Institute for Sustainable Finance

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*This series explores the foundations of sustainable finance, one of the most important emerging fields of our time. Sustainable finance aligns financial systems and services to promote long-term environmental sustainability and economic prosperity.*

SUSTAINABLE FINANCE PRIMER SERIES:

# Divestment

## WHAT IS DIVESTING?

Divestment generally refers to the act of selling securities held in a portfolio. For instance, when an investor no longer wishes to hold shares of a firm in their retirement portfolio, they tend to sell that stock and purchase shares in another firm. Sometimes investors, particularly large investors, decide to no longer hold shares in firms from specific industries for ethical reasons and to effect social change. For instance, in the 1990s some large investors divested their shares in tobacco firms due to the overwhelming scientific evidence linking smoking and premature death. Today, there is overwhelming scientific evidence that human activities are causing environmental degradation that may lead the planet to become less amenable to human life. As a result, large investors are divesting shares in firms that negatively impact the ecosystem, and even more investors are discussing plans to divest in the near future.

## HOW CAN DIVESTMENT LEAD TO STRANDED ASSETS?

When investors divest from specific industries, they can cause firms to markdown assets or even recognize assets as liabilities. For instance, productive assets and infrastructure that was developed and built during the 1960s may no longer meet current environmental standards, leading investors to sell shares in firms with old or dirty factories. The same logic can be applied to oil-fields or mineral deposits that are no longer economically viable to extract and become "stranded." Divestment can lower asset prices (stocks or bonds), making it harder for firms to raise capital to fund operations and new investments. In this way, divestment can lead to stranded assets as the capital for these types of assets dries up or becomes too expensive.

## DOES DIVESTMENT LEAD TO LOWER INVESTMENT RETURNS?

When large groups of investors sell their holdings in specific firms and industries, they may do so despite the fact that these firms and industries are expected to perform well in the future. In this way investors that divest may forgo market performance in order to meet their divestment goals. For instance, the California pension system CalPERS reported close to $4 billion USD in forgone gains related to tobacco divestment.

## DOES DIVESTING WORK?

The idea behind divestment is that by selling shares in subjectively "bad" companies, investors can exert negative pressure on the share prices of these firms. This negative pressure can lead firm-managers, whose incomes are tied to the share price, and the remaining shareholders to look for ways to reduce the "bad" activities and increase the good activities to bring investors back. This type of pressure may not work if there are other investors who aren't concerned with whether firms are "good" or "bad." Some investors will happily purchase shares sold at a discount by the divestors, and push shares prices back up to the old price, turning a profit along the way.

Unless everyone divests or the world runs out of investors that do not care about social change, divestment may not lead to the desired social outcomes. The topic becomes tricky when pension funds or retirement investments are used to affect social change and lead to questions around the ultimate mandate of the fund managers. Do they have a mandate to generate the highest possible returns to pensioners or a return without potential negative effects on the planet?

## DIVESMENT AND THE ENVIRONMENT

There is already a long history of divestment relating to environmental, social, and governance issues. More recently there has been considerable discussion about more divestment relating to climate change. Firms that pollute more tend to lose investors, and firms that pollute less tend to gain investors. A number of movements, include Fossil Free and 350.org are focused on encouraging large asset owners like pension funds to divest shares in fossil fuel intensive firms. To date, the Fossil Free initiative has surpassed the $11 trillion USD in divestment commitments. However, these commitments are not universally accepted as being useful. For instance, Bill Gates, the billionaire philanthropist suggests that investing in technology to reduce emissions is more impactful than divesting.

Many large investors, such as Japan's $1.3 trillion national pension fund pursuing a strategy of engagement instead of, or in combination with, divestment. They do so based on the premise that it is better to stay invested and engage firms to change their business practices. According to RBC's 2019 Responsible Investment Survey, 39% of investors believe engagement is more effective compared to 10% of investors who believe divestment is more effective, with 16% believing they are equally effective. Similar to Japan's national pension plan, RBC's approach to responsible investing is focused on engagement.

## HOW WILL DIVESTMENT IMPACT CANADA?

Canadian firms and investors will undoubtedly be affected by divestment and pressures to divest. The Canadian economy is carbon intensive, which means that Canadian firms are highly likely to be on the list of firms to be divested by large asset owners. This could lead to depressed asset prices, difficulties in acquiring funding, and may cause investors to skip Canadian markets to avoid indirect exposure to industries with high carbon emissions. Canadians, investors and asset managers will also likely be impacted as broad swathes of the Canadian market become "uninvestable." While domestic investors are more inclined to maintain these investments, global pressures will make this more difficult, by impacting market prices. Addressing these difficulties requires following a detailed roadmap, and a capital plan that underlines the investments to realize Canada's low carbon transition which will enhance the "investability" of such firms. Supporting companies on the path to competitive advantage in the transitioning economy will ensure that communities relying on certain industries are not left behind, and can adjust to the realities of such a transition.

*Explore other primers in the sustainable finance series here.*

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