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Engage or Divest? The Question at the Heart of Climate Impact

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The Need for Climate Action

Climate change is a systemic threat to the global economy and represents both a strategic and operational challenge for all companies. As awareness of the systemic impact of climate change has grown, there has been progress on many fronts.

Countries have committed to reducing carbon emissions in line with the 2015 Paris Agreement of limiting global warming to well under 2°C by the end of the 21st century. In addition, many countries and local jurisdictions, led by the European Union, are implementing carbon pricing and emissions trading initiatives in order to reach net zero carbon emissions by 2050.

We have seen a sustained shift in energy use, away from fossil fuels and towards renewable energy, driven by acknowledgement of the impact of fossil fuel pollution, the need to reduce carbon emissions, and the growing affordability and practicality of renewables.

Investors are increasingly incorporating climate and other ESG considerations into capital allocation decisions, in the belief that sustainable investment strategies are more robust.

These trends have led to a topical debate on how investors can create positive impact in the companies they invest. Should investors engage with fossil fuel companies or divest from them? In this note, we explain why there is room for both approaches, but why engagement is ultimately the more effective tool to create lasting impact.

Engagement: A Critical Lever for Long-Term Change

Engagement can be broadly defined as the ongoing dialogue between an asset manager and the leadership of invested companies to ensure the effective management of material financial and non-financial (ESG and climate) risks and opportunities.

Impactful engagement is particularly important for index asset managers, which cannot divest their holdings due to their investment mandates. Therefore, engagement (and proxy voting) become critical tools for oversight of corporate management on climate-related disclosure and practices.

Academic evidence shows that engagement and voting have the power to create positive impact and enhance value. In a review of the literature, Kölbel et al (2019)[1] conclude that “investors who seek impact should pursue shareholder engagement throughout their portfolio”. Dimson, Karakaş and Li (2015)[2] find that successful engagements are followed by positive abnormal returns.

In addition, companies experience improved accounting performance and governance, and increased institutional ownership after successful engagements, particularly on environmental and social issues. Hoepner et al (2020)[3] identify engagement as being particularly effective in lowering downside risk when addressing environmental topics (primarily climate change).

Climate change is a topic well suited for long-term engagement due to the alignment of the investment horizon and the timescale of the manifestation of climate risks. Below, we illustrate State Street's climate stewardship approach and explain how our engagement, proxy voting, company dialogue and shareholder activism, have led to positive climate outcomes for companies and the wider market.

State Street's Climate Engagement Approach

We have been engaging with companies on climate change-related matters since 2014. In that time, we have had over 630 climate-related engagements across a range of industries and markets. Our aim is to understand companies' approaches to mitigating and managing the physical and transitional impacts of climate change.

As long-term holders of capital, we believe engagement and voting is key to improving corporate climate standards and ensuring better disclosure of climate risks. We believe the success of our engagement strategy is built on our ability to prioritise and allocate resources to companies and issues that have the greatest potential impact on shareholder returns.

In our engagements with investee companies we found that progress is being made but not at a pace that is commensurate with the risk. As a result, in 2020, we enhanced our reporting by launching our new *Annual Climate Stewardship Review* and *Climate Stewardship Web Hub*.

We believe that the Covid-19 pandemic accelerates the need for transformative change to address climate change through effective stewardship. Looking ahead, we will continue to focus on companies that are particularly vulnerable to climate transition risks. Furthermore, we will continue our engagement with companies in other sectors which, while not carbon intensive, also face risks including exposure to the physical impact of climate change.

Below are some examples of our recent climate stewardship work.

2°C Scenario Shareholder Proposals

State Street Global Advisors was one of the first large institutional investors to support 2°C scenario shareholder proposals in 2016. Since then, we have been actively voting and engaging to improve climate disclosure with our issuers across all industries, including the oil and gas, mining and utilities sectors, which are typically targeted by 2°C proposals. In 2020, we supported 50% of shareholder proposals requesting that companies report on the financial and physical risks of climate change to their business, and their plans to reduce greenhouse gas (GHG) emissions.

As a result of voting action, engagement and thought leadership from State Street Global Advisors and other long-term investors, climate risk disclosure under the 2°C scenario has become standard market practice and consequently the need for 2°C shareholder resolutions at companies has diminished.

Net Zero Engagement and Proxy Voting Proposals

Recent years have seen investors pressure companies, particularly those in the energy sector, to provide insight into how their assets and strategy would need to evolve to accommodate net zero emissions by 2050. We have long engaged oil and gas majors to set ambitious GHG reduction goals. Over time, many companies particularly in Europe, have committed to major GHG reductions, including setting net zero emission goals by 2050. These include BP, Eni, Equinor, Repsol, Royal Dutch Shell and Total. We support and applaud such commitments.

