STATE TEACHERS' RETIREMENT SYSTEM

BILL ANALYSIS

Senate Bill 1433 **Senator Hayden (As Amended 4/27/1998)**

Proponents: **AFSCME, American Cancer Society, American Heart Assoc., American Lung Assoc., California Professional Firefighters Assoc., Cal-PIRG, Phil Angelides for Treasurer**

Opponents: **CRTA (unless amended), PERS, The Tobacco Institute**

SUMMARY

This bill would: 1) prohibit new or additional investments by the State Teachers' Retirement Fund and the Public Employees' Retirement Fund in tobacco companies on and after January 1, 1999; and 2) require phased divestment of current holdings each year beginning January 1, 1999, and continuing until January 1, 2003. The bill was amended April 27, 1998 to require STRS and PERS to report to the Legislature on or after January 1, 2003 regarding the effect of the divestiture on employer contribution rates.

HISTORY

Chapter 1254, Statutes of 1986, AB-134 (M. Waters), required divestment of state trust fund assets from companies doing business in or with South Africa. The Teachers' Retirement Board (Board) originally opposed the bill, but changed its position to neutral prior to the bill going to the Governor. The bill provided continued indemnification from the General fund for Board members and investment managers of trust funds from any liability relating to the investment restrictions.

Chapter 31, Statutes of 1994, AB-2448 (Brown & More), repealed the prohibition of investments in South Africa established by AB-134. The Board took a support position on this bill. The repealed provisions provided continued indemnification from the General Fund for Board members and investment managers of trust funds from any liability relating to the investment restrictions.

Chapter 1351, Statutes of 1992, AB-2251 (Margolin), prohibits the investment of state trust funds in business firms or financial institutions that engage in discriminatory business practices after January 1, 1994 relating to the Arab League's economic boycott of Israel. Though the legislation was enacted, the State Teachers' Retirement System has not implemented its provisions pursuant to an opinion of the Attorney General (No. 93-302) stating that the provisions of AB-2251 are preempted by federal law (specifically the United States Export Administration Act). The Board opposed this bill. It provided indemnification for any lawsuits, judgements, etc., brought against the TRB, STRS employees and investment managers.

AB 3445 (Knox, 1996), an earlier version of a tobacco products bill died in committee. The Board opposed this bill. It provided for indemnification for board members and their agents and employees.

US.S. 1414 (McCain), Reforms and restructures the processes by which tobacco products are manufactured, marketed, and distributed, to prevent the use of tobacco products by minors, to redress the adverse health effects of tobacco use, and for other purposes.

CURRENT PRACTICE

As of March 31, 1998, STRS has investments in 26 tobacco or tobacco related companies. The combined market value of these investments for that period is $555,472,194. This represents 0.960% of the total value of the domestic and international equities in the STRS portfolio. The increase in the number of tobacco or tobacco related companies since September 30, 1997, 18, represents improved methods of identifying such companies, not additional investments.

DISCUSSION

This bill declares that the state spends approximately $630 million treating tobacco related illnesses and another $50 million on anti-smoking education while the Public Employees' Retirement Fund holds $989,097,528 in tobacco company investments. In addition, due to recent litigation, the value of CalPERS tobacco-related equity holdings have declined and product liability litigation introduces an unreasonably high element of risk to state pension funds. Under the four year divestiture phase out, STRS would be required to divest about $372 million of these tobacco related investments in 1999, and the remaining $200 million would be divested over the next three years.

The employer contribution rates to STRS are set in statute and therefore would not be effected by divestiture.

At the March Investment Committee meeting the Board directed staff to obtain an analysis from an external third party to provide an independent assessment of the impact the divestiture of tobacco holdings would have on the fund. The firm BARRA ROGERSCASEY (BARRA) was retained to conduct the assessment.

The BARRA report outlines previous tobacco research conducted by BARRA, comments on the McCain Bill and addresses the analysis of the STRS Equity Portfolio.

Their analysis of the STRS Equity Portfolio focused on the elements of return and risk. BARRA looked at 55 months of STRS equity investment history and isolated the effects of tobacco industry exposure on both the U.S. and non-U.S. equity portfolios. The analysis yielded the cost figures from tobacco divestiture as well as divestiture's effect on the volatility or "riskiness" of the fund. The analysis contains detailed estimates of the dollar transaction cost to STRS if the tobacco holdings currently in the portfolio were divested and the proceeds invested in non-tobacco stocks.

The report concludes that based on the BARRA S&P index study and STRS portfolio analysis tobacco divestiture does not increase return and decrease risk. Divestiture increased active risk. Both the STRS U.S. and non-U.S. equity portfolios outperformed their ex-tobacco counterparts on an annualized basis. The absolute annual return differential, 7 basis points and 4 basis points, respectively, translate into annual investment losses of $21.7 million and $6.4 million, respectively, when applied to the large STRS portfolio. Were STRS to divest the fund's tobacco holdings and reinvest the proceeds in non-tobacco stocks, the estimated one-time costs would cost $8.1 million.

The report further concludes that tobacco divestiture does not stand up as an investment decision. It does not reduce risk in the typical pension fund context or in the specific example of the STRS fund.

FISCAL IMPACT

Program – Annual investment losses of $28.1 million and a one time cost of $8.1 million in lost commissions, or 2.15% of the value of STRS tobacco holdings to divest in tobacco and tobacco related investments.

Administrative – Possible $.9 million in commissions, or about $600,000 in the first year and about $150,000 in each of the three remaining years, to divest in tobacco and tobacco related investments.

POSITION

Oppose – The Board opposes SB-1433 based upon the report of the independent consultant, BARRA ROGERSCASEY, and the fiduciary responsibility of the Board.