# Institutional investors grappling WITH CALLS FOR CARBON DIVESTMENT

By
Yaldaz Sadakova

Five years ago, Mats Andersson had an epiphany.

The CEO of the Fourth Swedish National Pension Fund, known as AP4, was travelling to meet with other pension executives. He asked them about the biggest risks their investment portfolios were facing and got detailed, sensible answers in each case. "Then I asked them, 'What's your exposure to climate risk?' There was silence."

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*"The cleaner [energy technologies] are coming down so dramatically in price that they're going to make the demand for fossil fuels a big question going forward."*

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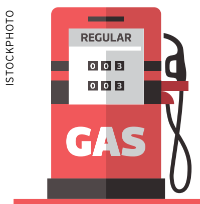


**57%** of divesting institutions were based in the United States in 2015, a number that compares to 78% in 2014.

Source: Arabella Advisors

Andersson flew back to Stockholm with a determination to decarbonize the portfolio of a pension fund then valued at US$35-billion. He saw climate change as one of the biggest financial threats AP4 faces but he acknowledges many other institutional investors didn't see it that way.

Today, they increasingly do. A number of global institutions are moving to divest their portfolios of fossil fuels and reallocate money to green assets. In Canada, a presidential advisory committee at the University of Toronto recently produced a report recommending it divest from companies that disregard a target of limiting the rise in global temperatures to 1.5 C. The University of British Columbia, however, recently voted against divesting but is planning to set up a fund focused on environmentally friendly investments.

Agreements negotiated during last year's Paris climate change conference suggest the potential for more aggressive future actions. In that light, companies and those that invest in them are sure to face questions about the issue.

Amid the pressures, critics of carbon divestment are getting louder as they question whether dropping fossil fuel assets and targeting commodities can, in fact, help fight climate change.

But to Andersson, even more important than those considerations is the big picture. "It's our fiduciary duty to make sure that we, as long-term investors, put climate risk on the agenda. We're agnostic in how you do it."

## How AP4 does it

AP4 started its divestment journey by calculating the carbon footprint of every company in its equity portfolio, not just those focused on fossil fuels. It took out 150 names — including BP, Diageo and Nestlé — representing the largest carbon polluters in each economic sector. The rationale behind going across the board was that climate change affects all companies, no matter what their line of business is, and they all need to do their part to fight it, says Andersson.

Today, AP4 has decarbonized about 25% of its global equity portfolio and the goal is to purge it completely by 2020. It has decarbonized its entire Swedish equity portfolio. That wasn't hard because the carbon footprints of Swedish companies are low compared to the rest of the world, Andersson notes.

"By doing this, we have lowered the carbon footprint in our entire equity portfolio by some 30%," he says. "And since the inception of this strategy, AP4 has gained 200 basis points. There's no conflict between sustainability and good returns. Sustainability is a way to actually enhance your returns long term."

The next step for AP4 is to decarbonize its fixed-income and alternative assets by 2020, says Andersson. The moves are part of a growing trend.

A 2015 report by Arabella Advisors reveals 436 institutions and 2,040 individuals with a total of US$2.6 trillion in assets have pledged to divest from fossil fuels. That compares to 181 institutions and 656 individuals in 2014.

They include California's two biggest public pension funds (the California Public Employees' Retirement System and the California State Teachers' Retirement System), as well as universities, faith-based organizations, municipalities and hospitals.

Pension funds represent the largest single group of investors committed to divestment, followed by private companies, according to Arabella Advisors.

## Stranded assets and other investment risks

But not everybody is abandoning the fossil fuel industry.

Some large investors, such as the Ontario Teachers' Pension Plan, are instead engaging with companies to encourage them to develop climate change solutions.

But Yossi Cadan, global senior divestment campaigner at 350.org, a global grassroots organization that calls on institutions to drop fossil fuels from their portfolios, sees no point in investors' engagement efforts. "I'm not sure what they're looking for. That tomorrow [these companies] will phase out all fossil fuels and move to produce wind turbines? That's not going to happen. It's their core business model that we're fighting, and engagement is not going to change that."

The core business model of fossil fuel companies means they could end up with unused reserves, or stranded assets, as the world moves towards limiting carbon.

