

**UW SYSTEM TRUST FUNDS
POLICY DISCUSSION REGARDING INVESTMENT
IN TOBACCO INTERESTS**

EXECUTIVE SUMMARY

BACKGROUND

At the meeting of the Business, Finance, and Audit Committee on April 6, 2006, Regent Loftus suggested that consideration be given to instituting a policy of prohibiting further investments in tobacco companies by UW System Trust Funds. This report is intended to provide some background information to support a fuller discussion on this topic.

REQUESTED ACTION

This item is for discussion purposes only.

DISCUSSION

To date, it appears that the only wide-spread divestment/screening activities conducted by peer universities have been those directed against companies that did business in apartheid South Africa, and, to a lesser extent, against tobacco companies. UW System Trust Funds did divest of companies doing business in apartheid South Africa, but no decision to divest of and screen out tobacco company investments has been made to date. Current investment holdings identified as tobacco-related total almost \$1.4 million, representing 0.37 percent of total assets. The attached report discusses public policy developments, divestment/screening activities by other institutions, complicating factors and issues, and offers some conclusions and policy alternatives for consideration.

RELATED REGENT POLICIES

Regent Policy 97-1: Investment and Social Responsibility

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Introduction

At the meeting of the Business, Finance, and Audit Committee on April 6, 2006, Regent Loftus suggested that consideration be given to instituting a policy of prohibiting further investments in tobacco companies by UW System Trust Funds. This report is intended to provide some background information to support a fuller discussion on this topic. The discussion begins below with a very brief history of the Committee's past involvement with the "tobacco issue."

In 1990, the Business and Finance Committee discussed a letter from an anti-tobacco activist who was then a UW teaching assistant, asking that the University divest from tobacco companies. The Committee decided at that time that divestment was not warranted, and a response to that effect was provided to the activist. Internal records indicate that, other than tobacco investments occasionally being cited by students and faculty during the Public Investment Forum, tobacco divestment was not specifically taken up again by the Board until 2001. A brief document on tobacco was presented to the Committee, noting that the University of Michigan and University of Washington had just recently implemented "no tobacco" policies. The suggestion was made by staff that the UW's System could consider similar action; the Committee decided not to pursue a divestment policy at that time.

The Tobacco Issue and Public Policy Developments

The public health issues surrounding tobacco usage are widely known today, despite the industry's past efforts to conceal the health risks and current efforts to produce "safer" tobacco products. A 2005 Background Report from The Investor Responsibility Research Center (IRRC) entitled, "Tobacco Production and Marketing," provides a good current synopsis of the health issues:

"The magnitude of the health problems associated with tobacco use cannot be fully appreciated until they are examined on a global scale. There are now about 1.3 billion smokers worldwide, and consumption is rising by 1 or 2 percent a year. Seventy percent of smokers live in developing countries, a figure that is expected to rise to 85 percent by 2025. By 2010, the number of people who die annually from tobacco-related disease is expected to reach 5 million. Given current trends, deaths caused by smoking will increase from 9 percent of all deaths each year to more than 12 percent in 2020—exceeding the toll from AIDS, tuberculosis, automobile accidents, maternal mortality, homicides and suicide combined. The World Health Organization estimates that the death toll will rise to 10 million a year by 2030."

Regarding U.S. public policy developments, in 2004, for the second year in a row, Congress proposed but failed to pass legislation that would give the Food and Drug Administration the authority to regulate tobacco products. A similar bill was reintroduced on March 17, 2005 (one that surprisingly has the backing of Altria, the parent company of Phillip Morris), and presumably such bills remain under Congressional consideration at this time. Regarding public policy developments internationally, the 2005 IRRC Background Report provides the following summary:

“Since 2000, the 191-member World Health Assembly, the governing body of the World Health Organization, has been working toward the adoption of a Framework Convention on Tobacco Control (FCTC). The FCTC is the first international treaty to address a health issue. Before entering into effect, 40 countries had to adopt corresponding national legislation accepting its terms. That happened last November, triggering a 90-day countdown for its entry into force. The FCTC officially went into effect on Feb. 27, 2005. The World Health Assembly unanimously adopted the FCTC in May 2003, following almost three years of negotiations. During the year that followed, while it was open for signature, 167 countries and the European Community signed, including the United States. As of this writing, a total of 57 countries have become contracting parties by ratifying its terms. Countries that adopt the FCTC must do so without amendment. Specific provisions include termination of tobacco advertising (subject to national constitutional constraints), putting new graphic warning labels on cigarette packages, limiting exposure to environmental tobacco smoke and promoting smoking cessation programs, among other things. The tough final text approved by treaty negotiators means that some major nations, including the United States and China, might not recommend its adoption as national legislation. There is no deadline for countries to become contracting parties. The Bush administration has yet to submit the FCTC to the Senate for ratification, and it remains unclear whether it will do so. According to the White House, the treaty’s legality is being reviewed by the State Department.”

