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Ethical and Financial Aspects of Divesting

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Without Abstract

Synonyms

[Disinvestment](#); [Divestiture](#); [Investment sanctions](#); [Socially responsible investing](#)

Definition/Introduction

Divestment is defined as the act of withdrawing investments from a company or industry for ethical or financial reasons. It can be described as a form of socially responsible investing (SRI) that applies nonfinancial (environmental and social) criteria as well as exclusionary screening to guide an investor's financial decisions. While divestment has been most famously pursued against companies compliant in the racial conflicts and human rights violations of the South African apartheid era, the recent fossil fuel divestment movement has burgeoned the largest and fastest growing divestment campaign in history (Hunt et al. [2016](#)).

Fossil fuel divestment is a form of shareholder activism (Gillan and Starks [2000](#); Guay et al. [2004](#)) seeking to withhold the financial capital and reduce corporate solvency (Caldecott and Dericks [2017](#)) that is needed to explore and to exploit fossil fuel resources (Bauer et al. [2018](#)). Divestment is perceived as a tool to force change upon the fossil fuel industry, by directly depressing share prices through sales of shares (Paum [2015](#)) or indirectly stigmatizing the industry (Ansar et al. [2013](#)) for its influence on increasing concentrations of carbon dioxide (CO₂) emissions most affiliated with fossil fuel use (Quééré et al. [2013](#)).

The decision to pursue fossil fuel divestment can be made because of both financial and ethical reasons. Grady-Benson and Sarathy ([2015](#)) find that fossil-fuel divestment is most often rejected on University campuses for either financial or ethical reasons. Institutional investors have also rejected divestment because it might violate fiduciary responsibilities, though the question whether fossil fuel

divestment contradicts fiduciary duty is itself controversial (Waitzer and Sarro [2012](#)). Notably, the arguments in favor and against the ethical and financial case for divestment remain inconsistent. This chapter delves into this discussion and presents a comprehensive perspective from both, proponents and critics of each position.

Introduction to Fossil Fuel Divestment

Fossil fuel divestment first gained a foothold in mainstream discourse following Bill McKibben's seminal Rolling Stones publication "Global Warming's Terrifying New Math" (McKibben [2012](#)). In this entry, McKibben articulated that if humanity is to mitigate global warming to under 2°, the majority of existing fossil fuel reserves cannot be used. Bill McKibben's article was one of the most widely circulated by the Rolling Stone (Nisbet [2013](#)), bringing the once radical message of divestment to mainstream discourse (Schifeling and Hoffman [2017](#)).

Undoubtedly, fossil fuel divestment has gained momentum. Since its inception in 2012, fossil fuel divestment has been endorsed by prominent social activists including Naomi Klein ([2013](#)) and Leonardo DiCaprio ([2015](#)), influential religious leaders including former Archbishop Desmond Tutu ([2014](#)), politicians including Barack Obama ([2013](#)) and Al Gore ([2013](#)), notable economists including Paul Krugman ([2013](#)) and Jeffrey Sachs ([2018](#)), and climate leaders including Christiana Figueres ([2015](#)) and Ban Ki Moon ([2014](#)). Simultaneously, prominent institutional investors, including but not limited to the Rockefeller fund ([2014](#)), Norwegian pension fund ([2015](#)), Church of England ([2017](#)), and New York City ([2018](#)) have all committed to divesting their holdings from the fossil fuel sector or from parts of it, for instance, the coal industry. To date, it is estimated that over \$6 trillion in assets under management have been pledged to divest from the fossil fuel sector (gofossilfree.org [2018](#)).

One mandate of fossil fuel divestment is to raise awareness and reinforce that a significant portion of proven fossil fuel reserves cannot be burned if we are to achieve the two-degree limit in temperature rise (Hunt and Weber [2018](#)). Furthermore, divestment strives to force the energy sector to move away from high carbon sources, by stigmatizing the industry and by reducing its access to financial capital. The consequences of divestment can thus be direct or indirect.

Divestment can directly decrease the price of fossil fuel shares if it is perceived to be a material threat to future growth projections or the valuation of the industry (Paum [2015](#)). Depressed share prices will discount the industry's projected cash flows, raise costs of capital financing, and weaken production capacity in the long run. Alternatively, divestment can indirectly stigmatize the industry (Ansar et al. [2013](#)). Negative stigma associated with divestment can undermine the industry's reputation with other salient stakeholders (i.e., policy makers and financiers), prompt increasingly restrictive legislation, and weaken investor confidence in the industry.

