RISCURA

Divestment or engagement: The investor's dilemma

Divesting from fossil fuel companies is often considered an easy way to act on climate change. On the surface, it seems simple enough. Starve fossil fuel companies of capital and watch their demise. However, in a complex, globalised economy, such decisions are rarely simple, usually ineffective, and typically come with several unintended consequences.

There is a big distinction between lowering the carbon footprint of an investment portfolio and reducing emissions in the real economy. Investors can decarbonise a portfolio through divestment. However, this will not help tackle climate change unless lower portfolio carbon footprints drive reductions in emissions at the company level. In some instances, divestment may even contribute to higher emissions in the real economy.

Investors have two primary levers at their disposal to decarbonise their portfolios. Engagement is the first lever. Investors can individually and collectively engage with companies to motivate positive change in their portfolio companies. Investors can also engage policymakers to encourage net zero commitments through policy actions. Divestment is the second lever. At its core, divestment is an asset or sector allocation decision involving re-allocating capital away from high-emitters to lower-emitters.

Both engagement and divestment levers have their place for an investor seeking to lower their footprint. It should not be an either/or decision, but rather a pragmatic, balanced one.

What is divestment?

Broadly, divestment is selling all or part of an investment in a company or sector engaged in specific controversial activities. Fossil-fuel divestment aims to make it difficult for the fossil fuel industry to survive, let alone thrive, by taking away both its social license and access to capital. The hope is that divestment will have a significant financial impact on the share price of fossil fuel companies, increasing their cost of capital and thus making it more difficult to fund fossil fuel projects.

A brief history of divestment

The first major documented divestment campaign globally targeted South Africa's Apartheid system. Student activists across the United States organised protests and called for universities and financial institutions to divest from companies doing business in South Africa.

There have also been long-running divestment campaigns aimed at the tobacco, alcohol and armaments industries. More recently, the fossil fuel divestment movement has gained significant traction globally. Since the campaign's humble beginnings on a few college campuses in 2011, it now includes asset owners, asset managers and governments across the globe.

Fossil fuel divestment gathering pace

Today, more than 1 500 institutions collectively responsible for almost US$40 trillion of assets under management are committed to divesting some, or all, of their fossil fuel exposure into the future.[1]

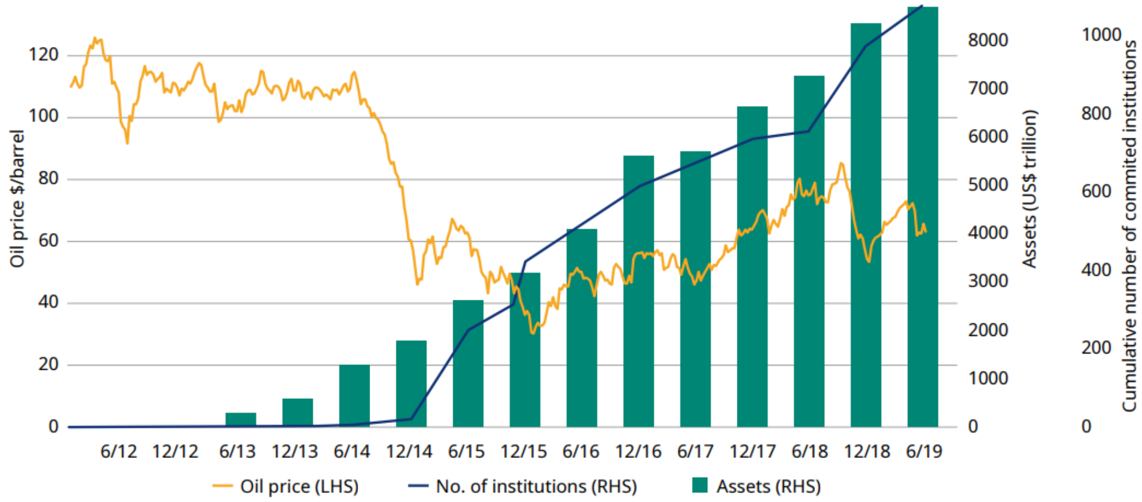
For example, in 2019, the world's largest sovereign wealth fund, Norway's Government Pension Fund Global (GPFG), which manages $1 trillion, announced that it would divest from oil and gas companies. Last week, one of the world's largest pension funds, the Netherlands' ABP, said it would sell its entire holdings in fossil fuel companies, worth more than €15 billion, by 2023. In early 2020, both BlackRock and BNB Paribas Asset Management announced that they would not invest in any companies that generate 25% and 10% of their revenues from thermal coal production, respectively.

