DEPARTMENT OF FIRE AND POLICE PENSIONS

701 E. 3RD STREET
SUITE 200
LOS ANGELES, CA 90013

(213) 279-3000 (Main Line)
(844) 88-LAFPP (52377) - TOLL FREE
FAX (213) 628-7716
TDD (213) 628-7713

EMAIL: PENSIONS@LAFPP.COM

CITY OF LOS ANGELES

CALIFORNIA

ERIC GARCETTI
MAYOR

LOS ANGELES CITY EMPLOYEES' RETIREMENT SYSTEM

202 W. 1ST STREET
SUITE 500
LOS ANGELES, CA 90012-4401

(213) 855-6770 (Main Line)
(800) 779-8328 - TOLL FREE

January 21, 2022

The Honorable City Council
City of Los Angeles
c/o City Clerk
Room 395, City Hall
200 N Spring Street
Los Angeles, CA 90012

Re: CF 21-1116 Facebook Motion and CF 21-1460 Unilever

Honorable Councilmembers:

On October 5, 2021, the Los Angeles City Council approved a motion stating that the three City pension fund systems and any other City investment entity, in coordination with the City Administrative Officer and the Office of Finance, be “directed” to begin the process of divestment from Facebook. Additionally, on December 8, 2021 a separate motion was introduced stating that the three City pension fund systems and the Office of Finance be directed to divest from Unilever. The Facebook motion was approved by the full Council and the Unilever motion has been referred to the Budget and Finance Committee. This joint letter of the Los Angeles Fire and Police Pensions (LAFPP) and the Los Angeles City Employees’ Retirement System (LACERS), (together, the City Pension Plans) is provided in response to both motions.

As of December 31, 2021, when combined with the investments of the Water and Power Employees Retirement Plan, the City Pension Plans hold approximately $279.1 million in Facebook equity and approximately $48.7 million in Unilever equity and fixed income securities. These investments, like all investments managed by the governing boards of the City Pension Plans—the LACERS Board of Administration and the Board of Fire and Police Pension Commissioners (together, the Boards)—are held in trust for the participants of the City Pension Plans. When considering divestment from specific companies like Facebook, Unilever, or from specific industries or geographic regions, it must be recognized that ultimately, the City Pension Plans’ boards alone have the legal authority to invest, or not to invest, in whatever they choose, consistent with their fiduciary responsibilities. However laudable the motivating policy reasons, divestment of pension trust funds for *any* reasons other than achieving the best risk-adjusted return for the participants of the City Pension Plans raises fiduciary concerns. This joint letter first provides an overview of the fiduciary principles governing the investment of trust funds by public pension plans, then provides some background on Facebook and its weight in the S&P 500 Index, Unilever and its market impact, and concludes with a brief comparison of the relative effectiveness of engagement versus divestment to achieve environmental, social, and governance (ESG) goals.

<u>Fiduciary Principles Governing Pension Plans</u>

In making any investment decision concerning City Pension Plan trust fund assets (Funds), regardless of how the investment opportunity or investment decision is presented to the respective Boards for decision, the Boards are bound by three overarching fiduciary principles. These three fiduciary principles are drawn from California statutory and constitutional law, particularly Article XVI, Section 17 of the California Constitution; the Los Angeles City Charter, particularly Section 1106; federal tax laws and regulations; the common law of trusts and uniform trust laws; and the federal Employee Retirement Income Security Act of 1974, as amended (ERISA), and related Department of Labor regulations implementing ERISA. The three principles are discussed briefly below.

First, under the exclusive benefit principle, Board members are charged with plenary authority over the Funds and carry out that authority by managing the Funds for the exclusive purposes of (1) funding the benefits promised to [active] members, retired members, and beneficiaries and (2) defraying the reasonable expenses of administering the system.

