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A QUICK LOOK INTO IMPORTANT ISSUES OF THE DAY

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Policies Drive Public Pension Divestments

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From fossil fuels to firearms, foreign policy to obscenity, state legislators cite a range of policy principles for pulling public pension dollars out of certain types of investments.

State moves to divest pension assets according to a range of politically charged policy aims are sparking new debates and reviving old ones. Among them: What is the proper role of states in international affairs, and how can pensions square their fiduciary obligations to retirees with calls for what's known as socially responsible investment (SRI)?

Divestment is one avenue for socially responsible investing. Its champions incorporate environmental, social and governance (ESG) considerations in their investment strategies.

SRI is not a new phenomenon. For example, religious organizations have guided the faithful away from "sin industries" like alcohol throughout U.S. history. Amid mounting global opposition to apartheid, public pensions joined other institutional and individual investors in pulling out of South African investments in the 1980s. More recently, states have enacted laws to divest pension assets from Sudan, Iran and other countries.

The integration of ESG factors into investment decision-making has accelerated in recent years. A 2018 report from the Forum for Sustainable and Responsible Investment showed SRI assets now account for $12 trillion—or $1 in $4—of the $46.6 trillion in total assets under professional management in the United States. This represents a 38% increase over 2016.

Did You Know?

- Socially responsible investment assets account for $12 trillion—or $1 in $4—of the $46.6 trillion in total assets under professional management in the United States.
- The country's largest pension fund, CalPERS, may have missed out on nearly $3.6 billion in investment gains by dumping tobacco stocks, according to a 2018 report. Other divestment initiatives have worked in its favor.
- Twenty-seven states have adopted measures requiring state contractors to pledge not to boycott Israel or pension boards to divest from companies that do.

State efforts may conflict with varying trade and foreign policy objectives, and federal courts have struck down some state legislation on social investing on constitutional grounds.

But ESG's critics see a host of problems, including the possibility of lower returns when investors consider social concerns along with financial ones. One study estimates that the average annual returns of public pension plans in states with divestment requirements are 40 basis points lower than those of unrestricted state plans.

Other observers question whether divestiture is an effective tool for shaping social policy, because the effect on targeted companies may be limited, and opportunities for shareholder activism disappear. If states remain invested, keeping a seat at the table could help them change company policy through shareholder letters, resolutions and votes.

Pension funds often hold mutual funds or exchange traded funds (ETFs), which include stocks from many companies in many industries. The complexities of divesting carry costs, from executing the transactions to monitoring a constantly shifting mix of investments to assure compliance with state laws.

State Action

■ **Fossil Fuel and Other Domestic Policy Targets.** Following California's adoption of thermal coal divestiture legislation in 2015, the idea of fossil fuel divestment continues to gain traction among states, cities, universities and other institutional investors in the U.S. and abroad. Proponents suggest that energy companies may actually pose a long-term risk to pension fund portfolios because they hold "stranded assets" (fossil fuel reserves that cannot be burned without triggering the worst effects of climate change). Climate change risk could also lead governments to regulate oil and coal companies so extensively that their stock takes a hit.

In 2019, the Massachusetts, Minnesota, New Jersey, New York and Vermont legislatures considered proposals that would direct public pensions to study or abandon certain types of fossil fuel investments. But simply identifying companies as targets for divestment can be tricky, especially if oil and gas companies begin to shift toward producing other forms of energy. These bills often call on plans to "constructively engage" with companies before pulling out, to determine if they are transitioning to clean energy generation.

Other state bills introduced in 2019 would screen out firearm manufacturers, makers of nuclear weapons, companies building a border wall and corporations shifting business operations outside the U.S. to lower tax liabilities.

■ **Foreign Policy.** Amid a rapidly shifting foreign policy landscape, state lawmakers continue to press for pension fund divestment from a variety of international holdings, often in countries linked to terrorism or genocide. In 2019, states where legislation has been introduced taking aim at pension fund investments in foreign countries include California, Massachusetts, New Jersey, New York and Pennsylvania. The countries include Brunei, Cuba, Iran, Saudi Arabia, Sudan and Turkey.

Many of the existing pension divestiture laws targeting international investments enjoyed bipartisan support, based in part on a consensus that unsettled political situations abroad can increase investment risk. NCSL supports the continued ability of states to divest from countries or companies that commit or support human rights atrocities.

A fast-growing list of states—27 in the last four years—have adopted measures to require state contractors to pledge not to boycott Israel or pension boards to divest from companies that do. Pro-Israel advocates have lobbied for the changes in response to calls from Palestinian rights activists to boycott, divest from and sanction Israel.

But for critics, thorny questions persist about the proper role of states in determining foreign policy. State efforts may conflict with varying trade and foreign policy objectives, and federal courts have struck down some state legislation on social investing on constitutional grounds.

Whether aimed at foreign policy goals or domestic ones, pension divestiture efforts appeal to deeply held convictions. But what does an ever-shrinking pool of permissible investments mean for retirees' bottom lines?

Additional Resources

- "Retirement Plan Investing: Clearer Information on Consideration of Environmental Social and Governance Factors Would Be Helpful," Government Accountability Office
- Principles for Responsible Investment, United Nations

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