City of Ann Arbor
Employees' Retirement System
Board of Trustees

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Date: October 17, 2013

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 engaging with the Board of Trustees of the Retirement System on the issue of fossil fuel divestment. The topic of fossil fuel divestment is complex, and the Board has not had sufficient time to review the subject comprehensively. However, over the past month, and at the request of Council, the Board worked with its investment consultant, Meketa Investment Group, to research certain aspects of a fossil fuel divestment approach within the Retirement System. Some of those preliminary findings and other information are provided below.

As you are aware, the Board of Trustees ("Board") have a fiduciary obligation under the plan provisions and Public Act 314 of 1965, as amended, to discharge their 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 June 30, 2013, the Retirement System (Pension and Retiree Health Care) had approximately $540 million in 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." Trustees 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.

HARD COSTS

Through discussions with individual investment managers, Meketa analyzed the impact of fossil fuel divestment or fossil fuel free portfolios on manager fees. Certain managers, representing 21% of the Retirement System's assets, can implement such a "filter" without cost. Other managers, representing 11% of the Retirement System's assets, can implement by changing the structure of the account at essentially no cost. Approximately 44% of Retirement System assets are invested in passively managed index funds that could be allocated differently by providing direction to the investment manager or moving assets to a different custodian. Any changes to the passive investments would incur higher asset management fees. Approximately 13% of the Retirement System's portfolio cannot implement the fossil fuel free strategy without exorbitant costs (that would clearly outweigh any potential benefit) or changing investment strategies. The remaining assets, approximately 11%, are invested in strategies unaffected by fossil fuel divestment, such as real estate or hedge funds.

The sum of increased fees to the Retirement System resulting from a fossil fuel divestment approach would be approximately $125,000 to $175,000 on an annual basis. The increase in fees incurred would be primarily a result of the following:

- Larger fees from the same provider to implement a more customized strategy;
- Switching to a different provider that offers customized solutions at a higher cost;
- Increased administrative charges from different account structures; and
- Higher trading costs from separate accounts instead of commingled funds.

It is important to note that, according to Meketa, there are no index providers today that offer a "fossil fuel free" index fund. It is passively managed index funds that allow institutional investors such as the Retirement System to invest with very low costs. As of June 30, 2013, the Retirement System has allocated $247M, or 46%, to such low-cost index strategies. If such indices became available, the cost impact of a fossil fuel free portfolio would be significantly lower.

In summary, the fossil fuel divestment would impact the investment management costs of plan assets as follows:

- 32% would incur no change in cost;
- 44% would incur additional costs;
- 13% cannot be implemented due to size restrictions or other limitations; and
- 11% is invested in areas where this approach does not apply.

SOFT COSTS

In addition to the fee increases and account charges, the Retirement System would likely incur higher costs to setup, manage and administer the fund. The Board of Trustees would need to set up more accounts, potentially in foreign countries, which would require increased oversight by staff as well as higher legal, accounting, and audit charges. In some cases, the liquidity of accounts would be lessened due to longer account settlement timing.

INVESTMENT RETURNS & MARKET RISK

At this time, the Board of Trustees has not studied the potential impact to market risk or investment returns associated with removing fossil fuel companies from the Retirement System's investment portfolio. Such analysis would likely require several months of investigation and analysis by the Board, Meketa and the Retirement System's Investment Managers. Several studies exist that attempt to quantify the impacts, but many have conflicting conclusions.

OTHER CONSIDERATIONS

It is important to re-emphasize that the Board only considered the anticipated direct costs associated with adopting a fossil fuel divestment policy. Clearly, the impact to risk and return would need to be seriously considered.

In addition, 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.

In addition, preliminary research indicates that only three city councils have approved the submission of fossil fuel divestment recommendations to their respective retirement boards. At this time, fossil fuel divestment has not yet been adopted by those retirement boards.

MOVING FORWARD

Consistent with the fiduciary role of the Board of Trustees to the Retirement System, the Board is always looking for established products that have a compelling risk and reward profile. As is the case with all investment decisions, when new approaches or strategies are suggested, the Board will evaluate the idea based on potential return, risk, liquidity, cost, complexity and other appropriate factors. At this time, the Board of Trustees is unlikely to further consider fossil fuel divestment due to the following:

- Increased annual cost to implement and administer;
- Lack of tools and investment vehicles; and
- Lack of established practices or approaches by other retirement systems, which could increase risk to the System.