However, these pledges should not be set and forgotten. We believe companies should set interim reporting goals to monitor progress and reset goals if required. This signals to investors that there are opportunities to assess the current glide path.

Banks and TCFD Alignment

State Street Global Advisors endorsed the Task Force on Climate-related Financial Disclosures (TCFD) framework[4] in 2017. As part of this commitment, we pledged to not only align our own corporate disclosure to the TCFD requirements, but also to advocate TCFD disclosure among investee companies, particularly other financial institutions.

Since then, banks have begun to embrace the TCFD framework. Notably, Deutsche Bank[5] in Germany has greatly enhanced its climate risk disclosure and made commitments to cease lending to carbon-intensive industries. In France, BNP Paribas has made sustainability a strategic priority and has issued hundreds of millions of euros in green bonds.[6] European banks have made progress, while banks in other regions that have not been transparent on their plans to finance a low carbon transition have been targeted by shareholder resolutions asking them to do so.

Historically, the majority of climate-related shareholder resolutions were aimed at energy companies, due to the energy sector's higher absolute GHG emissions. During the 2020 proxy season, we saw the emergence of a new trend of climate-related shareholder resolutions targeting financial institutions. These climate-related shareholder proposals were not concentrated in a single region but were spread out globally and filed at JPMorgan Chase & Co., Mizuho Financial Group and Barclays.

When analysing these proposals, we considered how these companies were managing climate-related risks, and specifically, their decision making regarding financing of fossil fuel activities and commitments to address climate change. Ultimately, we voted against management's recommendation at each of the meetings. These proposals received high levels of shareholder support and the companies are working to be responsive to investor feedback.

Success in Enhancing Climate-related Practices and Disclosures at Individual Companies

On an individual company basis, index investors like State Street can leverage long-term relationships with companies to track progress and hold companies to account for their responsiveness to shareholder votes on proxy items and requests made during engagement.

Glencore is a company that we have had a long-term relationship with and, over time, we have shared our views on climate risk and witnessed the company's strategic approach to climate change shift. Glencore has set a 40% GHG emissions reduction goal by 2035 and a 2050 net zero goal that it aims to achieve by reducing coal production, while expanding its metals portfolio.[7] This is a strategy that considers climate transition opportunities as well as risks, as the materials it is extracting are those needed for battery production and supporting electric vehicle production. During our engagement, Glencore explained that it did not want to immediately sell off its coal assets as the pricing may not have been favourable for shareholder value but understanding the potential for stranded asset risk, the company has made investments in — and diversified further into — non-carbon intensive energy resources. In addition, Glencore has instituted a new remuneration policy to tie executive pay to sustainability targets.

Other examples of our successful engagement with companies on climate change include:

- **Exxon Mobil Corporation** State Street Global Advisors has been highly engaged with Exxon for some time and has made meaningful progress with the company on numerous ESG issues:

  — **Environmental** Exxon responded to our requests by introducing reduction goals related to methane emissions for the first time in its history. This first set of goals aimed to reduce methane emissions by 15% and flaring by 25% by 2020.

  — **Social** Prior to 2020, Exxon did not provide investors with granular information on its participation in the political process, particularly with regards to its trade group affiliation. Following engagement with State Street Global Advisors, the company now provides information on trade groups where it provides $100,000 or more in support.[8]

  — **Governance** Until 2018, Exxon had maintained a policy that allowed for investors to engage with directors only through written communication. We found this policy to be overly restrictive, particularly as we were seeking to engage with the board to discuss their oversight of climate-related issues. Consequently, we withheld support from the chair of the Nominating and Governance Committee for maintaining such a policy. In 2018, the company changed its policy and we subsequently held our first meeting with a board member.

Even with this track record of progress and success, during Exxon's contested 2021 annual meeting we voted in favour of two dissident board candidates. As a long-term investor in Exxon we concurred with the dissident that performance has been challenged at the company. We also recognised that with Exxon's peers advancing efforts to evolve their businesses, Exxon's existing strategy leaves the company more exposed to climate-related transition risk over the long-term. We believe that Exxon has an opportunity to better leverage its expertise and resources to lead in the transition as the market continues to accelerate progress toward a net zero future. State Street's support, along with that of other long-term investors, led to three external directors joining Exxon's board following the resignation of three legacy directors.

- **Chevron Corporation** published its "Climate Change Resilience: A Framework for Decision Making" report, which is aligned to the TCFD framework, as well as to our guidance on climate disclosure. These actions resulted from prior feedback on the need for Chevron Corporation to increase its disclosure on the impact of climate change on its long-term strategy.

