FOSSIL FUEL
TO DIVEST OR NOT TO DIVEST IS NOT
THE RIGHT QUESTION

AUGUST 2013
INTRODUCTION

THE U.S. STUDENT-LED CAMPAIGN “GO FOSSIL FREE” HAS APPEARED ON HUNDREDS OF CAMPUSES AND IN CITIES AND FAITH BASED INSTITUTIONS ACROSS NORTH AMERICA.

Student groups at approximately 325 university campuses1 across North America are demanding that university endowments be divested of their holdings in the fossil fuel (oil, coal and gas) industry in an effort to address the issue of climate change. For the investors struggling to address these concerns and those of other stakeholders, there are often no easy answers.

The U.S. campaign has its roots in the activities of 350.org, a grassroots organization whose “Do The Math” campaign has served as the basis for calls to divest.

The “math” according to website 350.org is as follows:

- The London-based Carbon Tracker Initiative estimates that that the consumption of the earth’s proven fossil-fuel reserves would yield five times the level of emissions recommended by climate scientists to stay below a 2 degree Celsius rise in temperature.

- If governments act to keep the temperature rise below 2 degrees C by putting a higher price on carbon (which arguably becomes more likely as we get closer to that threshold), then the value of those “stranded assets,” and companies and sectors which hold those assets, will decrease sharply

1 http://gofossilfree.ca/campaigns
IS CLIMATE CHANGE A RISK WORTH ADDRESSING?

FROM OUR PERSPECTIVE, THE KEY QUESTIONS FOR TRUSTEES IN THIS CASE ARE:

- Is consideration of these types of issues consistent with fiduciary duty?
- Can the issue of climate change be addressed in a manner which maintains (or enhances) long term investment objectives and responds to stakeholder concerns?

Mercer regularly reviews research on environmental, social and governance factors including climate change and investment performance. Our research has identified a substantial body of evidence that suggests that climate change risk could have the potential to impact a Fund’s investments over the long-term. Further, Mercer’s own research on the potential impact of climate change for asset allocation found that climate risk could potentially represent 10 percent of portfolio risk for a hypothetical investor.2

With regards to published legal perspectives on whether a consideration of these types of issues is consistent with fiduciary duty, some argue that fiduciary obligations do exist:

1. The 2005 report A legal framework for the integration of environmental, social and governance issues into institutional investment authored by Freshfields Bruckhaus Deringer concluded that “integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.”3

2. Australian law firm, Baker & McKenzie’s report “Pension and Superannuation Trustees and Climate Change” argued that “most surveys have shown that the majority of Australian trustees now believe that addressing climate change risk is part of their fiduciary duty.” The authors concluded that “Given the risks and opportunities presented by climate change and the rapid introduction of carbon pricing regimes across multiple jurisdictions, trustees have a clear duty to consider climate change risks and relevant laws and policies in making investment decisions when such matters prove to be material.”4

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WHAT SHOULD INVESTORS DO TO BETTER UNDERSTAND CLIMATE CHANGE RISKS AND POLICY ISSUES?

Step one in our mind is a discussion with investment staff and board members about the nature of the risk (and opportunity) presented by climate change. More broadly, we believe that investors should review the potential impacts of environmental, social and governance issues, where material, on future fund performance. From here, each organization can determine the most appropriate way to address the risks/ opportunities.

Divestment is only one possible response. While it is not a new approach, divestment from fossil fuels is relatively untested and potentially difficult for investors for many reasons, such as:

- Fossil fuels represent a significant component of today’s energy mix and they are used in a wide range of commercial and consumer applications
- Appropriate substitutes for fossil fuel companies may be fewer compared to other divestment campaigns such as South Africa and Sudan
- Divesting from such a large sector of equities markets without attention to risk management and reinvestment might be considered a breach of fiduciary duty
- Divestment eliminates a shareholder’s ability to engage with companies and influence business strategy
- There is active debate over the ability of divestment to impact the value or behavior of companies
- Divestment is likely to have up-front and recurring costs
- Institutions may be wary of setting a precedent where they are subject to more frequent company or issue specific student requests (a.k.a. the “slippery slope” of divestment)
IN OUR VIEW, THE ISSUE REMAINS COMPLICATED. THE SIZE OR STRUCTURE OF AN INVESTMENT PROGRAM CAN MAKE WHOLESALE DIVESTMENT IMPractical, EXPensive OR RISKy. AMONG THE ALTERNATIVE OR COMPLEMENTARY OPTIONS THAT INVESTORS CAN CONSIDER ARE TO:

REVIEW EXISTING MANAGER APPROACHES
Investors can review if/how their investment managers consider sustainability issues in the context of managing portfolio risk or improving returns. For example, do they consider future carbon pricing scenarios when assessing investment opportunities?

ACCESS SUSTAINABLE INVESTMENT THEMES
These strategies offer exposure to long-term growth beyond renewable energy and build in downside protection against future carbon pricing. Such strategies are increasingly available across asset classes, and can be particularly attractive in real assets.

VOTE YOUR SHARES
Proxy voting guidelines can be amended to actively respond to shareholder votes on climate risk disclosure, political lobbying and sustainability. Surveys suggest that an increasing number of investors globally are establishing policies with regards to voting considerations on shareholder resolutions related to climate change.

ENGAGE WITH COMPANIES AND POLICY MAKERS
Participation in collaborative initiatives like the Investor Network on Climate Risk, Carbon Disclosure Project, The US Forum for Sustainable and Responsible Investment, and the UN-backed Principles for Responsible Investment urge companies, investors and governments to consider the benefits of climate change mitigation from an economic perspective. These initiatives allow investors of all types to share resources and maximize impact while providing valuable learning and networking opportunities.

START A COMMITTEE
Higher education endowments often have campus sustainability committees with student representation. Expanding the scope or creating a new committee – as some North American universities have - to review sustainability issues related to the endowment can provide the Investment Committee with useful information and serve as a valuable means of engaging key stakeholders, including students and alumni.

The conversation about fossil-fuel divestment and its implications should be an informed and open exchange exploring the relationship between sustainability and long-term investment objectives so that meeting the goals and objectives of the organization remain the primary aim. We believe there are ways in which investors can consider climate change and a broad range of sustainability issues within the context of their current investment structure and objectives.
Mercer encourages clients to consider responsible investment approaches and the proactive management of climate risk. Mercer employs a specialist team of 15 professionals that help institutional investors integrated environmental, social and governance factors throughout the investment process.

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