



RETIREMENT BOARD CALENDAR SHEET
Retirement Board Meeting of October 14, 2020

To: Retirement Board

Through: Jay Huish *JH*
Executive Director

William J. Coaker Jr., CFA, MBA
Chief Investment Officer

Kurt Braitberg, CFA, CAIA
Managing Director, Public Markets

From: Andrew Collins
Director of ESG Investing

Adrienne von Schulthess
Security Analyst, ESG Investing

Date: October 14, 2020

Agenda Item:

Targeted Divestment of Tobacco Companies: Level III of SFERS ESG Investment Policy

Background:

At the May 26, 1998 meeting, the Retirement Board ("Board") elected to divest holdings of domestic companies involved in the manufacture of tobacco products. This report describes recommended updates to the list of restricted tobacco companies, details the performance impact of not owning U.S. Tobacco companies in the SFERS' investment portfolio over the past year and since the inception of the restriction, and provides an update on developments within the U.S. tobacco industry over the past 12 months.

Recommendation:

Staff recommends that the Board reaffirm its intent to remain divested from U.S. tobacco companies, and adopt the list of restricted companies identified in Appendix B.

If the Board agrees with Staff's recommendation, the following motion is recommended:

Move that the San Francisco Employees' Retirement System maintain the current policy with respect to divestment from U.S. Tobacco companies and approve the list of restricted companies as outlined in Appendix B of Staff's memorandum.

Attachment:
Staff Memorandum




SFERS

San Francisco Employees' Retirement System

City and County of San Francisco Employees' Retirement System

To: Retirement Board

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Background:

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Updates to the List of Companies:

Investment Staff ("Staff") have licensed access to MSCI ESG Research LLC for data and information on companies' tobacco-related activities. Using this source and other resources (including SEC filings and public corporate communications), Staff analyzed the companies currently on the SFERS List of Companies Involved in the Production or Wholesale Distribution of Tobacco Products ("List of Companies") to determine if any modifications were necessary. In addition, SFERS used these resources to determine if any new companies warrant inclusion on the List of Companies.

Staff recommends the addition of the following companies that are manufacturers of tobacco and/or electronic cigarette products to the List of Companies¹:

¹ Consistent with the City of San Francisco regulation of electronic cigarettes in a manner consistent with combustible cigarettes, beginning in 2018 Staff began recommending the addition of the companies that design, manufacture, market, and/or distribute electronic cigarettes to the List of Companies.

- Gilla Inc. (OTCMKTS: GLLA) manufactures, markets, and distributes e-liquid used in vaporizers, electronic cigarettes, and other vaping hardware and accessories in Europe, Canada, and the United States. Gilla's brands include both generic and premium branded e-liquid including Craft Vapes, The Drip Factory, The Mad Alchemist, Surf Sauce, Siren, Vapor's Dozen, Vape Warriors, Crown, The Replicant, Vapor Liq, and Vinto Vape. The company was founded on 1995 and is headquartered in Daytona Beach, FL.

As of June 30, 2020, SFERS did not hold positions in Gilla Inc.

Staff recommends the following changes to the List of Companies to reflect changes in company names:

- mCig Inc. be updated to BOTS Inc.

Staff recommends the following removals from the List of Companies:

- Standard Diversified Inc due to the fact that it was merged into a wholly-owned subsidiary of Turning Point Brands Inc.
- Electronic Cigarettes International Group, Ltd. due to the fact that it is no longer a publicly tradable security as a result of the SEC revoking its 12(j)Registration.
- Medigreen Holdings Corporation as it is no longer a publicly traded security.

Staff reviewed companies involved exclusively in the distribution but not manufacturing of tobacco products in more detail. Using data and information from MSCI ESG Research, Staff was able to determine the revenue that this set of companies received from tobacco products. The data makes clear that certain companies receive a majority of their revenue from the distribution of tobacco products, while others receive a small or sometimes immaterial portion of their revenue from the category. As such, Staff recommends restricting investment in companies that receive greater than 10% of revenue from tobacco product distribution, in line with the threshold for financial reporting requirements for individually material business segments.

Based on this review, the following companies generate more than 10% and, in fact, more than 70% of revenues from tobacco distribution:

- AMCON Distributing Company
- Core-Mark Holding Company

2020 U.S. Tobacco Developments

The tobacco industry faced mixed trends over the last year. Better than expected sales in traditional cigarettes were contrasted with increased regulation across the board that poses a challenge to long term growth.

