Tom Sanzillo, IEEFA Director of Finance
Kathy Hipple, IEEFA Financial Analyst
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Fossil Fuel Investments: Looking Backwards May Prove Costly to Investors in Today's Market

Money Managers Need to Recognize Poor Performance and Offer Fossil-Free Options

The powerful fossil fuel industry continues its steady decline as evidenced by: Its last-in-class S&P position in 2018, a decade of lagging stock market performance, fewer institutional investors, depressed profits and a weak outlook.

Given the underwhelming performance of oil and gas stocks over the past decade, fiduciaries and money managers should be leading their investment pitches with fossil-free funds, only offering traditional indexes if pressed by clients, according to analyses by the Institute for Energy Economics and Financial Analysis (IEEFA).

A close look at the data over time makes it plain that meeting investment targets with fossil-free funds has become technically simpler—and financially more lucrative—over the past decade.

Last year, after almost three years of rising oil prices, the oil and gas sector placed dead last in the S&P 500. This follows a ten-year trend of lagging in the market. The industry's fall has been long in the making. In 1980, the industry claimed 29% of the S&P 500. Today, it only occupies 5.3%, the lowest level in more than 40 years. During the latter part of the last thirty years, the sector remained an important component of fund portfolios even as market support for the industry eroded.

For investment advisors and fiduciaries that continue to hold oil and gas stocks, it is a much smaller task to reallocate 5% of an investment portfolio than 29%. It also becomes less painful when the poor sector performance is acknowledged. The sector has underperformed in the stock market for a decade and continues to perform poorly and offer little in terms of a value proposition going forward. Finding alternatives to fossil fuel companies will not be difficult—every other sector in the economy is growing faster, smarter and healthier.

Figure 1: Energy Sector Weighting in the S&P 500 (Energy as a Percent of S&P 500 Index) 1980-2018

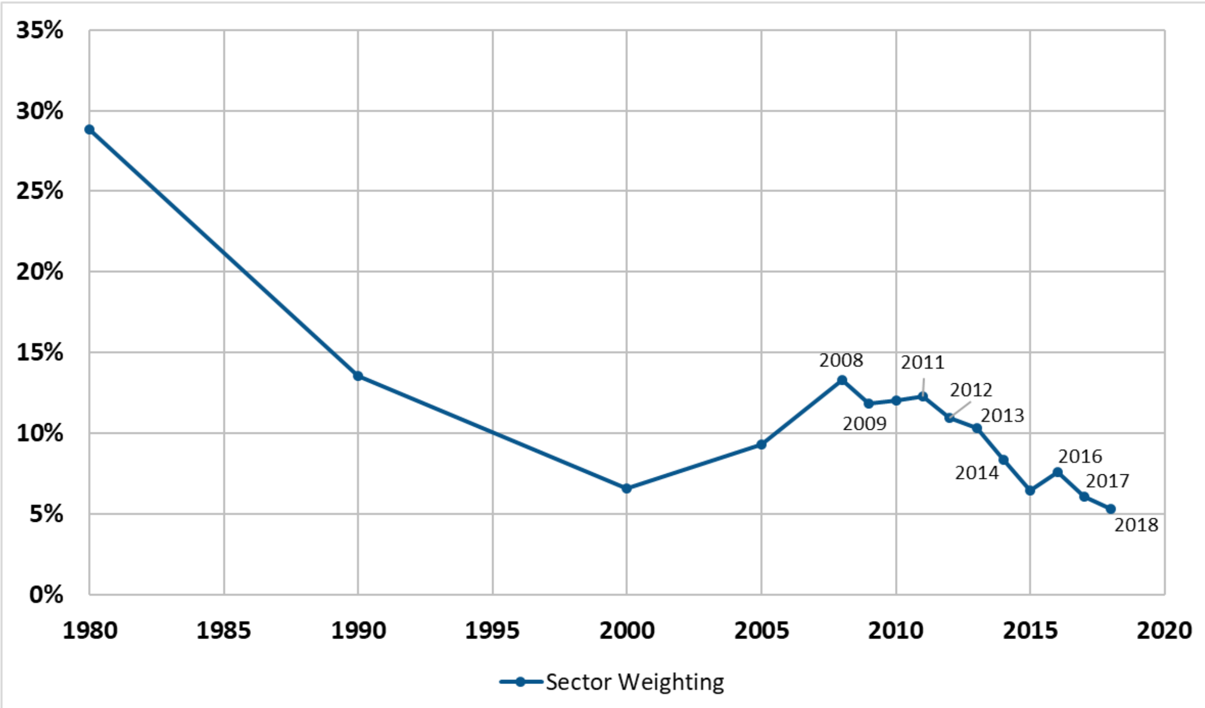


Figure Source: Sibilis Research, S&P 500 Sector and Industry Weightings, 1979-2018.