Second, under the prudent investor principle, the Boards are charged with making all investment decisions with Fund assets with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiarity with these matters would use" in a similar situation. This means that the Boards' actions will be judged objectively according to the standard of a prudent expert. Every investment decision must be made after undertaking careful, disciplined analysis, calling upon investment staff, outside investment professionals, and consultants as the Boards analyze an investment decision. And the analysis must be based solely upon considerations taken into account by prudent expert investors, including the need for portfolio diversification, cash flow requirements, opportunity costs, and projected risk-adjusted returns.

Third, under its duty of loyalty, the Board members are trustees who must act "solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system." But of these three exclusive purposes, the

Board's "duty to participants and their beneficiaries shall take precedence over any other duty."

Finally, the prudent investor rule requires the Boards to continuously evaluate their investment decisions in light of the facts concerning the assets within the portfolio. Relatedly, both the California Constitution and the City Charter specifically include a duty to diversify the fund's investments "so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so." In other words, the burden would be on the Boards to prove why a prudent investor, under the circumstances, would have made a specific divestment decision. This includes whether an investment decision would cause an overweighting or underweighting of certain market sectors when compared to the weight that might otherwise prevail in the Fund's asset allocation.

Facebook and Its Weight in the S&P 500 Index

Social media and the power that it wields to influence people has taken center stage over the last several years. Today's social media platforms such as Facebook, Instagram, YouTube, Twitter, SnapChat, TikTok and others, are used by millions of people around the globe. Our social and professional lives are enriched by sharing ideas, experiences, and community with friends, family and others. But we know these social media platforms can potentially be harmful and spread misinformation on a range of topics and opinions.

Facebook[1] is considered one of the largest social media platforms and the number of registered users has grown to approximately 2.8 billion. This growth in users mirrors the financial growth in Facebook as a company. Facebook was added to the S&P 500 in December 2013 and its stock price has rapidly grown since that time. As one of the leading technology companies, it has amassed a large market share as it acquired over 78 technology companies whose software created social media platforms such as Instagram and WhatsApp. With its growth and market size, Facebook is known to be one of the FAANG (Facebook, Amazon, Apple, Netflix and Google) companies (stocks) that dominate the equity market. It is estimated that Facebook has accounted for 5.8% of the S&P 500's total price gain since being added in 2013. Facebook's current estimated market capitalization is close to $900 billion. With this value, movement in the price of its stock can influence the S&P Index given its capital weight within the overall Index.

All three pension systems currently contract with an investment manager to run a passive S&P 500 index fund. These passive strategies are a very cost-effective option (low fees) to invest in the broader market. Without these options, the systems would be forced to engage with an investment manager to create a custom index and pay higher management fees or contract with an active manager where fees can double or triple over a passively managed strategy. The creation of a custom S&P index that eliminates a

[1] In October 2021, Facebook has changed its name to Meta.

company that has contributed 5.8% of the S&P 500's growth over the past eight years will have detrimental effect on returns.

<u>Unilever</u>

Unilever is a large, British multinational consumer goods company that provides a wide range of consumer goods and products such as food, condiments, vitamins, tea and coffee, cereal, cleaning agents and more. Unilever owns over 400 brands and its products are available in approximately 190 countries across the globe. Unilever is based in London and its market capitalization is over $120 billion. In 2000, Unilever purchased Ben & Jerry's as one of its many ice cream product lines.

When Unilever acquired Ben &Jerry's, the companies crafted an unusual acquisition agreement that legally vested an independent board with control over the ice cream company's social mission, brand integrity and policies. This unique acquisition agreement is at the center of the current debate, which is the subject of the Council motion. In July 2021, Unilever made the following statement:

> *"The Israeli-Palestinian conflict is a very complex and sensitive situation. As a global company, Unilever's brands are available in more than 190 countries and in all of them, our priority is to serve consumers with essential products that contribute to their health, wellbeing and enjoyment. We remain fully committed to our presence in Israel, where we have invested in our people, brands and business for several decades."*

As previously mentioned, the City Pension Plans hold approximately $48.1 million in equity and fixed income securities of Unilever. While not considered a "growth company' like Facebook, Unilever nevertheless holds considerable weight in the capital markets. Calls for divestment from Unilever, on top of Facebook, will further force the City Pension plans to create custom indexes, with increased fees. The potential cumulative effect of divestment actions could result in lower overall investment returns that will grow over time and result in negative fiscal consequences for the City and its taxpayers in the form of higher contributions to the City Pension Plans.

