DIVESTMENTFACTS.COM

Scott Stringer
New York City Comptroller
One Centre Street
New York, NY 10007

Subject: RFI for Investment and Fiduciary Analysis of Strategies for Divestment of Securities Issued by Fossil Fuel Reserve Owners

Dear Mr. Stringer -

On behalf of Divestment Facts, a project of the Independent Petroleum Association of America (IPAA), I'm writing in response to the Request for Information (RFI) on Mayor Bill de Blasio's proposal to divest $5 billion in fossil fuel assets from the New York City Retirement System (NYCRS), which includes five separate pension funds.

Through our site DivestmentFacts.com, IPAA has sought to educate the public, institutions, and city and state officials on the facts about divestment. As part of this effort, we have commissioned studies from some of the most renowned economists and professors in the United States to analyze the costs and risks associated with divestment. These studies all conclude that fossil fuel divestment will lead to significant financial costs for public pensions and institutions, while providing no substantial environmental benefits.

Prof. Daniel Fischel, Professor of Law and Business Emeritus at the University of Chicago Law School, found that divestment will lead to significantly lower returns. According to his study, portfolios divested of energy equities produced returns 0.7 percentage points lower than ones that invested in energy on an absolute basis. Over a 50-year timespan, a divested portfolio would be 23 percent lower than one that included fossil fuels. This is largely contributed to loss diversification. Of the 10 major industry sectors in the U.S. equity markets, energy has the lowest correlation with all others—which means it has the largest potential diversification benefit.

A report from Prof. Hendrik Bessembinder, Professor of Finance at the W.P. Carey School of Business at the University of Arizona, found the transaction costs and on-going management fees related to divestment have the potential to rob endowment funds of as much as 12 percent of their total value over a 20-year timeframe. For a typical large endowment, this would translate into a loss in value of as much as $7.4 billion.

An additional report by Prof. Bessembinder calculated the cumulative costs associated with divestment and found that pensions would take a significant, ongoing financial hit. As a result, there would be a five to seven percent reduction in monthly pension benefits for a typical pensioner.

Studies and experts also warn about the specific financial costs to New York City (NYC) if it goes through with divesting. Prof. Fischel's most recent study concluded that NYC's five funds would lose a combined $98 – 120 million annually and between $1.2 – 1.5 trillion over 50 years. Likewise, Scott Evans, the chief investment officer (CIO) for NYCRS, recently noted that divesting from fossil fuels could cause "major tracking errors" for the fund. New York State Comptroller Tom DiNapoli also warned against divestment and has stressed the importance of the energy sector to diversification.

Poor investment decisions not only hurt the pensioners who rely on this fund, but also hurt taxpayers who are forced to foot the bill. A study from the American Council for Capital Formation (ACCF) found that by 2019 a staggering four-out-of-five taxpayer dollars collected from NYC's personal income tax will go towards paying down NYC pension liabilities.

Furthermore, divestment is an ineffective strategy in terms of producing environmental benefits. William Coaker, CIO of the San Francisco Employees Retirements System, stressed that divestment does not

reduce carbon emissions: “Divestment alone does not harm or punish companies that produce fossil fuels, and the only parties that could be negatively impacted by divestment are those that are not invested in them.” In addition, Vicki Fuller, CIO of the New York State Common Retirement Fund, stated that divesting takes away the ability of shareholders to proactively influence companies: “If we divest, we don’t have a place at the table and we don’t change behavior.” Finally, it should be noted that energy companies have invested billions in energy efficiency and emissions reduction technologies, efforts that should be supported by environmental proponents.

Attached to this letter please find additional information along with the full text of studies that examine the costs of divestment. We hope you review and consider these materials as you move forward with your efforts to analyze the divestment proposal in NYC. We strongly encourage you to examine the true costs associated with divestment, the impact it will have on pensioners and taxpayers, the effectiveness of such policies, and how you will define what is means to be a “company owning fossil fuel reserves.”

Sincerely,

Jeff Eshelman
Divestment Facts, a project of the Independent Petroleum Association of America

Senior Vice President of Operations & Public Affairs
Independent Petroleum Association of America
1201 15th Street NW, Suite 300
Washington, DC 20005

Fact Sheet: Studies Show Fossil Fuel Divestment is a Costly, Ineffective Strategy

Renowned economists and university professors have studied the costs, impacts, and risks associated with public endowments and pensions divesting their funds of fossil fuel assets. The experts agree that divesting will impose substantial costs, reduce returns, and harm pensioners. Below are highlights of some of the most notable studies.

