Investment Insight

Engage or divest? The carbon debate

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"…Given the global interest in climate change and the upcoming United Nations conference which is seeking to achieve a legally binding and universal agreement on climate change, this article provides context and background for the investment community."

December 2015 will see Paris host the UN Climate Conference, COP21[1]. These talks are being heralded as a new era in global cooperation on climate change, with major emitting nations, including the US, China and India, indicating a willingness to achieve a definitive outcome. As countries lodge their intended carbon emission reduction commitments, indications are that governments are doing more to address climate change.

Concurrently, there has been a movement calling for investors to take action on climate change directly by divesting from the fossil fuel exposures in their portfolios. What started on university campuses has gained worldwide attention, and a number of university endowments and other organisations have committed to divest from fossil fuels. While this has largely been driven by the moral imperative to utilise investor influence to effect change, the spotlight on fossil fuels has seen institutional investors increasingly considering the investment implications of climate change policy for retaining carbon exposure in their portfolios.

There is growing consensus that investors must manage climate change risk in their portfolios, but less agreement on how best to do so. Some of the purist grass roots organisations tend to call for outright divestment, whereas others promote an "engagement" approach. But what is most appropriate from an investment standpoint?

Divestment

Divestment, or negative screening, is often associated with socially responsible or ethical investment, where an investor actively excludes investments that do not meet ethical or values-driven criteria. Most divestment campaigns have focused on the social imperative to use an investor's influence to effect change. Examples include the anti-apartheid divestment campaign of the 1970s and 1980s and the long-running campaign to divest from tobacco companies.

Investors that choose to divest today are just as likely to be driven by investment considerations as they are by ethics, with divestment increasingly being utilised as part of a broader investment risk management strategy. Active fund managers effectively exclude investments from their portfolios every day through their choice of what securities to include. At times, this will be driven by concerns about the long term sustainability of an industry or exposure. They may assess the risk adjusted return expectations for an investment and determine that inclusion in the portfolio is not warranted. Proponents of divestment see this as a means to identify and eliminate risk from the portfolio.

Is divestment effective?

Just as there is no consensus on whether divestment will be effective in influencing climate policy or corporate behaviour, there is no consensus on whether divestment is the best approach to manage the investment risk posed by climate change, or any other investment risks.

[1] The talks in Paris are the 21st Session of the Conference of the Parties (COP) to the United Nations Framework Convention on Climate Change (UNFCCC). The COP occurs annually to review the Framework, which was first adopted at the 1992 Rio Earth Summit.

Some of the factors that investors contemplating a divestment approach should consider include:

- **Price**

  Proponents of divestment often focus on risk without an assessment of price, or value: while an industry may face certain risks, if these are “priced in”, then an investor will arguably be compensated for the risk taken. If divestment occurs when investments are trading at a discount to fair value, it may result in a lower risk adjusted return for the investor.

  Active fund managers are expected to manage this risk/reward balance on behalf of their clients. However, developing an accurate assessment of the appropriate discount to take account of climate risk is a challenging task.

- **Market concentration**

  In Australia, we face a domestic market that is relatively small and concentrated in the largest companies. Divestment may not be practical for investors that are concerned about benchmark relative risk and/or that want to preserve portfolio diversification.

- **Diversified companies**

  Many companies have diversified business operations, of which only one part may have exposure to material climate risks. In many situations, a divestment approach requires an assessment of materiality of climate risk to the individual company in question.

- **Influence from within**

  Proponents of engagement would argue that seeking to influence investee companies as a shareholder is a more effective approach to influencing corporate behaviour and to generate better risk adjusted returns over the long term.

Engagement – the alternative to divestment?

In this context, “engagement” means utilising the influence investors have on a company to encourage better management of ESG risks. This may involve meeting with the company on specific issues, writing letters and using opportunities to cast votes on specific topics or in the election of directors. Engagement may be done directly by the investor, either individually or as a collaborative effort, via the fund manager or through specialist third party engagement service providers.

Can engagement add investment returns?

Until recently, there was limited academic research on the efficacy of engagement on ESG issues, with most studies focusing on “activism”, where shareholders seek to assert their influence by publicly raising their concerns. Research on the effectiveness of activism has drawn mixed conclusions, both in relation to the impact that activism may have on driving actual change in the target company, and whether activism results in an improvement in investment returns.

