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ENVIRONMENTAL, SOCIAL AND GOVERNANCE

Fossil divestment: investing to save the climate

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Investors are increasingly aware of climate-related risks and one response has been to divest from fossil companies, which, by supplying fossil fuels, are responsible for the source of emissions and are most vulnerable to financial impacts.

What motivates investors to fossil divest? A desire to halt extraction of carbon dioxide generating fuel reserves, while avoiding fossil company investment risks, which Barclays have estimated will lose $34 trillion (£25.8 billion) of revenue from future policy and technology. Differing definitions can confuse those considering this approach.

Investors also debate whether engagement is more effective at influencing fossil companies and there are a number of grey areas that need clarifying.

What is fossil divestment?

Fossil divestment involves severing ties with firms that extract fossil fuel reserves, selling or refusing to own stock in fossil extractors and producers, as backed by the UN Framework Convention on Climate Change in 2015. It is an exclusion, addressing the challenges of society's over-dependence on fossil fuels, and the climate dangers they pose.

The companies excluded extract or produce coal, oil or gas. Some investors set an exclusion policy based on industry sub-sectors or perhaps the FTSE Divest-Invest indices. These indices exclude the oil & gas producers, oil equipment, services & distribution, coal, and general mining sector.

This approach can appeal to investors who are accountable to stakeholders with less investment experience.

In 2018, the Intergovernmental Panel on Climate Change emphasised that to avoid the worst consequences of global warming, temperatures must be kept less than 1.5°C above pre-industrial levels. To achieve this, society needs to halt new fossil fuel infrastructure and bring about an immediate managed decline of fossil fuel production.

The energy transition dictates two investment implications: if fossil fuels are not wound down, the macro-economic climate impact will be severe, but winding down will cause marked losses to fossil companies. Extraction firms will be unable to realise the value of fossil reserves, meaning that current market valuations may be misjudged.

Some believe this is already occurring, arguing fossil fuel assets are increasingly uncompetitive and their market share has dropped from 29% of the S&P in 1980 to 5.3% today.

By avoiding investment in fossil firms, investors are withdrawing capital market support, which can impact new issuance in both equity and bond markets.

The social dimension

Many see fossil divestment as an active social and moral choice. Sections of society are impatient with apparently slow progress on addressing climate issues – and express their views by fossil divestment. They regard the climate damage done by carbon emissions as unacceptable and believe divestment sends a strong signal to companies, governments and their peers to phase out fossil fuels.

This is having an effect, with 20 countries joining an anti-coal alliance launched by the UK and Canada in November 2017.

This suggests divestment is not a 'silent' market operation. The moral aspect implies a public statement of views, censuring the activities of fossil firms for the harm they cause.

The social stigma that divesting investors seek to apply to fossil firms has ramifications. Unemotionally, it could be argued that divesting investors' holdings will just be purchased and held by others, or the firms themselves. Should this prove profitable, the moral dimension suggests the gains may be unacceptably made.

What fossil divestment is not

Some practices should not be regarded as fossil divestment – for example, portfolios that just happen to be fossil-free currently, and impact funds which, although targeting emissions reductions, do not have explicit divestment policies. Also any fossil investments, whether equity or bond and regardless of bond covenants, which may require a specific percentage be used to fund sustainable energy development.

Investment managers who are coincidentally fossil-free or 'impact-focused' should adopt explicit policies to guarantee their divested status. Stakeholders value this transparency.

Investors with a divestment mandate also distrust firms providing services making fossil companies more efficient or reducing their energy consumption. They fear such activities may facilitate more rapid extraction of fossil reserves. They consider attempts by fossil companies to 'green' their portfolios as mostly lobbying to extend their social license.

All investment funds, particularly ethical and sustainable managers, can adopt robust divestment policies. Taking early action can show leadership and accrue client reputation. Advisers and fund selectors can identify pro-active managers and guide their clients accordingly.

The science is clear, to prevent dangerous climate change, decisive steps need to be taken quickly. Media commentary shows that much of the public understands this message, even if the finance sector has been slower to adjust. Perhaps fund managers should listen – early movement could reap significant reputational benefits. ●