Zevin Asset Management

Comments of Pat Miguel Tomaino, Zevin Asset Management, to the University of Michigan Board of Regents submitted February 15, 2021

Greetings,

My name is Pat Miguel Tomaino. I am the Director of Socially Responsible Investing (SRI) at Zevin Asset Management[1], a socially responsible investing firm based in Boston.

Zevin Asset Management invests approximately $600 million on behalf of institutional clients and families who trust us to deliver superior returns, manage material social and environmental risk, and create positive impact with their money.

To build socially responsible, risk-managed portfolios, we routinely exclude (or "screen" out) harmful industries, such as companies that profit substantially from incarceration and immigration detention, firearms and weapons of war, tobacco products, and fossil fuels.

My overall message to the University of Michigan is that socially responsible investing strategies — including exclusion screens — are fundamental to sustainable investment practice, as it is now implemented by a diverse range of investors now managing approximately $12 trillion, according to a recent analysis.[2] That means that portfolios equal to approximately 1 in 4 dollars invested globally employ positive screening, negative screening, divestment, and/or other methods of integrating environmental, social and governance (ESG) insights into the investment process.

These types of strategies should be adopted by the University of Michigan. In my view, screening and divestment to reduce risk are not currently being properly employed by the University of Michigan. As a result, a range of harmful and risky activities, from military weapons firms to fossil fuels to prison profiteering, could potentially show up in the University's investment portfolios.

My urgent and particular message today is that the University can and should divest from fossil fuels and other harmful sectors/activities in existing and future investments. You can do this as part of an overall effort to adopt and implement a thoughtful, principled responsible investment

[1] Information at www.zevin.com
[2] "2018 Report on US Sustainable, Responsible and Impact Investing Trends," US SIF, October 31, 2018. https://www.ussif.org/trends

2 Oliver Street, Suite 806, Boston, MA 02109 | (617) 742-6666 | invest@zevin.com

policy. It will be a process, but the University of Michigan can start now with purpose and transparency.

I wish to encourage you as you consider embarking on this process. I also wish to reassure you in the following ways.

1. The fossil fuel industry is a harmful and risky investment. As a result, divestment is warranted.

As I mentioned, Zevin Asset Management employs a responsible investment approach that includes divestment as a tool, and it is possible for most investors to implement that approach. We screen certain harmful industries out of our clients' portfolios, including:

- Nuclear energy producers or suppliers of nuclear power industry–specific equipment and services, except for safety equipment
- Weapons producers
- Companies involved in the production of tobacco products
- Companies manufacturing agrochemicals such as toxic pesticides or chemical fertilizers

We also refrain from purchasing the shares of companies with a substantial involvement in gambling, harmful chemicals, pornography, thermal coal, factory farming of meat or fish, incarceration or oil sands development.

We avoid many of the above industries because the products they sell are harmful to customers, communities and other stakeholders, and the industry's business is so focused on that harmful activity that there is little chance that companies in the industry will change as a result of the investor advocacy that we routinely undertake. Shareholder engagement is a powerful tool, but it is definitely not the answer in every sector and in every circumstance.

That is a bit of context on the way that we view divestment as professional investors. In the case of fossil fuels, for example, there are two compelling reasons for divestment: the product is harmful, and the business is particularly risky.

For these reasons, which I will address in turn, Zevin Asset Management typically does not invest in fossil fuel companies. Avoiding fossil fuel investments is typically the best course for our socially responsible investment approach and for our clients' long-term interests.

First, I'll address the harm.

The fossil fuel industry has benefited massively from the primacy of oil, gas, and coal as energy sources since industrialization. We know that we must change direction. Research shows that in order to keep to international targets to limit global warming to less than 1.5 degrees Celsius

beyond pre-industrial levels rise, and thus prevent catastrophic levels of climate change, between two-thirds and four-fifths of fossil fuels need to remain in the ground.[3]

However, fossil fuel companies are not substantially changing their activities. Aside from a few token investments and non-core activities, the majority of the fossil fuel sector seems to be banking on these targets not being met. They continue to extract reserves and sell them – and they are actively prospecting for more. This failure to help society keep carbon in the ground is hastening our planet toward irreversible climate change that will cause catastrophic problems associated with rising sea levels, flooding, droughts, rising disease, increased conflicts and refugee crises.

