CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

BILL ANALYSIS

<u>Assembly Bill 107</u>	**Assembly Member Knox (As amended 8/8/00)**
<u>Position:</u>	**No Position**
<u>Proponents</u>:	**CFT, CTA, UTLA**
<u>Opponents</u>:	**CalPERS**

SUMMARY

AB 107 prohibits new or additional investments in tobacco companies, as defined, by the California State Teachers' Retirement System (CalSTRS) and the California Public Employees Retirement System (CalPERS), on and after January 1, 2001 and requires a divestment of existing investments by July 1, 2002. The bill also provides indemnification to board members of CalSTRS and CalPERS for a decision not to invest in tobacco stocks.

HISTORY

In 1997, two tobacco divestment bills, AB 1744 (Knox) and SB 1433 (Hayden), were introduced but failed passage.

<u>Chapter 1200, Statutes of 1982 (SB 211—Keene)</u> enacted provisions relating to the personal liability of board members.

SUMMARY OF LATEST AMENDMENTS

The August 8 amendments redefine a tobacco company to mean a business entity that derives more than 10 percent of its net revenue, excluding excise taxes, from the manufacture of consumer tobacco products or the processing of leaf tobacco.

CURRENT PRACTICE

CalSTRS passively and actively invests a portfolio valued at over $100 billion. The portfolio is broadly diversified and ranges from publicly traded bonds to privately held partnerships. At the end of last fiscal year, CalSTRS' portfolio allocation across asset classes was 70 percent domestic and international equity, 25 percent domestic fixed income, and 5 percent private equity. The Teachers' Retirement Law (TRL) provides, under certain circumstances, for the personal liability of a board member for breach of the prescribed duties and responsibilities, or a breach of fiduciary duty. Board members are not provided with indemnification from the General Fund under the TRL for breaches of fiduciary duty.

DISCUSSION

The bill prohibits new or additional investments by CalSTRS and CalPERS in tobacco companies on and after January 1, 2001, and requires the divestment of existing investments by July 1, 2002. At the June meeting of the Regular Board, the Board decided to modify its investment benchmark by removing manufacturers from CalSTRS' passive portfolio.

As of December 31, 1999, CalSTRS held domestic and international equities in 22 companies that manufacture and distribute tobacco products, at a market value of $319,270,861, or less than one half of one percent of equity holdings. AB 107 defines a tobacco company to mean a business entity that derives more than *10* percent of its *net revenue*, excluding excise taxes, from the manufacture of consumer tobacco products or the processing of leaf tobacco.

As an investment sector, tobacco stocks have had mixed results during the past six years. At the April 2000 Investment Committee meeting, the Teachers' Retirement Board (Board) was informed by various consultants, including Pension Consulting Alliance, Inc., that tobacco divestment would not increase the overall risk of CalSTRS aggregate portfolio. However, the consultants could not determine what impact, if any, tobacco divestment would have on the future investment returns of CalSTRS' aggregate portfolio. As a result, the Board chose to address investments in tobacco in the context of larger investment policy issues: the benchmark the system uses to determine specific investments and the extent to which CalSTRS delegates investment portfolio decisions to external portfolio managers.

At the May 2000 Investment Committee meeting, the committee adopted a policy to modify the benchmark against which investments are measured. Under the policy, the benchmark will be modified when it is in the economic interest of CalSTRS do so, when a more cost efficient alternative is available or when an industry is exposed to economic risk. The indicators of significant economic risk would include product liability judgements, industry-wide bankruptcy filings and regulatory and/or legislative actions. At the June 2000 meeting, the Investment Committee adopted a modification to its existing benchmark that excludes tobacco manufacturers. As a result, the system will not be holding such investments in its passive portfolio. The Investment Committee's action does not apply to its active investment of tobacco equities. AB 107 requires the divestment of all such holdings, even though the economic conditions facing domestic tobacco companies which reduce their desirability as an investment may not apply to foreign tobacco companies.

AB 107 provides indemnification for specified board members and state officers, and investment managers under contract with the state. Under the TRL, a Board member or officer who breaches any of his or her responsibilities, obligations, or duties as a board member can be personally liable and required to make restitution to the Teachers' Retirement Fund (TRF) for any losses resulting from the breach, and to restore any profits that have been made through use of TRF assets. Under certain circumstances, a board member or officer can be liable for a breach of fiduciary responsibility of another board member or officer. The TRL also provides that if the Board has acted with care, skill, prudence, and diligence in selecting and monitoring the investment managers, then no Board member will be liable for the acts or omissions of the investment managers or be under any obligation to invest or otherwise manage any assets of the TRF that are subject to the management of the investment managers.

FISCAL IMPACT

Benefit Program Costs – While the performance of the investment portfolio impacts the benefits CalSTRS may offer its membership, AB 107 does not directly impact the benefit programs.

Administrative Costs – At the June 2000 meeting, the Investment Committee adopted a modification to its existing benchmark that excludes tobacco manufacturers. As a result, the system will not be holding such investments in its passive portfolio. The bill, however, also prohibits CalSTRS from holding tobacco investments in its active portfolio. The divestment of tobacco company holdings in that portion of its active portfolio will create transaction costs as tobacco equities are sold and the proceeds reinvested in other companies. In addition, the bill would require ongoing staff time to monitor the activity of fund managers to ensure that the restricted equities are not purchased.

POSITION

No position. The Board has modified its benchmark to exclude tobacco manufacturers from its passive investment portfolio. The Board is concerned that the system would be precluded from resuming tobacco investments despite any economic benefits of doing so, and would require the divestment of its active investment in tobacco manufacturers.