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ENGAGING FOR A GREENER FUTURE



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Why engagement is an effective way to support the energy sector's transition to a lower-carbon future.

- We believe that, rather than shun them, it is important to engage with companies in the energy sector to help support and encourage a successful energy transition to renewables.
- Our view is that traditional active managers can embed engagement opportunities into their due diligence analysis of stocks before purchase, bringing a number of benefits over passive managers.
- Investors are increasingly voting against management. We expect this surge of investor activism to grow as we emerge from our current Covid-19 environment.
- There are strong expectations that US President Joe Biden will allow a global consensus to form on climate management, hence accelerating the low-carbon energy transition.

Though we have been seeing hints of a rotation back into value stocks over recent weeks, which could benefit oil and gas companies in the short term, these tactical moves belie long-term concerns about the sustainability of the energy industry as it exists today.

The systemic risk surrounding climate change and energy companies also underscores the difference in approach between active managers and universal owners – such as passive managers and large retirement funds – and the tools active managers have at their disposal to make persuasive cases for change.

Shrinking sector

It is no secret that substitution from price-competitive renewables, advances in technology, changing social norms and increased regulation are colliding with economic difficulties and taking their toll on oil, gas and coal company profits. The sector's woes are such that, despite short-term bumps, as of the end of September 2020, energy stocks accounted for just 2.6% of the S&P 500, down from over 16% in 2008, representing a significant loss of relative value over that period.

The spectre of stranded assets is also becoming more apparent, with asset impairment charges increasing across the fossil-fuel industry, and giving rise to the new concept of stranded liabilities. Specifically, this is the cost of retiring long-lived oil and gas infrastructure. Expanding production of the feedstock for plastics could prove another misallocation of capital, as changing attitudes to single-use plastics could translate into this 'growth opportunity' becoming an oversupplied or even declining market, given the awareness of pollution from plastics.

Stakeholders in the energy transition

As a result, investors have experienced increasing numbers of fund managers avoiding the energy sector, because they view it as an industry that is under pressure and experiencing the real prospect of permanent capital impairment. Asset owners, however, recognise that as universal owners of the market and, by default, the economy, they have a stake in encouraging a successful energy transition to renewables. Simply put, their view is that it is short-sighted and misguided to eschew the industry entirely.

While some asset owners have divested from fossil fuels – recognising that rising concern for the environment globally is linked to poor financial returns – some continue to hold them in the hope of driving change through engagement. Active managers, drawn by seemingly low valuations, are engaging alongside them, with the combined weight of their collective voices leading to better reporting and some shift in strategy towards redirecting a growing proportion of capital expenditure to renewables. The challenge will be if the change being supported by engagement will be sufficient to avoid fossil-fuel stocks becoming ‘value traps’.

Advantages of an active approach

Active managers have distinct advantages when it comes to proxy voting and engagement, the most obvious being that, through selectivity, active managers have a far smaller number of securities to cover than a passive manager. Furthermore, through their research processes, traditional active managers can embed engagement opportunities into their due diligence analysis of stocks before purchase, bringing a number of benefits over passive. Finally, the continuous feedback loop between management and active managers provides greater insight into the quality of corporate governance, a perspective that makes for better-informed decisions when it comes to proxy-voting judgements. In our view, this should make active managers more informed voters of proxies, with the ultimate sanction of selling if change is not forthcoming and client capital is at risk.

How are investors able to flex their collective muscle if engagement fails to produce the desired results? This is a central challenge facing active engagement with the fossil-fuel industry, given the role governments play in the ownership, production, and national energy strategy – coupled with significant and very real barriers that exist towards making a successful transition to cleaner energy at sufficient speed and scale to compensate for declines in traditional energy businesses.



Climate risk management promises increasingly to lead active managers to put fossil-fuel assets in a ‘why bother?’ bucket. For universal owners, however, achieving alignment with climate outcomes delivers different conclusions, as they are focused on managing long-term systemic risk associated with owning the market. Without the sanction of divestment, there is a danger that perpetual engagement becomes diluted and leads to just token action, such as committing to a net-zero carbon for 2050 target, while failing to commit to absolute emission reductions and adherence to key interim milestones.