Fossil Fuel Sector

From Leader to Laggard - Exemplified by ExxonMobil

The larger, more buoyant structural rationale that drove the industry for decades has been lost, and this is increasingly evident in the eroding position of fossil fuels. Fossil fuel investment is no longer synonymous with the long-term upward growth of the global economy.

For the better part of the last thirty years, the fossil fuel sector kept pace with, or led, economic indicators. The industry's stock performance benefitted every institutional investor in the world. Its leading company, ExxonMobil, has been in the top ten of the S&P 500 for decades, surpassing companies in every other industry.

Oil and gas sector goes from 29% of the S&P 500 in 1980 to 5.3% in 2018, the lowest in more than 40 years.

Figure 2: ExxonMobil Stock Performance Versus S&P 500 (1989 to 2019)

In 1980, there were seven oil and gas companies in the top ten of the S&P 500 – Exxon, Mobil, Standard Oil of Indiana, Standard Oil of California, Schlumberger, Shell Oil and Atlantic Richfield. They shared the top ten with IBM, AT&T and General Electric.[1] Today, only one oil and gas company, ExxonMobil, is in the top ten, and it no longer heads the list.

During the last decade, ExxonMobil has lagged in the S&P 500 by a wide margin. During this period the S&P 500 has increased more than 223%, while Exxon Mobil has declined by 4.56%.

Figure 3: Exxon Mobil Stock Performance Versus S&P 500 (2008-Present)

[1] ETF Database. Visual History of the S&P 500.

Tracking a Decline: Oil and Gas Has Fallen from Lofty Heights

Current Investment Advice to Stay the Course Is Based on a Distant Memory

Some argue that, on the basis of past performance, when fossil fuels led or kept pace with the market, investment in fossil fuels not only made sense but was imperative.[2] Yet in 2017, the energy sector was the second-to-last performer in the S&P 500. In 2018, a year when overall oil prices and profits improved, the industry was the last-in-class performer in the S&P 500.[3] Every other sector in the index outperformed oil and gas. In 2018, the S&P 500 Index ended down by 4.4% for the year with the energy sector declining by 18.1%.[4]

1. Stock market indicators over the last forty years tell us that the economy has changed. Most sectors in the S&P 500 have surpassed oil and gas based on actual company performance and future growth potential. For example, over the past decade, the rapidly growing health care and information technology sectors have largely displaced oil and gas stocks as top performers. Other reliable money-makers like real estate, utilities and consumer products have also typically outperformed oil and gas.

2. Advisors and fiduciaries who point to past performance as the basis for continued investment in fossil fuels need to take a refresher course. Indeed, the Securities and Exchange Commission (SEC) makes it clear *that an advisor (or fiduciary) that makes an investment decision based solely on past investment performance is violating fiduciary duty.* Investment advice must also take into consideration current circumstances that affect future value.

SEC Rule 156 Language on Use of Past Performance

(2) Representations about past or future investment performance could be misleading because of statements or omissions made involving a material fact, including situations where:

(i) Portrayals of past income, gain, or growth of assets convey an impression of the net investment results achieved by an actual or hypothetical investment which would not be justified under the circumstances, including portrayals that omit explanations, qualifications, limitations, or other statements necessary or appropriate to make the portrayals not misleading; and

(ii) Representations, whether express or implied, about future investment performance, including:
(A) Representations, as to security of capital, possible future gains or income, or expenses associated with an investment;
(B) ***Representations implying that future gain or income may be inferred from or predicted based on past investment performance; or***
(C) ***Portrayals of past performance, made in a manner which would imply that gains or income realized in the past would be repeated in the future.***