With regard to the impact of divestment, some studies argue that the direct impact is limited given that the small sum of funds being divested cannot significantly affect stock prices (Ansar et al. [2013](#); Bullard [2014](#)). Moreover, the divested equity will simply be acquired by less scrupulous investors relatively quickly and at a discounted rate (Ansar et al. [2013](#)). In this regard, it may be more beneficial to engage with the industry to pursue change. It is also argued that the decline in stock prices in recent years that has driven the financial case for divestment is more sensitive to changes in macroeconomic environments than to the reputational risks of divestment (Baron and Fischer [2015](#)). Finally, it is notable that divestment would not impact national or state-owned corporations like NICO and Saudi Aramco, that own a large bulk of proven reserves (Paum [2015](#)).

The Ethical Case for Divestment

Divestment can be understood as a means of social activism, illustrating how stakeholders can collectively mobilize to advocate for social justice (Grady-Benson and Sarathy [2015](#)). In the case of fossil fuel divestment, the social cause is the mitigation of climate change. The first ethical case for climate change assumes that financial gains should not be achieved through investments in practices and shares that harm the climate. Secondly, divestment proponents argue that divestment decreases the fossil fuel industry's ability to invest in further exploitation of fossil fuel resources that will increase climate change. Thirdly, divestment proponents argue that their campaign influences the reputation of the fossil fuel industry negatively, leading to lower profitability and to changes in the industry's business strategy. Fourthly, it has been suggested that by holding such shares, institutions are complicit in the harm caused to those affected by or are at risk of harm from climate change (Moss [2017](#)).

Governance scholarship recognizes that there are many influential climate actors from governments, to institutional investors, financial markets, corporations, and civil society who have the capacity to accelerate or constrain climate action locally and globally (Bulkeley *n.d.*; Gunningham and Sinclair [2017](#)). Divestment is a strategy by which institutional investors can delegitimize the fossil fuel industry, due to the impact of fossil fuel production on anthropogenic climate change. It could be argued that the stigmatization of divestment has prompted some response by the fossil fuel industry, such as in the case of Peabody, which now cites divestment in its risk disclosure as a factor that may adversely affect demand (Baron and Fischer [2015](#)). In markets with higher social norms, the widespread stigmatization of the industry could result in an underperformance of fossil fuel stocks because of increased negative investor sentiment (Hunt and Weber [2018](#); Liston [2016](#)). Increased awareness of the linkages between fossil fuel production, carbon emissions, and climate change through the fossil fuel divestment movement can thus indirectly impact the industry.

Moreover, institutional investors may have a moral obligation to divest. There lays an embedded claim, that "if it is in our power to prevent something very bad from happening, without thereby sacrificing anything morally significant, we ought, morally, to do it" (Singer [1972](#), p. 231). Climate change is increasingly seen as one of the greatest threats to ecological (Ceballos et al. [2015](#)) and human health (Whitmee et al. [2015](#)). Adverse climatic conditions can cause direct injury from extreme weather events, outbreaks of infectious disease, food insecurity and under-nutrition due to failing local agriculture, and mental health problems attributed to displacement, forced migration, and affected homes and workplaces (Kjellstrom and McMichael [2013](#)). The impacts disproportionately affect poor and marginalized populations, which can cause conflict within national borders and between vulnerable nations (Lynn [2015](#)). In this case, investors might see their ethical duty "not on whether we have contributed in some way to a harm but on whether we ought to do something positive to assist others" (Moss [2017](#), p. 419).

Critics, however, are uncertain whether divestment as an act of shareholder activism will have any influence on mitigating anthropogenic climate change. First, some investors favor engagement instead of divestment (Sprenkel and Busch [2010](#)). They argue that only shareholders can put pressure on firms in their annual meeting and therefore, divestment weakens the influence of ethically concerned shareholders.