Numerous banks such as HSBC, Deutsche Bank, RBS, and Standard Chartered have announced various lending restrictions relating to thermal coal mining projects and new coal-fired power plants globally. Companies rely on debt financing to fund their exploration, development and production activities.

[1] Divestmentdatabase.org

Unsurprisingly, some of the strongest pressure comes from insurers, given their increasing exposure to climate risk. According to a report by Unfriend Coal, 35 major insurers with almost US$9 trillion in assets representing 37% of the global market have divested from coal.[2] Among them are Lloyd's, AXA, Allianz and Munich Re.

Growth of fossil fuel divestment commitments gathers pace after oil price collapse in 2014



Source: Schroders, Bloomberg, Go Fossil Free, Arabella Advisors

Divestment: more bark than bite?

In theory, divesting from fossil fuel companies should result in reduced investor demand, an increase in the cost of capital, and the loss of valuable funds to support operations. All else being equal, divestment should lead to a lower share price, reducing the value of executive remuneration, thereby incentivising executive management to prioritise and manage material ESG risks and opportunities.

In practice, the impact of divestment on the share prices of fossil fuel companies is inconclusive. There is limited evidence to show that divestment alone has impacted share prices from a valuation perspective. A 2016 study suggested that divestment announcements have a statistically insignificant impact of less than 0.01% on the share price of fossil fuel companies.[3]

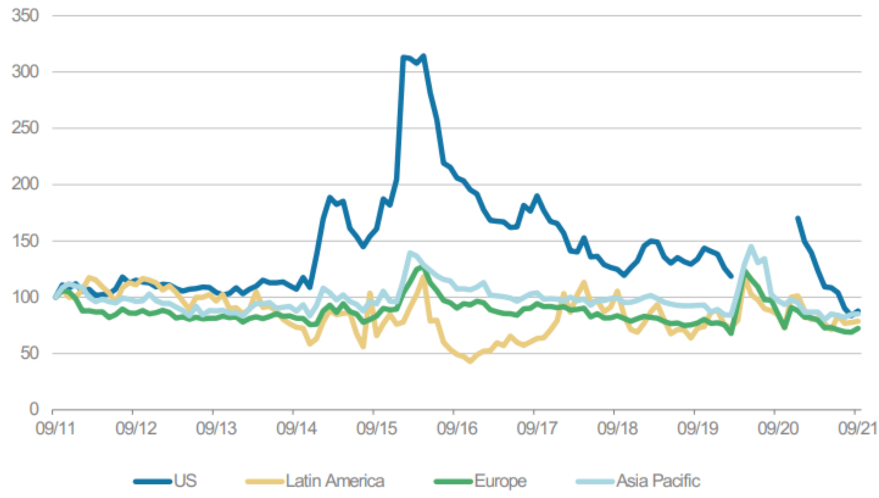
According to another study by Morgan Stanley, both oil and gas and thermal coal stocks have experienced Price to Earnings multiple (P/E) deratings and an implied increase in the cost of equity over the last five years.[4] However, the study notes that it is difficult to quantify exactly how much of these trends can be attributed to exclusions based on ESG concerns.

Of course, the reduction in financing for fossil fuel (e.g. coal and oil) has seen the price of these commodities rise substantially. As such, paradoxically, profitability in the sector has soared of late.

