# Recent developments and implications in *fossil fuel divestment*

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The movement pushing college endowments to divest from carbon-based assets has been gaining momentum. Recently, Stanford University announced that it would no longer invest in stocks of companies that are primarily engaged in coal mining. While this is a much narrower level of divestment, this news electrified the movement because Stanford, with its $18 billion dollar endowment,[1] is by far the largest and most prestigious of the universities and colleges that have pledged some level of divestment.

[1] Source: 350.org. Other colleges and universities include: College of the Atlantic, Foothill-De-Anza Community College Foundation, Green Mountain College, Hampshire College, Naropa University, Peralta Community College District, Pitzer College, Prescott College, San Francisco State University Foundation, Sterling College and Unity College.

The arguments in favor of divestiture range from the purely social to those anchored in fundamental analysis. The social and philosophical arguments are based first, and foremost, on the concept that benefiting financially from a harmful activity is unethical. This is very similar to the investment philosophy of some investors (including many public pension funds) that bars investments in alcohol, tobacco, firearms and other controversial industries.

Several studies suggest that the effect of divestiture on investment returns is minimal. In a report by Aperio Group, which backtested the effect of screening out carbon-based assets from a US equity portfolio, concluded that the effect was only a few basis points on average. While this analysis is correct and based on sound analysis, it is based on returns from a limited time period of January 1998 to December 2012.[2] This analysis is highly period-dependent, as a repeat (however unlikely) of the 1973 oil embargo or some other crisis that drives up oil prices would leave portfolios without exposure to traditional oil assets.

[2] Source: Aperio Group, "Do the Investment Math: Building a Carbon-Free Portfolio," 2013.

There is another argument for divestiture that is based primarily on fundamental analysis. These investors believe that the oil assets owned by oil companies are a "stranded asset," meaning an asset whose marketability is impaired by technological displacement and falling demand. These investors also point to the declining success of exploration programs and rising costs. The argument for divestiture based on philosophical or social values is countered by some by pointing to the possible investment costs and the concept that social issues are not compatible with fiduciary duty. However, the "stranded asset" argument implies that it is imprudent to own assets that are likely to be worth far less in the future, and so the sale decision could be, in fact, prudent and consistent with investment principles.

If oil prices have peaked and the push toward alternative energy impairs the demand for petroleum, then the stranded asset argument could have some validity. According to the US Energy Information Administration (EIA), US oil imports peaked in 2006–2007 and have been heading downward ever since. Demand has been curtailed by a number of forces, including improving gas mileage, Internet shopping and natural gas production. China, however, is the largest energy consumer in the world, accounting for about one-third of world consumption. While the Chinese government has sought to cap imports through conservation and the development of alternative energy sources, reining back demand will be very difficult. Given that China is the largest user of coal in the world, any effort to displace coals should naturally result in increased oil demand, since the EIA estimates that about 11% of world energy consumption is from renewable energy sources. Ironically, a slower GDP growth rate, a worrisome development for some investors, should actually be helpful in cutting back energy use.

Our conclusion is that divestiture of coal assets is not particularly risky, given that they are not very economic because of much cheaper and cleaner natural gas. The divestiture of oil companies is also probably not enormously risky because of relatively slow global economic growth and efforts to displace oil with other energy assets. Alternative energy is displacing some oil demand, but in general the impact on demand is modest, and huge investments in storage and distribution are necessary before stronger effects can be seen. We believe that natural gas in the US, however, is going to displace oil in the medium term because it is cleaner and cheaper. While there are some dangers from hydraulic fracturing and methane leakage, environmentally safe exploration and good production practices should provide enough safeguards to make natural gas preferable to other carbon-based alternatives.

The final question revolves around the effectiveness of divestiture itself. Here, the views are similarly divided. Many large public plans believe that by holding ownership stakes, voting their shares and agitating for change, the policies and strategies of energy companies can be subjected to public pressure. Those in favor of selling look to the positive effects of South African divestiture during the apartheid years. However, the primary effect of divestiture on South Africa was to trigger capital flight with the goal of impairing that nation's economy. This capital could not be replaced internally and was prevented from being replaced by economic sanctions. In contrast, the sale of carbon-based assets by one class of investors is matched by purchases from other investors, having little net effect. It seems to us that an activist approach may be more effective on changing corporate activity than divestiture.