Research conducted on ESG engagement appears to be telling a more consistent story thus far, with a number of recent studies concluding that successful ESG engagement can result in meaningful outperformance for investors. A study of over 2000 ESG engagements with US companies over the 10 years to 2009 found that successful engagements were followed by cumulative excess returns, most of which occurred in the 12 months (Active Ownership (2012); Dimson, Karaka & Li). This supports earlier research on a specific fund manager which concluded that the manager’s outperformance was the result of successful engagements rather than stock picking (Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund (2009); Becht, Franks, Mayer & Rossi). Research released this year found that engagements with companies in the extractives industry (being the extraction of raw materials from the earth to be used by consumers) specifically resulted in outperformance and were associated with a lower risk profile (Research by Andreas Hoepner, Ioannis Oikonomou and Xiao Yan Zhou, yet to be published).

While these academic studies provide strong support for the case for engagement, at least where the investor has a reasonable expectation of success, we should note that all three studies mentioned were limited in scope in that each utilised data from a single engagement services provider.

Past performance is not a reliable indicator of future performance.

Growing role of engagement

In the wake of the global financial crisis, weak corporate governance practices were identified as playing a role in disrupting financial market stability. The role shareholders need to play in monitoring their investee companies was highlighted by regulators and investors globally. This, along with a growing focus on ESG more generally, has supported a trend for increased corporate engagement. The UK and Japan have seen the introduction of stewardship codes that see fund managers formally commit to monitor and engage with investee companies on behalf of their clients. Further, organisations such as the Principles for Responsible Investment (PRI) and Australian Council of Superannuation Investors (ACSI) have presided over a growth in collaborative engagements by asset owners.

In Australia, engagement is also on the rise. The introduction of the “two strikes” rule in 2010[2] has resulted in more proactive corporate engagement on remuneration, and some would argue that this has opened the door for more engagement on broader ESG issues. The growth in superannuation fund assets has also supported this trend, as funds grow to be major shareholders in Australian companies and in some cases have moved to undertaking direct engagement with companies.

Does engagement work?

Proponents of engagement believe that interacting with companies can lead to meaningful changes in corporate behaviour and business direction. Theoretically, successful engagements may result in better returns for the investor, as the company may be rewarded for reducing their risk profile with a higher share price. Recent academic research suggests that successful corporate engagement can result in improved operating performance, reduced share price volatility and improved share price performance. Please refer to our ‘Can engagement add investment returns?’ section above. However, not all engagements are successful, nor will engagement be appropriate for every situation.

A balanced approach

The engage or divest debate is often framed as an “either, or” debate. In reality, both approaches may have a role to play as part of a broader investment risk management approach.

Many investors utilise active fund managers. In these cases, responsibility for managing security-specific risk lies with the appointed fund managers, as generally does the decision of whether to engage or divest/exclude. Investors should ensure that their fund managers have appropriate processes in place to identify, monitor and manage the full range of investment risks, including climate and other ESG risks, be it through avoidance or engagement activities.

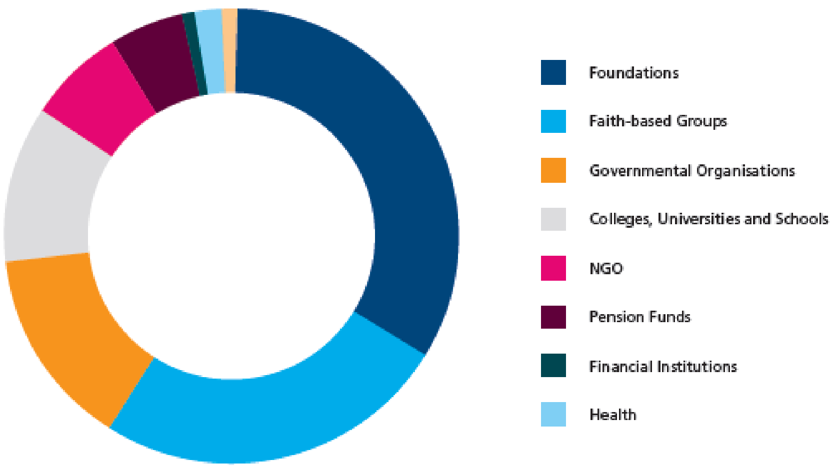
Investors may take a more active role in managing these risk exposures at the portfolio level. This may be appropriate where risks are not adequately managed by the underlying investment structure. A portfolio that holds passive investments may be an example of this. Index managers may undertake engagement activities, but security selection is rules based and has no consideration for risk or return.

