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The Logic of Divestment: Why We Have to Kiss Off Big Carbon Now

As climate-change activists pressure public institutions to dump their fossil-fuel investments, it's becoming increasingly clear that the right thing to do is also the smart thing to do

By Tim Dickinson | January 14, 2015

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The greatest impediment faced by the divestment movement today is misinformation. Jeff Chiu/AP

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When the fossil-fuel divestment movement first stirred on college campuses three years ago, you could almost hear Big Oil and Wall Street laughing. Crude prices were flirting with $100 a barrel, and domestic oil production, from Texas to North Dakota, was in the midst of a historic boom. But the quixotic campus campaign suddenly has the smell of smart money.

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One of the biggest names in the history of Big Oil – the Rockefellers – announced last September that they would be purging the portfolio of the Rockefeller Brothers Fund of "risky" oil investments. And that risk has been underscored by the sudden collapse of the oil market. After cresting at more than $107 in mid-June, the price of a barrel of West Texas Intermediate dipped below $50 a barrel in early January. The crash carries big costs: Goldman Sachs warned that nearly $1 trillion in planned oil-field investments would be unprofitable – even if oil were to stabilize at $70 per barrel. The industry is already scaling back the hunt for high-cost sources of new oil. Chevron has shelved drilling in the Canadian Arctic, and Hercules Offshore, a significant driller in the Gulf of Mexico, has idled four rigs and laid off more than 300 workers.

Plunging profits are also putting the brakes on fracking. The biggest player in North Dakota, Continental Resources, is cutting expansion plans by more than 40 percent for 2015. And if crude prices drop much lower, the U.S. boom could go bust. The break-even price in North Dakota's Bakken field, Continental CEO Harold Hamm confessed to *Business Week* in November, is $50 a barrel. Oil's collapse threatens to destabilize global governments from Caracas to Tehran to Moscow. And it is punishing the valuations of oil companies: From late June to early January, across the world, the 10 oil firms with the largest proven reserves collectively lost roughly 20 percent of their market value.

As painful for oil investors as this market spasm has been, it may just be a taste of greater punishment to come. In November, when the U.S. and China announced a historic agreement to curb carbon emissions in coming decades, it sent a strong, if vastly overdue, message to the world's carbon kingpins: Global governments are mobilizing to meet the threat of climate change. If they're going to take that message seriously, more than two-thirds of established fossil-fuel reserves will have to stay in the ground.

A 2013 study by the bank HSBC warned that between 40 and 60 percent of the market value of European fossil-fuel companies, like BP and Royal Dutch Shell, could be wiped out in a carbon-constrained world. This past October, the head of England's central bank, Mark Carney, declared that "the vast majority of reserves are unburnable." Carney warned that fossil-fuel investors, focused on short-term profits, were not pricing in this reality – a phenomenon he called a "tragedy of horizons."

