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CalPERS' Political Agenda Puts Taxpayers and Retirees at Risk

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Executive Summary

CalPERS' investment performance has been sub-par relative to other public pension funds, broad market indices, and alternative passive investment strategies. For example, CalPERS' 10-year average annual return through June 30, 2023 was 7.1 percent (CalPERS' 10-year average annual return through June 30, 2024 was an even lower 6.2 percent). A diversified portfolio that allocated 80 percent of investments toward stocks, 10 percent in U.S. Treasury Bonds, and 10 percent in Baa rated corporate bonds (a standard risk diversification portfolio) would have returned 9.8 percent annually over the same period.

Even a portfolio that invested 60 percent of its assets in the S&P 500, 20 percent in U.S. Treasury Bonds, and 20 percent in Baa rated corporate bonds (a lower risk/lower return investment portfolio) would have earned 7.9 percent, still beating CalPERS' returns.

In light of CalPERS' uncompetitive returns, its position on Environmental, Social, and Governance (ESG) advocacy is disconcerting. CalPERS continues to support political positions that can potentially conflict with its financial performance – the prime social responsibility of any public pension fund.

For instance, consistent with CalPERS' adherence to ESG, the public pension fund promotes underweighting investments in fossil fuel holdings and supports shareholder resolutions that seek to promote political goals regardless of their impact on financial performance.

ESG and other politicized investment theses introduce risks and can become obstacles to improved investment diversification and potential returns. Ultimately, it is beneficiaries and taxpayers who bear the risks from any underperformance created by this politically driven investment. It is essential, consequently, for the pension fund to fulfill its essential social responsibilities without distractions from ancillary political and social issues.

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Introduction

Often lost in the calls for socially conscious investing are the valuable roles that pension funds provide beneficiaries. The primary social responsibility of any public pension fund is to secure the retirement of public employees and retirees. Failing that mission either harms current retirees, future retirees, or as is more likely, shifts the costs of its failures on to taxpayers.

CalPERS is no different than any other public pension fund in this regard. As a fiduciary, it has well defined social responsibilities. With respect to private plans, the Department of Labor states that "the primary responsibility of fiduciaries is to run the plan ***solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses***. Fiduciaries must act prudently and must diversify the plan's investments in order to minimize the risk of large losses."[1] (emphasis added)

The emphasized phrase is key. The social responsibility of a fiduciary is to serve its beneficiaries, which is defined as exclusively focusing on the financial viability of the fund. But what does focusing on the financial viability of the fund mean? CalPERS claims that the positions it has taken with respect to global climate change, such as the fund's $100 billion commitment toward investing in "climate solutions" by 2030,[2] also promotes its financial responsibilities. The investment thesis being that an energy transition is occurring so positioning the fund to benefit from this transition is in the long-run financial interests of beneficiaries.

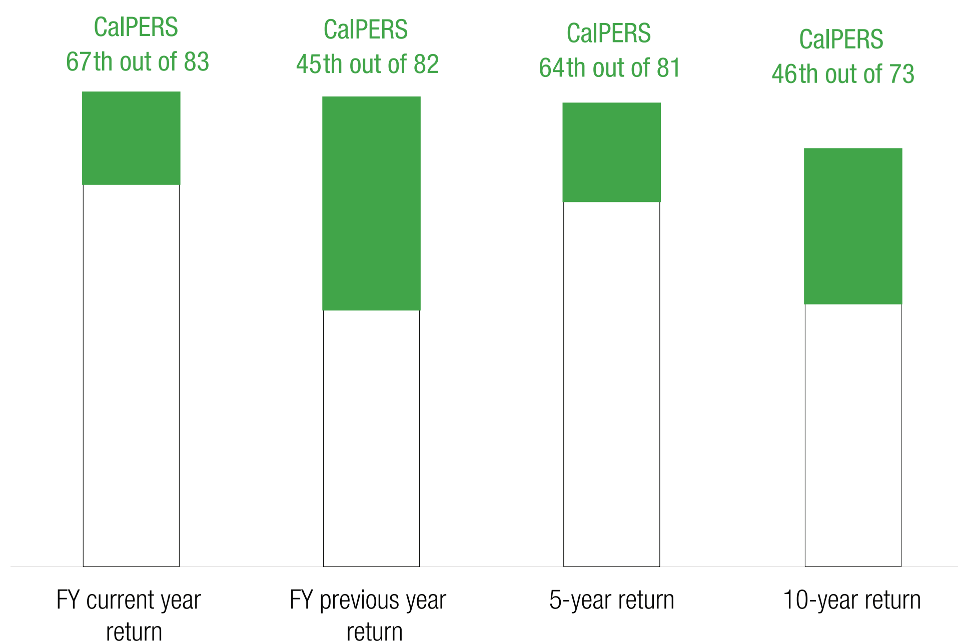
There are legitimate concerns that CalPERS' political views are conflicting with its fiduciary responsibilities.

