



## FOSSIL FUEL DIVESTMENT

Over recent months, we have seen the call for “fossil-free” portfolios reach a fever pitch. It seems like every time we open a paper that another university or foundation is announcing that they will be selling all of their investments in coal, oil and gas producers. It has been framed as a moral imperative – a way to avoid the risk of “stranded assets” and a means to address the causes of climate change. Whatever the motivation, the idea of fossil-free portfolios certainly seems to be gaining momentum and is moving from being something for endowment and not-for-profit portfolios only, to the mainstream of large institutional asset owners and retail investors. In this article, we look at going fossil free and consider an alternative approach that in the long run may be less direct but more effective.

### Why divest?

The fossil fuel divestment movement initially focused on universities, endowments and foundations, but it is rapidly moving to more mainstream and larger asset owners. The motivations for divestment seem to fall into three broad categories: moral, environmental and financial.

The moral argument equates fossil fuels with other undesirable or ethically dubious products – such as weapons, gambling, alcohol and tobacco – that a variety of investors choose not to invest in. For example, PH&N Community Values Funds exclude a number of these so-called “sin” industries from the portfolios. If investors wish, fossil fuel companies can certainly be screened from a portfolio in the same way, and indeed such exclusionary screens have been incorporated into many portfolios for decades. Eliminating fossil fuel producers from a portfolio to accommodate moral concerns with the industry is a valid and direct approach, with the added benefit that it is a very public statement of the investor’s views on the fossil fuel industry. So as a way to accommodate moral concerns with the fossil fuel industry, divestment would seem to be a useful tool.

Now let us consider divesting as a means to reduce or reverse the causes of climate change. While divestment may be intuitively appealing as a means to address the causes of climate change, in reality it is at best ineffective and at worst counter-productive. What we need to remember is that

man-made climate change is largely the result of burning fossil fuels and the only way to address it is by burning less. As such, it is an issue of demand (how much we use), rather than supply (how much is produced); therefore, solutions that address demand will be more effective than solutions that address supply, such as divestment. If a significant number of investors began selling shares in fossil fuel companies, it would result in a short-term decline in a fossil fuel company’s stock price. However, there will still be demand for the company’s underlying fossil fuel products and, as such, its production will not be impacted by the declining stock price. Ultimately, the decline in stock price will be short-lived, as other investors will see the disconnect between the stock price and the value of the company’s underlying fossil fuel assets, and will continue to buy the stock until this discount is eliminated. In this scenario, divestment does not impact demand for fossil fuels, which is the real driver of greenhouse gas (GHG) emissions.

The most often talked about financial reason for fossil fuel divestment is the “stranded assets” argument, which is a result of the generally recognized upper warming threshold of 2°C relative to pre-industrial levels to avoid the dangerous impacts of climate change. This threshold was formally adopted by world governments in 2010 as a goal to limit warming to an acceptable level and guide policy development. This 2°C limit has been used to calculate the world’s carbon budget, and these calculations indicate that we have already consumed over half of the available budget. At current rates of emissions, society will overshoot this budget in 50 years – 16 years if emissions keep rising unchecked. The inescapable consequence is that a significant portion of reserves will have to be left in the ground to avoid the more serious impacts of climate change. These reserves are referred to as stranded assets.

The stranded assets argument essentially relies on one flawed assumption – that the market is unaware of or mispricing this risk. We need to remember that markets are generally efficient and will incorporate all available information into the price of a security. Fossil fuel companies are not ignoring the potential impact of climate regulation, but rather they are actively monitoring the risk as it evolves and

are incorporating it into their planning and business models. Likewise, investors are aware of the risks of stranded assets and climate regulation, and incorporate them into any decision to buy or sell shares in a fossil fuel company. The general consensus from industry analysts is that there is no indication of a fossil fuel “bubble,” and it would appear that the market is incorporating the risk of stranded assets into current valuations. The most likely scenario is that regulation will be phased in over time and fossil fuel use will be phased out over time, which will allow the market to adjust supply to meet the changing demand. The likelihood of drastic and unanticipated regulation forcing the widespread write-off of significant fossil fuel reserves that would impact valuations is unlikely at this time.

Finally, it is important to note that fossil fuel companies have the potential to be part of the solution to the problem of climate change. Rather than fossil fuel companies somehow preventing progress on addressing climate change, they are strong advocates for some of the key elements of a lasting solution. A prime example of this is implementing a price on carbon. Fossil fuel companies have been strong advocates for putting a price on carbon at national and international levels, as this would remove the uncertainty of the current global patchwork of regulations and legislation – and this is especially true for Canadian fossil fuel producers. A global price on carbon would allow fossil fuel companies to make better decisions on what resources to develop and overall capital allocation. In addition, it will encourage the development and adoption of new technologies and more efficient energy use. It serves no benefit to exclude potential allies in the fight against climate change, and fossil fuel companies have an important role to play as we develop and implement climate change solutions.

## Measure and manage your portfolio’s footprint

An alternative approach to fossil fuel divestment is portfolio carbon intensity. This is where you measure the carbon intensity of your portfolio, usually on a CO<sub>2</sub> per-dollar-of-revenue basis. Once you have a measure of your portfolio’s carbon footprint, you can start to reduce its carbon intensity. Often, this is done on an industry basis and is a similar methodology to the best-of-sector approach developed

by Sustainalytics and used in PH&N Community Values Funds and RBC Jantzi Funds. Rather than excluding whole sectors, you would rank the companies in a sector from best to worst, then exclude the worst performers and concentrate your holdings on the better performing companies. So in the case of carbon intensity, you would look to “tilt” the portfolio’s holdings towards companies with lower CO<sub>2</sub> per dollar of revenue than other companies in the same industry and, by doing so, will reduce its overall carbon footprint. This approach has several advantages over the fossil fuel divestment approach. Firstly, it focuses on fossil fuel users, rather than producers, and it encourages companies to perform better than their industry peers. In particular, for fossil fuel producers, it encourages more efficient extraction methods. In addition, this approach will reduce the portfolio’s overall carbon intensity and emissions, to a much greater degree than just divesting from fossil fuel producers. Overall, taking a carbon intensity approach would seem to be an effective way to manage a portfolio’s carbon risk while also encouraging practices that reduce overall emissions.

Climate change is a complex problem that requires complex solutions. No doubt, investors do have a significant role to play, but with any approach we choose to take, we need to understand what it is we want to achieve and be as effective as possible for both our portfolios and the planet.

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