

TO: Budget Analysis and Review Committee (BARC)

RE: Divesting fossil fuel holdings in the ALA Endowment fund

ACTION REQUESTED/INFORMATION/REPORT:

Information Report

ACTION REQUESTED BY:

BARC at the request of the ALA Council to address Resolve #2 which

“Directs its Endowment Trustees to divest all holdings in the fossil fuel industry and invest in renewable energy initiatives”

CONTACT PERSON:

John Vitali – Senior Trustee, ALA Endowment Fund

DATE: April 20, 2013

BACKGROUND:

At the 2013 Midwinter Meeting in Seattle, the ALA Council discussed a proposed resolution requesting that the ALA Endowment Trustees divest any and all fossil fuel industry holdings in the ALA Endowment Fund and to invest in renewable energy initiatives. This resolution was forwarded to BARC to determine the financial impact on the ALA Endowment fund if such a request was carried out. In order to determine the impact involved the BARC Chair – Clara Bohrer - requested from the Senior Endowment Trustee – John Vitali – and the Endowment Trustees, to review the Council request and prepare a report on the financial implications of divesting fossil fuel holdings from the portfolio, as well as, investing in renewable energy initiatives.

After reviewing the request from Council the Endowment Trustees discussed and analyzed how the proposal would impact:

- The financial performance of the endowment portfolio
- The general risk profile of the endowment

- How the endowment is managed
- How the Trustees carry out their responsibilities

The Trustees solicited the assistance of its investment advisor Merrill Lynch. Merrill Lynch provided to the Trustees for their review a study titled “Do the Investment Math: Building a Carbon-Free Portfolio.” from the Aperio Group, an investment management firm that specializes in customized indexing strategies such as Socially Responsible Investing (SRI), sin free and carbon free portfolios. Note that the Trustees recognized that there was a potential “conflict of interest” in using the findings in the study as the basis for evaluating ALA’s portfolio. In this instance the conflict being that the author of the report specializes in the development of customized SRI portfolio’s, which has a built in bias toward non SRI portfolios. The following were some of the key findings.

Fossil fuel related holdings are a significant component of the Russell 3000 index

- 20% of the Russell 3000 (an index that broadly represents the US stock market) consists of energy, utilities and materials sectors
- 13% of the Russell 3000 consists of fossil fuel related mining, oil services and utilities - source: gofossilfree.org.
- As of 2/28/13 two of the top five holdings in the Russell 3000 were Exxon Mobil (#1) and Chevron (#4)

The Aperio Group study indicates that divestiture will increase risk

- The study looked at 2 divestiture methods:
 - Exclude a small sample of companies that have been identified as particularly harmful by climate change advocates, namely the “Filthy Fifteen”. 13 of these companies are publicly traded stock and were excluded.
 - Exclude a more comprehensive list of what they classified as “Oil, Gas & Consumable Fuels” (the study did not identify which stocks)
- While both divestiture methods will increase risk, the first exclusion had less impact because it excludes a smaller number of holdings. Aperio indicated that over long term holding periods that the risk would be relatively minor for both.

Calendar year volatility will be increased significantly

The Aperio study focused on long term performance and risk, including rolling 10 year periods which understate annual risks. The year to year variation in the returns posted by fossil fuel specific companies as a group can be very dramatic. As an example, during the 10 year period between 2/28/03 – 2/28/13, excluding energy and utilities from the S&P 500 would have had the following impact:

- Reduced returns in 7 out of 10 years
- Reduced cumulative overall returns by 10%

Investing in renewable energy would add significant risk to the ALA portfolio

Merrill Lynch identified ten (10) exchange traded funds (ETF’s) that invest in clean/alternative/renewable energy. They noted that the choices are very limited, are extremely

small¹, have short track records² and are relatively expensive. A review of these investments reveals much higher risk:

- Performance of these renewable energy investments was dramatically less than the Russell 3000 or the energy sector. The average 3 year annualized performance as of 12/31/12 for these funds was -22.2% vs. +11.2% for the Russell 3000 and +9.6% for the S&P Energy ETF
- The downside capture ratio for the funds was roughly twice the Russell 3000, i.e. market declines are approximately twice that of the market
- The underlying investments are generally not profitable, a sign of a speculative investment

The endowment trustees believe that this type of investment is more appropriately suited for alternative investments.

Endowment Fund Financial Impact of Divestiture – A review of ALA’s portfolio, which includes twelve managers – see attached – was conducted to identify if any of the managers held any of the “Filthy Fifteen” holdings in their individual portfolios. As of 2/28/13 ALA’s portfolio was found to contain three (3) holdings of the “Filthy Fifteen” (15). These holdings were Dominion Resources, Duke Energy and Edison International. Extrapolating out the findings in the Aperio Group study to the ALA portfolio, it is reasonable to conclude that on a short term basis divesting these holdings from the ALA portfolio would have little or no significant negative impact on returns realized in the portfolio as the tracking error to the index is very low. However, as stated earlier, the longer term impact could be significant. The ALA portfolio is actively managed and a screened portfolio will prevent the portfolio managers from positioning their respective portfolios from benefit during those times when the screened industry/asset class outperforms the index. We have found that year to year variances in asset classes like energy, materials utilities etc. can be significant in terms of outperforming the index and other asset classes. See impact above on the S&P 500 in study shortcomings. This is a clear indication that the ALA’s portfolio would be sacrificing returns if the portfolio was screened.

Trustee Identified Qualitative Findings - There are other considerations that the Trustees feel are as important as the financial considerations in the management of the Endowment fund. This relates to having available as many tools as possible to profitably manage the portfolio. The Trustees start with the following premise as stated in the ALA investment policy – page 4:

To achieve the maximum rate of return, within established risk parameters, over the long term that would significantly contribute to the cash flow needs of the Long-Term Investment fund for scholarships & awards, on-going operations, special initiatives and capital projects in support of the American Library Association.

By restricting or screening out specific holdings that may benefit the portfolio, the Trustees feel that the portfolio will be hampered in the following ways:

¹ Only 1 had more than \$100 million in assets

² Typically 3 years, only 1 has been in existence for 7 years

- Dividend yield of the portfolio would decline and inflation sensitivity would be reduced if energy and utility stocks were excluded
- It will reduce the effectiveness of sector rotation strategies which investment managers use to add value or manage risk
- Restricts the use of safe havens asset classes during recessions i.e. utilities, mandating investments in renewable energy stocks adds an element of speculation and increased volatility to the portfolio
- It limits the opportunity to diversify the assets in order to reduce the risk of wide swing in year to year market value
- It would prohibit the use of commingled investments such as exchange traded funds (ETF's) or institutional mutual funds
- Introduces a degree of subjectivity in determining what specific stocks are to be excluded and which are acceptable.

Summary/Conclusion: At this time the Endowment Trustees do not support the proposal to divest fossil fuel holdings from the ALA's endowment fund and invest in renewable energy initiatives. Given the current marketplace, serious data suggest that such a divestment would ultimately harm the fund's ability to fulfill its time-honored mandate. That is, to appreciate the corpus of the fund in such a way as to support scholarships, awards and ALA operations. Evidence against the proposal is as follows:

- Year to year fluctuations in performance among asset categories
 - Missed opportunities
- Reduces Trustee flexibility
 - Limits the tools available for investing
- Investing in renewable energy initiative
 - Increases the risk profile of the portfolio
 - Is very expensive
 - Renewable funds have short track records
 - Performance of this asset class has been poor