The evidence paints a different picture, however. CalPERS has earned sub-par returns (both short-term and longer-term), which raises questions regarding this investment thesis. The fund has also taken positions on corporate management that appear to be more consistent with a polemical view of the energy sector not a financial view. Further, these political biases discourage investment opportunities that offer diversification and return benefits. Simply put, there are legitimate concerns that CalPERS' political views are conflicting with its fiduciary responsibilities.

CalPERS' Unimpressive Financial Performance

Pensions & Investment (P&I) maintains a Pension Fund Return Tracker that allows users to compare the returns across major public pension funds.[3] Examining the returns for 2023, CalPERS' total returns compared to the other reported public pension funds are below average at best. Figure 1 presents the rank for CalPERS based on the number of funds that reported returns to *P&I* over various timeframes including each fund's current year returns (2023), last year returns (2022), average annual returns over the last 5-years, and the average annual returns over the last 10-years.

Figure 1
CalPERS Return Rank Compared to Other Major Public Pension Funds
Through June 2023



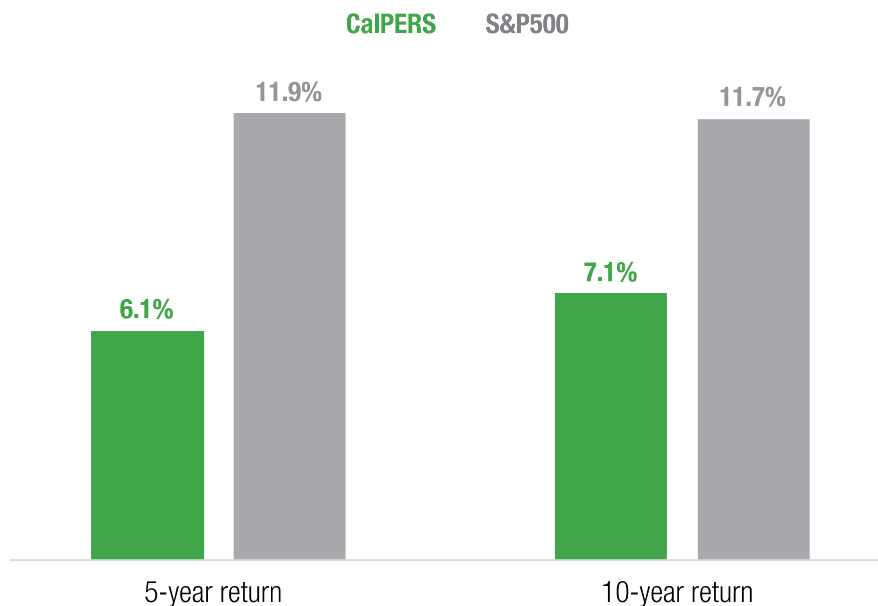
Source: Author calculations based on Pensions & Investment *data*

Figure 1 illustrates that, as of June 2023, CalPERS ranks among the bottom half of performers compared to other major public pension funds in the previous year and over a 10-year investing timeframe through. CalPERS was in the bottom quartile of performers in the current year and 5-year timeframes.

Not only has CalPERS been unable to match the returns of the better performing public pension funds, but it has also generally underperformed key market benchmarks such as the S&P 500. Figure 2 compares CalPERS' actual returns as reported by *P&I* to the returns of the S&P 500 over the longer term (i.e., over the past 5-year and 10-year periods) including dividends as reported by NYU professor Aswath Damodaran.[4] As Figure 2 demonstrates, CalPERS' performance over a 5-year and 10-year investment horizon has lagged the

performance of the broad market index. Put differently, CalPERS beneficiaries would have been better off had CalPERS simply invested their pension money in a passive index fund that tracked the performance of the S&P 500. In addition to the better long-term performance, the costs of managing their assets would have been significantly less, enhancing their returns even further.