Scientists estimate the planet can absorb no more than 900 gigatons of carbon dioxide by 2050 to have an 80% chance of remaining within a 2 C rise in global temperatures. But the amount of carbon dioxide emissions that would result if the world used all of its fossil fuel reserves is about 2,860 gigatons. "A precautionary approach means only 20% of total fossil fuel reserves can be burnt to 2050," according to a 2013 report by Carbon Tracker, a non-profit organization, and the London School of Economics.

"In the absence of negative emissions technologies, the carbon budget for the second half of the century would only be 75 (gigatons) to have an 80%

probability of hitting the 2 C target. This is equivalent to just over two years of emissions at current levels," the report noted.

There's also an economic argument for divestment, says Martin Grosskopf, vice-president and portfolio manager with AGF Investments. "The cleaner [energy technologies] are coming down so dramatically in price that they're going to make demand for fossil fuels a big question going forward."

And, says Andersson, fossil fuel companies will suffer as governments introduce carbon taxes or other regulations during the next 10 years or so "because they'll have higher costs and lower valuations."

Carbon taxes definitely dampen demand for fossil fuels because consumers will have to pay more for conventional energy as companies pass the cost on to them. But Werner Antweiler, an associate professor at UBC's Sauder School of Business, believes a carbon tax — which he sees as the definitive solution to climate change — could encourage fossil fuel companies to invest in renewable energy.

### 'Shades of grey' in the energy sector

Some companies are already doing that, which is why portraying them all as "the villain in this debate" is counterproductive, says Antweiler. "There are very much shades of grey across the different players in this industry," he notes.

"You have companies like Exxon Mobile, which has been lobbying against the climate policies that other companies like BP have taken a more proactive stance on and are actually major players in investments in renewable energy because they consider themselves energy companies, not just fossil fuel companies," he says, referring to BP's investments in wind and biofuels.

The Canadian Association of Petroleum Producers also sees divestment as counterproductive. "Any third-party campaigns that target a specific industry or commodity, like oil and gas, aren't appropriate or effective," says spokesperson Chelsie Klassen.

Canada's oil and gas industry, for example, has reduced greenhouse gas emissions by 30% per barrel since 1990, she adds. "Many companies in our industry are driving innovation. It doesn't make any sense to protest against [them]."

Several Canadian oilsands companies — through what they call Canada's Oil Sands Innovation Alliance — have recently invested more than $1 billion to develop and share among themselves 814 technology patents, many of which focus on the reduction of carbon emissions.

One of those technologies is carbon capture and storage, which involves burying the carbon dioxide resulting from extraction instead of emitting it. Shell Canada is using it for its Athabasca Oil Sands Project. The Alberta and federal governments have contributed a total of $865 million to the technology.

But carbon capture is costly. Since 2007, total investment in the technology has amounted to US$20 billion, according to the Global Carbon Capture and Storage Institute. But the money has resulted in only "tens of projects" currently in

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**Q: Divestment is just one possible investor response to climate change, what are some others?**

The investment community has developed a lot of different approaches to address climate change, including:

**Measure ›** Prepare a carbon footprint that analyzes the greenhouse gas emissions associated with investments.

**Engage ›** Initiate dialogues with companies and regulators to encourage policies, plans and performance that are consistent with limiting warming to 2°C above pre-industrial levels.

**Hedge ›** Adopt an investment strategy that reduces or offsets exposure to climate change related risks.

**Invest ›** Invest in renewable power, energy efficiency and other solutions that will help reduce greenhouse gas emissions.

**Q: Why would an investor calculate and disclose the carbon footprint of its investments?**

Carbon footprints can help investors evaluate some elements of climate change related risk, namely policy and regulation, reputation, litigation and quality of corporate policies and performance. A portfolio carbon footprint also allows investors to understand the contribution the entities they invest in are making to the increasing concentration of $CO_2$ in the atmosphere and to global climate change.

A carbon footprint is a measure of the greenhouse gas (GHG) emissions. A company's footprint is typically given as its GHG emissions over a given period of time (t $CO_2$-eq/y) while for investment portfolios, there are a variety of carbon footprint metrics including owned emissions (the sum of the portfolio's portion of the greenhouse gas emissions of each company in the portfolio) and weighted average carbon intensity (the average carbon intensity, tonnes of GHG per $1M revenue, of each investment in the portfolio weighted by the investment's weight in the portfolio).

