

**Statement of Anastasia Titarchuk, Interim Chief Investment Officer
New York State Common Retirement Fund**

**New York State Senate Hearing on the Fossil Fuel Divestment Act (S.2126)
April 30, 2019
Legislative Office Building, Albany, NY**

Thank you for your invitation to testify here today. I am Anastasia Titarchuk, the Interim Chief Investment Officer of the New York State Common Retirement Fund. I appreciate the opportunity to discuss climate change and its impact on the Fund's investment strategy — an issue of great concern to the Comptroller, the Fund and to me as an investor.

Certainly, we all agree that climate change presents significant risks and opportunities for the New York State Common Retirement Fund's investments. Comptroller DiNapoli has made it a priority for the Fund to address those climate change-related investment risks and to capitalize on those opportunities. He has been recognized as a global leader for his work on this significant investment challenge. And he acknowledges that there is much more work to be done.

Today I will update you on:

- our significant work to date;
- our ambitious plans for the future; and
- our substantial concerns about the Fossil Fuel Divestment Act.

I will begin by giving you a brief overview of the Fund's investment practices and policies, since understanding these basic tenets is essential to understanding our approach to this immensely complex investment issue.

Overview of NYSCRF Investment Practices and Policies

- **Fund Overview.** The New York State Common Retirement Fund (Fund) is the third largest public pension fund in the nation with an audited value of \$207.4 billion in assets (as of March 31, 2018) held in trust solely to pay pensions to the more than one million members, retirees, and beneficiaries of the New York State and Local Retirement System (System).
- **Payment of Benefits.** The System pays more than \$1 billion in benefits every month; 75 percent of these benefits come from investment earnings. In the event that the Fund does not generate sufficient investment income, employers, including the State itself, and more than 3,000 local governments and other public employers, may need to increase their contributions to make up the difference, imposing an additional burden on these entities and taxpayers.

- **Fiduciary Duty.** Comptroller DiNapoli, as Trustee of the Fund is legally bound by a fiduciary duty to act for the exclusive benefit of the members, retirees, and beneficiaries of the System for the sole purpose of paying benefits. The fiduciary duty also requires that he act prudently in making investment decisions: he is required to use “the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” N.Y. R.S.S.L. § 177(9). This is known as the “prudent expert” standard. Accordingly, Comptroller DiNapoli has investment policies and practices designed to uphold this duty and ensure that the Fund is managed with investment expertise as well as high levels of ethical conduct and transparency.
- **Asset Allocation.** Consistent with prudent expert standards, diversification is a cornerstone of our investment strategy. As a result, the Fund invests in a suite of different asset classes that are each further diversified by sectors, geographies, time horizons and other factors. We achieve that diversification through our asset allocation, which we believe, like many other institutional investors, is the single largest driver of our performance and risk profile. Our asset allocation is updated at defined intervals through a rigorous process including asset liability studies to identify the optimal mix of assets to meet the growth requirements of the System’s pension obligations while controlling risk. Our current long term policy allocation is 36 percent domestic equity, 14 percent international equity, 10 percent private equity, 10 percent real estate, 2 percent absolute return strategy, 3 percent opportunistic funds, 3 percent real assets, 17 percent bonds and mortgages, 4 percent inflation-indexed bonds and 1 percent cash.

With respect to its global public equity portfolio, the Fund employs two basic investment strategies — passive and active. The vast majority of the Fund’s public equity holdings are invested passively — that is, by replicating index funds. Through its passive investment strategy, the Fund does not select companies or sectors, rather it replicates an index fund — for example, the Russell 3000. The Fund rebalances its passively held public equities at least twice monthly to ensure that its investments mirror the index fund. Index investing has proven to be a low cost, efficient and superior strategy for investing and achieving diversification within our significant public equities portfolio. In addition to indexed holdings, the Fund contracts with external managers to create externally managed public equity portfolios aimed at outperforming the market.

With respect to its fixed income portfolio, almost 90 percent of the portfolio is internally managed at very low cost by replicating its benchmark.

- **Investment Process.** Given the breadth and complexity of the Fund’s portfolio, the Fund’s investment process is robust and necessarily draws upon the expertise of a wide range of internal and external investment and legal advisors to determine the appropriate investment choices for the Fund. The Comptroller appoints a Chief Investment Officer to oversee the Division of Pension Investment and Cash

Management's (PICM) operations, manage staff, and supervise investments on a day-to-day basis. 48 investment officers work in PICM, and 10 attorneys and 9 operational staff support their work. The Fund also relies on advice from a network of outside investment advisors, consultants, and legal counsel, as well as the members of independent external advisory committees appointed by the Comptroller. Internal investment staff present investment recommendations after extensive due diligence that are subject to legal reviews, further review, diligence and recommendations by independent consultants as well as the approval of certain advisory committees before they reach the Comptroller for final approval.