- **Commonwealth Bank of Australia** In 2021, we continued our constructive dialogue with Commonwealth Bank of Australia around corporate culture, remuneration and sustainability reporting. Following engagement with investors, the company published an annual report that aligns with the Sustainability Accounting Standards Board (SASB) materiality map. This market-leading report also continued to build from the TCFD recommendations through a robust climate scenario analysis.

- **Dominion Energy, Inc.** During our engagement, we suggested that the company enhance its climate-related disclosure by adding GHG emissions reductions goals. Following our subsequent engagement, the company announced that it would add GHG goals to its existing sustainability reporting.

- **Unilever** In December 2020, Unilever became the second company in the world to put its climate transition plan to a shareholder vote. In our engagement with Unilever, the CEO made it clear that the company is determined to be a worldwide leader in sustainability.

Collaborative Engagement

The size of State Street Global Advisors' global assets and reputation in the market provides our Asset Stewardship team with privileged access to the management and boards of investee companies. Therefore, the majority of corporate engagements are carried out on a one-to-one basis as we feel this is critical in building trust and establishing constructive long-term relationships with companies. However, certain issues, such as unified disclosure or a universal carbon price, must be addressed at the market level. As one of the largest asset managers in the world, we actively participate in collaborative initiatives that help shape the policy or regulatory landscape.

We are proud to have become a signatory to Climate Action 100+, a global initiative led by investors to foster the clean energy transition by engaging the companies and sectors with the highest GHG emissions. We are focusing on multiple companies as part of this effort including Hitachi in Japan and Rolls Royce in the UK. We have already seen progress with these companies implementing enhanced climate-related disclosures.

Recently, State Street Global Advisors also became a signatory to the Net Zero Asset Managers Initiative (NZAMI). As part of this international initiative, we will work in partnership with asset owner clients on decarbonisation goals, consistent with an ambition to reach net zero emissions by 2050 or sooner across all assets under management (AUM). Further, we will set interim targets for a proportion of AUM to be managed and review these interim targets at least every five years. NZAMI is consistent with our long-term efforts to integrate climate considerations into our investment processes and to provide research and support to portfolio companies as they manage decarbonisation goals.

In June 2021, State Street Global Advisors submitted a comment letter to the U.S. Securities and Exchange Commission with respect to the Commission's role in addressing climate change-related risks. We emphasized that we strongly support mandated reporting of certain climate-related disclosures, leveraging already well-established voluntary reporting frameworks. We also urged the Commission to continue its participation in global efforts to harmonise corporate sustainability reporting.

Divestment: Often A Necessary Tool

In general, divestment is the selling of all or part of a holding by an investor when the investment thesis changes and can be due to multiple reasons. With respect to ESG, the traditional reason for divestment were ethics — investors wanted to exclude certain investments that did not align with their values-based ideals. Over the last 30 years, divestment has evolved from an ethical decision, to one more driven by investment considerations.

Today, investors sell or exclude specific companies, sectors or countries from their portfolios based on a variety of ESG factors, for example:

- **Norms-based** Exclude investments that violate norms like the United Nations Global Compact.
- **Business Involvement-based** Exclude companies that are involved in production of controversial weapons, landmines and other areas deemed unacceptable.
- **Climate-based** Exclusion of companies in the context of climate change considerations.

Historically, such investments have simply been sold or excluded from an investor's portfolio. However, the challenge for index investors, is that this approach often results in undesirably high tracking error from the benchmark.

In general, companies are divested implicitly through optimisation strategies with multiple objectives leading to the reduction of a particular holdings below certain thresholds in order to achieve ESG and return objectives. This results in de facto divestment.

There are several reasons why investors may want to divest or screen out particular investments in relation to climate change:

- Some investments may be deemed wholly unacceptable on climate grounds and are therefore systematically excluded (for example, thermal coal and oil sands).
- Divestment, or a significant underweight in certain companies and sectors, may allow an immediate portfolio carbon footprint reduction to be achieved.
- Investors may not believe in the ability or willingness of a company to adapt quickly enough to climate change. Rather, they may want to focus their capital on companies with strong climate and ESG performance. The challenge is that this can be a backward-looking approach.
- Certain regulatory frameworks, like the European Union's (EU's) Climate Transition Benchmark and Paris-Aligned Benchmark regulation require divestment from certain areas to qualify. In addition, frameworks like the EU Taxonomy for sustainable activities define which business activities are deemed "sustainable". In order to adhere to certain activity thresholds, investment in certain activities becomes ineligible under this regime. There are also regional initiatives such as France's Autorité des Marchés Financiers (AMF) that make it mandatory to exclude or divest from a certain percentage of the investment universe in order to qualify as a "sustainable investment". While these are European initiatives, other regions are announcing intentions to develop their own approaches.
- The growth of investor adoption of voluntary initiatives like the TCFD and Climate Action 100+ may also encourage investors to divest from companies that do not meet certain standards of climate disclosure and climate-related risk management (acknowledging that Climate Action 100+ is an engagement initiative).