Second, the global entrenchment of fossil fuels not only as a source of energy but also through the dependence of fossil fuels across the economy is not addressed by the fossil fuel divestment movement. A study of the University of British Columbia's pensions and investments found that

divesting from all fossil fuel companies in their portfolio would only decrease the University's carbon exposure by around 3%, given the demand for carbon intensive products in other industries (Ritchie and Dowlatabadi [2015](#)).

Moreover, some groups argue that fossil fuel products are used by many and support economic development. Therefore, fossil fuel producers should not be punished for creating products and services that are bought and used by others. In a similar vein, fossil fuel divestment, by targeting the fossil fuel industry, neglects to address the issue of demand. Divestment might have a negligible influence in combating carbon emissions if demand continues to rise (Grady-Benson and Sarathy [2015](#)). Finally, it could also be argued that divestment from the fossil fuel industry can have negative impacts on the economy and employment in countries with a high dependency on the fossil fuel sector.

The Financial Case for Divestment

Based on modern portfolio theory (Markowitz [1952](#)), proponents of conventional finance argue that divestment decreases the universe of possible investments, and therefore, it is not possible to achieve optimal risk-adjusted returns. Furthermore, representatives of the efficient market hypothesis (Malkiel and Fama [1970](#)) argue that financial risk would be priced by the financial markets anyway and that additional ethical investment criteria are not needed to identify financial risks caused by carbon bubble and stranded assets. However, there are financial arguments in favor of divestment. We will explain them in the following paragraphs.

The increased production of greenhouse gases (GHG) in the atmosphere has raised global temperatures by 0.8 °C from the preindustrial era (IPCC [2014](#)); nearly half of the globally accepted 2 °C target that was agreed upon in the 2009 Copenhagen Accord. Increased concentrations of carbon dioxide (CO₂) emissions, most affiliated with increased fossil fuel use (Quéré et al. [2013](#)), continue to accumulate in the atmosphere well above the safe level of 350 parts per million (ppm), effectively raising global temperatures toward the 2 °C threshold (Hansen et al. [2008](#)). In a two-degree scenario, no more than one-fifth of the proven fossil fuel reserves may be burned (Meinshausen et al. [2009](#)). This is the “carbon budget.”

A fossil fuel company's valuation is in part calculated by its proven reserves and long-term growth potential. It is estimated that over 50% of a firm's value is dependent on the expected cash-flows a decade into the future (Trust [2008](#)). Maintaining the firm valuation is therefore dependent on increased capital expenditures toward continually expanding proven, albeit increasingly marginal reserves (Leaton et al. [2013](#)). Thus, fossil fuel companies continue investing in exploration, to replenish their reserves which may never be used.

Investing in companies that continue to allocate capital to replenishing proven reserves may be a risky decision. If the carbon budget is to be met, the grounded reserves and related activities may suffer from unanticipated or premature write-downs, devaluations, or conversions to liabilities (Caldecott et al. [2014](#)). A tightening carbon budget and the subsequent devaluation of existing reserves results in what is known as “stranded assets” (Ansar et al. [2013](#)). Markets may be mispricing the risks of stranded assets held by listed companies. In a 2 °C scenario, grounded reserves could put over \$28 trillion at risk; risks most concentrated on high-cost and high-carbon sources of production (Lewis et al. [2014](#)). The risk of asset stranding can dampen future growth projections and depress the industry's value.

The stranding of carbon assets in the case of fossil fuels can be caused by several environment-related risk factors that are poorly understood and regularly mispriced (Caldecott et al. [2014](#)). A

scenario analysis of stranded assets by Caldecott et al. ([2014](#)) provides an encompassing framework of the most pressing environment related risks that could lead to the stranding of assets. The report infers that government regulations, environmental challenges, changing resource landscapes, technology innovations, evolving social norms, and litigation may be some common risks to asset stranding. Unburnable carbon poses knock-on effects that not only affect investors but lenders, pension funds, and indeed individual savers as well. Bank lending exposures may face significant haircuts to the value of their loan books, pension funds may risk funding shortfalls to their pension entitlements as fossil fuel investments falter, and savers may face uncertainties akin to financial bubbles as their investments track carbon intensive markets (Campanale and Leggett [2011](#)). There is also empirical evidence that fossil fuel free portfolios outperform traditional indexes. Regarding environmental risks from the fossil fuel industry, several studies compare the financial performance of prevalent market indices to fossil free counterparts. The MSCI ACWI ex fossil fuels index, for instance, tends to be comparable to or out-perform the MSCI ACWI over a 5-year period (MSCI [2016](#)). Another complementary report by the FTSE finds that its counterpart ex fossil fuel index performs competitively with lower volatility than the traditional FTSE developed index (FTSE [2014](#)). Yet another study by Sustainable Insight Capital Management finds that of three fossil fuel free portfolios created, all outperformed the S&P 500 across 1, 3, and 5-year periods between 2008 and 2013 (Willis and Spence [2015](#)).

