Divestment, reinvestment:
What role can institutional investors play in financing the transition to a low carbon economy?

2 June 2016

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We believe that over the last few years, and especially since the December 2015 COP 21,[1] held in Paris, it has become abundantly clear that the financial system has an essential role to play in the transition toward a low carbon economy. Whether by creating dedicated investment products, or through the allocation choices of investors, the financial system does in fact have the power to massively redirect capital toward projects and companies that contribute to the struggle against climate change. We have seen the emergence of new solutions, such as Green Bonds or Renewable Energy Strategies in Infrastructure. Some institutional investors have made public commitments to climate protection. Pressure is also mounting, it would seem, to 'decarbonise' investment portfolios—that is to say, reduce their carbon footprint. We believe, for investors, the issue has multiple facets. First of all, that of responsibility: many citizen groups and non-governmental organizations have condemned the environmental consequences of fossil fuels and call for investors to withdraw their support from companies involved. Risks are an additional angle to be taken into account. Is it sound reasoning to invest in companies that will experience growing regulatory pressures and risk seeing their profitability and financial ratings crumble? The possibility of some companies going bankrupt cannot be denied, as witness the collapse of Arch Coal, a U.S. coal industry leader, in January of 2016. Lastly, the energy transition must be analysed from the perspective of the opportunities it holds, which investors wish to take advantage of: development of renewables, emergence of new energy-efficient business models etc.

In the midst of this context, a debate is raging over what position institutional investors ought to adopt. Can they continue to support the fossil fuel industries? Should they massively redirect their capital into financing a low carbon economy? On the one hand, critics point to market neutrality to deny the capacity of investors to effect change, while on the other, utopians push for total divestment from fossil fuels. Others, claiming to be pragmatic, recommend a judicious sectorial allocation based on realistic scenarios. Implementing this last, however, poses problems: how can one take into account the constraints of each investor and its initial position. What, then, is to be done?

[1] Climate Conference commonly known as COP21 (21st annual Conference of the Parties).

From criticism to inaction: is it not time for a change?

We believe that critics of divestment exert considerable force in the world of finance, and even within the realm of SRI.[2] In defence of stasis, they propose three main arguments. The first is that of investor neutrality. According to naysayers, investors do not have an active role to play in the economy, but ought rather to follow and reflect reality. Their portfolios should thus reflect the world as it is, seen through the prism of their investment universe. Against this view, one might, however, argue that investors' allocation choices affect the cost of capital for companies, in turn impacting their profitability and capacity to finance new projects. Let us for a moment imagine that the totality of investors in a company decides to sell their shares and bonds. Excluded from the capital markets, such a firm would have no option but to turn to banks for financing, potentially at high interest rates. But suppose that banks also turn away our hypothetical company: unless it secures private capital from outside the banking system—limited and often expensive—the business will find itself severed from all forms of financing and risks being smothered into bankruptcy. While such scenarios are rare, companies have always taken campaigns to boycott them seriously—the most striking example is South Africa, when individuals and investors withdrew their support from companies collaborating with the country's Apartheid regime.

The second argument of critics further advances this notion of investor neutrality. Divestment would not only be useless, according to them, but might in fact prove counterproductive. Useless—because each time an investor sells a company's stock, it is bought by another investor, and the process is consequently without real effect. Counterproductive—because stocks would likely be sold to investors who are indifferent to environmental issues. According to divestment naysayers, investors ought to use active engagement as a means to encourage good practices, rather than selling their securities. Theoretically, there is no denying the soundness of the argument: engagement is certainly an essential lever for investors, and a genuine impetus for change. However, it reaches its limit when applied to companies whose economic model is too clearly incompatible with the values being defended. Can we really envision investors in a coal company lobbying in favour of a reduction in coal production? Such a course of action would not only be financially damaging to the company, and thus to its investors, but would make it less competitive relative to competitors with less concern for environmental topics. This amounts to the same argument offered investors—by stepping aside, one simply opens the way for the less virtuous. Faced with this shell game, divestment seems to us the more straightforward and effective position.

And lastly, the third argument concerns the impact on divested companies. A full financial boycott of a business would result in its bankruptcy, and thus termination for its employees. For investors that consider themselves responsible, this is hardly an acceptable solution. What answer can be made to this? Naturally, bankruptcies and layoffs are not the goals to which advocates of divestment aspire. However, in the absence of systematic adherence, which remains highly unlikely at present, the consequences of divestment initiatives are likely to be limited to increasing the cost of capital for target assets. Is it not virtuous to financially penalise businesses whose future is endangered in favour of those with brighter horizons? We believe such measures actually promote job creation in the sectors of the future, and the migration of workers toward these areas.

