Briefing Note

September 2024
Connor Chung || IEEFA Research Associate
Dan Cohn || IEEFA Energy Finance Analyst

Engagement and Divestment: Shareholders Transcend a False Binary

- *For many investors, the debate around fossil fuel investments once centered around engagement vs. divestment. But the experience of fiduciaries today is leading to another realization: It's "and," not "or."*
- *Engagement strategies need divestment on the table if they want to be credible — and divestment decisions can facilitate fulfillment of broader stewardship goals.*
- *The need for action is heightened by fossil fuel companies' long history of rejecting good-faith investor engagement on issues of climate risk.*
- *When faced with risky corporate behavior, investors must act swiftly to reduce threats to their portfolio. This means being willing to use the right tool for the job.*

Introduction

Across the market, institutional investors are waking up to the reality of climate-related financial risk. Yet as they seek to harden their portfolios against the challenges of a warming world, they face a problem. The traditional energy sector stands disproportionately proximate to many of the causes and effects of climate instability — yet, by many evaluations, is refusing to meaningfully adjust course.

In response to this climate risk, commentators have traditionally theorized two options: exit, or voice. Should institutional investors cut exposure to the most misaligned assets? Or should they retain a seat at the table and try to steer corporate policy from within?

A growing body of evidence suggests that the choice is not so binary in practice. This briefing note summarizes ongoing developments in investor practice and standard-setting that illustrate how investors do not need to choose between meaningful portfolio-wide engagement and intentional deployment of divestment.

Investors should engage across their portfolio to reduce risk exposure and transition misalignment and should see divestment as an important tool to achieve the same ends. In practice, the approaches strengthen and facilitate each other. Engagement needs divestment to have teeth, and a specific divestment decision can strengthen fund-wide stewardship efforts. They are two sides of the same coin.

Engagement and Divestment: Rivals or Partners?

Arguments for an engagement-only approach claim that when investors divest from a company or sector, they give up their ability to exert powerful influence as shareholders. Yet from both a market-shaping and a risk-management perspective, this assertion lacks crucial nuance. By ruling out divestment from the start, asset owners abandon leverage and restrict their own ability to confront threats to the value of their portfolio.

> **Shareholder engagement is best conceived of not as a singular approach but as a range of tools.**

Investors should be engaging across their portfolio to reduce climate risk. But as IEEFA has written elsewhere, shareholder engagement is best conceived of not as a singular approach but as a range of tools. When seeking to shape markets and influence corporate decision making, investors' suite of options includes (but is not limited to) sending letters, making calls, and holding meetings with company management and directors; making public statements; filing shareholder resolutions; casting votes against directors or for alternative board members; launching litigation; and divestment. Binding this all together is the principle of credible and time-bound escalation: An investor starts with the simplest and most direct path to make change, and turns to more forceful means if its earlier actions fail to achieve desired results. Ruling out divestment from the outset conveys a lack of seriousness about an investor's goals. Companies have little incentive to listen to an investor who weakens his or her own negotiating position. Such actions undermine the credibility of the investor's broader stewardship strategy.

From a risk management perspective, too, it makes little sense for investors to tie their own hands. Pensions or endowments attempt to engage companies because they think such efforts will help fulfill fiduciary goals. Unquestioning and indefinite engagement leaves portfolios without recourse even if risks continue to pile up. Altering investment strategies to defend a portfolio from threats to its value is a standard part of fiduciary practice; the impacts of a warming world are no exception.[1] If continued exposure is not providing a pathway to meaningfully reduce systemic or idiosyncratic risks, investors need the ability to change course. By keeping all tools on the table—up to and including divestment—asset owners preserve their agility in responding to risk.

A number of standard-setters and market commentators have remarked on the coherence of pairing these strategies. Some noteworthy examples include the following:

- The International Association of Insurance Supervisors (IAIS) suggests that engagement should be "documented and time-bound" with "escalation measures in case those objectives are not achieved, including reductions of investments or exclusion decisions."

- The Science-Based Targets Initiative (SBTi) is developing net-zero criteria for the financial sector that establish how engagement should include deadlines, minimum benchmarks, and clear exit strategies when counterparties fail to listen.
- The Glasgow Financial Alliance for Net Zero (GFANZ) describes "an escalation process with consistent and transparent criteria" as critical for net-zero management—and highlights the "three-strikes-and-you're-out" approach of French insurer AXA as a paradigmatic example.
- The United Nations-convened Net-Zero Asset Owner Alliance encourages investors to drive transition alignment through engagement, and simultaneously to explore exit strategies when "they consider the risks posed by laggard companies too great."[3]
- Shareholder engagement proponents like ShareAction and As You Sow have emphasized the indispensability of divestment in credible escalation pathways.[4]
- A growing body of academic literature supports the idea that exclusion rationales fit firmly within broader shareholder voice strategies.