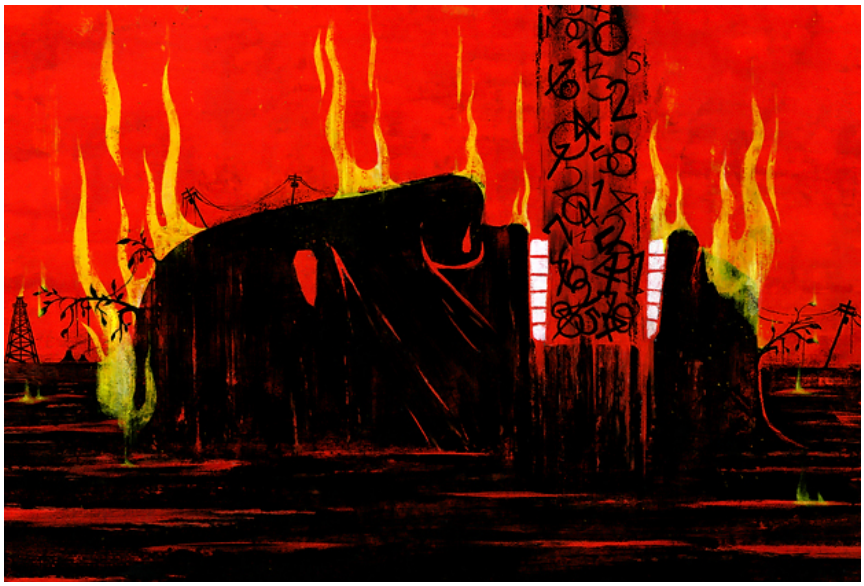
Mark Carney WPA/Pool

But a growing number of savvy, social-minded investors are waking up to this risk and moving their money out of fossil-fuel stocks. In September, as the price of oil was entering its free fall, 50 foundations announced they would be ending their investments in fossil fuels over the next five years – a deal orchestrated by Divest-Invest Philanthropy. An initiative launched by the Wallace Global Fund to encourage institutions to exit Big Carbon investments and begin capitalizing sustainable alternatives, Divest-Invest has now secured more than $50 billion in divestment commitments. And these climate-conscious philanthropists are driving toward an even more ambitious goal: $150 billion in divestment commitments before the next round of U.N. climate talks in Paris next December.

These foundations require high-market returns to fund their philanthropy, and are managed by investment professionals loathe to leave returns on the table. But Jenna Nicholas, project manager of Divest-Invest, says there was minimal arm-twisting required. "The financial argument for divestment is actually stronger than the argument for maintaining holdings in these companies," Nicholas says. Indeed, Big Carbon investments are "severely overpriced" in the market, wrote Bevis Longstreth in a 2013 piece called "The Financial Case for Divestment of Fossil Fuel Companies by Endowment Fiduciaries." Longstreth, who served as commissioner of the SEC under Ronald Reagan, wrote, "Fiduciaries have a compelling reason, on financial grounds alone, to divest these holdings before the inevitable correction occurs."

The headliner among the 50 divesting foundations was the $860 million Rockefeller Brothers Fund, which stewards part of the fortune of John D. Rockefeller, founder of Standard Oil – whose corporate offspring include Exxon Mobil and Chevron. "Obviously the money came from oil," says RBF trustee Valerie Rockefeller Wayne. "We embrace the irony of that."

Sidebar



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For RBF, the logic of divestment was twofold. "There was a very clear moral impetus to do this," Wayne says. RBF makes significant grants in the field of sustainable development, and the fund reached a breaking point with Big Carbon over what Wayne describes as "the schizophrenic notion that we had investments that were undermining our grants."

But there was also "an economic reason for divestment," Wayne says. RBF's business is philanthropy. It was determined not to damage its portfolio. But as RBF scrutinized its fossil-fuel investments, it began to have concerns. One of the primary assets on an oil company's books are its "proven reserves" – that is, the oil in the ground and beneath the oceans that will be the source of future profits. RBF questioned the wisdom of parking its money in companies that, in a low-carbon world, would not be able to bring that oil to market – "proven reserves" risked becoming "stranded assets." RBF also balked at investing in companies that continue spending astronomical funds in the hunt for even more unburnable oil. Exxon Mobil, America's largest oil company, despite having more than 25 billion barrels of proven reserves, sunk more than $7 billion into new exploration in 2013 alone. "There is no good reason for this vast expenditure of stockholder wealth," wrote Longstreth. (He has also served as chairman of the finance committee of the Rockefeller Family Fund.) "It is wasted capital," he continued, "an offense against stockholders in terms financial alone."

Heirs of oil magnate John D. Rockefeller, have decided to rid their family fund of fossil-fuel investment. Hiroko Masuke/NYTimes/Redux

There's no stronger marker of the growing clout of the divestment movement than the fact that the oil majors now feel compelled to trash it. After ignoring activists for years, Exxon Mobil took to its corporate website last October to blast divestment as "a movement that is out of step with reality," adding, as only an oil company could, that "to not use fossil fuels is tantamount to not using energy at all, and that's not feasible."

The dismissive stance of Exxon Mobil echoes that of large institutional investors – most conspicuously Harvard University, with its massive $33 billion endowment – who have argued that not to invest in fossil fuels is not to invest soundly. Harvard President Drew Faust presaged Exxon Mobil's line of argument by writing in a 2013 open letter that fossil-fuel divestment is neither "warranted or wise." (Faust declined to be interviewed for this article.)

