Divestment and engagement: different shades of green

To divest, or to not to divest: that is the question. We discuss the options available to investors and present Ruffer's approach.

Introduction

Climate change has been debated at the highest levels for more than a quarter of a century, but more recently there has been widespread acceptance of its existence. Arguably, one of the most important steps in achieving this was the Intergovernmental Panel on Climate Change (IPCC) report, released in November 2014, which concluded that climate warming is now 'unequivocal' and that human activity is 'extremely likely' to be the dominant cause.[1] Importantly, this report emphasised the link between greenhouse gas emissions and climate change. As the effects of greenhouse gas emissions are cumulative, persistent and not localised, it is fundamental that this issue is considered in a global context. The response needs to be international, and it must be based on a shared vision of long-term goals and agreed frameworks that will accelerate action over the next decade.

The ratification of the Paris Agreement, by 185 countries to date,[2] is an example of the co-operation required.[3] The first goal of the Paris Agreement is to limit the rise in global temperatures this century to, at most, 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5°C. To achieve this goal, greenhouse gas emissions need to be substantially reduced; much more needs to be done by governments and also by companies. Therefore, how companies are managing their greenhouse gas emissions has become fundamental to their long-term financial performance.

The IPCC report, released in October 2018, starkly laid out the likely consequences of global warming of 1.5°C and the additional damage that warming of 2°C could cause. According to the report, global temperatures have, on average, already risen 1°C above pre-industrial levels and are currently increasing at 0.2°C per decade. Therefore, it is likely that an increase of 1.5°C above pre-industrial levels will be reached between 2030 and 2052.[4] An increase of this extent will have considerable negative consequences around the world, from ice-free summers in the Arctic to species loss and extinction. Importantly, the magnitude of the environmental damage if temperatures rise to 2°C above pre-industrial levels is likely to be substantially worse.

The Paris Agreement requires each country to set out, in its Nationally Determined Contributions (NDCs), a commitment to reduce greenhouse gas emissions and how it intends to adapt to the impacts of climate change. Ruffer acknowledges that there are a diverse range of views on what greenhouse gas emissions reduction targets should be, but we expect that the NDCs will be tightened in 2023 to align with the pathway to meet the goals of the Paris Agreement.

Considering both the greenhouse gas emissions produced in the extraction, refining and processing of fossil fuels and the emissions released during combustion, the oil and gas industry is a significant contributor to global greenhouse gas emissions. As stewards of our clients' assets, it is our duty to take into account all investment risks, and consequently we are considering these issues

seriously and incorporating these risks into both our macroeconomic and company analysis.

There are a number of different approaches that can be taken, reflecting the different backgrounds and beliefs of investors. Some argue that fossil fuel companies will never change their business models and so it is not possible to reconcile owning their shares with a concern about climate change. Meanwhile others propose that by owning shares investors have the opportunity to influence these companies and be part of the transition necessary to achieve the goals of the Paris Agreement. And, of course, there are options that can combine these two approaches.

At Ruffer, we appreciate the importance of these decisions for investors. We explored this in a panel discussion on the merits of divestment and engagement at our Charity Conference in May 2018. We asked the audience some questions during the discussion to understand better what has driven their views and whether this has affected their investment decisions. A majority of the attendees responded that the values of their charities and their investment committees had driven discussions on fossil fuel investments.

We will discuss divestment and engagement in more detail below, and present Ruffer's approach and view of the role fossil fuel companies play in portfolios.

Divestment

Divestment is the act of selling the shares of a company in response to concerns over environmental, social, corporate governance or ethical issues. The main focus recently has been fossil fuel companies with investors having a wide variety of motivations.

The predominant argument in favour of divestment is that fossil fuel companies have known about climate change for many decades, and if shareholder pressure has failed to change their approach over this time, it is not likely to be successful now. Fossil fuel companies began publicly accepting the occurrence of climate change and the link between greenhouse gas emissions and climate change in the 1990s, such as in the speech by John Browne at Stanford in 1997, when he was CEO of BP America. However, it seems that many fossil fuel companies were conducting their own research on climate change in the 1970s and 1980s and some might have found evidence that greenhouse gas emissions were the most likely cause. Whilst in possession of this and other scientific research, many companies continued to publicly deny climate change and this is used as evidence that they are not willing to change.