Engagement, in other words, is not a counterargument against divestment or vice versa. At a conceptual level, investors need both to protect their portfolios and meet stewardship goals. Rather than debating one vs. the other, best practice for investors is to embrace the full toolkit — and to apply the best tools for a given job.

Evolving Investor Practice

A number of leading funds are providing case-studies for how engagement and divestment intersect in the real world.

Consider the case of the New York State Common Retirement Fund (CRF) and ExxonMobil. As fossil fuel holdings began to come under increasing scrutiny in the early 2010s, CRF initially rejected divestment, instead expressing a desire to change companies from within. The fund stepped up its lobbying of management and filed shareholder resolutions, in some cases winning important victories. In 2017, for example, CRF spearheaded a successful shareholder resolution calling on ExxonMobil to heighten climate risk disclosure. Yet the oil giant proved largely unresponsive to these resolutions. In 2018, the CRF commissioned a panel of outside experts to advise on more robust decarbonization pathways. In 2020, citing the company's "disappointing, frustrating" responses to shareholder counsel, CRF confirmed that it would review its energy sector holdings against "minimum transition readiness standards." For the first time, divestment was explicitly on the table for energy companies failing to make adequate net-zero progress. Meanwhile, the fund backed a slate of dissident directors for ExxonMobil's board, three of whom won board seats but were largely sidelined by the company.[5]

In 2024, the fund chose to divest the company and several peers from its debt and active equity portfolios, as well as to diminish fossil fuel exposure in the passive equity portfolio over time.[6] The fund's actions were taken after a systematic review was conducted of selected segments of the oil and gas sector, coupled with focused engagement efforts. The review was not only of corporate adoption of sustainability plans, but also how companies

were performing under those plans. This concentration on implementation results represents an important step forward for investor action on climate change. While many oversight and monitoring efforts by funds and external groups remain concentrated on whether plans exist, CRF made its judgment on whether existing plans were credible and whether company performance was meaningful.

Tellingly, the fund approached its decision as part of its broader engagement and stewardship goals—an important framing, since fossil fuel companies are only one component of the broader systemic climate risk puzzle. The fund's whole-portfolio decarbonization plan had been a direct outgrowth of divestment debates, and CRF consequently structured its divestment reviews within this wider net-zero push. The movement towards divestment led to the implementation of additional climate initiatives, such as more forceful proxy voting across the portfolio and expanding investments in climate solutions. The decision has also provided an opportunity for the fund to redirect engagement efforts towards other sectors with better evidence of impact. (Since CRF's decision to first begin exiting from fossil fuels, ExxonMobil has continued to frustrate shareholders—most recently, with its decision to sue investors who filed a shareholder resolution on net-zero alignment.)[7]

> **Many large-scale institutional investors have taken similar paths to New York by dropping broad swaths of the fossil fuel sector from their portfolio.**

Of course, this story goes far beyond New York or ExxonMobil. Climate Action 100+, for example, finds that no major fossil fuel company is fully aligned with the goals of the Paris Agreement, and CDP (formerly known as the Climate Disclosure Project) even finds evidence of some industry regression on climate readiness. In light of the potential transition risk that this misalignment creates, many large-scale institutional investors have taken similar paths to New York by dropping broad swaths of the fossil fuel sector from their portfolio once it becomes clear that this is the best means to fulfill their fiduciary goals. New York City's pension systems, for example, chose to shed fossil fuel equity and fixed income after rigorous independent analyses of the strategy's fiduciary soundness and in light of evidence that the sector was not making adequate progress towards net-zero.[8] After earlier engagement practices attracted charges of inadequacy, the Church of England pension added explicit benchmarks and red lines to its stewardship strategy, eventually resulting in an exit from remaining fossil fuel holdings. Dutch pension giant PFZW paired forceful engagement with time-bound escalation, and chose to exit most fossil fuel holdings after finding that "we cannot keep talking forever." Institutional investors like CalPERS have placed such actions at the core of their sustainable investing strategy going forward.

It is also notable that many of the institutional investors with the boldest and broadest strategies for addressing systemic climate risk began with fossil fuel exclusion policies and built from there. In practice, attention to escalation and divestment has tended to open doors for broader attention to economy-wide climate risk, creating opportunities to double down on engagement with other systemically important sectors, restart stuck dialogue with companies,[9] shift capital towards decarbonization solutions, elevate shareholder demands from disclosure to performance,[10] and engage with regulators and governments to address climate misalignment.

Divestment is sometimes portrayed as an investor giving up their influence. But in the hands of prudent and careful actors, it seems to do the opposite: strengthening the ability to respond to risks and exercise voice in the process. Addressing industry-specific risks to a portfolio is fully consistent with other actions to drive decarbonization of the real economy. By keeping divestment on the table, investors are preserving their capacity to do both.