Exxon Mobil and Harvard have business-as-usual on their side. What they don't have in their corner are the facts. The financial arguments mustered against divestment simply do not hold up under scrutiny. Indeed, the greatest impediment faced by the divestment movement today is misinformation – a litany of debunkable myths about the cost and benefits of kissing off Big Carbon.

MYTH #1: Divestment Costs Too Much

The most damaging misapprehension about divestment is that dumping fossil-fuel stocks means sacrificing profit. As Faust wrote in her letter, "Logic and experience indicate that barring investments in a major, integral sector of the global economy would . . . come at a substantial economic cost."

But more and more investment professionals are rethinking this assumption. Historically, oil and coal stocks have been solid investments, functioning as a bulwark against inflation and included in institutional portfolios by default, says Donald Gould, chief investment officer of L.A.-based Gould Asset Management, which manages more than $450 million in client funds. Gould has a unique perspective on divestment. His firm specializes in traditional asset management (not socially responsible investing). But he also chairs the investment committee at Pitzer College in Southern California, where last year he helped the administration figure out how to divest its $125 million endowment from fossil-fuel stocks, arguing that the moral benefit for the college trumped any possible financial fallout. While a market purist might deem a carbon-free portfolio "suboptimal," Gould says, "it's a very low impact. If you take the fossil-fuel companies out, you're still very well diversified."

> "To not use fossil fuels is tantamount to not using energy at all," Exxon said in a response to the divestment movement. "And that's not feasible."

In fact, financial professionals who model divestment returns have found there is no reason to assume there will be a "penalty" for shunning Big Carbon. The Aperio Group, based near San Francisco, modeled the returns of a carbon-inclusive index like the Russell 3000 against a hypothetical version of the index tweaked to exclude fossil-fuel stocks and reweighted to approximate the risk profile of the original index. The result? From 1988 through 2013, the Russell 3000 had a yield of 10.63 percent; the same index minus Big Carbon stocks would have yielded 10.68 percent – a barely measurable difference.

Other studies suggest that carbon-free investing could even offer higher returns: S&P Capital IQ, a division of McGraw Hill Financial, modeled the performance over the past decade of the S&P 500 index stripped of its fossil-fuel stocks. A $1 billion endowment invested in a carbon-free S&P 500 would have yielded an additional $119 million in profit through 2013 – a divestment dividend rich enough to fund 850 four-year scholarships.

MYTH #2: Fossil Fuels are a Safe Investment

Past performance, they say, is no guarantee of future results. And nowhere is this more true than with investments in fossil-fuel companies. The "spasms of volatility" now roiling the oil markets, Gould says, may cause portfolio managers to rethink the orthodoxies of oil stocks: "The risk," he says, "may be higher than it used to be."

Exxon Mobil, of course, scoffs at the notion that its ability to profit from its 25 billion barrels of proven reserves is in any way threatened. World governments, it wrote last March, lack the political will to impose the emissions reductions required to stabilize global temperature rise at 2 degrees Celsius: "The policy changes such a scenario would produce are beyond those that societies . . . would be willing to bear, in our estimation." Exxon calls this low-carbon scenario "highly unlikely" and neatly deems it unworthy of financial analysis.

Xi Jinping, China's president, left, and U.S. President Barack Obama at the G-20 summit in Brisbane, Australia on November 15th, 2014. Bloomberg/Getty

But even before President Obama and Chinese President Xi Jinping announced their climate accord in November, Exxon Mobil's spin had been undercut by the Paris-based International Energy Agency. In June, the IEA released an independent analysis projecting that carbon curbs strong enough to meet the 2 degrees Celsius threshold could leave nearly $300 billion in stranded fossil-fuel investments by 2035. The IEA's report buttressed the findings of the investment bank HSBC, which in its study of European fossil-fuel giants warned that the gigatons of unburnable carbon reserves on the books could become all but worthless.

The overall shock to the value of oil companies posed by these low-carbon targets, HSBC's analysts wrote, could be "equivalent to 40 to 60 percent of the market capitalization of affected companies." Free-market orthodoxy – specifically the theory of "efficient markets" – would argue such future risks are already reflected in a company's stock price. But it appears increasingly likely that the market in Big Carbon stocks is no more "efficient" than the subprime mortgage market was circa 2007. In a warning that should keep anyone with oil in their portfolio up at night, HSBC cautioned, "Because of its long-term nature, we doubt the market is pricing in the risk of a loss of value from this issue."