Several newer studies even suggest positive financial outcomes of fossil fuel divestment. Henriques and Sadorsky ([2017](#)), for instance, found that divesting from fossil fuel and investing in clean energy increased financial returns because of the higher performance of clean energy stocks. While it is notable that economic factors like oil prices have played a predominant role in recent underperformance of the industry, another study based on long-term data between 1927 and 2016 argues that divesting from fossil fuels does not harm financial returns because the fossil fuel sector does not contribute to diversification (Trinks et al. [2018](#)). Most recently, a study on shares found both higher risk-adjusted financial returns as well as lower carbon footprints for divestment portfolios compared to the conventional TSX 260 (Hunt and Weber [2018](#)). These results are further attested across analyses conducted by organizations like the Carbon Disclosure Project (Fanelli [2012](#)) and Impax Asset Management (Simm [2013](#)), which suggest that by reducing carbon exposure in their portfolio, investors can achieve competitive if not greater returns.

In contrast, there remains a notable body of literature that suggests that divestment will pose significant transitional or risk-induced costs (Grady-Benson and Sarathy [2015](#)). Some studies warn that any form of exclusionary screening may pose costs for investors (Geczy et al. [2005](#); Renneboog et al. [2008](#)). Other studies postulate that investors may face a cost of pursuing ethical or exclusionary screening, that may lead to increased risks or decreased returns (Richardson [1987](#)). One study by Bloomberg New Energy Finance proposes that fossil fuel investments remain favorable because they offer the scale, liquidity, growth, and yield with which alternative investments cannot compete (Bullard [2014](#)). The report further suggests the market would require a massive scale-up of new investment vehicles to offer comparable opportunities for reinvestment.

Other studies actively dissuade divestment, under the pretense that it could harm the financial performance of investors and endowments. The first study suggests that U.S. shares of oil and natural gas companies outpaced both the overall performance of university and college endowments and every other asset class examined (Shapiro and Pham [2012](#)). Another study suggests that the “costs to investors of fossil fuel divestiture are highly likely and substantial, while the potential benefits – to the extent there are any – are ill-defined and uncertain at best” (Fischel [2015](#), p. 3). The last study calculates that divestment could cost millions in lost returns annually, if endowments exchange portfolio diversification for moral imperatives (Cornell [2015](#)) because divestment creates higher administrative costs (Ennis and Parkhill [1986](#); Knoll [2002](#)).

Conclusions

This chapter presents an overview about the ethical and financial arguments in favor and against divestment. Both, ethical and financial arguments can be used to justify divestment and to argue against it.

Current empirical studies suggest positive financial impacts of divestment for the investors. These results, however, might be influenced by other external impacts such as a falling price for coal and other fossil fuels or other external impacts. On the other side, theoretical arguments from conventional finance against divestment might be influenced using historical data that cannot be extrapolated into the future because of disruptive economic changes caused by climate change. Hence, more research is needed to study the financial implications of fossil fuel divestment. Regarding ethical arguments, divestment is one of many responsible investment strategies. Currently, there are discussions about the effect of divestment versus engagement. While the discussion is interesting from an academic perspective, it should rather focus on how the different strategies can be combined and how they can create impacts if they are used in tandem. The effect of engagement is probably small if investees do not feel the pressure of divestment as a final consequence. On the other side, divestment as the exclusive strategy to put pressure on the fossil fuel industry may also not be successful because many investors are not able to apply the strategy.

Cross-References

- [Apartheid and Ethics](#)
- [Emerging Trends in Socially Responsible Investment](#)
- [Investor Response to the Climate Change Challenge](#)
- [Socially Responsible Investment and Corporate Engagement](#)
- [Socially Responsible Investments \(SRIs\) – Normative and Ethics-Based Rationale](#)

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