City of Ann Arbor
Employees' Retirement System
Board of Trustees

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Date: May 18, 2017

To: Honorable Mayor and City Council

From: Board of Trustees of the City of Ann Arbor Employees' Retirement System

RE: Fossil Fuel Divestment

Thank you for your continued interest on the issue of fossil fuel divestment (FFD). The Board of Trustees of the Retirement System continues to re-visit the topic to determine if FFD has become a more viable strategy subsequent to the original findings in 2013. In conjunction with the Board's investment consultant, Meketa Investment Group, the Board recently devoted time to review the latest developments in this movement.

As you are aware, the Board of Trustees ("Board") has a fiduciary obligation under the plan provisions and Public Act 314 of 1965, as amended, to discharge its duties solely in the interest of the Retirement System's participants and beneficiaries. The assets of the Retirement System are held in trust for the exclusive benefit of these plan members and beneficiaries. As of December 31, 2016, the Retirement System (Pension and Retiree Health Care) had approximately $618 million in combined assets. The Board has a statutory obligation to "make investments for the exclusive purpose of providing benefits to participants and beneficiaries, and defraying reasonable expenses of investing assets of the System." The Board must determine that "a particular investment or investment course of action is reasonably designed to further the purposes of the System, taking into consideration the risk of loss and the opportunity for gain or other return", as well as other factors such as, the diversification of the System's investments and liquidity needs of the System.

EXPOSURE

Below is a breakdown of the type of investments in the retirement system assets held at 12/31/16 grouped by degree of exposure to funds in the "Carbon Underground 200 (CU 200)", an annually updated listing of the top 200 public coal, oil and gas companies globally ranked by the potential carbon emissions content of their reported reserves.

- 84.2% Public Equity and Fixed Income – See commentary below
- 10.5% Private Equity and Real Estate – Very minimal exposure to Fossil Fuels
- 4.0% Hedge Fund Investments - Very minimal exposure to Fossil Fuels

For purposes of our discussion, we will focus on the 84.2% (approximately $400 million) invested in Public Equity and Fixed Income Investments. Based on analysis provided by Meketa, the Retirement System's total exposure to the CU 200 is 1.92%, with 1.70% attributable to equities and 0.22% attributable to fixed income.

HARD COSTS

Although there have been some advancements since the discussions in 2013, Meketa found that there are still no good viable Commingled Index Pools with an FFD mandate. These passively managed index funds allow institutional investors such as the Retirement System to invest with very low costs. As of December 31, 2016, the Retirement System has allocated approximately $282M, or 59%, to very liquid and low-cost index strategies. While there are several high cost ETFs offering FFD mandates, the expense ratios on these type of funds make them cost prohibitive to explore at this point.

The remaining option is to move these indexed investments from commingled funds to separately managed investment vehicles, which can "filter" out securities in the CU 200 list. Meketa provided the cost comparisons of mandating separately managed portfolios from two index fund providers; Northern Trust, the System' custodial bank and a current provider of index funds and Rhumbline, a firm that manages a small portion of the Retiree Health Care Benefit Plan and Trust. The fee analysis for the Retirement System includes U.S. equities, international developed equities, broad investment grade fixed income, and TIPS. The assets in Fisher is aggregated in the international equity fee calculations using the index fund fee.

The fee increase to the Retirement System resulting from an FFD mandate by Northern Trust would be approximately $260,000. The annual fee would increase to $382,600 from the current $122,500 by moving to separately managed investment vehicles. Similarly, the annual fee to the Retiree Health Care Benefit Plan & Trust would be approximately $125,000, an increase of approximately $85,000.

A separately managed FFD mandate by Rhumbline would increase the fees we currently pay also. The Retirement System's overall fee increases by approximately $106,000 to $228,100. The increase for the Retiree Health Care Benefit Plan & Trust increases to approximately $74,800 from the current approximate fee of $40,000.