Figure 2
CalPERS Performance Compared to S&P 500
5-year and 10-year Returns, Through June 2023



Source: Author calculations based on Pensions & Investment *data and Damodaran, January 2024*

Importantly, as Table 1 illustrates, the benchmarks through June 30, 2024 are not any more favorable for CalPERS. While CalPERS' one year performance improved to 9.3 percent in 2024, the return of the broader market improved to 22.6 percent. CalPERS' longer-term performance is even less competitive.

Table 1
Current-year, Five-Year, and Ten-Year Returns, Through June 30, 2024
CalPERS versus S&P500

	Current year return	5-year return	10-year return
CalPERS	9.3%	6.6%	6.2%
S&P500	22.6%	16.5%	11.3%

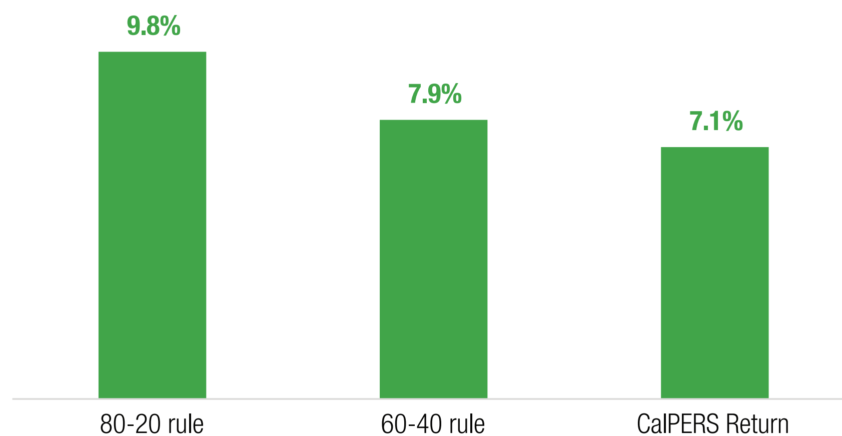
Source: Author calculations and CalPERS

An all-stock portfolio contains risks, of course. CalPERS holds other investments, such as fixed income investments, to provide beneficiaries with important diversification benefits. Greater diversification often comes at the expense of returns, and perhaps CalPERS' returns lag the broader market because the fund is providing these important diversification benefits to current and future retirees. Even if this is the case, the data illustrate that CalPERS' performance still lags a diversified portfolio that is designed to manage market risks.

Two general allocation rules are used to help investors diversify from market risks. Depending on risk tolerance of investors, the general rules are for an 80-20 allocation and a 60-40 allocation. Under an 80-20 allocation, investors allocate 80 percent of their investments toward stocks and 20 percent toward fixed income investments (i.e., bonds and other fixed income investments). The allocations to the stock market offer investors higher potential returns but expose them to higher market risks; the fixed income investments offer lower returns but expose investors to fewer market risks. The 60-40 allocation is more conservative because it allocates fewer resources to stocks (60 percent) and more to fixed income (40 percent).

Leveraging the financial data maintained by Damodaran, the approximate return from an 80-20 portfolio that invested 80 percent of its assets in the S&P 500, 10 percent in U.S. Treasury Bonds, and 10 percent in Baa rated corporate bonds would have returned 9.8 percent annually between 2014 and 2023 compared to CalPERS' return of 7.1 percent. Even a portfolio that invested 60 percent of its assets in the S&P 500, 20 percent in U.S. Treasury Bonds, and 20 percent in Baa rated corporate bonds would have earned 7.9 percent, still beating CalPERS' returns. To put these return differences in perspective, based on CalPERS $502.9 billion in assets as of June 30, 2024, the return differentials imply additional earnings between $4 billion and $14 billion for the 60-40 and 80-20 portfolios respectively.

