ACG Insights: Thinking About Fossil Fuel Divestment

Executive Summary

- **It is widely accepted that transitioning away from fossil fuel dependence is crucial in the fight against climate change**
- **Institutional investors are increasingly implementing plans to divest from fossil fuel companies**
- **There is plenty of gray area as to how to define and implement a divestment strategy for investors looking to pull money from fossil fuel businesses**
- **Shareholder engagement can be an alternative or a complement to full divestment strategies by helping to enact climate-friendly changes within fossil fuel companies**
- **Investors should weigh some legitimate arguments against blanket divestment such as loss of shareholder influence or ceding economic influence to state-owned oil giants**

Background

Setting the stage for the investment implications of divesting from fossil fuel companies is difficult without a quick aside into some science and history. As with many modern problems, there is much more nuance surrounding climate change and fossil fuels than the rhetoric shows. It is not necessarily contradictory to say that fossil fuel use has been a net positive for society while also endangering the planet via man-made warming and climate change. Back to some light science and history: pre-industrial societies primarily relied on muscle power or burning wood to provide energy for work and transportation. These methods were adequate for widely dispersed populations with relatively small-scale output needs. The world population began to increase exponentially during the 18th and 19th centuries as, or partially because of, a transition to coal and oil as a cheap energy source. Fossil fuels tend to be more energy dense than other energy supplies which made them an effective catalyst to power industry, transportation, and electricity generation. Somewhere around 60%[1] of global electricity is still generated from fossil fuels, and most modern luxuries related to items like transportation infrastructure and cheap electricity are a direct result of extracting and burning fossil fuels. Despite the societal benefits to this point, agreement is widespread that the world needs to wean itself from fossil fuels to combat the effects of climate change. The nuance mentioned earlier that many institutional investors will have to grapple with is what, specifically, they are looking to accomplish, and how to invest to accomplish both environmental goals and fiduciary objectives.

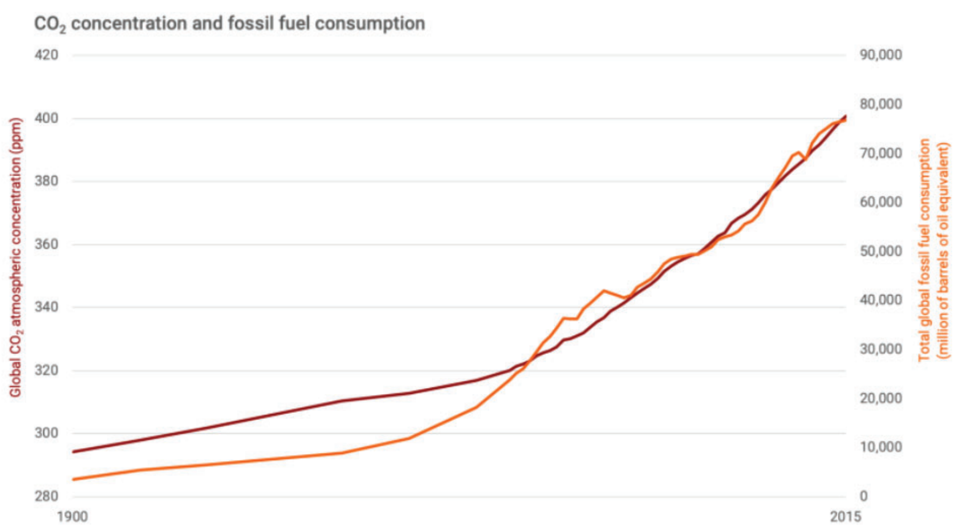
The Case for Divestment

The rationale behind quitting fossil fuels for investors is black and white compared to the nuance of methodology. It has been widely agreed amongst the scientific and political communities that an increase in greenhouse gas emissions from burning fossil fuels is contributing to climate change. Exhibit 1 below shows the

[1] Source: Brookings Institute, https://www.brookings.edu/essay/why-are-fossil-fuels-so-hard-to-quit/

direct relation between consumption of fossil fuels and the concentration of carbon dioxide in the atmosphere. Rising global temperatures due to the greenhouse gas effect have been shown to impact weather, sea levels, ecosystems, and agriculture among other areas.

