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## Vermont Pension Investment Committee

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### Fossil Fuel Divestment Discussion

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- **Energy sector divestment is a complex issue**
  - Future energy market pricing, cash flows, subsidies & regulation impossible to predict
  - Producer & consumer behaviors shift slowly over time in reaction to multiple factors
  - Capital expenditures in the energy sector (fossil and renewable) planned and implemented over very long cycles
  - Renewable energy capacity has been slow to develop to scale necessary to replace existing fossil fuel capacity
  - Large, integrated energy companies often also involved in funding renewable projects
- **Goals & measurement of the impact of divestment are not clearly defined**
  - Most market sectors exposed to some risk of declining sales/earnings, stranded or obsolete assets
- **VPIC's direct and indirect energy sector exposure is approximately \$232.8 million (5.8% of total VPIC assets)**
  - Direct (separate accounts) = \$67.7 million
  - Indirect (commingled funds) = \$165.1 million
  - Does not include non-energy sector companies listed on Carbon Tracker list
- **Direct and indirect exposure to coal producers is limited**
  - Direct separate account exposure of \$1.45 million mostly in bonds
  - Based on benchmark index weightings indirect exposure limited to < 0.5%
  - Exposure to Carbon Tracker list higher

- **Implementation presents many questions and challenges**
  - Should divestment target only producers of fossil fuels or also end-users, suppliers?
  - Ability for VPIC to use commingled funds?
  - Impact on manager products that utilize derivatives (S&P Futures)?
  - Impact of future changes to 3<sup>rd</sup> party divestment lists if utilized?
- **Lists of companies to target for divestment developed by 3<sup>rd</sup> parties are often developed with inconsistent or subjectively applied criteria**
  - Companies in utility, transportation, steel, mining and chemical industries regularly included
- **Proposals to divest from energy sector do not meet criteria detailed VPIC's ESG Policy**
  - Limiting VPIC's ability to invest in large sector would dilute the overall portfolio strategy
    - Reduce VPIC's ability to balance overall portfolio risk, including risk of inflation
  - VPIC would incur both initial costs to transition portfolio and ongoing cost to maintain customized product mandates without any defined benefit
- **NEPC does not recommend that VPIC move forward with any energy sector divestment initiative**

- **Fossil fuels are non-renewable resources that typically refer to Oil, Gas and Coal**
  - Fossil fuel and energy companies are components of major market benchmarks
    - Energy sector ranges between 5%-15%
    - Fossil fuel exposure ranges between 3%-10%
- **For Institutional investors the Energy sector represents an enormous sub-asset class**
  - MSCI AWCI Energy Index represents \$2.78 trillion as of 6/30/15
    - Top 159 Energy companies in largest 23 developed & 23 emerging markets (including U.S.)
  - S&P 500 Energy Sector Index represents \$3.31 trillion as of 6/30/15
    - Top 40 companies in U.S. Energy Sector
- **The world's largest governments and institutional investors are key shareholders in public and private energy sector companies**
  - Saudi Arabia, China, Russia, India
  - BlackRock, SSGA, Vanguard
- **Other large sectors offer some of the risk & return attributes of the Energy Sector but not all of them**
  - Financials (\$8.2 trillion\*) – low growth, intensive regulation, more highly levered
  - Technology (\$5.2 trillion\*) – potential for higher growth, but pay lower dividends

## VPIC Estimated Energy Sector Exposure (as of 6/30/15)

Manager	% of VPIC Portfolio	Asset Class	Vehicle Type	Estimated Energy Exposure %	Estimated Energy Exposure \$
SSGA S&P 500 Cap Wtd.	8.7%	US Large Cap	Commingled	10.1%	\$ 35,423,334
SSGA S&P 500 Equal Wtd.	2.8%	US Large Cap	Separate Account	7.6%	\$ 8,677,551
SSGA S&P 400 Cap Wtd.	0.6%	US Small-Mid Cap	Commingled	10.9%	\$ 2,412,325
Champlain	2.1%	US Small-Mid Cap	Separate Account	4.0%	\$ 3,288,208
Wellington SCV	2.1%	US Small-Mid Cap	Separate Account	6.6%	\$ 5,478,945
SSGA Russell 2000 Growth	1.1%	US Small-Mid Cap	Separate Account	1.6%	\$ 671,314
Acadian Int'l Equity	4.1%	International Equity	Separate Account	8.6%	\$ 14,061,400
Mondrian Int'l Equity	4.1%	International Equity	Separate Account	11.2%	\$ 18,134,788
SSGA MSCI ACWI ex US	2.5%	International Equity	Commingled	12.6%	\$ 12,695,883
Aberdeen Emerging Mkts	6.2%	Emerging Equity	Commingled	5.8%	\$ 14,234,120
Allianz Structured Alpha*	2.8%	Fixed Income	Commingled	10.1%	\$ 11,312,836
SSGA BC Aggregate Index	3.1%	Fixed Income	Commingled	2.6%	\$ 3,230,134
PIMCO Core Plus	5.4%	Fixed Income	Separate Account	0.7%	\$ 1,470,273
PIMCO Unconstrained**	6.4%	Fixed Income	Separate Account	0.8%	\$ 834,765
GAM Unconstrained**		Fixed Income	Commingled	1.4%	\$ 2,265,098
Wellington DAS	2.7%	Fixed Income	Commingled	0.0%	\$ -
KDP	1.0%	High Yield	Separate Account	6.3%	\$ 2,618,825
Guggenheim	3.1%	High Yield	Separate Account	10.0%	\$ 12,488,978
BlackRock U.S. TIPS Index	3.0%	US TIPS	Commingled	0.0%	\$ -
Mondrian Global Fixed	2.8%	Global Fixed Income	Separate Account	0.0%	\$ -
Wellington Opp. EMD	5.2%	Emerging Debt	Commingled	2.2%	\$ 4,683,517
Grosvenor	5.1%	Hedge Funds	Commingled	10.0%	\$ 20,355,756
Mellon Dynamic Growth	2.2%	Global Asset Allocation	Commingled	3.0%	\$ 2,634,045
AQR Global Risk Premium*	8.0%	Global Asset Allocation	Commingled	10.3%	\$ 32,973,484
PIMCO All Asset	5.8%	Global Asset Allocation	Commingled	8.2%	\$ 19,133,184
Schroders	3.0%	Commodity	Commingled	3.2%	\$ 3,787,170
HarbourVest	0.8%	Private Equity	Commingled	0.0%	\$ 1,682
Total Real Estate Composite	5.4%	Real Estate	Commingled	0.0%	\$ -
Total Separate Account				5.5%	\$ 67,725,047
Total Commingled				6.0%	\$ 165,142,568
Total All Accounts				5.8%	\$ 232,867,615