The fossil fuel industry is not simply carrying on with business as usual. They are deepening harm by actively preventing positive change. According to a 2019 report, the largest five stock market listed oil and gas companies spend nearly $200m a year lobbying to delay, control or block policies to tackle climate change.[4] And much like the tobacco companies before them, the fossil fuel industry evidently went to great lengths to obscure the science of climate change and the threat we face. For the most part, current lobbying and public policy efforts by the fossil fuel industry only continue to obscure those dangers.[5]

The same can be said of other harmful industries, such as companies that profit from the prison-industrial complex and predatory private education companies. Such industries have core business models which are tied to a harmful activity. They would rather obfuscate and lobby policymakers to protect their harmful business models than meaningfully change that model for the sake of long-term risk management. For that reason, companies in these sectors are not good candidates for investor engagement. Rather, they are candidates for divestment.

Finally, the fossil fuel industry is generally rife with negative impacts on human rights, local communities, and surrounding ecosystems. We are conscious of the fact that decades of fossil fuel exploitation has proceeded with flimsy community consultation, especially consultation with indigenous people, and it has fueled conflict in communities around the world. There have been some developments in managing some of these impacts over the years, but we still find very few exceptions to a long history of poor practice on human rights and environmental protection.

Second, I will address the risk.

There are a myriad of material ESG risks associated with the human rights, community and environmental concerns I have just mentioned. But the largest risk facing the fossil fuel sector stems from climate change.

[3] The geographical distribution of fossil fuels unused when limiting global warming to 2 °C, *Nature,* January 2015, https://www.nature.com/articles/nature14016.
[4] "Top oil firms spending millions lobbying to block climate change policies, says report," *The Guardian*, March 2019, https://www.theguardian.com/business/2019/mar/22/top-oil-firms-spending-millions-lobbying-to-block-climate-change-policies-says-report.
[5] "The Climate Accountability Scorecard (Updated), Insufficient Progress from Major Fossil Fuel Companies," Union of Concerned Scientists, October 2018, https://www.ucsusa.org/resources/climate-accountability-scorecard-0.

Very simply: if international agreements on climate change are met, and our society mobilizes to confront climate change with real policy and regulation, as it must, fossil fuel investments and the fossil fuel sector will become worthless. This is the reality of *stranded assets*: fossil fuel reserves that are currently valuable and buoying fossil fuel companies, but which will become worthless and toxic when they are rendered unexploitable by future policy and technological innovation.

The fossil fuel sector has created a huge "carbon bubble" which could wreck its own value and plunge the world into another economic crisis as the reality of climate change manifests. The value of that bubble, according to a 2018 study, could be the equivalent of between $1 trillion and $4 trillion, which could disintegrate from the global economy in fossil fuel assets alone. In comparison, a loss of "just" $250 billion triggered the crash of 2008. This is an enormous risk.[6]

Short-term risks in the fossil fuel sector are already playing out. Energy has been the worst performing sector in the S&P 500 in recent years, so it has paid to avoid fossil fuel stocks. Into the longer-term, Mercer research shows that "regardless of the response scenario, climate change will impact pension fund returns, with the biggest impacts experienced in climate vulnerable sectors such as fossil fuels."[7] Fiduciaries such as yourselves must be attuned to these risks and respond accordingly.

Similar risk concerns apply in several other harmful industries, such as the incarceration industry, for example. In 2017, the boards of all five New York City pension funds decided to divest from for-profit prison companies. New York City Comptroller Scott Stringer has been very clear that this policy decision was motivated by the city's understanding of its social responsibility <u>and</u> by the demands of sound risk management. In a 2018 *New York Times* op-ed, Stringer wrote that the prison industry "has turned human suffering into a billion-dollar business." Critically, however, Stringer also said that private incarceration companies, in addition to being morally suspect, fail a "basic risk assessment." Divesting from the industry means decreasing risk in investment portfolios.[8] New York is right. Private prison stocks swung wildly between the Obama and Trump administrations, and future legal changes would bring more volatility and risk.

What is the appropriate response?

We believe that divesting from the fossil fuel sector and other harmful sectors is an appropriate response. For example, as I mentioned above, in our own clients' portfolios, Zevin Asset Management typically does not invest in fossil fuel companies. In that way, we seek to avoid both the harms and the risks discussed above. Additionally, a significant portion of our clients

[6] 'Carbon bubble' coming that could wipe trillions from the global economy: study," Phys.org, June 2018, https://phys.org/news/2018-06-carbon-trillions-global-economy.html?utm_source=newsletter&utm_medium=email&utm_content=2019-09-08&utm_campaign=greenbuzz
[7] "A Guide to Climate Change Investment Risk Management for US Public Defined Benefit Plan Trustees by Mercer Investment Consulting," Mercer Investment Consulting, October 2016, http://transformtrillions.org/reports/.
[8] Stringer, Scott and Javier H. Valdés. "More Cities and States Should Divest From Private Prisons," *The New York Times*, July 2018.

have chosen to have 100 percent fossil-free portfolios as a matter of policy. As I will discuss shortly, those portfolios are not a heavier burden or larger challenge to manage.