Figure 3
CalPERS Return Compared to Illustrative Diversified Portfolios
2014 - 2023



Source: CalPERS and author calculations based on Damodaran

The lower returns are particularly concerning given the findings of a 2017 American Council for Capital Formation (ACCF) study that found

> *While it's difficult to calculate exactly how the pension's total environmental investments have performed over time, a review of the current state of its private equity holdings as of March 31, 2017 (most recent data provided by CalPERS), shows the system had 238 private equity investments. Of the nine worst performing funds at this time, four were identified as focused primarily on renewable/clean energy (none of the top 25 funds were ESG).*[5]

And the evidence indicates that the ESG fund underperformance problem persists as

> *U.S. sustainable funds suffered their first calendar year of outflows since Morningstar began keeping track more than 10 years ago, making 2023 their worst calendar year on record. Investors pulled $5 billion from U.S. sustainable funds in the fourth quarter for a total of $13 billion last year amid lagging performance, continued political scrutiny in the United States, and a bad year for an iShares fund.*[6]

While the returns presented above are illustrative, and actual performance would depend on specific asset allocation decisions, CalPERS' consistent underperformance issues when coupled with the poor returns from ESG funds raise serious questions regarding the value CalPERS creates for members.

CalPERS' Positions Are Consistent with Political Advocacy, Not Financial Performance

In light of CalPERS' relatively uncompetitive returns, its position on Environmental, Social, and Governance (ESG) advocacy is disconcerting. According to CalPERS, the investment staff will integrate ESG practices into the fund's investments based on "CalPERS' Investment Beliefs, the United Nations Principles for Responsible Investments (UNPRI) and our Governance & Sustainability Principles." In practice, these beliefs and principles raise concerns that the stated ESG considerations conflict with the fund's fiduciary responsibilities.

For instance, according to UNPRI, the principles for responsible investment include being "active owners" incorporating "ESG issues into…ownership policies and practices," which include participating "in the development of policy, regulation, and standard setting."[7] Consequently, by stating that CalPERS adheres to the practices laid out by UNPRI, the fund is committing itself to developing policies, regulations, and standards. These actions are inherently political and lay clearly outside the scope of a fiduciary whose most important responsibility is to efficiently manage the risk-reward trade-offs to secure the retirement of millions of beneficiaries.

CalPERS' recent position regarding the re-election of the board at ExxonMobil exemplifies the inherent conflict between its fiduciary responsibilities and the ESG goals laid out by UNPRI that are often supported by CalPERS.

CalPERS unsuccessfully opposed the re-election of ExxonMobil's board and chief executive for the sin of seeking greater judicial clarification regarding whether shareholder proposals that have been previously rejected multiple times need to be reconsidered once again. The root problem causing the scuffle was the attempt by activist investors Arjuna Capital and Follow This to resubmit a proposal on Exxon's 2024 proxy statement. The proposal would have asked shareholders to, once again, consider imposing stricter greenhouse gas (GHG) emission targets on the company that include Exxon's direct emissions (Scope 1), indirect emissions (Scope 2), and emissions of customers (Scope 3).

There have always been sound fiscal reasons to reject this carbon accounting proposal because it would have been unworkable and costly.[8] Yet, such proposals are also consistent with the UNPRI principles and are often supported by CalPERS. Despite UNPRI's support, carbon accounting exercises often provide inaccurate emissions information to investors and do not improve investors' understanding of the company's operations or financial health. Further, while there is no assurance that meeting the arbitrary targets would reduce global emissions, carbon accounting exercises can often have negative impacts on the companies that implement them.

While there is no assurance that meeting the arbitrary targets would reduce global emissions, carbon accounting exercises can often have negative impacts on the companies that implement them.

First, as an energy and fossil fuel company, an ill-considered GHG target would essentially impose an arbitrary growth cap that would hurt shareholders financially and limit growth prospects. Second, from an outlay perspective, carbon accounting reports can cost more than $1 million annually.[9] Therefore, the proposal would have required the company to spend a lot of money creating a report that harms the organization. Finally, beyond the direct outlays, the total costs of the proposal could be even higher. If accepted, the proposal would likely encourage the company to deemphasize fundamental efficiency considerations – such as choosing the supplier that produces the right inputs at the right price, in favor of the supplier that can help the company report lower emissions. Disincentivizing efficiencies will harm the company's financial performance to the detriment of shareholders.