\* Based on Energy Sector Exposure of S&P 500 assumed for Equity Futures Exposure; \*\*Estimated % Energy Exposure tied to estimated 6/30/15 account values



- **Asset Allocation could be impacted by a decision to divest**
  - Divestment solutions may be limited within certain asset classes or strategies (e.g. hedge funds, real assets or global asset allocation)
  - Eliminating these asset classes from an investment portfolio could dramatically alter the risk and return profile
- **Risk Management should be considered when discussing divestment**
  - Exposure to the energy sector has been a valuable source of return, diversification and inflation protection
  - Limiting exposure to diversifying strategies may impact overall return and risk expectations
  - Evaluating currency, country and regional concentration is important if divesting from international companies and re-allocating capital
- **Manager Selection will likely be significantly limited**
  - Larger organizations may have greater ability to access separate accounts or influence the terms of commingled funds
  - The current universe of managers/strategies that divest is limited and many have low asset levels, shorter track records and higher management fees
  - There is a sizable and growing universe of managers/strategies that integrate ESG factors in to their analysis, however this will not guarantee a fossil fuel free strategy
  - In general, there has been an increase in the number of strategies available to address this issue and NEPC expects the trend to continue

- **Investment performance may be influenced by divestment and there are a number of ways to assess the potential impact**
- **Some organizations have evaluated the performance impact of divestment by reviewing performance of the energy sector versus that of the overall market**
  - Restricting investments in a certain sector, industry, etc. limits the investment manager opportunity set and may impact performance positively or negatively
  - Since 2001, the energy sector has been a strong relative performer, albeit with higher volatility
  - This is an inexact way to evaluate the impact of divestment as the entire energy sector is not included in the Carbon Underground Company List
- **Other organizations have concluded that divestment would require the forfeiture of future alpha**
  - If fossil fuel companies are viewed as a risk likely to underperform going forward, the decision to divest could be interpreted as an active management decision
  - Divesting an actively invested program by reallocating funds to a fossil fuel free index fund may sacrifice alpha
- **The lack of established actively managed fossil fuel free funds may leave investors with few choices in re-allocating capital**
  - Requesting that a manager implement negative screening shrinks the investment universe
  - Investors may experience underperformance and/or heightened volatility

- **Investment Related Fees are important to quantify when assessing divestment, specifically:**
  - Transaction costs to divest and re-invest securities in separately managed accounts
  - Transaction costs associated with changing investment products
  - Potential changes to investment management fees
- **Investment Policy Statements will have to be updated if the decision is made to divest**
  - State the goal of divestment
  - Describe the divestment approach (asset classes, timeline, etc.)
  - Monitoring process should be determined in order to continually assess exposure
  - Determine roles and responsibilities for the Board, Investment Committee and any sub-Committees



# Appendix



- **When considering divestment it is important to evaluate the impact on fiduciary responsibility**
- **The definition of Fiduciary Duty is a legal term meaning that trustees must act in the best interest of the institution or its direct beneficiaries**
- **For Public Pension Plans or Corporations, retirement act legislation governing the investment of pension assets should be evaluated**
  - Assets are to be invested “exclusively in the best interests of plan participants”
  - When assessing divestment strategies, the DOL provided guidance under Bulletin 08-1 on socially targeted investments
    - Before selecting an economically targeted investment, fiduciaries must have first concluded that the alternative options are truly equal, taking into account a quantitative and qualitative analysis of the economic impact on the plan<sup>3</sup>
- **For Endowments and Foundations, statutory laws such as UPMIFA<sup>1</sup> or UPIA<sup>2</sup> should be reviewed when assessing divestment**
  - Subject to the duty of loyalty “a trustee shall invest and manage the trust assets solely in the interest of beneficiaries”

<sup>1</sup>Uniform Prudent Management of Institutional Funds Act

<sup>2</sup>Uniform Prudent Investor Act

<sup>3</sup> Source: [www.dol.gov](http://www.dol.gov)

- **Past performance is no guarantee of future results.**
- **The opinions presented herein represent the good faith views of NEPC as of the date of this report and are subject to change at any time.**
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