DIVESTMENT ENTAILS SIGNIFICANT FINANCIAL LOSS FOR THE INSTITUTIONS INVOLVED

- Report from Prof. Daniel Fischel, Professor of Law and Business Emeritus at the University of Chicago Law School, finds that portfolios divested of energy equities produced returns 0.7 percentage points lower than ones that invested in energy on an absolute basis.
    - A 0.7 percent per year reduction would mean that universities' combined $456 billion endowment would lose $3.2 billion in value.
    - Over a 50 year timespan, the report finds a divested portfolio would be 23 percent lower than one that included fossil fuels.
    - Divested funds will also experience increased risk resulting from a loss of investment diversification. Of the 10 major industry sectors in the U.S. equity markets, energy has the lowest correlation with all others—which means it has the largest potential diversification benefit.
    - On management costs, the Fischel study finds that an increase in compliance costs of just one percent on the estimated $22 billion of those endowments invested in energy stocks would further decrease growth by an additional $220 million per year.

- A report from Prof. Bradford Cornell, Professor of Financial Economics at the California Institute of Technology, found that Yale would lose $51 million annually from divestment. From the report:
    - "Consistent with basic financial economic principles, divestment almost always generates long-term investment shortfalls due to reduced diversification, and the shortfalls are typically substantial, given the size and importance of the energy sector being divested." (p. 3)
    - "The mean risk-adjusted shortfall due to divestment for a weighted average across the five universities is approximately 0.23 percent per year, each year. This mean shortfall varies across the universities: 0.16 percent (Columbia), 0.30 percent (Harvard), 0.14 percent (MIT), 0.12 percent (NYU), and 0.21 percent (Yale)." (p. 4)
    - "As applied to these schools' current endowments, shortfalls of this magnitude would translate to annual reductions in endowment value of $14.43 million (Columbia), $107.81 million (Harvard), $17.75 million (MIT), $4.16 million (NYU), and $51.09 million (Yale). Therefore, these five schools alone stand to forfeit more than $195 million in investment returns each year, without changing portfolio risk." (p. 4)
    - "On a gross (not risk-adjusted) basis, the mean annual shortfall due to divestment for a weighted average across universities is 0.31 percent per year" and 0.33 percent (Yale). "Whether risk-adjusted or not, reductions in investment returns of these magnitudes would likely have a meaningful impact on universities' ability to satisfy their institutional goals of research and education." (p. 4-5)
    - "Due to the plasticity of the capital markets and the diversity of investors worldwide, basic financial economic theory indicates that it is unlikely the divestiture movement, with or without any specific university's participation, will have any material effect on the cost of capital of the divested companies or any other relevant outcome.." (p. 13)

- A report from Prof. Hendrik Bessembinder, Professor of Finance at the W.P. Carey School of Business at the University of Arizona, found the transaction and management costs related to divestment – what he refers to as "frictional costs" – have the potential to rob endowment funds of as much as 12 percent of their total value over a 20-year timeframe. Additional details include:

  - Frictional costs include onetime immediate transactions costs an endowment must endure, as well as ongoing annual management fees to stay in line with the changing definition of "fossil free."
  - Focusing on a sample of 30 universities, including large, medium-sized, and small endowments, conservative estimates of these transaction costs range between 60 basis points and 269 basis points for large endowments, between 25 basis points and 180 basis points for medium endowments, and between nine basis points and 124 basis points for small endowments. Meanwhile, conservative estimates of ongoing annual compliance costs range between 8 basis points and 58 basis points.
  - For a typical large endowment, this would translate into a loss in value of as much as $7.4 billion over 20 years. For medium and small endowments the loss is equal to between $52 million and $298 million, and $17 million and $89 million respectively.
  - Since many endowments hold assets in mutual funds, commingled funds, and private equity funds, divestment generally requires the sale of an entire fund – not just its fossil fuel holdings. This imposes substantially larger transaction costs for endowments.
  - Given the changing and varying definitions of what fossil-free actually means, investment managers would need to actively undertake substantial and ongoing research and management costs to maintain compliance with their divestment goals.
  - The top 10 actively managed funds with an environmental focus charge management fees 10 basis points higher than peers in the active management space, and 73 basis points higher than the passively managed funds that long-term investors tend to favor.