These expected impacts confirm that there were sound justifications for the shareholders' previous decisions to reject this proposal – twice. Nevertheless, ESG investors Arjuna Capital and Follow This tried to raise this proposal again for a third time. Constantly resubmitting a proposal despite shareholders consistently rejecting it is problematic. It raises concerns that the true intention is to force a political agenda on the company regardless of the policy's financial impact. And while shareholders could have rejected this proposal once again, forcing shareholders to consistently reconsider the same proposal imposes a cost.

As noted by the SEC, handling one shareholder proposal can cost a company up to $150,000 or more.[10] Company shareholders ultimately bear these expenses. In addition to these dollar outlays, there are also lost opportunities. Annual meetings have time limits; the time spent consistently rehearing the same issue is time that management, the Board, and shareholders cannot use to consider other material issues. While these costs are difficult to precisely quantify, they are no less real.

Saving shareholders from having to reconsider a twice-rejected proposal would seem to be efficient corporate governance. Further empowering activists to use shareholder meetings to implement controversial (and important) government policies is detrimental to long-term corporate sustainability and undermines the broader democratic process.

ExxonMobil's lawsuit was ultimately dismissed by a judge who ruled that the issue "was moot after Arjuna Capital made an 'unconditional and irrevocable' pledge to not file a similar shareholder proposal."[11] While this case is no longer active, CalPERS' position on the issue is telling. As the Securities and Exchange Commission (SEC) itself recognizes, regulators have changed "long-standing" position to enable more "social policy" issues to be raised at shareholder meetings.[12] Turning corporate board meetings into a forum for social policy is troubling and could conflict with fund managers' fiduciary responsibilities but is something CalPERS appears to support.

From a broader societal perspective, it is undemocratic to allow corporate shareholder meetings to set significant public policies. Important issues, such as how to address global climate change, are best addressed through the appropriate political institutions. From an investor perspective, usurping shareholder meetings to address important social issues creates unnecessary costs and imposes additional potential risks on corporate performance. Such impacts harm shareholders and thus CalPERS' beneficiaries.

Saving shareholders from having to reconsider a twice-rejected proposal would seem to be efficient corporate governance.

Despite these clear harms, CalPERS opposed the current Board and Chairman of ExxonMobil under the unpersuasive argument that they are protecting shareholders' interests. In its justification for opposing Exxon's Board of Directors, CalPERS claims,

> *Shareholder rights are a cornerstone of CalPERS' approach to corporate governance and an essential component of our investing principles. The roots of our approach stretch back almost 40 years to the crusading efforts of the late California Treasurer Jesse Unruh, who used his seat on the pension fund's Board of Administration to rail against instances where, he said, "shareholder interests have been stepped on."*
>
> *The two small shareholder groups being sued by ExxonMobil seek additional actions on climate change, a serious threat to long-term investment returns. But let's be clear: This is not about climate change. The company's decision to seek new, broad corporate power puts every issue on the table.*
>
> *If ExxonMobil succeeds in silencing voices and upending the rules of shareholder democracy, what other subjects will the leaders of any company make off limits? Worker safety? Excessive executive compensation?*
>
> *Might future shareholders who seek answers from a company's leaders be ignored because of the legal precedent now sought by ExxonMobil?*[13]

CalPERS' argument sounds persuasive when taken out of context. It ignores the fact that the activist investors in question were asking the company to take actions on climate change that the majority of shareholders had rejected twice previously because shareholders reasonably viewed the proposals as harmful to the company. Allowing the issue to be continually raised is what would upend "the rules of shareholder democracy." It pri-

oritizes the views of a minority of shareholders over the demonstrated majority. CalPERS' argument that their position protects shareholders' rights falls flat, consequently.

While CalPERS' stance does not protect shareholders' rights, it does promote the aforementioned polemical positions that the public pension fund has taken with respect to the issue of global climate change. Worse, from the perspective of a fiduciary, it does so by worsening the fund's expected risk-return profile and misallocating capital leading to serious return constraints.

Unfortunately, CalPERS' position with respect to ExxonMobil is not an outlier. The pension fund is actively pursuing "a plan to put CalPERS on a pathway to Net Zero by 2050, investing over $100 billion towards climate solutions by 2030 (which is consistent with more than a 50 percent reduction in portfolio emissions intensity by 2030)".[14] As another example, the pension fund's corporate engagement process explicitly calls for sharing its "Governance & Sustainability Principles and Investment Beliefs" with portfolio companies that CalPERS has identified as requiring a "corporate engagement."[15] These principles include incorporating ESG considerations that, as discussed below, are associated with lower investment returns.

