Divestment and engagement: different shades of green

Introduction

Climate change is not a new phenomenon, but having been passionately debated for a number of decades there has, more recently, been widespread acceptance that it is happening. Arguably one of the most important steps in achieving this acceptance was the Intergovernmental Panel on Climate Change (IPCC) report released in November 2014, written by 700 of the world's leading climate scientists from more than 70 countries, which stated that climate warming is now 'unequivocal' and that human activity is 'extremely likely' to be the dominant cause.[1] This report importantly 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 agreement on frameworks that will accelerate action over the next decade. The Sustainable Development Goals launched by the United Nations in 2015 were an important starting point. The ratification of the Paris Agreement to limit the rise in global temperatures to, at most, 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5°C was a further step forward and an example of the co-operation required to address this type of issue.

To achieve the goals of the Paris Agreement, greenhouse gas emissions need to be substantially reduced. But, after three years of stability, a preliminary report from the Global Carbon Project[2] suggests carbon emissions grew 2% in 2017 and within the next four years if emissions stay at their current levels we will have produced so much carbon that it will no longer be possible to limit global warming to within 1.5°C above pre-industrial levels. It is obvious that much more needs to be done by governments but also by companies and therefore, greenhouse gas emissions have been pushed from an environmental issue that some investors and companies still ignore, to one which is fundamental to their long-term financial performance.

When both the greenhouse gas emissions produced in the extraction, refining and processing of fossil fuels are considered, and the emissions released during combustion, the oil and gas industry is a significant contributor to global greenhouse gas emissions. Consequently, it is right that as investors we are considering these issues seriously and incorporating this dimension into our analysis of these companies.

There are many different approaches that can be taken, reflecting the different backgrounds and beliefs of investors. Some argue that fossil fuel companies will never change and so it is not possible to reconcile owning their shares with a concern about climate change. Whilst others propose that by owning shares you have the opportunity to influence these companies and be part of the transition, which is necessary to achieve the goals of the Paris Agreement. And, of course, there are paths that can be taken that try to find a compromise between these two approaches.

1 Intergovernmental Panel on Climate Change (IPCC) 2014 Synthesis Report

2 Global Carbon Project, Global Carbon Budget 2017

At Ruffer, we appreciate the importance of these decisions for investors and for charity trustees in particular. Therefore, we held a panel discussion on the merits of divestment and engagement at our recent Charity Conference in May 2018. We asked the audience to answer 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 audience responded that the values of their charity and their investment committees had driven the discussions on fossil fuel investments.

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

Divestment

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

Often divestment is based on the argument 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 accepting publically 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, when he was CEO of BP America, at Stanford in 1997. However, it seems that many 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 research, many companies continued to deny climate change publically and this is used as evidence that these companies are not willing 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 created 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. This can happen for a number of reasons including regulatory, economic or physical changes[3] and is particularly important for conventional fossil fuel assets due to the length of their useable lives. These concerns are intensified due to the legal risks to fossil fuel companies, as demonstrated by the on-going lawsuits in America.

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, quite obviously, only possible once. And so while it can be used to make a statement which is 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 model of the companies remains unchanged. These are the main arguments in favour of engagement.

Engagement

Engagement is the process of continued dialogue with companies and other relevant parties, with the aim of influencing their behaviour in

3 www.carbontracker.org/terms/stranded-assets

relation to environmental, social or governance considerations. 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 considerable changes which suggest that engagement could now be a very powerful tool to effect real 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 of their impact on climate change and to reduce their emissions. At the end of March 2018, more than 250 investors representing over $26 trillion of assets had signed up.[4] 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 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.

Secondly, the support of organisations such as CDP (formerly Carbon Disclosure Project) and the Transition Pathway Initiative have given investors tools and quantitative analysis to use as the basis of meaningful engagement with companies. This is crucial to achieving the desired impact.

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.[5] A number of these findings have been incorporated into the structure of the most recent collaborative initiatives, 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 last year, Royal Dutch Shell announced its commitment to reducing the net carbon footprint of its products.

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 used to great effect in recent years, most noticeably at ExxonMobil. In 2016, we voted for a climate change related shareholder resolution at ExxonMobil co-filed by the New York State Common Retirement Fund and the Church of England Endowment Fund. 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 the ExxonMobil board.[6] The shareholders voted for the company to report annually on how technological advancement and 2°C global climate change policies will affect its business and investment plans. This resolution led to ExxonMobil producing its 2018 Energy and Carbon Summary Report earlier this year, which will form the basis of further engagement.

Portfolio approach

At Ruffer, we believe that different assets may be interesting investments at particular points in the cycle. We have had periods with minimal or low exposure to fossil fuel companies but at the moment we do hold some oil companies. Our investment case is based on our assessment that these companies offer high dividend yields which will be sustained even at much lower oil prices and are at attractive valuations. Additionally, if commodity prices rise in an environment of strong growth, these companies should perform strongly. They also provide an important hedge for the portfolio against political problems in the Middle East.

4 www.climateaction100.org

5 UN PRI (2018), How ESG engagement creates value for investors and companies

6 ExxonMobil proxy voting results: cdn.exxonmobil.com/~/media/global/files/investor-reports/2017/summary-of-proxy-votes-2017.pdf

While we take very seriously the environmental concerns discussed above, and work to systematically incorporate environmental, social and governance concerns 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. The International Energy Agency 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.[7] 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 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 to enable them to be a positive force for change.

Ruffer's ability to construct segregated portfolios does also give 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 recent Charity Conference, we asked the audience some additional questions. In response to the first question about whether engagement can have a positive influence on companies, most responded that it can. In response to the second question about whether engagement, divestment or a combined approach is most appropriate, a significant majority thought a combined approach will work best. 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 timeline is shared with the companies. The time taken to effect real change must be considered though with some academic papers finding that engagement takes on average 1.5 years to be successful.[8] Another alternative is to divest from companies that produce oil sands and 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 doesn't have to be applied to the whole industry. There is great dispersion in both the achievement and commitment of fossil fuel companies to these changes, and so engagement is more likely to be successful with some than with others.

In conclusion, 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 at the moment 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
Associate–Responsible Investment

Ruffer LLP is authorised and regulated by the Financial Conduct Authority. This article does not constitute investment advice or research. © June 2018 Ruffer LLP, 80 Victoria Street, London SW1E 5JL

7 International Energy Agency (2017), World Energy Outlook, OECD/IEA Paris

8 Dimson, E et al (2015), Active Ownership. The Review of Financial Studies 1 (28)