# Looking to an older Protocol *to reduce future greenhouse gases*

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The Kyoto Protocol is dead; long live the Kyoto Protocol. While not actually dead, the Protocol has certainly not been very effective, as the two largest carbon emitters—the US and China—have not actively met their targets for carbon reduction. When the Protocol was signed in 1997, President Clinton indicated that the agreement would not be ratified without a pledge of participation by China and developing countries. By 2005, when the agreement went into force, the US had pulled out. The 37 participating countries had some success in reducing emissions, but this came fairly easily since Eastern Europe had massive scope to modernize its utility and industrial base, greatly reducing emissions. Meanwhile, the rest of Europe, with an aging population and slow economic growth, did not have much trouble reducing emissions either.

Unfortunately, while some regions of the world have reduced emissions, these reductions were completely overwhelmed by a surge in emissions from China, South Asia, South America and Africa. Using 1990 as a base year, emissions have increased by about 50%.[1]

Today, because of a combination of political opposition, economic pressure and lack of cooperation between the nonparticipants, the chance of participation by the world's largest industrial economies, the US and China, is slim indeed. The good news, however, is that an agreement struck by President Ronald Reagan in 1989 stands as the most effective environmental treaty in history. While originally intended to eliminate the use of chlorofluorocarbons (CFC), the Montreal Protocol has had the unintended effect of eliminating some of the most powerful greenhouse gases.

Both Reagan and Prime Minister Margaret Thatcher enthusiastically backed the 1989 Montreal Protocol on Substances that Deplete the Ozone Layer. Their motivation for supporting the agreement is not well recorded, but Nobel Prize-winning research showed that CFC compounds had actually created a hole in the ozone layer.[2] In her early career, Thatcher had been a research chemist, and Reagan was an avid outdoorsman who had had skin cancer, so it is thought that they understood that CFCs had a dire effect on our atmosphere that could lead to significant destruction of the protective ozone layer.

[1] Quirin Schiermeier, "The Kyoto Protocol: Hot Air," *Nature*, Nov. 28, 2012.

[2] Justin Gillis, "The Montreal Protocol, a Little Treaty That Could," *The New York Times*, Dec. 9, 2013.

A recent scientific paper suggests that one important factor in slowing global warming has been the elimination of CFCs because of the Montreal Protocol.[3] The paper suggests that a slowdown in global warming in the 1990s was aided by the elimination of CFCs, as well as by a drop in methane emissions.

[3] Francisco Estrada, Pierre Perron and Benjamín Martínez-López, "Statistically derived contributions of diverse human influences to twentieth-century temperature changes," *Nature Geoscience*, Nov. 10, 2013.

CFCs were replaced by hydrofluorocarbons (HFCs), chemicals that do not deplete the ozone layer, but do act as greenhouse gases. The good news is that there is hope for an amendment to the Montreal Protocol that would phase out and ban HFCs. The US and China have agreed to ban these chemicals, and the last holdout, India, appears to be coming on board.

A coherent global regime to eliminate these damaging greenhouse gases has practical implications for a number of industries, including appliances, autos, housing and other industries that use refrigerants. These are global industries that would greatly benefit from global standards and a common set of permissible chemicals to provide cooling. The supply chains that make refrigerators, air conditioners and other products that use these chemicals span the globe and often involve the manufacture of products in one region that are then sold and delivered in another. For example, appliance supply chains often originate in China but are completed in the US. Auto air conditioner supply chains often begin in the US or Japan and complete in Asia or in Europe. A common standard would likely mean much simpler assembly routines and common products across geographies that improve efficiency, servicing and repair. In turn, these developments bring efficiencies that allow better margins, profitability and simplification of the manufacturing process itself.

# Improving *corporate governance* in Japan

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One of the factors holding back corporate restructuring in Japan has been the inability of shareholders or activists to wield significant influence over companies. In particular, US-based activist shareholders have been largely ineffective, although local Japanese activists have not had much luck either.