- **ESG Integration.** The Fund considers environmental, social and governance, or ESG, factors such as climate change in its investment process because there is strong evidence that they can influence both risk and return. Studies have shown that companies that do a good job of managing ESG factors outperform their peers.
- **Diversified Approach Has Served the Fund Well.** As a long-term investor, the Fund has a diversified investment approach that is designed to capitalize on market opportunities and weather the market's ups and downs. We seek to diversify our investments to manage risk and maximize returns. We diversify among asset classes, sectors, geographies, time horizons, and other factors. This helps to protect the Fund from market cycles that may affect specific sectors or industries. We believe that in highly efficient markets, we should gain exposure through low-cost, passive strategies. In less efficient markets, we consider active strategies where:
 - We understand the drivers of the inefficiency,
 - We believe the inefficiency is likely to persist, and
 - We are able to identify managers capable of consistently exploiting the inefficiency.

As mentioned index investing has proven to be a low cost, efficient and superior strategy for investing our significant public equities portfolio. It is worth noting that the vast majority of active managers do not outperform passive strategies and we believe that, as long-term investors, tactical trading on short-term market movements will likely lead to long-term under-performance.

The breadth of the Fund's investments, the allocation of its assets, and the manner in which it executes and manages those investments reflect informed and deliberate investment strategies adopted by the Comptroller in furtherance of his fiduciary duty. These investment strategies have served us well, with the result that the Fund is widely regarded as one of the nation's best-managed and best-funded pension plans.

Climate Change-Related Risks and Opportunities: Sustainable Investing, Active Ownership and Public Advocacy

- **Climate Risks and Opportunities.** To be very clear, Comptroller DiNapoli believes that climate change presents enormous risks to the Fund's investments and the

economy as a whole. He also believes that climate change presents enormous opportunities for investment in the low-carbon economy. Consistent with his fiduciary duty, Comptroller DiNapoli uses the most effective strategies at his disposal to address climate-related investment risks and to capitalize on opportunities. Through its Sustainable Investment Program, the Fund employs a multifaceted approach to addressing climate-related investment risks that includes: sustainable investing, active ownership and public policy advocacy. I must emphasize here, however, that consistent with the Comptroller's legal/fiduciary obligation, the sole purpose of this multi-faceted approach is to earn the investment returns necessary to make the \$1 billion plus monthly payments to the retirement system's retirees and beneficiaries.

- **Sustainable Investing.** Comptroller DiNapoli believes it is vital to invest in the low-carbon economy of the future. The Comptroller has committed \$10 billion to the Fund's Sustainable Investment Program for investments in climate solutions and other investments consistent with the United Nations' sustainable development goals. This includes:
 - creating a \$4 billion ground-breaking Low Emissions Index, which shifts investments away from high greenhouse gas emitters. The carbon footprint of the index is 75% lower than its benchmark; and
 - targeting an additional \$6 billion to sustainable investments across asset classes, including LEED certified buildings, green bonds and private equity investments.
- **Active Ownership.** One of the strategies that the Fund employs in these efforts is active stewardship: through voting its proxies in support of climate and other ESG resolutions; filing shareholder resolutions and other forms of engagement. The Fund has been recognized as one of the most active owners of any pension fund in the country.

The Fund has filed over 140 climate change-related shareholder resolutions resulting in agreements with 64 portfolio companies on issues including: analysis of climate risks; decarbonization of business operations; setting goals for greenhouse gas emissions reduction; and the use of renewable energy and energy efficiency. A majority of the proposals (60 percent) have been filled at utilities and energy sector companies and 48 percent of our climate change-related agreements have been with these sectors.

Our engagement program is enhanced through participation in multi-investor initiatives like: Climate Action 100+ an initiative aimed at the top greenhouse gas emitting companies in the global economy and supported by over 300 investors with more than \$33 trillion in assets under management; the Portfolio Decarbonization Coalition; the Ceres Investor Network; the Principles for Responsible Investment; and CDP (formerly Carbon Disclosure Project).

Some people are skeptical of the potential for shareholder engagement to achieve results in addressing climate issues. Those critics will say that fossil fuel companies will never change their business model. Yet, the fact remains that this year, largely in

response to shareholder engagement, Royal Dutch Shell announced that it would do just that. And just last week, Norway's Equinor, which has made major investments in offshore wind, including here in New York, agreed to shareholder requests to align its business model with the goals of the 2015 Paris Agreement.