---

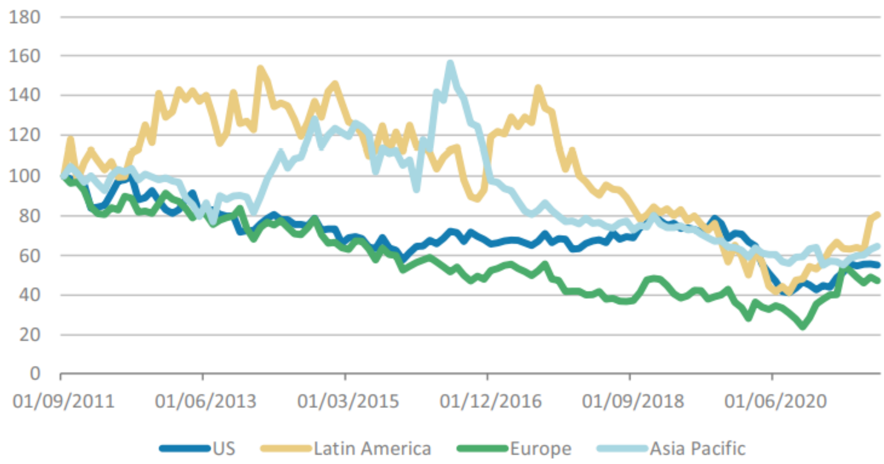
[2] Insureourfuture.co
[3] Truzaar, D., "An event study analysis of the fossil fuel divestment movement", August 2016
[4] Morgan Stanley, ESG Exclusions: Not All The Same, October 2021

P/E multiples relative to the local market (Oil and Gas)



Source: Morgan Stanley Research

P/E multiples relative to the local market (Thermal coal)



Source: Morgan Stanley Research

The limited impact of divestment thus far is perhaps not too surprising if we consider that many of the top investors i.e. with the largest holdings in fossil fuel companies, are governments. Furthermore, publicly listed fossil companies are only a small piece of the pie. Approximately 59% of global industrial GHG emissions come from state-owned enterprises (SOEs), while 30% is from publicly listed companies and 11% from private companies.[5] Investors cannot influence SOEs through divestment where governments have significant control.

So what then is the point of divestment? Simply to tarnish the industry's reputation? Raising global awareness of the urgency of climate change and stigmatising targeted companies and the industry as a whole is where divestment movements have been most successful. Some companies have consequently sold some of their assets, although this hasn't necessarily shut down fossil fuel production (more on this later).

In the case of South Africa, after mounting pressure from the divestment movement, US Congress passed the Comprehensive Anti-Apartheid Act of 1986, banning investment in South Africa and imposing trade restrictions. By the late-1980s, more than 155 universities, 22 governments and 90 cities had divested from companies trading or

[5] CDP Carbon Major Report, July 2017

operating in the country.[6] While it's clear that the campaign played a significant role in raising public awareness of the injustices of Apartheid, the impact on share prices and the cost of capital of South African firms was negligible. In fact, many argue that those forced sales provided wonderful opportunities and returns to local institutions, and investors who were restricted from investing offshore.

Indeed, divestment is seen as a tool to affect social discourse and influence government policy rather than drive share prices lower. Whilst disinvesting from fossil fuel can send a strong message, it may not be the best way to achieve ESG objectives.

Beware of the law of unintended consequences

One disadvantage of divestment is the loss of opportunity to engage directly with a company. Investors who divest lose their voice, voting rights and a seat at the table to discuss ESG issues and drive real change at the company level.

The nature of public equity markets means that you sell your shares to a willing buyer when you divest. In many cases, the willing buyer may be a make-a-profit-at-any-cost investor who lacks any commitment to decarbonisation, or a private investor with no (listed) market governance and oversight. The real irony is that divestment may actually lead to worsening emissions. This is either because buyers of the stock have no intention to engage with the corporate on these issues and are profit-at-any-cost driven, or the fear of largescale and widespread divestment could lead companies to spin-off their high-emitting divisions, making them appear "greener". If the new owner chooses to delay mine closure or ignore requirements to rehabilitate the mines or oil fields, it could worsen environmental outcomes.

One of the stark examples of this is Anglo American Plc's spin-off of Thungela Resources Ltd in 2021 In response to growing investor demand to decarbonise and Anglo's responsible investment policy to transition away from coal, the company demerged its thermal coal operations into a new South African holding company, Thungela, which got listed on the Johannesburg Stock Exchange and London Stock Exchange.

Anglo's intentions were noble — get out of coal without sacrificing jobs in a country facing massive unemployment, and leave the mines in "trusted hands" to run down responsibly. Yet within days, Thungela CEO July Ndlovu laid out ambitions to grow, not shrink, coal production. In addition, Thungela's share prices soared since its June IPO as coal prices surged due to supply-side pressures from the recovery of the global economy and renewed demand for electricity.