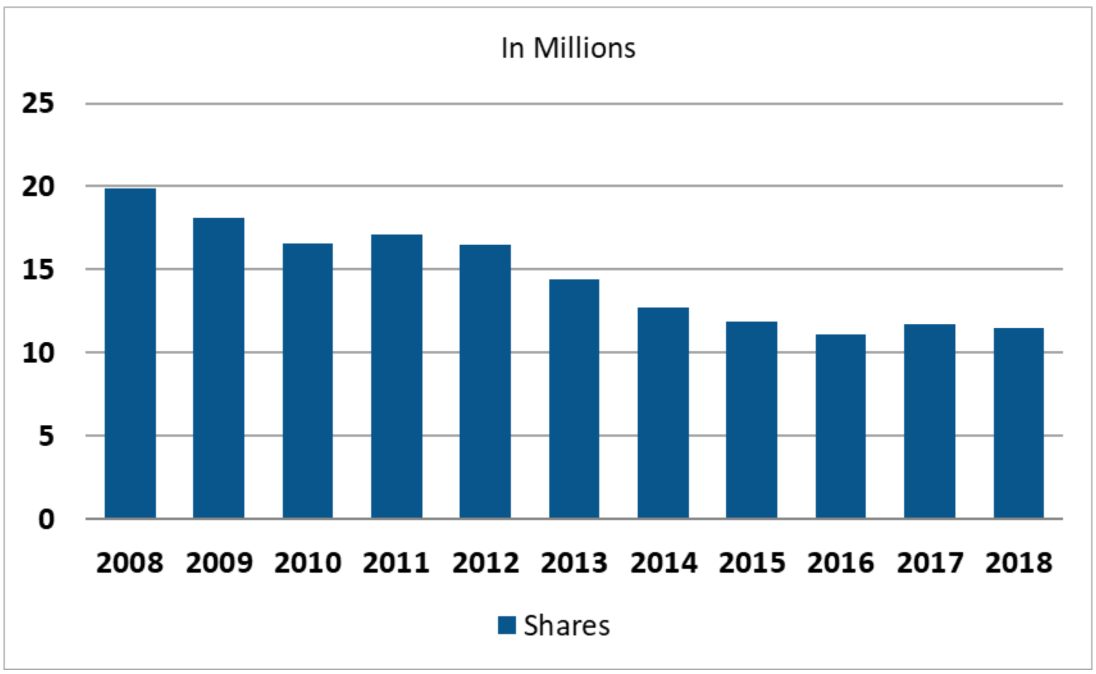
Source: The Code of Federal Regulations (CFR).

[2] Fischel, Daniel et al, divestmentfacts.com "Fossil fuel divestment and public pension funds," June 2017.
[3] DiLallo, Matthew. The Motley Fool. "2018: Oil and Gas Stocks Year in Review." 12/29/18.
[4] Novel Investor. "Annual S&P Sector Performance."

3. Despite this admonition, almost every major institutional money manager continues to be of the view that fossil fuel investments are essential for building a stable investment portfolio. Their arguments largely defend theories that have long since been disproven by the actual, real-world performance of oil and gas stocks. Diversification of an investment portfolio should not be a reason to justify investment losses. The much touted "fact" that if one investor divests, new investors will simply buy the stock is factually wrong. Institutional investors are, in fact, buying fewer shares of fossil fuel stocks.

   The number of shares of ExxonMobil held by large institutional investors has declined. For example, ExxonMobil's holdings in the New York State Common Retirement Fund (CRF), New York's pension fund, dropped by 42% (from 19.9 million shares to 11.5 million shares) between 2008 and 2018.[5] During this time, the value of CRF's holdings dropped from $1.68 billion to $857 million, a 48% reduction. This slide took place while the total value of the CRF increased from $154 billion to $207 billion, an increase of 34%.

Figure 4: Shares of ExxonMobil Stock Held by the New York State Common Retirement Fund (2008-2018)



4. Perhaps the most significant argument in favor of fossil fuel stocks—the dividend—offers further insight into the sector's decline. Investors lost confidence in oil and gas company management when billions of dollars of market value were erased in the wake of the 2014 market downturn. To remain

[5] Office of the New York State Comptroller. NYSLRS. Comprehensive Annual Report: 2018 3/31/18, p. 198-199.

attractive to investors, the dividend—direct cash payments to shareholders—was prioritized over long-term, speculative oil and gas capital investments. The demand for immediate cash, however, tied oil and gas companies more tightly than ever to the price of oil. As oil prices increased, dividends were solid. As oil prices declined, dividends became shaky. The industry is now driven by oil price volatility. In an oversupplied market, it faces a negative long-term outlook.[6]

