningful dialogue with its managers about specific companies.

   Once a more narrow focus list is determined, an appropriate initial course of action would be to send written inquiries to the pertinent SCERS investment managers and corporate managements of the holdings in question and review their collective responses. This would allow SCERS to go on record as addressing the fossil fuels issue. The Investment Committee could then address the managers' responses on a case-by-case basis. To the extent that SCERS is not satisfied with its managers' responses, the Investment Committee could consider adjusting specific manager guidelines to divest/disinvest of pertinent holdings.

Finally, <u>Consider Establishing Investment Responsibility Subcommittee.</u> Social/geopolitical issues, such as assault weapons and fossil fuels, will likely surface from time-to-time. As a result, PCA believes SCERS might consider forming an investment responsibility subcommittee that would have responsibility for (i) recommending corporate governance policy largely via proxy voting standards and (ii) analyzing and vetting social/geopolitical issues as they arise. Such a subcommittee framework might be loosely modeled after Stanford University's Special Committee on Investment Responsibility (SCIR). There are several critical aspects to the SCIR model, including (i) a very precise definition of "substantial social injury" that is used to assess specific issues, (ii) the committee's members represent different stakeholders with respect to social issues, and (iii) the SCIR makes policy recommendations to Stanford's trustees after significant analysis has taken place – in this respect, the Investment Committee optimizes the use of its time in considering how to respond to social/geopolitical issues.

Finally, it is important to recognize that there is strong anecdotal evidence that past divestment decisions (whether South Africa, Tobacco, or Sudan, etc.) have actually reduced the economic investment performance of institutional investment portfolios. One recent example is CalSTRS' decision to divest of tobacco holdings in the early 2000's (tobacco represented 1%-2% of public equity at the time). Since that time, the opportunity cost of not holding tobacco companies (and having investment policies that exclude investment in tobacco) has exceeded $1 billion. Similar results also accumulated with respect to South Africa divestments. Given these outcomes, decision makers should apply significant caution and deliberation in crafting any form of divestment strategy with respect to the fossil fuel segment of the economy. Particularly when divestment activities such as those described above would likely require significant resources that may be diverted from other essential investment activities at SCERS.