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Fiduciary responsibility and climate change

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NYC pension funds begin to craft a fossil-fuel divestment path

NYC Mayor Bill de Blasio. Photo by Kevin Case

A certain recent RFP from the New York City comptroller on behalf of the city's pension funds could be the beginning of something big.

It calls for a carbon footprint analysis of the funds' holdings and advertises an opening for a climate-risk investment-strategy consultant. While the RFP is shrouded in pension-speak, its aim is clear: to introduce a series of asset-allocation decisions that will minimize fossil fuel risk *and* optimize portfolio returns.

Such a goal is becoming easier than ever to achieve. Fossil-fuel holdings, once a mainstay of pension fund portfolios, have grown less relevant over the past 30 years. A recent report by As You Sow, a San Francisco think tank, explains why ("Unconventional Risks: The Growing Uncertainty of Oil Investments"). The report documents several indicators that point to increasing structural risks that include declining revenues and profits, mounting debt, and falling prices.

The study comes against the backdrop of an oil-industry decline that began a generation ago. Seven of the 10 biggest companies in the Standard and Poor's 500 Index were oil companies in 1980. Today, Exxon Mobil is the only one still there. For decades ahead of the 80s, oil and gas companies drove increases in the S&P indexes with quarter after quarter of rising cash flow and dividend growth. By the mid-1990s, these stocks remained profitable but no longer drove larger stock market returns. And while U.S. stock markets have soared in recent years, Exxon Mobil has posted eight straight quarters of market-lagging performance.

Oil is cheap today, much to the consternation of oil-industry executives, and likely to stay cheap. This reality is tearing at the very fabric of the old energy economy. Market coordination between major oil companies and state-owned enterprises (and between state-owned enterprises) has collapsed, and in its wake global competition prevails –nation against nation, company against company, company against nation.

Low prices create a huge impairment to oil producers who face higher extraction costs everywhere they look, and of course low prices are bad news for countries dependent on oil revenues for fiscal stability. The Canadian oil sands industry, for example, once a bright spot for fossil fuel investors, has been battered by years of failed projects and bankruptcies. Conventional oil exploration is simultaneously hobbled by rising costs. Big oil companies are cutting their capital spending now, a move that assures diminished profits. Natural gas markets are plagued by oversupply.

Oil and gas companies, if they are to weather the new energy economy, must pivot toward a low-carbon future. Investors much do the same. Those who choose otherwise –companies and investors alike – run the risk of following the coal industry into ruin and of logging 100 percent losses.

Which is where the importance of the New York City RFP is apparent: issued in September at the behest of Bill de Blasio, who is not just the mayor but also chairman of the city’s five pension funds, the notice was overshadowed by a simultaneous announcement that the city was divesting from coal.

It deserves more attention than it has received, however, because it sets a timely example for institutional investors and pension fund beneficiaries everywhere. The mayor – and the city’s pension boards – through this initiative are acting like fiduciaries are supposed to act. They are telling their money managers that they want a responsible plan to minimize carbon risk amid deep market changes and that they want a plan that will also achieve the funds’ targeted returns. These goals were contradictory in years past. In the current investment climate they are not.

Institutional investors need not be part of any charade that suggest fossil fuel investments are safe, and indeed should prepare solid exit strategies now.

A recent paper by former SEC Commissioner Bevis Longstreth makes clear that fiduciaries are obligated now to avoid holding fossil fuel assets whose risk exceeds any potential benefit. Just this month, Kathy Hipple, who teaches in the sustainability MBA program at Bard College, publicly questioned (with co-author Perry Goldschein) whether fund managers who invest in fossil fuels are meeting their fiduciary responsibilities.

The service being performed by the de Blasio administration in its push to reduce its pension funds’ carbon footprint through sound asset reallocation helps moves the ball forward and suggests a model others can follow. You can bet that assorted money managers and most of Wall Street will oppose the initiative, so a good plan will depend on the consultant, the skill and will of the mayor and his staff, support from the funds' boards and the city comptroller.

Full transparency around whatever happens is crucial, and public scrutiny is key.

Institutional investors everywhere today should be equipped with a solid exit strategy from fossil fuels. The type of plan New York is contemplating, in addition to allowing a prudent path to divestment, can increase leverage for demanding clear plans from oil companies on either pivoting toward renewables or returning dividends to shareholders. Absent such a tool, fiduciaries are unprepared for the necessary transition.

Institutional investors have mostly shrugged off total losses on coal stocks and the huge hits they have taken on coal-industry bonds, but coal was always a negligible holding with negligible expectations – small assets, modest growth and limited attention to innovation. Coal investments performed historically more like risky fixed-income gambits than equities. It's been years since any pure-play coal company was a top S&P holding, and today most fail to meet even penny-stock standards.

Oil and gas are different, and their losses will be far more consequential. Losses will grow and and headline risks will rise. Significant industry contraction is already under way. While oil and gas executives are busy securing their parachutes, Wall Street looks the other way, and its refrain can be heard now. No one saw this coming.

Some institutional investors, by contrast are behaving as responsible fiduciaries, as Mayor de Blasio has chosen do. They can expect grief from opponents but they can know also that they are acting in the best interest of pension beneficiaries.

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