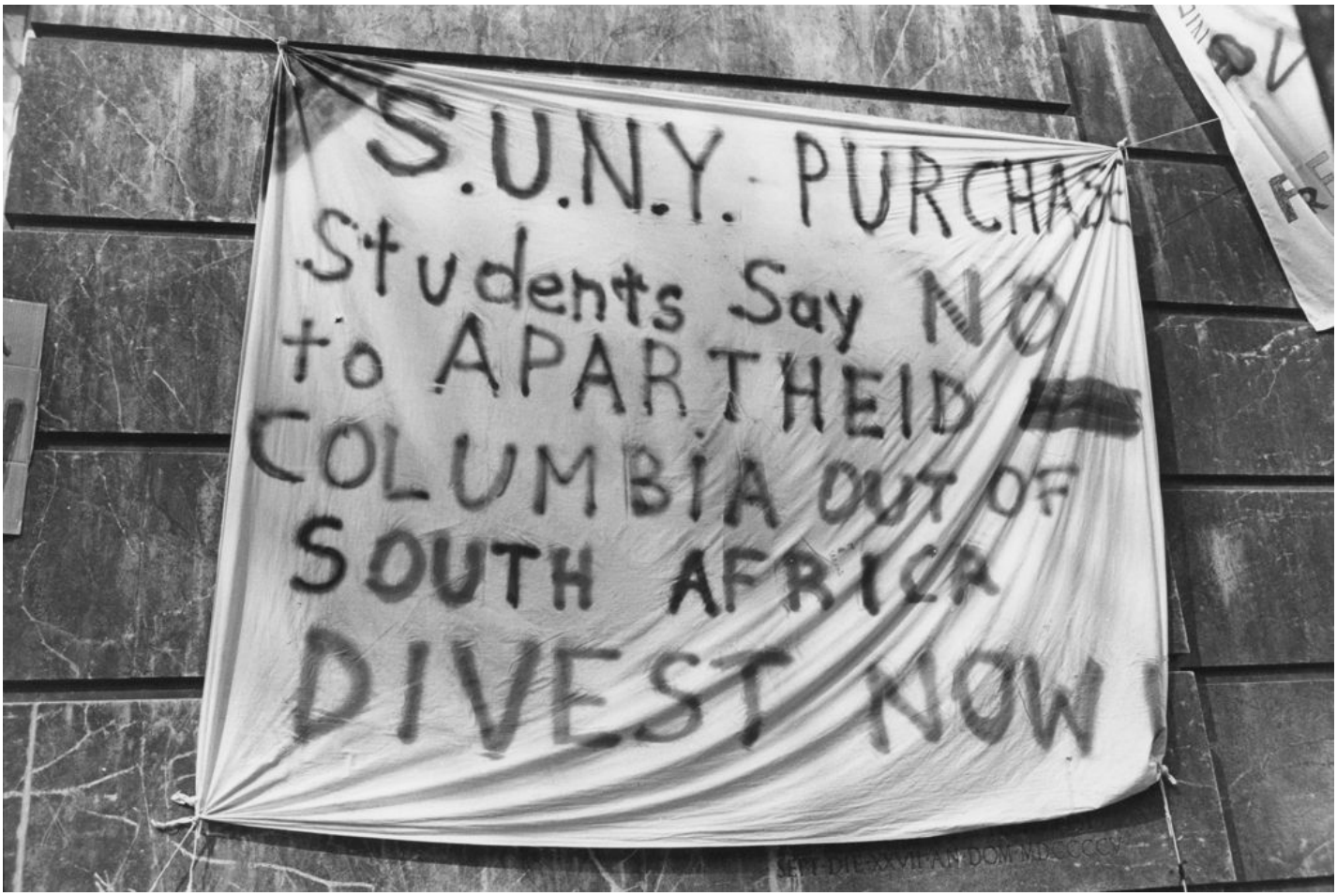
MYTH #3: Divestment is Too Political

Exxon Mobil may have dismissed concerns about the threats to the value of its proven reserves, but it's interesting to note that the oil giant did not contest the science of climate change. Instead, the company revealed its confidence that it has the upper hand in the politics of climate change: It's simply betting that the world's governments lack the will to enforce low-carbon scenarios scientists insist are necessary to avoid climate havoc.