5. Finally, the dividend payments in today's market are cold comfort to investors who have historically been accustomed to hefty pay-outs from both dividends and stock buybacks. In 2008, Exxon Mobil, for example, made a combined dividend and stock buyback payment to investors of $43 billion. In 2017, the total was only $13.7 billion.[7]

Global Index Funds Without Fossil Fuels Outperform Standard Indexes that Include Fossil Fuels

Since 2010, the MSCI-ex global index (excluding fossil fuels) has posted performance results that are superior to the MSCI Global Index, which includes fossil fuels.* A pension fund worth $130 billion in 2010, had it invested in a fund that tracked the MSCI-ex, would have added $1.0 billion over eight years, or roughly $125 million annually. For example, New York's pension fund, the New York Common Retirement Fund (CRC), had assets of approximately $130 billion in 2010. If it had invested in the MSCI Index excluding fossil fuels in 2010, it would have added $125 million annually, enough to pay the annual benefits of more than 5,000 retirees** from the Employees' Retirement System (ERS). Or, this annual $125 million of additional investment returns could have been used to reduce annual employer contributions and lower property taxes for New York State homeowners.

* MSCI. ACWI Ex Fossil Fuels Index (GBP)
** Office of the New York State Comptroller 2018 Comprehensive Annual Financial Report. p.174. The average payment to an ERS retiree in 2018 was $23,680.00.

Investment Advisors, Fiduciaries Who Ignore Fossil Fuel Decline Are Failing Their Beneficiaries

Investment advisors and fiduciaries that have not noticed—and acted on—the fall of the fossil fuel sector are failing to protect their beneficiaries. The short-term and long-term trends are clear. The short-term trend is characterized by *cash is king*. The long-term trend represents a flawed rationale for value creation. Both short-term and long-term trends portend great value destruction to the sector in the years ahead.

Fossil fuel stocks have become highly speculative and volatile. When they remain in a portfolio, the way to limit losses is to make a relatively short-term bet on a specific oil and gas combination with a fixed exit date, separated from any broad index. As the opportunity to generate returns continues to narrow, a fund manager using this approach could theoretically extract value from oil and gas stocks, while trading them with greater flexibility and control.

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[6] Sanzillo, Tom. IEEFA. "IEEFA Update: Norway's recognition of a declining fossil fuel sector sends a message." 12/21/18
[7] SEC. Exxon Mobil 10Q 9/30/2018

The question fiduciaries must ask is: What will the portfolio look like when it is fossil-free? If, however, they refuse to even pose the question or continue to follow the erring advice of most money managers, they may be caught flat-footed at every turn—and downturn—in the sector.

Fiduciaries should move forward with a sound plan to free their portfolios from fossil fuels. At a minimum, institutional investors should require their money managers to provide them with a fossil-free portfolio that meets investment targets and a time frame in which they can achieve the portfolio changes.

About IEEFA

The Institute for Energy Economics and Financial Analysis conducts research and analyses on financial and economic issues related to energy and the environment. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy. www.ieefa.org

About the Authors

Tom Sanzillo

Tom Sanzillo, director of finance for IEEFA, is the author of several studies on coal plants, rate impacts, credit analyses and public and private financial structures for the coal industry. He has testified as an expert witness, taught energy-industry finance training sessions, and is quoted frequently by the media. Sanzillo has 17 years of experience with the City and the State of New York in various senior financial and policy management positions. He is a former first deputy comptroller for the State of New York, where he oversaw the finances of 1,300 units of local government, the annual management of 44,000 government contracts, and where he had oversight of over $200 billion in state and local municipal bond programs and a $156 billion pension fund.

Kathy Hipple

Kathy Hipple, a financial analyst at IEEFA, teaches the finance sequence at Bard's MBA in Sustainability and is the founding partner of Noosphere Marketing. Hipple has written extensively about sustainable, responsible and impact finance and investing. As Vice President at Merrill Lynch for 10 years, she placed fixed income securities with international institutional clients, and advised international life insurance companies and pension funds. She later founded Ambassador Media, a local search firm in New York City, and served as its CEO. She has served on several boards, including the national Local Search Association and Bennington County's Meals on Wheels.