Exhibit 1: CO2 Concentration in Atmosphere and Fossil Fuel Consumption [2]



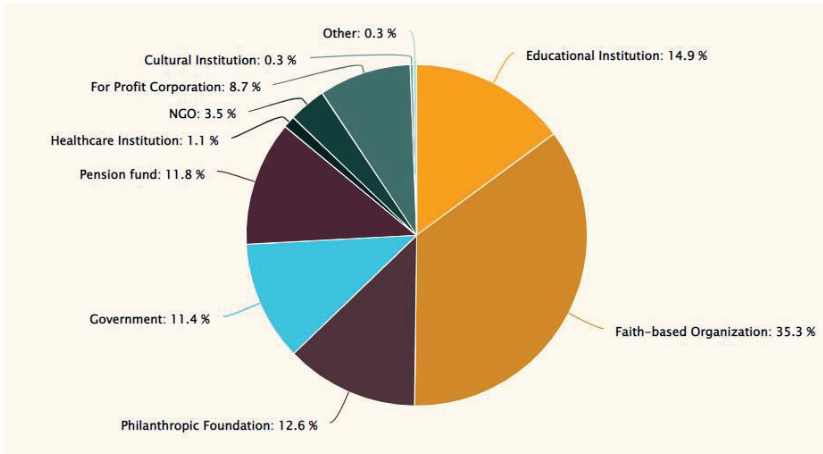
Naturally, economies and markets will feel the effects of climate change if it worsens over time. Investors have increasingly opted to fight climate change by pulling capital from coal, oil, and gas companies. Divestment strategies, in broad terms, aim to starve fossil fuel companies from funding or force change by raising their cost of capital to the point that the business of fossil fuels is no longer economically viable.

Institutional Adoption

Institutional investors tend to have a large influence within capital markets due to their large asset-bases and long-term horizons. There has been a push over the last decade within the institutional investment community to adopt divestment policies. Strategies for divestment differ, and accurate numbers can be difficult, but the Global Fossil Fuel Divestment Commitments Database estimates that around 1500 institutions managing nearly $40 trillion in assets have made commitments to divest from fossil fuels. Exhibit 2 below shows the diverse base of institutions who have enacted divestment strategies. Some notable names among those with current commitments are the Harvard and Yale endowments, New York City's employee pension plan, the Ford Foundation, and the Norwegian Sovereign Wealth Fund. Institutional adoption of divestment mandates puts direct pressure on fossil fuel companies, but also tangentially puts pressure on other institutions to draft their own fossil fuel policies. The difficulty that arises from following the trend toward divestment is defining exactly how the strategy can be executed to accomplish the goal of reducing our reliance on fossil fuels.

[2] Source: Brookings Institute

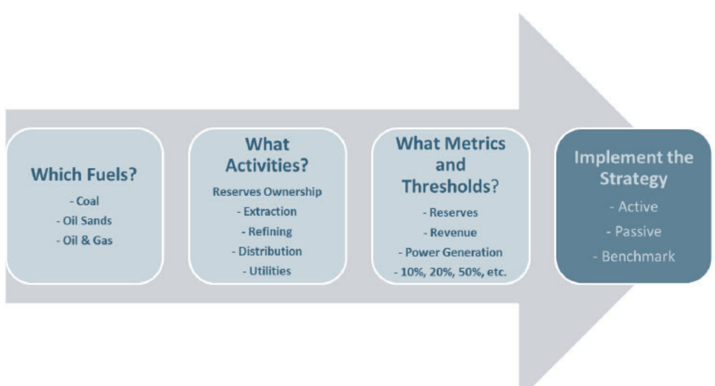
Exhibit 2: Types of Institutions with Divestment Mandates [3]



Setting a Divestment Strategy

If the decision is made to move toward divestment, much of the nuance related to enacting a policy comes from defining target companies. Of the fossil fuels, coal has generally been the largest contributor to emissions and has therefore been a focus of early divestment strategies. Additionally, it has been relatively straightforward for investors to target companies who own fossil fuel reserves. The S&P 500 Fossil Fuel Free Index, for example, eliminates companies who own recoverable sources of oil, gas, and coal. There are also readily available online services that will provide a list of the top 100-200 reserve owners in the world. Reserve ownership is a good starting point with the thinking that any fossil fuel sources left in the ground will be unavailable to burn and increase emissions. Some institutions have sought to cast a wider net based on similar questions to those posed in Exhibit 3 below.