- **Public Policy Advocacy.** In addition, the Comptroller provides public policy leadership on climate change issues that may impact the Fund's returns, at the global, federal and state levels. He has actively supported the Paris Agreement, the Clean Power Plan, tax credits for solar and wind power, fuel efficiency standards, carbon pricing, the Regional Greenhouse Gas Initiative and federal legislation to require greater corporate disclosure of climate risks.
- **Public Recognition.** This multi-faceted approach to climate-related investment risks and opportunities has resulted in the Asset Owners Disclosure Project ranking the Fund the top U.S. public pension fund and 3rd among the world's largest global public pension funds in managing climate-related investment risk.

Decarbonization Advisory Panel (DAP) and Climate Action Plan (CAP)

- **DAP:** The Fund is committed to building on its record of being a leader in addressing this issue. A little over a year ago, Comptroller DiNapoli, in partnership with Governor Cuomo, appointed the Decarbonization Advisory Panel, a group of six individuals with significant expertise in addressing the intersection of climate change and financial management. The Panel worked diligently over the course of the year, holding numerous calls and in person meetings; receiving briefings and research from staff on the Fund's investment processes and climate change-related work; hearing from experts from around the world on climate change risks and investment opportunities in climate solutions; and drafting comprehensive and ambitious recommendations that reflected a consensus of the Panel. Earlier this month the Panel's recommendations were presented to the Comptroller and then released to the public.

The Panel's primary recommendation is for the Fund to transition its investments to 100 percent sustainable assets by 2030. Sustainable assets are defined as investments, of any type, that are consistent with a 2-degree or lower future. The Panel suggests that this would be accomplished by ramping up investment in sustainable assets and climate solutions, and establishing minimum standards to prioritize engagement and possible divestment.

Specifics include:

- the Fund should establish a new climate solutions investment program;
- the Fund should establish minimum standards to measure the readiness of its investments for climate change impacts and the transition to a low-carbon economy; and
- the Fund should utilize all active ownership tools including engagement.

Notably, the Panel did not recommend the Fund divest specific stocks or stocks from specific sectors.

The Panel also recognized that the actions they proposed would take time, additional resources and aligned market compensation to implement, and it encouraged the Fund to start work on a plan with urgency. It acknowledged that implementation would have to be phased in, staff added and that criteria would evolve over time, but offered flexibility in the recommendations for short-term actions and longer-term ambitions given the urgency of the issue.

- **CAP:** Comptroller DiNapoli has directed the Fund's staff to develop a Climate Action Plan to implement the Panel's recommendations, and we are developing a plan that we believe will move the portfolio toward the goal articulated by the Panel.

Problems with the Fossil Fuel Divestment Act

Given the Fund's global leadership on addressing climate change-related investment risks, it should not be surprising that we take issue with the Legislature's attempt to mandate these specific investment decisions for us. The Fossil Fuel Divestment Act poses serious Constitutional implications as well.

Here are the Fund's specific problems with the bill:

- **Constitutional Issues with the FFDA.** The State Constitution has guaranteed since 1938 that pension benefits "shall not be diminished or impaired." This "nonimpairment clause" was interpreted in the *Sgaglione* case in 1975 to include the independent investment discretion of the Comptroller as Trustee. The Court said that while the legislature has authority to authorize investment of funds, its flexibility is not unlimited because the Comptroller's independence is "integral to maintaining the security" of the Fund. Importantly, the Court said that the legislature can "restrict the classes of investments," as it did in 1938 when the constitution was adopted, but it may not make mandates about specific investments. All attempts by the legislature to mandate specific investment decisions have been struck down for violating the Comptroller's independent discretion. Because this legislation, in requiring divestment from 200 specific companies, mandates very specific investment decisions, it would be vulnerable to legal challenges and likely found unconstitutional.

- **Fiduciary Problems with the FFDA.** The fiduciary duty to the beneficiaries of the Fund runs not only to the Comptroller; it also constrains the State. Thus, *any* investment decision made through the legislative process for the Fund is subject to the same fiduciary standard that requires the Comptroller to act for the exclusive benefit of the members, retirees, and beneficiaries of the System for the sole purpose of paying benefits.

The bill chooses a single factor (fossil fuel reserves as measured by carbon content) as the metric for divestment. This is a poor measure of investment risk and a crude measure of the climate impact of a company. Reinventing the investment strategy of a \$200+ billion pension fund requires significantly more study and nuance than generating a list of 200 companies based on a single factor. It would be impossible for the State to defend this as consistent with fiduciary standards.