Tobacco Divestment/Screening Activities

Divestment and screening of tobacco investments first took place among U.S. institutional investors in the 1980s, when public health groups like the American Medical Association and American Cancer Society began selling and screening their investments. Then in the early 1990s, universities such as Harvard and Johns Hopkins followed suit. In early 2000, the University of Washington became the first public university system to divest and screen. Since that time, the following additional universities have implemented “no tobacco” policies: University of Michigan, University of California, Northwestern University, City University of New York, and Wayne State University. A report by the IRRC entitled, “Tobacco Divestment and Fiduciary Responsibility,” stated that as of 2000, six states, ten major municipalities, and more than 15 colleges and universities had set policies to restrict or divest of tobacco investments.

Without talking directly to people involved with these “no tobacco” decisions, most of which were made five or more years ago, it is difficult to divine the thought processes they went through and how distinctions were drawn between tobacco and other products, companies, and industries that could also be considered “socially irresponsible.” There are some clues here and there, however. From the University of Michigan’s web site, the following information was available regarding their divestment decision:

“In June 2000, the University of Michigan’s Board of Regents voted to divest from the University’s stock holdings in tobacco manufacturing companies. The campaign to divest began in the late 1990s when a faculty member on the executive committee of the University of Michigan Faculty Senate Assembly raised the issue. The executive committee subsequently released a report that spurred a recommendation to divest by the Faculty

Senate. This resolution was supported by the University of Michigan Student Assembly. Other student organizations and members of the college community also opposed the University's tobacco stock holdings.

As divestment became an increasingly debated topic across campus, University President Lee Bollinger [now President of Columbia University] ordered the formation of the Ad Hoc Advisory Committee on Tobacco Investments in September 1999 to explore the University of Michigan's tobacco investments more carefully.

A six-month investigation by the Committee on Tobacco Investments focused on two major questions:

1. What features differentiate tobacco industry products and activities from those of other industries, warranting divestment from tobacco stocks?
2. Does investment in tobacco company stock represent such a contradiction to the University's mission that divestment is ethically necessary?

Other issues taken into account by the Committee included:

- Whether divestment from tobacco would result in a "slippery slope" of divesting from other companies or industries whose business ethics could be called into question.
- How the Michigan State Legislature might respond to divestment by a state institution.
- Whether University policy dictated that investments be based solely on financial factors. Notably, a precedent for divestment on moral and ethical grounds had been set in 1978 when the Board of Regents voted to divest from companies operating in South Africa, as a means of opposing apartheid.

The Committee on Tobacco Investments received over 200 emails regarding tobacco divestment. In numerous public and electronic forums the community response was overwhelmingly in favor of divestment. The State Legislature also indicated that they would not oppose divestment.

The Committee concluded that divestment was warranted based on the following factors that were in direct contrast to the University's educational mission:

- The public health threat posed by tobacco products.
- The dishonest actions of the tobacco companies who knowingly deceive the public about the health risks associated with tobacco use.
- The tobacco industry's tradition of targeting youth consumers.

Results: The University of Michigan's Board of Regents voted in favor of divestment, which took place over a period of ten months. The university divested from a list of companies compiled by The Investor Responsibility Research Center, a non-profit organization that provides investment information. The University of Michigan was among the first major public universities to divest from tobacco stocks."

Although it is not clear that the University of Arizona has investment restrictions against tobacco (it appears that their investments reside primarily with the University's Foundation), the school's Zuckerman College of Public Health instituted a policy against accepting tobacco money for research. Their web site states the following primary rationale:

“Tobacco is the only manufactured product that if used as intended, causes harmful health effects and has no redeeming benefits to individuals or our society. Overwhelming scientific evidence has accumulated that shows tobacco use to be the single greatest cause of preventable disease, disability and death in the United States.”

Public pension plans (and their related state governments) have not been as active as universities in establishing tobacco investment restrictions to date. As mentioned earlier, in 2000, only six states had implemented such policies. Massachusetts was apparently one of the first, enacting a policy into law in 1997. The web site of their public employee retirement system notes that “the statute prohibits retirement systems from making any new investments in stocks, securities, or other obligations of any company which derives more than 15% of its revenue from the sale of tobacco products.” (Interestingly, it also states, “In applying the statute to pooled funds, [the retirement system] will assess the 15% rule against the entire pool as the board is purchasing shares in the pool, not the individual holdings of the pool.”) It does not appear that the State of Wisconsin Investment Board currently has any restrictions on tobacco company investments.

Also, to satisfy investor interest in tobacco-free investing, the investment management industry has developed both retail and institutional mutual funds that screen out tobacco company securities. Both actively-managed and passively-managed (or “index”) tobacco-free funds are available.

UW Trust Funds Tobacco Investments

Given below are UW Trust Funds' current holdings in companies identified as falling within the tobacco industry classification.

