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Oil & Water: Fossil Fuel Divestment in Sustainable Bond Portfolios

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To many sustainable investors, owning fossil fuels is a black-and-white issue. Oil, coal and other hydrocarbons are major sources of pollution and contributors to climate change; therefore, many investors simply do not want to own companies that extract, produce or distribute fossil fuels.

The fossil fuel divestment "movement" has gained some momentum in recent years, and it is a topic we discuss with a growing number of clients. We have learned that our clients have differing motives—some simply want the comfort of knowing their bond portfolio is "clean," while others want to invest in bonds that are funding the transition to wind, solar and other renewable energy sources. When we look at bonds, we try to keep these multiple perspectives in mind. We also feel that some nuance is needed when thinking about fossil fuels in the bond market; unlike with stocks, we need to think about both the issuer of the bond, and the project that the bond is funding. For example, a bond from a big utility company may make sense for our sustainable portfolio if the issuer is a good actor in our view and the bond's proceeds are earmarked for a renewable energy source. Overall, we try to focus on the big picture: We want to own bonds that are, on balance, helping with the transition to a "post-carbon" economy.

Divestment, Assessment and Impact: Three Complementary ESG Tools

We manage fossil fuel exposure in our sustainable bond strategies using a mix of three main approaches.

1. *We seek to **avoid bonds from certain energy issuers with poor ESG profiles.***

This is the equivalent of a "divestment" approach (although we cannot technically "divest" from bonds we never owned!). Our ESG research is an integrated and essential step in our investment process; every bond and every issuer we consider is evaluated across a spectrum of environmental, social and governance factors, including their extent of involvement in fossil fuel exploration, production and distribution, and their ability to manage the various risks inherent in fossil fuel-related activities. When issuers fail to clear our hurdles in these areas, we do not invest in their bonds.

2. *We may invest in bonds from a select set of issuers involved in fossil fuels, if we believe that those issuers are earnestly and effectively helping to **accelerate the switch from hydrocarbons to renewables.***

To identify such issuers, our ESG analysts look at their energy mix over time (for example, are they decreasing energy production from fossil fuels in favor of renewables?) and the targets that they have embedded in their long-term planning. We also look for confirmation in issuers' capital expenditure plans—essentially, we are looking for hard evidence that they intend to follow through on stated goals.

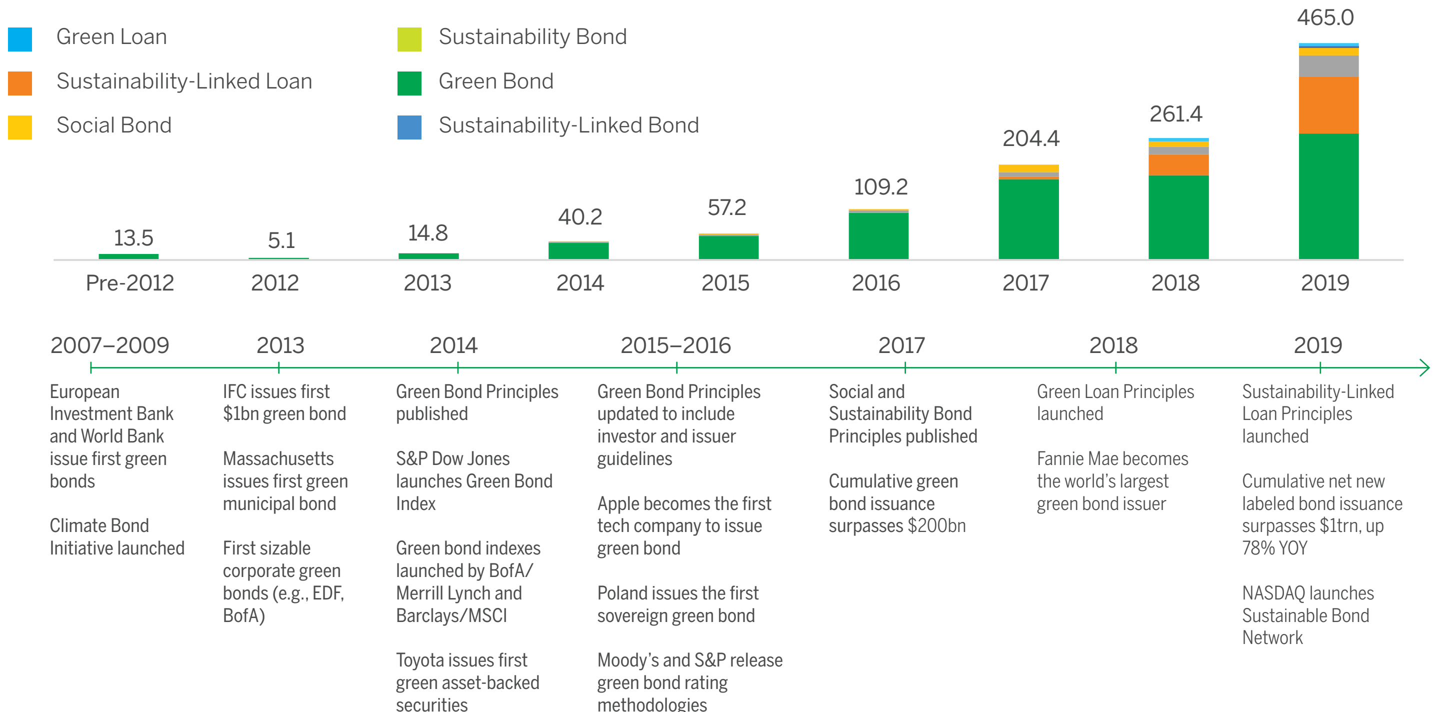
In other words, for us to participate in a general purpose bond from such an issuer, we need to see a company-wide commitment to clean energy and a place for that company in a post-carbon world. We think our investment in bonds from NextEra is a good example of this dynamic. While this electric utility company still has coal and natural gas generation capacity, it is the world's largest generator of wind and solar energy, generating 46% more power from these sources than the next largest global producer. Alternative energy sources are central to the company's growth plans, and these plans are being consistently reinforced by its capital spending. This is a company that is positioned to thrive in a world of growing alternative energy usage and why we believe it makes sense to own its securities as a sustainable investor.