Traditional cigarettes represented 80% of U.S. tobacco sales over the past 52 weeks ending July 2020 with moist snuff and chewing tobacco accounting for 10%, and electronic cigarettes and cigars each at 5% of sales.²

While the tobacco industry projected 2020 declines in cigarette sales volumes in the 4-6% range, as of July 2020 volumes were on pace to decline by only 2%. Analysis of these better than expected volumes attributed sales to short term determinants, including stockpiling at the beginning of the COVID-19 pandemic.³

² https://journalnow.com/business/traditional-cigarettes-continue-to-outperform-electronic-cigarettes-during-pandemic/article_cc3cab51-9f57-5cf7-9bad-4b9cf34ce7ce.html

The tobacco industry continued to raise list prices in 2020, a key element in limiting the impact of sales declines on revenues. Philip Morris USA raised its list price by 11 cents a pack for Marlboro and eight other brands. This marked the second price increase of 2020 with the first coming in February at 8 cents a pack for traditional cigarettes.⁴

In comparison, U.S. e-cigarette unit sales were down 14% in Q2 2020 in comparison to 2019, according to Altria Chief Executive Billy Gifford.⁵ Gifford attributed slowdowns in current and projected e-cigarette sales to increased U.S. Food and Drug Administration (FDA) regulations.

Regulations over the last year targeted both the tobacco industry as whole along with a specific action on e-cigarettes.

Legislation amending the Federal Food, Drug, and Cosmetic Act raised the federal minimum age for the sale of tobacco products from 18 to 21 years at the end of 2019. The legislation covers all tobacco products (including cigarettes, cigars, and e-cigarettes).⁶ Individual states are following suit with legislation “to align themselves with federal law so that local authorities can prosecute violators.”⁷

Furthermore, in March 2020, the FDA issued a final rule to require new health warnings on cigarette packages and in cigarette advertisements. The warnings will feature textual statements with photo-realistic color images depicting some of the lesser-known, but serious health risks of cigarette smoking, including impact to fetal growth, cardiac disease, diabetes and more. As Mitch Zeller, J.D., director of FDA’s Center for Tobacco Products noted, this update is “the most significant change to cigarette labels in more than 35 years.”⁸ These warnings will go into effect on packaging by October 2021.⁹ Several lawsuits have been filed by tobacco companies challenging these new warnings.¹⁰

In the e-cigarette market, the FDA stepped up enforcement with a focus on flavorings due to high usage rates among teens.

In 2016 the FDA asserted regulatory authority over e-cigarettes, but allowed products to remain on the market, providing a grace period through September 9, 2020 for companies to prepare pre-market applications.¹¹ The products remained on the market at the agency’s discretion. As the Wall Street Journal reported, this regulatory authority means that “to keep their vaping products on the market, the companies must demonstrate that their e-cigarettes present a net benefit to public health—in other words, that the benefit of helping adult cigarette smokers switch to a safer alternative outweighs the potential harm of hooking young people on nicotine.”¹²

In early 2020, the FDA selectively revoked the grace period and issued a policy covering enforcement priorities for tobacco products without premarket authorization. This policy focused on the manufacturing, distribution, and sale of unauthorized flavored cartridge-based e-cigarettes, excepting tobacco or menthol. Prioritized areas are:

³ <https://www.forbes.com/sites/charlesnorton/2020/07/06/why-cigarette-sales-are-outperforming-expectations-despite-a-pandemic/#4c2fe7c246a6>

⁴ https://journalnow.com/business/traditional-cigarettes-continue-to-outperform-electronic-cigarettes-during-pandemic/article_cc3cab51-9f57-5cf7-9bad-4b9cf34ce7ce.html

⁵ <https://www.wsj.com/articles/altrias-net-revenue-falls-11595938465>

⁶ <https://www.fda.gov/tobacco-products/retail-sales-tobacco-products/tobacco-21>

⁷ <https://apnews.com/5cfd67a741b6e5aa3278f0865556e0a5>

⁸ <https://www.fda.gov/news-events/press-announcements/fda-requires-new-health-warnings-cigarette-packages-and-advertisements>

⁹ <https://www.fda.gov/tobacco-products/labeling-and-warning-statements-tobacco-products/cigarette-labeling-and-health-warning-requirements>

¹⁰ <https://www.cspdailynews.com/tobacco/court-postpones-cigarette-health-warning-deadline>

