SC.16.12

UNIVERSITY OF ILLINOIS
AT URBANA-CHAMPAIGN

College of Law
504 East Pennsylvania Avenue
Champaign, IL 61820

Date: February 27, 2015
To: Chancellor Phyllis M. Wise
From: Lesley Wexler, Chair & Jeffrey R. Brown, former Chair
Ad-Hoc Licensing Advisory Committee
Re: Student Vote on Divestiture from Coal Mining and Coal Utility Companies

As you know, students on the Urbana campus recently passed a referendum requesting that the University of Illinois at Urbana-Champaign divest from 15 major coal mining and coal utility companies. The referendum recommended a "negative screen" for the university's $1.81 billion endowment, meaning that these companies would be excluded from our investment portfolios. Students collected over 4000 students to get the referendum to appear on the ballot and the referendum passed with the support of 1730 out of 2020 votes cast (reflecting a voter turnout of under 5 percent of eligible voters). We wish to commend the students of the Beyond Coal Campaign for their commitment in bringing this issue to the University's attention.

This matter was referred to the Ad-Hoc Licensing Advisory Committee for further consideration. This committee is comprised of representatives from faculty, staff, and students and has historically been used to provide advice on a number of economic and financial issues. In consultation with university and campus investment officials, we have drafted this memo as a recommendation for possible next steps.

Background on the Role of Coal Companies in the University's Investment Portfolio

Approximately $500 million is held in the university's endowment, and another $1.3 billion is held and managed by the University of Illinois Foundation (UIF). As is common in higher education, both the university and the foundation hire external investment managers, who in turn utilize a variety of active and passive management strategies to provide broad portfolio diversification. The university, acting in a fiduciary capacity, is required under the Uniform Prudent Management of Institutional Funds Act (760 ILCS 51/1) to "diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification." Diversification is essential to providing a portfolio that maximizes the expected investment returns for any given level of risk.

Neither the UIF nor the university has any *direct* holdings in the coal companies that were targeted by the referendum. However, the endowment has an *indirect* exposure, via the externally managed funds, to the 15 major coal mining and coal utility companies valued at $5.1 million. This represents just 0.28% of the total endowment. $4.2 million of this exposure, or 82% of our total exposure to the 15 companies, is held in passively managed indexed funds that seek to mirror overall market performance at very low cost – the average index fund fee is less than 0.10% of assets annually.

Context for the Issues Raised in the Student Referendum

Over time, social issues regarding investments change to reflect the current zeitgeist. Historically, there have been calls for divestment from gun and weapons manufacturers, tobacco companies, alcohol producers, companies with unpopular labor practices, agricultural GMOs, financial services firms, and companies using animal testing. Although the university certainly is concerned about many of these issues, it would be impossible to build an efficient investment portfolio that is acceptable to all constituents. Thus, an important consideration when evaluating any call for divestiture is to consider whether this sets a precedent for further winnowing of our investment opportunities as additional issues arise in the future.

We also note that although some social issues, e.g., apartheid in South Africa, are quite obviously net negatives for society, the use of fossil fuels is a more complex societal issue. Although the use of fossil fuels does generate significant negative environmental externalities that are not reflected in their market price, it is also true that society benefits from the use of fuel to manufacture goods, cultivate crops, conduct research, deliver medical care, and provide transportation. At present, a significant proportion of U.S. energy comes from fossil fuels, including coal. That said, the University has signed the American Colleges and University Presidents' Climate Commitment and is in the process of "systematically shifting [its] reliance on fossil fuels to an appropriate balance of energy conservation and alternative and renewable energy sources."[1] The university community is currently addressing the environmental impact of fossil fuels through building design efficiency, behavioral changes that reduce consumption, and continued research and development of renewable energy sources.

Implications of Negative Screening

Though the committee shares the Beyond Coal Campaign's unease with the environmental effects of fossil fuel usage, we also want to raise some potential costs and concerns about adopting a strategy of divestment through negative screening.

1. *Negative screening would increase investment costs*: Switching to a manager that would screen out coal investments would require an investment policy statement change by the Board of Trustees, engagement of investment consultants, plus a lengthy and potentially costly search process. Moreover, the change would increase annual investment costs by two and one half times (fees would increase from 0.10% for passively managed funds to at least 0.35% for actively managed funds). This increase would result in additional investment costs of at least $2.5 million annually based on a $1 billion portfolio.

1 Energy Management, University of Illinois at Urbana-Champaign, Goals & Strategies, http://www.energymanagement.illinois.edu/goals-strategies.cfm.

2. *Negative screens may hinder investment performance*: As a general principle of financial economics, placing investment restrictions on a portfolio makes it more difficult to invest in the "efficient frontier" that maximizes expected returns on a risk-adjusted basis.

