July 17, 2015

Vermont Pension Investment Committee
Stephen Rauh, Chair
Office of the State Treasurer
109 State Street Fl4
Montpelier, VT 05609-6200

Dear Chairman Rauh and Members of the Vermont Pension Investment Committee:

The Vermont Chapter of the Sierra Club (“the Chapter”) believes that the State of Vermont has urgent moral and fiduciary responsibilities to divest Vermont Pension Investment Committee (“VPIC”) managed pension funds from companies with a significant stake in fossil fuel production. While the Chapter recognizes that the decision to divest on moral grounds may be interpreted to be outside of the scope of VPIC’s mission, it is nonetheless worthwhile to recognize that the moral hazard posed by the unabated use of fossil fuels is on par with previous moral hazards, such as the sale of tobacco, which have prompted legislative directives restricting how the pension funds are invested. Outside of the profound moral problems associated with investing in these companies, we firmly believe that the fiduciary risks associated with holding assets whose value are derived from fossil fuel holding are more than sufficient to justify VPIC divesting from these assets.

Because of the inherently unpredictable nature of future investment returns, it is impossible to prove definitively that either the inclusion or exclusion of a particular asset or class of assets will benefit the performance of the pension funds under VPIC management. Consequently, any assessment of the future return from fossil fuel investments, including NPEC’s Preliminary Analysis of Potential Impact of Energy Sector Divestment (“the NPEC Report”), must be evaluated on the strengths of its underlying assumptions. We believe that the exclusively backward looking nature of the NPEC Report as well as numerous internal inconsistencies in the report mean that it is an inadequate basis for assessing the financial implications of divestment. We lay out here, in general terms, our assessment of the short and long-term prospects of investment in fossil fuels followed by our assessment of the shortcomings of the NPEC Report. Taken together, we believe that it is clear that investments in fossil fuels offer little financial upside and considerable risk of significant financial downside relative to other investments. We therefore call upon VPIC to begin a carefully considered divestment of all of its pension funds from the top 200 publicly traded companies that hold the largest carbon content fossil fuels reserves to enhance the financial outlook of the funds while simultaneously bringing its investment portfolio more closely into alignment with the morals of the State of Vermont.
Short Term Return on Fossil Fuel Investments

Recent history suggests that there is minimal or even negative short term value to holding fossil fuel assets relative to other investment options. The abundance of new fossil fuels that are accessible due to widespread hydraulic fracturing has driven down energy prices and profits of fossil fuel companies. There is little evidence to suggest that a reversal of fortunes is likely in the near future. In fact, the Energy Information Agency projects fuel price for most fuel types to stay at or below 2013 level through 2025. The question that VPIC must answer, therefore, is whether or not fossil fuels assets are competitive with other assets given current fossil fuel prices. There is ample evidence that the answer is no:

- A recent analysis of MSCI, one of the leading global indices used by pension and hedge funds, showed that over the last five years investors who divested from fossil fuel companies would have earned 1.2% more than investors whose portfolio included these assets.²
- Prior analysis by Impax Asset Management reached similar conclusions. Fossil free portfolios constructed using multiple methods (passive investment in an index of non-fossil assets, and active investment emphasizing alternative energy assets) outperformed indices that included the assets in the 5 and 7 years prior to December 2013.³
- Finally, VPIC itself has implicitly recognized that fossil fuels are a bad investment in the short term. Since September of 2012 (the first date for which VPIC holdings are available in a manipulatable format, as prior holdings reports are in pdf form), VPIC has reduced the share of its portfolio in energy sector assets nearly 25% from 2.2% of all investments to 1.7% as of June 2015.⁴

Clearly, the short term value in holding fossil fuel assets is low. In order to make a fiduciary case against disinvestment, fossil fuel assets must offer more robust returns in the long term.