Choosing the Right Tool

Converging signals from investor practice, standard-setting, and academic/practitioner literature all indicate that divestment should be on the table—even and especially within the context of an engagement plan. But when does it come time to actually take the off-ramp? When is an exit strategy the best option? There is no one-size-fits-all template for climate risk mitigation, and each investor needs to develop a plan that meets individual needs and goals. But several factors can help inform fiduciary decision making.

One key indicator: a company's risk profile. When a company faces significant, long-term market headwinds yet fails to satisfactorily respond, indefinite investment is hardly conducive to sound investing. For the fossil fuel industry, this picture is beginning to come into focus. As IEEFA research has shown, the fossil fuel industry has substantially underperformed the stock market for the last 10 years — a pattern that the significant temporary spikes in global oil and gas prices due to Putin's invasion of Ukraine and the COVID-19 recovery have been unable to reverse. Absent the tailwind of Russia's invasion, returns would have fared far worse. Meanwhile, the sector has seen its market weighting in the Standard & Poor's 500-stock index slip from almost 30% to the low single digits since 1980. Fiduciaries have a fundamental responsibility to protect their funds from continued losses, and any stewardship strategy should also be in service of this goal.

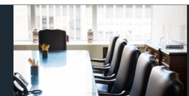
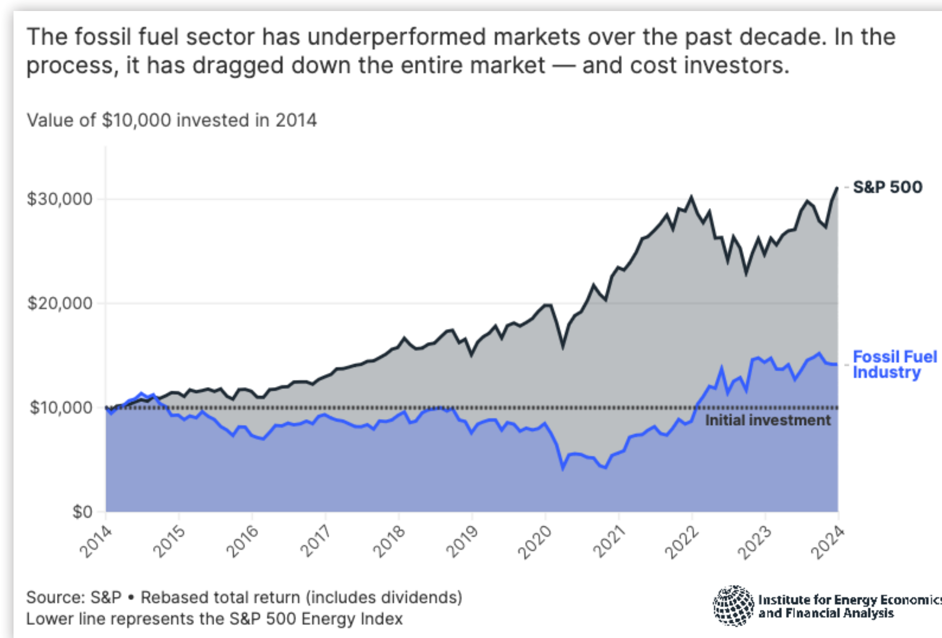


Figure 1: Fossil Fuel Stocks Harm Investment Returns



Another important test: whether credible pathways for change exist. There is plenty of evidence that shareholders can persuade companies to shift business practices, but less precedent for shifting fundamental industry-wide business models. In a traditional energy producer's case, a decline in fossil fuel use strikes at the very core of its revenue stream—and it remains uncertain whether the sector's alternative revenue streams will deliver as expected. Any prudent investor must carefully consider how to most efficiently allocate and target its engagement efforts, and this means making a careful and measured judgment about what a company's past record, present agility, and long-term pathways say about its ability to ensure a commercially viable future.[11]

A third test is the company's good faith: its willingness to take shareholder dialogue seriously, even where it might not initially agree. When a company repeatedly signals that it has little interest in considering investor counsel, it is right to ask whether it is making decisions in a way that leaves it well-positioned to manage shareholder value in the long run.

Climate change and the energy transition present serious challenges and opportunities for institutional investors. Engagement remains an important response to this reality. But sometimes, the exercise of options along a well-known, well-designed, generally accepted pathway for negotiating conflict fails. When risks pile up and change proves elusive, the patience of asset owners can't last. Investors eventually must ask whether continued exposure to a company or sector with diminished relative size, poor financial performance and a negative long-term outlook is truly in their fund's best interest—or helpful for their broader stewardship goals.