Conversely, Glencore and Exxaro Resources have had a more pragmatic approach to winding down their thermal coal assets. These companies and other stakeholders such as South African asset manager Coronation Fund Managers have long argued that they should hold onto their fossil fuel assets and manage their decline in an environmentally responsible manner. There is no guarantee that the new owners would act the same way if the assets were sold.

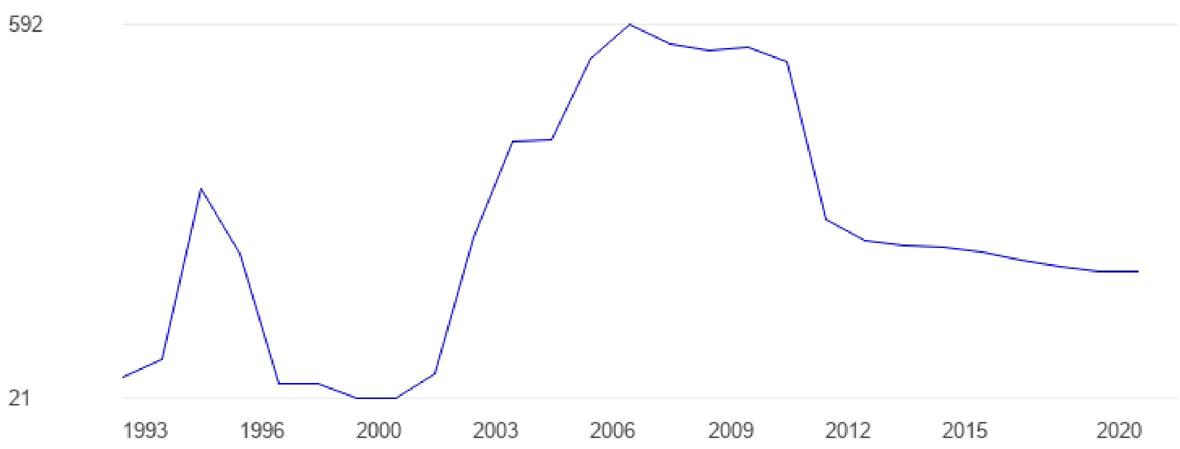
There are other nuances to consider around divestment. For example, energy company Ørsted transitioned from an oil and gas company to one of the largest offshore wind energy producers. Since 2006, the company has cut its carbon emissions by 83%. The company has also committed to carbon neutrality in its energy generation by 2025 and carbon neutrality in its total carbon footprint by 2040.[7] However, since 17% of its energy generation comes from thermal coal, many investors would still divest. Ignoring this important, forward-looking data means investors will miss out on an opportunity to invest in a company committed to ensuring a sustainable future.

Another unintended consequence is that by restricting the investable universe, a portfolio may have increased tracking error compared to its benchmark. Greater volatility and less diversification are often undesirable for institutional investors. This issue is particularly acute in resource rich emerging markets like Russia and South Africa, with their stock exchanges being dominated by fossil fuel heavy energy, mining and manufacturing companies. Not to mention that there has been a significant decline in listed companies on these exchanges. In South Africa, local institutional investors have to invest most of their assets in the local equity markets, and don't have the luxury of avoiding or divesting from fossil fuel companies entirely, like their global counterparts.