Investors as activists

In important and visible ways, investors are all activists now. The recent and rapid growth of both active and passive environmental, social and governance (ESG) and sustainable assets has been accompanied by a rise in active engagement and proxy voting. Rather than pliantly voting with management, investors are increasingly voting against management. This new-found, vigorous investor activism only promises to grow as we emerge from our current Covid-19 environment. The increasing adoption of Task Force on Climate-related Financial Disclosures (TCFD) reporting, the commitment to net-zero targets and to absolute emission-reduction targets by a few companies, alongside accelerated investment in renewables, is evidence that fossil-fuel companies are responding to pressure, both economic and from shareholders. The question that hangs over the industry is whether it can remain relevant in a rapidly changing world.

Denial of access to capital can be a powerful force, as seen in major banks’ withdrawal of funding for private prisons, for example. The energy industry, however, rests on a different order of magnitude and complexity, and is inextricably interwoven with geopolitics. That makes avoidance, divestment, and engagement the sharpest arrows in investors’ quiver as we aim towards achieving a cleaner energy for tomorrow.

US election postscript

Much has already been said about the implications for renewable energy of Joe Biden's victory in the US presidential election. Under President Trump, the US was increasingly starting to look isolated and disconnected from climate reality, but there are strong expectations that President Biden will allow a global consensus to form on climate management, hence accelerating the low-carbon energy transition. Indeed, Korea and Japan have already signed up to net-zero emissions for 2050 and – more importantly – China is targeting 2060, while Russia is also contemplating such a pledge.

Many of President Trump's decisions while in power came as a global shock, and his swift decision to remove the US from the United Nations' Paris Agreement within the first year of his presidency was no different. Joe Biden has already made a number of speeches publicly supporting the pact, and has a hugely different stance on the use of coal and fossil-fuel emissions, with Trump being an avid supporter of fossil-fuel use while Biden has taken the 'No Fossil-Fuel Money' campaign pledge that all his fellow Democratic presidential candidates took.

Renewables boost

In November 2020 alone, seven utility companies in the US committed to close or repurpose around 9,500 megawatts of coal-powered electricity production, while 2020 looks set to establish a new record for wind-generation capacity in the US.¹ Therefore, based on environmental statements and track records, a Biden presidency looks more promising in terms of the US integrating more ESG practices within the nation's companies and their investors. In contrast, Trump previously took a harsh stance on some more environmentally friendly business approaches.

1. Source: Institute for Energy Economics and Financial Analysis (IEEFA.org). 20 November 2020. <https://ieefa.org/ieefa-u-s-coal-plants-close-as-renewable-energy-construction-rises/>

When analysing the US energy market, it's clear to see it is increasingly driven by pure economics, not policy, and that the country has a rising demand for and use of renewables. Renewables are increasingly cost competitive with fossil fuels, especially coal. Despite the previous administration's support for coal, in April 2019 renewables provided more of US power needs than coal (23% vs 20%). In fact, 2019 was a record year for renewable-energy investment in the US.

Rising global demand

Even despite a Biden presidency, the fossil-fuel industry is increasingly aware that it faces a challenged future, with demand, even in the developing world, set to diminish over the next decade. In our view, oil companies are also increasing their investment in renewables, carbon capture and hydrogen as they try to remain relevant in a changing world.

We have also seen the recent publication of the UK government's 10-point green recovery plan to make the UK's energy supplies more sustainable, and increasingly, investors in the US, UK and around the world see sustainable strategies as aligned with their values as well as their financial needs. Sustainable themes resonate with them, as they are about the world's direction of travel to a more sustainable future, and not about clinging to the past. While the scale of the commitment of the UK government to the energy transition has disappointed many, and places too much faith in as yet undiscovered technologies, we believe the momentum of the seismic shifts happening globally across our energy markets will be too hard to resist.

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