CalPERS' Political Bias Introduces Additional Risks

Many academic evaluations of social investing strategies, such as the one CalPERS employs, confirm that there are consequences with respect to financial performance. A study in the *Journal of Portfolio Management* found that "the cost of socially responsible investing is substantial."[16] In another study, this one by the Center for Retirement Research at Boston College, the authors found that socially responsible funds significantly under-performed their benchmarks and concluded that public pension funds are not suited for social investing.[17] Global index provider Scientific Beta,

> *analyzed the performance data of all US equity ETFs classed as ESG or 'socially responsible.' These ETFs are domiciled in North America or Europe, and the analysis covered the period from 2012 to the end of 2022.*
>
> *Scientific Beta found that the average annual return for ESG ETFs was 0.2 percentage points lower than for comparable non-ESG ETFs. Although ESG ETFs outperformed by a margin of 4.2 percentage points in 2020, this was an anomaly, and such outperformance was not consistently delivered over the long term.*
>
> *Current evidence for meaningful outperformance in the mutual fund sector is similarly lacking. According to a study by The Journal of Finance, which examined 20,000 mutual funds with a collective $8 trillion in assets, funds rated highly for ESG factors did not outperform those rated poorly.*[18]

In recognition of these concerns, the Department of Labor, which oversees private pension funds, issued a Field Assistance Bulletin in December of 2020 that reiterated the department's policy that "a fiduciary may not subordinate the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives and may not sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or goals."[19]

Despite this evidence, in a July 15, 2024 presentation titled "Climate-Aware Investing in Global Public Equities," CalPERS recommends that the low carbon transition should be incorporated into active and passive investment approaches.[20] As part of the strategy to ensure global climate change "transition readiness," the CalPERS presentation recommends investors underweight companies with large fossil fuel reserves.[21] This position reflects a clear bias against fossil fuel companies that demonstrably leads to lost potential returns.

Activist investors' value proposition is supposed to be the ability to exploit emerging market trends to provide superior returns for beneficiaries. Fossil fuel stocks such as ExxonMobil provided such an opportunity over the last several years. As Table 1 illustrates, sometimes ExxonMobil underperformed other investment classes; other times it outperformed those same indices.

Table 2
Comparative Monthly Returns Through July 2024
ExxonMobil, Tesla, QQQ, and S&P500

	Monthly Returns Through July 2024	
	3-Year Returns	**5-Year Returns**
ExxonMobil	**103.5%**	**62.0%**
Tesla	**7.0%**	**1644.1%**
QQQ	**31.0%**	**165.5%**
S&P500	**23.3%**	**90.6%**

Over a five-year investment horizon through July 2024 and excluding dividends (an important consideration for an investor in ExxonMobil), an investment in ExxonMobil underperformed investments in Tesla or the broader market indices of the QQQ (an index that mimics the return of the NASDAQ 100) and S&P 500. However, over a three-year horizon through July 2024, ExxonMobil is up around 104 percent, which outperformed these investment alternatives. Therefore, the option to overweight ExxonMobil in a portfolio would have enhanced returns over the last three years. Even greater returns were possible for investors who timed the rise in ExxonMobil's stock better.

Correctly timing the market is undoubtedly difficult, and active investing is hard. Knowing a priori which stocks will outperform the market is also much harder than reviewing the trends that occurred in the past. Yet, CalPERS' purpose is to actively manage the resources it invests on behalf of its beneficiaries and discover such opportunities. Successfully achieving this goal requires openness to alternative investment theses.

For instance, right before ExxonMobil's stock started outperforming the market, its dividend yield (the dividend as a percent of the share price) was around 7 percent and eventually exceeded 10 percent by the end of 2020.[22] This was at a time when the Fed Funds rate was essentially zero. The ability of investors to earn 10 percent was quite extraordinary compared to other potential investments and the subsequent run up in Exxon's stock price relative to the rest of the market demonstrates that the market believed the stock was significantly undervalued. The thesis that CalPERS should underweight companies with large fossil fuel reserves creates obstacles that make it more difficult for the fund to objectively discover this value enhancing opportunity.