The brazenness of this approach bursts another myth: that remaining invested in fossil-fuel companies is somehow a neutral choice. In her open letter, Harvard's Faust insists that the endowment is strictly an economic resource, and should not be used "as a tool to inject the University into the political process." But any institution that remains invested in fossil fuels today is implicated in the politics of global warming. "If you own fossil fuels, you own climate change," says Ellen Dorsey, Wallace Global Fund executive director. "And it's not just owning their environmental impacts. You own their political impacts too" – from the PR campaigns challenging climate science to the direct lobbying by oil companies of federal, state and municipal governments to block emissions limits. "You're helping to build their war chest."

MYTH #4: Fossil-Fuel Divestment is Harder than South Africa Divestment

Every conversation about divestment loops back to South Africa – where the student-led divestment movement in the 1980s helped topple the apartheid government. Veterans of that struggle recognize climate change as a cause of equally fierce moral urgency. Archbishop Desmond Tutu recently called reducing greenhouse emissions "the human-rights challenge of our time," and has exhorted investors to embrace divestment. "Move your money out of the problem," he said, "and into solutions."



A banner at an anti-apartheid protest by students at the entrance to the Hamilton Hall building of Columbia University, New York City on April 4th, 1984. Barbara Alper/Getty

But the idea persists that moving money out of fossil fuels is a more daunting task than unwinding investments in South Africa was. In reality, Big Carbon divestment is simpler – so much simpler, Dorsey insists, that it is "ridiculous" to compare the two.

At the dawn of the 1980s, roughly 40 percent of the companies in the S&P 500 did business within segregated South Africa. Divesting from South Africa meant jettisoning some of the hottest stocks of the day – including IBM and Kodak – sacrificing the kind of upside we might associate with Apple or Alibaba stocks today.

By contrast, the divestment movement is targeting just 200 of the largest publicly traded fossil-fuel firms, globally – 100 from oil and gas and 100 from coal – ranked by the size of their proven reserves. Despite a few notorious marketing feints, none of these companies have shown an appetite for reinventing themselves as sustainable businesses. BP, which once marketed its initials as standing for "Beyond Petroleum," is in the process of getting out of wind and solar.

Here at home, such companies account for less than 11 percent of the S&P 500. Fossil fuel also comprises a small portion of the typical investment portfolio – typically four to eight percent. Consider Pitzer College. In its $125 million endowment, just $5.4 million was wound up in Big Carbon. Since embarking on divestment in April, Pitzer has now reduced its exposure to less than $1 million. As an asset manager, Gould couldn't be happier. "Divesting in April 2014," he says with a smile, "was a good financial decision."

MYTH #5: The Alternatives are Too Risky

While it's true that many activist investors choose to pair divestment from Big Carbon with investment in clean energy, these are separate investment strategies with different risk profiles. "For many portfolios," says Jamie Henn, director of strategy and communications for 350.org, the hub for college-divestment activism, "it doesn't literally make sense to shift money out of Exxon Mobil and into solar."

But it also doesn't mean that the entire energy sector is off limits. Consider the case of the electric company NRG, today the nation's fourth-largest carbon polluter, and owner of dozens of coal- and natural-gas-fired power plants. In November, its CEO, David Crane, committed to reducing the company's emissions by 90 percent by 2050, telling *The New York Times* that he sees the divestment movement as a powerful market signal. He likened his company's dash to sustainable power to the hallmark of NHL great Wayne Gretzky: skating to the puck.

As a result of the bright line the divestment movement draws between fossil-fuel producers and today's fossil-fuel consumers, divestors have more flexibility in creating a diversified, low-risk portfolio, says Henn. An investment in Exxon Mobil, he says, can be unwound and replaced by investments in an array of other large industrial concerns, featuring similar risk profiles: "They're basically equivalent."