Exhibit 3: Sample of Considerations for a Divestment Strategy [4]



A good example is a utility company who does not directly own fossil fuel reserves, but still burns a significant amount of fuel to generate power. Other companies involved in the transportation, storage, refining,

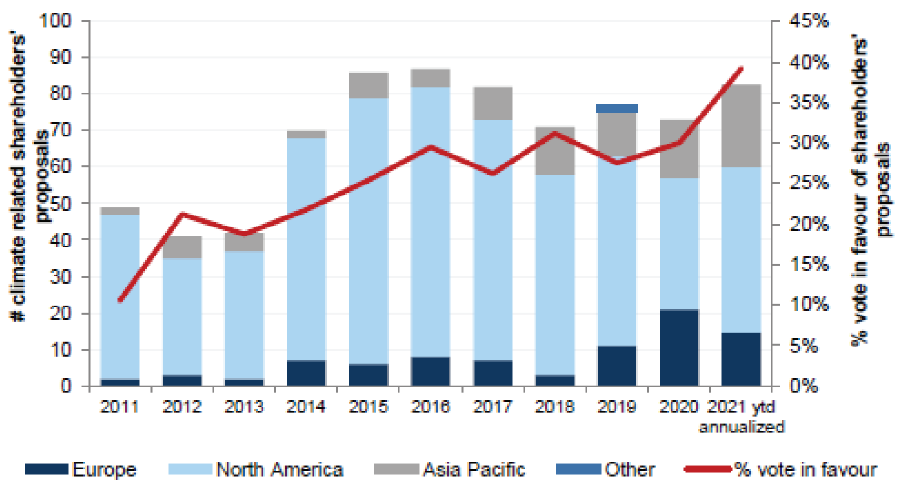
[3] Source: Global Fossil Fuel Divestment Commitments Database, https://divestmentdatabase.org/
[4] Source: MSCI ESG Research

processing, and/or marketing & distribution of fossil fuels may be meaningful targets for divestment strategies that seek to decrease our fossil fuel dependence up and down the supply chain. Identifying companies beyond the major reserve owners can be challenging. One method is to set a maximum threshold of revenue that a company is allowed to generate from fossil fuel related activities before excluding that company from the portfolio. Large data providers like MSCI are continually updating their information packages to provide company-specific revenue figures for certain business activities including fossil fuel involvement.

Divestment vs. Engagement

Formulating a divestment strategy also requires consideration of other economic levers that are available to combat climate change. Shareholders of public companies theoretically have the power to affect change through engagement with management and through advocacy work. A famous recent case saw activist fund Engine No. 1 grab three seats on Exxon Mobil's board on the platform that they would push Exxon to transition toward cleaner and more sustainable energy solutions. This was an extreme case, but any shareholder of a certain size has the right to propose actions or advocate management for change related to climate issues. Exhibit 4 depicts the upward trend of both proposals and votes in favor of climate-related proposals over the last decade.

Exhibit 4: Climate-Related Shareholder Proposals and % Votes in Favor [5]



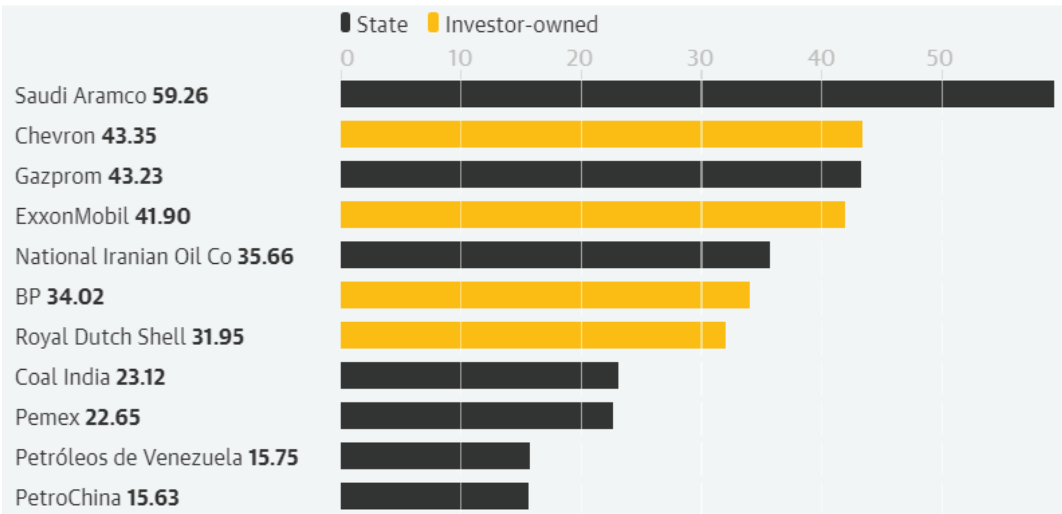
Shareholder engagement strategies recognize that transitioning away from fossil fuels will take time. Clean and renewable energy technology is advancing rapidly but is not yet near the capacity to completely replace fossil fuels in terms of access and cost. Engaging with fossil fuel companies who accept that transitioning to cleaner energy is a social and economic benefit could be impactful to speeding the transition. Yale's endowment, to illustrate, proposes a dual approach in that a "…divestment movement and strong investor engagement are, in certain contexts, complements and not substitutes."[6]