Proponents of divestment argue it is a means to influence a company's climate-related activities by reducing its share price and increasing its cost of capital. Dordi and Weber (2019)[9] find that divestment announcements decrease the share price of fossil fuel companies and that 'divestors' can influence the share price of their target companies. The implication is that certain poor ESG practices or lagging performance will lead to financial losses that have not yet been properly priced in by the markets. Assuming that (all else equal) divestment will lead to a lower share price, this reduces the value of management's share-based remuneration, thereby giving senior executives an incentive to integrate ESG considerations.

The effectiveness of divestment campaigns, such as the fossil-free divestment movement, could be reinforced by a strong non-linear relationship between the proportion of investors that divest and the impact on company share prices and cost of capital. Some researchers point to the existence of so-called tipping points that suddenly break any linear relationship (Ewers et al., 2019).[10]

State Street's Approach to Climate Change-Related Divestment

Climate change is increasingly a priority for many of our clients, particularly in Europe, and we have seen growing client interest in divesting or minimizing exposure to fossil fuels in their portfolios.

To help our clients navigate this landscape, State Street Global Advisors has created a framework that comprehensively detects and classifies fossil fuels. Our approach to fossil fuel exclusions follows State Street's standard approach shown in Figure 1.

Figure 1
State Street's ESG Exclusion Approach

Source: State Street Global Advisors.

Fossil Fuel POV Screen Approach

The framework focuses on the following activities, which are generally associated with fossil fuels:

- Oil extraction and power generation
- Natural gas extraction and power generation
- Thermal coal extraction and power generation
- Shale extraction
- Oil sands extraction
- Arctic oil and gas exploration

State Street's standard Point of View (POV) screens employ, where possible, a 10% revenue threshold, and focus specifically on entities with direct involvement (vs. ownership criteria) in a particular area such as fossil fuels. This approach allows us to balance screening preferences with other investment considerations. Our POV screens leverage best-in-class ESG data provided by Sustainalytics and are updated on a quarterly basis.

We are also able to provide some level of customisation in our screening process. For example, investors can adjust the revenue thresholds of each specific screen and expand the "blacklist" to include indirect/ownership dimensions or add/remove a particular metric or indicator.

Another means of customisation is using the volume of CO_2 emissions (in millions of tons) owned by a company as a means of identifying fossil fuels. While that method has the upside of allowing for a more granular understanding of the volume of emissions, it introduces some subjectivity in the screening process. In other words, we would need to establish specific emissions thresholds (in million tons of CO_2) to flag companies in violation of the screen. Therefore, we prefer our revenues-based approach.

Divestment Focused on Achieving Specific Climate Objectives

In contrast to a straightforward screening approach to fossil fuel producers, it is possible to take a more nuanced approach to managing climate risks. Investors can focus on mitigating the drivers of climate change, while also increasing exposure to companies that are actively adapting to the actual or expected future effects of global warming and other environmental changes, helping investors to build more climate-resilient portfolios in the process.

Three metrics to consider in relation to the climate impact are:

- **Carbon Intensity** Greenhouse gas emissions over which the company has direct control and derives from direct suppliers (indirect control) divided by company revenue.

- **Fossil Fuel Reserves** Total greenhouse gas emissions from proven and probable fossil fuel reserves.

- **Brown Revenues** The proportion of revenues a company derives from activities related to the extraction of fossil fuels, or power generation using fossil fuel-based energy sources.

More sophisticated climate strategies address all three of these metrics. Analysis shows that carbon intensity, fossil fuel reserves and brown revenues are concentrated in a few companies and sectors. The three worst polluting sectors in the MSCI World index are energy, materials and utilities, contributing about 62% of the benchmark weighted average carbon intensity (WACI).[11] Similarly, fossil fuels are almost all concentrated in the energy and materials sectors. Divesting from these companies would clearly have an immediate positive impact on an investor's portfolio climate metrics.

As a result, State Street's Sustainable Climate Equity Framework targets Paris-Aligned reduction in all three metrics, while also maximizing two metrics linked to climate investment opportunities — companies' green revenues and adaptation score.

- **Green Revenues** The revenue exposure of public companies in the transition to the green economy.