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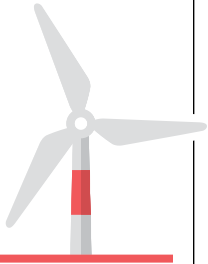

Worldwide investment in clean energy hit **US$310 billion** in 2014.

Source: Arabella Advisors

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operation or under construction, the institute notes, pointing out they "take time to design, permit and construct."

Yet carbon capture requires wide adoption to make a difference, according to a 2012 report by the International Energy Agency. And another problem with carbon capture is it perpetuates reliance on fossil fuels, says Cadan.

### Will divestment make a difference?

Critics of carbon divestment don't buy those arguments. To them, the main problem is that divestment won't alleviate climate change.

"It's a symbolic move that has no practical consequences," says Antweiler. "Let's not fool ourselves that it will have any effect on carbon emissions."

Even if all institutional investors drop their assets when companies' stock prices decline, other investors will snap them up at a bargain, Antweiler notes. "Unless you have a 100% boycott of fossil fuel companies, it's not going to make a dent."

There will always be fossil fuel buyers, Cadan concedes. The reason for 350.org's campaign isn't to cripple companies financially but to strip them of what he says is their influence over environmental regulations. "In Canada, every single climate change regulation was directly written by the fossil fuel industry," he suggests. "We're looking to break this power structure to the point that politicians are free to make the right decisions based on science and not on pressure."

### Other opportunities abound

Those who divest of carbon assets often redirect the cash to cleaner alternatives. "There are millions of opportunities," says Andersson.

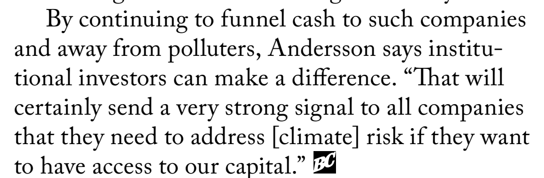
For AP4, the next step in that space is unlisted assets. Swedish law, however, forbids the pension fund from buying unlisted assets. That means it can't invest directly in renewable energy projects, for example, but must instead invest in funds to do so. But Andersson expects that regulation will disappear at some point.

"What's holding the industry back is that many pension funds and long-term investors have not really admitted that climate risk is one of the big risks that we have," he says.

Another barrier is the fact that the green industry is emerging and investment professionals are less familiar with it. The fossil fuel industry, on the other hand, is an asset managers know well. "If you've worked in this industry for 30 years, you're going to be way more familiar with doing the math on a deal in oil and gas than you will be in solar," says Grosskopf.

"Right now, within some of the renewable power companies, there's a lot of transition going on: business models, cost of capital, government policy changes. So you've got a lot of moving parts that people are not that comfortable with," he adds.

But, he says, investors shouldn't limit themselves to companies selling products and services that help the environment and should also consider traditional companies. "We've owned Whole Foods in the past. For years, Whole Foods was getting the best margin from being very early into the natural and organic theme. Now, a lot of the margin is flowing to conventional grocers who are taking it seriously."



By continuing to funnel cash to such companies and away from polluters, Andersson says institutional investors can make a difference. "That will certainly send a very strong signal to all companies that they need to address [climate] risk if they want to have access to our capital." BC

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### FOSSIL FUELS A RISKY INVESTMENT?

In the second half of 2014, Canada's biggest public pension funds suffered losses as commodity prices declined.

"The top 20 funds had estimated holdings of approximately $27 billion in fossil fuel company stock prior to the commodity price fall. This translates into losses of approximately $5.8 billion, a conservative estimate based on equities only," according to a recent study by the Canadian Centre for Policy Alternatives.

The top 20 public pension funds in Canada had about 4% to 9% of their assets invested in fossil fuel equities, according to the report.

It also suggested the losses make divestment all the more necessary and recommended reinvesting the money in projects like green infrastructure.

But Werner Antweiler, associate professor at the University of British Columbia's Sauder School of Business, doesn't necessarily see those losses as a reason to divest. Pension funds have lost money because energy stocks are susceptible to commodity cycles. For a long-term investor, he says, a temporary loss is normal.