Fossil Divestment: investing against global warming

By Dr Quintin Rayer and Tom Harrison | June 27, 2019

Investors are increasingly aware of climate-related risks [1],[2],[3], [4],[5], [6]. One response has been to divest from fossil companies, which by supplying fossil fuels are responsible for the source of emissions [7], and are most vulnerable to financial impacts [8].

What motivates investors to fossil divest? A desire to halt extraction of carbon-dioxide generating fuel reserves [9], while avoiding fossil company investment risks, which are estimated to lose $34 trillion of revenue from future policy and technology [10]. Differing definitions can confuse those considering this approach. Investors also debate whether engagement is more effective at influencing fossil companies [11]. This article discusses what fossil divestment involves, clarifying some 'grey areas'.

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, being backed by the UNFCCC in 2015 [12]. It is an exclusion, addressing the challenges of society's over-dependence on fossil fuels, and the climate dangers they pose. Estimates from July 2017 indicate that the 200 global publicly owned firms with the largest fossil reserves have 492 gigatons of potential CO_2 emissions underground. This is six times more than can be burned to have an 80% chance of limiting global temperature rise below 2°C [13].

The companies excluded extract or produce coal, oil or gas. Some investors set an exclusion policy based on industry sub-sectors. Perhaps the FTSE Divest-Invest Indices which exclude Oil & Gas Producers; Oil Equipment, Services & Distribution; Coal; and General Mining [14]. This approach can appeal to investors who are accountable to stakeholders with less investment experience.

Investment Implications

In 2018, the IPCC (Intergovernmental Panel on Climate Change) emphasised that to avoid the worst consequences of global warming, temperatures must be kept below 1.5°C above pre-industrial levels [15]. To achieve this, society needs to halt new fossil fuel infrastructure and bring about an immediate managed decline of fossil fuel production [16],[17].

The climate-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 [18] and their market share has dropped from 29% of the S&P in 1980 to 5.3% today [19].

By avoiding investment into fossil firms, investors are withdrawing capital market support, which can impact new issuance in both equity and bond markets [20]. Recent estimates suggest that portfolios and endowments approaching $8-9 trillion are now following a fossil divested strategy [21], [22].

The Social Dimension

Many see fossil divestment as an active social and moral choice, with many religious institutions taking a lead [21]. 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 dissociation 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 [23].

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. One objective of divestment is to remove fossil fuel companies' social licence to operate [21]– the ongoing acceptance of a company or industry's practices by employees, stakeholders and the general public [24]. This would be expected to weaken fossil firms' political lobbying power, making it easier for governments to take meaningful action on global warming.

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:
» Portfolios that just happen currently to be fossil free.
» Impact funds which, although targeting emissions reductions do not have explicit divestment policies.
» Any fossil investments, whether equity or bond and regardless of bond covenants.

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 licence.

How this helps Advisers

Ethical and sustainable investors can consider adopting robust divestment policies. By taking early action, wealth managers can show leadership and accrue reputation with their clients. Advisers and fund selectors can identify pro-active managers and guide their clients accordingly. The science is clear, decisive action to prevent dangerous climate change needs to be taken quickly.

Media commentary shows that much of the public understand this message, even if the finance sector has been slower to adjust. Clients increasingly wish to invest ethically; the Investment Association reports £17.0 billion assets in the UK ethical funds sector in March 2019, a yearly increase of £1.7 billion [25]. Advisers need to know how to best help clients by selecting the most appropriate ethical funds and accessing the skills of wealth managers who can support them in this crucial area.

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