¹¹ https://www.wsj.com/articles/fda-declares-ban-on-fruit-mint-flavors-in-cartridge-based-e-cigarettes-11577989114?mod=article_inline

¹² <https://www.wsj.com/articles/e-cigarette-makers-could-get-extension-on-fda-application-11585612823>

- Any flavored, cartridge-based Electronic Nicotine Delivery Systems (ENDS) product (other than a tobacco- or menthol-flavored ENDS product);
- All other ENDS products for which the manufacturer has failed to take (or is failing to take) adequate measures to prevent minors' access; and
- Any ENDS product that is targeted to minors or whose marketing is likely to promote use of ENDS by minors.¹³

Building on that policy, the FDA closed a loophole in July that allowed fruit flavored *disposable* e-cigarettes to avoid earlier restrictions placed on reusable e-cigarette devices.¹⁴ The FDA also sent warning letters to ten of these companies noting that they never received permission for sales in the U.S. and had 15 days to remove their products and notify the FDA of compliance.¹⁵

One positive development for the U.S. tobacco industry is IQOS, which is a heat-not-burn tobacco product. Philip Morris has partnered with Altria to bring the product to the US and has entered three cities to date (Atlanta, Richmond, and Charlotte) with expansion plans over the next year and a half.¹⁶ Significantly, in July, the FDA authorized the marketing of the IQOS Tobacco Heating System as a modified risk tobacco product (MRTPs).¹⁷ This enables products to be marketed as reducing "exposure to deadly chemicals contained in traditional cigarettes."¹⁸ Altria continues to prioritize investment in this area and sees IQOS as a growth opportunity.

Looking to the state level, in August 2020, California enacted a law banning the sale of most flavored tobacco products starting January 1, 2021. This ban includes menthol flavored products which cover a third of the \$94 billion US cigarette market, and accounts for 55% of Reynolds American's cigarette sales by volume and 19% for Altria Group. While California accounts for only 7% of U.S. cigarette unit sales, this move has the potential to expand to additional states and eventually the federal level.¹⁹ California's law follows a 2019 ban in Massachusetts.²⁰

Meanwhile, Arizona won a \$22.5 million judgment against Eonsmoke (a New Jersey-based vaping firm), highlighting the legal risk associated with new e-cigarette products. Attorney General Mark Brnovich filed a consumer fraud lawsuit against Eonsmoke and Juul Labs for violating state consumer fraud laws and targeting youth with flavored vaping products. The lawsuit asks for the return of profits from both companies and a \$10,000 fine per violation of the state Consumer Fraud Act. The lawsuit against Juul Labs continues with other states filing similar lawsuits.²¹

There were no notable changes to divestment efforts at other public pensions. CalPERS and CalSTRS maintain their tobacco divestment policies; CalPERS last reaffirmed its policy in 2016 despite staff recommendation to remove the restriction. The CalPERS board is planning a comprehensive review in 2021 of all of the fund's existing divestment policies, which including those on thermal coal, firearms, and companies operating in Sudan and Iran.

¹³ <https://www.fda.gov/media/133880/download>

¹⁴ https://www.wsj.com/articles/fda-bans-sale-of-puff-bar-e-cigarettes-11595279439?cx_testId=3&cx_testVariant=cx_2&cx_artPos=1#cxrecs_s

¹⁵ <https://www.fda.gov/news-events/press-announcements/fda-notifies-companies-including-puff-bar-remove-flavored-disposable-e-cigarettes-and-youth>

¹⁶ <https://csnews.com/philip-morris-usa-plots-expansion-path-iqos>

¹⁷ <https://www.fda.gov/news-events/press-announcements/fda-authorizes-marketing-iqos-tobacco-heating-system-reduced-exposure-information>

¹⁸ https://www.washingtonpost.com/business/altria-expands-sales-of-heated-cigarette-as-revenue-slides/2020/07/28/edc29878-d0db-11ea-826b-cc394d824e35_story.html

¹⁹ <https://www.wsj.com/articles/california-lawmakers-approve-ban-on-menthol-cigarettes-11598639354?mod=searchresults&page=1&pos=3>

²⁰ <https://www.wsj.com/articles/california-lawmakers-approve-ban-on-menthol-cigarettes-11598639354?mod=searchresults&page=1&pos=3>

²¹ [https://apnews.com/af8a0cf5767a7556978e88e1a3172a2c#:~:text=PHOENIX%20\(AP\)%20%E2%80%94%20Arizona's%20attorney,judgment%20against%20Eonsmoke%20on%20Friday.](https://apnews.com/af8a0cf5767a7556978e88e1a3172a2c#:~:text=PHOENIX%20(AP)%20%E2%80%94%20Arizona's%20attorney,judgment%20against%20Eonsmoke%20on%20Friday.)