<u>Engagement Versus Divestment Approaches to ESG Policy Goals</u>

As environmental, social, and governance (ESG) considerations have grown over the years, public pension plans have debated the merits of divestment versus engagement. Engagement is defined as proactively, constructively, and collaboratively engaging with the management teams of companies to enact change. Divestment is defined as the act of selling an investment from a portfolio to cease ownership of a company's securities. Both engagement and divestment are tools used by investors for promoting ESG causes or beliefs. Arguments for both activities are summarized below.

Reasons for Engagement:

- Divestment eliminates an investor's ability and shareholder right to engage with company management to enact long-term change (ex. The 2021 Exxon proxy contest - many large institutional investors rallied behind Engine No.1 and elected three Board members with backgrounds in clean energy; some argue a fourth seat might have been secured if institutional investors did not divest).
- Divestment can be costly. It may reduce expected risk-adjusted performance by reducing portfolio diversification and increasing risk, management fees, transaction costs, and opportunity costs.

Reasons for Divestment:

- Potentially increases the cost of capital for a company, making it more difficult for a company to invest in new projects. It may also reduce the share price of a company's stock, reducing company management's incentive pay and motivating management to change corporate behavior.
- Investors avoid the potential of holding and incurring losses from "stranded assets" (assets unable to earn an economic return due to changes in the landscape in which the assets operate).

Research studies suggest that divestment is not an effective means of restricting a company's access to capital or influencing a company's management to change behavior. Divestment may also result in the loss of substantial investment returns on divested companies, such as in the case of CalPERS which missed out on $3.6 billion in investment gains over a 17-year period due its divestment from tobacco. Many investors promote engagement over divestment; engagement allows shareholders to more effectively voice change to corporate policies and actions through the exercise of shareholder rights.

When the City Council debates divestment initiatives targeted at specific companies, industries or sectors, it must be recognized that with regard to City Pension Plans' Funds, ultimately the Boards have the exclusive authority to invest, or not invest, and engage with, or not engage with, the companies and investment managers in the Funds' portfolios. Fiduciary counsel for the respective Boards have advised that selective divestment, driven by the policy issues of the moment, however offensive they might be to any decision-maker at this moment, opens the door to the possibility of a long sequence of similar actions, whose cumulative effect on the universe of investment opportunities grows over time. As the data above indicate, even a single company can carry enough weight to potentially alter returns for the involved pension systems by limiting plan investment options—which in turn will have negative fiscal consequences for the City and its taxpayers, in the form of higher contributions to the City Pension Plans.

Conclusion

In summary, there are a number of ways the Boards can voice shareholder concerns of ESG related issues to effectuate long-term changes in company behavior or policies without the risks posed by divestment, including engagement. Above all, the Boards must carefully review proposals to ensure that they are comporting with the three fiduciary principles summarized above. At this time, divesting from Facebook and/or Unilever is inconsistent with those principles. As both Facebook and Unilever are two of the largest companies traded in the financial markets, divestment would require the Plans to "carve out" the companies from its low-cost index strategies, risking a reduction in returns while also increasing management fees.

We trust that this joint letter has provided a comprehensive response to the City Council's motions regarding divestment from Facebook and Unilever, and respectfully request that the Council keep these principles in mind when considering future motions seeking divestment from the Funds invested by the City Pension Plans' Boards.

Sincerely,

Raymond Ciranna

RAYMOND CIRANNA
General Manager
Los Angeles Fire and Police Pension System

Neil M. Guglielmo

NEIL M. GUGLIELMO
General Manager
Los Angeles City Employees' Retirement System