End Notes

1 For further discussion on climate risk and fiduciary duty, see: IEEFA, op. cit., p. 52-56. Also see: Bevis Longstreth. Outline of Possible Interpretative Release by States' Attorneys General Under The Uniform Prudent Management of Institutional Funds Act. 2016. Also see: Center for International Environmental Law (CIEL). Trillion Dollar Transformation: Fiduciary Duty, Divestment, and Fossil Fuels in an Era of Climate Risk. January 2017.

2 IEEFA. SBTi steps up its game on net zero for finance. August 24, 2023. The exact standards remain in development, but the latest drafts continue to retain guidance on phasedown of fossil fuel financing. Also see: Science-Based Targets Initiative. Financial Institutions Net-Zero Standard, Consultation Draft V0.1. July 2024.

3 UNEP and UNPRI. Position on the Oil and gas Sector. March 2023. Section 2.3.1.

4 ShareAction. Undermining Transition, Risking Capital. June 17, 2024. Also see: As You Sow. 2020: A Clear Vision for Paris Compliant Shareholder Engagement. September 18, 2018.

5 Bloomberg TV. CalSTRS CIO: Exxon in Danger of Being Next Blockbuster. December 31, 2021. Also see: IEEFA. Months after tumultuous ExxonMobil annual meeting, no substantial change expected. August 6, 2021.

6 New York State Common Retirement Fund. NY Common Retirement Fund Announces New Measures to Protect State Pension Fund From Climate Risk and Invest in Climate Solutions. February 15, 2024; Also see: IEEFA. New York State Common Retirement Fund takes action to protect New Yorkers from further losses from oil and gas company investments. February 15, 2024.

7 The Guardian. US oil company ExxonMobil sues to block investors' climate proposals. January 22, 2024. The company's complaint was subsequently dismissed. See: Reuters. US judge dismisses Exxon case against activist investor over proxy filing. June 17, 2024.

8 For more on the independent analyses commissioned by NYC funds, see: IEEFA. Major investment advisors BlackRock and Meketa provide a fiduciary path through the energy transition. March 22, 2021. For more on the funds' decision-making, see Net Zero Investor. NYC Comptroller's John Adler: "Everything we do is in the name of fiduciary duty." August 15, 2024

9 Responsible Investor. We get more attention from management after we exclude a company. February 10, 2022. Also see: Climate-Votes. How escalation pathways can drive active stewardship from investors. Accessed August 16, 2024.

10 See earlier discussion of the CRF's systematic evaluations of oil and gas subsectors.

11 Net Zero Investor. NYC Comptroller's John Adler: "Everything we do is in the name of fiduciary duty." August 15, 2024 ("Major fossil fuel exploration companies don't have a net zero plan.... Asking them to stop is like asking Starbucks to stop selling coffee. Oil is Exxon's business. They don't want to stop.") Also see: IEEFA. Moody's sets new course to rigorously assess carbon transition net-zero plans as a business imperative. April 16, 2024. Moody's Net Zero Assessment is one example of a tool investors can use to evaluate the credibility of company low-carbon transition plans and whether actual performance against stated goals is meaningful. The systematic steps used in coming to these analytical conclusions offers an important perspective to the climate risk management discussion.

About IEEFA

The Institute for Energy Economics and Financial Analysis (IEEFA) examines issues related to energy markets, trends and policies. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy. www.ieefa.org

About the Authors

Connor Chung

Connor Chung is an IEEFA research associate who focuses on the intersection of climate change and financial risk, and on protecting investors, markets, and the public from the economic uncertainties associated with fossil fuel reliance. He is a summa cum laude graduate of Harvard.

Dan Cohn

Dan Cohn is an IEEFA energy finance analyst. His research focuses on protecting institutional investment funds from the volatility associated with global commodity prices and the fossil fuel industry. He is an expert on the U.S. coal mining industry and regulatory framework, with specializations in mine cleanup, financial assurance instruments, and energy transition issues in the Powder River Basin. He has a degree from Washington University in St. Louis.

Disclaimer
This report is for information and educational purposes only. The Institute for Energy Economics and Financial Analysis ("IEEFA") does not provide tax, legal, investment, financial product or accounting advice. This report is not intended to provide, and should not be relied on for, tax, legal, investment, financial product or accounting advice. Nothing in this report is intended as investment or financial product advice, as an offer or solicitation of an offer to buy or sell, or as a recommendation, opinion, endorsement, or sponsorship of any financial product, class of financial products, security, company, or fund. IEEFA is not responsible for any investment or other decision made by you. You are responsible for your own investment research and investment decisions. This report is not meant as a general guide to investing, nor as a source of any specific or general recommendation or opinion in relation to any financial products. Unless attributed to others, any opinions expressed are our current opinions only. Certain information presented may have been provided by third parties. IEEFA believes that such third-party information is reliable, and has checked public records to verify it where possible, but does not guarantee its accuracy, timeliness or completeness; and it is subject to change without notice.