- **Adaptation Score** Measure of a company's position and actions on climate change. It evaluates the following for each company: its position on climate change, greenhouse gas reduction plans and assessment of its industry risks regarding climate change.

Figure 2
Paris-Aligned Objectives of the State Street Sustainable Climate Equity Framework

Objectives	Metrics
Minimise Carbon Emission Intensity	CO_2 Emissions per $M Revenues
Minimise Fossil Fuel Reserves	Total Reserves of CO_2 Emissions (Metric Tonnes)
Minimise Brown Revenues	% Revenues from Extractive Activities
Maximise Green Revenues	% Revenues from Low Carbon Technology
Build Resilient Portfolio	Score on Climate Change Preparedness

Source: State Street Global Advisors.

To achieve these multiple objectives, an optimisation is required for portfolio construction. Optimisation allows for a more efficient trade-off between climate objectives, diversification, trading costs and portfolio risk. Optimisation strategies often reduce holdings below buying thresholds to achieve ESG objectives immediately leading to de facto divestment, as mentioned previously.

If significant or complete divestment is required, then a screening approach is suitable. However, restricting the investable universe outright can lead to wide tracking error deviations against policy benchmarks, which can pose problems for many institutional investors.

Explicit divestment in the form of screening and implicit divestment through integration of climate objectives are not mutually exclusive approaches. They can be used together to create a portfolio with the desired climate characteristics. Indeed, this is the approach we take in the State Street Sustainable Climate Equity and Bond Funds — initial screens are combined with implementation of multiple portfolio climate objectives.

To Engage or To Divest?

While divestment is necessary at times, we believe it is not sufficient to create genuine climate impact by itself. Why?

With divestment, investors lose their impact to bring about positive and lasting change. Instead, companies can be bought by investors who lack a clear climate strategy or they can go into the hands of private owners with no market scrutiny. We find it concerning that fear of large-scale divestment from institutional investors and other public market participants could lead companies to spin-off their high-emitting divisions or go private, which can, at times, be seen as an attempt to shelter them from being positively influenced (in the context of climate change).

Divestment is also a point-in-time approach that usually does not account for the direction of travel. As we discussed, Glencore is a large mining company with historical ESG and climate challenges, yet it has ambitious plans to cut carbon emissions by 40% by 2035 and ultimately, achieve net zero total emissions by 2050.

Academic studies find that engagement is a more effective strategy than divestment. Broccardo, Hart and Zingales (2020)[12] find that "In a competitive world, exit is less effective than voice in pushing firms to act in a socially responsible manner".[13] In a survey of institutional investors, many of the larger, long-term, and ESG-oriented investors considered risk management and engagement, rather than divestment, to be the better approach for addressing climate risks (Krueger, Sautner and Starks 2019).[14]

Ultimately, an approach centered around impactful engagement most closely aligns to the Universal Owner Principle that large asset owners should aim not just to protect individual portfolios from systemic environmental and social risks, but also to mitigate systemic risks themselves, thus internalising externalities and protecting the long-term health of the system (Quigley 2020).[15] This is the philosophy that underpins State Street's climate investing approach and climate stewardship agenda, through regular individual and collaborative corporate engagements, proxy voting, thought leadership and lobbying for stronger climate standards in the market.

Conclusion

The debate around engagement and divestment is clearly nuanced and it should be clear that it is not an either/or matter. There is room for both approaches, depending on an investor's objectives. The rise of ESG-related investor coalitions that conduct collective engagement campaigns can be seen as an illustration of the possibility of combining engagement and divestment for maximum impact.

When evaluating the two approaches to address climate change, it is important to differentiate between immediate improvement in portfolio climate metrics and creating long-term environmental and societal investor impact. Divestment can be an immediate solution to reduce specific ESG and climate risks. However, it fails to address the systemic, long-term impacts of climate change. Divestment also abrogates responsibility for tackling climate change to another party. Therefore, an investment approach purely founded on divestment is not desirable in our view.

We must acknowledge the reality that our economies have been underpinned by the activities of fossil fuel companies for decades. To sell companies within the fossil fuel value chain with immediate effect would forego the opportunity to engage with these companies, to help them adapt and ultimately be a part of the climate solution. That is not to mention the potential collateral damage of worsening emissions.

As climate standards improve and new norms develop among companies and their investors, we expect the debate will shift beyond divestment and engagement, towards how investors can maximise engagement impact with companies — particularly the highest emitters — to ensure companies adapt and thrive amid climate change. However, we expect divestment to remain an option for certain activities (like thermal coal) whose ESG thesis will remain unconvincing.

Endnotes

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- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 30 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $3.90 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of June 30, 2021 and includes approximately $63.59 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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