---

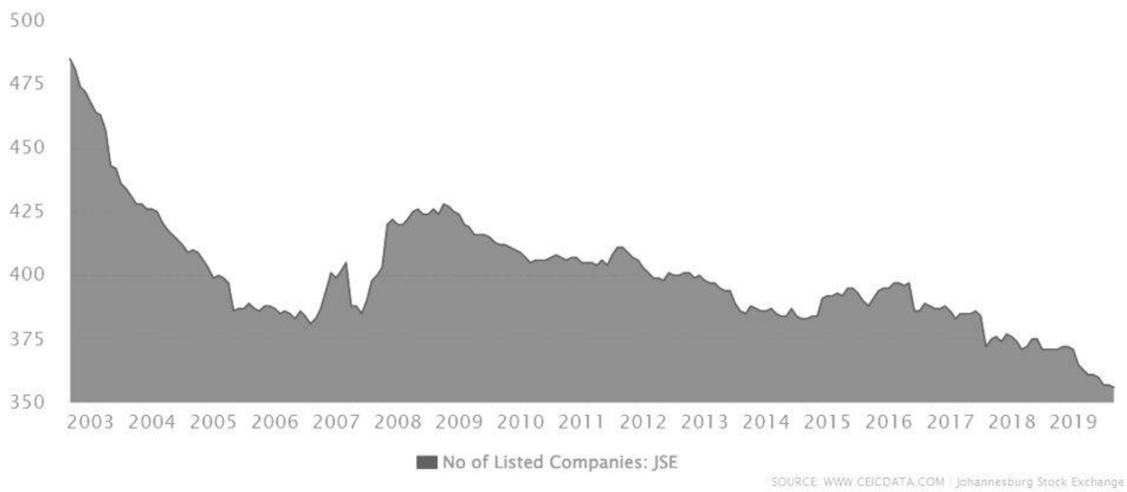
[6] Knight, R., "Sanctions, Disinvestment, and U.S. Corporations in South Africa". Sanctioning Apartheid, 1990.
[7] Orsted.com

Declining number of investible shares on the Moscow Exchange.



Source: The Global Economy

Declining number of investible shares on the JSE



Transferring ownership from concerned shareholders to others who are far less concerned by such, will then, quite clearly, not address the challenge of climate change. Rather, an approach that promotes renewable energy, decarbonises consumption and limits the fossil fuel industry's profitability by internalising costly environmental externalities is critical. Tackling this will require a more measured, pragmatic approach driven by tough engagement, rather than divestment.

What is engagement?

Engagement can be broadly defined as an ongoing dialogue between asset managers and company management on any matter that may impact long-term performance and shareholder value, including ESG practices, business sustainability, rights of minority shareholders or the company's role as a responsible corporate citizen.

Engagement: It's not about where you are but where you are going

Engagement is a powerful tool that can drive deeper commitments to decarbonise at the company level. It is also the mechanism by which the impact on real-world emissions is most likely to materialise. This is why engagement is at the heart of initiatives like the Net Zero Asset Owner Alliance, Net Zero Asset Manager Initiative and Climate

Action 100+. Engagement is built around the belief that companies considered part of the problem can create climate change solutions. However, investors need to keep their seats at the table to drive this.

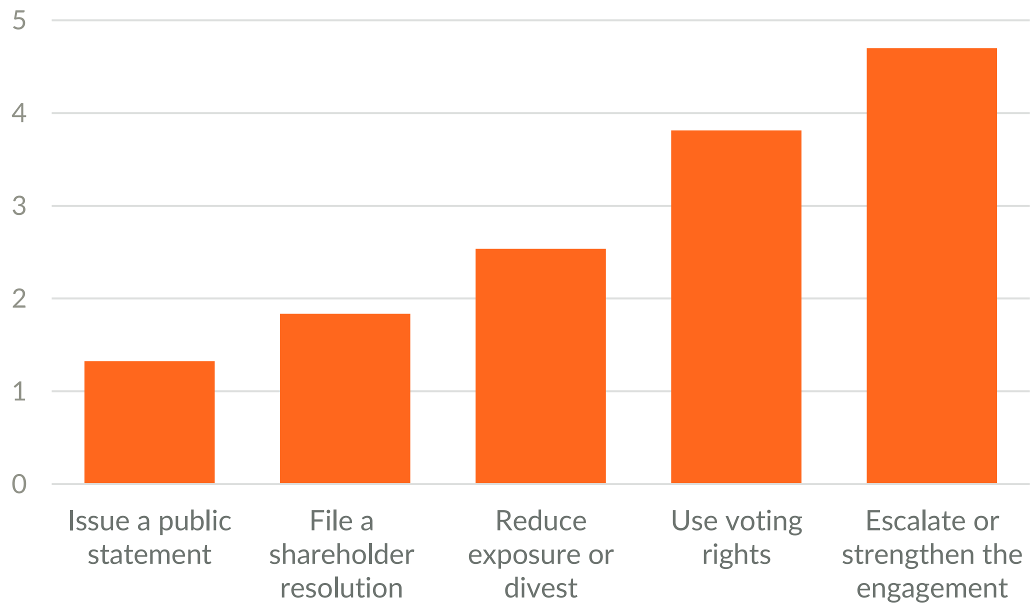
First engagement gives investors insight into a company's willingness and ability to manage material ESG risks and drive sustainable, long-term value creation. Moreover, investors can use their influence as stewards of capital to motivate positive change through constructive dialogue with company management.