Company	Country	Security Type	Market Value	Separate Account?
KT&G Corp.	South Korea	Equity	\$325,183	No
US Tobacco Inc.	USA	Debt	\$309,257	Yes
Gallaher Group PLC	UK	Equity	\$276,796	No
Remgro/Reunert LTD	South Africa	Equity	\$237,408	No
Souza Cruz SA	Brazil	Equity	\$133,394	No
Shanghai Industrial Holdings	Hong Kong	Equity	\$81,645	No
Total			<u>\$1,363,683</u>	

It should be noted that all of the above holdings, with the exception of US Tobacco bonds, are held within commingled or institutional mutual funds. These holdings could therefore not be divested, nor future screenings implemented, unless UW Trust Funds divested its entire positions in these funds (in this case, the UBS International Equity Relationship Fund and the GMO Emerging Markets Fund III). These mutual fund positions now total \$72 million, or some 22 percent of the UW Long Term Fund. The tobacco holdings cited above (in both separate and commingled funds), represent 0.37 percent of total Trust Funds assets.

Complicating Factors and Issues

UW Trust Funds staff believes that eliminating tobacco companies from the universe of investable companies would not unduly restrict investment options nor compromise the primary fiduciary responsibility of seeking optimal investment returns, for both donors and beneficiaries. However, staff does believe strongly that, where investments are to be made through institutional mutual or commingled funds, limiting the universe to only tobacco-free funds would unduly restrict investment options and compromise our fiduciary responsibilities at the present time. Given the level of UW Trust Funds assets, institutional mutual or other such commingled funds are frequently the vehicle of choice (particularly for international and private equity investing) for one or more of the following reasons:

- All-in investment costs may be significantly lower.
- Minimum investment levels for a separately-managed account may be too high.
- A separate account may be too small to achieve sufficient investment diversification.

To ignore the advantages of commingled funds, restrict the universe to “tobacco-free” funds, or potentially eliminate an entire investment asset class from consideration if “tobacco-free” funds are not available, all in the name of eliminating any tobacco-related investments would seem to be imprudent. A better approach would seem to be eliminating tobacco holdings as and when we have the ability to do so without otherwise compromising fiduciary responsibilities.

Another potentially complicating factor in a university’s decision to divest of and screen out investments in a particular company or an entire industry, is whether and how such an anti-company/industry position is to be applied “campus-wide.” For instance, it would seem inconsistent and even hypocritical to not prohibit any and all dealings with that company/industry. Such other dealings would include accepting research money/grants or outright gifts, or conducting any business with these entities. (From the University of California – San Francisco web site, it was learned that the system divested its tobacco holdings in 2001, and in 2004, faculty at several UC campuses voted in favor of policies against acceptance of tobacco industry funding for research. It is unclear at this time whether this policy has been officially adopted by the UC System.)

Also complicating matters, is the fact that many large companies today have multiple business lines and/or distinct subsidiaries, some of which may not be “offensive.” For example, Altria is the parent company of both Phillip Morris and Kraft Foods. In such cases, does one apply a “percent of total revenue” approach (e.g., the State of Massachusetts uses a 15 percent threshold), exclude companies with any tobacco-related revenue, permit other business dealings (including acceptance of research money/gifts) with non-tobacco subsidiaries or business units, etc.? (Presumably in the vast majority of cases, only the parent company issues debt and equity securities. This would seem to preclude the possibility of making any distinction between “good” and “bad” subsidiaries for investment purposes.)

Finally, many universities have legally separate and privately-governed foundations that support their mission. It must at least be acknowledged that these foundations may not apply the same policies (investment or otherwise) as do the institutions they support.

Conclusions and Policy Alternatives

To date, it does appear that the only wide-spread divestment/screening activities conducted by peer universities have been those directed against companies that did business in apartheid South Africa, and, to a lesser extent, against tobacco companies. Clearly, many universities were able to make a distinction between such companies' activities or products and other perceived evils. For tobacco, this distinction was conveyed in the University of Michigan's web site discussion. That distinction was echoed by then-Secretary of Health and Human Resources Louis W. Sullivan, who said in 1990, "Cigarettes are the only legal product that when used as intended cause death."

Given all of the foregoing discussion on the tobacco issue and various complicating factors, there seems to be only a few possible broad policy alternatives:

1. Do not divest/screen, recognizing that tobacco products remain legal substances and that it is difficult or impossible to sever all ties with an entire industry in a consistent fashion.
2. Divest/screen tobacco-related investments where prudently feasible.
3. Divest/screen tobacco-related investments where prudently feasible, and institute a system-wide policy prohibiting all dealings with tobacco companies.

Should the Regents decide that a clear distinction can and should be made for tobacco (and potentially other products in the future), Trust Funds' staff suggests that the following specific policy components be considered:

- Add to Regent Policy 97-1, "Investment and Social Responsibility," a statement along these lines:
Companies or industries whose primary lines of business are the manufacture, marketing, sale or distribution of products that directly cause substantial social injury, where there can be no reasonable justification for their use in any circumstances, will not be considered for future investment and current holdings will be divested.
Lines of business currently identified as such: tobacco.
- Any such investment restrictions will be applied where separate investment accounts are used. Where mutual or commingled funds are the preferred or only vehicles available, their investment managers and/or boards will be notified in writing of the UW's position on tobacco investments and will be asked to consider divestment and screening.
- Where such companies or industries are so identified, all UW institutions will be prohibited from accepting funds or conducting any business with either a parent company or any "offending" subsidiary. This prohibition will not apply to dealings with any clearly-identifiable "non-offending" subsidiaries.