David Crane views solar panels above a parking lot at Arizona State University in Tempe, Arizona. Bloomberg/Getty

MYTH #6: Divestment Doesn't Do Anything

A final entrenched belief among top institutional investors is that fossil-fuel divestment is empty symbolism. "If we and others were to sell our shares, those shares would no doubt find other willing buyers," Faust wrote. "Divestment is likely to have negligible financial impact on the affected companies." The Swarthmore College board relied on the same logic in choosing to prop up its dirty-carbon portfolio: "If we thought divestment would change the behavior of fossil-fuel companies, or galvanize public officials to do something about climate change, or reduce America's reliance on fossil fuels," it wrote, "this would be a much tougher decision."

Such proclamations of inefficacy ring strange, in particular coming from Harvard, which has a proud divestment history: South Africa in the 1980s, Big Tobacco in the 1990s and Darfur in the 2000s.

They also ignore the effects of stigmatization documented in a recent study by Oxford University. Stigma in business routinely depresses the valuations of huge companies. The Oxford researchers pointed to the comparative valuations of oil giants Rosneft and Exxon Mobil. As of June 2013, the Russian company Rosneft was actually pumping more oil per day than Exxon. Yet its market value was less than one-fourth of Exxon's, owing to Rosneft's reputation for poor corporate governance. That stigma gave investors comparatively less confidence in Rosneft's ability to convert current reserves into future profits.

The divestment movement, the Oxford analysis concludes, is succeeding in stigmatizing coal companies, whose shrinking markets and high pollution output have made them corporate pariahs – and the first investments to be jettisoned by portfolio managers under pressure to go green.

The campaign could impose equally lasting financial damage on the oil majors. Financial markets respond to subjective judgments, the Oxford authors argue. To the extent that divestors create an expectation that regulation will increase, they can "materially increase the uncertainty surrounding the future cash flows of fossil-fuel companies." That, in turn, "can lead to a permanent compression in the trading multiples – e.g., the share price to earnings (P/E) ratio of a target company."

In addition to its potentially stark financial impacts, divestment is also driving wider, less quantifiable social change. By uniting universities, philanthropies, churches and countless individual investors in shared action, says Dorsey, "it is providing a tool for advocacy that was clearly missing – or stymied, because the political system, at least in this country, was shut down."

If many institutional investors remain skeptical of its efficacy, the divestment movement itself keeps racking up victories. "This snowball is rolling downhill," Dorsey says. In October, the University of Glasgow became the first school in the European Union to commit to purge its endowment of fossil-fuel investments. Down Under, the Australian National University announced it would unwind investments in seven resource and mining firms – striking a nerve in a nation that ranks second in the world in coal exports, and leading hard-right Prime Minister Tony Abbott, who pines for Australia to become "an affordable energy superpower," to call the decision "stupid."

Sidebar

Fracking's Real-Life Victims »

Divestment is increasingly being taken up by religious groups around the world – in September, the Church of Sweden announced it had purged its $830 million portfolio of fossil fuels. Cities on the front lines of climate change are also purging their investment funds – including Seattle and Oakland.

Slowly, the wheels of our political systems are also beginning to move. In July, the World Bank, responding to pressure from climate activists, announced that it would largely stop financing coal-fired power plants. In December, the pro-tem leader of the California State Senate proposed legislation that would force the state's massive public retirement funds – with more than $400 billion in assets – to divest from coal. And in his January inaugural address, California Gov. Jerry Brown called for his state – already a leader in wind and solar – to get half of its electricity from renewables by 2030.

Drawing particular scorn from Exxon Mobil, the U.N.'s special envoy for climate change endorsed the tactic of divestment last July. "We can no longer invest in companies that are part of the problem of the climate shocks that we're suffering from," said Mary Robinson, formerly the president of Ireland. And in perhaps the most radical word uttered in his presidency, even Barack Obama has given voice to the movement, exhorting activists in a 2013 climate speech delivered at Georgetown University to "divest."

Ultimately, argues John D. Rockefeller's great-granddaughter, the tipping point will come when mounting losses awaken investors to the false security of fossil-fuel investments and they begin to embrace the upside of a clean-energy future.

"If you look back," says Valerie Rockefeller Wayne, "when John D. Rockefeller Sr. got into the business, we got our oil from whales. It's preposterous, right? His big breakthrough was to get oil out of the ground. The breakthrough now is going to be in clean energy. You should be there at the forefront. Those are the investors who are going to make the most money."

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