- A subsequent report by Prof. Bessembinder calculated the cumulative costs associated with divestment and found that the financial hit these endowments and pensions take is significant and ongoing, and impacts these institutions' ability to support critical student, faculty and academic programs, as well as payouts to beneficiaries.
  - Factor in all the losses incurred thanks to trading costs (1.65 percent), compliance costs (0.56 percent), and diversifications costs (0.23 percent), and the average endowment "hole" created by divestment results in a 15.2 percent drop in transfers from endowment accounts to school programs.
  - A 15.2 percent annual reduction in endowment spending translates to increases in annual tuition rates (or a reduction in existing scholarships) of as much as $3,265 per student per year, or, as much as an 11.5 percent reduction in faculty spending, which in turn could lead to fewer classes or increased class sizes.
  - For pensions, a 5 to 7 percent reduction in monthly pension benefits for a typical pensioner.
  - The transactional costs of divestment reduce the value of an endowment immediately, while the ongoing costs of divestment reduce the rate of growth (or increase the rate of shrinkage, should the assets lose value) in the endowment over time. These costs imply that the university must reduce either current or future spending from the endowment, or some combination thereof.
  - Endowments exist to help universities attain institutional goals, and the costs of divestment are not just entries in an accounting ledger. Rather, divestment costs reduce the university's ability to fulfill its educational and research missions, and these costs are borne by university stakeholders, present and/or future.

- Prof. Fischel's most recent report found that 11 of the nation's top pension funds would lose up to a collective $4.9 trillion over 50 years if they were to fully divest from the energy sector.
  - Adjusting for risk, the average cost of divestment among the 11 funds is 0.15 percent for narrow divestment and 0.20 percent for broader divestment.
  - The weighted average portfolio of the 11 funds would have lost 7.1 percent due to narrow divestment and 9.3 percent due to broader divestment over the past 50 years.
  - New York City's five funds would lose a combined $98 – 120 million annually and between $1.2 – 1.5 trillion over 50 years.

- The expected loss due to fossil fuel divestment for particular funds varies, but we estimate that all 11 funds will suffer a shortfall as a consequence of divestment.
- These are funds that will be unavailable to pension recipients and which will have to be made up in some way, either with lower pension payouts, or through taxpayer bailouts.
- Many public pension funds in the U.S. are currently deeply underfunded. The 100 largest public pensions in the U.S. are funded below 70 percent, and total unfunded liabilities are approximately $1.25 trillion. Particularly given this situation, anything that reduces expected returns on pension investments, as fossil fuel divestment would, is likely to directly harm pension benefits and increase the likelihood of taxpayer bailouts.
- The costs estimated above are solely those attributable to lost diversification benefits for the equity portion of these pension funds' portfolios. There are likely to also be costs from lost diversification when a fund divests its non-equity holdings as well, including corporate bonds, alternative strategy holdings such as hedge funds or private equity, and other investments.
- In addition, there are transaction costs from selling fossil fuel securities (and replacing them with other securities), such as the bid-ask spread and the price impact of trades, as well as commissions that may be owed on transactions. There are also likely to be ongoing compliance costs to maintain a pension fund's adherence to their pledged standard of fossil fuel divestment. All of these costs are in addition to the substantial costs of fossil fuel divestment for pension funds we estimated above.

Report Appendix

Fossil Fuel Divestment: A Costly and Ineffective Investment Strategy**
Prof. Daniel R. Fischel, President and Chairman, Compass Lexecon
January 2015

The Divestment Penalty: Estimating the Costs of Fossil Fuel Divestment to Select University Endowments**
Prof. Bradford Cornell, Visiting Professor of Financial Economics at Caltech, Senior Consultant at Compass Lexecon.
August 2015

Frictional Costs of Fossil Fuel Divestment**
Prof. Hendrik Bessembinder, Professor of Finance professor of finance at the Arizona State University's Carey School of Business, Senior Consultant at Compass Lexecon
June 2016

Fossil Fuel Divestment and Its Potential Impacts on Students, Faculty and Other University and Pension Stakeholders**
Prof. Hendrik Bessembinder, Professor of Finance professor of finance at the Arizona State University's Carey School of Business, Senior Consultant at Compass Lexecon
April 2017

Fossil Fuel Divestment and Public Pension Funds**
Prof. Daniel R. Fischel, President and Chairman, Compass Lexecon
June 2017

POLITICS OVER PERFORMANCE: The Politicization of the New York City Retirement Systems
Tim Doyle, Vice President of Policy & General Counsel, American Council for Capital Formation (ACCF)
January 2018

NEW DEVELOPMENTS IN SOCIAL INVESTING BY PUBLIC PENSIONS
Alicia H. Munnell, Director of the Center for Retirement Research at Boston College (CRR) and the Peter F. Drucker Professor of Management Sciences at Boston College's Carroll School of Management
Anqi Chen, research associate at the CRR
November 2016

INSIDE DIVESTMENT: THE ILLIBERAL MOVEMENT TO TURN A GENERATION AGAINST FOSSIL FUELS
National Association of Scholars
November 2015

The Financial Contribution of Oil and Natural Gas Investments To Public Employee Pension Plans in Seventeen States, Fiscal Years 2005 – 2013
Robert J. Shapiro, Chairman of Sonecon, LLC
April 2015

*** Indicates material funded by the Independent Petroleum Association of America.*