The divestment dilemma

Jennifer O'Neill of Aon says schemes have a choice: divest capital to address climate risks or engage to influence change

THE CROSSROADS between divestment and engagement is an important consideration for pension scheme investors as they seek to understand and better monitor their climate risk strategy and mitigate portfolio risks. However, the decision to divest, or not, is often complex and multifaceted.

Many investors see a key role for effective engagement with investment managers and companies, to promote and effect the changes they want to see in the transition to a low-carbon economy – a familiar counter to divestment is that 'you cannot influence what you do not own'. However, some feel that the risks of holding assets at risk from broader structural trends, for example in the energy sector, may be too great.

In the case of the energy sector, for example, the perception among investors seeking to divest is often that many firms' response to the climate crisis has been inadequate. As a result, the physical outcomes of climate change, and the legislative impetus to address the crisis, puts those firms at risk of valuation impairments and stranded assets. Divesting from these assets and denying these firms capital, it is argued, may force a reassessment of their priorities and future strateg: to better support the transition to a low-carbon economy and to improve their resilience to climate change risks.

By contrast, investors who actively engage – whether directly, or through their appointed investment managers – seek to add value

by positively influencing future outcomes for the firms in which they are invested. By retaining investment holdings, they have the potential to influence and support companies in the transition to a low-carbon economy. Recent shareholder votes at prominent energy companies' AGMs have brought this perspective into focus.

Some supporters of engagement-led approaches are critical of divestment for its inability to bring about meaningful corporate action on climate change, primarily since the amounts divested typically account only for a small proportion of targeted companies' value. Their arguments were bolstered by a 2020 study, *Exit vs. Voice,* in which scholars at Harvard, Chicago and Trento universities found that engagement-led approaches yielded greater success than divestment-led approaches in driving corporate outcomes.

Investors' motivations for divestment are varied but are generally driven by a desire to address the climate crisis, to mitigate climate change risk in their portfolios, to avoid reputational and stranded asset risks and to respond to stakeholder pressure – whether from pension scheme members, the sponsoring employer, or external organisations. There is also increasing concern among some investors that certain firms are 'greenwashing' their credentials – for example, by making public statements surrounding net-zero targets while making little meaningful change to their corporate operations and behaviour.

These motivations are not mutually exclusive and more than one may apply at any given time, adding complexity to the decision to divest or not. As with any strategic investment decision, it is important to be clear on the objectives a scheme wants to achieve – divestment is no different.

STRATEGY QUESTIONS

Several important considerations for any divestment strategy include:

- Which activities should be targeted? Extraction of raw materials only? Ownership of fossil fuel reserves? Refining products? Distribution of fossil fuel products?
- Should utility firms be excluded, given their exposure to energy pricing? If a 'reserves-focused' approach is used, this is unlikely to exclude many utilities, which are the largest direct users of fossil fuels.
- How significant are fossil fuels to the business as a proportion of revenue or operations? Is it feasible to gradually reduce portfolio exposures, through establishing a baseline and setting appropriate time-bound targets?

Engagement considerations are also important to divestment decision-making – investors should reflect on how they or their managers are engaging to determine the effectiveness of their approach. Ultimately, active engagement provides an effective mechanism to measure the progress of desired change, better supporting investors in decisions to divest from investments if this is not successful.

Aon's Responsible Investment team works with pension schemes to identify priorities, investment beliefs and to develop and implement engagement and divestment strategies. To learn more, contact Jennifer via talktous@aon.com

Jennifer O'Neill, associate partner, Aon