[5] Source: Goldman Sachs Global Investment Research
[6] Source: Yale, "Report of the Committee of Fossil Fuel Investment Principles"

Arguments Against Divestment

Some proponents of shareholder engagement take the next step to argue that full divestment is the wrong way to tackle fossil fuel companies. One of the basic arguments is that for every seller there is a buyer on the other side. In the case of fossil fuel stocks, the buyer may not have the same environmental goals as the seller. Moving to supply and demand on a global scale, quick divestment from the public oil producers does little to impact the large nationally owned players in the market, who may even gain market share assuming demand for fossil fuels remains relatively steady in the near term. Exhibit 5 shows that state-run fossil fuel producers in the Middle East and Asia make up a large chunk of the problem.

Exhibit 5: Top Carbon Emitters are Largely State-Owned [7]

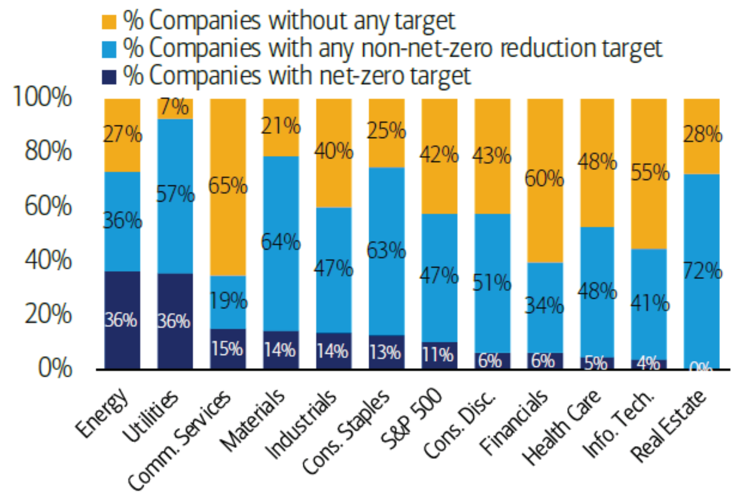


These companies are generally much less transparent and not exposed to the social pressures of publicly traded peers.[8] Accelerating the transition to green energy is one way to put pressure on state-owned oil giants, and many public energy companies have shown willingness to fund research into technologies like carbon capture and alternative energy solutions. Full divestment from the majority of the Energy or Utilities sectors, for example, reduces portfolio exposure to companies who have been among the most willing to commit to reducing carbon emissions. The chart in Exhibit 6 below illustrates that companies in the Energy and Utilities sectors have been leaders within the S&P 500 in terms of setting targets to reduce emissions and have been especially willing to commit to 'net-zero' targets when compared to the rest of the large-company index. If the point of a divestment strategy is to move capital away from polluters and towards renewable energy sources, the argument stemming from Exhibit 6 could be that the polluters of yesterday are now also the leaders of the emissions reduction and renewable energy movements.

[7] Source: https://www.theguardian.com/environment/2019/oct/09/revealed-20-firms-third-carbon-emissions

[8] Source: https://theconversation.com/fossil-fuel-divestment-will-increase-carbon-emissions-not-lower-them-heres-why-126392

Exhibit 6: % of S&P 500 with Emissions Reduction Targets [9]



Summary

One of the major themes permeating markets is a push to integrate environmental and social awareness into the investment process. Institutional investors have become increasingly interested in fossil fuel companies due to their impact on the global climate crisis. As more and more large investors have committed to divesting from the fossil fuel industry it has put increasing pressure on other institutions to formulate a strategy to shield their portfolios from ties to fossil fuel businesses. Stating the need for a policy and committing to an implementation strategy, however, are two extremely different tasks. The gray area within defining and implementing a fossil fuel policy is wide. What companies should be targeted? Would engagement be more impactful than blanket divestment? Does full divestment accomplish the goal transitioning away from fossil fuels? The answer will differ for each organization and will likely fall somewhere in the middle of the spectrum from blanket divestment to full-on engagement. The one certainty is that the fossil fuel industry will continue to find itself in the crosshairs of investors. Thinking about an investment strategy related to the transition from fossil fuels to greener energy will only be more emphasized over time.

[9] Source: Bank of America Global Research

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