Hostile takeovers in Japan have often failed. Of 23 takeover attempts in Japan since 2000, 16 were not successful.[1] At arms' length, Japan would appear to be a ripe target for activist investors and shareholders. Corporate profitability is low, returns on assets and equity are low by global standards, and many Japanese companies hold billions of dollars of excess noncore assets, including excess cash, real estate, share holdings, excess manufacturing facilities and many noncore businesses that have been acquired haphazardly over time.

[1] Kana Inagaki, "Japan Is Hostile to Activist Investors," *The Wall Street Journal*, May 13, 2014."

However, several factors, some peculiar to Japan, make outside pressure much less effective in getting results. First, many public Japanese companies are part of groups of related companies that own shares in each other. This cross-holding culture is a direct outgrowth of the zaibatsu, or business groupings, which launched Japan's industrial revolution at the turn of the last century. Typically, these arrangements feature a large bank at the center to provide capital and holding companies to build and diversify the industrial base. As a result, four zaibatsu—Mitsubishi, Sumitomo, Yasuda and Mitsui—control a great deal of the Japanese economy

Originally, the zaibatsu structure was meant to share knowledge and capital and to coordinate management input. But now, the cross-holding structure preserves a clubby group of insiders who appear largely impervious to outside influence. As a result, failed business strategies, poor decision-making and diversification into completely unrelated business lines have not had significant negative consequence for managements and their boards. Mistakes are papered over, and only in very extreme instances, usually involving some sort of public scandal or an industrial accident, do managements apologize and resign.

However, Prime Minister Shinzo Abe wants to change these cozy arrangements. There is now an understanding that for "Japan Inc." to grow—through increasing economic opportunity, growing wages and ending the destructive deflation of the last decade—

there must be reform and restructuring that result in more competitive levels of profitability. This can be greatly helped by external pressure.

Outside of Japan, pension funds and investment managers have played a central role in ensuring better corporate governance. Pension funds, led by some of the largest in the world, have not been shy to call out managements that they feel are not acting in the shareholders' best interests. To further leverage their influence, pension funds have been allocating assets to activist managers that make a living shaking up companies. Academic articles support this approach to the generation of strong returns.[2]

The newly minted Japanese stewardship code is remarkable for achieving sign-on from 130 institutional investors. The stewardship code calls for shareholder disclosure of voting at annual meetings, inspired, at least in part, by the new UK stewardship code written after the financial crisis of 2008.[3]

It will take some time to see if external pressure, as well as internally led reform, can raise Japanese corporate profitability. There are early signs of movement in the right direction. Panasonic is focusing on housing and automotive while pulling back from consumer electronics.[4] Hitachi, one of Japan's most complex companies, is shedding noncore businesses and also refocusing on core competencies.[5] This wave of restructuring has the potential to close the profitability gap with the rest of the world and to drag the Japanese economy out of the doldrums, in an environment where Japanese corporations have underearned and overinvested. With low valuations, and many Japanese companies priced at less than the replacement cost of assets, investment managers remain cautiously optimistic about the future.

The implications for active investors are considerable, as Japanese firms have generated some of the lowest returns on equity (ROE) and invested capital of any developed market for many years. While the Japanese market has risen off its lows due to Abenomics, we believe that a more durable recovery will need to be driven by a revival of earnings and profitability. A wave of restructuring that changes the level of ROE in Japan from single digits to mid-double digits would increase the valuation of companies substantially, probably by as much as 40%–60%. In our view, this hidden potential could be unlocked by management and employees if they accept it as a goal. Better governance and constructive external pressure have an important role to play in prompting a long-term improvement in corporate profitability, a change that would be experienced at the company level, potentially benefiting active investors who can identify this transition as it happens. ⁂

2 April Klein and Emanuel Zur, "Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors," *Journal of Finance*, Vol. 64, Issue 1 (February 2009), pp. 187–229.

3 Reuters, "Almost 130 institutional investors adopt Japan shareholder code," June 10, 2014.

4 Reuters, "Panasonic plans $2.7 billion of fresh restructuring," March 28, 2013.

5 Stephen Harner, "Hitachi Ltd. CEO Nakanishi Writing Template for Restoring Global Competitiveness for Japanese Industry," *Forbes*, October 29, 2012.

# Sustainable Investing Team Leadership

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