October 8, 2013

To: Ann Arbor City Council
From: City of Ann Arbor Energy Commissioners

During and after the discussion of the resolution which the City of Ann Arbor Energy Commission brought to City Council regarding recommendations for fossil fuel divesting, several Councilmembers requested some follow-up research. This memo summarizes our initial findings and we hope sparks further conversation. We are open to discussing any or all of these issues with City Council as best suits Council's needs.

We wish to clarify two key points of information. First, City Council does not have the power or authority to require the City's Retirement or Pension Board to divest or do anything else with these funds. City Council does, of course, have the right to request that the publicly-funded investments align with the stated objectives of the City, as this resolution recommends. City Council recommendations do not supersede the fiduciary responsibility of the Retirement & Pension Board, as the revised resolution hopefully clarifies. Second, the Energy Commission understands that climate change is the most pressing and urgent need facing society and Ann Arbor. If we fail in our response to climate change and do not have a tolerable planet for human habitation, issues like retirement savings become null and void. Issues facing the City because of climate change are of prime importance and did not surface in the discussion about the resolution.

1) Risks of fossil fuel investments

Attached (and listed in the appendix) you will find 4 reports which comment on the risks inherent in investing in fossil fuels. The HSBC report assesses risks from lower carbon emission limits, lower prices and "unburnable reserves" of carbon. Standard and Poor's report on "What A Carbon-Constrained Future Could Mean For Oil Companies' Creditworthiness" concludes that "The financial models that use past performance and creditworthiness may be insufficient to guide investors looking to understand the possible effects of future carbon constraints on the oil sector." Mercer Company's report "Climate Change Scenarios – Implications for Strategic Asset Allocation" warns institutional investors of being exposed to too much climate risk given the potential economic and environmental upheaval. Finally, HIP's report "Resilient Portfolios & Fossil-free Pensions" – done in partnership with the Fossil-Free Campaign – concludes: "Climate change, accelerated by the fossil fuel industry's business plan, poses observable, trackable, and knowable future risks to pension funds, but in most cases, mitigation of these risks is not yet incorporated into pension portfolios." The report goes on to suggest strategies to reduce exposure. While the details of these reports vary, the underlying message is very similar: Heavy investments in fossil-fuel reserve companies pose risks that may not be accounted for in the standard portfolio management services, given the unprecedented risk that is posed by climate change.

2) Risk of Lost Returns from Fossil Fuel Divestment

There is a lack of very strong data on returns although there is an emerging consensus that divestment poses little, if any, risk to returns. In addition to the Aperio report that you already received, we uncovered 3 more reports (attached and referenced in the appendix). Morgan Stanley Capital International (MSCI) removed 247 companies owning fossil fuel reserves from the All-Country World Index Investable Market Index (which covers over 9,000 securities in 46 Developed and Emerging

Markets). In the time period they analyzed (dating back to 2008), the index minus the fossil fuel companies performed better than the benchmark by 1.2 percent cumulatively. The assumption here is of a proportional reinvestment strategy to replace the top 200 fossil fuel holding companies. A London based management firm called Impax Asset Management, took it one step further. Impax replaced the fossil fuel stocks of the MSCI World Index with a variety of stocks selected from a wide range of environmental investment opportunities. The divested – then optimized – fund had a relatively benign tracking error (1.6 percent) and slightly outperformed the benchmark (.5 percent) while investing in a clean energy future. Finally, the Boston Common Asset Management analysis suggests that, if properly-implemented, divestment would add only marginally to the tracking error of an index fund over the next three to five years. These studies suggest that divestment may have a positive return to investment.

3) Availability of Fossil-Fuel Free Investments/Potential for Increased Fees

Currently, there are no fossil-fuel free index funds commercially available. There are other financial products available that are fossil-fuel free, such as mutual funds. And, of course, the City of Ann Arbor often creates its own blend of investments which can be balanced with whatever criteria that the Retirement & Pension Board requires. We want to clarify that the recommendation contained in the resolution suggests a 5-year time period during which we would expect more financial instruments to be available, particularly if more cities and institutions ask this question of their financial advisors. The debate in City Council around the increased costs to pull out of index funds since none of them are fossil fuel-free was misleading. The resolution does not require or suggest changing the core investment strategy of the Retirement & Pension Board. The assumption that higher fees will result from this strategy leads to an inflated fee projection that is unlikely to become reality. There are investments available today – at similar fees and potential for increased returns – that would move Ann Arbor's investment closer to alignment with Ann Arbor's stated climate plan goals.

4) Updates on 18 other municipalities who are moving forward on divestment

There are at least 18 identified municipalities or similar entities in various stages of moving forward on fossil fuel divestment. Every city or government entity has its own unique structure and politics. We identified three cities that appear to have very similar structures to Ann Arbor and which are further along in the process. San Francisco's Board of Supervisors voted unanimously to urge the city's Retirement Board to divest $583 million of fossil fuel holdings in the city's $16 billion retirement fund. The Board is about to take this up. Similarly, Providence, Rhode Island (11-1) and Cambridge, MA (unanimous vote) have elected bodies which voted favorably on a similar resolution, which are now being considered by their Retirement & Pension Board equivalents. In California, Berkeley (unanimous vote), Richmond and Santa Monica have all divested from directly city-owned assets. Their retirement and pension holdings are through CalPers and they are urging divestment, similar to the resolution under consideration in Ann Arbor. Ithaca, NY has a similar situation with a New York-wide pension fund. Each of these cities are moving forward with similar approaches and findings, although there are no measureable results yet as these efforts are very new.

5) Changes to Resolution

Attached you will find suggested changes to the resolution from the Energy Commission. In response to City Council's concern, we hope we clarified that the resolution does not supersede any fiduciary responsibility and we clarified language about the potential uses for investments.

Again, we are more than happy to discuss any of these issues in more detail, and hope that we have provided the resources you need to follow the recommendations of the Energy Commission when the resolution comes up for a vote again.

Appendix: List of Reports

Aperio Group. "Do the Investment Math: Building a Carbon-Free Portfolio".

Boston Common Asset Management. "Risk Analysis of 350.org Fossil Fuel Divestment".

HIP. "Resilient Portfolios & Fossil-Free Pensions".

HSBC Global Research. "Oil & Carbon Revisited: Value at risk from 'unburnable' reserves".

Impax Asset Management. "Beyond Fossil Fuels: The Investment Case for Fossil Fuel Divestment".

Mercer. "Climate Change Scenarios – Implications for Strategy Asset Allocation".

MSCI. "Responding to the Call for Fossil-fuel Free Portfolios".

Standard & Poor's Rating Services. "What a Carbon-Constrained Future Could Mean for Oil Companies' Creditworthiness".