The second type of argument is based on the beliefs or values of investors. This can be driven by environmental or societal concerns, or religious values. Both the Church of England and the Catholic Church, through Pope Francis' encyclical Laudato Si, have stated the importance of addressing the moral issues, primarily concerning intergenerational justice, raised by climate change. Some investors have made the decision that continuing to invest in companies that have had such a significant impact on climate change is irreconcilable with their moral values.

The third type of argument is based on the economic risks of continuing to invest in fossil fuel companies. To achieve the goals of the Paris Agreement, society needs to reduce its emissions of greenhouse gases considerably and so it is likely that the consumption of fossil fuels will need to fall. Consequently, there is a risk that fossil fuel assets will not be able to earn an economic return for their entire useable life, and hence are often referred to as 'stranded assets'. This can happen for a number of reasons including regulatory, economic or physical changes and is particularly important for conventional fossil fuel assets due to the length of their useable lives.[5] These concerns are intensified by the legal risks to fossil fuel companies, as demonstrated by the on-going lawsuits in the US, and the risk of further intergovernmental responses.

While these arguments are all important and play a significant part in the debate about whether to continue to invest in fossil fuel companies, there are other factors that also need to be considered. Firstly, divestment is only possible once. While it can be used to make a statement likely to gain the attention of fossil fuel companies, once

the shares have been sold, it is often no longer possible to be involved in discussions with these companies. Secondly, there is an argument that, by selling the shares and depressing the share price, other investors without these concerns will be able to purchase shares at a lower price allowing them to increase their profit while the business models of the companies remain unchanged. These are the main arguments in favour of engagement.

Engagement

Engagement is the process of continued dialogue with a company and other relevant parties with the aim of influencing their behaviour in relation to environmental, social or corporate governance practices. Investment managers and asset owners, along with many environmental groups, have been engaging with fossil fuel companies about climate change for a number of years. The concerns raised about the success of engagement with these companies cannot be dismissed. However, in the last few years there have been developments that suggest engagement could now be a powerful tool for effecting long-lasting change.

Firstly, as concerns about climate change have intensified around the world, the desire to engage with companies on these issues has grown. This has led to the launch of a number of shareholder initiatives, including most recently Climate Action 100+. Through this five-year global initiative, investors commit to engaging with the 100 largest corporate greenhouse gas emitters to improve their governance and disclosure and to reduce their emissions. At the end of December 2018, more than 320 investors representing over $32 trillion of assets had signed up.[6] The scale of this initiative gives considerable power to investors and most companies have so far responded positively. This creates a valuable opportunity to exert continued pressure on companies to align their business models in order to successfully transition to a low-carbon economy. Ruffer believes in the power of collaborative engagement and so has been an active participant in this and a number of other initiatives.[7]

Secondly, the support of organisations such as CDP (formerly Carbon Disclosure Project) and the Transition Pathway Initiative has given investors tools and quantitative analysis to use as the basis for meaningful engagement with companies.

Thirdly, academic research in this area has started to identify how to make engagement more successful and the mechanisms by which it can create value for both investors and companies.[8] A number of these findings have been incorporated into the structure of collaborative initiatives such as Climate Action 100+, and we are hopeful this will lead to increased success.

We are encouraged by the actions of some companies. For example, after increased shareholder engagement on climate change over the last few years, Royal Dutch Shell announced in November 2017 its commitment to reducing the net carbon footprint of its products by around 20% by 2035 and 50% by 2050.[9] In December 2018, after numerous discussions with investors, the company announced a further commitment to set short-term targets and link these to executive remuneration. This announcement was particularly heartening given the amount of progress made in a relatively short time, which gives us reason to be optimistic as to what engagement could achieve at other companies in the coming years.

There will be some instances in which companies do not respond in the desired way to engagement. However, in this situation divestment is not the only option. Shareholder resolutions have been gaining increasing importance in recent years, most noticeably at ExxonMobil. In 2016, Ruffer voted for a climate change-related shareholder resolution at ExxonMobil co-filed by the New York State Common Retirement Fund and the Church Commissioners for England. Although it failed to win the support of a majority of shareholders in 2016, a similar resolution was filed in 2017. The second resolution was successful, with 62.1% shareholder support, despite not receiving the backing of ExxonMobil's board.[10] The resolution asked the company to report annually on how technological advancement and international climate change policies focussed on

keeping temperatures well below 2°C will affect its business and investment plans. This resolution led to ExxonMobil producing its first Energy and Carbon Summary Report in 2018 analysing scenarios that limit the increase in temperatures to 2°C, which has formed the basis of further engagement with the company.