The upshot is that we believe that investors avoiding the fossil fuel sector are safeguarding the long-term value of their investments by avoiding undue risk while also minimizing the harm that their assets enable in the world. Divestment decisions also send a powerful signal to the capital markets, companies and policymakers that business as usual is changing. Service providers, investment managers and other market actors are increasingly responding to those messages with solutions.

No wonder that major financial institutions and asset owners are pursuing divestment to avoid the risks and harms of the fossil fuel sector and other harmful industries. We have seen notable fossil fuel divestment commitments from the University of California, the World Council of Churches, the City of New York, and the Rockefeller Brothers Fund. Dozens and dozens of institutional investors, asset owners, and pension funds have made similar commitments. Large asset owners and major banks, such as JPMorgan Chase, Wells Fargo, Bank of America, SunTrust, BNP Paribas, and Fifth Third Bancorp, have divested from the private prison industry. In short, the University of Michigan would be in good company as it moves to improve long-term risk management via divesting from harmful industries.

Divesting from the Carbon Underground 200 is a rational first step which many asset owners have found useful: https://www.ffisolutions.com/research-analytics-index-solutions/research-screening/. In consultation with your consultants and investment managers, I would encourage you to go beyond the Carbon Underground 200 list for a variety of reasons related to risk management. The University may be invested in fossil fuels and other harmful sectors in a variety of other asset classes beyond public equities, and those investments present similar (and often greater) long-term risks. I encourage the University to develop a divestment policy that addresses all asset classes, including private equity and others. As I discuss in Section 3 below, working to implement the University's divestment policy across all asset classes may present certain logistical challenges, but these challenges are manageable.

Briefly, I'll address a final, minor, objection to fossil fuel divestment that goes something like this: "How could we divest, if, as a University and as people, we continue to use fossil fuels?" I don't know whether to call this objection sophistry or just plain silly. More importantly, it misses the point. This economy needs a transition away from risky and harmful fossil fuels and our collision course with catastrophic planetary warming. That transition will happen via far-reaching regulation or via even more abrupt and disruptive physical changes playing out. That transition creates risk, threatening companies and portfolios, that simply needs to be addressed.

Different actions are required of us as stewards of investment capital facing long-term risk than as individuals trying to figure out how to order our lifestyles. We will continue to live as well and as responsibly as we can while we aim to invest and divest as responsibly as we can.

2. Socially responsible investment (SRI) and divesting from harmful, risky industries do not hurt portfolio performance.

Evidence indicates that there is no significant performance penalty for taking steps such as the above. Socially responsible investment screening does not necessarily or materially constrain the universe of investment options. Where there are constraints, a skilled investment advisor can manage limitations by creatively finding needed exposure (investing in alternative sectors, sub-sectors, or asset classes) and also by seizing opportunities to invest in attractive, socially responsible companies and activities.

- An RBC study comparing the performance of screened SRI indices with conventional indices found that socially responsible investing does not result in lower investment returns. RBC said: "This is an important finding because it provides support to individual investors and trustees of institutional funds that they can pursue a program of socially responsible investing with the expectation that investment returns will be similar to traditional investment options."[9]
- A nuveen/TIAA analysis of leading SRI equity indices in 2017 found no statistical difference in returns compared to broad market benchmarks, which, to them, suggested no systematic performance penalty for SRI.[10]
- More generally, it is clear that SRI practice can reduce long-term risks in portfolios. A 2015 Oxford University study found that responsible business practices are linked to better financial performance.[11] In the same year, a meta-study of sustainable investment practices found a positive or neutral effect on investment performance 90 percent of the time.[12]

Moreover, there is likely nothing specific to fossil fuel divestment which should give inordinate concerns about performance. Look to a 2017 University of Groningen study covering a period of 88 years, from before the Great Depression to after the Great Recession. That research concluded that "divestment [from fossil fuels] did not reduce risk adjusted returns…these findings can be explained by the fact that fossil fuel company portfolios do not generate above-market performance and provide relatively limited diversification benefits."[13]

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[9] "Does socially responsible investing hurt investment returns?" RBC Global Asset Management, September 2012. http://funds.rbcgam.com/_assets-custom/pdf/RBC-GAM-does-SRI-hurt-investment-returns.pdf

[10] "Responsible Investing: Delivering competitive performance," nuveen/TIAA Investments, July 2017. https://www.tiaa.org/public/pdf/ri_delivering_competitive_performance.pdf

[11] Clark, Gordon (Oxford University) and Andreas Feiner (Arabesque Asset Management), "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance," March 6, 2015. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508281