3. *We proactively seek out labeled green bonds or similarly structured bonds that are* ***directly funding renewable energy or energy efficiency projects.***

Bonds often represent an investment in a specific project or a capital investment. By investing in bonds that are funding renewable energy production, or energy efficiency initiatives, we can directly fund the transition away from fossil fuels toward cleaner energy.

This concept has caught on with a growing number of investors, but a key problem is verification and monitoring: How can investors be sure that their money is going where the issuer says it is? The Green Bond Principles and similar labeling/certification systems seek to address this problem. In issuing a labeled green bond, an issuer pledges to spend bond proceeds on specified projects that meet the Green Bond Principles, and to report to investors on the impact of those projects. This concept has proven quite popular, and the labeled bond and loan universe has grown rapidly from nothing ten years ago to $465 billion as of the end of 2019, according to Bloomberg.

A MATURING MARKET: THE EVOLUTION OF IMPACT BOND LABELING



Source: Bloomberg New Energy Finance.

These bonds can still raise questions for divestment-focused investors, if the issuer of a labeled bond is involved in fossil fuels elsewhere in its business. For example, MidAmerican Energy issued its first Green Bond in 2017 to finance two massive wind facilities in Iowa with a total of 2.5GW of generation capacity. MidAmerican owns more wind-powered generation assets than any other U.S. regulated utility, but it still operates coal and natural gas facilities.

Should an investor looking for a fossil fuel-free portfolio consider this bond? We cannot make that decision for every investor, but we see it as a worthy investment for our sustainable portfolios. It is financing a major clean energy generation project, and to move the needle on the overall mix of energy production in the U.S. and around the world, big investments are needed--the kinds of investments that only large utilities with scale economies can make. Further, the issuer is demonstrating through action its commitment to a low-carbon transition: In 2004, the company produced 70% of its power from coal and nothing from wind; by 2018, its energy mix had completely transformed and it was producing nearly 60% of its power from wind and less than a quarter of its power from coal.

If the goal is moving away from fossil fuels and toward cleaner energy sources, we believe that it is essential to steer capital to the major energy producers who are truly driving that transition in the market today. While we do not want to generalize, we have found repeatedly that the issuers who are focused on making this shift tend to be among the better-managed operations in their peer groups, and we think that by aligning ourselves with these issuers our portfolios will be better positioned over the long-term, reducing risk and potentially leading to outperformance.

Conclusion

Ultimately, decisions about divestment from fossil fuel or management of fossil fuel exposure are up to each investor, and we work with a number of clients to tailor their portfolios to meet their specific needs and restrictions. As we have noted, some investors seek to push this transition forward by divesting from fossil fuel companies, while others want to focus more proactively on renewable energy investments.

We are among those who are trying to do both. In the future, we may reach the day when our society is entirely powered by the sun and the wind, but it is not going to happen overnight. Specifically, we think that bonds offer us a unique way to participate in the ongoing transition to renewable energy; not only can we steer capital toward (or away from) issuers based on our assessment of their merits, but we can also steer capital toward specific projects that are changing the global energy mix and putting us one step closer to a clean-energy future.

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