While many will continue to rely on their fund managers to conduct engagement on their behalf, we expect that more Australian superannuation funds and other institutional investors will undertake direct engagement activities over time, either collaboratively or unilaterally. Superannuation funds and other institutional investors have grown to be significant shareholders in the Australian share market and many have investment strategies that will see them be significant, long-term investors in most listed Australian companies.

Superannuation funds and other institutional investors are well placed to engage with and influence companies, especially if multiple investors are engaging on the same issue. Depending upon the investment structure, the level of risk assessment undertaken by the managers and the extent of climate risk management an individual investor wishes to implement, the use of a divestment approach may also be appropriate.

[2] Under the ‘two strikes rule’, a company that receives 25% or more “no” votes on the resolution that their Remuneration Report be adopted in two consecutive years must then ask the AGM to vote on whether the entire board of directors will need to stand for re-election. This has placed increasing pressure on boards to consult with investors in relation to executive remuneration policies and practices.

Chart 1: The global composition of institutions committed to divesting from fossil fuels



As at August 2015. Source: 350.org

These figures include Australian and New Zealand institutional investors. The picture is fairly similar within Australia, with faith based organisations and foundations dominating the chart.[3] Pension funds and other financial institutions are by and large not participating in the divestment movement, at least so far.

COP21: What's it all about?

Attempts to come to a global agreement on how best to tackle climate change have been ongoing for more than 20 years with mixed results. The first treaty, the 1997 Kyoto Protocol, set legally binding emissions targets for developed countries. The second commitment period under the treaty comes to an end in 2020. COP21 seeks to achieve a legally binding and universal agreement that would come into place in 2020 and with the aim to keep global warming below 2°C by 2100.

"Universal" in this case means that both developed and emerging countries will be required to reduce emissions – one of the key criticisms of the Kyoto Protocol was that developing nations were not required to reduce emissions. Over the 18 years since the Kyoto Protocol came into being, the growth in emissions from developing nations, and China in particular, has been staggering. China is now the world's largest emitter of carbon dioxide.

Fossil fuel divestment – talk or action?

The global fossil fuel divestment campaign has been successful in gaining momentum over a relatively short time period when compared with past divestment campaigns, but how much of this relates to awareness as opposed to actual divestment activity?

According to international environmental organisation 350.org, 349 institutions globally have committed to divest from fossil fuels. Perhaps unsurprisingly, the composition is dominated by foundations and faith-based groups, followed in short order by government and education related institutions.

[3] Note that JANA's classification of superannuation funds is slightly different to that of 350.org. We have excluded unknown organisations listed as pension funds and included UniSuper, which 350.org classified as an educational institution.

Carbon footprint: measurement and disclosure

Quantifying ESG risks is a challenging task, with many ESG risks considered subjective in nature, and therefore hard to place a financial value or a "number" on. Where there has been some success is in the measurement of portfolio carbon footprint. There are now a number of providers that can measure the carbon footprint of an investment portfolio under varying methodologies, and the practice of measuring and reporting on carbon footprint is growing amongst institutional investors. The Principles for Responsible Investing (PRI) has supported this trend, with the 2014 launch of the Montreal Pledge, under which institutional investors commit to measure and publicly disclose the carbon footprint of their investment portfolios on an annual basis. There are 64 signatories to the pledge to date.

While the primary motivation for measuring carbon footprint has been to better identify and manage investment risk, there has also been growing pressure for institutional investors to disclose their carbon footprint to beneficiaries and other stakeholders. Superannuation funds are increasingly facing member enquiries regarding their exposure. Pressure groups advocate compulsory reporting on carbon footprint by institutional investors. France has been the first country to take this step, with all institutional investors required to disclose their carbon footprint from the financial year ending December 2016.

Conclusion

The last ten years has seen rising awareness and greater understanding of ESG risks amongst the institutional investment community. The growth in assets in superannuation funds, along with increased awareness and pressure from members and beneficiaries will leave many superannuation funds, university endowments and other institutional investors questioning how best to manage these risks. We anticipate that engagement and divestment are likely to play a growing role in portfolio risk management, both directly by investors and by fund managers.