Massive divestment: the utopian fallacy

While arguments in favour of stasis appear fairly questionable, we believe the solution is by no means to be found in the other extreme, which would consist in total and massive divestment. It is unlikely that a brutal and total reallocation of capital would resolve the issues facing the energy transition.

Some movements call for immediate and massive divestment, in order to completely eliminate polluting activities from the economic landscape. While highly visible and sometimes perceived as representative of divestment, they are vulnerable to criticism and garner little following. The energy transition is precisely that: a transition. We believe it's a necessary one; a desirable one, but still a process that must take place progressively. How quickly is open to debate—faster might be better—as are its objectives, which might

[2] SRI: Sustainable & Responsible Investments.

be more ambitious if the goal of a 1.5°C to 2°C global temperature rise is to be respected. Nonetheless, it is only realistic to admit that our economic system is not today ready to abandon all forms of fossil fuels, nor likely to be within the 2050 horizon.

In point of fact, a number of seemingly radical divestment activists prove to be significantly more pragmatic than would appear. They are aware that it is neither probable nor desirable that their recommendations be immediately and unanimously adopted. And, while they seem to actively call for a boycott of fossil fuel companies, we believe this is not their real objective. Rather, they have made a calculated wager that the transition has need of engaged participants, leaders of the pack so to speak. By adopting radical positions they step up to play this role, so essential for developing awareness of the risks associated with 'business as usual' and directing capital toward the solutions needed to conduct the energy transition.

Is pragmatism the solution?

Given that none of the extreme positions appear satisfactory, would a pragmatic approach to asset allocation on the part of institutional investors constitute an answer? Probably, but how would one define such an allocation? As concerns the energy transition, we believe anticipation rather than established fact holds sway. This is true, for instance, of the International Energy Agency's annually published scenarios.[3] Such scenarios are not prescriptive in nature; their function is to help guide the decisions that everyone must make on their own. The main risk of the pragmatic approach would then be taking such scenarios at face value, resulting in 'rigid pragmatists', seeking at all costs to align their investment strategy with published forecasts—as though these might actually predict what the world of tomorrow might look like or need. This kind of behaviour would be erroneous and risky.

We believe the energy transition is a subject too complex and fraught with conflict for authority to dictate its contours beyond a doubt. Were it even possible, this would not suffice to justify a categorical approach. The financial world is not a mirror image of the economic world, and thus no projection can precisely equate to an investment strategy. The latter will always contain some form of bias: representational bias for instance—the realm of listed equities is not representative of the entire economy; geographical bias, for another—as issues facing the United States are different from those affecting France, Germany or Japan and so on. Rigidity can even be dangerous. Imagine a world in which *all* investors relied on a single scenario in forming expectations. There would be no innovation, no differentiation, and *in fine*, no more capacity to adapt. The result would be the ubiquity of pro-cyclical management—the very behaviour regulators are currently seeking to reduce—as well as increasing recourse to passive management, which has been called into question by some in finance.

This being said, although a macro-economic scenario is clearly dangerous to follow blindly, it should by no means be ignored. We believe we are experiencing a major energy transition, and it is appropriate to develop an investment strategy that fits into this dynamic. For this reason, energy transition issues, and social and environmental issues generally, are attracting ever more attention from agents in the realm of finance, who consider these topics from two angles: that of responsibility, certainly, but also that of asset management and their own interests, meaning: what position ought they to assume in this rapidly changing environment. In the end, we believe that it is more important to share a common goal than subscribe to a prescriptive scenario, thus offering players enough latitude to find the path best suited to their situation.

Offering solutions to investors in the shift to a low-carbon economy

Thus, views are many and varied where divestment is concerned. Each must adopt a position as they see fit. Mirova seeks to offer investors financially attractive long-term solutions that provide significant social and environmental impact. This centred and pragmatic but open positioning has led us to develop solutions that are open and multi-purpose, as for instance, our global investment strategy of 'Energy

[3] World Energy Outlook, International Energy Agency

Transition'. Nonetheless, we believe certain investors wish to engage more deeply. As a third party asset manager, Mirova's role is to respond to such requests, as long as they appear to be in keeping with a sustainable economic model. This is why we created and currently manage an infrastructure strategy entirely dedicated to renewable energy, a European 'Environmental' strategy and a global bond strategy dedicated to Green Bonds. For the same reason, we also offer large investors engagement strategies that permit them to exert a concrete influence on the assets they hold.

Mirova's investment strategies are pragmatic and diverse. Our objective is to offer investors of differing scales, regardless of their initial position, solutions that provide a good fit in addition to being excellent from an environmental, social and financial perspective.