3. *Negative screening may not be consistent with donor intent*: Donors to the endowment pool have a reasonable expectation that their gifts will be invested to maximize benefits to the university. The donors themselves have not requested restrictions on investments or negative screens.

4. *It is not clear that negative screening will produce positive effects:* If we required our fund managers to sell the approximately $1 million of stock in coal and utility companies, those shares will be purchased by another buyer with virtually no long-term impact on the companies. The cash would not be withdrawn or taken away from the company. Divestment would have no effect on the firm's revenues and no long-term effect on the share prices.

If the goal is simply to express a message that is supportive of renewable energy and distance the University from a relationship with coal, we worry that a strategy of passive divestment coupled with ongoing use of coal burning plants on campus and along with other existing and potential connections to coal companies will be viewed as hypocritical.

5. *Negative screening for coal does not contain an obvious limiting principle*: Other student groups interested in divestment from a plethora of companies involved in socially questionable or controversial practices may be emboldened by the adoption of negative screening for coal companies. The current divestment campaign does not contain an obvious limiting principle that would exclude other groups for asking for similar measures which, if adopted, would magnify the potential negative implications. The licensing committee is not the ideal venue for addressing such campaigns and the University does not currently employ a comprehensive approach to these issues. We think it makes more sense to address such concerns systematically, if possible, rather than opening the door to future ad-hoc divestment decisions.

Recommended Next Steps

1. *Going forward, we would strongly encourage the reconstruction of a Social Responsibility Committee.* Such a committee ought to address both licensing and investment issues with members drawn from relevant bodies including the University of Illinois Foundation, the Chancellor's office, the faculty, and the students. The existing licensing committee might function as a subcommittee to the larger committee by convening for those matters within its expertise. A broadly constituted Social Responsibility committee could consider not only the pros and cons of a single divestment campaign, but systematically address socially responsible behavior including the creation of access to investment funds for future donors to make gifts consistent with their social preferences and the ongoing work of the licensing committee. It is our understanding that such a committee used to exist, but we are unaware for the reasons leading to its disbandment.

2. *In the present environment, the Committee recommends that we do not divest from coal.* Although the Committee recognizes that social or ethical issues could warrant active shareholder engagement or divestment, we do not think this committee is well positioned to endorse an ad-hoc approach to divestment. Rather we think such issues along with possible pro-active social responsibility investment strategies should be considered by a Social Responsibility Committee. In the absence of such a committee, we are not convinced that divestment from coal companies is a compelling case for the reasons identified above. Coal and other fossil fuels are a necessity of the production of energy in today's modern life. Although there are negative environmental effects from the use of fossil fuels, divestment would have no immediate impact on the production or use of these products.

3. *We recommend that the campus continue to invest in other efforts to directly reduce energy consumption and move towards more sustainable energy sources.* The campus has already taken a number of direct steps that are consistent with the attainment of the ultimate goals of the "Beyond Coal" movement, and we encourage continued support of these and similar activities. These include:

a. continue to support the mission of the Institute for Sustainability, Energy, and Environment, which was reaffirmed at the November 14 Board of Trustees meeting;

b. continue the existing policies of making university endowment farms available for wind turbine development, placing Zipcars on campus, planning for the 7.5 GWH per year solar farm at the corner of First Street and Windsor Road in Champaign, installing solar photo-voltaic on the Business Instructional Facility and the Electrical Computer Engineering building;

c. continue to work towards the campus goal of reducing energy consumption in existing buildings (note: the Urbana campus has reduced energy consumption in existing buildings by 25%) and pursue the campus goal of 5% renewable energy by 2015; and

d. continue to support campus research that seeks to develop alternative energy and battery storage technologies where students could get directly involved in developing technologies that may replace fossil fuels for energy production.

4. *Develop a long-term plan for the Abbott Power Plant that reduces coal consumption.* We note that coal has not been burned at the Abbott Power Plant during the past three summers. Facilities and Services is reviewing infrastructure and fuel options for the Abbott Power Plant with an eye toward continued reduction in coal consumption balanced with meeting campus demand for reliable steam, cooling, and electricity.

5. *Finally, we view this referendum as a possible opportunity to more fully engage the university community.* Our faculty includes many leading experts on the technical, environmental and economic impacts of energy. This referendum may be an opportunity for the campus to support an on-going campus conversation, such as through a panel discussion or workshop, which more fully explores issues related to climate change initiatives. We welcome the dedicated students of the Beyond Coal campaign to join us in this conversation.

Lesley Wexler
Professor of Law
University of Illinois College of Law

Jeffrey R. Brown
Professor of Finance
University of Illinois College of Business

c: J. Barrett
J. Brown
M. DeLorenzo
M. Gold
M. Kaufmann
L. Mwilambwe
L. Wexler
C. Wojtan
A. Woronowicz