Even if the legislature could constitutionally choose specific investments, it is legally bound as a fiduciary to constantly reevaluate its choices. (This is the 2015 *Tibble* case from the U.S. Supreme Court.) Enacting a statute with no sunset clause and a five-year time horizon with no reevaluation and adjustment is a clear violation of the fiduciary duty.

And it is important to note that the bill as currently written requires the Fund to lose over \$1 billion due to divestment, and then write a report documenting the loss, before taking any remedial action. This so-called “safety valve” is not safe at all, is inconsistent with the Comptroller’s fiduciary duty, and could result in significant impact for the 3,000 employers and affected taxpayers across the state.

- **Additional Problems with the FFDA.**
 - The bill also includes all parent, child, and affiliate companies of any of the 200 companies. So if the Fund has a major investment in a large, diversified company that acquires another company that may be a small fossil fuel reserve owner, this bill may actually mandate divestment from that large, diversified company, which could have a significant, unintended impact on the Fund.
 - In addition, it should be noted that simply because a company is situated in a market sector that is facing climate risk, it does not necessarily mean that it is a bad investment in the short, medium or even long term. Some companies, such as energy producers and utilities, which are at greatest climate change risk, are also capable of providing the greatest investment opportunities because, in the face of significant uncertainty, they have the ability to adapt to provide climate solutions.
 - The bill could actually prevent the Fund from investing in climate solutions, especially as fossil fuel companies begin to diversify and acquire renewable energy companies. For example, we are concerned because this legislation would likely require us to divest from Equinor, a partner in New York State’s efforts to develop offshore wind infrastructure

- We are concerned that the single-factor-based divestment proposed in this legislation will not actually address the true climate risks to our diverse portfolio. As the G20 Financial Stability Board’s Task Force on Climate related Financial Disclosure noted, climate risk and the low carbon transition are non-diversifiable risks that affect nearly all industries. And as noted in the recently released Mercer Study, *Investing in a Time of Climate Change: The Sequel 2019*, industries from all sectors of the economy will be affected by climate change, simply divesting from one industry will not inoculate the Fund against these effects.
- It is also important to note that buying a share of a company entails an evaluation of the future cash flows of a company. The price one is willing to pay for that share depends on the amount one expects a company to earn in the future. When a company is performing well, its stock price increases because investors expect that the growth of the company will lead to increased cash flows, and therefore increased dividends in the future. Active investors try to buy the stock cheaply — that is identify undervalued stocks — but if an investor such as the Fund is forced to sell stock by mandated divestment as required in this bill, it simply creates an opportunity for a different buyer to buy that stock cheaply as it does not alter the cash flow of such a business. And that buyer may not be a responsible and active owner like the Fund. A more profound impact on a company may be achieved through retention of an ownership interest, which provides the Fund with the opportunity to vote its shares on proxy issues and engage directly with the board and management based on the Fund’s position as a global leader in addressing climate change-related investment risks.
- Finally, the bill is likely to transfer hundreds of millions of dollars from the beneficiaries into Wall Street’s hands by forcing the Fund to customize everything it does and straying away from low cost passive strategies. There will also be trading costs in millions of dollars incurred as a result of both selling these companies and also buying stock to replace them.

Conclusions

While all of our actions must be legally focused on generating returns to provide for benefits owed to the members of the retirement system, it is worth noting that divestment is certainly not universally accepted as an effective means of mitigating climate change in the academic literature or among investment professionals.

Effective mitigation of climate change impacts requires comprehensive legislative, regulatory or policy action by state and federal governments such as a carbon tax, congestion pricing, 100% carbon free power generation or mandated electrification of transportation and heating. These critical initiatives *cannot* be accomplished

through divestment. They can only be accomplished through legislative or regulatory actions — the very powers that you control.

Divestment from fossil fuels is a blunt instrument that does not actually address the greatest risks for the Fund. For example, action on fossil fuel *producers* alone does nothing to address the climate change risks associated with major fossil fuel *consumers*, such as airlines, automobiles and power plants.

Climate change is complex, and that is why Comptroller DiNapoli is finalizing a multifaceted strategy and Climate Action Plan for addressing the risks and capitalizing on the opportunities. And it is important to note again that we have not ruled out targeted divestment as one of those actions that can be used to address climate change risk, but any decision to restrict or sell investments must be for the overall benefit of the Fund, must be based on the prudent advice of investment professionals and must be supported by an economic analysis demonstrating that it will not have a negative impact on the Fund. This legislation fails to meet these fundamental requirements.