Glencore is a great example of this. Glencore signed up for the Climate Action 100+ initiative following ongoing engagement with investors. In 2019, the company also announced it would cap its coal production. Glencore was the obvious buyer when BHP and Anglo wanted to sell their stakes in a Colombian coal mine. In the past, increasing its exposure to coal might have drawn criticism. Interestingly, behind the scenes, Climate Action 100+ supported the sale as it saw the transaction as a way of preventing any mine extensions or the asset from being passed to a less responsible owner. Glencore agreed to reduce its emission targets even more as part of the deal.

Major utility company in the US, Xcel Energy, is another good example. Before engagement in 2018, the company based 60% of its electricity generation on coal and other fossil fuels. Nine months after the engagement started, Xcel became the first US utility to commit to delivering 100% emissions-free electricity by 2050. The company also committed to an 80% reduction in emissions associated with electricity by 2030. Xcel aligned its CEO with the performance of low carbon objectives and published its inaugural Task Force on Climate-related Financial Disclosure (TCFD) report in 2020.

The benefits of engagement are also supported by academic research. Kölbel et al. (2019) concluded that "investors who seek impact should pursue shareholder engagement throughout their portfolio". Dimson, Karakaş and Li (2015) find that positive abnormal returns follow successful engagements. Broccardo, Hart and Zingales (2020) state that "In a competitive world, exit is less effective than voice in pushing firms to act in a socially responsible manner". In a survey of institutional investors, Kreuger, Sautner and Starks (2019) found many of the "larger, long-term, and ESG-oriented investors considered risk management and engagement, rather than divestment, to be the better approach for addressing climate risks". A recent report by RisCura, titled Moving the Needle in South Africa: Stewardship in South Africa, also supports this. The overwhelming majority of asset managers surveyed preferred engagement over divestment.

Escalation measures scored and ranked in order of importance



Source: RisCura

However, engagement isn't easy and can often take years to see the fruits of one's labour. Engagement requires ESG subject-matter experts who can dig deep, evaluating a company's business practices, governance structure, and environmental footprint. It's not periodic letter writing or something only conducted during proxy season. It demands consistent and collaborative dialogue with company boards and executives, requiring grit and determination.

Divest or Engage or Both?

The debate around engagement and divestment is nuanced, and it should be clear that both approaches are not mutually exclusive. There is room for both, depending on an investor's objectives.

When evaluating the two approaches to address climate change, it is important to differentiate between immediate improvement in a portfolio's carbon footprint and creating long-term climate solutions. Divestment is a quick solution to reduce specific ESG and climate risks in a portfolio. However, focusing on divestment alone misses the bigger picture and should rarely be the first preference. Divestment fails to address the systemic, long-term effects of climate change. Divestment also transfers responsibility for tackling climate change to another investor.

Still, there are examples of where corporate engagement has not led to adequate progress. The threat of divestment lends credibility to an investor's engagement strategy when companies fail to respond. Divestment can play a critical role as an escalation tactic and a last resort in an engagement strategy where the requested changes do not materialise. RisCura's stewardship report found that "divestment became an option when it became clear that the issues were too significant to be influenced through engagement, where management or the board were incapable of reasonable resolution through engagement, or when engagement hinted at fraud or other forms of corporate malfeasance." It is essential that investors take a forward-looking view of company decarbonisation ambitions and actively divest from companies failing to demonstrate a sufficient commitment to cutting emissions over time.

As climate disclosure standards are adopted (such as TCFD), and initiatives such as Climate Action 100+ and the Net Zero Asset Manager Initiative and Net Zero Asset Owner Alliance gain traction, we expect the debate will shift beyond divestment and engagement towards how investors can maximise engagement impact to ensure companies become part of the climate solution.