[12] Friede, Gunnar et al, "ESG and Financial Performance: Aggregated Evidence From More Than 2,000 Empirical Studies," *Journal of Sustainable Finance & Investment*, October 2015. https://paxworld.com/esg-and-financial-performance-aggregated-evidence/

[13] Trinks, Pieter Jan; Scholtens, Lambertus; Mulder, Machiel; Dam, Lammertjan. "Divesting Fossil Fuels: The Implications for Investment Portfolios." University of Groningen. 2017. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2903926

A 2020 University of Groningen study, which analyzed an international sample of nearly 7,000 companies over a period of 40 years, found that "the investment performance of portfolios that exclude fossil fuel production companies does not significantly differ in terms of risk and return from unrestricted portfolios. This finding holds even under market conditions that would benefit the fossil fuel industry." The researchers went on to conclude that "divesting from fossil fuel production does not result in financial harm to investors, even when fossil fuels continue to play a dominant role in the energy mix for some time."[14]

This is consistent with my experience helping to construct sustainable, fossil-free portfolios. As I mentioned above, a significant portion of our clients have chosen to have 100 percent fossil-free portfolios as a matter of policy. These portfolios are not a heavier burden or larger challenge to manage. In general, our investment firm navigates fossil-free investing by seeking opportunities in corresponding sectors, seeking opportunities in clean energy alternatives and sustainable solutions providers, and sound risk management. Similar logic applies to divesting from other harmful sectors, beyond fossil fuels, and from divesting in other asset classes, such as private equity and others.

Our investment professionals do not believe there is any significant trade-off in investing fossil-free portfolios, especially now that exposure to the fossil fuel sector is historically low across a broad range of indices and benchmarks. Oil and gas companies now account for just 4.4 percent of the S&P 500, while in 1980 they represented more than 28 percent of the index.

3. Divestment is practicable, and you have support, advice, and products to responsibly implement this course.

The University of Michigan can begin the process of divesting from fossil fuels right now. This would entail giving your in-house investment officers, your consultants, and your asset managers clear instructions regarding roughly the following, for example:

A. Your investment officers, consultants, and asset managers should report to the University and to the public on the University's exposure to fossil fuels. This would include reporting across the range of asset classes in the University's portfolios.
B. Your investment officers, consultants, and asset managers should begin divesting on an expeditious, best-efforts basis.
C. Your investment officers, consultants, and asset managers should report substantively to the University and to the public in successive years on their progress regarding (A) and (B). The University should, in turn, report regularly to the public on its assessment of progress.

The above is a standard process scaffold for divestment in use by several large institutional asset owners like the University of Michigan. From what I understand of the state of this market and

[14] Plantinga, Auke and Bert Scholtens. "The financial impact of fossil fuel divestment." *Climate Policy*, Volume 21, Issue 1, 2021. https://www.tandfonline.com/doi/full/10.1080/14693062.2020.1806020

the desire of consultants to play this role for you, the above is all within the University of Michigan's capabilities. The point is to leverage the expertise of expert consultants, vendors, and service providers to get the job done in a thorough and deliberate manner in keeping with fiduciary duty.

Your consultants and asset managers are your service providers, and they are eager to please you with solutions and product innovation. The University of Michigan is the client. It might take some time, but your expert vendors will mobilize to help the University to cease its support for and exposure to the fossil fuel industry and other harmful sectors.

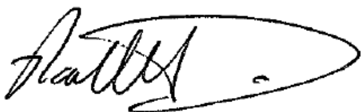
I encourage you to develop and implement a divestment policy that applies to the full range of asset classes in which the University is invested. As you work across the range of asset classes, some aspects of the University's portfolios might present unique logistical challenges — but these challenges are manageable. For instance, some of the University's private equity investments might have lock-up requirements that prevent action in the short term. The University can and should adopt a reasonable plan for divesting those assets as soon as practicable

In all of the above, it is important to remember that competent, creative service providers should be charged with designing solutions for the University to carry out its divestment decisions efficiently and across all asset classes. University boards which have divested have done so by focusing on assessing options and making the best policy decision possible. Then, they delegate and oversee service providers in the technical aspects of implementing that policy decision over time. I would strongly recommend this approach.

In closing, major pension funds, asset managers, foundations and other institutions like the University of Michigan are putting all of the above insights into action. They have already begun to implement socially responsible investment strategies, divest from harmful industries like fossil fuels and private prisons, re-invest in regenerative assets, and reap the attendant benefits.

I urge the University of Michigan to follow suit and divest from the fossil fuels. I remain at your disposal to assist in that process.

Sincerely,



Pat Miguel Tomaino
Director of Socially Responsible Investing
Zevin Asset Management, LLC