It should also be noted that the System achieves the current lower expense ratios due to the volume of investments and moving assets to a different manager may trigger a less favorable fee structure.

SOFT COSTS

In addition to the fee increases, the alternatives discussed above would likely require increased oversight by staff as well as higher legal, accounting, and audit charges. The System currently has a flat rate contract with the custody bank, Northern Trust, so the cost to setup, custody and administer these separate accounts would not be a factor at this time. However, there is a potential for increase when the existing contract is up for re-negotiation, especially if a significant investment migrates from the custody bank. In addition, the liquidity of some accounts may lessen due to longer account settlement timing.

INVESTMENT RETURNS & MARKET RISK

Although studies exist that attempt to quantify the return impact of FFD, many have conflicting conclusions. There is still no conclusive evidence on whether FFD adds or detracts to returns as such data is very dependent on end point bias. There are as many historical periods of FFD strategy outperforming the overall market in general as there are periods where the reverse happens. The future returns of fossil fuel companies is very dependent upon the market demand of these commodities, the economic viability of alternative fuel sources, and the risks associated with the stranded assets theory becoming a reality.

RECENT FFD ACTIVITIES

Although this topic has seen progress since our discussions in 2013, the majority of recent divestment activities have occurred in Europe rather than in the U.S.A. Universities of Bristol and Kings College London in the U.K. both adopted divestment plans, with Kings College London announcing a full divestment by 2022. The Irish Parliament also passed the FFD Bill in January 2017. This is the first step to full divestment. The $7 Billion Euro Berlin Doctors' Pension Fund announced that it was divesting from all companies that generate more than 25% of income from coal and coal related businesses. The one significant U.S. institution to divest in 2017 is the Riverside Church in N.Y.C. They announced that all investments in fossil fuel companies will be divested from the $140 million endowment within the next five years.

2016 also saw some well-known institutions announcing either full divestment or adopting plans to divest. Several German cities and states have announced their intentions to divest in 2016. They include the Cities of Munster, Berlin, and Stuttgart, and the State of Baden-Wurttemberg. University of Copenhagen also decided to invest strictly in fossil fuel free strategies.

Of the many institutions to adopt divestment in 2015, two non U.S. institutions stand out. The giant Norwegian Government Pension Fund announced that they will divest from coal and coal burning companies. This will result in approximately $8 billion of divestment. Church of England also announced that they will divest all coal and tar-sands companies. In the US, we had the University of Maine, United Methodist Church, California State University at Chico, Syracuse University, and the Rockefeller Foundation all announce their intentions to divest from coal and all carbon related companies. The most interesting announcement came from the Rockefeller Foundation, which was established by John D. Rockefeller of the Standard Oil. Most of today's major oil companies can trace their roots back to Standard Oil.

MOVING FORWARD

It is important to note that the definition of socially responsible investing (SRI) not only varies by individual and community, but also over time. If one SRI issue is adopted as part of an investment approach, the Board and/or City Council will likely be presented with other SRI issues (i.e., alcohol, tobacco, firearms, emerging manager allocations, alternative energy investments, etc.). Analyzing the relative merits of numerous SRI issues could be time consuming and detract from time spent to evaluate and monitor the remainder of the investment portfolio.

As stated in the 2013 memo to Council, part of the fiduciary role of the Board of Trustees of the Retirement System is to look for established products that have a compelling risk and reward profile. As is the case with all investment decisions, when new approaches or strategies emerge, the Board will carefully evaluate the idea based on potential return, risk, liquidity, cost, complexity and other appropriate factors.

At this time, the Board remains wary of pursuing a socially responsible strategy of FFD as it opens the door to pursuing other kinds of SRI strategies. Although admirable in purpose, the Board must balance this with its fiduciary responsibility, which is based in part on comparing performance and fees to the full market's risk/rewards profile. For these reasons and the data presented in this communication, the Board is still not comfortable pursuing a fossil free strategy at this time. It will continue to monitor this investment strategy and movement as they develop.