Long Term Return on Fossil Fuel Investments

The long term prospects for fossil fuel companies are yet clearer and bleaker than their short term prospects. While measures to curb fossil fuel use have been slow to take root, the prevalence of these measures has been increasing steadily and will inevitably erode the value of companies that own significant fossil fuel reserves or derive revenue from the sale of fossil fuels. Thirty U.S. states, the European Union, Canada, China, and numerous other countries have all implemented

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² MSCI MSCI ACWI EX FOSSIL FUELS INDEX. Available at: https://www.msci.com/resources/factsheets/index_fact_sheet/msci-acwi-ex-fossil-fuels-index-gbp-gross.pdf
⁴ VPIC Pension Fund Holdings. Available at: http://www.vermonttreasurer.gov/pension-funds
mandatory renewable energy targets. The United States, the European Union and 16 other countries have all formally submitted greenhouse gas emissions reduction targets to the United Nations through the UN Framework on Climate Change. As these measures begin to take effect, fossil fuel companies will see their markets and the value of their holdings reduced significantly. The precise timing of the impacts is uncertain, but the trend is clear. Fossil fuel investments have a strong downside risk due to increased regulatory pressures and the risk that the fossil reserves themselves will become stranded assets.

In short, in the most optimistic scenarios, the short and long term benefits of holding fossil fuel related assets are minimal. Recent history suggests that including fossil fuel assets in a broad portfolio brings down the value of the portfolio and that VPIC sees little value in holding these assets.

**Shortcomings of the NPEC Report**

In addition to its overly broad focus on energy sector, rather than fossil fuel assets, the NPEC Report suffers from two major shortcomings. First, it is excessively backward looking in evaluating the value of holding fossil fuel assets, failing to account for recent trends that have driven down the return on these assets or the probable investing environment going forward. Second, its logic is internally contradictory on several points, most notably in its assumptions about the likelihood that other investors will divest and in its treatment of assessment of the appropriate role or moral judgement in VPIC’s investment decision making.

By far, the largest single financial drawback identified in the NPEC Report is the reduction in return to total global equity portfolio. The NPEC Report makes the unsubstantiated assumption that the return on this portfolio would drop by 0.5%. As the report acknowledges, NPEC did not assess the reweighted returns of the S&P 500, MSCI EAFE, or any other indices but rather made this assumption because it was “in line with the historical impact of the energy sector over longer-term time periods.” While this may be consistent with some historical time periods, it is not consistent with recent performance and it fails to take into account either the changing regulatory environment facing fossil fuel companies or increased competition from renewable fuel sources going forward. Consequently it is difficult to consider this assessment, or the assessment of the cost of lost managerial discretion to be credible.

In addition, the NPEC Report makes contradictory assumptions about the prevalence of divestment, assuming simultaneously that it will be rare, requiring highly customized, and therefore costly, investment strategies and that divestment will be sufficiently widespread so as to material impact energy sector returns and fuel costs. Clearly divestment on that scale would results in an explosion of low cost fossil fuel free options. Even in the absences of widespread divestment, developing algorithms for non-fossil, passive portfolios is computationally trivial and market
competition is likely to quickly eliminated any differences in management fees between total market and market ex fossil fuel portfolios.

Finally, the NPEC Report opens by suggesting that financial return is the only acceptable criteria on which VPIC should evaluate investment choices, but, in a glaring reversal, includes higher transportation and food costs as a potential downside to widespread divestment. If the broader societal impacts of investment decisions are considered, the societal harm done by higher fossil fuel costs is dwarfed by the societal harm associated with climate change which adversely impact human health, food production, and built infrastructure, to say nothing of the impacts on biodiversity and the natural environment.

In conclusion, given 1) the poor recent performance of fossil fuel assets relative to other investments, 2) the likelihood for continued underperformance in the short and long term, including the risk of sudden and dramatic drops in value due to changing regulatory regimes, and 3) the clear shortcomings of the preliminary analysis of the NPEC report, we believe it is not only morally right, but in fact, a fiduciary imperative for VPIC to set in motion a plan to divest its pension funds from the top 200 publicly traded companies that hold the largest carbon content fossil fuels reserves.

Thank you for your consideration of this important matter.

Sincerely,

Mark Nelson
Chair, the Vermont Chapter of the Sierra Club

Nate Hausman, Esq.
Energy Committee Chair, the Vermont Chapter of Sierra Club