The Case for Forceful Stewardship

Synopsis

We are at a point of high uncertainty about the future course of global warming. If a strong political agreement is forthcoming later this year, warming may be restricted to 2°C above pre-industrial. If not it may reach 4° or more by the end of the century. The probability of 4° warming this century cannot be ignored. Research prepared for the World Bank places it in the range of 20% to 40% depending on the success of the effort to reduce emissions.

Much of the uncertainty will be resolved in due course as we see whether or not emissions start falling and a better understanding is gained of how strongly the climate is reacting to increased atmospheric greenhouse gas concentrations. One might guess that 2030 is a plausible earliest date for knowing with something approaching certainty that we are, or are not, headed towards 4° this century.

There is also great uncertainty about the damage that 4° warming will cause to the global economy. The standard model of climate damage that economists use projects damage at around 4% of world GDP by the time 4° warming is reached. Although damage at this level would be locally disruptive it is effectively negligible in the global context of continuing 2% to 3% annual growth. This level of damages is, however, likely to be a best case.

Recent economic work, that reflects more closely the possibly high impacts that concern climate scientists, experiments with damage rising to a much more daunting 50% of world GDP by 4°. Damage at this level would have widespread effects and would tip long-term economic growth into lasting decline. The possibility of this level of damages cannot be overlooked and is arguably a plausible worst case.

A connection between equity value and future economic growth may be made through the assumptions that over the long-term the dividend income from a diversified equity portfolio grows at the same rate as world GDP and that the value of the portfolio is the present value of expected future dividends. By assuming that 4° warming is reached in a range of years during the second half of this century, the present value of the change in dividend income due to climate damage can be calculated.

In this way it is readily estimated that by 2030, if we then know that we are headed towards 4°, the value of a diversified portfolio will, in the worst case, be 5% to 20% lower than in an economy without warming. This reduction is the equity 'value at risk' due to future climate damage. In the best case, the value at risk will be negligible.

Additional discounting between 2015 and 2030 combines with uncertainty about the future course of warming to imply that the value at risk in 2015 is negligible for both the best case and the worst case damages. This result, the low estimate of damages by the standard model

and the current uncertainty about the future course of both warming and damages explain why investors currently pay little attention to climate risks. As we have just seen, however, by 2030 the position may be quite different.

Because the value at risk could be large and increasing by 2030 if warming is heading towards 4°, the only practicable way to deal with the financial risk of climate damage is to reduce emissions by a rapid energy transition to decarbonise energy supply. The consequences of this transition for the value of a diversified portfolio as a whole would be negligible if it is begun soon, although it would shift value within the portfolio away from fossil fuel investments towards clean energy and engineering investments. If delayed for too long, the transition might negatively impact portfolio value.

Since the potentially severe economic damage that may be caused by promoting the use of fossil fuels puts at risk a significant portion of the value of a diversified portfolio, there is a conflict of interest between investors in, and directors of, fossil fuel companies on the one hand and diversified investors on the other. This conflict could be significantly reduced if investors used their voting rights to require publicly listed fossil fuel (and other) companies to move towards adopting business plans that not only enhance shareholder value but are also consistent with only 2° warming. To achieve this, investors would need collectively to vote in favour of changes to corporate behaviour[1]. We call this 'Forceful Stewardship' to contrast it with the rather less urgent form of engagement that has been tried over several decades.

Voting in favour of business plans that enhance shareholder value but move companies towards consistency with 2° warming is something diversified investors can do without expense and risk. Unless there are indications of corporate distress, however, investors are temperamentally opposed to voting against management.

Nevertheless, investment fiduciaries, such as pension trustees, have a duty to control for risk and therefore to do what they reasonably can to reduce climate risk. They might also have a duty not to abstain or vote uncritically with management against resolutions aimed at reducing climate risk, unless they can evidence a better plan to manage this risk. Beneficiaries, such as pension scheme members, are able to test legally these duties. In doing so they would extend Forceful Stewardship to investment fiduciaries.

The papers of which this is a synopsis may be found at
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2551478 (Part 1) and
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2551485 (Part 2)

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[1] Investors currently have just such an opportunity in the context of resolutions put by a group of shareholders to the Shell and BP boards.