The distortions work in reverse too. Take Tesla as an example – a stock that would be favored by CalPERS based on the anti-fossil fuel reserves investment thesis. Between 2019 and 2021 Tesla's stock increased around 2,000 percent, so exposure to Tesla stock would have significantly improved the pension fund's financial performance. Then again, between 2021 and 2023, Tesla stock lost more than half its value. It has experienced volatile growth since. Clearly, an ideal allocation would have overweighted Tesla stock during its appreciation phase but then reduce its exposure to the stock between 2021 and 2023. The bias against fossil fuels would create pressures to maintain greater exposure to the competitive product (e.g., electric vehicles) even during this time of extreme market underperformance. Interestingly, the period where Tesla stock was underperforming was the same period that Exxon was outperforming the market, indicating that a shift of investment focus was a particularly beneficial strategy. Yet, CalPERS' investment thesis, while beneficial on the upswing, would also encourage the fund to ride out Tesla's decline for too long.

CalPERS' position that it should underweight companies with large exposure to fossil fuel reserves regardless of market timing and current valuations makes it harder for the public pension fund to fulfill its purpose of enhancing returns by recognizing when assets are underpriced and when they are overpriced. It is important to note that reviewing the alternative performance of ExxonMobil and Tesla is not meant as an evaluation of CalPERS' performance per se as the information discussed is not sufficient to judge the fund's investment allocation both broadly speaking and, in these assets, specifically. However, reviewing these trends demonstrates that polemical investment theses inefficiently narrow investment options and that these lost options create additional investment risks. The loss of these options conflict with the fiduciary responsibilities of any public pension fund, including CalPERS.

These reduced returns are particularly troubling given that California's public pensions are already in a precarious financial position. As *CalMatters* documents, "CalPERS owes more money in benefits over time than it has on hand today. As of June 30, it had 72% of the assets it would need to pay out all of the benefits it owes."[23] The worse CalPERS' performance, the larger the state's public pension crisis problem will be. Alternatively, the better CalPERS' performance, the smaller the state's crisis will be.

Unless the state is willing to reduce the value of retirees' pensions, taxpayers will be called upon to cover the revenue shortfall. This is an implicit tax on California's taxpayers that can run into the billions of dollars. Such a large tax increase will have adverse impacts on the state's economy including smaller incomes, fewer employment opportunities, and greater migration away from the state.

Conclusion

CalPERS has a very important social responsibility – maximize shareholder returns to ensure that all current and future beneficiaries can enjoy a prosperous retirement without imposing additional burdens on taxpayers. Fulfilling this responsibility is difficult enough. Attempts to pursue political agendas in addition to these financial responsibilities only makes serving this essential role more difficult.

Despite this reality, several of CalPERS' investment strategies and proxy positions raise concerns that political considerations are potentially conflicting with their fiduciary responsibilities, as exemplified by recent energy transition strategies and proxy voting positions. Ultimately, it is beneficiaries and taxpayers who bear the risks from any underperformance these political activities impose. Consequently, ensuring that the pension fund fulfills its essential social responsibilities, without distractions from ancillary political and social issues, is imperative.

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About the Author

Wayne H. Winegarden, Ph.D. is a Senior Fellow in Business and Economics at the Pacific Research Institute and director of PRI's Center for Medical Economics and Innovation. He is also the Principal of Capitol Economic Advisors.

Dr. Winegarden has 25 years of business, economic, and policy experience with an expertise in applying quantitative and macroeconomic analyses to create greater insights on corporate strategy, public policy, and strategic planning. He advises clients on the economic, business, and investment implications from changes in broader macroeconomic trends and government policies. Clients have included Fortune 500 companies, financial organizations, small businesses, state legislative leaders, political candidates and trade associations.

Dr. Winegarden's columns have been published in the *Wall Street Journal*, *Chicago Tribune*, *Investor's Business Daily*, *Forbes.com*, and *Townhall.com*. He was previously economics faculty at Marymount University, has testified before the U.S. Congress, has been interviewed and quoted in such media as CNN and Bloomberg Radio, and is asked to present his research findings at policy conferences and meetings. Previously, Dr. Winegarden worked as a business economist in Hong Kong and New York City; and a policy economist for policy and trade associations in Washington D.C. Dr. Winegarden received his Ph.D. in Economics from George Mason University.

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