Historical Performance Impact:

SFERS has licensed custom indices to approximate the performance impact on the total fund due to restricting investment in U.S. tobacco companies. The methodology and limitations of this approach are detailed in a separate Board report.

As shown below, SFERS decision to restrict its managers from investing in U.S, tobacco companies has had a negative impact on the performance of the total fund since 1998. This impact has been minimal at about 3bps on an annualized basis over the duration of the period.

Custom Index Relative Returns and Volatility - Total returns (net dividends) in USD

Index Name	Restriction Weighting*	Cumulative Return**	Annualized Return**	Annualized Volatility**	Dollar Impact
ACWI IMI ex Tobacco	0.35%	-1.65%	-0.02%	+0.04%	-\$88.0m

* Weightings of restricted stocks in the generic MSCI ACWI IMI Index at June 30, 2020.

** Relative returns and volatility are against the MSCI ACWI IMI Index from custom index inception (May 31, 1998) through to June 30, 2020.

Source: MSCI. Refer to disclaimer below.

ACWI IMI ex Tobacco Rolling 12 Month Relative Returns

Quant Analytics - Rolling Relative Return (12M)

MSCI ACWI Investable Market TR Net USD



Total returns (net dividends) in USD.

Source: MSCI. The MSCI data is comprised of a custom index calculated by MSCI for, and as requested by, SFERS. The MSCI data is for internal use only and may not be redistributed or used in connection with creating or offering any securities, financial products or indices. Neither MSCI nor any other third party involved in or related to compiling, computing or creating the MSCI data (the "MSCI Parties") makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and the MSCI Parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to such data. Without limiting any of the foregoing, in no event shall any of the MSCI Parties have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.

Analysis and Recommendation:

As indicated above, the restriction of U.S. tobacco stocks from the eligible universe of public equity securities has had a small but negative impact on the Trust's total return over the past 21 years – the period since the divestment decision was approved by the Retirement Board.

If the Retirement Board agrees to continue the current divestment policy, Staff recommends the following motion:

Move that the San Francisco Employees' Retirement System maintain the current policy with respect to divestment from U.S. Tobacco companies and approve the list of restricted companies as outlined in Appendix B of Staff's memorandum.

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Appendix A

List of US Companies Involved in the Production or Wholesale Distribution of Tobacco Products, Reflecting Recommended Changes from 2019 to 2020

Schweitzer-Mauduit International, Inc.	Universal Corporation
Vector Group, Ltd.	Pyxus International, Inc.
Philip Morris International Inc.	Altria Group, Inc.
22nd Century Group, Inc.	Turning Point Brands, Inc.
Amcon Distributing company	VPR Brands LP
Core-Mark Holding Company, Inc.	Smokefree Innotec Inc
Wee-Cig International Corp	Medigreen Holdings Corporation
Electronic Cigarettes International Group, Ltd.	Vapor Hub International Inc
mCig Inc-BOTS, Inc.	Fyolo Technology Corp
Vapor Group, Inc.	Healthier Choices Manufacturing Corp.
Standard Diversified Inc.	Gilla Inc.

Note 1: MSCI ESG Research data was used to create the information provided

Note 2: Companies in red font indicate those that have been added to the restricted list; companies in red font and strike-through indicate those that have been removed from the restricted list.

Appendix B

List of US Companies Involved in the Production or Wholesale Distribution of Tobacco Products, Recommended for 2020 Adoption

Schweitzer-Mauduit International, Inc.	Universal Corporation
Vector Group, Ltd.	Pyxus International, Inc.
Philip Morris International Inc.	Altria Group, Inc.
22nd Century Group, Inc.	Turning Point Brands, Inc.
Amcon Distributing company	VPR Brands LP
Core-Mark Holding Company, Inc.	Smokefree Innotec Inc
Wee-Cig International Corp	Vapor Hub International Inc
BOTS, Inc.	Fyolo Technology Corp
Vapor Group, Inc.	Healthier Choices Manufacturing Corp.
	Gilla Inc.

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