Portfolio approach

At Ruffer, we have had periods with minimal or low exposure to fossil fuel companies, but at the moment we do hold a number of energy-related companies. This is based on a shorter-term view of a likely cyclical recovery in energy markets as supply and demand dynamics come back in line. Our investments are concentrated in companies that either offer high dividend yields that we believe can be sustained at lower oil prices, or companies whose business models offer significant exposure to rising energy prices. These investments also have an important role in portfolios as they provide exposure to continued global economic growth and protection in the scenario we most fear: rising global inflationary pressures.

While we take very seriously the environmental concerns and work to systematically incorporate environmental, social and corporate governance considerations into our investment process for all companies, we think that fossil fuel companies will continue to provide a significant proportion of global energy for the foreseeable future and therefore will need to be part of the transition to a low-carbon economy. We believe that the current pace of the transition provides time for these companies to alter their business models, but we remain alert to changes in the pace of this transition.

The International Energy Agency's analysis and scenarios add weight to this argument. In 2016, 81% of world energy came from coal, oil and gas, while only 2% came from solar and wind.[11] Renewables are growing at a considerably faster rate than fossil fuels, but even in the most ambitious scenarios, which reach the goals of the Paris Agreement, oil and particularly gas will still provide a significant proportion of our energy globally in 2050. There are some areas in which it is incredibly difficult to substitute oil or gas for renewables, such as aircraft fuels and heat generation for manufacturing processes. In addition, oil is used as a feedstock in many other processes. This is why we think that engagement is so important, as we need to encourage these companies to adapt their business models and be a positive force for change.

Ruffer's ability to construct segregated portfolios gives us the flexibility to incorporate client-specific ethical investment restrictions into the management of portfolios. We currently use MSCI ESG Research as our screening and research provider and this allows us to include restrictions in relation to fossil fuel companies if desired. One advantage of a segregated portfolio is the transparency it provides, and this gives comfort to our clients that we are investing in line with their ethical investment restrictions.

At the end of the panel discussion at our 2018 Charity Conference, we asked the audience some additional questions. A majority of the respondents agreed that engagement can have a positive influence on companies and that an approach combining both divestment and engagement is most appropriate. These results confirmed to us that our current approach is in line with the views of our clients.

Conclusion

As we have discussed, our view is that investors do not need to choose either divestment or engagement, as there are ways to combine both approaches. Some investors have adopted the approach of committing to engage for a set number of years but if companies haven't achieved certain targets by the end of this period, they will divest. This approach can be particularly powerful if the time-line is shared with companies. However, the time taken to effect real change must be considered, with some academic papers finding that engagement takes on average 1.5 years to be successful.[12] Another alternative is to divest from companies that extract oil from oil sands or produce thermal coal. These fossil fuel companies are among the worst carbon emitters and

their products are much more carbon intensive than other types of oil and gas. In addition, the decision of whether to divest or engage does not have to be applied to the whole industry. There is dispersion in both the achievement and commitment of fossil fuel companies with regard to these changes, and so engagement is more likely to be successful with some than with others.

There are a number of alternatives available to investors, which can be tailored to their specific concerns. The pace of change in this area is exciting and there is considerable momentum, which has already led to some significant commitments by fossil fuel companies. There is still much work to be done, but we think that engagement through collaborative initiatives is the best way to encourage fossil fuel companies to adapt their business models to align with the transition to a low-carbon economy and achieve the goals of the Paris Agreement. ●

ALEXIA PALACIOS

ANALYST, RESPONSIBLE INVESTMENT

Joined Ruffer in 2014 after graduating from the University of Cambridge with first class honours in land economy. Having gained experience in responsible investment while working with Ruffer's charity team, she has specialised in this area since 2018. She has completed the PRI Academy Responsible Investment Essentials and Enhanced Financial Analysis courses and is a CFA charterholder.

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